Information for investment professionals

In Credit

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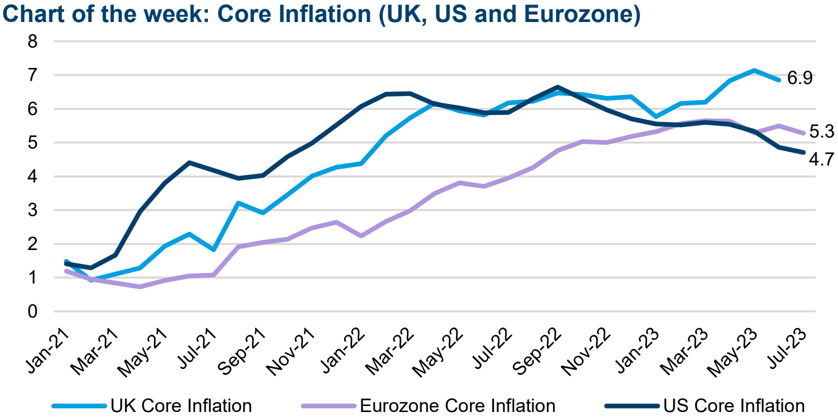
Inflation jigsaw not falling into place

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	4.19%	15 bps	-1.6%	0.0%
German Bund 10 year	2.63%	6 bps	-1.1%	0.1%
UK Gilt 10 year	4.53%	15 bps	-1.2%	-5.0%
Japan 10 year	0.61%	-4 bps	-1.8%	0.9%
Global Investment Grade	131 bps	0 bps	-0.5%	2.2%
Euro Investment Grade	149 bps	1 bps	0.6%	2.7%
US Investment Grade	122 bps	0 bps	-1.1%	2.1%
UK Investment Grade	129 bps	-1 bps	1.2%	0.1%
Asia Investment Grade	196 bps	0 bps	0.3%	3.4%
Euro High Yield	455 bps	-7 bps	1.2%	5.6%
US High Yield	383 bps	-18 bps	1.1%	6.6%
Asia High Yield	913 bps	41 bps	-2.7%	-2.9%
EM Sovereign	336 bps	-12 bps	0.5%	4.3%
EM Local	6.3%	-2 bps	0.9%	8.7%
EM Corporate	323 bps	-11 bps	0.7%	4.3%
Bloomberg Barclays US Munis	3.7%	-6 bps	-0.4%	2.2%
Taxable Munis	5.3%	11 bps	-2.6%	2.3%
Bloomberg Barclays US MBS	57 bps	2 bps	-1.7%	0.1%
Bloomberg Commodity Index	236.30	-0.2%	4.7%	-3.5%
EUR	1.0895	-0.5%	0.4%	2.3%
JPY	145.41	-2.2%	-0.5%	-9.6%
GBP	1.2643	-0.4%	-0.1%	5.1%

Source: Bloomberg, Merrill Lynch, as of 11 August 2023.

Chart of the week: Core Inflation (UK, US and Eurozone)



Source: Bloomberg and Columbia Threadneedle Investments, as of 11 August 2023.

Macro / government bonds

There is a prevailing narrative in the market that we are approaching terminal rate levels and that central banks will be in a position to start cutting rates from next year. Last week the pieces of the macro jigsaw did not fall into place. At its last meeting, the Federal Reserve said it was awaiting data on inflation and the labour market which would help determine the future direction of monetary policy. It was a dovish message that favoured economic downside surprises. US Core CPI for July came in at 4.7% **(see Chart of the Week)** – although marginally lower than the previous reading of 4.8%, it was still elevated.

The cloud of US macro uncertainty was reflected through comments from both voting and non-voting members of the Fed. While some conceded that interest rates could remain unchanged at the next meeting, provided there were no economic upside surprises, others argued there was still more work to do on inflation. The core CPI figure appeared to justify the latter view, undermining investor confidence in new US Treasury longs. From a technical perspective the market also had to absorb $103 billion in new issuance. While the auctions at the three- and 10-year tenors drew robust demand, that of the 30-year was less well received. The increased level of issuance fed concerns that, especially for longer dated tenors, expansive fiscal policy in the US would be inflationary, making it ever harder to get back to the 2% target. Although US Treasury yields edged higher there was no breakout from the current trading range.

