Information for investment professionals

In Credit

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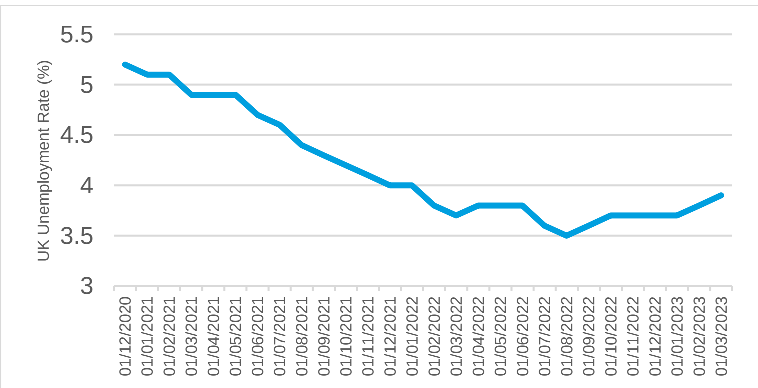
Markets love labour lost.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	3.72%	26 bps	-1.1%	2.0%
German Bund 10 year	2.46%	18 bps	-0.7%	0.8%
UK Gilt 10 year	4.06%	28 bps	-4.4%	-2.3%
Japan 10 year	0.39%	0 bps	0.3%	2.6%
Global Investment Grade	152 bps	-1 bps	-0.7%	2.1%
Euro Investment Grade	167 bps	0 bps	0.2%	1.7%
US Investment Grade	145 bps	-3 bps	-1.2%	2.2%
UK Investment Grade	143 bps	-2 bps	-1.2%	1.1%
Asia Investment Grade	218 bps	-11 bps	0.9%	3.2%
Euro High Yield	481 bps	-23 bps	0.9%	3.9%
US High Yield	462 bps	-14 bps	0.1%	3.8%
Asia High Yield	882 bps	47 bps	-5.0%	-2.2%
EM Sovereign	403 bps	2 bps	-0.8%	1.4%
EM Local	6.5%	2 bps	0.0%	5.1%
EM Corporate	378 bps	-4 bps	0.0%	2.2%
Bloomberg Barclays US Munis	3.6%	24 bps	-1.0%	1.7%
Taxable Munis	5.0%	24 bps	-1.4%	4.0%
Bloomberg Barclays US MBS	62 bps	-3 bps	-1.0%	1.5%
Bloomberg Commodity Index	223.57	0.0%	-3.5%	-8.7%
EUR	1.0800	-0.4%	-0.3%	0.9%
JPY	138.65	-1.7%	-3.7%	-5.0%
GBP	1.2420	-0.1%	0.9%	3.0%

Source: Bloomberg, Merrill Lynch, as of 19 May 2023.

Chart of the week: UK unemployment rate (12/2020 to 3/2023)



Source: Bloomberg, Columbia Threadneedle Investments, as of 22 May 2023.

Macro / government bonds

It was a difficult week for government bonds. Indeed, US 10-year bonds rose in yield by the largest margin this year of 26bps.

Government bond markets had traded in a tight range these last few weeks. The 10-year US Treasury note, for example, had sat in a 30bps range since mid-March (3.3% -3.6%). Markets remain supported by fears of low growth / recession but thwarted by ongoing elevated levels of inflation and hawkish rhetoric from central bankers.

Last week's UK Labour market data offered hope that labour market tightness is easing, and that this in turn can help the Bank of England to pause its rate rise cycle. There has been a similar picture, though perhaps more advanced, in the US where Initial Jobless Claims have been generally rising since the beginning of the year. In the UK, there were 136k jobs lost in the labour force (markets had expected a gain of 25k). Meanwhile, the unemployment rate rose to 3.9% – not high admittedly – but higher than the 3.7% at the start of the year and the 3.5% seen last summer **(see chart of the week).** The hope is that this reduces the pressure for wage rises and hence dilutes some of the inflationary pressure.

Investment grade credit

Credit markets continue to weaken albeit at a slow pace. Global investment grade spreads ended the week at 152bps, which is up from the 143bps seen in mid-April and after the turmoil and volatility of March (mini banking crisis). Global spreads have been in a range of 127bps to 170bps so far this year according to data from ICE BofML indices.

