In Credit

27 February 2023

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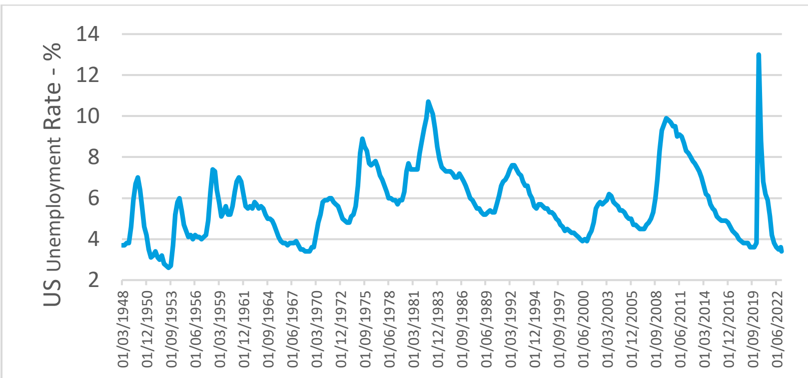
February blues.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	3.97%	16 bps	-2.7%	-0.1%
German Bund 10 year	2.59%	15 bps	-1.8%	-0.1%
UK Gilt 10 year	3.82%	31 bps	-3.0%	-0.3%
Japan 10 year	0.51%	0 bps	1.4%	0.3%
Global Investment Grade	133 bps	2 bps	-2.4%	0.8%
Euro Investment Grade	145 bps	3 bps	-1.0%	1.0%
US Investment Grade	128 bps	2 bps	-3.1%	0.6%
UK Investment Grade	142 bps	3 bps	-1.9%	1.6%
Asia Investment Grade	192 bps	-1 bps	-1.1%	1.2%
Euro High Yield	439 bps	5 bps	0.1%	3.4%
US High Yield	428 bps	-10 bps	-1.8%	2.0%
Asia High Yield	622 bps	9 bps	-2.2%	4.8%
EM Sovereign	367 bps	-10 bps	-2.2%	0.8%
EM Local	6.8%	4 bps	-3.2%	0.9%
EM Corporate	326 bps	-3 bps	-1.6%	1.4%
Bloomberg Barclays US Munis	3.6%	10 bps	-2.3%	0.5%
Taxable Munis	5.1%	13 bps	-3.1%	2.7%
Bloomberg Barclays US MBS	45 bps	4 bps	-2.9%	0.3%
Bloomberg Commodity Index	232.63	-0.8%	-5.3%	-5.8%
EUR	1.0554	-1.4%	-2.9%	-1.5%
JPY	136.34	-1.7%	-4.7%	-3.9%
GBP	1.1985	-0.8%	-3.1%	-1.2%

Source: Bloomberg, Merrill Lynch, as of 24 February 2023.

Chart of the week: US unemployment rate, 1948-2023



Source: Bloomberg, Columbia Threadneedle Investments, as of 27 February 2023.

5483882 Issued February 2023 | Valid to end April 2023

Macro / government bonds

It is looking like a fairly brutal end to a pretty miserable month for markets. This contrasts with the strength seen in the first month of this year and the end of last year, where government bond yields fell and credit spreads tightened.

As the expectation of the ‘terminal’ rate of interest in the US continues to increase (now 5.4% between July and September), so government bond yields have followed – especially at the short end of the yield curve which is, of course, more rate sensitive. Monetary policy expectations have been pushed higher by the ongoing tightness in labour markets (3.4% unemployment rate in the US) **(see chart of the week)**, higher inflation (CPI and PCE), stronger retail sales and higher business sentiment than expected. Rising rate expectations have also helped the US dollar to rally to around 1.05 versus the euro at the start of this week. In a sense good news about the economy has been unwelcome information for financial markets.

Specifically, the week ended with Personal Consumption Expenditure (PCE) data in the US. This came in at +0.6% m/m higher than the 0.4% expected and at 4.7% y/y, also higher than the 4.3% anticipated. That followed Consumer Price inflation data that also exceeded market expectations and came in at 6.4% y/y (expected 6.2%) and at 5.6% for the core (excludes food and energy prices) measure of inflation. Meanwhile, retail sales rose by a staggering 3% in one month taking the annual rate of sales to 6.4%. Globally (eurozone, UK and US) we saw PMI data released last week that also indicated that business confidence was higher than expected and above the pivotal 50.0 mark that marks the pivot point between contraction and expansion.

