In Credit

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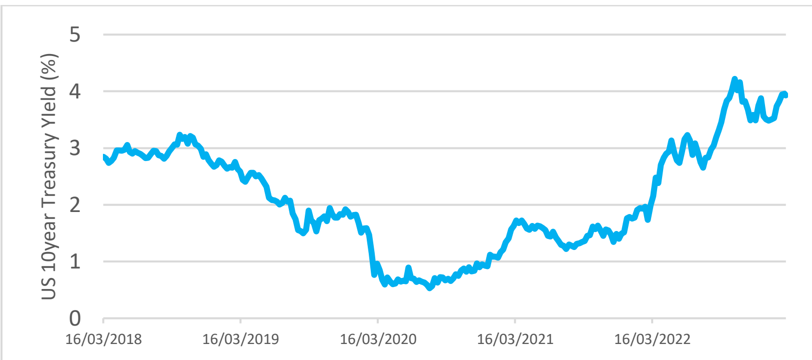
Shortest month, largest drawdown.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.93%	-1 bps	0.0%	0.0%
German Bund 10 year	2.67%	13 bps	-1.5%	-1.5%
UK Gilt 10 year	3.82%	16 bps	-1.4%	-1.4%
Japan 10 year	0.51%	0 bps	0.7%	0.7%
Global Investment Grade	132 bps	-1 bps	0.8%	0.8%
Euro Investment Grade	146 bps	1 bps	0.1%	0.1%
US Investment Grade	125 bps	-3 bps	1.0%	1.0%
UK Investment Grade	143 bps	1 bps	1.0%	1.0%
Asia Investment Grade	192 bps	-1 bps	1.0%	1.0%
Euro High Yield	436 bps	-3 bps	3.1%	3.1%
US High Yield	405 bps	-23 bps	2.9%	2.9%
Asia High Yield	615 bps	-6 bps	5.2%	5.2%
EM Sovereign	374 bps	7 bps	0.6%	0.6%
EM Local	6.8%	1 bps	1.6%	1.6%
EM Corporate	327 bps	1 bps	1.3%	1.3%
Bloomberg Barclays US Munis	3.7%	3 bps	0.4%	0.4%
Taxable Munis	5.1%	-1 bps	3.2%	3.2%
Bloomberg Barclays US MBS	47 bps	2 bps	0.2%	0.2%
Bloomberg Commodity Index	236.03	2.7%	-3.2%	-3.2%
EUR	1.0649	0.8%	-0.7%	-0.7%
JPY	135.85	0.5%	-3.5%	-3.5%
GBP	1.2030	0.8%	-0.4%	-0.4%

Source: Bloomberg, Merrill Lynch, as of 3 March 2023.

Chart of the week: US 10-year treasury yield, 2018-2023



Source: Bloomberg, Columbia Threadneedle Investments, as of 6 March 2023.

Macro / government bonds

February was a difficult month for core bond markets. The result was the generation of negative returns, with Deutsche Bank noting that the month produced the worst returns for the Bloomberg Aggregate index since its inception in 1990.

Yields were higher across the curve, but especially so at the short end of the yield curve which is, of course, more heavily influenced by rising interest rate expectations. The benchmark 10-year US treasury yield had traded as low as around 3.3% in January before rising to end the month of February at around 3.9% and close to where it is presently **(see chart of the week).**

A series of stronger than expected economic data releases upset confidence in an upcoming pivot to monetary policy. Notably, unemployment remains exceptionally low indeed in most areas (eg, 3.4% in the US: a 50+year low). Meanwhile retail sales and business confidence have surprised to the upside. Likewise, there remains concern about the persistence of inflation where, for example, core inflation in Europe reached a new record of 5.3% y/y. It is not just historic inflation data that is of concern. Market expectations about future inflation are rising. The US two-year break-even (short-term expectations) rose from -1% in March 2020 to 5% two years later. More recently, it fell back to around 2% around the start of this year before rising once again back to 3.4% today. Longer-term measures have displayed greater stability but even here 10-year break-evens have risen by around 40bps this year to 2.5%.

Investment grade credit

Investment grade credit markets were hit with the twin forces of rising government bond yields (see above) and some widening in credit spreads through February. This led to negative market returns during the month and into the first week of March.

