In Credit

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David Oliphant
Executive Director,
Fixed Income

Contributors

David Oliphant

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Angelina Chueh

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Chris Jorel

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Laura Reardon

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Kris Moreton

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Justin Ong

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Charlotte Edwards

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Jake Lunness

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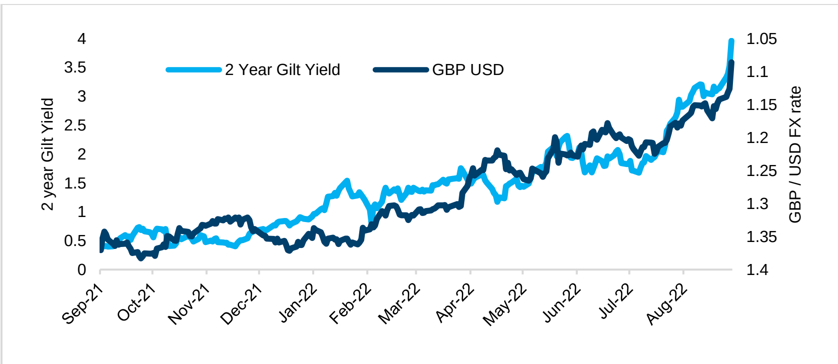
Mini budget, maxi impact.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.75%	30 bps	-4.0%	-12.8%
German Bund 10 year	2.09%	34 bps	-3.9%	-14.7%
UK Gilt 10 year	4.06%	93 bps	-14.1%	-26.8%
Japan 10 year	0.25%	-1 bps	1.4%	-3.2%
Global Investment Grade	162 bps	2 bps	-3.1%	-15.7%
Euro Investment Grade	198 bps	3 bps	-2.3%	-14.2%
US Investment Grade	151 bps	3 bps	-3.3%	-16.8%
UK Investment Grade	161 bps	1 bps	-9.0%	-20.3%
Asia Investment Grade	211 bps	-5 bps	-2.5%	-10.6%
Euro High Yield	566 bps	3 bps	1.7%	-13.7%
US High Yield	512 bps	12 bps	0.7%	-13.5%
Asia High Yield	949 bps	32 bps	-1.7%	-20.6%
EM Sovereign	435 bps	11 bps	-1.5%	-20.1%
EM Local	7.1%	15 bps	-3.2%	-17.3%
EM Corporate	377 bps	-1 bps	-0.9%	-14.7%
Bloomberg Barclays US Munis	3.9%	30 bps	-2.5%	-11.3%
Taxable Munis	5.0%	23 bps	-5.2%	-20.5%
Bloomberg Barclays US MBS	70 bps	17 bps	-4.7%	-13.1%
Bloomberg Commodity Index	240.81	-3.7%	-3.4%	14.4%
EUR	0.9684	-3.3%	-7.6%	-14.8%
JPY	143.87	-0.3%	-5.3%	-19.7%
GBP	1.0901	-4.9%	-10.8%	-19.8%

Source: Bloomberg, Merrill Lynch, as at 23 September 2022.

Chart of the week: UK gilt yields (LH) and sterling – LTM



Source: Bloomberg Columbia Threadneedle Investments, as at 25 September 2022.

Macro / government bonds

Onwards and downwards.

This year is proving to be one of the worst post WW2 years for total returns. There were yet more interest rate rises last week. As expected, the US Federal Reserve ratcheted borrowing costs higher in the US by 75bps; in a third consecutive move of that magnitude. The Bank of England moved rates higher but by less and by half a percent (to 2.25%). This was the fifth tightening in this cycle from the Fed and the seventh from the Bank of England. There is more to come it would seem. Hawkish rhetoric was maintained by Fed Chair Powell last week. Indeed market estimates are for a 'terminal rate' in the US of around 4.5%+ by the middle of next year. All the while, the Fed's forecasts for GDP growth were lowered (now 0.2% for this year and 1.2% for next). Inflation expectations were raised modestly in the coming year though a prediction of 2.1% by 2025 would take the inflation rate back close to its target rate of 2%.

Yields were substantially higher last week. Unsurprisingly the effects of these moves also helped invert the US yield further with the yield differential between 10- and 2-year notes around -0.55%. The last time the curve was this inverted was in the early 1980s. The US dollar also enjoyed a further push higher with the increased interest rate expectations. The DXY (Dollar) index is at the highest level since mid-2002.

The UK saw a slump in its currency to the weakest level to the US dollar on record. This reflected concern about the size of a massive fiscal package (c£45bn) announced at a 'mini' Budget last week. UK gilts also spiked higher in yields taking 2-year yields towards 4% (from less than 0.5% a year ago): **see Chart of the week**. The Institute of Fiscal studies reckons that public borrowing would exceed £190bn this year, which serves up a lot of gilt issuance to digest. Tax cuts include a reduction in the basic rate and highest rates of income tax and an increase in threshold in stamp duty on housing.

