COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

9 January 2023

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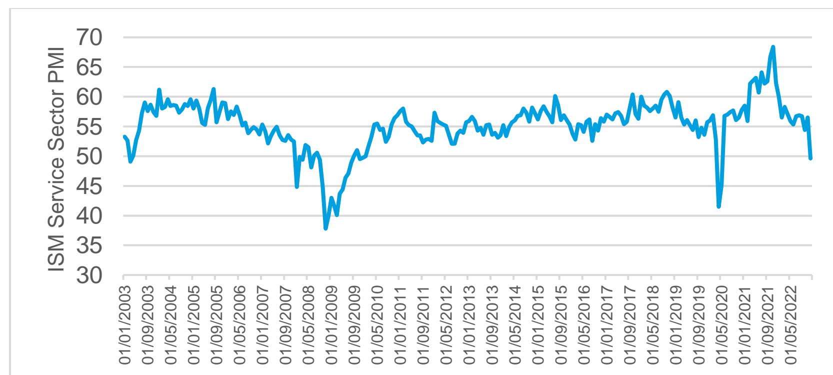
Off to the races.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index YTD return	Index 1 year return
US Treasury 10 year	3.57%	-31 bps	1.7%	-10.0%
German Bund 10 year	2.26%	-31 bps	2.0%	-15.4%
UK Gilt 10 year	3.51%	-17 bps	1.1%	-22.8%
Japan 10 year	0.51%	8 bps	1.4%	-5.1%
Global Investment Grade	149 bps	2 bps	1.5%	-12.3%
Euro Investment Grade	167 bps	1 bps	1.2%	-12.7%
US Investment Grade	140 bps	2 bps	1.8%	-12.6%
UK Investment Grade	160 bps	-1 bps	1.3%	-15.8%
Asia Investment Grade	214 bps	4 bps	0.7%	-8.2%
Euro High Yield	509 bps	-8 bps	1.1%	-10.8%
US High Yield	447 bps	-32 bps	2.3%	-8.6%
Asia High Yield	658 bps	-79 bps	4.1%	-8.3%
EM Sovereign	393 bps	18 bps	0.9%	-14.4%
EM Local	6.7%	-16 bps	1.3%	-9.7%
EM Corporate	355 bps	9 bps	1.1%	-10.8%
Bloomberg Barclays US Munis	3.4%	-19 bps	1.1%	-7.1%
Taxable Munis	4.9%	-32 bps	3.6%	-16.2%
Bloomberg Barclays US MBS	44 bps	-7 bps	2.1%	-9.2%
Bloomberg Commodity Index	238.91	-4.1%	-4.1%	9.6%
EUR	1.0716	-0.6%	-0.6%	-5.8%
JPY	131.93	-0.7%	-0.7%	-12.3%
GBP	1.2167	0.1%	0.1%	-10.6%

Source: Bloomberg, Merrill Lynch, as at 6 January 2023.

Chart of the week: US service sector business confidence



Source: Bloomberg, Columbia Threadneedle Investments, as at 9 January 2023.

5400978 Issued January 2023 | Valid to end March 2023

Macro / government bonds

It was a strong opening for government bonds after a weaker close to last year with yields plummeting across the board.

Last week, data wise we saw a greater reduction in eurozone headline inflation (energy led), strong employment data from the US (payrolls, initial claims and ADP) and a crash in service sector business sentiment in the US. Specifically, eurozone inflation fell to 9.2% year-over-year in December, from 10.1% in November and below estimates of 9.7%. Core inflation increased by 0.2%, to 5.2%, which was higher than estimates of a 5.0% increase. In the US, non-farm payrolls showed a 223k increase in jobs last month. The unemployment rate declined to 3.5%. However, there was a fall in wage growth and in hours worked and revisions lower in previous payrolls. The big surprise of the week was a collapse in the ISM Service Sector PMI into recessionary territory (less than 50). It came in at 49.6 from 56.5 last month and an estimation of 55 **(see chart of the week)**. Weakness was led by new orders and employment, followed by weakness in the manufacturing sector. All in all, this data meant that rate expectations were reduced with 'peak' Fed Funds seen as around 4.9% and lower by about 10bps last week.

This week's most important data release is Consumer Price Inflation from the US. It is expected to decline to 6.5% y/y (from 7.1% the prior month) and core inflation (less food and energy) to 5.7% y/y (from 6%).

Investment grade credit

Investment grade credit was broadly unchanged last week despite a deluge of issuance across financials (around three quarters of issuance) in euros and in the US dollar market. Issuance appears likely to continue ahead of earnings season blackout.

