

# In Credit

13 JUNE 2022

## Great(er) expectations.

Markets at a glance



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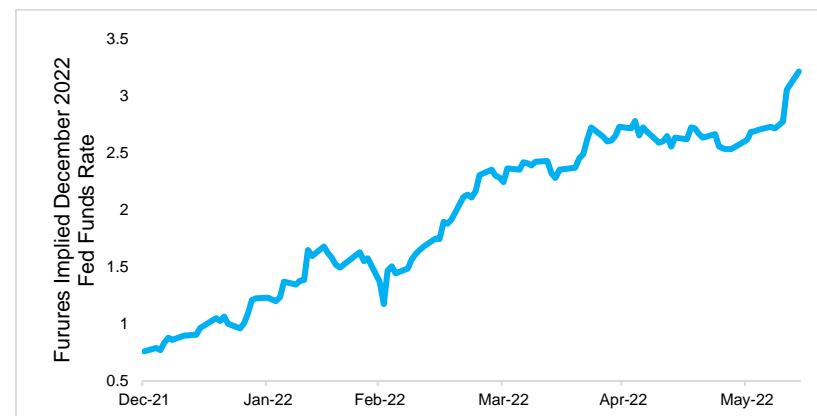
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	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	3.23%	30 bps	-4.8%	-10.1%
German Bund 10 year	1.56%	29 bps	-7.2%	-12.0%
UK Gilt 10 year	2.49%	33 bps	-8.1%	-15.0%
Japan 10 year	0.26%	2 bps	-0.7%	-2.3%
Global Investment Grade	148 bps	4 bps	-6.1%	-12.1%
Euro Investment Grade	166 bps	8 bps	-6.2%	-11.1%
US Investment Grade	141 bps	3 bps	-6.4%	-13.7%
UK Investment Grade	142 bps	4 bps	-6.0%	-11.8%
Asia Investment Grade	216 bps	-5 bps	-2.2%	-7.4%
Euro High Yield	490 bps	12 bps	-5.6%	-10.0%
US High Yield	451 bps	30 bps	-6.0%	-10.3%
Asia High Yield	763 bps	3 bps	-3.6%	-14.0%
EM Sovereign	400 bps	17 bps	-7.8%	-16.4%
EM Local	7.0%	20 bps	-6.7%	-12.7%
EM Corporate	336 bps	-9 bps	-3.3%	-11.8%
Bloomberg Barclays US Munis Taxable Munis	3.0%	12 bps	-2.1%	-8.2%
	4.4%	17 bps	-7.9%	-16.8%
Bloomberg Barclays US MBS	40 bps	7 bps	-4.5%	-9.2%
Bloomberg Commodity Index	286.49	1.2%	9.1%	36.9%
EUR	1.0475	-1.9%	-5.0%	-7.5%
JPY	134.32	-2.7%	-9.5%	-14.4%
GBP	1.2216	-1.4%	-6.3%	-9.0%

Source: Bloomberg, Merrill Lynch, as at 13 June 2022.

## Chart of the week: US interest expectations – for December 2022



Source: Bloomberg, Columbia Threadneedle Investments, as at 13 June 2022.

## Macro / government bonds

The two big events of last week were the meeting of the European Central Bank and the consumer price inflation report from the US.

First let's consider the ECB. As expected, the central bank left interest rates unchanged. Quantitative easing will end at the start of July. It also seems rates will rise, and by 25bps, in July. Why didn't the ECB just tighten last week one wonders?

In the US, inflation came in much stronger than expected. The consumer price index rose by 1.0% m/m and 8.6% y/y, which was more than the 8.3% expected. Core (ex-food and energy) inflation recorded a 6% y/y rise. Inflation was pushed higher by items such as air fares and food. How did markets respond to this news? Not well! Yields rose materially over the week and especially on Friday in the wake of the report. The expectations of US interest rate rises also rose with December Federal Funds expectations now running around 3.2% (see [Chart of the week](#)). Yield curves flattened with the 2-year note up in yield by 25bps on Friday alone. The benchmark 10-year US treasury note was 30bps higher in yield though the damage to bond markets was felt globally with both German and UK government bonds higher in yield by a similar amount.

