COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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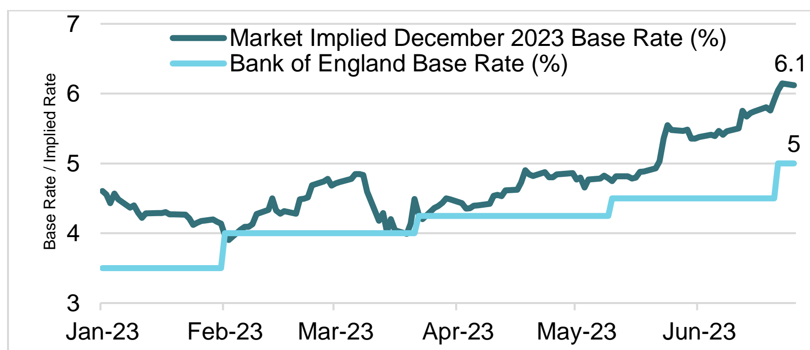
Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.69%	-7 bps	-1.0%	2.0%
German Bund 10 year	2.30%	-17 bps	-0.1%	1.4%
UK Gilt 10 year	4.29%	-12 bps	-5.8%	-3.7%
Japan 10 year	0.36%	-5 bps	0.6%	3.0%
Global Investment Grade	143 bps	1 bps	-0.1%	2.8%
Euro Investment Grade	160 bps	3 bps	0.7%	2.3%
US Investment Grade	135 bps	0 bps	-0.2%	3.2%
UK Investment Grade	142 bps	2 bps	-2.9%	-0.6%
Asia Investment Grade	202 bps	3 bps	1.2%	3.6%
Euro High Yield	465 bps	20 bps	1.5%	4.5%
US High Yield	440 bps	25 bps	0.8%	4.6%
Asia High Yield	784 bps	23 bps	-2.0%	0.8%
EM Sovereign	371 bps	-1 bps	1.4%	3.7%
EM Local	6.3%	-4 bps	2.4%	7.7%
EM Corporate	350 bps	1 bps	1.4%	3.7%
Bloomberg Barclays US Munis	3.5%	-4 bps	-0.1%	2.7%
Taxable Munis	5.0%	-3 bps	-0.1%	5.3%
Bloomberg Barclays US MBS	52 bps	2 bps	-0.2%	2.3%
Bloomberg Commodity Index	229.70	-2.6%	-1.8%	-7.1%
EUR	1.0894	-0.4%	0.5%	1.8%
JPY	143.14	-1.3%	-7.5%	-8.8%
GBP	1.2740	-0.8%	3.1%	5.2%

Source: Bloomberg, Merrill Lynch, as of 23 June 2023.

Chart of the week: Bank of England – Base Rate vs Evolving Market Expectations for the December 2023 Rate



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

Macro / government bonds

Price market action moved to the UK where the Bank of England (BoE) met to determine interest rates. The release of UK CPI data last Wednesday appeared to cement the case for an interest rate hike, with the only debate now focusing on whether it would be 0.25% or 0.5%. In the year to May 2023, UK Core CPI (excluding, energy, food, alcohol and tobacco) rose from 6.8% to 7.1%. This reflected elevated core goods inflation, alongside an increase in services inflation, which pointed to relatively resilient consumption despite the hit to incomes from rising mortgage costs. **Chart of the week** plots the increase in expectations about the UK base rate at the end of this year – through 2023 – against the actual base rate.

Last Thursday, the BoE raised its benchmark interest rate 0.50% to 5% as it sought to guide inflation back to its 2% target. Policymakers at the bank attributed the blame for higher prices on external cost shocks, which have fed through to higher prices and higher wages. Andrew Bailey, Governor of the BoE, even made a polite request in subsequent media interviews for some moderation in wage demands and the rebuilding of corporate profit margins. The conundrum for the BoE, as well as other central banks, is that interest rates are a blunt tool. While tighter monetary policy will dampen demand, it will do nothing to address the supply-side shocks, such as Covid and the war in Ukraine, which have impacted the global economy. We interpret the UK central bank's actions as front-loading interest rate hikes rather than raising the terminal interest rate to a new higher level. Although the market has priced in terminal interest rates of circa 6%, we believe the market is being overly pessimistic in its outlook for UK interest rates, especially if economic data comes in softer than expected. Greater market confidence that the BoE would act forcefully against inflationary pressures resulted in increased demand for UK longer-dated government securities.

In Europe, evidence of weaker manufacturing data emerged. This supported a market narrative that the magnitude of past interest rate hikes by the European Central Bank could tip the eurozone into recession, stimulating investor appetite for relatively high yielding eurozone sovereign debt.

Investment grade credit

There was little change in global investment grade spreads last week.

