COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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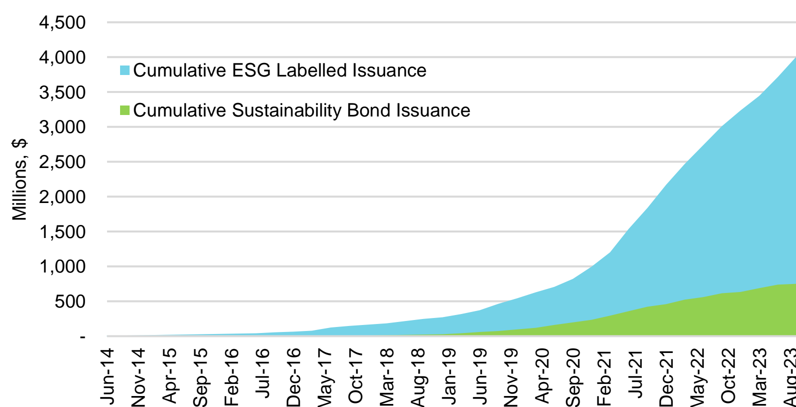
The only way is up.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.81%	-2 bps	0.1%	1.7%
German Bund 10 year	2.40%	-11 bps	-0.1%	1.0%
UK Gilt 10 year	4.19%	-26 bps	1.0%	-2.8%
Japan 10 year	0.46%	-2 bps	-0.7%	2.0%
Global Investment Grade	134 bps	-2 bps	0.5%	3.3%
Euro Investment Grade	150 bps	0 bps	0.7%	2.8%
US Investment Grade	126 bps	-2 bps	0.4%	3.7%
UK Investment Grade	134 bps	-3 bps	1.9%	0.8%
Asia Investment Grade	200 bps	-3 bps	0.6%	3.7%
Euro High Yield	455 bps	7 bps	0.7%	5.1%
US High Yield	389 bps	-1 bps	1.1%	6.6%
Asia High Yield	848 bps	28 bps	-1.7%	-1.9%
EM Sovereign	351 bps	-1 bps	1.1%	5.0%
EM Local	6.3%	0 bps	2.3%	10.3%
EM Corporate	339 bps	-5 bps	0.7%	4.4%
Bloomberg Barclays US Munis	3.4%	-8 bps	0.7%	3.4%
Taxable Munis	5.0%	0 bps	0.2%	5.2%
Bloomberg Barclays US MBS	53 bps	1 bps	0.2%	2.0%
Bloomberg Commodity Index	239.42	1.6%	5.0%	-3.2%
EUR	1.1089	-0.9%	2.0%	3.9%
JPY	141.36	-2.1%	1.8%	-7.5%
GBP	1.2836	-1.8%	1.2%	6.4%

Source: Bloomberg, Merrill Lynch, as of 21 July 2023.

Chart of the week: ESG-labelled issuance reaches $4 trillion



Source: Bloomberg and Columbia Threadneedle Investments, as of 24 July 2023.

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Macro / government bonds

Bond yields remained range-bound during the week. In the US, the Federal Reserve Blackout period meant there were no market communications from FOMC participants or staff, while there was also a dearth of meaningful data to influence market direction. Although the presumed market direction, after last week's US CPI print was lower, US treasury yields at the two-year maturity point actually drifted 10bps higher during the week.

In the UK, the inflation story finally took a positive turn. UK CPI rose by 7.9% in the 12 months to June, its lowest level in 15 months, and down from the figure of 8.7% for May. This reflected a slide in motor fuel costs, although food prices moderately rose. Could this be the watershed moment for the gilt market that finally arrested the upwards shift in gilt yields? Many in the markets initially seemed to think so. However, pieces in the inflation jigsaw remained missing. Although economic growth has decelerated, the UK labour market remains tight – insufficient conditions for the Bank of England to take its foot off the monetary policy pedal. Gilt valuations still remain cheap on a relative and an absolute basis, notwithstanding recent market strength. Two-year gilt yields finished the week 23bps lower but remained in range-bound territory.