In terms of outlook, the market continues to face rising interest rate expectations in the US and Europe and expectations that such conditions will remain restrictive (above neutral) in the coming year(s). The economic prognosis has, however, improved somewhat in terms of consensus growth expectations for the year ahead. Where recession was once the central forecast for Europe, so modest expansion is now expected as is the case in the US. Elsewhere, pessimism remains about the outlook for the UK though it is less pronounced than previously.

Market valuations (spreads) have moved from being attractive (wide of short and longer-term averages) to more balanced and closer to those levels. As we ended February, the Global IG Index (ICE BofAML) spread is remarkably close to the long-term (20-year) average at around 132bps. Regionally, euro and sterling markets look cheaper relative to those averages than their US cousin. Market valuations (yields) were, however, much higher through the last month and after the large decline seen since the middle of October last year. The same global index, for example, has seen its yield rise by around 80bps since the first week of February. The index now offers a yield of around 5.3%. This is much higher than the 3.5% average seen over the last 20 years and 1.3% at the end of 2021. Good news for those seeking income.

Corporate credit quality is expected, by our analyst team, to improve modestly in the US through 2023 and deteriorate by a small amount in Europe: but both from a strong starting point. Banks meanwhile are well capitalised and benefitting from rising margins though ‘cost of risk’ is seen to be normalising.

Meanwhile, low levels of market / spread volatility were noted in the month while fund flows appear to have become more balanced than was the case: coincident with poorer market performance as is often the case.

High yield credit & leveraged loans

Despite rate expectations ratcheting higher, US high yield bond spreads remained resilient amid supportive macro data, improving capital market access, and prospects for another resilient quarterly earnings period in Q1 amid firmer than expected nominal growth. The ICE BofA US HY CP Constrained Index returned 0.66% and spreads were 23bps tighter. According to Lipper, the asset class reported a $2.3bn retail fund outflow, marking the third consecutive $2bn+ weekly outflow. Meanwhile, the average price of the J.P. Morgan Leveraged Loan index was unchanged around $94.12. Retail loan funds saw their 27th outflow over the last 28 weeks with a $616m withdrawal.

European High Yield (EHY) had a fourth week of negative returns (-0.30%) resulting in February finishing down, marginally, for the month (-0.08%) after completely wiping out the positive performance at the start of the month and already starting March in the red. The market remains largely dominated by macro moves as EHY spreads contracted -3bps on the week (to 436bps) and -23bps in February, while yields rose +21bps (to 7.59%) on the week and +14bps on the month. Decompression also continued as CCCs underperformed BBs and Bs. Given the low interest for duration, Bs outperformed BBs (the latter has a higher level of longer maturity bonds). Sterling high yield outperformance versus EHY continues. Fund flows moved net negative with managed accounts joining ETFs as the latter experienced its second week in the row of outflows. Last week's corporate primary market was dominated by the new Teva issues (€1.3bn), with only Ford also bringing a £500m bond to the show.

In credit rating news, several companies have started signalling that they are actively seeking an IG rating (eg, IGT, Darling) as they accept that those companies with a conservative capital structure are far more resilient in financially stressed macro environments.

The asset class appears caught between a resilient equity market and volatile government bond market as EHY corporate earnings reports show resilience, largely in line with, and often better than, expectations. Defaults for EHY remain low at 0.5%, in absolute as well as relative terms, given the uptick seen for US high yield. With issuance remaining on the low side, flows seen from maturities, coupons, tender offers, and rating upgrades still happening, technicals are balanced to relatively supportive for the asset class.

Asian credit

The National People's Congress (NPC) commenced its annual congress on 5 March 2023. Premier Li Keqiang, who is stepping down, delivered his final government work report. The government guided for a conservative GDP growth target of around 5%, which is lower than the 2022 target of 5.5%. The conservative GDP growth target implies the absence of major monetary and fiscal stimulus. China also set a budget deficit of 3% for 2023 (2022 target: 2.8%).

The issuance of equity-linked instruments by Asian companies could continue to pick up with Wynn Macau reportedly planning to raise $500m by issuing convertible bonds due in 2029.

iQIYI, a subsidiary of Baidu, has also issued $600m of convertibles due in 2028 to strengthen its liquidity position.