This week began rather miserably with a contraction in the UK economy, where GDP fell by 0.3% m/m in April, below expectations of a +0.1% rise. The 3 m/m growth rate fell to 0.2%, which was also less than expected.

The next five days also brings US retail sales and producer price inflation numbers while in the UK we get employment news. It is a quieter in period in Europe on the data front.

## Investment grade credit

Credit spreads had tightened from mid-May but last week saw a reversal of fortune with spreads edging somewhat wider (global investment grade by 4bps) and after the US inflation news. The weakness was led by higher risk, lower-rated issuers, and the real estate sector.

Summer is coming and that is normally a time of lower primary issuance. Hence the last week has been a busy period for investment issuance desks ahead of that season. There was little specific corporate news to report upon.

## High yield credit & leveraged loans

The past week's steady decline in US high yield bond prices intensified Friday as an upside surprise on US inflation data and downside surprise on consumer sentiment led investors to position for a more meaningful growth impact from a more front-loaded response from the US Fed. The ICE BofA US HY CP Constrained Index returned -2.36% and spreads were 30bps wider. The asset class did report an inflow of \$1.3bn, according to Lipper. Meanwhile, leveraged loans also succumbed to the macro weakness on Friday as investors' positioned for a more meaningful growth impact. After rising \$0.16 over the past week to \$95.30, the average price of the J.P. Morgan Leveraged Loan Index declined \$0.50 on Friday. Underneath leveraged loan mutual funds posted a second consecutive mild weekly inflow totalling \$40m following three consecutive withdrawals.

European High Yield (EHY) returned to spread widening (+12bps) but with yields much higher, mostly due to the increase in underlying government yields. Opposite to the previous week, single Bs, this time, underperformed BBs and CCCs. Fund flows also reversed with outflows (-€306m) happening both in ETFs and managed accounts. The corporate primary market remained shut though there were some sub-financials issued (€1.2bn). It is said that issuers are coming to terms with the current market levels but are just waiting for market stabilisation/new issue pricing renormalisation before they start to issue. The market was weak, seriously souring towards the end of the week given the ECB news and, higher than expected US CPI. Not seeing much rating dispersion with sell offs largely liquidity driven with some opportunistic buying around the bid side. Higher beta and longer-duration bonds especially underperformed. Some are starting to call the market “broken”. ETF trading, unabated selling, is as much as a 2.25-point discount.

In credit rating news, S&P upgraded Autostrade per L'Italia two notches to BBB- with 'outlook positive'. This is due to S&P considering the company to be a government related entity (GRE) and gives a positive outlook to mirror the country's positive outlook.

With the reporting season for EHY ending, the general tone has been that companies, for now and including a 1-to-3-month visibility, are saying they are not experiencing any impact on demand, or any slowdown. However, within these comments, there are supply chain factors, which are propping this up.

The market is beginning to look for higher default rates given talk now of recession to possibly occur in 2023 with Deutsche Bank calling for EHY default to reach 3.8% by end 2023, peaking at 6.6% in 2024 before starting to fall in 2025.

## Structured credit

Mortgages had outperformed up until the recent spike in volatility. Agency MBS spreads had widened out to a point where the relative value story enticed investors to step back into the market. Money managers in the US have legged back into the space and are reducing their underweights, getting closer to their historical ownership averages. We prefer higher coupon MBS due to wider spreads, more attractive carry, and less US Fed balance sheet exposure. On the credit side, technicals have and continue to be a major headwind as supply in certain markets has overwhelmed demand. The fundamental performance has remained strong as borrowers are holding up relatively well on both the residential and commercial side. Although we have observed an uptick in delinquencies on the consumer side, we expect it to be more of a normalization in consumer fundamentals. There have been some pockets of distress; however, it has been confined so far to the lowest tier quality of borrowers. Currently, spreads in the structured credit universe are considerably wide with a slowing growth environment pricing in greater default risk.

