COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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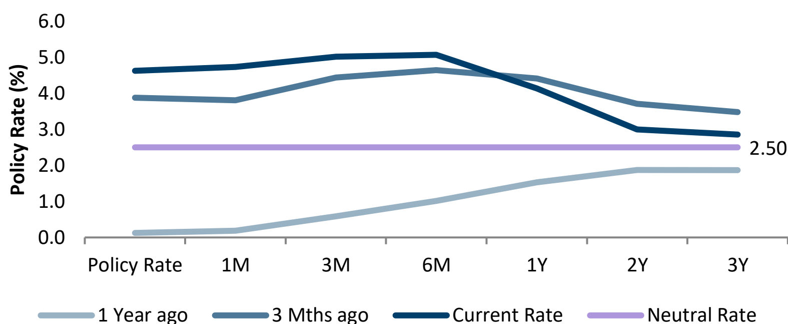
The beginning of the end

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.62%	12 bps	2.4%	2.4%
German Bund 10 year	2.29%	5 bps	2.2%	2.2%
UK Gilt 10 year	3.24%	-9 bps	4.6%	4.6%
Japan 10 year	0.51%	1 bps	0.4%	0.4%
Global Investment Grade	128 bps	-5 bps	3.7%	3.7%
Euro Investment Grade	142 bps	-7 bps	3.0%	3.0%
US Investment Grade	120 bps	-5 bps	4.0%	4.0%
UK Investment Grade	138 bps	-3 bps	5.3%	5.3%
Asia Investment Grade	196 bps	-12 bps	3.3%	3.3%
Euro High Yield	444 bps	-16 bps	4.5%	4.5%
US High Yield	395 bps	-28 bps	5.1%	5.1%
Asia High Yield	580 bps	-50 bps	8.1%	8.1%
EM Sovereign	353 bps	-13 bps	4.2%	4.2%
EM Local	6.5%	-6 bps	4.7%	4.7%
EM Corporate	320 bps	-10 bps	3.5%	3.5%
Bloomberg Barclays US Munis	3.1%	-1 bps	3.0%	3.0%
Taxable Munis	4.7%	-2 bps	6.3%	6.3%
Bloomberg Barclays US MBS	38 bps	2 bps	3.4%	3.4%
Bloomberg Commodity Index	232.25	-4.0%	-4.7%	-4.7%
EUR	1.0738	-0.7%	0.8%	0.8%
JPY	132.81	-1.0%	-0.1%	-0.1%
GBP	1.2025	-2.6%	-0.2%	-0.2%

Source: Bloomberg, Merrill Lynch, as at 3 February 2023.

Chart of the week: US Interest rates and expectations



Source: Bloomberg, Columbia Threadneedle Investments, as of 3 February 2023.

Macro / government bonds

The first month of the year is behind us. After the market misery of 2022, it was a pleasant contrast. Market returns were as strong as they were broad based.

China reopened for business, gas prices plunged and inflation continued to decline. Though we started February with a series of well telegraphed rate hikes (US +25bps, Europe & UK +50bps), the buzz in the market is about central banks pausing to reflect on the 'damage done' thus far. Commentators and market pricing are both flagging terminal rates of interest close to present levels (at least in the US) and even the chance of rate cuts later this year. Is this wishful thinking? On the one hand, economic data has been uniformly poor. Business and consumer sentiment has fallen, consumers face demand destruction from higher prices (historic) and policy conditions (present). The problem is that employment conditions remain tight with few signs (yet) of a let up. Unemployment rates are admittedly a lagging indicator but all the same are at cycle lows. Again, central banks need to weigh the lagged effects of prior tightening with the loosening of some monetary conditions, such as tightening credit spreads and falling yields (more below). For now, we favour a modest further fall in bond yields through the year, feeling that weaker economic growth will lead to a softening of the labour market and the chance of a shift in the direction of policy.

Investment grade credit

Investment grade credit also enjoyed a period of strong performance in January.

