In Credit

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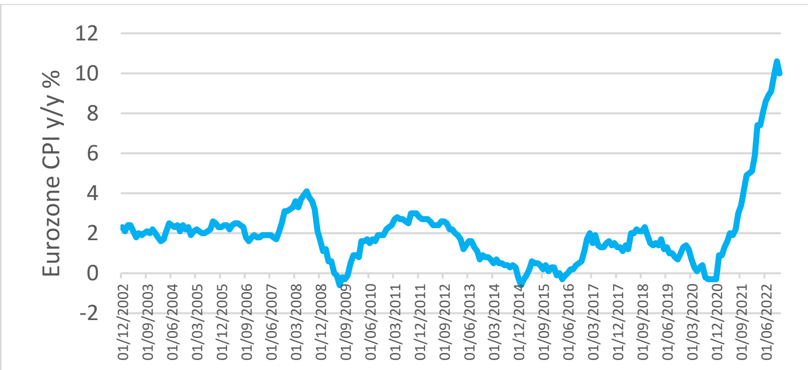
Peaking inflation, pushes prices higher.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.58%	-10 bps	2.5%	-11.3%
German Bund 10 year	1.88%	-9 bps	2.1%	-13.6%
UK Gilt 10 year	3.10%	-2 bps	5.9%	-21.9%
Japan 10 year	0.26%	0 bps	1.4%	-4.0%
Global Investment Grade	151 bps	-2 bps	4.8%	-13.0%
Euro Investment Grade	173 bps	-5 bps	3.7%	-12.0%
US Investment Grade	140 bps	0 bps	5.4%	-13.9%
UK Investment Grade	167 bps	0 bps	8.0%	-16.3%
Asia Investment Grade	226 bps	-18 bps	1.7%	-9.5%
Euro High Yield	522 bps	9 bps	5.3%	-10.6%
US High Yield	450 bps	-2 bps	5.6%	-9.8%
Asia High Yield	810 bps	-201 bps	7.3%	-17.5%
EM Sovereign	387 bps	-13 bps	8.6%	-15.5%
EM Local	6.8%	-18 bps	7.4%	-12.5%
EM Corporate	380 bps	-19 bps	4.2%	-12.7%
Bloomberg Barclays US Munis	3.5%	-18 bps	4.3%	-8.3%
Taxable Munis	4.9%	-21 bps	5.1%	-18.3%
Bloomberg Barclays US MBS	44 bps	-3 bps	4.0%	-10.2%
Bloomberg Commodity Index	243.94	-0.3%	3.4%	17.4%
EUR	1.0496	1.3%	7.5%	-7.3%
JPY	136.60	3.6%	7.8%	-14.3%
GBP	1.2169	1.6%	9.9%	-9.3%

Source: Bloomberg, Merrill Lynch, as at 2 December 2022.

Chart of the week: Eurozone inflation – 2002/22



Source: Bloomberg, Columbia Threadneedle Investments, as at 5 December 2022.

Macro / government bonds

Government bonds continue to enjoy a period of better performance. Falling bond yields and tightening credit spreads mean that returns since the mid-point of October have been more than respectable. Benchmark US treasury 10-year yields had reached around 4.25% at one point and are now around 75bps lower in only a month and a half.

After the encouraging reduction in US inflation last week, recent information from Europe and elsewhere suggests a similar trajectory. Of most importance, eurozone inflation fell to 10% y/y in November, a reduction from 10.6% the previous month; the consensus expectation was for a 10.4% y/y rate. Hence, this data release shows inflation has fallen and by more than expected. Core inflation (ex food and energy) remained at 5% y/y. Falling energy prices were the main reason for the decline. Staying in Europe, the German unemployment rate continues to rise – increasing to 5.6%. The rate has been driven higher mainly by a positive supply shock.

Ahead of the pre-FOMC news 'blackout', Chair Jay Powell noted that a moderation in the pace of monetary tightening might be in order – so expect a 0.50% rather than 0.75% increase in rates next week. The market continues to expect that the terminal rate of US interest rates will be achieved in Q2 of 2023 at around 5%. Hopes of a pivot in rates were not assisted by a stronger employment report on the last day of last week. Payroll job growth increased by 263k (that is more than the 200k expected). The biggest 'bad' news was the 0.6% increase in wages on the month. This was double the expected increase.

The reduction in US interest rate expectations has not been helpful for the US dollar. Where recently it traded below parity to the euro it ended the week nearer 1.05.

Investment grade credit

This encouraging news about inflation did not go unnoticed in credit markets.

In a generally quiet week, there was a grind tighter in spreads led by the euro market. Global spreads ended the week with a spread to government bonds of 151bps. You will recall that number was around 185bps at one point in October. So, when you add that to the decline in core government bond yields, total returns for the global index are over 6% in the last five or so weeks according to data from ICE indices.

We are at the tail end of results season with only a couple of companies to report this week (eg, DS Smith). Bonds remain supported by inflows, light dealer inventory and buy-backs (eg, InBev last week). In other specific news, telecom giant Vodafone's CEO stepped down unexpectedly.

