INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

11 JULY 2022

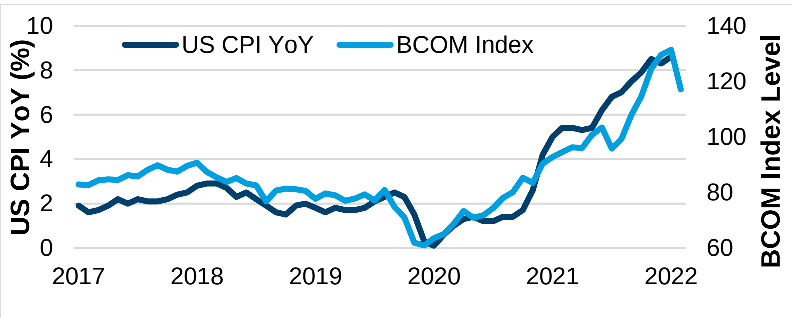
Credit markets improve even as sentiment sours.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.05%	17 bps	-0.9%	-10.0%
German Bund 10 year	1.29%	5 bps	0.6%	-10.7%
UK Gilt 10 year	2.20%	11 bps	-0.1%	-14.9%
Japan 10 year	0.25%	2 bps	0.0%	-3.0%
Global Investment Grade	169 bps	-8 bps	0.0%	-13.0%
Euro Investment Grade	201 bps	-11 bps	1.3%	-11.1%
US Investment Grade	157 bps	-8 bps	-0.5%	-14.3%
UK Investment Grade	162 bps	-2 bps	0.1%	-12.3%
Asia Investment Grade	242 bps	8 bps	-0.4%	-8.6%
Euro High Yield	656 bps	-19 bps	1.1%	-14.2%
US High Yield	536 bps	-56 bps	1.6%	-12.7%
Asia High Yield	940 bps	54 bps	-2.1%	-20.9%
EM Sovereign	453 bps	-5 bps	0.0%	-18.8%
EM Local	7.0%	6 bps	-1.5%	-15.9%
EM Corporate	413 bps	-2 bps	-0.6%	-14.5%
Bloomberg Barclays US Munis	3.0%	-14 bps	1.2%	-7.9%
Taxable Munis	4.4%	22 bps	-1.3%	-17.2%
Bloomberg Barclays US MBS	42 bps	-2 bps	-0.1%	-8.9%
Bloomberg Commodity Index	250.03	-1.0%	-0.9%	17.3%
EUR	1.0101	-2.2%	-2.9%	-10.4%
JPY	137.41	-0.6%	-0.2%	-15.4%
GBP	1.1942	-0.5%	-1.2%	-11.1%

Source: Bloomberg, Merrill Lynch, as at 11 July 2022.

Chart of the week: US CPI vs the Bloomberg Commodity Index



Source: ICE indices, Bloomberg, Columbia Threadneedle Investments, as at 30 June 2022 (CPI as at 31 May 2022).

David Oliphant
Executive Director,
Fixed Income

Contributors

David Oliphant
Macro / Government bonds, Investment Grade Credit

Angelina Chueh
Euro High Yield Credit

Chris Jorel
US High Yield Credit,
US Leveraged Loans

Katherine Nuss
US Investment Grade Credit

Kris Moreton
Structured Credit

Justin Ong
Asian Fixed Income

Doug Rangel
Municipals

Charlotte Edwards
Responsible Investments

Jake Lunness
Commodities
Emerging Markets

Macro / government bonds

The second half of last year in markets was all about rising inflation fears and the first half of this year involved digesting the changing policy response to these higher prices. The last few weeks have seen attention shift to the perceived increased chance of recession.

Last week delivered a mixed picture in terms of US employment. Initial jobless rose again with another 235k reported last week, the highest since January. The week ended with non-farm payrolls, which showed 372k jobs were added. This was higher than expected by around 100k though a revision of -74k to prior months reports offset most of this. Average earnings also slowed to around 4.3% 3m/3m annualised. This is lower than was the case earlier in the year. The unemployment rate remained at 3.6%. A score draw all in on the recession probability front. For Europe, the threat that Russia switches off gas supplies – forcing rationing of power and a decline in manufacturing run centre stage. Meanwhile in the UK the resignation of Prime Minister Boris Johnson was ultimately predictable though there is little clarity as to who will succeed him.