The market has rallied in both spread and total return terms since the 'dark days' of early October 2022. Indeed, spreads are over 25bps tighter for the Global IG Index (see 'markets at a glance') and yields are closing in on a 100bps point rally. This means that the Global index total return is now around 4.5% since the end of September last year in local currency terms. The euro market (last year's laggard) has led the rally.

Reporting season kicks off this week with several the major US banks (eg, JP Morgan) reporting before the weekend.

High yield credit & leveraged loans

US high yield bonds were supported over the first week of the year by limited new issue activity and declining US treasury rates. The ICE BofA US HY CP Constrained Index returned 2.28% and spreads were 32bps tighter. According to Lipper, the asset class reported a $2.2bn outflow for the week, continuing the prior year's trend which set the record for calendar year retail fund outflows at $47bn. Meanwhile, the J.P. Morgan Leveraged Loan index returned 0.52%, lagging the rest of fixed income given the rate driven nature of the week's rally. Loans saw their 20th consecutive weekly outflow with $587m withdrawn. 2022 loan retail fund net flows totalled $12.7bn.

European High Yield (EHY) finished 2022 with marginally tighter spreads for December (-6bps) but unchanged spreads (522bps) for the year in 2022. Still, the asset class posted a negative return for the month (-0.73%) and was basically flat for the last week of December (+0.03%) on the back of higher underlying government bond yields. Sterling High Yield outperformed EHY while BBs outperformed lower rated credits with CCC performing significantly worse in December. The new year started on a strong note for EHY with +1% performance for the first week as spreads tightened in 13bps with B's outperforming BBs and CCCs while Sterling High Yield underperformed EHY. Continuing the net positive inflow trend of December 2022, January start saw more investments coming back to the asset class, especially for managed accounts.

The trailing 12-month default rate for 2022 was only 0.4% for EHY, lower than most had forecasted as well as the lowest in the last 20 years. However, the recovery rate at 55%, though still higher than the long-term historical average, was sharply lower to the previous recent years (c80%). Expectations for 2023 are in the 3% (Fitch and JPM) range.

In sector news, UK autos posted strong sales figures for December (+18%); this was despite what is meant to be a weak UK market. European car sales also posted strong figures for December, especially in Germany (+38%). In retail, both B&M and NEXT reported strong trading figures. The airline sector is also doing well with Ryanair upping its 2022 fiscal year outlook by 25%.

Structured credit

It was a big week for Agency MBS alongside duration-sensitive assets as the bond market broadly responded to more recessionary like data. The sector posted a 2.14% total return on the back of a 19bps rally in the 10-year US treasuries. 30-year bonds outperformed 15-year bonds, as did lower coupons. Mortgage spreads tightened with 30s now back to recent 6-month range lows. The supply/demand picture continued to shift resulting in stronger investor appetite as well. The slowdown in housing activity bodes well for Fed paydowns as does the demand from foreign investors on a weaker US dollar and lower hedging costs. In non-agency MBS, spreads tightened in 15-60bps as supply remained tight, which was a consistent theme in CMBS as well.

Asian credit

The reopening story in China continues to be in the spotlight. The country has lifted quarantine requirements for inbound travellers, while on 8 January the mainland-Hong Kong border was reopened. The Spring Golden Festival and Lunar New Year holidays will officially start on 21 January 2023, marking the first spring holiday season without domestic travel restriction since 2020.

The Chinese regulators are reportedly planning to ease the three red-line policy for property developers, according to Bloomberg. As background, the three red-line policy was introduced in August 2020, which imposed constraints on the financial profiles of the property developers, based on three ratios: leverage, gearing and liquidity. The property developers were given a grace period of three years, up to June 2023, to meet all three ratios. The government is now considering easing the borrowing caps of certain property companies and to extend the grace period by at least six months. Additionally, China is also expanding some measures to support

home buyers directly. Mortgage rates for first-home buyers will be lowered if newly constructed house prices drop for three consecutive months. The local government in the cities have the leeway in making adjustment to those mortgage rates.

S&P has removed the credit watch negative outlook for Sands China and Melco Resorts. The favourable ratings action is driven by the rapid easing of covid control measures in China. For gross gaming revenue, S&P expects the mass GGR to recover to 60%-70% of 2019 levels. The recovery is likely to be gradual in the first few months due to the high covid infection rate. However, the recovery should be more significant in second half.

Emerging markets

A fall in US treasury yields contributed positively to the return of emerging market hard currency assets over the week. The index posted +0.88% with spreads widening 18bps, mostly coming from the investment grade sub sector because of lower core rates, as well as an increase in supply from higher quality names. For example, last week we saw new issuance from Indonesia, Mexico and Hungary, a sign of improving sentiment in the market.

