In Credit

15 May 2023

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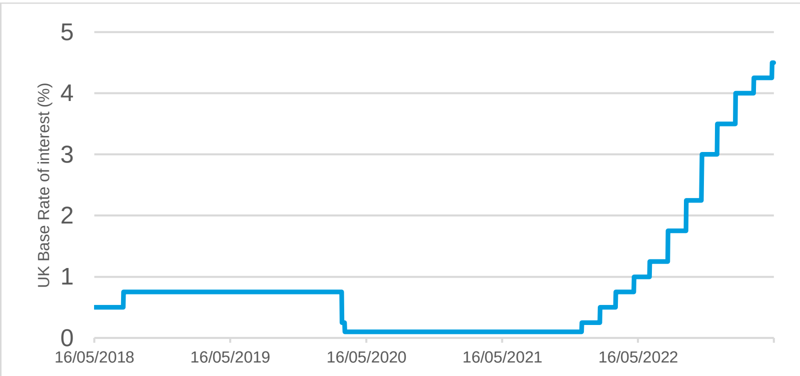
Living on the ceiling.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	3.41%	-3 bps	0.4%	3.5%
German Bund 10 year	2.26%	-3 bps	0.4%	1.9%
UK Gilt 10 year	3.76%	-2 bps	-2.5%	-0.3%
Japan 10 year	0.39%	-3 bps	0.3%	2.6%
Global Investment Grade	154 bps	0 bps	0.5%	3.3%
Euro Investment Grade	167 bps	1 bps	0.9%	2.5%
US Investment Grade	149 bps	1 bps	0.2%	3.7%
UK Investment Grade	145 bps	-1 bps	-0.1%	2.2%
Asia Investment Grade	235 bps	14 bps	1.6%	3.9%
Euro High Yield	508 bps	1 bps	0.7%	3.6%
US High Yield	481 bps	4 bps	0.5%	4.3%
Asia High Yield	830 bps	35 bps	-3.0%	-0.2%
EM Sovereign	405 bps	-1 bps	0.6%	2.9%
EM Local	6.5%	3 bps	1.0%	6.2%
EM Corporate	381 bps	1 bps	0.8%	3.1%
Bloomberg Barclays US Munis	3.3%	0 bps	0.2%	3.0%
Taxable Munis	4.7%	4 bps	0.8%	6.2%
Bloomberg Barclays US MBS	61 bps	1 bps	0.3%	2.9%
Bloomberg Commodity Index	226.68	-1.6%	-3.5%	-8.7%
EUR	1.0887	-1.5%	0.1%	1.3%
JPY	134.91	-0.7%	-2.1%	-3.4%
GBP	1.2504	-1.4%	1.0%	3.1%

Source: Bloomberg, Merrill Lynch, as of 12 May 2023.

Chart of the week: UK interest rates, last five years.



Source: Bloomberg, Columbia Threadneedle Investments, as of 15 May 2023.

Macro / government bonds

Core government bond yields have been range bound since mid-March. The benchmark US 10-year note has been trading within a 3.3%-3.6% range through the period. Markets continue to ‘hope’ that the interest rate cycle is over yet worry about still high levels of inflation.

This week will be light in terms of data releases with the UK employment report the most important piece of economic news. In the US, President Biden will meet congressional leaders on Tuesday to try and resolve the debt ceiling issue before his trip to Japan.

Last week, the University of Michigan released data that showed inflation expectations had reached a cycle high at 3.2%. The UK economy grew by 0.1% in 2023 after a weak March (-0.3%). The Bank of England completed its 12th increase in interest rates, raising the base rate to 4.5%, which was a 0.25% increase and in line with forecasts **(see chart of the week)**. In the US, Consumer price inflation rose 0.4% m/m, which was also in line with expectations and took the annual rate lower again to 4.9%. Core inflation also rose 0.4% m/m (expectations 0.3%) to 5.5%. Lastly, small business confidence in the US reached a 10-year low.

