COLUMBIA THREADNEEDLE INVESTMENTS

# In Credit

19 June 2023

**David Oliphant**
Executive Director,
Fixed Income

## Contributors

**David Oliphant**

Investment Grade Credit

**Simon Roberts**

Macro/Government Bonds

**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 Finch**

Responsible Investments
Investment Grade Credit

**Jake Lunness**

Commodities
Emerging Markets

**Sarah McDougall**

General Fixed Income

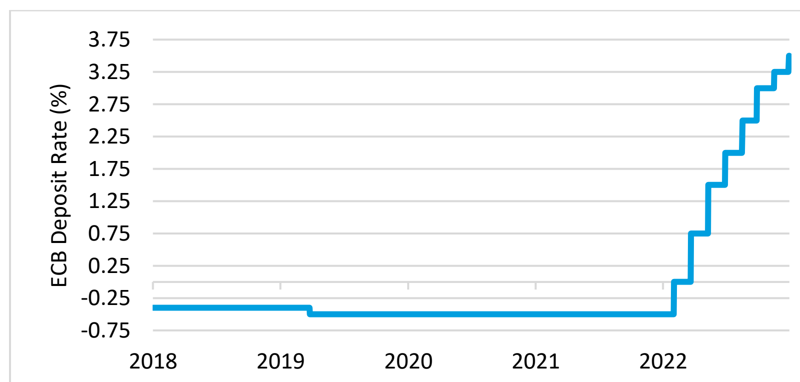
# A pause not a pivot.

## Markets at a glance

| | Price / Yield / Spread | Change 1 week | Index QTD return | Index YTD return |
|---|---|---|---|---|
| US Treasury 10 year | 3.76% | 2 bps | -1.2% | 1.8% |
| German Bund 10 year | 2.52% | 14 bps | -0.9% | 0.6% |
| UK Gilt 10 year | 4.48% | 24 bps | -6.5% | -4.4% |
| Japan 10 year | 0.40% | -3 bps | 0.4% | 2.7% |
| Global Investment Grade | 142 bps | -5 bps | -0.3% | 2.5% |
| Euro Investment Grade | 157 bps | -5 bps | 0.3% | 1.9% |
| US Investment Grade | 135 bps | -5 bps | -0.4% | 3.0% |
| UK Investment Grade | 140 bps | -1 bps | -3.1% | -0.8% |
| Asia Investment Grade | 199 bps | -8 bps | 1.3% | 3.6% |
| Euro High Yield | 445 bps | -20 bps | 2.0% | 5.0% |
| US High Yield | 415 bps | -14 bps | 1.6% | 5.4% |
| Asia High Yield | 761 bps | -17 bps | -1.3% | 1.5% |
| EM Sovereign | 372 bps | -10 bps | 1.0% | 3.3% |
| EM Local | 6.3% | 0 bps | 2.8% | 8.1% |
| EM Corporate | 349 bps | -11 bps | 1.3% | 3.6% |
| Bloomberg Barclays US Munis | 3.5% | -3 bps | -0.4% | 2.4% |
| Taxable Munis | 5.0% | 0 bps | -0.5% | 4.9% |
| Bloomberg Barclays US MBS | 50 bps | -4 bps | -0.3% | 2.3% |
| Bloomberg Commodity Index | 234.45 | 4.2% | 0.8% | -4.7% |
| EUR | 1.0927 | 1.7% | 0.9% | 2.2% |
| JPY | 141.84 | -1.7% | -6.3% | -7.6% |
| GBP | 1.2798 | 1.9% | 3.9% | 6.1% |

Source: Bloomberg, Merrill Lynch, as of 16 June 2023.

### Chart of the week: ECB deposit rate 2018-2023




Source: Bloomberg, Columbia Threadneedle Investments, as of 19 June 2023.

## Macro / government bonds

Price action last week focused on the hawkish stance of central banks in the US and Europe with yields on short-dated bonds tracking to higher yields.