S.B. Adani Family Trust (promoter entity of the Adani Group) sold stakes in Adani Ports, Adani Green Energy, Adani Enterprises Ltd and Adani Transmission Ltd for around $1.87bn to GQG Partners in the secondary market. The proceeds should enable the Adani promoter entity to pay down its share-backed loans.

Greenko Energy Holdings (GEH) is raising $700m through a primary equity funding with its key shareholders (GIC, Abu Dhabi Investment Authority, ORIX and the founders). GEH will use the proceeds to grow its pumped storage energy project from 25GWh to 50GWh. GEH has also recently obtained a $400m 1-year bridging loan from six banks to pay the holding company bond, GRNKEN 6.25% ‘23s at maturity. It also announced the redemption of the GRNKEN 4.875% Aug ‘23s ($500m) using its internal cash flow.

Emerging markets

The index returned -0.26% over the week with high beta African names faring the worst. Spreads were 7bps wider on the week but overall YTD they have been flat despite the move in US treasuries. The technical backdrop remains favourable with $6bn inflows YTD into the asset class (EPFR data).

Squabbling amongst opposition parties in Turkey is making it more likely that President Erdogan will retain his presidency when people head to the polls in May. From a spread point of view this would be negative for Turkey as Erdogan already rules with some unfavourable politics and economics.

In Nigeria, Bola Tinubu was declared the winner of the previous weekend’s Presidential election with almost 37% of the vote. There were frustrations as the results were delayed but with voter turnout low, at just 27%, this high level of political apathy across the country should hopefully prevent protests in Lagos and Abuja from turning into more widespread social unrest.

In Hungary, interest rates were held at 13% for the fifth consecutive month. Pakistan’s Central Bank raised interest rates 300bps to a record high, 20%, as the country is in the middle of an economic crisis. Inflation has surpassed 30% and FX reserves are low. Policy makers are working to get a bailout from the IMF. Ratings agencies Moody’s and Fitch both downgraded the country two notches to Caa3/CCC-.

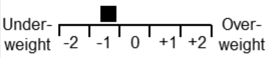
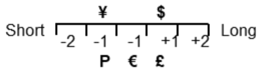
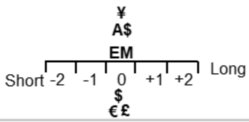
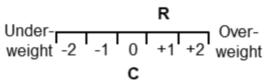
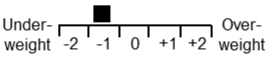
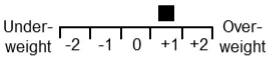
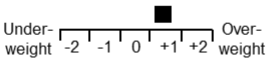
Responsible investments

The UK Government has launched a taskforce to support the pensions industry in addressing the risks and issues around the social implications of pension scheme investing. The taskforce will be led by the Minister for Pensions, in conjunction with partners such as UKSIF, Church of England Pensions Board, Scottish Widows and RailPen, and will investigate reliable data sources to evaluate the material social risks and opportunities within the industry. For the one year it will run, the hope is that the output will contribute to standards, principles and metrics in the foreseeable future.

Just as we had all memorised every ESG related regulation out there, the EU Commission has added another to the list! It was expected at some point, but we have finally seen the EU release its Euro Green Bond Standard (EuGB) regulation. This will mean bond issuers can label their green bonds with the standard so long as they meet several requirements. The bond must conform to the EU taxonomy with all proceeds aligning to one or more of the economic activities covered by that taxonomy. A 15% “flexible” allocation outside of the taxonomy is allowed for specific activities not covered by the taxonomy, but these will be repeatedly evaluated. The regulation is designed to complement existing principles and regulations, with an additional registration and supervisory framework for non-European green bonds.