Investment grade credit

Credit spreads drifted a little wider through the week. The global index ended the week with a spread of 153bps. For context, this a little higher than the long run average of around 140bps.

Financials, which have been weak given the turbulence in US regional banks, outperformed last week – though this was driven by an elevated level of new issuance in the corporate area of the market. Euro IG non-financial supply, for example, was around €15bn last week, which is the largest amount of issuance in over a year according to data from Morgan Stanley.

We are nearly three quarters of the way through results season, which have generally come in line or ahead of expectations. Banks continue to enjoy higher net interest margins, high capital and low cost of risk.

High yield credit & leveraged loans

High yield returns and valuation changes were muted over the week amidst better-than-feared earnings and thawing capital markets.

The ICE BofA US HY CP Constrained Index rose 0.01% and spreads were unchanged. According to Lipper, the asset class reported a $1.2bn retail fund outflow over the week. YTD outflows total $11.2bn. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index declined modestly (-$0.12) for the fourth consecutive week. Retail loan fund outflows reaccelerated with another $727m withdrawn, the largest outflow in eight weeks. YTD outflows total $15bn.

It was a sideways week, finishing with a slightly firmer tone for European High Yield (EHY) as spreads and yields held their ground, closing in 3bps tighter in both cases with the asset class returning +18bps. This was in spite of a heavy primary week, the busiest YTD, with around €3.64bn equivalent in new issuance. Altogether, there were six new offerings in euro and US dollar tranches from names like O-I Glass (glass packaging), Dana (automotive parts), and Engineering (Italian technology services). These were well received by the market. Flows though, turned negative again, largely due to managed accounts, including short duration accounts (up to now, one of the few strategies that had inflows). Still, compression also returned to the market as CCCs strongly outperformed BBs and Bs.

In credit rating news, a number of changes were announced by the rating agencies. On the negative side, Casino, the French retailer, was downgraded two notices to CCC- by S&P who cited weak operating performance, liquidity issues and an unsustainable capital structure making “default, distressed exchange or redemption” appear inevitable within the next six months. Another downgrade SBB, the Nordic real estate firm, was downgraded to BB+, becoming the latest Fallen Angel to enter the EHY universe for its senior bonds. Its subordinated bonds were pushed down to B+.

In sector news, healthcare names are showing some weakness in the latest earnings reports. Teva reported a weaker Q1 impacted by inflation and the headwinds from a strong US dollar. Also, there was weakness in telcos with Liberty Global posting lower EBITDA for Q1, 2023, driven by delayed pass throughs as increased costs pushed leverage higher. Some industrial markets are suffering from destocking and the slower than expected reopening of the Chinese market. In more positive news, sectors performing strongly and showing good earnings figures are autos, aerospace, and leisure.

Asian credit

TSMC Melco Resorts (MPEL) and its subsidiary Studio City reported positive business momentum in Q1, 2023 with MPEL’s EBITDA recovering to $177m (Q4, 2022: negative $20m), which is equivalent to around 44% of the 2019 level. For Studio City, the Q1,2023 EBITDA was $21m (Q4, 2022: negative $25m), equivalent to around 22% of the Q1, 2019 level. MPEL expects that at least 20-25% of the savings achieved during the Covid period will be permanent. The support from the banking sector to the Macau gaming sector continues to be strong. Sands China Ltd has extended the maturity date of its unsecured revolving facility by two years to July 2025. The company has also obtained several covenant relaxations with regards to the definition of consolidated total debt and leverage ratios.

In Thailand, the preliminary vote count, with more than 95% of total votes accounted for, showed that the opposition has won the election. The Move Forward (MF) party won the highest number of seats in the Parliament, contrary to pre-election polls that had suggested that Pheu

Thai (PT) would be the winner. The market will watch whether MF will be able to lead a coalition, together with PT, to establish the next government.