On Wednesday, the US Federal Reserve paused its interest rate hiking programme. The market regarded this pause 'hawkishly'. Jay Powell, Fed Chair, said at his press conference that the questions of speed and level were separate monetary policy considerations and that they wanted to evaluate the impact on the real economy of cumulative interest rate hikes, as well as tighter credit conditions in the banking sector. In the accompanying projections to the press conference, FOMC participant projections pointed to a median year end Fed Funds rate of 5.6%, a 0.5% increase from previous estimates in March. One impact of the projections, alongside recent jawboning by Fed members, was to effectively push back market expectations of any cuts in interest rates for this year.

The following day, the European Central Bank raised interest rates by 0.25% **(see chart of the week)**. Macroeconomic projections from the ECB saw a rise in core eurozone inflation from 4.6% to 5.1%. ECB president, Christine Lagarde, repeated her line that there was more ground to cover and that the meeting in July was likely to result in a further quarter point rate hike. The market continues to price in two further rate hikes for the eurozone, with the process of loosening monetary policy, as for the US, now expected to begin in the new year.

Inflation dynamics in the UK continue to disappoint. Core inflation has continued to rise while UK labour market data brought little respite last week: earnings remained elevated while the unemployment rate fell from 4.0% to 3.8%. The sticky and elevated level of price pressure means the market is now pricing in terminal rate levels in the UK of close to 6%. A further quarter point interest rate hike this coming week is taken as a given.

As we navigate the path towards terminal interest rates in Europe and the US, we feel increasingly constructive on the outlook for government bonds, reflecting the attractiveness of current yield levels and the prospect of capital gains as interest rates fall.

## Investment grade credit

Global investment grade spreads continue to tighten from wides for the year seen in March of around 170bps. We ended last week at 28bps tighter and 142bps over government bonds led by the US dollar market.

The 'technical' backdrop is being supported by lower recent new issuance volumes amid inflows into the investment grade asset class as we head into the typically quieter summer season.

Our team of research analysts is forecasting low top line growth (excluding negative contributions from energy in the US and utilities in EMEA given high base effects). EBITDA

margins are forecast to improve slightly in 2024 but have been revised down slightly for Europe this year (lower in all sectors ex-industrials and miners). Capital spending will remain elevated, but with strong free cash flow generation, leverage is expected to trend sideways through to 2024. Last week there were positive rating actions for Virgin Money (Fitch) and Altria (S&P)

## High yield credit & leveraged loans

European High Yield (EHY) continued its positive return streak with +22bps return for the week and another 20bps spread tightening. Yields remained unchanged given the rise of underlying government bond yields as the ECB raised rates 25bps and made clear that more rate hikes could be expected.

It was another week of credit rating compression as CCCs continued their outperformance, relative to higher rated credit. EHY also outperformed sterling high yield. Positive flows into the asset class continued and improved with +€153 n across ETFs and managed accounts. Corporate primary market picked up with British Telecom (£700m hybrid) and Assemblin, Nordic provider of technical systems (€480m).

It was another week of rating downgrades too. Citycon became the newest Fallen Angel as Moody's downgraded the Finish retail landlord, to Ba1 from Baa3, on high leverage and uncertain outlook for improvement. The rating agency also downgraded Altice France to B3.

In the continuing saga for French retailer Casino another proposal was announced, this time from the previous participants in the earlier TERACT proposal. Though the support size is the same (€1.1bn), unlike the Kretinsky offer which involves a substantial reduction in debt, the focus here is more on commercial turnaround. In other M&A news, Vodafone announced the planned merger of Vodafone UK with Three UK, to be completed by 2024. Also last week, Ball, the packaging company announced it is looking to sell its aerospace unit for $5bn+.

## Asian credit

The economic data of China for May 2023 was underwhelming, which highlights a slowdown in post-Covid recovery. Fixed asset investment (FAI) decelerated further to 2.2% y/y in May (April: +3.9%), while industrial production growth was 3.5% y/y (April: +5.6%). At the monetary front, the PBOC has cut the MLF (medium-term lending facility) by 10bps to 2.65%, which is the first cut in 10 months. This paves the way for the domestic banks to reduce their lending rates too.

Bharti Airtel is weighing a potential offshore bond issuance to raise up to $1bn to refinance debt and fund its 5G capex needs. The company is likely building up its liquidity buffer ahead of the call dates of its BHARTI 5.65% perpetual (January 2025).

