COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

7 November 2022

David Oliphant
Executive Director,
Fixed Income

Contributors

David Oliphant
Macro / Government bonds,
Investment Grade Credit

Angelina Chueh
Euro High Yield Credit

Chris Jorel
US High Yield Credit,
US Leveraged Loans

Laura Reardon
Emerging Markets

Kris Moreton
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Justin Ong
Asian Fixed Income

Charlotte Edwards
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Jake Lunness
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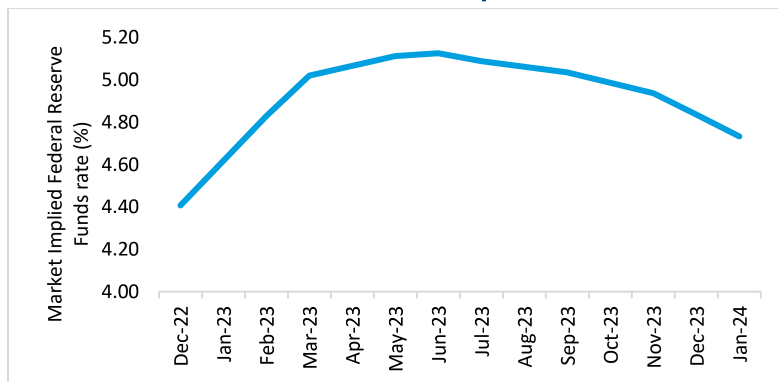
75….and not yet done.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	4.17%	15 bps	-2.1%	-15.3%
German Bund 10 year	2.29%	18 bps	-1.3%	-16.5%
UK Gilt 10 year	3.55%	7 bps	2.8%	-24.3%
Japan 10 year	0.26%	1 bps	1.4%	-4.2%
Global Investment Grade	176 bps	-4 bps	-1.0%	-17.8%
Euro Investment Grade	208 bps	-9 bps	0.0%	-15.1%
US Investment Grade	161 bps	-5 bps	-1.5%	-19.5%
UK Investment Grade	185 bps	0 bps	4.8%	-18.9%
Asia Investment Grade	281 bps	1 bps	-3.7%	-14.3%
Euro High Yield	588 bps	-23 bps	1.9%	-14.1%
US High Yield	477 bps	23 bps	1.9%	-13.0%
Asia High Yield	1320 bps	18 bps	-10.2%	-30.9%
EM Sovereign	434 bps	-14 bps	0.3%	-22.0%
EM Local	7.4%	-4 bps	0.3%	-18.3%
EM Corporate	435 bps	-12 bps	-1.9%	-17.8%
Bloomberg Barclays US Munis	4.2%	-4 bps	-0.5%	-12.6%
Taxable Munis	5.6%	15 bps	-3.7%	-25.1%
Bloomberg Barclays US MBS	64 bps	-1 bps	-1.5%	-14.9%
Bloomberg Commodity Index	256.10	5.2%	5.8%	20.1%
EUR	0.9998	-0.1%	1.6%	-12.4%
JPY	146.20	0.7%	-1.3%	-21.5%
GBP	1.1475	-2.0%	1.9%	-15.9%

Source: Bloomberg, ICE BoML Indices, as at 4 November 2022.

Chart of the week: US Interest rate expectations – 2022/24



Source: Bloomberg, Columbia Threadneedle Investments, as at 7 November 2022.

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Macro / government bonds

It was a week of interest rate rises.

Rates went up by 75 basis points in both the US and the UK. This was as expected by markets. However, it is commonly the 'post match' commentary that provides guidance to the markets of the future direction of interest rates. Here, is where the differences lie.

The Bank of England raised interest rates to the highest since 2008 and to 3%. After the event comments suggest that the BoE feels present market estimations of future interest rates are higher than need be the case in order to tackle the present inflation problem. Indeed, two voting members of the monetary Policy Committee declined to raise interest rates as much as the consensus. BoE forecasts suggest that should interest rates remain at present levels in the coming 24 months inflation will return to its own target. The reaction to all of this was for gilt yields to rise and for sterling to fall by around 2% on the day of the rate move. If this is confusing, then the commentary from the Federal Open Market Commission in the US was even more so. This suggested that the US Federal Reserve was more dovish about the outlook for interest rates that had been the case. However, Jay Powell the chair of the US Fed said that the risk of under achieving on inflation was far greater than over achieving. Hence interest rate expectations over the course of the next year have risen in the US and fallen in the UK.