On the geopolitical front, the announcement of mobilisation of army reserves in Russia did little to calm already frayed nerves. In the wake of 'nonsense' referenda in Eastern Ukraine, Russia's claim to be defending its own territory suggests a proliferation and extension to this conflict. Meanwhile, the far-right Brothers of Italy party appears to have secured victory in the election. This will see Italy's first female Prime Minister in Giorgia Meloni.

Investment grade credit

Credit markets continue to struggle for direction.

Indeed, the global investment grade index spread has oscillated around the 160bps mark for much of the last two months. The fall in government bond prices and widening in spreads has, however, helped yields rise for corporate bonds. For example, the yield on the global investment grade market at around 5% is the highest since 2009 and well above the 20-year average of 3.5%. Good news if it is income you seek. As mentioned for weeks, euro credit is the underperformer and an area of the market that seems cheapest when compared to short- and longer-term averages. Indeed, there are also examples of global issuers whose bonds trade over 50bps cheaper (hedged / swapped back to US dollars) in euros than in the US market.

Last week, and as expected, the energy crisis in Germany saw the nationalisation of Uniper the power plant operator.

High yield credit & leveraged loans

US high yield bond yields rose 48bps over the past week to a level last seen in April 2020 alongside a surge in US treasury yields and the most inverted 2s/10s curve since 1982, amid hawkish central banks and resurfacing recession concerns. The ICE BofA US HY CP Constrained Index returned -1.65% while spreads were just 12bps wider. According to Lipper, the asset class reported a $1.7bn outflow for the week. This was the fourth outflow over the past five weeks in excess of $1bn, leaving YTD outflows at $50.6bn. Meanwhile, the average price of the J.P. Morgan Leveraged Loan index decreased $0.68 to $93.67 over the week as rapidly rising interest rate expectations were accompanied by underlying economic concerns. Fund outflows continued for loans as well with $1.2bn withdrawn over the week, leaving YTD inflows at just $3.8bn.

It was another down week (-1.3%) for European high yield largely due to the rise in underlying government yields as spread movement was marginal (only +3bps to 566bps). Fund outflows continued with €160m exiting via both ETFs and managed accounts, taking the YTD figure to -€11bn. Cyclicals were relatively weak, following some profit warnings in the US. Chemicals, especially, showed signs of weakness as firms including INEOS, OLIN and CHEMOURS lowered their guidance given comments from management, which pointed towards a slowing demand, particularly in Europe and Asia, due to a worsening of global economic conditions, coming at a faster pace than expected. Building and construction as well as consumer durables were also cited as being particularly weak. Other signs of things slowing down included container shipping firms indicating that the pace of the demand slowdown had risen.

The primary market almost showed some signs with a new issue from Inetum (€300m), and a price talk of 10.25 % -10.50%. In the end, the deal was pulled in favour of loans.

In rating news, Antolin was downgraded by Moody's to B3 from B2 while Parts Europe was upgraded to B1 from B2. Grifols (Spanish pharmaceuticals), was downgraded by S&P to B- (from B) with the rating agency pointing out that the firm's margins hadn't improved as much as expected. Ontex (nappies company) was downgraded to B from B+ with S&P citing depressed EBITDA margins.

In M&A news, proof that deals are still happening in spite of the macro backdrop and challenging financing market. The Bank of Italy cleared the way for the buyout of Atlantia by Benetton/Blackstone consortium. In Asia, SATS, a Singapore air freight logistics, announced it is discussing the purchase of WFS, a UK air cargo unit owned by Cerberus, the private equity group. In Europe, GIC agreed to acquire Sani/Ikos (Mediterranean luxury resorts) for €2.3bn.

In other news, VW said that it could look to shift production out of Germany/Eastern Europe if the gas shortage persists this winter.

Structured credit

It was another tough week for the US Agency MBS market, which posted a -2.21% total return. While the market responded favourably to Fed Chair Powell's statement that near-term sales of mortgages are off the table, the weight of the rate sell-off pulled returns into negative territory. While the Fed is going to continue to reduce holdings gradually, the asset class remains supported by money managers, especially as the potential for credit market volatility looms. In terms of the US housing market, we need to acknowledge that the headwinds are very real. Mortgage rates have more than doubled and affordability metrics are unattractive. Home prices have begun to decline marginally MoM; however, this is not expected to be anything like 2008.

Probabilities of a major drawdown in home prices remain low. One reason relates to payments. Homeowners have locked in very low interest rates and the sale of one home either means a new home at a higher mortgage rate or moving into the rental market, which is unattractive. Another reason relates to tighter lending standards post GFC. Underwriting over the last several years has been very strong and the profile of homeowners has drastically improved from a financial perspective. And finally, supply. In 2008, there were roughly four million existing homes for sale. That was the normal inventory level at that time. On top of that, there was another four million or so of shadow inventory or distressed sellers. Today, there is 1.3 million of normal inventory with perhaps 200,000 of shadow inventory on top of that. That's less than 25% of 2008 levels. In 2008, homeowners had to sell for many reasons, the most prevalent of which was the labour market that was experiencing high levels of unemployment. Home equity was very limited and many properties were underwater. In today's environment, the labour market remains healthy and homeowners are largely in a position of strength as it relates to home equity. The housing market dynamics are therefore very different this time around.