## Asian credit

In China's tech space, there have been positive headlines that the Chinese authorities are easing the regulatory measures. This includes potential discussions to revive the Ant Group IPO, approval of new video games titles after eight-month freeze, and plans to allow Didi back on the app stores.

In Chinese property, headlines of SOE M&A intensified, following onshore bond issuance with CDS/CRWM. The SOE step-in may bring game changer in terms of refinancing. Project level cooperation may be faster than holdco level stake move; this includes China Jinmao proposal to take China VAST Industrial urban Development private, China Vanke to invest in LVGEM's urban

renewal project in Shenzhen, and Central China's controlling chairman selling a 29% stake to a firm owned by Henan province.

Powerlong terminated an agreement to sell a Shanghai office building for CNY868m to its property management arm. The company's asset disposal plans have been below expectation. The company plans to repay \$1.3bn of maturing or puttable public debt in H2/22, funding from asset disposals and new loans. However, it has only obtained CNY500m of financing to date, from pledging two hotels. Powerlong is also in talks with China Huarong to dispose of an office building in Hangzhou.

Indika Energy launched a cash tender offer for US dollar notes. The company is willing to buy back up to \$250m. Vedanta gets a \$1bn term loan secured by 5.77% out of the c.65% holding in Hindustan Zinc as security.

## Emerging markets

Hard currency spreads widened 17bps on the week in line with broad risk-off sentiment across developed markets. High yield names were the worst affected widening by 49bps, regionally African countries widened 61bps on aggregate with riskier names such as Ghana and Zambia selling off significantly. The Middle East was more insulated from the sell-off widening by a mere 2bps, supported by sustained higher oil prices and higher credit ratings.

The polls are split in the Colombian election with Rodolfo Hernandez and leftist Gustav Petro competing for the lead. Hernandez aims to cut government waste and corruption while Petro is focusing on taxing the rich and phasing out oil exploration. The second round of the election takes place this coming Sunday.

Weeks after loosening enhanced covid measures, China is now looking to re-impose restrictions following rising cases in major cities (143 nationwide on Sunday). The re-opening of schools is now delayed in Beijing with three rounds of testing announced in the city's most populous district of Chaoyang. Shanghai is suspending dine in services and is conducting citywide testing. In more positive news, China's inflation moderated last month with y/y CPI printing at 6.4%, down from 8% in April; CPI was 2.1% unchanged from the April print.

Fitch upgraded India's outlook from negative to positive, affirming its BBB- rating, meaning the country retains its investment grade status with all three agencies. Fitch cited diminished downside risks to growth due to India's rapid economic recovery.

In central bank news, the Bank of Thailand left interest rates unchanged; however, there was a hawkish tone and expectations that the hiking cycle will commence at the August meeting. Elsewhere, rate hikes were seen in Poland (+75bps) and Chile (+75bps).

## Commodities

Commodity markets rallied 1.2% on the week with weakness in industrial metals being offset by strong gains in agriculture and more modest gains in energy markets.

Wheat (+3.0%) has been supported by a lack of progress on the Russia/Ukraine talks on food exports via Ukrainian ports, both sides accusing each other of mining ports to cause disruption. Russia stated exports can resume as soon as Ukraine removes its mines; however, Ukraine is

reluctant to do this due to fear of amphibious assault on the Ukrainian controlled port of Odessa. Corn prices (+6.1%) rallied strongly on the week supported by the announcement of a bigger biofuel blending mandate in the US resulting in higher expected demand for corn.

In energy markets, Freeport LNG (liquefied natural gas) one of the largest US exporters producing LNG will shut for over three weeks following an explosion at one of its Texas Gulf Coast facilities. The shutdown will take 1m tonnes of LNG off the market, with around two thirds of Freeport's exports going to the UK and Europe. Dutch and British 1-month futures rallied sharply on the news.

Industrial metals fell by 3.3% driven by large declines in copper (-3.9%) and Nickel (-3.1%) driven by rising covid cases and concern of demand destruction in China.