The week ended with the US employment report. It showed a larger amount of job gains (261k) than expected but a weaker rate of private sector employment growth. Wages rose by 0.4% in the month (higher than expected) but the unemployment rate also rose more than expected to 3.7%.

This week (Tuesday) brings the US mid-term elections where the Republican Party should end up with control of the House and probably the Senate. US Consumer Price inflation data will be the most widely watched piece of economic news in the next five days (Thursday). There is also data from the University of Michigan around consumer sentiment to end the week (Friday).

Investment grade credit

It was a good week for credit markets. Spreads tightened across the board but most noticably in Europe (which has been the weakest market this year). Data from ICE Bond Indices shows the Global Corporate Credit Index reached a year to date spread wide of 185bps around a month ago before ending last week at a spread of 176bps.

The 'technical' background is supportive for the market at present with dealers reporting light levels of inventory coincident with a time where light levels of new issuance are unable to fill the void. Meanwhile, corporate results seem thus far to be reasonable. Banks, for example, are reporting a modest deterioration in asset quality that is more than offset by increased net interest margins as interest rates rise.

Another reason for market strength, particularly in euros, is the fact that after recent market weakness spreads already compensate for the likely economic recession we face. A spread of around 200bps over government bonds is often a good estimation of a level that prevails in recession and the euro market offers a spread in excess of that mark (208bps). Lastly, after the recent sell off this year, lower coupon bond prices are low (some in the 60s) and all-in yields are attractive – so combined make the investment grade credit market look attractive to some investors.

High yield credit & leveraged loans

US high yield bond prices consolidated the past month's gains over the week after Fed Chairman Powell suggested on Wednesday that rates had to "go higher" and remain "higher for longer." The ICE BofA US HY CP Constrained Index returned -1.36% and spreads were 26bps wider.

New issuance remained light and is down 78% y/y, earnings have thus far been better than feared, and the retail mutual fund base reported its largest inflows ($4.28bn) in 14 weeks according to Lipper. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index edged $0.27 higher to $92.65 amid the hawkish Fed outcome, better than feared earnings and ETF inflows. Loan retail funds saw a $53m outflow, the lightest outflow over the last 20 weeks.

European High Yield (EHY) posted another positive week, returning 0.6%, as sterling high yield again outperformed EHY, and euro Bs outperformed both BBs and CCCs while sterling CCCs were the strongest performers, overall (+1.1%). Returns were dominated by credit spread tightening (-23bps to 5.88%), as underlying yields moved marginally (-6bps to 8.29%) given the rise in underlying government bond yields. Flows were positive (+€203m) coming in via both ETFs and managed accounts. The primary market for EHY was closed last week, as there was only a €56m tap from Fedrigoni (Fiber BidCo) of an existing bond. An indication of the appetite for new deals was a loan offering by INEOS in US dollars and euros that was upsized from €1.2bn to €2bn.

Third quarter reporting continues with recent releases showing that even as many report meeting or beating expectations (ex. packaging company Trivium, Retailer DuFry, Chemicals company SGL Carbon, Portuguese airlines TAPs), there are signs from others of weakness creeping in (ex. oil industry services firm CGG, healthcare firms Organon and Teva, auto parts company Forvia, formally Faurecia) on falling sales and lower EBITDA.

On the rating front, Chelplepharm (pharmaceuticals), was upgraded by S&P to B+, from B citing strong operational performance and successful integration of recent new acquisitions.

Adler, the beleaguered German real estate group, may be looking to sell a subsidiary's Leipzig assets. It is said that these assets have a valuation of around €400m with timing of a deal potentially within weeks. If true, this could provide a much-needed boost to Adler's liquidity ahead of an April 2023 maturity as well as help towards repayment of mortgage debt.

Structured credit

With a US Federal Reserve that remains hawkish, the US treasury yield curve continued to shift higher. Unsurprisingly, shorter maturity MBS outperformed longer MBS, with spreads widening by 15bps on 15-year current coupons versus 25bps on 30-year current coupons. The question on many minds right now is who is going to be the marginal new buyer of agency mortgages in the market with the Fed and banks stepping away. For now, the answer is the money manager community who has stepped in and progressively reduced their underweight throughout the year and are now approaching a neutral weighting in the third quarter. On the credit side, non-agency RMBS spreads continued to widen in response to the Fed's hawkish tone although fundamentals have held strong. CMBS spreads were mostly unchanged week-over-week despite the rates sell-off and a hawkish Fed.