Thai Oil delivered a good set of Q1,2023 results q/q, thanks to better Gross Refining Margin (GRM) and hedging gain. The company will adopt a more cautious hedging policy through 2023, on the back of hedging losses (THB15.8bn) in FY22. Thai Oil has not seen much impact since the announcement of the OPEC production cut. The company continues to see high availability of Middle East crude in Asia and the crude premium remains low. Management attributes this situation to the export of Russian crude to Asia (China and India), which substitutes the Middle East crude. GRM, however, will be weaker in Q2,2023 due to higher exports of refined products from China and macro concerns that impact the demand for diesel and jet fuel.

Moody's has revised the outlook of China's property sector from negative to stable on better sales and funding conditions. The agency expects nationwide contracted sales in Chinese property to stabilise over the next 12 months, partly helped by the favourable government policy to support home sales.

Structured credit

The US Agency MBS market was down 40bps last week, slightly underperforming other high quality asset classes as rates edged higher. Spreads traded in a narrow range as mortgage financing got slightly more expensive for consumers and increased supply concerns weighed on investors. Fed balance sheet run-off while tame is now coupled with FDIC sales, which were bumped higher Friday to $12.5bn per week. It's worth noting, however, that strong demand and reverse inquiry is why the FDIC has increased the forecasted amount. During the week, 15s outperformed 30s and higher coupons (shorter durations) outperformed lower coupons (longer durations). We are currently at 17% of Agency pass throughs sold and 4% of CMOs sold off the SVB/Signature bonds and no Ginnie project lists have been released yet. Non-agency RMBS new issuance was about $0.2bn last week and 2023 issuance is down about 70% over the same period last year as higher interest rates and property prices have significantly hit that market. Fundamentals remain sound.

Emerging markets

Emerging market hard currency sovereign bonds returned +0.23% in US dollar terms over the week as spreads moved 5bps tighter to 401bps (as measured by the JPM EMBI Global Index). The high yield sub-component outperformed investment grade as single B names retraced some of their recent widening,

Turkish elections took place on Sunday and President Erdogan surprisingly polled better than expected. At the time of writing, he was ahead with 49.4% of the vote, which is a little short of the 50% needed to avoid a second round. Voter turnout was strong at 89% and Erdogan's parliamentary alliance also looks likely to win a majority. Turkish bonds last week rallied strongly ahead of the elections on hopes that the opposition candidate, Kemal Kilicdaroglu, would win. Turkish spreads have seen significant widening.

There were nationwide protests in Pakistan as former Prime Minister Imran Khan was finally arrested on charges of corruption. If convicted, he would not be able to stand for election again, which would rule him out of elections later this year. This latest bout of turmoil is credit negative for Pakistan as it deals with its worst economic crisis in decades and hopes of further IMF support fade.

Kenya was downgraded to B3 by Moody's and placed on negative watch due to an increase in government liquidity risks.

We saw supply this week from the Middle East with Mubadala, the United Arab Emirates' sovereign wealth fund, issuing 10- and 30-year bonds. Saudi Arabia also issued a dual tranche 6 and 10-year sukuk deal. Investment grade sovereign sukuk issuance is quite rare so it should draw high demand.

Commodities

The BCOM index declined by 1.6% on the week with all major subsectors (except for energy) declining on the week.

In Agriculture news, the USDA released its crop estimate reports for 2023/24. Key takeaways include that US and global corn production are expected to rise 10% and 6% y/y. The report also predicted US ending wheat stocks to fall by 7% y/y, to the lowest levels in 16 years.

In Crude, brent prices fell by 1.7% on the week. Prices have weakened recently following the EIA reporting an inventory build of 2.9m barrels vs a 900k expectations. Elsewhere, Iraq has agreed to resume the export of crude from its autonomous Kurdish region, which exports approximately 475k barrels a day.

Base metals performed poorly on the week with nickel (-9.6%) and zinc (-5.2%) delivering the largest losses. Markets have been disappointed with the pace of China's post covid recovery following the April manufacturing PMI printing in contractionary territory and Chinese copper imports for the first four months of the year at 13% lower than this time in 2022. Recovery in China's property sector has also slowed as indicated by declining existing home sales and prices.