Asian credit

The Indian government is reportedly considering the deconsolidation of Rural Electrification Corp Ltd (RECL) from Power Finance Corp (PFC). PFC may sell its 52.6% stake in RECL to Power Finance Corp. This would be a reversal of the consolidation of PFC and RECL in 2018. Through this deconsolidation, PFC and RECL would become separate power financing entities again with their respective lending caps. In aggregate, this opens up the lending capacity.

Vedanta Ltd will convene a shareholder meeting in October to vote on the company's proposal to transfer its accumulated general reserves (INR125bn, or around $1.5bn) to retained earnings. This will give the company more flexibility to declare dividends, which is positive for Vedanta Resources (which owns a 69.7% stake in Vedanta Ltd).

Tata Steel is executing an amalgamation of six subsidiaries and one associate company to simplify its structure. The subsidiaries are Tata Steel Long Products (74.91% stake), Tinplate Company of India Limited (74.96%), Tata Metaliks Limited (60.03%), Indian Steel & Wire Products Limited (95%), Tata Steel Mining Limited (100%), S&T Mining Company Limited (100%) and TRF Limited (34.1%). While Tata Steel has previously spoken about simplifying its structure, it did provide a timeline for the amalgamation, which is also subject to regulatory approval. That said, the amalgamation is not a material development from a credit perspective.

For the Chinese property sector, the financial guarantee from CBIC (China Bond Insurance) is reportedly expanded to include a second bucket of weaker companies. The recent issuers of CBIC-guaranteed bonds are Longfor, Midea, Seazen and Country Garden but the size per-issue is relatively small CNY1-1.5bn. The cap per-issuer that CBIC can only provide around CNY2bn of guarantees per-issuer. According to REDD, China SCE, Agile, Excellence Commercial and Greenland are also in talks to issue the CBIC-backed bonds. China SCE has been downgraded by all agencies to B3/B- during the last two weeks. Its closest bond maturity is a CNY2bn onshore bond puttable in October 2022 and presumably the CBIC-guaranteed bond, if successfully issued, can help it refinance the puttable bond.

Emerging markets

The EMBI index sold off with the rest of the market with distressed names such as Pakistan, Ukraine and Argentina seeing heaviest declines. El Salvador bonds were one of the few positive performers as the nation bought back $565m worth of its 2023 and 2025 issues in attempt to bolster market confidence of the country's ability to service its debts.

In currency markets, the yuan is now trading at the weakest levels against the US dollar since 2008. The weakness results from a hawkish Fed compared to a more dovish PBOC, following recent cuts to the medium-term lending facility and prime loan rates. To limit yuan depreciation, the PBOC aims to make shorting the yuan more expensive by imposing a 20% risk reserve requirement on currency forward sales by banks. The measure means short sellers will have to tie up more margin in transactions, limiting the volume of short sales. In a similar vein, the Bank of Japan also intervened to support the yen as the market grapples with US dollar strength.

In central bank news we saw hikes from South Africa (+0.75%), Philippines (+0.50%), Taiwan (+0.125%) and Indonesia (+0.50%). Turkey cut rates by 1% despite inflation standing at 80.2% as the nation stands firm with its unconventional monetary policy.

In Brazil, the central bank held the selic rate at 13.75%, a pause following 1175bps in rate hikes over the last 18 months, a faster trajectory than the US Fed and other emerging market peers. Brazil's CPI peaked at 12% in April 2022 and printed at 8.7% in August 2022. Brazil has benefitted from positive real rates resulting in some capital inflows that have supported the Brazilian real, making it one of the few positively performing major currencies this year.

Commodities

The commodity index sold off heavily last week led by losses in the cyclical energy and base metal complex.

In Crude, prices initially rallied to $92 on the news that OPEC+ was missing its production targets by a record 3.58m barrels a day. Production has been subdued by underinvestment from members such as Nigeria and Angola alongside the impact on the Russian crude ban. Prices sold off following the FOMC's 75bps rate hike and the ensuing concerns of a global economic slowdown, brent fell to $86 at the end of the week.

Commodity markets have also faced headwinds from the rising US dollar, which rose 3.1% on the week measured the Bloomberg US Dollar Index.

Wheat was one of the few positive performers on the week, with Chicago contracts rising 2.4%. Prices of agricultural commodities are trading at levels seen before Russia's invasion of Ukraine but are still at elevated relative to the past five years.

Summary of fixed income asset allocation views (as at 26 September 2022)

Fixed Income Asset Allocation Views
26th September 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 ▪ 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 resurgence ▪ EM funding crises drive curves higher and steeper ▪ Tightening global financing conditions
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 & Lead vs Zinc ▪ o/w Softs ▪ o/w Grains ▪ u/w Gold ▪ o/w Oil ▪ u/w Silver	▪ 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 26.09.2022, unless otherwise stated.