Asian credit

According to China Real Estate Information Corp (CRIC), the largest 100 property developers reported new home sales declined 28.4% y/y to CNY556bn (c.$80bn) in October. The m/m decline was 2.6%, a deterioration from the 10% m/m growth in September.

PGN is not extending a $77.6m shareholder loan to Saka Energi, due in January 2023 (source: REDD). Saka will repay the shareholder loan to PGN upon its scheduled maturity, helped by the windfall from strong global energy prices. For context, Saka H1 revenue was $308.3m (doubled y/y) and operating flow was $178.4m (more than triple y/y). Cash was $214.1m at end-June 2022 (2021: $289.4m), lower h/h because Saka spent $232.1m to partially repurchase the SAKAEI bonds

Bharti's Q2 results (quarter ended 30 September 2022) were above market consensus. Q2 sales rose 21.9% y/y to INR345.3bn and EBITDA increased 26% y/y to INR177.2bn. Its mobile services business in India was boosted by tariff increases and a higher proportion of subscribers on data plan. The Q2 ARPU (average revenue per user) rose to INR190 (previous quarter June 2022: INR183, prior year September 2021: INR153)

In Korea, the surprise domestic bond default by Legoland Korea theme park in late September and the sharp increase in interest rates have resulted in higher liquidity distress within the Korea domestic capital markets. The yields on onshore commercial paper and domestic credit spreads have rose significantly, with spill-over effects to the US dollar market. When Heungkuk Life announced that it will not exercise its call option on its $500m subordinated capital securities (first call date of November 2022), after having previously stated that it will do so, that triggered a sell-off in the Korea financial perpetual bonds.

Emerging markets

Despite tighter EM spreads over the week, the rise in US treasury yields detracted from the return of the JPM EMBI Global index (-0.10% for the week). African names rallied while distressed Asian countries impacted negatively.

Whilst EM central banks continue to tighten monetary policy for the most part (Colombia hiked rates 100bps, 25bps less than the market had expected; Malaysia raised rates by 25bps), we are starting to see some policy makers pause or hint that they are at the end of their hiking cycle; Russia held rates at 7.25% and the Czech Republic also held at 7%.

In ratings news, Qatar was upgraded to AA from AA- by S&P as Moody's changed its outlook to positive.

In Colombia, leftist president Petro has had his tax reform bill approved by the senate. The bill is expected to raise $4bn annually for the next four years and aims to finance social spending programmes. The raises will come from increased duties on oil and coal, and higher taxes on high earners, single use plastics, sugary drinks, and ultra-processed foods. Critics are concerned the bill will discourage investment, especially given the coal and oil sectors account for around half of Colombia's export revenue; the Colombian peso is currently trading at all time lows versus the US dollar.

In China, exports declined to -0.3% YoY in October, the worst drop since May 2020, and well below expectations of 4.5%. Imports also declined to -0.7% YoY versus

expectations of 0%. China re-iterated its commitment to zero covid, warning of a “more severe and complex” situation as we enter the flu season. In more encouraging news, Chinese health authorities criticized excessive covid controls in the city of Zhengzhou, who have now pledged more targeted measures.

Commodities

The BCOM index rallied 5.2% on the week led by gains in energy and industrial metals. Within industrial metals there were substantial rises in aluminium (+6.5%), copper (+7.5%) and nickel (+7.6%) all of which were rallying from subdued levels and have given back some of these gains on disappointing news from China (see ‘Emerging markets’ section).

In Europe, natural gas prices rallied 3.6% on the week. French Nuclear operator EDF cut its power production outlook again. Four reactors facing “stress corrosion” issues, that were due to come back online in a few weeks, have had their return to service pushed out to January/February.

US natural gas prices rallied 13.4% on the week. Freeport LNG, whose Texan natural gas export facility has been shuttered since an explosion back in June has yet to submit a restart plan despite pressure from US regulators. Prior to the explosion, the facility accounted for around 15% of US LNG exports.

Responsible investments

It doesn’t seem so long ago that we were seeing a plethora of net zero promises from nations across the world at the COP26 summit in Glasgow last year. This week, top climate analysts, scientists, journalist and world leaders are in Sharm El-Sheikh, Egypt, for COP27. Key themes at this summit will be ‘Loss and Damage’, where poorer countries suffering the most from climate change should be expecting extra finance and support from richer nations – especially when some of those richer nations are at the top of the list of highest contributors to climate change. Another hot topic will be to hear of the progress and development from countries and companies who set net zero goals last year and how they’ve been acting upon the deliverables they set out.

