COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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Lower oil price fuels inflation optimism.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.56%	8 bps	2.1%	-11.7%
German Bund 10 year	1.91%	6 bps	1.8%	-13.9%
UK Gilt 10 year	3.18%	2 bps	5.6%	-22.2%
Japan 10 year	0.25%	0 bps	1.4%	-3.7%
Global Investment Grade	148 bps	-3 bps	4.7%	-13.1%
Euro Investment Grade	170 bps	-3 bps	3.6%	-12.0%
US Investment Grade	137 bps	-3 bps	5.2%	-14.1%
UK Investment Grade	165 bps	-2 bps	8.2%	-16.2%
Asia Investment Grade	218 bps	-14 bps	2.3%	-9.0%
Euro High Yield	531 bps	9 bps	5.6%	-11.0%
US High Yield	446 bps	-4 bps	5.5%	-10.0%
Asia High Yield	793 bps	-61 bps	9.7%	-15.6%
EM Sovereign	379 bps	-9 bps	8.7%	-15.5%
EM Local	6.8%	4 bps	7.4%	-12.6%
EM Corporate	362 bps	-18 bps	4.6%	-12.4%
Bloomberg Barclays US Munis	3.4%	-5 bps	4.7%	-8.0%
Taxable Munis	5.0%	5 bps	4.8%	-18.5%
Bloomberg Barclays US MBS	52 bps	8 bps	3.3%	-10.8%
Bloomberg Commodity Index	246.47	-2.3%	1.0%	14.7%
EUR	1.0527	0.0%	7.5%	-7.3%
JPY	137.37	-1.6%	6.0%	-15.7%
GBP	1.2259	-0.2%	9.7%	-9.4%

Source: Bloomberg, Merrill Lynch, as at 9 December 2022.

Chart of the week: Oil price (WTI), 2017-2022

Source: Bloomberg, Columbia Threadneedle Investments, as at 9 December 2022.

Macro / government bonds

After the recent surge higher in bond prices, the last week has been a period of rather more directionless trading.

US bond yields do, however, remain significantly lower since October, as real yields have fallen in the hope that present interest rate assumptions include enough of a premium. These rising government bond prices have also provided a steady base for credit markets to rally in an encouraging end to the year for total returns in fixed income.

Recent economic information has been fairly mixed. Markets are looking for emphatic signs that inflation has peaked (certainly possible) and the 5% 'terminal rate of interest' priced into markets need not be increased any further. Commodity prices which were one of the 'legs' upon which inflation fears were built have ebbed, with oil prices now lower by c40% since mid-year. For the US consumer, sentiment will likely be boosted by these falling gas prices but also by higher stock and bond prices. What will be less supportive is the gradual rise in jobless claims, which seems set to continue and was evidenced in last week's rising continuing claims news.

Against this background, the US Federal Reserve meets this week and will deliver another move higher in rates. The increase is likely to be limited to a 0.50% hike though rather than the 0.75% increases we have seen more recently. This will take the upper band of the policy rate to 4.5%. While rates continue to rise, financial conditions, with lower mortgage rates and credit spreads are moving in the opposite direction, which is undesirable from the Fed's perspective. We expect to see similar rate moves from the Bank of England and the European Central Bank. We also get CPI inflation data in the US and PMI data globally.

Investment grade credit

Investment grade credit is enjoying a 'Santa Claus' rally with spreads now nearly 40bps tighter since the 'dog days' of mid-October. This means that the global index has posted a return of over 6% since that date according to data from ICE bond indices.

The attraction of the asset class includes a significant income premium compared to last year (when yields were below 2%), as well as credit spreads that are wide of long-term norms. The market is also being supported by inflows from clients ahead of year end, light levels of new issuance and bond tenders. These actions have seen companies such as AB InBev and Glaxo Smith Kline buy back their own debt. This action may seem, on the face of it, surprising given higher yields and wider spreads but it seems many companies have excess cash, want to delever ahead of an expected recession and can buy back long-term debt at very low cash prices (given the fall in prices this year). We also hearing that dealer inventories are light, hence market liquidity remains challenged on the 'offer side' at present.

In stock specific news Amgen the US biotechnology giant seems likely to have bought Horizon Therapeutics in a $26bn deal; this would be the largest deal for the US firm.