## Emerging markets

Emerging market hard currency spreads tightened 10bps over the week leading to a positive return of +0.66% for the index. High yield spreads tightened almost 20bps, outperforming the investment grade sub-sector. EM spreads are now 372bps over US treasuries, offering a yield of 7.7%.

Mexico's BBB- rating was affirmed by Fitch who cited a prudent macroeconomic policy framework as well as stable and robust external finances. Staying in Latin America, Brazil's outlook was upgraded to positive by S&P as its GDP growth trajectory looks better than expected, the country is rated BB- by S&P.

Nigerian bonds rallied strongly on the week, contributing +5.4% to the overall hard currency index return. This follows increasingly positive news on reforms. One of these reforms, the loosening of FX controls, took another step with the removal of restrictions on the amount of US dollar deposits held at local banks. The aim of this measure is to improve the supply of US dollars and enhance customer confidence and stability in the market. With the removal of controls, the official Naira rate has sold off sharply, to converge towards fundamentals: this translates into a 30% decline vs the US dollar YTD to an all time low.

## Commodities

Commodity markets enjoyed a strong week, rallying by 4.2% overall. The rally was largely attributed to rising agricultural (+10.3%) and energy sub-sectors (+5.7%).

The agriculture sector was lifted by gains in corn (+12.2%) and soybeans (+10.6%), which were supported by dry weather in the US Midwest that has raised concerns that harvests will fall below expectations. Elsewhere, news that Russia is considering withdrawing from the Black Sea export deal offers further potential price upside for the sector.

The rally in energy markets was largely driven by US natural gas, which rallied 16.2%. Prices were supported by a weaker US dollar (down 1.3% on the week) and EIA inventory data showing inventories declining by more than expected.

## Responsible Investments

The month of May marked the largest May issuance of green bonds ever.

Estimates from market players are stating this year could be the largest ever issuance for ‘specific use of proceeds’ bonds, with green bonds accounting for over half (estimates seem to aim towards a grand total of $600bn for 2023). Key sovereign issuance has aided the growth as we saw Hong Kong raise almost $6bn and Germany’s KFW raise just over $3bn, both in green bonds last month.

Social issuance can’t quite find first gear as it stalled post-pandemic, but increasingly issuers are looking to link green to social projects where they can in the form of sustainability bonds.

In the UK, large asset managers will soon be expected to release the first issue of the Task Force on Climate-related Financial Disclosures (TDCF) Product Level Reports. As lengthy as the title may be, essentially climate related data on all pooled products will be reported on each year, with a purpose to identify, manage and report on climate related risks and opportunities. The UK Financial Conduct Authority released the requirement some time ago and the timer is about to go off for asset managers to respond.