In the UK, gilt yields also came under pressure. Previously some softening in the inflation numbers had led to a rally in the gilt market, with even the governor of the Bank of England, Andrew Bailey, arguing that a further rate rise was not a done deal. Data once again highlighted the resilience of the UK economy. Monthly real GDP was estimated to have grown by 0.5% in June, following a fall in April, while quarterly GDP came in stronger than expected, growing 0.2% in Q2. The UK statistics agency, the ONS, explained the rise through strong household and government consumption. The Q2 2023 figure was the strongest level of quarterly growth since Q1 2022. Elevated levels of consumption did not dovetail with the narrative of slowing inflation. The market cast its verdict on what the data meant, and gilt yields edged higher.

Investment grade credit

It was a quiet week in investment grade, with very little spread movement. Spreads across core markets continue to coast around their five- and 20-year averages. Issuance also remained quiet in Europe, and like last week the US had the most to offer in new corporate issuance.

Results season continued with several insurance companies releasing strong results despite the increase in natural disaster pay outs. Profitability remains strong with balance sheets looking reasonably healthy.

UBS has said “thanks, but no thanks” to the Swiss government safety net of the riskier Credit Suisse assets it bought almost five months ago. After months of due diligence, a UBS taskforce decided not to retain the $10.3 billion loss protection agreement it had with the government, meaning it has more control over what it does with the non-core part of the business. It’s a good indication towards the financial strength and confidence of Switzerland’s biggest bank ahead of the delayed Q2 earnings report.

High yield credit & leveraged loans

US high yield valuations tightened over the week as investors absorbed an increase in capital market activity, mixed earnings, and a CPI report consistent with a broad trend in moderating inflation. The ICE BofA US HY CP Constrained Index returned 0.34% and spreads were 19bps tighter. According to Lipper, the asset class reported its third consecutive retail fund outflow with $559 million withdrawn over the week.
Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index rose modestly over the week and is only $0.15 below July’s year-to-date high, with the past week’s focus on refinancing activity and better-than-feared earnings. Retail loan funds saw $182 million withdrawn.

European High Yield (EHY) returned to positive performance combined with a return of compression. The asset class returned 19bps for the week, with spreads tightening 7bps to 455bps, with yields 2bps lower at 7.74%. CCCs and Bs strongly outperformed BBs at +86bps and 51bps respectively. Sterling HY underperformed EHY. The primary market remained close even as talk continued of upcoming issuances once summer holidays are done. The positive performance of the week came even as the asset class saw its largest outflows (€320 million) in a number of weeks. Funds exited via both ETFs and managed accounts.

In credit rating news, Rolls Royce was upgrade to BA2 by Moody's.

In stock-specific news, Patrick Drahi, founder and major shareholder of Altice, spoke to investors at the start of the week, re-assuring them that the corruption allegations are isolated to a small number of individuals. He referred to a focus on reduction of leverage, reducing the debt of Altice France, with the potential of disposals as one lever. "Whatever it takes in due time and in the right manner," he said. Reporting showed Altice International beating expectations while Altice France reported weak numbers, as expected with EBITDA down 5.7%.

For Telecom Italia there was more positive news regarding KKR's bid. The firm confirmed the Italian economic ministry has reached an agreement where Italy will get up to 20% of the NetCo as well as a key role in strategic decisions. Probability of a deal closing has greatly improved.

Structured credit

Despite inflation data which was largely in-line with expectations, rates sold off on myriad other concerns including deficit funding supply, the Bank of Japan's yield curve policy change and the Fitch downgrade. General malaise offset dovish CPI news and took quality assets into negative total return territory. The US Agency MBS sector was not immune, generating a negative 78bps on the week. Elevated hedging costs for overseas investors, coupled with reduced bank appetite, has put the focus on money managers to pick up the slack. Fortunately, supply remains constrained with mortgage rates now tipping towards 8%.

In last week's performance, 15-year agency MBS outperformed 30s and higher coupons outperformed lower coupons as the curve steepened. Spreads pushed wider across the stack, although valuations remain cheap relative to investment grade corporates. In non-agency MBS issuance was light and well bid. While CRT spreads were wider by 5-20bps, other sectors were largely unchanged. CMBS news swirled on WeWork's solvency. Additionally, 28 bonds across seven deals were downgraded.

Asian credit

Deloitte has resigned as the statutory auditor of Adani Ports & SEZ (APSEZ). Earlier in May, Deloitte issued a qualified audit opinion on certain potential-related party transactions in APSEZ. According to APSEZ, Deloitte also indicated a lack of a wider audit role as auditors of other listed Adani portfolio companies. While APSEZ appointed MKSA, an independent member firm of BDO International, as its statutory auditor, the resignation of Deloitte continues to underscore the governance overhang.