Key events and news last week included Tesla announcing expansion plans for its factories in Germany, an unusual warm October in the UK meant the government saved over a quarter of a billion pounds in planned energy subsidies and ‘work from home’ orders along with school closures have been announced in New Delhi as the city becomes the most polluted place on earth.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views
7th November 2022

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	▪ Credit spreads have widened since the last meeting with volatility still high and a market-wide softening in technicals and fundamentals. This has **kept the group negative on credit risk with only sector change to upgrade Agency MBS.** ▪ We are past the peak of economic growth with first few hikes done and expectations for two more 75 hikes through the end of 2022. Pullback in liquidity created opportunity for market volatility. ▪ Uncertainty remains elevated due to fears surrounding pace of central bank hiking, inflation, recession probabilities, weakening consumer profile and the Russian invasion of Ukraine.	▪ Upside risks: the Fed achieves a soft landing, Europe sees commodity pressure easing, consumer retains strength ▪ Downside risks: simultaneous low unemployment, high inflation, hiking, and slowing growth cause a recession. Russian invasion spills into broader global/ China turmoil. New Covid variants. Supply chain disruptions, inflation, commodity shocks persists 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 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)	¥ A$ EM Short -2 -1 0 +1 +2 Long $ €£	▪ The invasion of Ukraine will hit global growth, hinder risk markets and lend a bid to the Dollar ▪ The repricing of the ECB has so far failed to boost the Euro as Eurozone growth expectations have underperformed the US	▪ End of zero-covid strategy in China normalises supply chains and raises global growth, to the detriment 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 to EM fund flows ▪ Central banks tighten aggressively to counter fx weakness ▪ EM inflation peaks higher and later ▪ EM funding crises drive curves higher and steeper ▪ Further rises in DM yields
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ EMD spreads wider since last meeting; still seeing bifurcation in market with value in MENA energy producers ▪ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, central bank tightening, China lockdown/growth, idiosyncratic political risks, difficult global financing conditions (US rates and USD strength), increasing use of IMF programs, geopolitical risks ▪ Techincals (outflows and supply) remain a headwind	▪ Chinese reopening postponed – weakened property market and confidence drag on growth ▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US & EMEA spreads have widening. ▪ Watching for upcoming disclosure in Q3 earnings and Q4 outlooks. Inflation, labor supply, low dispersion and monetary tightening remain headwinds pressuring margins and operating environment in 2H 2022. ▪ Technicals have continued to struggle with slow issuance, negative fund flows and poor liquidity	▪ M&A expected to slow; cash flow prioritizing shareholder payouts ▪ Market indigestion as central banks sell EMEA corporates ▪ Rate environment remains volatile ▪ Russian invasion worsens operating environment globally
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads have widened since August. Combined with greater downside risks, the group prefers conservative position while open to attractive buying opportunities. ▪ Technicals remain a headwind with light primary issuance and negative YTD fund flows, however default activity remains benign/idiosyncratic. Watching for Q3 earnings and outlook commentaries ▪ Bank loan market has moved lower from greater volatility and fund outflows, but seeing stable CLO formation and less new loan issuance; concerns about recession and interest cost remain headwinds	▪ Default concerns are focused on demand destruction, margin pressure and macro risks ▪ Loan technicals & flows weaken ▪ Global consumer health weakens ▪ Russian invasion & spillover ▪ Commodity prices continue to retrace
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage spreads have widened in past month to the cheapest level in a decade; valuations and long-term fundamentals pushed the group to upgrade Agency MBSCurrent coupon spreads near recent wides ▪ Headwinds as money manager demand is small relative to Fed, bank, REIT and overseas selling pressure ▪ Looking to add as preference shifts to high quality assets	▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Our preference remains for Non-Agency RMBS ▪ RMBS: Increase in mortgage rate creates headwinds for prepays and fundamentals. Delinquency performance remains strong, but housing is slowing. Reducing risk ▪ CMBS: Mostly solid fundamentals but weakening. Spreads flat MoM. Better relval in other sectors, continue to trim. ▪ CLOs: AAA spreads leaking wider as market deals with outflows. Default rate low but increasing. ▪ ABS: Lower income, renters, lower fico borrowers continue to underperform. Higher quality borrowers' performance remains with expectations. Reducing exposure to inflation-sensitive borrowers	▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening, consumer retail/travel behavior fails to return to pre-covid levels ▪ Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS). ▪ SOFR deals slows CLO new issue ▪ Rising interest rates dent housing market strength
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Softs ▪ u/w Gold ▪ o/w Oil ▪ u/w Silver	▪ Global Recession

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