High yield credit & leveraged loans

US high yield bond yields rose modestly over the week alongside a 2.6% loss in the S&P 500 and double-digit percentage point decline in oil prices as investors await next week's US CPI and Fed meetings. Primary markets also priced the first transaction in December (Chart Industries - $2bn). The ICE BofA US HY CP Constrained Index returned -0.11% and spreads were 4bps tighter. According to Lipper, retail high yield funds saw their sixth consecutive weekly inflow, albeit a modest +$66m. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index declined $0.12 to $93.02 amid steady outflows. Retail loan funds saw $408m withdrawn, marking the 16th consecutive weekly outflow.

European High Yield (EHY) experienced another week of spread widening as well as a reversion of the positive performance of the previous 1.5 months. The asset class posted its first negative return week, since early October, with a -0.37% as spreads widening another 9bps to 531bps as yields rose 0.14% to 7.58%. EHY underperformed sterling high yield as some decompression was seen with BBs outperforming lower-rated credits. The asset class saw a continued pick up of inflows (€234m), its fourth straight week and the largest size of the year, largely due to ETFs. The corporate primary market saw the strongest weekly issuance seen in many months (€1.5bn) as issuers rushed to bring new issues to the market before Christmas. Issuers included Iliad, French telecoms, (€750m) Intrum, debt collectors, (€450m), 888, gaming, (€332m tap of the July issue) and PHM, Finnish property management, (€70m floater). Bonds generally priced well inside initial price talk and continued to perform well after the launch.

Corporate reporting season is finally coming to a close with results confirming the theme that financials numbers are still coming in fairly well but a weakening in demand has been noted.

In stock specific news, Adler Group came out with a press release saying that more than 60% of bond holders have acceded to the lock-up agreement and with the passing of this threshold the group will be able complete the amendments to the bond documents "using an alternative implementation route" if the required 75% consent is not received for all bonds in the upcoming solicitation. S&P downgraded the issuer to CC- from CCC, viewing the proposed transaction as "tantamount to a default because it contradicts the original promise of the bond". (A bond is in default when it is called by the custodian not by a rating agency). In other negative news, Teva, the Israeli healthcare company is back in the news with another lawsuit: anti-trust case, this time, on accusations of collusion.

Structured credit

It was a tougher week for high-quality fixed income sectors. Returns were negative across the board including the US Agency MBS market, down 69bps, underperforming the Bloomberg US Aggregate Bond Index. Rates were higher across the curve and the slight bear steepener allowed 15-year mortgages to outperform. Prepay speeds continue to slow, declining 17% in November for 30-year conventional mortgages; a level not experienced since 1995. Further Fed tightening is still expected over the next couple of meetings, which will likely slow prepays further. Spreads widened week over week with no clear catalyst as to why. In secondary non-agency RMBS, spreads tightened between 1-10bps across most sub-sectors on light supply. New issuance was non-existent. In commercial real estate, prices are up 7% y/y, which is down

from peak growth of +20% y/y in January. Office and retail are feeling the brunt of the decline as lending standards are at the third tightest levels on record.

Asian credit

EGMR Hyderabad is planning to issue up to INR12bn of 10-year bonds to implement the partial tender offer for its two US dollar bonds (‘24s and ‘26s). Given the relatively higher costs of offshore financing and currency hedging, Indian issuers are looking at onshore issuances / domestic loans to partly refinance offshore debt.

In China, with the ongoing easing of covid restrictions, Chinese officials are now downplaying the risk of a covid-19 restriction with Mr Zhong Nanshan (a leading medical adviser to the Chinese government) stating that the omicron fatality rate of 0.1% is line with that of influenza. He also stated that the covid-19 infection wave in Guangzhou will likely peak between January and mid-February 2023 with a potential return to pre-pandemic conditions in H1,23.

In the Chinese property sector, Sunac is one of the first major developers to propose its debt restructuring plan that includes the conversion of around $4bn of $9.1bn of offshore debt to ordinary shares or equity-linked instruments. The remaining amount will be exchanged to new US dollar bonds with maturities of around 2-8 years and a suspension of coupon payments for two years. The $9.1bn amount does not include certain secured offshore debt, which was obtained via bilateral arrangements. According to Sunac, there was not substantial change to the amount of interest-bearing debt as of H1,22 compared with that at end-2021. The principal amount of the offshore interest-bearing debt was around $11bn, including bilateral loans and around $3.7bn of debt with original maturity before end-2022

Emerging markets

Emerging market hard currency sovereign returns were broadly flat for the week with spreads 9bps tighter. Distressed names such as Ghana, Sri Lanka and Pakistan had a poor week.