# Fixed Income Asset Allocation Views

19th June 2023

| Strategy and positioning (relative to risk free rate) | | Views | Risks to our views |
|---|---|---|---|
| **Overall Fixed Income Spread Risk** | ■<br>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 leans negative on Credit risk overall favouring higher quality sectors.**<br>▪ The Fed Funds market is pricing in a peak of 5.3% and rates being cut to 5.0% in 2023. This market has been volatile, with the first full cut now priced for Nov.<br>▪ The CTI Global Rates base case view is no cuts in 2023, and possibly one more hike during the summer. Expect the Fed to hold steady in 2H 2023. Focus remains on wages, financial conditions, and inflation expectations.<br>▪ 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, consumer retains strength, end of Russian Invasion of Ukraine<br>▪ 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)**<br>('P' = Periphery) | ¥ $<br>Short -2 -1 0 +1 +2 Long<br>P £ € | ▪ Longer yields to be captured by long-run structural downtrends in real yields<br>▪ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures<br>▪ Hiking cycles to be curtailed by the impact of tighter credit conditions post SVB | ▪ Inflationary dynamics become structurally persistent<br>▪ Labour supply shortage persists; wage pressure becomes broad and sustained<br>▪ Fiscal expansion requires wider term premium<br>▪ Long run trend in safe asset demand reverses |
| **Currency**<br>('E' = European Economic Area) | EM ¥ A$<br>Short -2 -1 0 +1 +2 Long<br>€$£ | ▪ Rising expectations around a soft landing and peak Central Bank rates have weakened the dollar<br>▪ EM disinflation to be more rapid than DM<br>▪ Drop in global rate volatility supports local flows<br>▪ 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<br>Under-weight -2 -1 0 +1 +2 Over-weight<br>C | ▪ EM central banks slowing or terminating hike cycles<br>▪ Sharply reduced Fed expectations may permit EMFX strength<br>▪ 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<br>▪ Sticky global inflation or wage/ price spiral keeps EM interest rates higher for longer<br>▪ Structurally higher global real rate environment subdues risk assets |
| **Emerging Markets Sovereign Credit (USD denominated)** | ■<br>Under-weight -2 -1 0 +1 +2 Over-weight | ▪ EMD spreads beginning to tighten from March wides.. Technicals remain weak<br>▪ Maintaining conservative positioning while open to select idiosyncratic or relval based buying opportunities.<br>▪ Tailwinds: Central bank easing in less inflationary countries.<br>▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, increasing use of IMF programs, geopolitical risks, domestic political uncertainty. | ▪ China/US relations deteriorate; China reopening less stimulating than hoped.<br>▪ Issuance slows<br>▪ Chinese reopening paused<br>▪ Spill over from Russian invasion: local inflation (esp. food & commodity), slow global growth.<br>▪ Persisting COVID growth scars hurt economies & fiscal deficits |
| **Investment Grade Credit** | ■<br>Under-weight -2 -1 0 +1 +2 Over-weight | ▪ US spreads have tightened & EMEA spreads unchanged since last month; Fundamentals and Technicals still weak to pre-COVID. EUR valuations are cheap, prefer USD and Euro to Sterling<br>▪ May issuance mostly in longer end of curve. Earnings resilience with deteriorating credit metrics point to idiosyncratic opportunities. Fundamental concerns remain focused on commercial real estate for Banking sector, tight labour supply, weaker consumer, recession concerns. | ▪ Additional bank failures with too little governmental intervention<br>▪ Volatility remains high and 2023 supply isbelow expectations.<br>▪ Market indigestion as central banks sell EMEA corporates<br>▪ Rate environment remains volatile<br>▪ Geopolitical conflicts worsen operating environment globally |
| **High Yield Bonds and Bank Loans** | ■<br>Under-weight -2 -1 0 +1 +2 Over-weight | ▪ Spreads have tightened since early May, fundamentals and technical remain unchanged, with beginning of June reversing May outflows.<br>▪ Prefer conservative position while open to attractive buying opportunities, especially in short HY & BB's.<br>▪ US HY defaults higher than last year but still at reasonable levels, possibly normalising to historic trends.<br>▪ Bank loan market has widened along with other credit sectors. Themes: retail fund outflows, rising defaults, limited issuance, credit concern in lower quality loans | ▪ Additional bank failures with too little governmental intervention.<br>▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks<br>▪ Rally in distressed credits, leads to relative underperformance |
| **Agency MBS** | ■<br>Under-weight -2 -1 0 +1 +2 Over-weight | ▪ Mortgage index remain wide to historic levels, the group sought to capitalise on Mya's weakness.<br>▪ Supply below expectations but improving. FDIC liquidations from Banks nearly half done.<br>▪ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon | ▪ Additional bank failures<br>▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates<br>▪ Fed continues to shrink position even as hiking is paused |
| **Structured Credit Non-Agency MBS & CMBS** | ■<br>Under-weight -2 -1 0 +1 +2 Over-weight | ▪ Our preference remains for quality Non-Agency RMBS<br>▪ RMBS: Home prices remain 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.<br>▪ CMBS: We feel cautious, especially on office and multifamily. Credit curve is very steep; non-office sectors remain stable<br>▪ CLOs: Spreads have widened slightly since May. Downgrades outpacing upgrades. More tail risks for subordinate bonds<br>▪ ABS: Attractive relval in some senior positions; higher quality borrowers remain stable. Market is active | ▪ Weakness in labour market<br>▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening. Consumer (retail/travel) behaviour fails to return to pre-covid levels<br>▪ WFH continues in 2023 (positive for RMBS, negative for CMBS).<br>▪ Rising interest rates dent housing market strength and turn home prices negative in 2023<br>▪ Cross sector contagion from CRE weakness. |
| **Commodities** | ■<br>Under-weight -2 -1 0 +1 +2 Over-weight | ▪ o/w Copper ▪ o/w Oil<br>▪ o/w Grains ▪ u/w Silver<br>▪ u/w Gold ▪ o/w Wheat<br>▪ o/w Soybeans ▪ o/w Corn | ▪ Global Recession |

