Information for investment professionals

COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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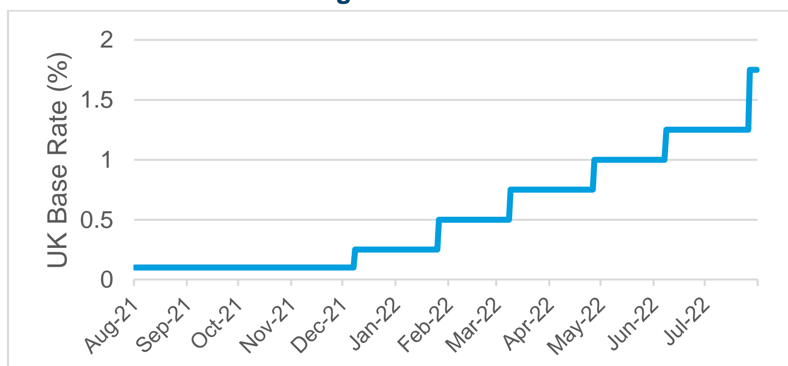
Recession..what recession?

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	2.78%	13 bps	0.5%	-8.7%
German Bund 10 year	0.89%	7 bps	3.6%	-8.1%
UK Gilt 10 year	1.95%	8 bps	1.9%	-13.1%
Japan 10 year	0.18%	-1 bps	0.9%	-2.0%
Global Investment Grade	159 bps	-3 bps	2.3%	-11.0%
	181 bps	-2 bps	4.1%	-8.6%
Euro Investment Grade	149 bps	-2 bps	1.9%	-12.3%
US Investment Grade	154 bps	-1 bps	2.1%	-10.6%
UK Investment Grade	270 bps	1 bps	-0.3%	-8.5%
Asia Investment Grade	560 bps	-34 bps	6.1%	-9.9%
Euro High Yield	444 bps	-33 bps	6.6%	-8.4%
US High Yield	967 bps	14 bps	-2.4%	-21.1%
Asia High Yield	421 bps	-25 bps	4.0%	-15.6%
EM Sovereign	6.7%	-10 bps	1.0%	-13.6%
EM Local	397 bps	-24 bps	1.4%	-12.8%
EM Corporate	2.8%	5 bps	2.5%	-6.7%
Bloomberg Barclays US Munis	4.3%	17 bps	1.0%	-15.3%
Taxable Munis	35 bps	8 bps	1.8%	-7.2%
Bloomberg Barclays US MBS	251.08	-3.2%	0.9%	19.5%
Bloomberg Commodity Index	1.0211	-0.4%	-2.9%	-10.4%
EUR	134.68	-1.3%	0.5%	-14.7%
JPY	1.2131	-0.8%	-0.9%	-10.8%
GBP	1.2110	-1.4%	-0.7%	-10.6%

Source: Bloomberg, Merrill Lynch, as at 8 August 2022.

Chart of the week: Ever higher UK interest rates – LTM



Source: Bloomberg, Columbia Threadneedle Investments, as at 8 August 2022.

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Macro / government bonds

In recent weeks, government bonds had regained some of their poise. Fears of recession had overcome concerns about inflation in the face of tightening monetary conditions and hawkish central bank rhetoric. This took yields lower with the benchmark US 10-year note falling from around 3.5% to below 2.6% as we entered August. Last week saw a reversal of fortune and a torrid end to the week.

US data released on Friday last characterised an economy in rude health. Non-farm payrolls saw the largest creation of jobs since February and nearly twice the amount expected. This means the level of employment has now exceeded pre-pandemic levels. The unemployment rate fell to 3.5% (from 3.6%) and earnings rose by over 5% y/y. The key areas of strength were the leisure, hospitality and construction sectors of the economy. This took yields higher again and the yield curve inverted further. Expect a 75bps hike in US rates in September.

The Bank of England raised interest rates for a sixth time last week. This takes policy rates to 1.75%, which is the tightest since 2009. Interestingly, the central bank reported that it expects a multi-quarter recession, yet market pricing suggest further rate rises to come amid its fight with inflation. The MPC has also announced that it will begin government bond sales after its September meeting; probably reducing its stock of such debt by around £10bn per quarter.

This week brings consumer price inflation news in the US and GDP data in the UK. The recent fall in energy prices suggests that inflation will fall below last month's 9.1% y/y CPI rate. Meanwhile, it is likely that the UK economy contracted in the second quarter of this year.