Spreads ended one basis point wider in the last seven days though there was a little more weakness in sterling credit after the surprise (extent of the) rate rise. Interestingly the IG market has underperformed high yield in the last few months with spreads only 3% tighter for global IG while nearly 10% so for the global high yield market. New issuance has started to wane as we enter the seasonally quiet summer period. This comes at a time of strong interest in the market from investors (inflows).

This week brings US bank stress tests. Our own expectations for banking sector fundamentals are as follows: firstly on asset quality (cost of risk) – we expect this to remain at the normalised level in Europe (helped by existing provisions from Covid). In the US, we expect it to move slightly above the normalised level (deteriorate) due to exposure to the commercial real estate sector and tighter credit conditions at the regional banks. Secondly, on capital, in Europe we anticipate capital improving by around 0.3% from 2022 to 2024. In the US, we expect capital to be 0.75% higher over the same period. Thirdly, for margins, we see an improvement in Europe but peaking margins in the UK, Nordic region and Southern Europe and falling by 2024. A similar peaking then modest decline is expected in the US. Lastly in terms of earnings (ROE), in both Europe and the US we expect increased ROE but a lower increase than we expected three months ago.

High yield credit & leveraged loans

US high yield valuations widened over the week amid hawkish rhetoric from the US Federal Reserve and an active primary market. The ICE BofA US HY CP Constrained Index fell -0.81% and spreads were 26bps wider. According to Lipper, US high yield retail funds reported a modest $265m inflow, leaving YTD outflows at $10.5bn. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index increased slightly to $93.87, approaching the YTD high, as investors absorbed mixed economic data, light retail outflows, and limited new supply. Retail loan funds reported a $152m withdrawal. YTD retail loan fund outflows totalled $18.3bn.

European High Yield (EHY) experienced some market consolidation after four weeks of positive performance as the asset class finished the week with wider spreads (+29bps to 465bps) and higher yields (+18bps to 7.82%). Decompression also returned as BBs outperformed higher beta credits while EHY underperformed sterling high yield. Flows were close to flat as outflows in ETFs and most managed accounts were offset by inflows for short dated EHY funds. The corporate primary market continues to pick up with €430m from three new corporate issues taking the YTD figure to €33bn, already an improvement of 64% compared to this time last year.

In M&A news, Telecom Italia reviewed the various bids and have decided to continue with the offer from KKR. SBB, the beleaguered Swedish real estate group, is reported to be in “exclusive” talks with Brookfield Asset Management Group to sell SBB’s 51% interest in EduCo. The proceeds from this will help address the company’s sizeable near term maturity wall.

In Casino news, the French retailer said that "in order to strengthen its liquidity”, Casino Group has launched the sale of its remaining stake in Assaí, a Brazilian retailer. Casino also finished the week with an announcement of the likely debt conversion of all unsecured debt and the need for €900m equity boost. This number is in line with the proposals by Czech entrepreneur, Kretinsky, and the group by French retail entrepreneur Zouari.

Structured credit

The US Agency MBS market was essentially flat last week, posting a 6bps positive return. Rates were higher on the short end on the curve and lower on the long end, which allowed both 30-year and 15-year Agency MBS to deliver modest returns. That said, wider spreads (5-8bps) pushed excess returns relative to US treasury counterparts negative.

In his testimony, Chair Powell took selling balance sheet MBS off the table, a tailwind for the sector. Additionally, the FDIC has now sold the vast majority of its lower coupons, which is a positive supply technical. In non-agency, we saw roughly $2.6bn come to market. Spreads were tighter by 5-10bps.

Asian credit

Based on the data from the Ministry of Culture and Tourism, the three-day Dragon Boat Festival (22-24 June 2023) saw a total of 106 million domestic trips (+32% y/y) and tourism revenue of CNY37.3bn (+44.5% y/y). The number of domestic trips was 12.8% higher than the level during the 2019 festival but the tourism revenue was 5% lower, indicating a lower spend amount per-trip compared with the pre-pandemic period. For comparison, the number of domestic trips and tourism revenue during the recent Labour Day holidays (29 April to 3 May 2023) were around 0.7% and 19% higher than the corresponding period in 2019.

Foxconn is looking out for another large India corporation to form a JV to manufacture semiconductors in India. The proposed JV with Vedanta Group to build a 28-nm semiconductor manufacturing facility is reportedly facing challenges, given the Indian government's concerns about the financial profile of Vedanta Group. On 31 May 2023, the government announced its invitation for new applicants to set up semiconductor fabrication and display fabs in India under the Modified Semicon Indian Program. Eligible companies and JVs could apply for 50% fiscal incentives.

