In Credit

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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
Structured Credit

Justin Ong
Asian Fixed Income

Charlotte Edwards
Responsible Investments

Jake Lunness
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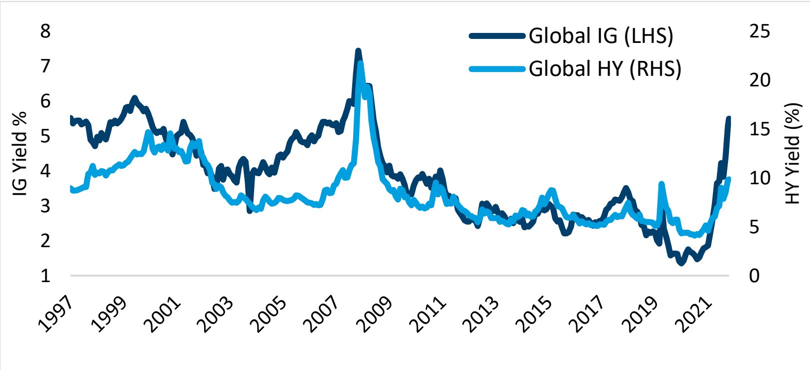
The return of the yield.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	4.02%	14 bps	-1.3%	-14.6%
German Bund 10 year	2.26%	7 bps	-1.9%	-17.0%
UK Gilt 10 year	4.07%	-17 bps	-6.1%	-30.8%
Japan 10 year	0.26%	0 bps	1.4%	-3.9%
Global Investment Grade	184 bps	10 bps	-1.4%	-18.1%
Euro Investment Grade	224 bps	8 bps	-1.0%	-15.9%
US Investment Grade	170 bps	10 bps	-1.4%	-19.5%
UK Investment Grade	198 bps	14 bps	-1.8%	-23.9%
Asia Investment Grade	245 bps	16 bps	-1.3%	-12.2%
Euro High Yield	642 bps	28 bps	-0.6%	-16.2%
US High Yield	525 bps	23 bps	0.3%	-14.3%
Asia High Yield	1126 bps	98 bps	-3.7%	-25.9%
EM Sovereign	477 bps	20 bps	-1.4%	-23.3%
EM Local	7.4%	15 bps	-1.0%	-19.4%
EM Corporate	418 bps	21 bps	-1.2%	-17.2%
Bloomberg Barclays US Munis	3.9%	0 bps	0.9%	-11.4%
Taxable Munis	5.4%	13 bps	-1.7%	-23.5%
Bloomberg Barclays US MBS	77 bps	6 bps	-1.9%	-15.3%
Bloomberg Commodity Index	244.61	-2.9%	2.1%	15.9%
EUR	0.9739	-0.2%	-0.8%	-14.5%
JPY	148.47	-2.3%	-2.6%	-22.6%
GBP	1.1204	0.8%	0.0%	-17.4%

Source: Bloomberg, Merrill Lynch, as at 14 October 2022.

Chart of the week: Credit yields, 1997- 2022



Source: ICE BoAML Indices, Bloomberg, Columbia Threadneedle Investments, as at 14 October 2022.

Macro / government bonds

Government bond market price action has resembled the motions of a rollercoaster in the last couple of weeks. This has been the case in general but most evident in the movement in yields seen in the UK gilt market. The gilt market has been under pressure ever since the so-called mini budget in the UK a few weeks ago. This fiscal giveaway has been seen as reckless by markets and has led to rising yields especially at the long end of the yield curve. This in turn has led to margin calls at so-called liability driven pension fund schemes. These margin calls need to be met by the sale of other assets such as corporate bonds and so a vicious circle has emerged. News, on Friday that the Chancellor of the Exchequer was returning a day early from meetings in Washington led to speculation of a further U-turn in UK fiscal policy and so prompted an initial rally in gilts as the week drew to a close. This was turned around at lunchtime with the announcement that Chancellor Kwarteng had been sacked, pushing gilt yields to end higher for the week (though not at the week's high of 4.63% for the 10-year gilt.)

Meanwhile, in US all eyes were focused on the release of the monthly consumer price inflation index. Inflation has been at the forefront of market participants attention in the last year or so. There were hopes that this data series would show a further decline in the annual rate of inflation and so lead to expectations of a 'pivot' in US Federal Reserve policy in the next year. These hopes were dashed. The inflation rate had been expected to rise by 0.2% in the last month. In reality we saw a doubling of the rise in inflation from that expectation. This undermined hopes of a pivot and in fact led to expectations of a rise in the so-called terminal rate of US policy up to around 4.75%.

Investment grade credit

Credit market spreads edged wider last week as the US CPI print put paid to any hope of a Fed 'pivot' and rate expectations rose once again.