Commodities (detailed below) have not been immune to recession fears with the BCOM index and the price of oil in full flight this past month. The good news here is that that provides a welcome break for inflation fears given the notable correlation between the BCOM index and Consumer Price Index shown in **(see chart of the week).**

Investment grade credit

Last week and after a grim year, global investment grade spreads reached a new wide (178bps) for this cycle, before staging a rally taking prices higher and spreads tighter.

Market conditions are reported, by our dealing team, as fragile and illiquid with little new issuance, heightened risk aversion and outflows from the asset class over the last few weeks.

In specific news, there was a focus on the European utility sector with the announcement that the German government could provide support / take a stake in Uniper (facing stress from gas supplies). In France, the state announced the nationalisation of utility giant EDF, which needs financial repair against a background of stringent regulation and pricing mechanisms. After the news, EDF bonds rallied fairly strongly (around 20bps). BMW reported Q2 vehicle sales that were down 20%, reflecting supply chain challenges from China.

This week brings the start of US earnings season, from certain of the large banks.

High yield credit & leveraged loans

US high yield bond valuations tightened sharply amidst higher rates as buyers waded in following June's sell-off. The ICE BofA US HY CP Constrained Index returned 1.39% and spreads were 57bps tighter. Retail fund inflows also resurfaced this week with an $889m contribution following three weekly withdrawals totaling nearly $10bn. In leveraged loans, the recent steady decline in prices received a brief reprieve this week amid the broader risk-on tone. That said, loan prices are down $3.21 m/m to $92.10. The asset class saw continued outflows with a $1.1bn withdrawal over the week, marking seven outflows over the past nine weeks.

European High Yield (EHY) had its first positive week of performance since the start of May as spreads tightened in 19bps and the EHY index yield fell 15bps. BBs were the strong outperformer, returning 3X the performance of CCCs. There also appears to be more pricing differentiation between sectors with senior secured bonds also performing better. ETFs took an improved turn, finally moving back to pricing at a premium (+0.5) after weeks of pricing at a discount. Still, outflows from the asset class continued with this week posting €-629m, across ETFs and managed funds. For much of the week, any market improvement still appeared to be mainly used to reduce risk. Only by Friday were there signs of improvement but trading in higher risk and longer durations remained especially tricky with bid prices often absent.

The long-awaited new issue, 888, to fund the buyout of William Hill, finally came to the market on Friday, with a coupon of 7.6% but pricing at a high discount at 85.3, resulting in a final yield of 11.5%. This was the same deal that a few weeks earlier had a suggested IPT of 10%. The high yield and steep discount price for a relatively strong rated issue (B1 / B / BB+) are signs of how much the market has deteriorated, making bringing a new bond to the market a real challenge. Since the start of 2022, 30+ European issuer deals were halted or cancelled.

In issuer specific news, it was announced last week that EDF will be nationalised. Details are still to be released, but the news is being viewed positively for the bonds, though still a way before they can be considered fully government backed. There was bad news for Rexel as the company was given notice by the French competition agency regarding tax evasion (Swiss subsidiaries). Rexel noted that the pricing mechanism mentioned is standard in the industry and that it is not at fault. At INEOS, in a trading update, the firm mentioned evidence of signs of demand softness, especially in certain chemicals, like ethylene. There was some good news from Peach Property which announced that it is tendering for some 2023 bonds, taking advantage of a recent price drop in bond prices. This is a positive sign of the available liquidity the firm has to reduce its leverage on a tactical basis.

In M&A news, Dufry has agreed to buy Autogrill from the Benetton family forming a $6bn group. This will be an all share transaction so no cash requirement for DuFry. As a result, Benetton will become a majority shareholder in DuFry. The transaction is expected to complete by Q3.

Asian credit

For H1,22, the Chinese Finance Ministry is reportedly looking to allow local governments to raise 1.5trn yuan (c$220bn) through special local government bonds (SLGBs). This additional tranche of SLGBs would be brought forward from next year's quota, likely earmarked for more front-loaded infrastructure spending. The timing of using up next year's quota, happening as it would in the coming months, is earlier than previous years. For example, last year when the government announced using up the 2022 SLGB quota of 1.46trn yuan, that was announced close to year end in December 2021.