## Responsible investments

The Council of Europe issued a \$1bn 3-year social bond last week, as its second social bond targeting the Ukraine refugee crisis. Early last month we saw a €1bn 7-year social bond, which attracted considerable interest in the European debt market. This second tranche issue in US dollar will continue the help disburse grants to help its members to meet the immediate needs of Ukrainian refugees: transport, shelter, food, and medical care.

Last week also saw new specific use of proceeds bond issuance from China, namely Bank of China's Frankfurt Branch and Shandong Hi-Speed (transport and infrastructure construction services) both issuing a \$500m 3-year Green bond, as well as ports and harbours operator Shanghai Hong Kong International Investments issuing a \$250m 3-year Green bond.

Alongside the busy issuance, a remarkable vote from the EU on Wednesday meant it is moving to ban the selling of new combustion engine cars by 2035. This powerful transition is a clear step towards the EU's promise of cutting vehicle emissions by 100% by 2035. Before the decision is final, all 27 EU nations will need to agree, which will be some feat given some of the world's largest car manufacturers are based in Europe.

# Summary of fixed income asset allocation views

## Fixed Income Asset Allocation Views

13<sup>th</sup> June 2022



Strategy and positioning (relative to risk free rate)	Views	Risks to our views
<b>Overall Fixed Income Spread Risk</b> 	<ul style="list-style-type: none"> <li>Credit spreads have widened from recent volatility- driven tightening, as we are seeing a market-wide softening in technicals fundamentals. This, along with rates-driven credit vulnerability, has moved the group negative on credit risk</li> <li>We are past the peak of economic growth, with first two hikes announced and expectations for more 50bp hikes through the end of 2022. Pullback in liquidity created opportunity for market volatility.</li> <li>Uncertainty remains elevated due to fears surrounding pace of central bank hiking, inflation, recession probabilities, and the Russian invasion of Ukraine.</li> </ul>	<ul style="list-style-type: none"> <li>Upside risks: lowered volatility once expansionary environment is established as the new normal</li> <li>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</li> </ul>
<b>Duration (10-year)</b> ('P' = Periphery) 	<ul style="list-style-type: none"> <li>Carry offered by front end yields now attractive in UK</li> <li>Longer yields to be captured by long-run structural downtrends in real yields</li> <li>Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures</li> <li>Hiking cycles may be curtailed by weakening growth, as risk of a policy error increases</li> </ul>	<ul style="list-style-type: none"> <li>Inflationary dynamics become structurally persistent</li> <li>Labour supply shortage persists; wage pressure becomes broad and sustained</li> <li>Fiscal expansion requires wider term premium</li> <li>Long run trend in safe asset demand reverses</li> </ul>
<b>Currency</b> ('E' = European Economic Area) 	<ul style="list-style-type: none"> <li>The invasion of Ukraine will hit global growth, hinder risk markets and lend a bid to the Dollar</li> <li>The repricing of the ECB has so far failed to boost the Euro as Eurozone growth expectations have underperformed the US</li> </ul>	<ul style="list-style-type: none"> <li>End of zero-covid strategy in China normalises supply chains and raises global growth, to the detriment of the Dollar</li> </ul>
<b>Emerging Markets Local (rates (R) and currency (C))</b> 	<ul style="list-style-type: none"> <li>Substantial monetary policy tightening now embedded into EM local rates</li> <li>Aggressive Fed pricing may now open the door to selective EMFX performance</li> <li>EM real interest rates relatively attractive, curves steep in places</li> </ul>	<ul style="list-style-type: none"> <li>Negative sentiment shock to EM fund flows</li> <li>Central banks tighten aggressively to counter fx weakness</li> <li>EM inflation resurgence</li> <li>EM funding crises drive curves higher and steeper</li> <li>Tightening global financing conditions</li> </ul>
