# In Credit

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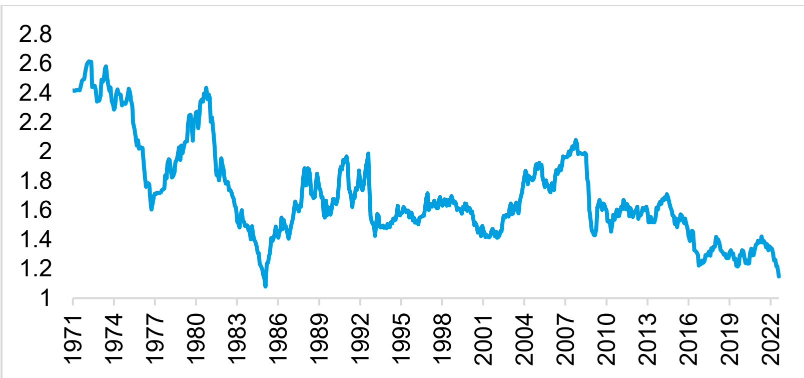
## Gilt-edged insecurity

### Markets at a glance

| | Price / Yield / Spread | Change 1 week | Index QTD return | Index YTD return |
|---|---|---|---|---|
| US Treasury 10 year | 3.19% | 15 bps | -1.3% | -10.4% |
| German Bund 10 year | 1.57% | 18 bps | -0.7% | -11.8% |
| UK Gilt 10 year | 2.97% | 37 bps | -6.9% | -20.6% |
| Japan 10 year | 0.24% | 1 bps | 1.4% | -2.8% |
| Global Investment Grade | 163 bps | 7 bps | -0.3% | -13.3% |
| Euro Investment Grade | 200 bps | 11 bps | 0.4% | -11.8% |
| US Investment Grade | 150 bps | 8 bps | -0.4% | -14.2% |
| UK Investment Grade | 166 bps | 6 bps | -4.2% | -16.1% |
| Asia Investment Grade | 222 bps | -24 bps | -0.9% | -9.1% |
| Euro High Yield | 587 bps | 39 bps | 3.3% | -12.3% |
| US High Yield | 506 bps | 41 bps | 3.3% | -11.2% |
| Asia High Yield | 947 bps | 75 bps | -0.6% | -19.7% |
| EM Sovereign | 430 bps | 17 bps | 1.4% | -17.7% |
| EM Local | 6.9% | 5 bps | 0.2% | -14.4% |
| EM Corporate | 385 bps | 7 bps | 0.9% | -13.1% |
| Bloomberg Barclays US Munis | 3.4% | 15 bps | -0.1% | -9.1% |
| Taxable Munis | 4.5% | 14 bps | -1.7% | -17.5% |
| Bloomberg Barclays US MBS | 41 bps | 2 bps | -0.4% | -9.1% |
| Bloomberg Commodity Index | 256.35 | -4.4% | 2.2% | 21.0% |
| EUR | 0.9927 | -0.1% | -5.1% | -12.5% |
| JPY | 140.60 | -1.8% | -3.2% | -17.9% |
| GBP | 1.1510 | -2.0% | -5.5% | -14.9% |

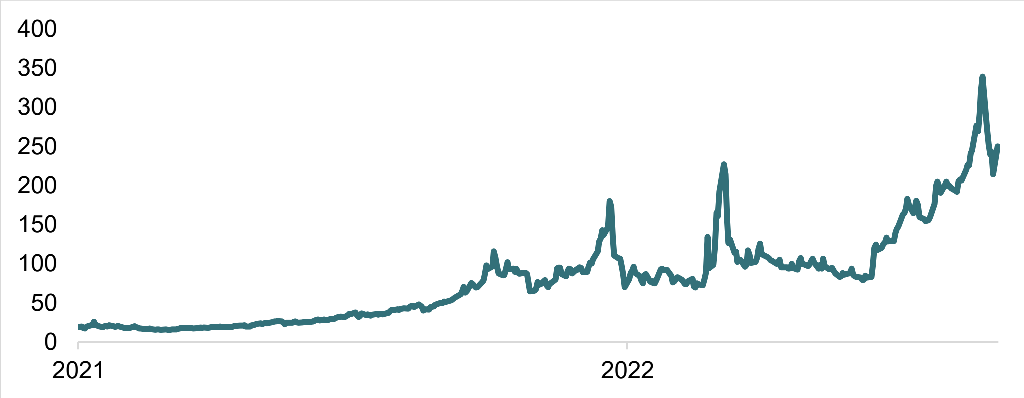
Source: Bloomberg, Merrill Lynch, as of 2 September 2022.