The global IG index returned over 3.2% in local currency terms in January (according to ICE indices). Credit markets have enjoyed the twin benefits of lower government bond yields (see above) and tighter spreads. The Global Index spread, which was around 185bps over government bond yields in mid-October, has tightened to end January 2023 at 134bps, which is an impressive 28% tightening. In January, spreads were led tighter by euro and sterling credit (laggards last year) and by short-dated credit as credit curves have steepened / dis-inverted.

So much for history – what about the future? For us policy conditions which are tight and tightening remain a headwind – though one that is well understood / discounted and perhaps peaking. Meanwhile, economic prospects remain challenging though Europe and the US are likely to avoid recession – albeit that the UK faces a more challenging outlook. Valuations have also moved to be more neutral (in line with the longer- term average) after the tightening seen since Q3, 2022. In our view, euro and sterling remain better value than the US. We continue to expect credit fundamentals to improve but more so in the US than Europe. Overall, it now leaves us feeling neutral about the direction of spreads. It is worth mentioning though that overall yields certainly look more attractive than was the case a year ago, which suggests total returns should also be reasonable and positive this year. Meanwhile, investor cash balances seem to be high and supply should dwindle after January's heavy volume of primary issuance.

High yield credit & leveraged loans

US high yield bond spreads tightened this week to a low since April 2022 as resilient earnings and labour markets, coupled with dovish messaging from the Fed, ECB, and BoE, gave a green light for investors to enhance carry trades, duration, and credit risk within their portfolios as the end of the tightening cycle approaches. The ICE BofA US HY CP Constrained Index returned

1.02% and spreads were 29bps tighter. According to Lipper, the asset class reported a $1.5bn outflow for the week. Meanwhile, leveraged loan prices also extended their steady climb since the start of the year, with the average price of the J.P. Morgan Leveraged Loan Index increasing $0.26 to $94.70. This is the highest average price for the index since August. Outflows continued from retail loan funds with a $786m withdrawal.

European High Yield (EHY) experienced its eighth consecutive week of positive returns. Compression continues to be the theme as CCCs strongly outperformed higher rated credits, returning more than twice the performance of BBs, in the last week. Sterling HY also outperformed EHY. Performance came from both spread tightening (-16bps to 444bps) as well as from the fall in government yields. Flows into the asset class continued with both ETFs and managed accounts benefiting. After the strong primary market seen in January, February got off to a slow start, with only one new corporate issue: Stena, the Swedish shipping line, (€325m, 5-year, BB rated).

EHY finished January with the strongest start of the year since 2012 at 3.2%. Supporting the market performance have been trading reports showing many issuers meeting or beating expectations as well as the market optimism that the pace of central bank rate hikes may be slowing down / coming close to the end. Trading has been resilient with good two-way flow. Pricing, though, remains on the wide for the bid/offer.

In credit specific news, 888, the gaming company, was in the headlines on potential money laundering regarding VIP Middle East customers. This has resulted in the CEO leaving and bonds weakening sharply.

In M&A news, Casino announced it is in merger talks with Teract for Casino’s French retail arm. This could mean combining the two groups’ French distribution activities, potentially leading to spinning off a new company. This could enable Casino to pay down some of its outstanding debt. On the flipside, Stonegate, the pubs operator, was in the news that it is looking to sell a quarter of its pubs.

Finally, a turnaround story to report. CMA CG, the shipping company, announced it was redeeming its last outstanding bond and will leave the high yield universe. Presumably, it is using the huge cash pile it generated in the post-covid period, which resulted in cash generation of $35bn over two years as compared to being negative free cash flow since 2008.

Structured credit

Volatility prevailed last week amongst duration-sensitive asset classes. Agency MBS enjoyed a mid-week rally on the back of Chair Powell’s dovish press conference following the well anticipated 25bps hike in rates. That was short-lived, however, with a strong labour market print on Friday. Jobs, jobs, and more jobs reversed earlier gains and pushed the Agency MBS index lower to close out the week marginally negative at -9bps. More uncertainty regarding the path of interest rates caused the sell-off. The offset over the longer term, however, is higher yields = slower Fed paydowns + lower supply. Ultimately, more terminal rate clarity will benefit the mortgage market. In Commercial risk, concern continues to centre around office exposure, which has benefited Single Asset Single Borrower vs conduit risk. Trophy properties have been well bid with AAAs 30-50bps tighter.