Investment grade credit

It was a quiet, though strong, week for investment grade credit.

Spreads continued to compress, through what has been a strong period since the mid-point of the year. The global index spread is now inside 160bps having been close to 180bps in early July this year. Euro credit markets have performed a little better after severe underperformance in the first half of 2022.

A strong technical (supply / demand) background seems the most likely explanatory variable for recent spread performance. New issuance has been near zero for seasonal reasons (results season / summer). All the while, inflows to the market have picked up, as investors are attracted by higher yields and wider spreads.

High yield credit & leveraged loans

US high yield bond valuations continued to tighten sharply over the week as strong balance sheets and technical tailwinds are allowing spreads to tighten despite the expected slowdown in growth indicators due to tighter financial conditions.

The ICE BofA US HY CP Constrained Index returned 2.59% and spreads were 44bps tighter, ending the week at +494bps. According to Lipper, the asset class saw an $855m outflow for the week; the fifth outflow over the last six weeks. T-Mobile's upgrade boosted 2022's rising star volume to $82bn which, coupled with a 77% y/y decline in supply, increased this year's contraction in high yield bonds outstanding to c9% (or $133bn).

Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index rose the most since November 2020 over the week as expectations that corporates can withstand slower growth coupled with July's resilient CLO demand ($9bn) and a decade low for supply ($2.2bn) have

secondary prices now $1.51 off the low at $93.5. Loan retail funds remained in outflow mode, however, as $855m was withdrawn.

European high yield posted its fifth positive performance week with a return of +94bps as spreads narrowed 34bps, driven by improved sentiment on inflation rates. This comes with a strong performance rebound in July (+5.1%). Outflows continue though showing signs of slowing down with only €114m exiting last week. This was only due to managed accounts as ETFs experienced a small inflow and is back to pricing at a premium, evidence of some returning to high yield. This is despite continued poor liquidity as screen prices are very much just an indication. The primary market remains shut for the summer. Given banks' reticence to underwrite deals, issuers are looking towards other avenues for financing, including private lending. This could mean new issues for M&A and LBO deals shifted by a year as well as a change in risk structure for issuers if they go down the private lending route.

Second quarter earnings reports continue; corporates are looking good with 2022 guidance holding as is or being improved. An example is Atlantia, the European infrastructure company, which increased its guidance from €6.3bn to €6.8bn for 2022. SGL Carbon, the chemicals company, is another example with improvement in both sales and EBITDA meaning it could confirm its increased guidance made in early July. Even Telecom Italia's figures, though down in absolute terms, were not as bad as expected, improving full year guidance from being down but less so than originally expected.

A sign of the times: Lufthansa agreed to wages increases with ground staff (20,000) of 13-18% (depending on role / location) in three stages to the end of 2022. The wage increases take into consideration both wage cuts made during covid as well as inflation effects.

In M&A news, Autodis announced the sale completion of PHE to the D'Iteren Group. There was more bad news for Adler as LEG confirmed it will not be exercising its option to acquire the remaining 6% of BCP from the German real estate group. This will be a hit on Adler's liquidity as it was expecting a sales price of €765m.

In other news, due to high temperatures and long dry spells this summer, EDF announced that it may have to lower nuclear reactor production. Higher river temperatures and lower water levels have affected how much warm water can be released from the nuclear facilities into the environment as well as how much reactors can be cooled down. This means higher electricity prices in France, which will then be pushed to the wider market.

Asian credit

Alibaba's operating results for Q1,23 (quarter ended June 2022) were better than expected, thanks to its focus on cost control and optimization with lower promotional deals and subsidies. Alibaba watches the domestic consumer spending as a percentage of disposal income. Based on NBS figures, the ratio was 64% in H1, 2022 (down 5pt), with a higher drop in the urban areas, which management views as a reflection of weak consumer sentiment amid the covid outbreak. While the company is seeing indications of a recovery in consumption, management said it could take some time for consumer sentiment to fully recover.

SJM Holding announced an additional boost to its liquidity position through a HK$2bn shareholder loan from its shareholder (STDM) and a HK$3bn rights issue. The shareholder loan has a six-year term with an interest rate of 4%. These additional funds, together with the HK$19bn of new loan facilities in June, will allow SJM to operate for five-six quarters in a zero-revenue environment.