In Brazil, supporters of former president Bolsonaro stormed congress, the presidential palace and the country's top court in attempt to trigger a military intervention. These efforts were unsuccessful, and Bolsonaro subsequently issued a statement (from Florida) condemning the riots. The unrest adds to the recent instability with Latin America following the ongoing protests and 30-day state of emergency in Peru following the impeachment of former president Castillo.

In Mongolia, the government is looking sell a US dollar denominated issue to repay near term 2023 and 2024 maturities following debt markets becoming more conducive. Mongolia faces substantial debt payments this year and is heavily aligned to China.

Commodities

The BCOM index has started 2023 in decline with anticipated macro weakness weighing on prices, epitomised by the IMF predicting one third of the global economy will enter recession in 2023. In contrast, China's pro-growth tilt with the easing of restrictions on movement and enhanced support for the property sector offer a tailwind. Turning to the supply side, the recent underinvestment in commodity production may offer respite for the asset class despite macro headwinds.

European natural gas prices have eased substantially over the festive period to trade at levels seen prior to Russia's invasion of Ukraine, the decline offers relief to energy intensive industries such as the chemicals sector. The sell-off was supported by unseasonably warm weather across Europe (to the detriment of the ski season) and EU measures such as gas consumption reduction targets. Gas storage levels are now around 10% higher than the 5-year average level for this time of year. In the US, gas prices declined 17.3% on the week to hit 18-month lows. US prices have also been suppressed by warmer weather alongside record shale production and continued delays to the re-opening of the freeport LNG export terminal. Copper has been a bright spot rallying 2.6% on the week and 4.7% year-to-date. On the demand side the re-opening of China has been key particularly given the scale of their decarbonisation efforts. On the supply side there's concern the ongoing protests in Peru (the world's second largest producer) and the 30-day state of emergency declared in mid-December will hit copper exports.

Responsible Investments

This time last year we were looking ahead to potentially another record-breaking year in ESG issuance. However, ESG bond issuance in 2022 did not exceed figures from 2021 and fell for the first time, around 22% according to Barclays. Sustainability-linked bonds fared worse, down 37% on 2021. This could be that investors are now more aware of the risk of greenwashing as numerous regulations were released throughout 2022, or that SLBs don't offer as much premium as green bonds do versus conventional corporate bonds. In addition to this, green bonds saw a smaller decline of 15% in issuance compared to 2021, while social bonds were down 11%.

According to Bloomberg, more money was raised in 2022 for climate-friendly projects than for fossil fuel companies, but although that makes a good headline it's not due to environmental based debt winning. Rather, oil and gas companies made more of what they needed from the surge in prices and private equity and did not need to raise debt in the capital market.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

9th January 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	▪ Valuations have become less attractive since November, technical and fundamentals moving sideways. **The group shifted negative on credit risk, downgrading Investment Grade and upgrading Structured Products and Emerging Markets.** ▪ We are past the peak of economic growth, with expectations for more 25bp hikes in 1H 2023, followed by multiple cuts in 2023. ▪ Uncertainty remains elevated due to fears surrounding recession probabilities, schedule of central bank hiking/easing, inflation, 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, 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)	¥ 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 tighter since last meeting; strong performance, even with in weaker credit quality names. ▪ 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 (outflows and supply) remain a headwind	▪ Chinese reopening paused – 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 continued tightening to less attractive valuations as fundamentals and technicals are unchanged. ▪ Fundamentals remain stable, have yet to see expected deterioration – may be a 2023 story. ▪ Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment. Waiting for Q4 results and '23 outlooks.	▪ 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 continued widening. Combined with greater downside risks, the group prefers conservative position while open to attractive buying opportunities. ▪ Technicals have started to improve with positive fund flows and no defaults in October. Light primary market ▪ Bank loan market has moved sideways: greater volatility and fund outflows are offset by stable CLO formation and less new loan issuance. Concerns about recession and interest cost remain headwinds. No defaults since September, calendar is opening for higher quality issuers	▪ 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: Higher mortgage rate is headwind for prepays, fundamentals and transaction activity. Delinquency performance remains strong, but housing is slowing. Risk premiums are attractive; moving to buy higher quality risk ▪ CMBS: Mostly solid fundamentals but weakening. Spreads attractive for historical CMBS, but better relval elsewhere. ▪ CLOs: Spreads modestly tighter, Mezz spreads firming along with macro. Default rate increasing. ▪ ABS: Lower income, renters, lower fico borrowers continue to underperform, higher quality borrowers remain stable.	▪ 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 fullsteam-ahead post-pandemic (positive for RMBS, negative for CMBS). ▪ Rising interest rates dent housing market strength and turn home prices negative in 2023
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Oil ▪ u/w Silver	▪ Global Recession

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