<b>Emerging Markets Sovereign Credit (USD denominated)</b> 	<ul style="list-style-type: none"> <li>Spreads have given back most of recent rally, technicals weaker with heavy EM outflows and little HY new issuance</li> <li>Fundamental headwinds: elevated fiscal deficits, rising debt to GDP ratios, significant inflation, Chinese growth, idiosyncratic political risks, increasing use of IMF programs</li> <li>Fundamental consequences of invasion are unevenly distributed via trade links and commodity exposure. Good for commodity producers, bad for resource importers</li> <li>Focus on buying strong reval opportunities as headwinds and volatility increase</li> </ul>	<ul style="list-style-type: none"> <li>Chinese growth derails with softer policy stance after shutdowns</li> <li>Fundamental consequences of invasion are unevenly distributed via trade links and commodity exposure. Good for commodity producers, bad for resource importers</li> <li>A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD</li> <li>Persisting COVID growth scars hurt economies &amp; fiscal deficits</li> <li>Weakening technical with large fund outflows and slower supply</li> </ul>
<b>Investment Grade Credit</b> 	<ul style="list-style-type: none"> <li>US and EMEA spreads have widened since last month. Index last hung out at these yield levels in June 2010.</li> <li>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</li> <li>Liquidity remains very poor, with heightened volatility and wide new issue concessions taking focus away from secondaries.</li> </ul>	<ul style="list-style-type: none"> <li>Supply dynamics remain a headwind</li> <li>Rate environment remains volatile</li> <li>Investors return to government bonds from IG as their risk/return preference for safe assets is changing in new rate environment</li> <li>Russian invasion worsens operating environment globally</li> </ul>
<b>High Yield Bonds and Bank Loans</b> 	<ul style="list-style-type: none"> <li>Spreads have widened since last month, still inside of long-term medians. New focus on higher quality &amp; risk management, expect volatility to continue.</li> <li>In EMEA, spreads at previous recession points. Risks for EMEA HY are heightened because of proximity to and economic impact of Russian invasion.</li> <li>Primary market slow and weak liquidity in secondary</li> <li>Bank loan market drifted lower since April highs; overall sentiment more negative over slowing economy and higher interest cost, focus on de-risking</li> <li>Bonds &amp; loan defaults set to remain near historic lows</li> </ul>	<ul style="list-style-type: none"> <li>Default concerns are focused on demand destruction, margin pressure and macro risks</li> <li>Loan technical and flows</li> <li>Waves of ratings upgrade continue into this year.</li> <li>Russian invasion significantly rattles US bond loan/market as already seen in EMEA from commodities.</li> </ul>
<b>Agency MBS</b> 	<ul style="list-style-type: none"> <li>The risk/reward mix in Agencies is at fair value; MBS Basis spreads now look cheap to long-term averages.</li> <li>Higher Coupon securities are the most attractive in MBS Basis, as lower coupons appear vulnerable due to tight valuations, poor carry and upcoming Fed sales.</li> </ul>	<ul style="list-style-type: none"> <li>Housing activity slows and rising rates move prepaids to normal levels without hurting mortgage servicing rates.</li> <li>Uncertainty with the Fed hiking schedule and long-term position within the Fed balance sheet</li> </ul>
<b>Structured Credit Non-Agency MBS &amp; CMBS</b> 	<ul style="list-style-type: none"> <li>Our preference remains for Non-Agency RMBS</li> <li>RMBS: Housing continues to perform well but expect normalization coming from heavy supply, extension concerns, and general risk off. Selectively reducing risk.</li> <li>CMBS: Most segments maintain strong fundamentals but widening has shifted reval preferences to other sectors.</li> <li>CLOs: Spreads have been widening in sympathy with structured product credit; new issue supply slowed by wider spreads</li> <li>ABS: US consumer looks well positioned, watching performance given inflation &amp; rates.</li> </ul>	<ul style="list-style-type: none"> <li>Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening, consumer retail/travel behavior fails to return to pre-covid levels</li> <li>Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS).</li> <li>SOFRA deals slows CLO new issue</li> <li>Rising interest rates dent housing market strength</li> </ul>
<b>Commodities</b> 	<ul style="list-style-type: none"> <li>o/w Copper &amp; Lead vs Zinc</li> <li>u/w Livestock</li> <li>u/w Gold</li> <li>o/w Oil</li> </ul>	<ul style="list-style-type: none"> <li>Global Recession</li> </ul>

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