The latest round of spectrum auction in India has concluded with the companies (Reliance Jio, Bharti Airtel, Vodafone Idea and Adani Group) bidding for $19bn of spectrum, higher than market expectation. Reliance Jio leads with its $11.1bn bid for spectrum that includes the expensive 700MHz frequency band. Bharti Airtel put in the second largest bid worth $5.4bn. Altogether, around 91% and 87% of the bids by Reliance Jio and Bharti Airtel are for the 5G frequency bands (700MHz, 3300MHz, 2.6GHz).

Structured credit

The US Agency MBS market had a rough week posting a -1.42% return on heightened rate volatility, which continues to be the clear and present danger in the sector. Home price growth continues to slow (but is still pacing at +19.7% y/y) and the deceleration is becoming more widespread geographically. Demand is down sharply as well on higher interest rates and lower affordability. Unsurprisingly, inventory levels have just started to rise for the first time in 37 months. In CMBS, new issuance is slowing. Four single asset single borrower deals were priced in all of July with a total balance of $2.7bn, which is 28% lower y/y. No Conduit deals came to market. Full-year agency CMBS issuance is projected at $114.3bn, which is roughly 14% lower than last year's total. With the economy starting to decelerate and the Fed focused on tightening financial conditions, consumer behaviour trends are top of mind. We're seeing deterioration for all borrowers, with lower quality FICO borrowers experiencing the quickest pace of decline. Specifically, there are signs of weakness in unsecured consumer consolidation loans offset by a modest uptick in subprime auto. CRTs are experiencing very low levels of delinquency given the elevated levels of equity in the housing market.

Emerging markets

Emerging market hard currency sovereigns posted another positive return for the week. Despite the sell-off in treasuries towards the end of the week, spread tightening across the board, particularly in high yield names, led to a return of +0.76%. (As measured by the JP Morgan EMBI Global index).

In central bank news, India raised rates by 50bps. Romania also hiked by 75bps, which was below consensus, suggesting the country is becoming more concerned with the growth outlook. Romania is often a lead indicator for the rest of the Central Eastern Europe region.

Ghana was downgraded by S&P to CCC+, outlook negative and in positive new Azerbaijan was upgraded by Moody's to Ba1 due to improved fiscal management.

US house speaker Nancy Pelosi visited Taiwan last week despite threats of military action from China who saw Pelosi's visit as violation of the 50-year-old US pledge not to formally recognise the government of Taiwan. Pelosi, a lifelong critic of China's human rights record, pledged the US will continue to support Taiwan and support a democratically elected government. In response, China has announced, and has already been conducting a series of military drills in and around Taiwanese waters in which Taiwan sees as simulated invasion. China has announced sanctions on Taiwan Including halting exports of sand to Taiwan and halting Taiwanese imports of fruit and fish products. Taiwan has an outsized role in the world's semiconductor market, which is at the heart of recent supply chain disruptions. The island manufactures 80% of microcontrollers used in cars and 90% of the most advanced semiconductors.

Saudi Arabia's sovereign wealth fund launched an investment fund to invest in Egypt's economy including infrastructure, real estate and healthcare among other sectors. The news follows $15bn of previously pledged Saudi support, Egypt is also looking to secure a new IMF loan.

Commodities

The commodity index declined last week driven by a broad-based decline in energy markets with Brent dropping to $94, the lowest level since mid-February.

OPEC announced one of the smallest supply increases ever at +100,000 barrels/day (c0.1% global demand), starting in September. Some concern was cited regarding the possibility of a fall in demand. Separately, demand at the pumps in the US fell 7.1% despite the normally high demand summer season and the current lower pump prices.

Agricultural markets declined 2.4% as the first shipments successfully left Ukraine with four vessels exporting a combined 170,000 tonnes of agricultural products on Sunday. Crop prices have been supported by unfavourable weather conditions in the US and Europe with UK, France and Germany expecting temperatures of above 36 degrees alongside France recording the driest July on record. Higher temperatures are also having a knock effect on nuclear power generation (See EDF in high yield credit) alongside boosting cooling demand.

Zinc was the strongest performer on the week rising 5.8% as Glencore warned Europe's energy situation poses a threat to supply and said that smelters within Europe are barely turning a profit. Glencore has already suspended one if its smelters in Europe.