Fixed Income Asset Allocation Views

6th March 2023

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk		▪ Valuations are slightly more attractive relative to Jan, with technicals improving and fundamentals mixed. ▪ The group remained negative on credit risk. The Fed Funds market is pricing in a peak of 5.3% and rates being cut to 5.1% 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. Risk skewing to slightly higher. ▪ 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 achieves a soft landing, strong China reopening, Europe sees commodity pressure easing, consumer retains strength, end of Russian Invasion of Ukraine ▪ Downside risks: simultaneous low unemployment, high inflation, hiking, and slowing growth cause a recession. Russian invasion spills into broader global/China turmoil. New Covid variant. Supply chain disruptions, inflation, volatility, commodity shocks persist to 2023.
Duration (10-year) ('P' = Periphery)		▪ 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 become structurally persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)		▪ Rising expectations around a soft landing and peak Central Bank rates have weakened the dollar ▪ EM disinflation to be more rapid than DM ▪ Drop in global rate volatility supports local flows ▪ EM real rates relatively attractive, curves still steep in places	▪ Central banks need to keep rates at terminal for much longer than market prices, to the detriment of risk and growth and to the benefit of the Dollar
Emerging Markets Local (rates (R) and currency (C))		▪ EM central banks slowing or terminating hike cycles ▪ Aggressive Fed pricing may now open the door to selective EMFX performance ▪ EM real interest rates relatively attractive, curves steep in places	▪ US "no-landing" scenario raises terminal Fed rate ▪ EM inflation proves stickier ▪ EM central banks require restrictive policy in resurgent USD environment ▪ Global recession damages risk sentiment and EM capital flows
Emerging Markets Sovereign Credit (USD denominated)		▪ EMD spreads widened since Jan, but strong start to 2023. ▪ Better global risk sentiment, low rate vol and China reopening optimism. Europe higher as energy fears ease ▪ Fundamental headwinds: 22/23 growth deltas very large, elevated fiscal deficits, rising debt to GDP ratios, significant inflation, LATAM 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	▪ China/US relations deteriorate ▪ Issuance slows ▪ Chinese reopening paused ▪ Continued spillover from Russian invasion: local inflation (esp. food & commodity), slowing growth in trade partners, supply chains ▪ Persisting COVID growth scars hurt economies & fiscal deficits
Investment Grade Credit		▪ US & EMEA spreads have widened from early Feb; fundamentals remain stable and technical challenges are easing. EMEA valuations remain cheap to USD. ▪ 4Q earnings coming in better than feared. Fundamentals remain stable with strong 2023 starting point – expected deterioration may be 2023 story ▪ Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment.	▪ 2023 supply below expectations. ▪ M&A expected to slow; cash flow prioritizing shareholder payouts ▪ Market indigestion as central banks sell EMEA corporates ▪ Rate environment remains volatile ▪ Geopolitical conflicts worsen operating environment globally
High Yield Bonds and Bank Loans		▪ Spreads have moved wider. Prefer conservative position while open to attractive buying opportunities. ▪ Technicals have improved in Jan with positive fund flows, two rising stars, strong primary market volume ▪ Corporate fundamentals have been mixed, but generally supportive. Two defaults in January. ▪ Bank loan market has rallied YTD driven by more CLO issuance, moderating fund outflows and limited new supply. Concerns about recession/weakening economy and interest cost remain headwinds.	▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ▪ Rally in distressed credits, leads to relative underperformance ▪ Loan technicals & flows weaken ▪ Global consumer health weakens ▪ Russian invasion & spillover ▪ Commodity prices retrace
Agency MBS		▪ Mortgage index has widened along with other risk assets. Valuations still slightly cheap but have modestly reduced exposure due to outperformance. ▪ Performance remains strong on the heels of lower volatility and money manager buying. ▪ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon	▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates ▪ Fed continues to shrink position even as hiking is paused in recessionary scenario
Structured Credit Non-Agency MBS & CMBS		▪ Our preference remains for quality Non-Agency RMBS ▪ RMBS: Higher mortgage rate is headwind for prepays, fundamentals and transaction activity. Delinquency performance remains strong, need labor market weakness to see housing deterioration. Risk premiums still cheap. ▪ CMBS: Mostly solid fundamentals but weakening. Prefer Single Family Rental with its favorable 2023 supply outlook. ▪ CLOs: Spreads unch since Jan. Downgrades outpacing upgrades. Increased tail risks for subordinate bonds ▪ ABS: Lower income, renters, lower fico borrowers continue to underperform; higher quality borrowers remain stable.	▪ Weakness in labor market ▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening. Consumer (retail/travel) behavior fails to return to pre-covid levels ▪ WFH continues in 2023 (positive for RMBS, negative for CMBS). ▪ Rising interest rates dent housing market strength and turn home prices negative in 2023
Commodities		▪ o/w Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Oil ▪ u/w Silver ▪ o/w Wheat ▪ u/w Corn	▪ Global Recession