**Important information:** For use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients). Source for all data and information is Bloomberg as at 19.06.2023, unless otherwise stated.
This material in this publication is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments to anyone in any jurisdiction in which such offer is not authorised, or to provide investment advice or services. Offerings may be made only on the basis of the information disclosed in the relevant offering documents and the terms and conditions under the relevant application forms. Investment involves risk. You are advised to exercise caution in relation to this material. Please refer to the relevant offering documents for details and the risk factors. Past performance is not a guide to future performance. The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. This means that an investor may not get back the amount invested. The analysis included in this publication has been produced by Columbia Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice and should not be seen as investment advice. Information obtained from external sources is believed to be reliable, but its accuracy or completeness cannot be guaranteed. The mention of any specific shares or bonds should not be taken as a recommendation to deal. This document includes forward looking statements, including projections of future economic and financial conditions. None of Columbia Threadneedle Investments, its directors, officers or employees make any representation, warranty, guarantee, or other assurance that any of these forward-looking statements will prove to be accurate. This document may not be reproduced in any form or passed on to any third party in whole or in parts without the express written permission of Columbia Threadneedle Investments. This document is not investment, legal, tax, or accounting advice. Investors should consult with their own professional advisors for advice on any investment, legal, tax, or accounting issues relating an investment with Columbia Threadneedle Investments. This document and its contents have not been reviewed by any regulatory authority. **In Australia**: Issued by Threadneedle Investments Singapore (Pte.) Limited ["TIS"], ARBN 600 027 414 and/or Columbia Threadneedle (EM) Investments Limited ["CTEM"], ARBN 651 237 044. TIS and CTEM are exempt from the requirement to hold an Australian financial services licence under the Corporations Act and relies on Class Order 03/1102 and 03/1099 respectively in marketing and providing financial services to Australian wholesale clients as defined in Section 761G of the Corporations Act 2001. TIS is regulated in Singapore (Registration number: 201101559W) by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289), which differ from Australian laws.
Issued by Threadneedle Investments Singapore (Pte.) Limited, Winsland House 1, Singapore 239519, which is regulated in Singapore by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289). Registration number: 201101559W. This advertisement has not been reviewed by the Monetary Authority of Singapore. Issued by Threadneedle Portfolio Services Hong Kong Limited 天利投資管理香港有限公司. Unit 3004, Two Exchange Square, 8 Connaught Place, Hong Kong, which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 regulated activities (CE:AQA779). Registered in Hong Kong under the Companies Ordinance (Chapter 622), No. 1173058. Issued by Threadneedle Asset Management Limited (TAML). Registered in England and Wales, Registered No. 573204, Cannon Place, 78 Cannon Street, London EC4N 6AG, United Kingdom. Authorised and regulated in the UK by the Financial Conduct Authority. **In Japan**: Issued by Columbia Threadneedle Investments Japan Co., Ltd. Financial Instruments Business Operator, The Director-General of Kanto Local Finance Bureau (FIBO) No.3281, and a member of Japan Investment Advisers Association and Type II Financial Instruments Firms Association. This document is distributed by Columbia Threadneedle Investments (ME) Limited, which is regulated by the Dubai Financial Services Authority (DFSA). For Distributors: This document is intended to provide distributors with information about Group products and services and is not for further distribution. For Institutional Clients: The information in this document is not intended as financial advice and is only intended for persons with appropriate investment knowledge and who meet the regulatory criteria to be classified as a Professional Client or Marketing Counterparties and no other Person should act upon it. **Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies.** columbiathreadneedle.com