Heavy primary activity has weighed upon the market in recent weeks, Notably, Pfizer issued the fourth largest issue of investment grade debt in history to fund its acquisition of biotechnology group Seagen Inc last week. Verizon's 2013 $49bn deal is the largest in history.

What has been more helpful for market sentiment has been a benign / supportive earnings season with results from Munich RE, Zurich, Siemens and Experian all categorised as strong. We expect investment grade credit quality to remain robust in the coming year(s).

Valuations or spreads, especially in the UK and Europe are reasonable and wide of both short (five-year) and 20-year averages, which is also supportive.

High yield credit & leveraged loans

US high yield bond prices were lower over the week as rates rose sharply amid cautious optimism for a bipartisan debt limit agreement. The ICE BofA US HY CP Constrained Index returned -0.45% while spreads were 14bps tighter.

Notably, three years after being downgraded, Occidental Petroleum's $18bn of bonds were upgraded to investment grade by Fitch over the week, making it the third largest rising star on record behind only Ford and Kraft Heinz. According to Lipper, the asset class experienced a $1.2bn outflow. Meanwhile, the average price of the J.P. Morgan Leveraged Loan index was $0.21 lower amidst a nine-week high in outflows and light CLO origination. Retail loan funds saw $954m withdrawn over the week.

European High Yield (EHY) finished with a firmer tone last week, despite the rise in underlying government bond yields, as spreads tightened in 23bps to 481bps. Sterling high yield marginally underperformed EHY while market compression continued for another week as CCCs outperformed higher-rated credits. EHY continues to experience outflows, solely due to managed accounts as ETFs continued to experience net inflows. The primary market was busy with almost €2bn worth of new deals coming to the market, which were largely well received. This included the single B name (Adler Pelz) even though it had to offer quite a high coupon of 9.5% for its 4-year paper.

In credit rating news, Casino was downgraded two notches by Fitch to CC from CCC-. The rating agency said the downgrade reflects that it sees an increasing likelihood of some form of debt exchange leading to a material reduction in terms for existing creditors. This would be considered a distressed debt exchange under Fitch's Corporate Criteria. Fitch’s actions come after the recent downgrade by S&P to CCC- from CCC+ on 9 May. Another downgrade, but in the service sector, was Atalian (maintenance services) by Moody’s to Caa2 from Caa1. The rating agency cited uncertainties about the debt repayment for bonds maturing in 2024 and 2025 given the firm’s weak liquidity. In more positive news, Moody’s upgraded Lottomatica to BA3 following its recent IPO.

In sector news, healthcare continues to be challenged with the latest news focusing on Catalent. This provider of drug delivery systems again announced the delay of the release of their financials.

In M&A news, Dufry, the airport retailer, announced the completion of the purchase of remaining Autogrill shares. As this was with a low cash component it is considered credit positive and could potentially lead to further rating upgrades. In the leisure space, the FT announced that Brookfield is selling Center Parcs.

Asian credit

The China Securities Regulatory Commission (CSRC) has announced new rules for Chinese companies looking to issue a Global Depositary Receipt (GDR). In March, the CSRC suspended the approval for new GDR applications. The new rules require companies to register with the CSRC within three working days after submitting the applications for GDR listing. Companies must also disclose the identities of the GDR subscribers within fifteen working days of the issuance. Over the near term, certain companies including Contemporary Amperex Technology Co Ltd may revisit their plans to issue GDRs.

Alibaba provided more details about its business reorganization. The company will list its Freshippo business (retail chain for groceries and fresh food, under Hema brand) over the next 6-12 months. It will also list Cainiao (logistics business) where it holds a 67% stake, over the next 12-18 months. Additionally, Alibaba will spin off its cloud business via a stock dividend distribution, which will be completed in the next 12 months.

For the Adani Group, the expert committee appointed by the Supreme Council stated that it was not possible to conclude whether there has been any regulatory failure on the allegations of stock price manipulations. According to the expert committee, there is no prima facie violation of existing rules.