Peru was the main story of the week as President Castillo was impeached and removed from power after he attempted to dissolve parliament. His VP Dina Boluarte has taken the helm as president. Elected only last year in a tightly fought contest, the President had already faced two impeachment attempts. Peruvian bond spreads initially widened but snapped back owing to the country’s strong fundamentals despite the ongoing political instability.

A busy week for central bank meetings where we saw more policy makers pausing their hiking cycles; Chile, Brazil and Poland all held rates. There were hikes in Peru and India.

In Brazil, President Lula named left-wing loyalist Haddad as finance minister. Haddad is seen as market unfriendly as he’s likely to pursue looser fiscal policy, supporting Lula’s multi-billion dollar plan. The plan aims to boost social spending, including a budget carve out for welfare spending, a minimum wage hike and greater funds for healthcare.

China is paving the way for allowing higher covid cases as they re-open. Officials have continued playing down the severity of the Omicron variant, citing the death rate at 0.1%, similar to flu, and that most people recover within 10 days. Elsewhere China issued a plan to enhance

medical facilities to protect people in rural areas from rising cases. Hong Kong has also now reduced the isolation period for covid patients from seven to five days.

Elsewhere, we got news of a Dutch plan to limit exports of equipment making advanced 14 nanometre chips to China. The measure is part of a deal with the US, which has been stepping up pressure on the Chinese chip industry following this summer's "CHIPS" act.

Commodities

In energy, WTI dropped to $71 a barrel, the lowest level in 2022 (**see chart of the week**). The decline has been supported by the recently agreed EU oil price cap at $60 and a declining demand outlook for 2023. Elsewhere, the recently announced OPEC+ cut of 2m barrels per day has not been that deep on the face of it and is only amounting to a 1m cut in reality, due to nations such as Angola and Nigeria failing to hit their quotas.

In the US the keystone pipeline has been halted following a leak that spilled over 14,000 barrels of crude in Kansas. The pipeline typically moves 622k barrels a day and its closure has hampered deliveries of crude from Canada to Cushing storage facilities and to refiners on the Gulf Coast. Turning to Europe, natural gas prices were steady on the week despite colder temperatures in northern Europe. Utilities benefited from a milder autumn allowing them to top up their gas supplies.

Responsible investments

Last week one of the world's largest asset managers Vanguard controversially departed from the Net Zero Asset Managers initiative. It's reported this is due to the overwhelming political pressure from US Republians making comments around banks and asset managers being deemed unfriendly toward the fossil-fuel industry. Vanguard has said it "won't affect our commitment" to helping investors "navigate the risks that climate change can pose to their long-term returns", and that their index-fund business made things complicated.

The UK government has consulted on changes to the current ban on new onshore wind turbines in England. A relief of the ban would be subject to new wind farms deomonstrating support for local areas, be solely under the remit of the local councils and would still have measures in place to stop wind turbines in protected areas of the country, national parks, greenbelt etc. Consultation has begun and will conclude in April 2023.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

12th December 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 (■ at 0)	▪ Valuations have become more attractive since October, as volatility came off 2022 highs and signs of improvement came from technicals and fundamentals. The group is now neutral on credit risk, upgrading Investment Grade and High Yield. ▪ We are past the peak of economic growth, with expectations for more 50bp hikes through 2H 2023, followed by multiple cuts in 2023. Pullback in liquidity created opportunity for market volatility. ▪ 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)	Short -2 -1 0 +1 +2 Long (¥ at -1, P at 0, $ at +1; € at 0, £ at +1)	▪ 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)	Short -2 -1 0 +1 +2 Long (¥, A$, EM at 0; $, €£ at 0)	▪ 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))	Under-weight -2 -1 0 +1 +2 Over-weight (R at +1; C at 0)	▪ 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 (■ at -1)	▪ EMD spreads tighter since last meeting; continued outperformance in HY, high-beta credits ▪ 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 ▪ Technicals (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 (■ at 0)	▪ US & EMEA spreads have tightened since October. ▪ 3Q earnings met and management commentary exceeded expectations. Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment. ▪ Technicals have started to improve, with the long end outperforming the widening in spread terms	▪ 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 (■ at -1)	▪ 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 (■ at +1)	▪ 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 (■ 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 are attractive; moving to buy higher quality risk ▪ CMBS: Mostly solid fundamentals but weakening. Spreads at summer lows. Better relval elsewhere, continue to trim. ▪ CLOs: AAA spreads modestly tighter, Mezz spreads firming along with macro. Default rate low but 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
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight (■ at +1)	▪ o/w Copper ▪ o/w Softs ▪ u/w Gold ▪ o/w Oil ▪ u/w Silver	▪ Global Recession

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