Asian credit

Adani Enterprises Ltd (AEL) withdrew its fully subscribed Follow-on Public Offering (FPO). Given the sharp decline in the AEL share price, management decided to withdraw the $2.5bn offering and refund the proceeds to investors to protect them from financial losses. Moody's and Fitch affirmed the credit ratings and outlook of the group entities (Adani Ports & SEZ, Adani Transmission Ltd, Adani Electricity Mumbai Ltd, Adani Green Energy Ltd) but they will watch the entities' access to financing and their cost of financing closely. S&P maintains the credit ratings but lowers the outlook of Adani Ports & SEZ Ltd and Adani Electricity Mumbai due to the governance risks and funding challenging for the larger Adani Group, partly offset by the adequate short-term liquidity and manageable debt maturities over the next 12 months

Adani Enterprises' plan to sell INR10bn ($122m) of onshore bond was cancelled due to market conditions. According to Mint, Adani Group is planning to slow down its capital expenditure with a target of 16-18 months for growth in certain businesses, instead of a 12-month target.

S&P has revised the ratings outlook of SK Hynix to negative (previous: stable) to reflect the scope for a meaningful deterioration in SK Hynix's credit profile in 2023. Excess inventories and suppliers will weaken memory but the supply-demand dynamics will start to balance in H2, 2023 and credit measures will improve in 2024. The BBB- ratings of SK Hynix was affirmed.

Emerging markets

Emerging market hard currency sovereigns extended their gains last week, posting +0.56%. Spreads tightened 13bps to 353bps. Investment grade bonds outperformed high yield.

China's economy showed signs of expansion following improved Manufacturing and Service sector ISM data. However, on the geopolitics front, US-China relations came under pressure following a Chinese balloon which was in US airspace. The balloon was shot down by the US as it was believed to be used for spying, an allegation which China denies. This comes after recent renewed optimism that this relationship was showing signs of improvement.

Some signs of inflation having peaked in EM last week as Brazil's central bank kept rates on hold at 13.75%. Egypt also held at 16.25%, a dovish surprise relative to the 100bps expected rise. The Czech central bank paused at 7%.

In ratings news, Moody's cut Peru's outlook to negative from stable as result of the recent protests.