Genting Berhad's plan to sell its Miami Herald Land for $1.24bn to Smart City Miami is not going forward on the back of disagreement with certain sales terms. The failure of this transaction is negative for Genting Berhad and its subsidiary Genting Malaysia Berhad (GENM). GENM is looking to reinvest the proceeds from the transaction to bid for a gaming license in New York City.

Emerging markets

Emerging market hard currency spreads were unchanged over the week, remaining at 371bps over treasuries with the investment grade sub sector outperforming high yield.

Turkey's new Central Bank governor Erkan hiked interest rates for the first time since the end of 2020 and while it was an increase to 15%, it was still much less than markets expected. President Erdogan, who adopts an unorthodox approach to monetary policy, appointed Erkan earlier in the month following the confirmation of his third presidential term.

Policy makers in Mexico left interest rates unchanged at 11.25% as did those in Brazil, leaving the rate at 13.25% but with a more dovish tone. The pausing theme continued in the Philippines and Indonesia too.

On Saturday, the 50,000 strong Russian Wagner paramilitary group marched on the Russian city of Rostov taking over regional military command alongside military facilities in two other cities. This follows accusations by the group's leader, Prigozhin, that the Russian army was deliberately undersupplying them and bombing Wagner soldiers that were fighting in Ukraine. Despite Putin promising to punish the group, criminal charges have now been dropped following a peace agreement being brokered by Belarusian leader Lukashenko. Prigozhin has now withdrawn to Belarus.

The episode has showed "real cracks" in Putin's authority according to US secretary of state Blinken and caused the ruble to fall to its lowest level since the initial invasion of Ukraine.

In China, we had two more real estate defaults, Central China Real Estate Ltd and Leading Holdings Group. This follows a renewed slowdown in Chinese real estate sales and continued disappointing data on Chinese consumption. While Central China bonds were trading at highly distressed levels one of the losers is the local government who holds 29% of shares alongside a substantial convertible bond holding making them the 'de facto' majority shareholder.

Commodities

Commodity markets saw falls of -2.6% driven by softness across the commodity complex. The biggest losers were nickel (-7.5%), silver (-7.4%) and palladium (-9.6%), with bright spots in US natural gas (+4.0%) and wheat (+6.4%).

In commodity news, the latest US crop report highlighted a further decline in crop conditions following dry weather across key growing regions. This has been supportive of wheat prices in recent weeks.

Elsewhere, the Biden administration increased the volume of biofuels that refineries must mix into fuel over the next three years. The announcement was below the expectations of biofuel groups with soybean oil contracts declining by 5% on the week.

Responsible Investments

Last week, a popular green bond issuance from BPI France was almost 18 times over-subscribed. The French investment bank, known for supplying loans to small to medium companies, came to the market with a €1bn 10-year deal and gained around €17.8bn in orders. With this green bond, BPI France intend to use its proceeds to lend to clients aligned with the Paris Agreement and those projects and companies promoting the ecological and energy transition. The high interest is somewhat unsurprising, albeit a large over-subscription, given the expectation that we will see record breaking issuance this year for ESG labelled bonds – especially in Europe.

A top trader at Shell has quit after the oil and gas company put profits ahead of its environmental and social efforts. A change in strategy by CEO Wael Sawan will mean more investments into fossil fuel in the years to come, despite still aiming to be net-zero by 2050, and drove their top trader from their renewable power trading subsidiary away. According to Bloomberg, this weaker effort to be net-zero is defended by Shell which states it will miss its target if the world as a whole doesn't cut CO2 fast enough. News travelled fast as The Church of England Pensions Board announced last week it plans to sell its stake in Shell after assessing the company is failing to address climate risks.

Fixed Income Asset Allocation Views

26th June 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 leans negative on Credit risk overall favouring higher quality sectors.** ■ 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. ■ 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. ■ 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 ■ 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 beginning to tighten from March wides.. Technicals remain weak ■ Maintaining conservative positioning while open to select idiosyncratic or relval based buying opportunities. ■ Tailwinds: Central bank easing in less inflationary countries. ■ 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. ■ Issuance slows ■ Chinese reopening paused ■ 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 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 ■ 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 ■ Volatility remains high and 2023 supply isbelow 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 early May, fundamentals and technical remain unchanged, with beginning of June reversing May outflows. ■ 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	■ 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 remain wide to historic levels, the group sought to capitalise on Mya's weakness. ■ Supply below expectations but improving. FDIC liquidations from Banks nearly half done. ■ 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: We feel cautious, especially on office and multifamily. Credit curve is very steep; non-office sectors remain stable ■ CLOs: Spreads have widened slightly since May. 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 ■ Cross sector contagion from CRE weakness.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	■ o/w Copper ■ o/w Oil ■ o/w Grains ■ u/w Silver ■ u/w Gold ■ o/w Wheat ■ o/w Soybeans ■ o/w Corn	■ Global Recession

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