Responsible investments

The month of April marked the second largest total issuance for specific use of proceeds bonds so far this year, at just over $93.5bn, and the largest total for April on record. The majority were green bonds, followed by sustainability bonds. Social bond issuance was consistent with previous months, although still lower than what we were seeing during the pandemic. Worth noting is the green bond sale from the Republic of Italy, a massive $10.9bn was raised and was over five times oversubscribed. The bonds maturing in eight years are to help raise capital to fund the countries net zero efforts, becoming a climate neutral by 2050.

Fixed Income Asset Allocation Views

15th May 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 remain cheap relative to Feb, but spreads have tightened in since March's banking-driven spike. Technicals and fundamentals are still worse than Feb. **The group remained negative on credit risk.** ■ The Fed Funds market is pricing in a peak of 5.1% and rates being cut to 4.7% in 2023. This market has been volatile, with first cut now priced for July. ■ 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 in 2H 2023. Focus remains on wages. Financial conditions, and inflation expectations. ■ Uncertainty remains elevated due to fears surrounding banking crisis spill over, 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, 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 re-emerge.
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 ■ Hiking cycles to be curtailed by the impact of tighter credit conditions post SVB	■ 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 tightened since mid-March. Technicals weaker ■ Moving into select relval opportunities while maintaining conservative positioning ■ Tailwinds: China reopening optimism , central bank easing in countries with receding inflation. ■ Headwinds: higher debt to GDP ratios, wider fiscal deficits, increasing use of IMF programs, geopolitical risks	■ China/US relations deteriorate ■ Issuance slows ■ Chinese reopening paused ■ Continued spill over 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 widened from mid-March; fundamentals and technical are similarly weak as in March. EMEA valuations are cheap, GBP fair to USD ■ Fundamentals had a strong starting point in 2023, however the banking crisis and growth/recession concerns are top-of-mind going into earnings ■ Inflation, labor supply, sector dispersion and monetary tightening continue to pressure margins and operating environment. The group is looking to earnings commentary and 2023 outlooks for more clarity	■ Additional bank failures with too little governmental intervention ■ Volatility remains high and 2023 suppluis 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 have tightened since mid – March's banking crisis, with fundatmentals and technical unchanged. Prefer conservative position while open to attractive buying opportunities, especially in short HY. ■ CTI's US HY default forecast increased to 2.1% for 12m and 4.7%24m fwd. Drivers: global banking stress, recession probabilities, margin pressure, demand deterioration, and idiosyncratic sector risk ■ Bank loan market has tightened in along with other credit sectors. Themes: retail fund outflow, limited issuance, credit concerns for lower quality segment	■ Additional bank failures with too little governmental intervention. ■ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ■ Rally in distressed credits, leads to relative underperformance
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Mortgage index has widened sinvce March. Since Feb, the group has modestly reduced exposure due to outperformance. Low net supply, but expected to pick up ■ Performance remains stable. SVB/Signature liquidations expected to be orderly and spread over the next 12- 15 months. ■ 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	Under-weight -2 -1 0 +1 +2 Over-weight	■ Our preference remains for quality Non-Agency RMBS ■ RMBS: Home prices remain resilient despite headwinds. Delinquency, prepayment, and foreclosure performance remains strong; need labour market weakness to see housing deterioration. Risk premiums still cheap to LT avg. ■ CMBS: Mostly solid fundamentals but weakening. Credit curve is very steep; non – office sectors remain stable.. ■ CLOs: Spreads tighter since March. Downgrades outpacing upgrades. More tail risks for subordinate bonds ■ ABS: Attractive rel val in some senior positions; higher quality borrowers remain stable	■ 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 ■ 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	Under-weight -2 -1 0 +1 +2 Over-weight	■ o/w Copper ■ o/w Grains ■ u/w Gold ■ o/w Oil ■ u/w Silver ■ o/w Wheat ■ u/w Corn	■ Global Recession