S&P has lowered its gross gaming revenue (GGR) for Macau, with the assumption that GGR in 2022, will only be 20-30% of the 2019 levels: 10ppt lower than its expectation earlier this year. The key driver is the uncertainty related to the duration of China's zero-covid policy. Accordingly, S&P placed the ratings on Las Vegas Sands Corps and its subsidiary Sands China on credit watch negative. S&P also placed the ratings on Melco Resorts and Studio City on credit watch negative. Negative rating actions continue in Chinese properties. Moody's downgraded the senior unsecured ratings of Times China from B3 to Caa2 (negative outlook) to reflect the company's weak liquidity position, the decline in contracted sales and limited access to funding. Moody's also cut the senior unsecured rating of Powerlong Real Estate Holdings from Caa2 to Caa3 (negative outlook) given the uncertainty in refinancing its near-term debt maturities.

Emerging markets

There has been an increase in Covid cases in China with Shanghai recording 69 new infections on Sunday, the most since late May. Data releases from China last week surprised to the upside, evidencing that despite the government's zero-covid policy, the Chinese economy is reopening.

Protestors stormed the official residence of Sri Lankan president Gotabaya Rajapaksa demanding his resignation following ongoing fuel shortages and general economic turmoil. The president has fled to an undisclosed location and has subsequently announced his resignation. There is now concern that the ongoing IMF engagement will be disrupted; Barclays has suggested the process could now take 1-3 years.

The Ukrainian government has allowed state run energy company Naftogaz to change its loan agreement with its UK based Eurobond issuer, Kondor finance. The company was due to default on its upcoming 19 July $335m issue after it released a statement saying it was looking to "preserve cash" and focus on supporting Ukraine's strategic priorities.

Central Banks across emerging markets continue to increase interest rates to combat rising inflation: in Eastern Europe Poland (+50bps) and Romania (+100bps) hiked and in Asia, the Malaysia Central Bank hiked 25bps, its second increase this year.

Commodities

The BCOM index sold off 1% last week led by recessionary concerns causing declines in energy and base metals. The biggest loss was felt in precious metals, which sold off in the face of a stronger US dollar.

European natural gas futures sold off following the news that Canada has now repaired one of Russia's Nord Stream 1 gas turbines that was sent off for maintenance. Russia previously blamed delay to repairs for the 60% reduction in gas flows via the pipeline to Germany. Annual maintenance on the pipeline is due to be completed next week, but the market is now concerned flows will not fully resume resulting in gas rationing; German gas storage is around 63% full.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

11th July 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 from March volatility- driven tightening, as we are seeing a market-wide softening in technicals fundamentals. This, along with rates-driven credit vulnerability, **has kept the group negative on credit risk** ■ We are past the peak of economic growth, with the first hike 75bps done and expectations for more 50/75bp 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 more attractive, new optimism for struggling fundamentals motivated upgrade despite weak technicals. ■ Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, Chinese growth, idiosyncratic political risks, increasing use of IMF programs ■ Fundamental consequences of invasion are unevenly distributed via trade links and commodity exposure. Good for commodity producers, bad for resource importers ■ 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 June 2010. ■ Despite strength in fundamentals (leverage, debt, service capacity, liquidity), we are past peak in credit quality for the cycle. Inflation, monetary tightening and technicals remain headwinds ■ Liquidity remains erratic, with heightened volatility and wide new issue concessions taking focus away from secondaries.	■ Supply dynamics remain a headwind ■ Rate environment remains volatile ■ Investors return to government bonds from IG as their risk/return preference for safe assets is changing in new rate environment ■ 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 last month, still inside of long-term medians. New focus on higher quality & risk management; expect volatility to continue. ■ In EMEA, spreads at previous recession points and reflect default outlook. Elevated risks for EMEA HY because of proximity to Russian invasion. ■ Primary market slow and weak liquidity in secondary ■ Bank loan market drifted lower with more volatility; sentiment weakening over slowing economy and higher interest cost, still see primary market support ■ 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 ■ Waves of ratings upgrade continue into this year. ■ Russian invasion significantly rattles US bond loan/market as already seen in EMEA from commodities.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Mortgages recently outperformed as volatility dropped. ■ Higher Coupon securities are the most attractive, as lower coupons appear vulnerable due to tight valuations, poor carry and upcoming Fed sales and less money manager sponsorship. ■ A preferred place to add positions in TBA, pools and IIO	■ 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. Like higher quality collateral ■ CMBS: Fundamentals remain mostly solid but weakening. Widening has shifted relval preference to other sectors. ■ CLOs: Spreads have been widening in sympathy with structured product credit; secondary bonds difficult to source as sellers became buyers. ■ 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 ■ ow Livestock ■ o/w Softs ■ o/w Grains ■ u/w Gold ■ o/w Oil	■ Global Recession