High yield credit & leveraged loans

US high yield bond yields declined over the week, and spreads widened as investors absorbed rate volatility in the wake of a Fed Chair Powell speech and Friday's stronger than expected payrolls. The ICE BofA US HY CP Constrained Index returned 0.87% while spreads were 8bps wider. According to Lipper, the asset class saw a $1.7bn outflow, ending a five-week inflow streak that saw a total of $13.5bn contributed. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index rose $0.06 to $93.13 despite steady withdrawals. Retail loan funds saw an $880m withdrawn, the 15th consecutive weekly outflow for the asset class.

European High Yield had a strong November (+3.7%) as it finished with more than twice the positive performance of October, making the month the second best performing one in 2022, after the year's high in July. Performance continued its positive run for the sixth week in a row as CCCs strongly outperformed BB and Bs, both in euros and sterling. This was despite some spread widening (+9bps) over the week though yields remained unchanged. Positive flows into the asset class, continued, albeit at a smaller level relative to the previous week, both via ETFs and managed accounts. The corporate primary market saw only a hybrid issue from EDF, the French utility company, coming in at 7.5%, inside of initial 8.25% price talk, for a size of €1trn, upsized from €800m.

In credit rating news, ThyssenKrupp, the German metals company was upgraded by Moody's to Ba3 from B1 on a strengthening capital structure as well structural improvements to its business profile. Also from Germany was the upgrade of Deutsche Lufthansa by S&P to BB from BB- with positive outlook. The agency cited higher EBITDA and free operating cash flow expectations as well as an expectation that it will raise the credit rating again, within the next 12 months. In the continuing Telecom Italia saga, any last expectations of bids for TI fixed network was quashed as both Macquarie and Open Fiber announced they would not present a proposal. Regarding last week's Falling star, Wizz Air, the Hungarian discount airline, business numbers showed further improvement as the airline reported a 70% increase y/y in passenger numbers with load factors in November, up 12% from 2021 figures.

Securitised credit

The US Agency MBS market enjoyed a strong rally last week alongside other high-quality fixed income sectors. The index was up 1.43% on the back of a more dovish Chairman Powell and a subsequent rate rally. 30-year mortgages outperformed 15-year mortgages given their greater duration sensitivity. The same can be said for lower coupons vs higher coupons. Agency MBS spreads continued to tighten but remain very attractive on a longer-term basis. The story in mortgages now is more about the originators who are cutting staff given very low levels of production. November's prepayment speed will release this week and is expected to come in faster again. In non-agency, RMBS spreads were mostly tighter by 10-30bps. The sector overall has lagged other risk sectors of late. In CMBS, 2022 has been a year of spread widening. AAA spreads are c70bps wider while BBB- spreads are c350bps wider. While delinquencies have improved from their Covid peak, they are starting to trend higher once again and assessing longer-term relative value remains challenging in a dynamic return to the office environment.

Asian credit

In China, the PBOC and CBIRC (China Banking and Insurance Regulatory Commission) instructed four state-owned banks (Bank of China, China Construction Bank, ICBC, Agricultural Bank of China) to issue offshore loans to help developers address their offshore refinancing needs. A number of quality private-owned Chinese property companies such as Country Garden, Midea and Seazen are mentioned as potential beneficiaries. The four state-owned banks are instructed to issue offshore loans that will be secured against collaterals from the property developers, by 10 December 2022.

Earlier last week, the China Securities Regulatory Commission also announced five measures to facilitate the access of listed real estate companies to equity financing in the A-share market. On another hand, the transmission of these measures is likely to take some time compared with the more immediate boost to short-term liquidity, coming from the recently announced provision of various credit lines by Chinese state-owned banks to 17 property companies.

Longfor Properties has successfully issued a second onshore bond, guaranteed by the CBIC (China Bond Insurance Corporation) at 3%. The amount raised was CNY2bn, higher than its first issuance of CNY1.5bn at 3.3% in August.

Emerging markets

Another strong week for emerging market bonds as the index posted a return of +2.23% due to a fall in treasury yields and tighter EM spreads (-13bps). We saw a strong compression theme as high yield outperformed investment grade. Latin American countries fared the strongest.

Tunisia was upgraded by Fitch to CCC+ following a deal with the IMF. The country has secured a $1.9bn Extended Fund Facility, which should cover the government's funding gap. Indonesia hiked 50bps to 5.25%, the fourth month of consecutive hikes. Poland held at 6.75% as inflation fell slightly to 17.4%. In the primary markets, Colombia issued $1.36bn in a long 10-year bond.

In South Africa, president Ramaphosa is facing pressure to step down for breaking the law in allegedly covering up a theft at his farm. Ramaphosa has disclosed that $580,000 was stolen from a sofa, a sum that he claims was acquired from the sale of 20 buffalo (that's $29k each). The president appeared to be on the cusp of resigning on Friday; however, Ramaphosa' s lawyers will now be challenging the grounds for his impeachment, with parliament expected to debate the issue on Tuesday. Markets reacted poorly, with the rand selling off 2.4% on the week and sovereign spreads widening by 42bps.