For perspective US real yields at 1.6% or so are in the region of the long-term average (since 1996) so valuations are not stretched.

Investment grade credit

Credit and equity markets have not been immune to the change in policy expectations and are also a little weaker. The duration effect has reduced prices while spreads have widened a little.

Despite strong inflows into the asset class, the fear of higher interest rates than previously envisaged dented market performance. Global IG spreads widened to 133bps at the end of last week. Spreads had tightened from 148bps at the end of last year to 127bps in early February. The long-term average spread is 140bps (20 years), according to data from ICE BofA indices.

As what has been a decent corporate result season draws towards a close, we can expect an increase again in new issuance, which is weighing a little on markets as well.

High yield credit & leveraged loans

US high yield bond yields increased for a third consecutive week as improving macro trends in 2023 are fuelling a more hawkish Fed narrative and higher interest rates.

The ICE BofA US HY CP Constrained Index returned -0.15% and spreads were 11bps tighter. The market has now fully priced in 25bps hikes at the March, May, and June meetings. And a 70bps increase in 2-year yields since early February is accompanied by the third largest weekly exodus from high yield mutual funds on record according to Lipper (-$6.1bn weekly outflow) and a stall in capital market activity. Meanwhile, the average price of the J.P. Morgan Leveraged Loan index declined $0.32 over the week to $94.56, although the asset class continues to outperform high yield bonds YTD amid a rapidly rising forward curve and firmer technicals. Retail loan funds saw a $618m outflow for the week.

European High Yield (EHY) had a third week of negative returns. Though the weakness was still largely dominated by macro moves as government yields pushed higher, there was also some credit weakness as spreads widened (+5bps to 439bps) and the index yield rose 17bps to 7.38%. Signs of decompression have also re-emerged, as BBs outperformed both Bs and CCCs. Sterling high yield outperformance vs EHY remains on track. Fund flows were still positive, but the size was marginal as ETFs experienced net outflows. The corporate primary market was subdued with only a Monte De Paschi new issue. Trading was balanced over the week but with some weakness in long maturity bonds given the increase rhetoric from central banks for continued rate hikes.

In sector news, autos are looking positive with S&P global mobility report expecting auto production of 85 MN (3.3% y/y growth) for 2023. In chemicals, there was finally some positive noises for the sector after the last few months of weakness due to lower sales and demand in this sector. Reports suggest that the destocking seen in the 3rd and 4th quarter is expected to come to an end and there are now expectations for growth to return to mid cycle levels in H2 2023, partially supported by China’s reopening. Airlines continue to perform well as indicated last week by British Airways with IAG reporting strong revenue (+10%) and EBITDA (+10%) for 2022. They are expecting FY23 capacity at 98% of 2019 levels.

High yield credit & leveraged loans

US high yield bond yields increased for a third consecutive week as improving macro trends in 2023 are fuelling a more hawkish Fed narrative and higher interest rates. The US Agency MBS market is hanging on to positive total returns by a thread, similar to all high-quality bonds. The sector, now up 32bps YTD, has given back the vast majority of its historic January run with the back-up in interest rates. All areas of the sector were down last week with higher coupons (lower durations) performing best. Spreads widened on a higher terminal rate and the possibility of more Fed hikes. The FHA announced a 30bps reduction in the annual mortgage insurance premium rates, an attempt at making loans less costly to mid Fico score borrowers. The health of the housing market is top of mind. With mortgage rates double their covid-levels (+6% vs 3%) mortgage payments are up 50%. Sellers and buyers are mutually turned off and essentially on strike with existing home sales down 40% from the peak.

In non-agency, spreads widened for most sectors last week with CRT widening 10-50bps, depending on tranche. In commercial space, office market headlines continue highlighting performance issues. Hotels are performing better with higher occupancy especially in warm weather destinations. ABS spreads were flat to 5-10bps wider on the week ending a nearly 12-week streak of consistently stable to tighter spreads.

Asian credit

ReNew Energy Global announced an improvement in the Days Sales Outstanding (DSO) during December 2022. The state distribution companies have been clearing their past dues and ReNew's DSO fell to 178 days in December 2022 (prior year: 256 days). The reduction in DSO contributed $122m to its Q3 cash flow.