Structured credit

The US Agency MBS market suffered a blow last week as rates sold off. The sector was down 1.32%, slightly outperforming other high-quality bonds, on no new significant data that can be directly tied to the move. Shorter and higher coupon bonds outperformed given their reduced duration sensitivity as the curve bear flattened. Spreads were relatively unchanged and remain near multi-year wides. At this point, the FDIC has sold 40% of its Agency MBS portfolio from the failed banks. Asset sales have been very well bid such that the increased supply is largely priced in. In non-agency, new issuance was only $600m last week. Trading volumes were down, and spreads were marginally tighter.

In commercial risk, the big story was the downgrade of a NYC office building on Park Ave. Fitch downgraded the property from AAA to BBB on lower lease payments and occupancy. The overall office sector is under pressure and will take years to play out as leases rollover.

Emerging markets

The move higher in US treasury yields last week was the main driver of returns for emerging market hard currency bonds. The index posted a negative return of -1.44% with spreads unchanged at 403bps. Following the spread decompression theme we have seen of late, we did see high yield spreads compress this week – with African names outperforming.

In Ecuador, spreads widened 165bps as President Lasso called snap elections and dissolved parliament in an attempt to prevent his impeachment. Lasso will not run in the upcoming elections but will rule by decree until a new President takes over. There are expectations of social unrest during that period in an effort to force Lasso to leave earlier.

New issuance continued from the Middle East region included a green sukuk from United Arab Emirates property company MAF Group.

There was positive ratings news over the week as Oman was upgraded to Ba2 by Moody's due to an improvement in the country's debt burden and debt sustainability in 2022.

Responsible investments

Last week, UK based water and sewage companies apologised for the lack of urgent action on sewage spills across the country. In 2022, according to Bloomberg data, ten water and sewage companies released overflowing sewage into rivers and the sea on 301,091 occasions. Some beaches in England had to close last summer due to wastewater being present on the shoreline. After months of campaigning from environmental agencies, the industry revealed a National Overflows Plan, which includes an additional £10bn to be invested into modernising the UK's water works system and preventing sewage overflows in the future. Currently £3.1bn was reserved for such projects between 2020 to 2025. Water companies will be turning to the debt market to raise such funds but will face scrutiny on their performance on these projects, creating competition for best and worst performers.

On a non-credit topic, FTSE Russell has released a new index series consisting of ESG-adjusted versions of their flagship FTSE 100, FTSE 250, FTSE 350 and FTSE All-Share indices. The adjustments cater for exclusions against thermal coal production, controversial weapons, tobacco production and other common factors with some industries excluded on a revenue threshold basis.

Fixed Income Asset Allocation Views

22nd 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 have widened since the last meeting: still cheap relative to Feb but tighter than March's highs. Technicals and fundamentals are still worse than Feb. The group remained negative on credit risk but upgraded investment grade credit to neutral. ▪ The Fed Funds market is pricing in a peak of 5.1% and rates being cut to 4.4% in 2023. This market has been volatile, with the first full cut now priced for Sep. ▪ The CTI Global Rates base case view is no cuts in 2023, with a best case of potentially one cut. 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 unch 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 in the past month; fundamentals and technicals still weak to pre-covid. EUR valuations are cheap, GBP vals fair to USD. ▪ Earnings season confirmed the theme of resilient corporate balance sheets, with low leverage and stable margins. The fundamental concerns remain focused on elevated macro risks from the US banking crisis, commercial real estate, tight labor supply, weaker consumer, and elevated recession concerns	▪ 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 widened since mid-April, fundamentals and technicals remain unchanged. Prefer conservative position while open to attractive buying opportunities, especially in short HY.US HY default forecast increased, driven by global banking stress, recession fears, margin pressure, demand deterioration and idiosyncratic sector risk ▪ 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. ▪ 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 continued to widen. Since Feb, the group has reduced exposure due to outperformance. Mortgage index has continued to widen. Since Feb, the group has reduced exposure due to outperformance. ▪ Supply picking up due to seasonals, still below expectations. FDIC liquidations from SVB/Signature beginning with lists trading better than expectations ▪ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon	▪ Additional bank failures ▪ 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
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 labor market weakness to see housing deterioration. Risk premiums still cheap to LT avg. ▪ CMBS: Investors cautious, especially on office. Credit curve is very steep; non-office sectors remain stable. ▪ CLOs: Spreads unch since April. Downgrades outpacing upgrades. More tail risks for subordinate bonds ▪ 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 ▪ 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