Pakistan made a $1bn principal payment on a 2022-dollar bond (due this week). Pakistan remains a distressed story following the recent floods and commodity price shocks, but this payment staves off imminent default and markets reacted positively.

In China, there were signs of lighter touch covid restrictions following recent anti-zero covid protests. Restrictions in major cities were abruptly lifted alongside a community in Beijing allowing some cases with mild symptoms to isolate at home. State officials have also downplayed the severity of covid given higher vaccinations and the less lethal omicron strain.

Commodities

Commodity markets were marginally down on the week; base metals, particularly nickel and aluminium supported returns with US natural gas dragging down returns. US gas prices were supported by the US energy department's inventory release showing a smaller than expected decrease in natural gas stockpiles.

Base metals were supported by signs of China taking a lighter stance on covid restrictions. Manufacturing, notably iPhone supplier Foxconn, has been severely restricted in recent weeks. China's manufacturing PMI has been sub 50 (contractionary) for the past two months, with Foxconn recently seeing worker protests in response to poor working and living conditions, exacerbated by strict covid controls. Nickel and aluminium prices rallied 13.6% and 7.8% respectively.

In crude, the EU agreed a Russian oil price cap of $60, below the previous proposal of $65-70. Despite the lower cap, this is still above levels that Russia is currently selling, the cap comes into force on 5 December 2022. Elsewhere OPEC+ met with no change to policy, continuing with its previously announced cuts of 1 million barrels a day. WTI rallied 4.9% on the week.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views
5th December 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	▪ Valuations have become more attractive since October, as volatility came off 2022 highs and signs of improvement came from technicals and fundamentals. The group is now neutral on credit risk, upgrading Investment Grade and High Yield. ▪ We are past the peak of economic growth, with expectations for more 50bp hikes through 2H 2023, followed by multiple cuts in 2023. Pullback in liquidity created opportunity for market volatility. ▪ Uncertainty remains elevated due to fears surrounding recession probabilities, schedule of central bank hiking/easing, inflation, 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, 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)	¥ 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 ▪ 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 $ €£	▪ 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; inflation peaking in some places ▪ 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 peaks higher and later ▪ EM funding crises drive curves higher and steeper ▪ Further rises in DM yields
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ EMD spreads tighter since last meeting; continued outperformance in HY, high-beta credits ▪ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, central bank tightening, China lockdown/growth, idiosyncratic political risks, difficult global financing conditions (US rates and USD strength), increasing use of IMF programs, geopolitical risks ▪ Technicals (outflows and supply) remain a headwind	▪ Chinese reopening postponed – weakened property market and confidence drag on growth ▪ 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 tightened since October. ▪ 3Q earnings met and management commentary exceeded expectations. Inflation, labor supply, low dispersion and monetary tightening continue to pressure margins and operating environment. ▪ Technicals have started to improve, with the long end outperforming the widening in spread terms	▪ M&A expected to slow; cash flow prioritizing shareholder payouts ▪ 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 continued widening. Combined with greater downside risks, the group prefers conservative position while open to attractive buying opportunities. ▪ Technicals have started to improve with positive fund flows and no defaults in October. Light primary market ▪ Bank loan market has moved sideways: greater volatility and fund outflows are offset by stable CLO formation and less new loan issuance. Concerns about recession and interest cost remain headwinds. No defaults since September, calendar is opening for higher quality issuers	▪ Default concerns are focused on demand destruction, margin pressure and macro risks ▪ Loan technicals & flows weaken ▪ Global consumer health weakens ▪ Russian invasion & spillover ▪ Commodity prices continue to retrace
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage spreads have widened in past month to the cheapest level in a decade; valuations and long-term fundamentals pushed the group to upgrade Agency MBSCurrent coupon spreads near recent wides ▪ Headwinds as money manager demand is small relative to Fed, bank, REIT and overseas selling pressure ▪ Looking to add as preference shifts to high quality assets	▪ 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 Non-Agency RMBS ▪ RMBS: Higher mortgage rate is headwind for prepays, fundamentals and transaction activity. Delinquency performance remains strong, but housing is slowing. Risk premiums are attractive; moving to buy higher quality risk ▪ CMBS: Mostly solid fundamentals but weakening. Spreads at summer lows. Better relval elsewhere, continue to trim. ▪ CLOs: AAA spreads modestly tighter, Mezz spreads firming along with macro. Default rate low but increasing. ▪ ABS: Lower income, renters, lower fico borrowers continue to underperform, higher quality borrowers remain stable.	▪ 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 fullsteam-ahead post-pandemic (positive for RMBS, negative for CMBS). ▪ Rising interest rates dent housing market strength
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Softs ▪ u/w Gold ▪ o/w Oil ▪ u/w Silver	▪ Global Recession