GMR Hyderabad has announced another round of tender offers for up to $100m of its GMRLIN '24s and '26s bonds, a positive step in liability exercise management. In December 2022, GMR Hyderabad completed one round of bond buybacks for $139.1mn of the '24s and '26s bonds.

Adani Transmission stated that it will reduce the debt in its operational projects through debt payments and amortization. Management also does not rule out the potential for a tender offer for the ADTIN '26s, in contrast to the ADANIG '24s bonds, for which a tender offer is unlikely given the RBI regulations on the average maturity post-bond buyback.

For Sun Hung Kai Properties (SHKP), its H1 operating performance (period ended 31 December 2022) was impacted by the pandemic, resulting in rental income declining 6% y/y to HKD11.9bn. Positively, the company may have passed the bottom with the reopening in Hong Kong and Mainland China. Over the near term, SHKP can benefit from higher tenant sales at shopping malls and its upcoming investment property completion. SHKP plans to expand its attributable GFA of completed properties to above 37mn sq. ft by FY26 in Hong Kong.

The number of visitors to Macau in January 2023 more than doubled y/y to 1.4m, helped the easing of cross-border travel from Mainland China and the Lunar New Year holidays. The GGR (gross gaming revenue) rose 83% y/y to MOP11.58bn (~$1.44bn) in January 2023, which is equivalent to around 46.4% of the GGR in Jan 2019 (pre-covid).

Emerging markets

Rising US treasuries were detrimental to EM hard currency sovereign returns over the week, despite spreads being 10bps tighter, the overall return was -0.10% with high yield outperforming investment grade.

Nigerians went to the polls at the weekend to vote for the next president; these are the closest fought elections since military ruled ended in 1999. Results are still pending with people growing increasingly frustrated with the lack of updates from the electoral commission; the longer the delays, the more likely there will be allegations of fraud.

In ratings news, Costa Rica was upgraded to B+ by S&P after the country posted its first primary surplus in over a decade. Ivory coast was affirmed by Fitch at BB- stable outlook and Kenya's outlook was revised to negative by S&P. In Ghana, government bonds were downgraded to restricted default by Fitch.

In Turkey, the central bank resumed its rate cutting cycle with a 50bps reduction to 8.50%.

South Africa and Nigeria have been added to the Financial Action Task Force "grey list" of countries that need to do more to prevent terrorist financing and money laundering. Being placed on the grey list means transactions for banks and investors are subject to more scrutiny, which comes with increased costs.

We also had the South African budget which had a focus on state owned power company ESKOM following over 200 days of blackouts in 2022. The government will now absorb two thirds of ESKOM's debt on its balance sheet in addition to providing tax incentives for households and corporates to generate renewable energy. ESKOM bonds rallied strongly on the news. Following the budget, the CEO of ESKOM stepped down following his criticism of the South African government over corruption, saying the state-owned company is losing $55m a month due to corruption. In December the same CEO became violently ill after allegedly drinking poisoned coffee.

Commodities

The Bloomberg commodity index sold off by 0.8% in the week. The market is now down 5.8% on the year with 'soft' commodities (+8%) being the only subsector that has rallied materially.

The US announced it is raising tariffs on more than 100 Russian metals, minerals, and chemicals. The measure will significantly increase the cost of importing Russian aluminium into the US, which accounts for around 10% of US supply. Despite the increasing cost the measures fall short of an outright ban on Russian metal. Aluminium prices declined by 2.3% on the week.

Chicago wheat contracts fell by 7% on the week. Prices have softened following a wave of Russian exports, higher than expected US wheat planting and favourable conditions for France's wheat crop. Elsewhere the Black Sea grain export deal, which expires on 18 March, is now expected to be renewed despite intensifying fighting between Russia and Ukraine.

Responsible Investments

There was a 'Greenwashing' theme to last week.

Commerzbank AG lost a lawsuit regarding claims of its sustainability-linked products in the firm's investment arm having a 'measurable ecological impact'. A court in Germany ruled that the claim should have been supported by detail into how the carbon dioxide reduction is calculated. Elsewhere, HSBC has added the term 'greenwashing' to a list of risks it believes have the potential to prevent banks' access to capital markets. If it was discovered a bank was misleading stakeholders on any ESG related factors, failing to achieve net-zero ambitions or carbon reduction targets for example, then HSBC said it could face "greenwashing risk resulting in significant reputational damage, impacting our revenue generating ability and potentially our access to capital". Several banks have already been subject to greenwashing fines, including Goldman Sachs and Bank of New York Mellon.