### Chart of the week I: **Uncool Britannia** USD to GBP, 1970-2022




Source: Bloomberg Columbia Threadneedle Investments, as of 5 September 2022.

**Chart of the week II: European Natural Gas Prices (Dutch TTF).**




Source: Bloomberg Columbia Threadneedle Investments, as of 5 September 2022.

## Macro / government bonds

What a terrible month for government bonds in general and UK Gilts in particular. The UK Gilt index returned -8% in the four weeks of August. This is the worst monthly total return since ICE index data began in 1986. It was grimmer yet for inflation-linked bonds, which you might have thought would do well in today's environment. They are now down aound by a quarter in the year thus far. Other government markets tried to compete with Gilts, but while declines were impressive they were not as bad as the UK. Meanwhile, in another sign of "uncool Britannia" the pound sank to new lows of around 1.15 to the US Dollar **(see Chart of the Week I).**

The ruling Conservative Party anointed Foreign Secretary Liz Truss as the UK's next prime minister. She faces the unenviable task of reviving a beleaguered economy. The UK business sector is probably already in recession – as evidenced by the sharp decline in the Purchasing Managers Index and reflecting spiralling fuel costs. For British consumers, the prospect of an imminent sharp rise in household energy bills and surging mortgage costs are also huge issues – and would be expected to result in demand destruction with declines in spending on areas of lower necessity such as discretionary items and leisure activities. If there is good news, it is that the unemployment rate is still historically low and consumers, especially in higher income bands, amassed savings during the Covid lockdowns. Later this month we can expect Ms Truss to offer an emergency budget with the aim of addressing this cost-of-living crisis. So while fiscal policy looks set to become more expansionary the Bank of England will continue its fight against inflation and is expected to raise interest rates to above 4% according to market pricing in the next year, from 1.75% today.

Th US was on holiday on Monday 5 September for Labor Day. Last week ended with the US unemployment report which saw job creation come in around expectations at 315,000. There were revisions lower to prior months data, however. The unemployment rate popped higher to 3.7%, against an expected 3.5%, though this did not reflect layoffs – rather an increase in the workforce/participation rate.

## Investment grade credit

Credit markets had enjoyed a period of tightening spreads from wide prints of around 180bps in early July to closer to 150bps by mid-August. The renewed hawkishness from central banks has forced them higher/wider, however, with the global index closing last Friday (2 September) at 163bps.

What is good news is the much more attractive yields on offer – where the cocktail of higher yields and wider spreads has taken yields back to their highest levels this year, and indeed the past five and 10 years. You would need to go back to 2009 to find a global index yield significantly higher than today.

As with earlier in the year, euro-denominated markets have underperformed the US dollar market. This has been impacted recently by a heavy calendar of issuance in this market which, in spite of attractive new issue premia, has proved difficult to digest. Spreads are well over two standard deviations cheap to the five-year average and one standard deviation cheap to the 20-year equivalent.

Globally, credit curves have also flattened this year with shorter maturity bonds underperforming. Year to date, real estate, banking and autos have been the weakest sectors while energy, utilities and telecoms have displayed the greatest degree of defensiveness.