We have talked about valuations / spreads looking appealing in Europe and the UK (post LDI deleverage) recently and more neutral in the US market. This remains the case. Yields also look historically attractive given the addition of the surge higher in government bond yields to wider spreads **(see chart of the week).**

Meanwhile, our expectation as we enter earnings season is for a possible deterioration, albeit from a strong starting point. Through the second quarter earnings guidance was mostly affirmed, though accompanied with a cautious tone /outlook. We expect to see lower leverage in the US in 2023 than in 2022 and of course 2019. This has been accompanied by a continuation of the ratings upgrade cycle (September 2022 was best in US since 2021 according to BoAML) and a high volume of issuers on positive outlook or watch. Higher leverage is expected in Europe taking this metric back towards a similar position to 2019. For banks, we see higher/ weakening 'cost of risk'/ asset quality but better interest margins and suspended share buybacks in the US while in Europe, a lower deterioration in 'cost of risk' and Covid writebacks.

So if valuations are neutral to positive and fundamentals are neutral then the technical picture is poor if not very poor. We are seeing, post the 'mini-budget' in the UK, havoc in the gilt market and liquidity unwinds for UK pensions structured in LDI. This has led to indiscriminate fire-selling of risk assets including investment grade credit. The Bank of England corporate bond sales has been postponed, albeit temporarily.

High yield credit & leveraged loans

US high yield bond yields rose above July's high alongside a surge in US Treasury yields amid another firmer-than-expected US CPI and a corresponding rise in the market-implied terminal rate. The ICE BofA US HY CP Constrained Index returned -1.07% and spreads were 13bps wider. For context, yields are at a high since April 2020, whereas spreads are 84bps below their YTD high in early July. According to Lipper, the asset class reported a $713m retail fund outflow, leaving YTD outflows at $54bn. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index declined $0.39 to $92.37 amidst the 8th consecutive retail fund withdrawal and slower CLO origination. Loan yields to a 3-year take out reached 11.18%, a high since March 2020. Loan retail fund flows were -$1.1bn for the week, leaving YTD net flows for the asset class at -$2.1bn.

European High Yield (EHY) went back to negative performance territory last week as the asset class experienced both widening spreads (+28bps to 642bps) and rising yields (+36bps to 8.84%) returning -1.3%. The market continued to show dispersion as higher rated credit outperformed CCCs. Sterling high yield was especially hit, underperforming EHY, as the former continued to suffer from the fallout of the UK mini budget and LDI market related turmoil. The latter continued to rock the market given the latest headline that UK companies were facing loan requests from their pension funds. Outflows slowed down (€223m) compared to the previous week but returned to being across both ETFs and managed accounts. The primary market remained subdued with Enquest, the UK oil and gas company bringing a new bond to the market ($305m 5-year, yielding 12%) and Fedrigoni, Italian paper manufacturer (upsized €1.025 bn floater and fixed tranches)

In credit rating news, Elior, the French catering business, was downgraded by Moody's to B2 from B1 citing an expectation that high inflation will weigh on company profitability unless Elior overdelivers on contract renegotiation to improve pass throughs. Telecom Italia was downgraded by S&P to B+ from BB-, bringing it in line with Moody's B1 rating. S&P cited the worsening macroeconomic conditions and concern over the amount of bonds maturing in the next 24 months. This came as the telecom's board postponed action on the network sale as Vivendi, the French media firm and a key investor, said they would not be able to attend the meeting. This followed earlier in the week news that the CDP consortium asked for an extension of the end October deadline. Peach Property was downgraded by Fitch to BB from BB+ citing the company's increased relative percentage of secured financing.

In sector news, more profit warnings from the chemicals sector, this time from Synthomer, UK chemicals company, which announced it was taking action to reduce leverage, one being to halt dividend payments until end 2023. Ineos, also reaffirmed softening of demand with customer destocking into year end. A sign of global market slowdown: it was noted that shipping freight rates have declined 51% since the end of July, this year, falling below contract rates seen at the start of 2022.

Structured credit

The US Agency MBS market took a beating last week, underperforming the broad bond market with a negative total return of -1.54%. Declining demand from banks and the US Fed are weighing on the sector and causing heightened volatility while better valuations, which are at their cheapest level in 10 years have brought money managers in to provide some support. In non-agency, performance remains strong despite slowing housing metrics. A 7% mortgage rate has had a meaningful impact on prepay speeds and transaction volumes. In ABS, lower income, lower fico score renters are struggling and defaults are rising. These are borrowers most impacted by rising inflation. The bifurcation is notable in performance of higher fico score homeowners who have locked in very low rates of interest on their largest debt obligation.

Asian credit

The US Department of Defense has released an additional list of Chinese military-linked companies, in accordance with Section 1260H of the National Defense Authorization Act (NDAA). ChemChina, which was previously removed from the list in June 2021, has been designated again as a Chinese military-linked company.

S&P withdrew the BBB- long-term issue rating on Adani Transmission Ltd (ATL) obligor Group's senior secured notes at the company's request, following the completion of restructuring at ATL in September 2022. Adani Transmission Step One Ltd (ATSOL) is now the new holding company in the obligor group and ATSOL also replaces ATL as the issuer of the senior secured notes. Adani Transmission stated that it is in with S&P to get a rating but there was a change in S&P's rating methodology. According to S&P prior to the ratings withdrawal, the new corporate structure and covenants would not weaken the structural protection for bondholders.