A new law in Germany is expected shortly that will mean any home built new or renovated will be required to source two thirds of its energy from renewable sources. Heat pumps, which take warm air from outside for hot water and heating, are a key solution to this with current offerings from the government subsidising up to 45% of the cost of a heat pump if it is replacing an old oil supplied boiler.

Fixed Income Asset Allocation Views

27th February 2023

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	▪ Valuations are slightly more attractive relative to Jan, with technicals improving and fundamentals mixed. ▪ The group remained negative on credit risk. The Fed Funds market is pricing in a peak of 5.3% and rates being cut to 5.1% in 2023. ▪ The CTI Global Rates base case view is no cuts in 2023, with a best case of potentially one cut. They expect rates to peak between 5-5.25% in first half, with Fed holding steady through the second half. Risk skewing to slightly higher. ▪ Uncertainty remains elevated due to fears surrounding recession probabilities, schedule of central bank hiking/easing, persisting inflation, weakening consumer profile and the Russian invasion of Ukraine.	▪ Upside risks: the Fed achieves a soft landing, 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 to 2023.
Duration (10-year) ('P' = Periphery)	¥ $ Short -2 -1 -1 +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 may be curtailed by weakening growth, as risk of a policy error increases ▪ change in UK fiscal position to contractionary is a positive for the front end	▪ 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 $ €£	▪ 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 ▪ Aggressive Fed pricing may now open the door to selective EMFX performance ▪ EM real interest rates relatively attractive, curves steep in places	▪ US "no-landing" scenario raises terminal Fed rate ▪ EM inflation proves stickier ▪ EM central banks require restrictive policy in resurgent USD environment ▪ Global recession damages risk sentiment and EM capital flows
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ EMD spreads widened since Jan, but strong start to 2023. ▪ Better global risk sentiment, low rate vol and China reopening optimism. Europe higher as energy fears ease ▪ Fundamental headwinds: 22/23 growth deltas very large, elevated fiscal deficits, rising debt to GDP ratios, significant inflation, LATAM political risks, difficult global financing conditions (US rates and USD strength), increasing use of IMF programs, geopolitical risks ▪ Technicals improving with higher new year issuance	▪ China/US relations deteriorate ▪ Issuance slows ▪ Chinese reopening paused ▪ 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 from early Feb; fundamentals remain stable and technical challenges are easing. EMEA valuations remain cheap to USD. ▪ 4Q earnings coming in better than feared. Fundamentals remain stable with strong 2023 starting point – expected deterioration may be 2023 story ▪ Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment.	▪ 2023 supply below expectations. ▪ M&A expected to slow; cash flow prioritizing shareholder payouts ▪ 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 moved wider. Prefer conservative position while open to attractive buying opportunities. ▪ Technicals have improved in Jan with positive fund flows, two rising stars, strong primary market volume ▪ Corporate fundamentals have been mixed, but generally supportive. Two defaults in January. ▪ Bank loan market has rallied YTD driven by more CLO issuance, moderating fund outflows and limited new supply. Concerns about recession/weakening economy and interest cost remain headwinds.	▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ▪ Rally in distressed credits, leads to relative underperformance ▪ Loan technicals & flows weaken ▪ Global consumer health weakens ▪ Russian invasion & spillover ▪ Commodity prices retrace
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index has widened along with other risk assets. Valuations still slightly cheap but have modestly reduced exposure due to outperformance. ▪ Performance remains strong on the heels of lower volatility and money manager buying. ▪ Place to add, prefer high quality and higher coupon assets; constructive view over longer time horizon	▪ 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 in recessionary scenario
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Our preference remains for quality Non-Agency RMBS ▪ RMBS: Higher mortgage rate is headwind for prepays, fundamentals and transaction activity. Delinquency performance remains strong, need labor market weakness to see housing deterioration. Risk premiums still cheap. ▪ CMBS: Mostly solid fundamentals but weakening. Prefer Single Family Rental with its favorable 2023 supply outlook. ▪ CLOs: Spreads unch since Jan. Downgrades outpacing upgrades. Increased tail risks for subordinate bonds ▪ ABS: Lower income, renters, lower fico borrowers continue to underperform; higher quality borrowers remain stable.	▪ Weakness in labor market ▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening. Consumer (retail/travel) behavior 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	▪ Global Recession

COLUMBIA THREADNEEDLE INVESTMENTS