## High yield credit & leveraged loans

It was a poor week for European HY, largely contributing to the negative performance for August. EHY returned -1.7% last week with spreads widening 39bps to 587bps, while yields rose 54bps to 7.36%. Single Bs underperformed both CCCs and BBs for the week, while CCCs were the best performing non-investment grade credit in August. Outflows continued across EHY in the week to 31 August (EPFR data), with $150 million leaving the space. YTD outflows now stand just outside -$9 billion. The US fared worse, haemorrhaging $4.5 billionn, the second largest YTD for a cumulative figure of -$40.4 billion. The previous two weeks of outflows are reflective of increased energy crisis fears and a step up in central bank rhetoric. The primary market remained shuttered with talk geared to potential deals in September. STG-denominated issues, especially in the leisure sector, were especially hit last week on the back of a poorly executed portfolio trade – also an indication of the continued tough trading environment.

Second quarter reporting finishes with most companies reporting generally solid figures as they show results in line or better than expected. Real estate names reported seeing increased growth rates for rental income with some small portfolio valuation uplifts reflecting improvements in key performance indicators like reduced vacancy. Healthcare names mostly reported in-line results but did note they were starting to get hit by cost inflation as the pass through of inflation for the cost of production of certain molecules was not appearing to be as efficient as seen in other industries.

In autos news, July was a better month for European original equipment manufacturers (OEMs), with an improvement in volumes as pricing remains high. This suggests European autos will perform well in Q3. Concern over 2023 is driving current performance. Already, French car sales are showing a +3.8% year-on-year rise. Expectations are that the theme will continue as chip shortages ease.

In energy news – and a sign of the times – energy companies are asking SMEs for early/upfront payments to get an energy contract. This has been happening in the UK and has started to occur in France. As a result, some enterprises have halted operations – for example, Duralex, a French glass manufacturer, has stopped manufacturing for four months due to energy costs. It should be noted that some OEMs have been stock piling and have six months' supply to manage this. The Gazprom announcement on Friday that it will not resume gas delivery to Europe has had the expected negative effect on the market, but given inventory levels rationing is looking less likely for this winter. It will however be an issue for 2023/24 given how low storage levels could be at that time. More worrisome for corporates is the German government's talk about suspending energy derivative trading and the implication of this for a corporate's hedging situation as well as counterparty risks.

In transportation news, there was continued challenges on the labour front as exhibited by Lufthansa last week. The pilot union struck last Friday resulting in 10,000 pilots walking out and affecting as many as 7,000 flights. Supposedly, the union's set of demands would increase cockpit personnel cost by 40%, or an extra €0.9 billion to an existing €2.2 billion cost base. The demand was rejected.

## Asian credit

The preliminary data from CRIC (China Real Estate Information Corp) showed the new home sales value for the top 100 property developers in China in August 2022 fell by 32.9% y/y to $75.9 billion. While the August decline was an improvement from the July numbers (-39.7% y/y), this was largely due to a low base and the overall recovery in the property sector remains weak.

CIFI Holdings announced a share placement to raise net proceeds of HKD622.57 million ($79.3 million) to refinance existing debt and for general corporate purposes. The liquidity risk has receded and CIFI does not have any public bonds coming due in 2022. In April, the company issued HKD2.5 billion of convertible bonds and is reportedly planning to issue a three-year CNY1-1.5 billion bond, which will be guaranteed by China Bond Insurance, a credit support provider, under a new scheme proposed by the government. Other property developers reportedly looking to issue state-backed bonds with guarantees from China Bond Insurance include Country Garden, Longfor Group, Seazen, Gemdale and Sino-Ocean.

Azure Power confirmed that the whistleblower's allegations around safety issues and project data manipulation are for one single project. Management cannot comment on the specifics of the project, either operational or under-construction, but said the affected project has a small number of employees.

The US Department of Commerce has imposed a new license requirement for the export of high-end graphics-integrated circuits by US companies (NVIDIA and AMD) to China and Russia. These products are typically used in data centers, high performance computing and artificial intelligence applications. According to NVIDIA, around $400 million of potential sales (including its A100 and forthcoming H100 integrated circuits) to China may be subject to the new license requirement. The Chinese government has called on the US government to repeal this latest technological curb.