In Europe, ECB Governing Council member and President of the Dutch Central Bank, commented that while a July bank rate hike of 25bps appeared a done deal, the case for the next interest rate rise would be data dependent. Before his intervention the market had been pricing in two 25bps rate hikes, the probability of which it subsequently adjusted downwards. Two-year eurozone bond yields fell by 9bps over the week. In sum, a frustrating week for fixed income traders, who strained their eyesight looking at screens, trying to ascertain what the next catalyst could be that would take bond valuations higher.

Investment grade credit

After the excitement of March, the investment grade market has delivered a lower volatility experience these last four months. Spreads have tightened and the amplitude of monthly spread variation has become somewhat compressed. The week ended with the global IG spread at 134bps; tighter by a margin from the 170bps reached in mid-March of this year.

Meanwhile, given the season, primary market activity is light – especially in Europe. On the demand side, the highish yields on offer in all markets seem to be attracting the interest of investors. They have been deprived of a reasonable income opportunity, until relatively recently, without taking a more significant amount of credit risk. The market is therefore well-supported technically at present.

We are in company results season and discussed US bank results last week. As we broaden into corporate and European results, results remain relatively robust though Netflix and Tesla missed expecations last week.

High yield credit & leveraged loans

It was a modest performance week for European High Yield (EHY) as the asset class only returned +10bps. Underlying, though, was the sharp decompression of rates as CCC's strongly underperformed higher-rated credits, as they returned -1.1% for the week. Given the fall in underlying government bond yields, EHY yields were unchanged for the week (7.7%) even as spreads widened marginally (+7bps) to 455bps. The primary market was subdued last week with only one new issue out (Energia, Irish renewable energy developer, €600m). Flows into EHY continued with another €230m coming into both ETFs as well as managed accounts.

On a sector basis, there is a growing view that Q2 will be better than expected in the auto space, improving the H1,23 numbers. This was supported by the latest Volvo figures, which showed a rise of 43% yoy in sales as well as ACEA car sales in June (+17.8% in all markets except Hungary). There was good news in food retail with UK supermarkets performing well on the inflation news. This follows comments from the Ocado CEO that the worst of UK food inflation is over as well as Kantar data out showing a fourth consecutive month of falling

inflation. While in basic industries, the chemicals sector had further confirmation of weakness with INEOS results showing a weak headline print driven by inventory holding losses, but with underlying numbers slightly better than expected. Leverage was also higher due to a loan to INEOS Energy.

Structured credit

As excess returns moved tighter for credit sectors, duration-sensitive sectors like Agency MBS struggled. The sector was down 10bps on the week with higher rates being the primary culprit. We have a big week ahead with the US Federal Reserve meeting. Expectations for another 25bps is mostly priced into the market and the question remains how much more tightening might be on the way to ensure inflation is headed towards its 2% target. Week-over-week, higher coupons outperformed lower coupons. News primarily surrounded the final ruling on Basel III, which is expected this week. If passed, this ruling will require additional capital for higher LTV mortgage loans. The net impact could be a positive to Agency MBS demand as banks prefer to hold MBS over direct mortgage loans. This, coupled with the fact that the FDIC has sold 80% of the pass-throughs acquired from the failed banks, create a positive technical. Non-agency RMBS trading was light last week. CRT spreads tightened alongside other risk assets. In CMBS, spreads rallied on the week. Tailwinds in the near term include limited issuance, healthy paydowns and strong relative value versus corporates.

Asian credit

The Chinese government announced some targeted stimulus for certain sectors. For the EV (electric vehicle) sector, the NDRC (National Development and Reform Commission) announced 10 steps, which include lowering the costs for EV and tax breaks. The NDRC is also encouraging local governments to buy new EVs for the public sector. Other measures include the upgrading of the charging infrastructure for EVs and building out the rural power grids to support EV use in rural areas.

For the electronics products sector, the NDRC announced 12 steps, which include getting companies to use domestic AI technologies and to promote more green and energy-saving smart home appliances. The intent is to drive up the consumption of electronic products.