The three-month probe by the Securities and Exchange Board (SEBI) on Adani Group is scheduled to be concluded on 14 August, albeit SEBI is reportedly requesting an additional 15 days from the Supreme Court. The investigation is on potential breaches of stock exchange regulations such as the MPS (minimum public shareholding) of 25% other financial violations.

Moody's cut the ratings outlook of AAC Technologies from stable to negative but affirmed the Baa3 rating. This came on the back of the company's proposed acquisition of Acoustics Solutions International BV, with a first-tranche payment of $320 million for an 80% stake. This will weaken AAC Technologies' financial buffers and comes with execution risks. The Baa3 rating is affirmed because the proposed acquisition will improve the end-market diversification and there are potential strategic synergies over the next 12-24 months. Additionally, AAC has a track record of maintaining a solid capital structure and liquidity position.

Country Garden announced a profit warning for 1H23 with a net loss of CNY45-55 billion due to a decline in gross profit margin, impairment and foreign currency losses. It also reportedly appointed CICC as financial advisor for its public bonds. Moody's also downgraded Country Garden by three notches from B1 to Caa1 in light of missed USD-bond coupon payments.

Emerging markets

Emerging market hard currency sovereign spreads were 12bps tighter over the week, led by distressed names including Ukraine where there has been renewed optimism over the growth outlook. The move higher in US treasuries was negative for the EM index return, but coupled with tighter spreads the overall return was 0.15%.

Whilst we have seen rate cuts in Latin America over the past few weeks from Chile and Brazil, central bankers in Mexico and Peru voted to hold rates at 11.25% and 7.75% respectively.

In Argentina, the first round of the presidential election delivered a shock with right wing populist candidate Javier Milei emerging as front runner. Milei's economic policies include sharp spending cuts and replacing the struggling Argentine Peso with the US dollar. The electorate's shift to a non-conventional candidate is illustrative of the frustration following years of mismanagement, rising poverty and IMF bailouts. Inflation is currently running in excess of 100% with Argentina having to secure a $775 million loan from Qatar to repay IMF interest. Argentina's 2030 dollar bonds dropped by 4 points to 26 cents on the dollar following the result.

Commodities

The BCOM index delivered modest losses of -0.2% on the week. Industrial metals were the biggest losers (-3.6%) following deteriorating news from China (particularly developer Country Garden). The energy complex rallied by 3.1% on aggregate.

Outside the BCOM index, European natural gas rallied 20% following news of impending Industrial action at LNG plants operated by Woodside Energy and Chevron. This is likely to take place towards the end of August and could last for months. Whilst Australian LNG usually goes to Asian buyers, a supply shock would likely cause more competition for LNG that is typically bound for Europe. The impacted plants account for an estimated 10% of global LNG supply. Despite future supply concern, European gas storage currently stands at a healthy 89% of capacity following muted demand. European companies are also shifting large volumes of gas to Ukrainian storage facilities despite the ongoing war.

Grains declined 1.5% on the week following a mildly bearish USDA report. Wheat ending stocks were revised upwards on expectations of lower demand and exports.

Responsible investments

Temperatures continue to soar with wildfires becoming almost an everyday occurrence in the news. Maui, an island in Hawaii, is the latest to be ravaged by deadly wildfires with the death toll near 100. Typically, the dry spells in Hawaii cause smaller wildfires that are controlled by rainfall, but recent extended dry weather and growth of non-native grasses were the perfect condition for a blaze when a supercharged hurricane off the south coast fanned fires, spelling disaster for the small island.

A good reminder that "greenwashing" is still prevalent could lie with a recent Blue Bond (a green bond issued to protect marine life) issuance from African nation Gabon. The issue came to the market last week with some investors worried about both the use of proceeds and the financial strength of the issuer itself. The bond was arranged by Bank of America which raised the yield to entice investors, but the credibility of the issuer and what the money was going to be spent on worried a few initially interested buyers.