## Emerging markets

In response to the yuan deprecating 8% this year the PBOC has cut the foreign exchange reserve ratio. Financial institutions now need to hold 6% of their foreign currency deposits in reserves, down from 8%. The lower requirement will free up approximately $19 billion in foreign currency.

In Indonesia, the government will raise subsidised fuel prices by around 30%. The decision comes after the nation's fuel subsidiary budget for 2022 tripled. The subsidiary has restrained inflation, currently at 4.69% in August, and allowed the central bank to hike at a slower pace than its peers. The last price hike occurred in 2014 resulting in widespread protests. Small protests have been occurring in recent days.

In Chile, voters overwhelming rejected the proposed new constitution. This aimed at improving the rights of Chile's indigenous population (covering lands and resources) alongside enhancing women's rights. The rejection was despite 80% of the population favouring a new constitution in 2020.

In central bank news we saw hikes from Hungary (+1% to 11.75%), Dominican Republic (+0.25% to 8%) and Kazakhstan (+1% to 11.75%).

## Commodities

European natural gas prices surged 26% on Monday **(see Chart of the week II)** following the news that Russia's Nord Stream 1 pipeline will suspend flows indefinitely. The pipeline was supposed to resume operations on Saturday following regular maintenance. Gazprom have blamed an oil leak in a turbine for the closure. Fortunately, German gas storage has filled up quicker than expected, currently at 86%, but the country's Federal Network Agency regulator says that storage at 95% equates to around 2.5 months of demand if Russian flows are halted.

Industrial metals declined 8.2% on aggregate with zinc and tin declining by 12.1% and 14.5% respectively, following further Chinese lockdowns. The latest wave of restrictions started with the lockdown of Chengdu, a city of 21 million residents. Currently 70 Chinese cities are under partial or full lockdown covering more than 300 million people out of a 1.4 billion total population.

Turning to oil, brent declined 6% on the week as the market grappled with the prospect of recession-driven demand destruction, Chinese lockdowns, and the Iranian nuclear deal discussions. Additionally, on Friday the G7 agreed to set a price cap on Russian oil exports to limit the financing of the war in Ukraine and to only permit the trade of Russian-based oil products below the set level. The plan will use the London insurance market, which covers 95% of global oil shipping, as leverage, refusing Russia access if they fail to comply.