Responsible investments

It was only a few weeks ago that US President Joe Biden made a speech announcing climate change as an "existential threat". Now, here we are and a bill worth $739bn has been passed through the US senate. Around $370bn has been earmarked for climate action including grant payments for citizens purchasing electric cars, heat pumps, high-tech water heaters and battery-storage systems. The bill will also reinstate a 30% tax credit for homeowners installing solar systems and will backdate any already installed in 2022, with the programme being extended out to 2034. This bill has, however, been drastically reduced in terms of ambitious measures that the Democrats were hopeful would have been passed last year. After a tiresome 18 months, once the bill is backed by the Democrat-controlled house this week, President Biden will be able to sign it into law.

Elsewhere, Singapore issued its first green bond worth $1.1bn. It will be the longest green bond issued by a sovereign in history, dated to 2072. The issue came to the market on Friday and was 2.26x over subscribed. Proceeds will go towards eligible projects including renewable energy, energy efficiency and climate change adaption, among many others.

Summary of fixed income asset allocation views (as at 8 August 2022)

Fixed Income Asset Allocation Views

8th August 2022

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 continued to widen as volatility remains high and there is a market-wide softening in technicals and fundamentals. This, along with rates driven credit vulnerability, has **kept the group negative on credit risk.** ▪ We are past the peak of economic growthwith first few hikes done and expectations for more 50-100bp 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, and the Russian invasion of Ukraine.	▪ Upside risks: lowered volatility once expansionary environment is established as the new normal ▪ Downside risks: simultaneous low unemployment, high inflation, hiking, and slowing growth cause a recession. More spillover from Russian invasion, sanctions difficult to remove post-conflict. New Covid lockdowns. Supply chain disruptions, inflation, commodity shocks persist to H2 2022
Duration (10-year) ('P' = Periphery)	¥ P $ Short -2 -1 0 +1 +2 Long € £	▪ Carry offered by front end yields now attractive in UK ▪ 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	▪ Spreads continue to move wider as global liquidity conditions tighten and the market sees bifurcation ▪ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, Chinese growth, idiosyncratic political risks, increasing use of IMF programs ▪ Recent commodity price retracement has refocused attention on underlying fiscal health; fundamental consequences of invasion remain unevenly distributed ▪ Focus on buying strong relval opportunities as headwinds and volatility increase	▪ Chinese growth derails with softer policy stance after shutdowns ▪ Continued spillover from Russian invasion: local inflation (esp. food & commodity), slowing growth ▪ A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD ▪ Persisting COVID growth scars hurt economies & fiscal deficits ▪ Weaking technical with large fund outflows and slower supply
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US & EMEA spreads have widened since last month. Index last hung out at these yield levels in 2015. ▪ Despite strength in fundamentals (leverage, debt, service capacity, liquidity), we expect deterioration and softer Q3 outlooks. Inflation, monetary tightening and technicals remain headwinds pressuring margins. ▪ Liquidity remains poor, new issue market has slowed	▪ Q2 earnings show surprise weakness, materially lower Q3 outlooks ▪ Supply dynamics remain a headwind ▪ 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 have continued to widen, open to opportunities for adding on weakness. Focus on higher quality & risk management in higher volatility. ▪ In EMEA, spreads reflect recession or stagflation outlook. Elevated risks for EMEA HY because of Russian gas situation and earlier demand weakness. ▪ Primary market slow and weak liquidity in secondary ▪ Bank loans drift lower as new CLO formation is too slow to match outflows; sentiment weakening over slowing economy and higher interest cost ▪ Bonds & loan defaults set to remain near historic lows	▪ Default concerns are focused on demand destruction, margin pressure and macro risks ▪ Loan technicals and flows weaken ▪ Russian invasion significantly 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 recently outperformed as volatility dropped. ▪ Prefer higher coupon because of more attractive valuations, carry, priority in Fed sales and sponsorship ▪ 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. ▪ Uncertainty with the Fed hiking schedule and long-term position within the Fed balance sheet
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Our preference remains for Non-Agency RMBS ▪ RMBS: Fundamental performance remains strong but expect normalization coming from heavy supply, extension concerns, and general risk off. Prefer higher quality collateral and seasoning – marking pricing still inefficient ▪ CMBS: Fundamentals remain mostly solid but weakening. Relval preference to other sectors, continue to trim. ▪ CLOs: Spreads are softer in sympathy with loans; new issues trading at historic wides, robust new issue supply. ▪ ABS: US consumer looks well positioned, watching performance given inflation & rates.	▪ 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	▪ Global Recession

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