Emerging markets

A negative return for the hard currency emerging market bond index (-1.82%) as treasury yields rose higher and spreads widened (+17bps) with Latin American and African names faring the worst. There were, however, some positive developments out of Africa over the week as Tunisia secured a Staff Level Agreement (SLA) with the IMF after 18 months of negotiations, the first disbursement is expected by year end. Egypt also made progress, finalising an SLA with details of size and conditionality expected later this week.

In rates news, Chilean policy makers continued tightening, raising rates 50bps to 11.25%. After signalling the end of its hiking cycle just last month, the Hungarian central bank surprised markets with emergency measures to stop the huge decline of the forint and higher inflation. Measures included a 9.5% hike on its overnight collateralised loan facility (lending to banks), a new 18% 1-day deposit facility (to make holding forint more attractive) and a 17% 1-day FX swap (to lower forint trade volumes). Hungarian CPI stands at 20% and has largely been driven by euro and US dollar priced energy imports.

Chinese President Xi spoke at the start of the 20th annual party congress. He reaffirmed his commitment to common prosperity and zero covid, alongside stressing the goal to re-unify China (take back Taiwan). The market was looking for signs of zero covid measures easing, there's no indication of that so far. Xi's comments on tech struck a more optimistic tone indicating he wants China to be a leader in scientific and technological research. This follows the recent Chinese tech crackdown, and the Biden administration Chip sanctions, preventing "US persons" from supporting the Chinese chip industry.

There were no ratings changes but Kyrgyzstan and Tajikistan were both moved to outlook positive by Moody's.

Commodities

Brent prices declined 6% following recent OPEC+ induced price strength. The IEA lowered its 2023 global petroleum liquid forecast by 500k b/d to 101mn b/d on lower expected GDP growth. The 2023 brent forecast was lowered from $97 to $94.5 .

European natural gas prices eased 60% from August highs while Germany reached the 95% gas storage levels they aimed achieve by 1 November. Elsewhere, China, the world's largest LNG importer, has instructed state owned energy companies to stop re-selling LNG to Europe and Asia to shore up winter supplies.

In precious, silver was down 10.8% on the week. Recent weakness has been a consequence of higher interest rates and a negative near-term outlook for the industrial demand for silver.

Base metals were down modestly on the week, tin was the best performer (+3%) with nickel selling off the most (-3.3%). In sanctions news, The Biden administration is reportedly looking to restrict imports of Russian aluminium. This follows the LME launching a discussion paper to potentially ban Russian aluminium, nickel and copper.

Responsible investments

Companies are under immense pressure to committ to some variation of a net-zero target, whether it be by 2030 or 2050, to retain both reputation and investment. Although we've seen a great uptake in net-zero commitments, is it all too good to be true. A report from Climate Action 100+ group (of which Columbia Threadneedle Investments is a member of) has concluded that for some companies setting net-zero goals, a large sum are in fact quite far from being able to realisticly achieve that goal. Just under 160 companies with the largest carbon footprints were invesitgated to discover that although 75% of these companies have set a net zero goal, very few of them have aligned targets to the Paris Agreement of 1.5C, as well as not doing enough to involve scope 3 emissions (involving the entire value chain).

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

17th October 2022

COLUMBIA THREADNEEDLE INVESTMENTS

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 no changes to sector outlooks.** ■ We are past the peak of economic growth with first few hikes done and expectations for more 75-100bp 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 Q4 2022.
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	■ 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 unchanged from August; still seeing bifurcation in market with value in BBB and BB names ■ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, central bank tightening, China lockdown/growth, idiosyncratic political risks, increasing use of IMF programs ■ Recent commodity price retracement has supported some names under pressure (India & Turkey); China real estate remains challenged with weaker data and growth forecast ■ Techincals (outflows and supply) remain a headwind	■ Chinese growth derails with less stimulus and uncertain zero covid policy after economy reopens ■ 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 widened since August. ■ Stable fundamentals beat pessimistic expectations for Q2 earnings. 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	■ Companies release materially lower Q4 outlook revisions ■ 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 remains a headwind with light primary issuance, however August US fund flows were positive and default activity remains benign/idiosyncratic ■ Bank loan market has moved lower with fewer new issues and low secondary trading volumes; concerns about recession and interest cost remain headwinds	■ Default concerns are focused on demand destruction, margin pressure and macro risks ■ Loan technicals & flows weaken ■ Russian invasion & spillover rattles US bond loan/market as already seen in EMEA ■ Commodity prices continue to retrace
Agency MBS	Under-weight -2 -1 ■0 +1 +2 Over-weight	■ Mortgages spreads have widened in the past month in sympathy with risk assets, supply continues to drop along with purchase activity and cash out refinancing ■ Current coupon spreads near recent wides ■ Headwinds as the Fed is reducing balance sheet position and bank demand has cooled as deposit growth slows	■ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates. ■ Uncertainty with the Fed hiking and future balance sheet position
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: Default rate low but increasing. AAA spreads stable, supported by overseas investing. Mezz spreads worse as BB's 100 wider and manager tiering 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