## Summary of fixed income asset allocation views (as at 5 September 2022)

### Fixed Income Asset Allocation Views

5th 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 tightened 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.**<br>▪ We are past the peak of economic growth with first few hikes done and expectations for more 50-100bp hikes through the end of 2022. Pullback in liquidity created opportunity for market volatility.<br>▪ 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<br>▪ 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)**<br>('P' = Periphery) | ¥ P $<br>Short -2 -1 0 +1 +2 Long<br>€ £ | ▪ Carry offered by front end yields now attractive in UK<br>▪ Longer yields to be captured by long-run structural downtrends in real yields<br>▪ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures<br>▪ Hiking cycles may be curtailed by weakening growth, as risk of a policy error increases | ▪ Inflationary dynamics become structurally persistent<br>▪ Labour supply shortage persists; wage pressure becomes broad and sustained<br>▪ Fiscal expansion requires wider term premium<br>▪ Long run trend in safe asset demand reverses |
| **Currency**<br>('E' = European Economic Area) | ¥<br>A$<br>EM<br>Short -2 -1 0 +1 +2 Long<br>$<br>€ £ | ▪ The invasion of Ukraine will hit global growth, hinder risk markets and lend a bid to the Dollar<br>▪ 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<br>Under-weight -2 -1 0 +1 +2 Over-weight<br>C | ▪ Substantial monetary policy tightening now embedded into EM local rates<br>▪ Aggressive Fed pricing may now open the door to selective EMFX performance<br>▪ EM real interest rates relatively attractive, curves steep in places | ▪ Negative sentiment shock to EM fund flows<br>▪ Central banks tighten aggressively to counter fx weakness<br>▪ EM inflation resurgence<br>▪ EM funding crises drive curves higher and steeper<br>▪ Tightening global financing conditions |
| **Emerging Markets Sovereign Credit (USD denominated)** | Under-weight -2 -1 0 +1 +2 Over-weight | ▪ Strong month for EMD returns with tightening spreads and rallying in oversold names; still seeing bifurcation in market<br>▪ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, Chinese lockdown/growth, idiosyncratic political risks, increasing use of IMF programs<br>▪ Recent commodity price retracement has refocused attention on underlying fiscal health; benefiting commodity importers and harming exporters; fundamental<br>▪ Techincals (outflows and supply) remain a headwind | ▪ Chinese growth derails with less stimulus and uncertain zero covid policy after economy reopens<br>▪ Continued spillover from Russian invasion: local inflation (esp. food & commodity), slowing growth in trade partners, supply chains<br>▪ 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 after hitting YTD wides in July, supported by positive economic data.<br>▪ Stable fundamentals beat pessimistic expectations for Q2 earnings. Inflation, labor supply and monetary tightening, however, remain headwinds pressuring margins and operating environment in Q3 2022.<br>▪ Technicals have improved with reopening new issue market, positive fund flows and better liquidity | ▪ Remaining Q2 earnings show surprise weakness, materially lower Q3 outlooks<br>▪ Market indigestion as central banks sell EMEA corporates<br>▪ Rate environment remains volatile<br>▪ Russian invasion worsens operating environment globally |
| **High Yield Bonds and Bank Loans** | Under-weight -2 -1 0 +1 +2 Over-weight | ▪ Spreads have quickly tightened after hitting YTD wides in May/June. Combined with greater downside risks, the group prefers conservative positioning while remaining open to attractive buying opportunities<br>▪ Technicals remains a headwinds with light primary issuance, however fund flows are shifting positive and default activity remains benign/idiosyncratic<br>▪ Bank loan market has moved higher with more new issues and non-traditional loan investors; concerns about recession and interest cost remain headwinds | ▪ Default concerns are focused on demand destruction, margin pressure and macro risks<br>▪ Loan technicals & flows weaken<br>▪ Russian invasion & spillover rattles US bond loan/market as already seen in EMEA<br>▪ Commodity prices continue to retrace |
| **Agency MBS** | Under-weight -2 -1 0 +1 +2 Over-weight | ▪ Mortgages recently outperformed as volatility dropped and spreads tightened.<br>▪ Prefer higher coupon because of more attractive valuations, carry, priority in Fed sales and sponsorship<br>▪ Mortgage spreads have stabilized in past month at historically wide levels, supply continues to drop along with purchase activity and cash out refinancing | ▪ Housing activity slows and rising rates move prepays to normal levels without hurting mortgage servicing rates.<br>▪ Uncertainty with the Fed hiking and future balance sheet position<br>▪ Less bank holdings of MBS as deposit growth slows |
| **Structured Credit Non-Agency MBS & CMBS** | Under-weight -2 -1 0 +1 +2 Over-weight | ▪ Our preference remains for Non-Agency RMBS<br>▪ RMBS: Spread slightly better with stable fundamental performance , but expect normalization coming from heavy supply, extension concerns and general risk off. Prefer to move up in quality and seasoning<br>▪ CMBS: Mostly solid fundamentals but weakening. Spreads flat MoM. Better relval in other sectors, continue to trim.<br>▪ CLOs: Spreads tighter MoM but lagging competing products. AAA spreads over 200 are attractive from long-term perspective.<br>▪ ABS: US consumers are stable but with areas of weakness-trimming 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<br>▪ Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS).<br>▪ SOFR deals slows CLO new issue<br>▪ Rising interest rates dent housing market strength |
| **Commodities** | Under-weight -2 -1 0 +1 +2 Over-weight | ▪ o/w Copper & Lead vs Zinc<br>▪ o/w Softs<br>▪ o/w Grains<br>▪ u/w Gold<br>▪ o/w Oil<br>▪ u/w Silver | ▪ Global Recession |

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