Fixed Income Asset Allocation Views

14th August 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 tightened recently but remain wide of February's market. Technicals have stabilised, fundamentals remain a headwind. **The Group stands neutral on Credit risk overall favouring higher quality sectors.** ▪ The Fed Funds market is pricing in a peak of 5.4% and rates being cut to 5.4% in 2023. This market has been volatile, with the first full cut not priced until 2024 ▪ The CTI Global Rates base case view is no cuts in 2023, with one or two more cuts before holding to end the year. Focus remains on wages, financial conditions, and inflation expectations. ▪ Uncertainty remains elevated due to pullbacks in lending surrounding banking crisis, monetary policy schedules, recession probabilities, persisting inflation, weakening consumer profile and ongoing geopolitical tension.	▪ Upside risks: the Fed achieves a soft landing with no labour softening, banking crisis eases with no lasting changes to fundamentals, consumer retains strength, end of Russian Invasion of Ukraine ▪ Downside risks: additional bank failures, simultaneous low unemployment, high inflation, hiking and slowing growth cause a recession. Russian invasion spills into broader global/China turmoil. Supply chain disruptions, inflation, volatility, commodity shocks reemerge.
Duration (10-year) ('P' = Periphery)	¥ $ Short -2 -1 0 +1 +2 Long P € £	▪ 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	▪ 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)	EM A$ ¥ Short -2 -1 0 +1 +2 Long €$£	▪ 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))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ EM central banks slowing or terminating hike cycles ▪ Sharply reduced Fed expectations may permit EMFX strength ▪ EM real interest rates relatively attractive, curves steep in places	▪ Severe US recession and/or financial crisis drives stronger US dollar and portfolio outflows from EMD ▪ Sticky global inflation or wage/ price spiral keeps EM interest rates higher for longer ▪ Structurally higher global real rate environment subdues risk assets
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ EMD spreads continue tightening, with destressed credits leading the rally. Technicals have stabilised. ▪ Maintaining conservative positioning, opportunities at idiosyncratic level, but prefer local to hard currency. ▪ Tailwinds: Central bank easing in less inflationary countries, IMF program boost for distressed names. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical risks, domestic political uncertainty.	▪ China/US relations deteriorate; China reopening stall. ▪ Issuance slows ▪ Spill over from Russian invasion: local inflation (esp. food & commodity), slow global growth. ▪ Persisting COVID growth scars hurt economies & fiscal deficits
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US and EMEA spreads have tightened since last month; with fundamentals mixed versus pre-COVID. EUR valuations are cheap, prefer USD and EUR to sterling ▪ YTD net issuance greater than last year, held back most by financials, but expect to pick up in 2H23. Focus on earnings, and gauging credit metrics admid recession uncertainty. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, weaker consumer, recession concerns.	▪ Costlier funding and tighter lending standards from bank crisis ▪ Volatility remains high and 2023 supply is below expectations. ▪ Market indigestion as central banks sell EMEA corporates ▪ Rate environment remains volatile ▪ Geopolitical conflicts worsen operating environment globally
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads continue to tightening with valuations inside historic medians. Unchanged fundamentals and technical ▪ Prefer conservative position while open to attractive buying opportunities, especially in short HY & BB's. ▪ US HY defaults higher than last year but still at reasonable levels, possibly normalising to historic trends. ▪ Bank loan market has widened along with other credit sectors. Themes: retail fund outflows, rising defaults, limited issuance, credit concern in lower quality loans	▪ Costlier funding and tighter lending standards from bank crisis ▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ▪ Rising stars continue to outpace fallen angels, shrinking HY market ▪ Rally in distressed credits, leads to relative underperformance
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index tightening from last month but remain wide of historic levels, the group sought to capitalise recent outperformance. ▪ Supply below expectations from rates but improving with seasonals. Liquidation of failed banks better than feared. ▪ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon	▪ Costlier funding and tighter lending standards from bank crisis ▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates ▪ Fed continues to shrink position
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Our preference remains for quality Non-Agency RMBS ▪ RMBS: Home prices resilient despite headwinds. Delinquency, prepayment, and foreclosure performance remains strong; need labor market weakness to see housing deterioration. Risk premiums still cheap to LT avg. ▪ CMBS: We feel cautious, especially on office and multifamily. Credit curve is very steep; non-office sectors remain stable. Delinquencies increasing as maturities come due and floating rate debt becomes more expensive. ▪ CLOs: Spreads have tightened since June. Downgrades outpacing upgrades. More tail risks for subordinate bonds. 2023 supply estimate revised lower. ▪ ABS: Attractive relval in some senior positions; higher quality borrowers remain stable. Market is active	▪ Weakness in labour market ▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening. Consumer (retail/travel) behaviour fails to return to pre-covid levels ▪ Rising interest rates dent housing market strength and turn home prices negative in 2H23. ▪ Cross sector contagion from CRE weakness.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Soybean Meal ▪ o/w Oil ▪ o/w Lead	▪ Global Recession