In China, the PBOC stepped in with a higher daily fixing of CNY7.1466 (per US dollar, 680 pips stronger) to support the yuan on 20 July. The PBOC and SAFE (State Administration of Foreign Exchange) raised key macro-prudential adjustment parameters from 1.25 to 1.5, which defines how much a company can borrow relative to its net assets. The government is trying to expand the cross-border funding sources for companies and financial institutions.

In Thailand, after the Constitutional Court suspended Mr Pita’s status as a lawmaker, the Senate majority, which is dominated by the royalist and military establishments, seized the opportunity to block Mr Pita from standing for the second parliamentary vote on 19 July. The next parliamentary vote has been rescheduled to 27 July. Pheu Thai, which is the second largest party in the coalition with Mr Pita’s Move Forward party, will nominate its candidate for the next vote to be the Prime Minister.

Emerging markets

Returns for EM hard currency sovereigns were fairly flat last week at +0.10% with spreads unchanged at 350bps. The recent improved risk sentiment seen in the asset class was evidenced by the return of inflows for hard currency bonds funds after 22 weeks of consecutive outflows. Primary market activity also picked up a little after a quiet spell with new issuance in the corporate space.

Ghana's Central Bank hiked interest rates 50bps to a record high of 30% as the country looks to ensure inflation continues to decline. It currently stands at 42.5% having reached 54% last year. Turkey also raised interest rates for the second consecutive month, increasing by 250bps to 17.5%. While the move away from President Erdogan's long standing unorthodox views on monetary policy have been welcomed, markets still believe the rises are not large enough to combat the 38% inflation rate. Meanwhile, in South Africa rates were held at 8.25%.

Commodities

The BCOM index delivered a 1.6% return over last week. US natural gas had a strong week rallying by 7% thanks to higher temperatures in the US leading to elevated demand for cooling.

Wheat rallied by 5.4% over the week (Chicago contracts) and is extending gains as of Monday morning. The rally follows the recent axing of the Ukrainian grain export deal and its increasingly unlikely resumption in the near term, given Russian attacks on the port of Odessa and one of Ukraine's river ports. Russia said it will now assume any vessels travelling to Ukraine to be carrying weapons with the ship's flag countries being considered part of the war. Russia also accused Ukraine of using the deal to launch terrorist attacks.

Industrial metals continued their recent weakness following underwhelming stimulus from China. However, China did announce targeted support to boost sales of cars (particularly EVs) and electronics. Ten steps were announced that include lower costs for EV charging, extending tax breaks and encouraging local governments to increase car purchase quotas **(see Asian credit section for more details)**.

Responsible investments

The ESG labelled bond market has now reached over $4 trillion in size **(see chart of the week)**. As we look ahead to the traditional summer lull of new primary issuance, we can look behind over our shoulder to see just how big this market has really become. Although green bonds are very much part of somewhat everyday occurrence now, it is possibly most exciting to see social bond issuance slide back onto main stage with new opportunities and display the potential to drive tangible change from a social perspective. Sustainability bonds (a mixture of both green and social projects) have also been taking some of the limelight as we saw over $25bn issued in June, which was over a quarter of all ESG-labelled bond issuance that month. Let's hope as the leaves fall in September, we see the momentum continue.

'Catastrophe bonds' made headlines last week as certain corners of the planet fight to stop wildfires raging in what has become the norm to expect of the hotter summers. Catastrophe bonds are designed to cover losses from natural disasters, including named storms and other severe weather events. Headlines last week involved Swiss Re Capital Markets as it placed a $250m securitised catastrophe bond for certain real estate funds linked to Blackstone affiliates. These bonds are typically short in maturity and guarantee high returns to bond holders in the event the natural disasters don't happen…a risk only some may be willing to take!

Fixed Income Asset Allocation Views

24th July 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 ▪ u/w Silver ▪ o/w Aluminium ▪ o/w Corn ▪ o/w Lead	▪ Global Recession

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