Fixed Income Asset Allocation Views

6th February 2023

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk	Under-weight -2 -1 0 +1 +2 Over-weight (■ at -1)	▪ Valuations are less attractive relative to December, technicals and fundamentals stable to improving. **The group remained negative on credit risk, upgrading Investment Grade to neutral and downgrading Structured Products to neutral.** ▪ The Fed Funds market is pricing in a peak of 5% and rates being cut to 4.5% in 2023 ▪ The CTI global Rates base case view is no cuts in 2023, with a best case of potentially one cut. They expect rates to peak between 5 – 5.25% in first half, with Fed holding steady through the second half. ▪ Uncertainty remains elevated due to fears surrounding recession probabilities, schedule of central bank hiking/easing, persisting inflation, weakening consumer profile and the Russian invasion of Ukraine.	▪ Upside risks: the Fed achie strong China reopening, Eu commodity pressure easing strength, end of Russian Inv ▪ Downside risks: simultaneo unemployment, high inflatio slowing growth cause a rec invasion spills into broader turmoil. New Covid variant. disruptions, inflation, volatili shocks persist to 2023.
Duration (10-year) ('P' = Periphery)	¥ P $ Short -2 -1 0 +1 +2 Long € £	▪ Longer yields to be captured by long-run structural downtrends in real yields ▪ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures ▪ Hiking cycles may be curtailed by weakening growth, as risk of a policy error increases ▪ change in UK fiscal position to contractionary is a positive for the front end	▪ Inflationary dynamics becor persistent ▪ Labour supply shortage per pressure becomes broad ar ▪ Fiscal expansion requires w ▪ Long run trend in safe asse
Currency ('E' = European Economic Area)	¥ A$ EM Short -2 -1 0 +1 +2 Long $ € £	▪ Rising expectations around a soft landing and peak Central Bank rates have weakened the dollar ▪ China reopening has amplified this by boosting growth expectations helping risk markets ▪ A material weakening of the dollar from here will need to see growth expectations move significantly higher	▪ Central banks need to kee for much longer than marke detriment of risk and growtl of the Dollar
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ Substantial monetary policy tightening now embedded into EM local rates; inflation peaking in some places ▪ Aggressive Fed pricing may now open the door to selective EMFX performance ▪ EM real interest rates relatively attractive, curves steep in places	▪ Negative sentiment shock t ▪ Central banks tighten aggre fx weakness ▪ EM inflation peaks higher a ▪ EM funding crises drive cur steeper ▪ Further rises in DM yields
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	▪ EMD spreads unchanged since last meeting, following strong Q4 spread compression and performance. ▪ China reopening story is huge turnaround since November. ▪ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, central bank tightening, idiosyncratic political risks, difficult global financing conditions (US rates and USD strength), increasing use of IMF programs, geopolitical risks ▪ Technicals improving with higher new year issuance	▪ Chinese reopening paused property market and confide growth ▪ Continued spillover from Ru local inflation (esp. food & c slowing growth in trade part chains ▪ Persisting COVID growth sc economies & fiscal deficits
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	▪ US & EMEA spreads have continued tightening to less attractive valuations as fundamentals remain stable and technicals remain soft. ▪ Fundamentals remain stable, with strong starting point – expected deterioration may be a 2023 story. ▪ Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment. All eyes on Q4 results and '23 outlooks.	▪ Supply remains low. ▪ M&A expected to slow; cas shareholder payouts ▪ Market indigestion as centr corporates ▪ Rate environment remains ▪ Russian invasion worsens c environment globally
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight (■ at -1)	▪ Spreads have moved tighter. Prefer conservative position while open to attractive buying opportunities. ▪ Technicals have started to improve with positive fund flows and no defaults in December; more rising stars than fallen angels in 2022. Fundamentals still stable. ▪ Expect 2023 performance will be driven by credit selection amidst fundamental dispersion and distress. ▪ Bank loan market has tightened: market is in equilibrium with fund outflows offset by stable CLO formation and lower new supply.. Concerns about recession and interest cost remain headwinds.	▪ Default concerns are revise demand destruction, margi macro risks ▪ Loan technicals & flows wea ▪ Global consumer health we ▪ Russian invasion & spillove ▪ Commodity prices retrace
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight (■ at +1)	▪ Mortgage index has tightened along with other risk assets. Despite outperformance, valuations still attractive from historic perspective and volatility remain elevated. ▪ Headwinds as money manager demand is small relative to Fed, bank, REIT and overseas selling pressure ▪ Place to add as preference shifts to high quality assets and sentiment is constructive over longer time horizon	▪ Housing activity slows and r prepays to normal levels wi mortgage servicing rates. ▪ Fed continues to shrink pos is paused in recessionary s
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	▪ Our preference remains for Non-Agency RMBS ▪ RMBS: Higher mortgage rate is headwind for prepays, fundamentals and transaction activity. Delinquency performance remains strong, but housing is slowing. Risk premiums still cheap to historical averages but tightening. ▪ CMBS: Mostly solid fundamentals but weakening. Spreads attractive for historical CMBS, but better relval elsewhere. ▪ CLOs: Spreads tighter since December. Default rate increasing and slow new issue supply to start the year ▪ ABS: Lower income, renters, lower fico borrowers continue to underperform, higher quality borrowers remain stable.	▪ Consumer fundamental pos lower income) weakens wit tightening, Consumer retail/ fails to return to pre-covid le ▪ WFH continues in 2023(pos negative for CMBS). ▪ Rising interest rates dent h strength and turn home pric 2023
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight (■ at +1)	▪ o/w Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Oil ▪ u/w Silver	▪ Global Recession

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