In Credit

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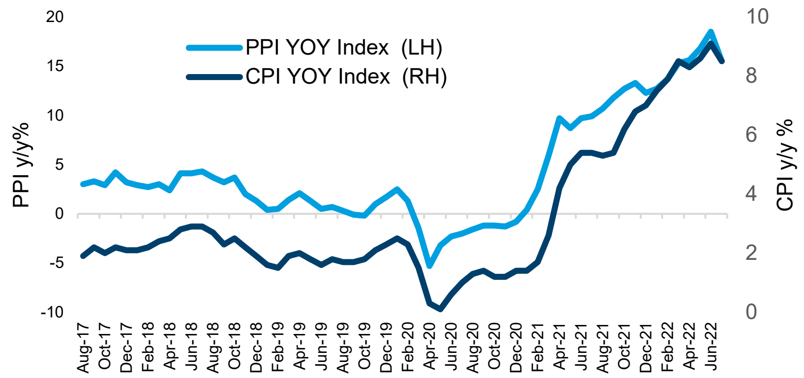
‘Taxation without legislation’

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	2.79%	-4 bps	0.3%	-8.9%
German Bund 10 year	0.91%	-5 bps	3.1%	-8.5%
UK Gilt 10 year	2.03%	-2 bps	0.7%	-14.2%
Japan 10 year	0.19%	2 bps	1.0%	-2.0%
Global Investment Grade	153 bps	-6 bps	2.6%	-10.8%
Euro Investment Grade	177 bps	-4 bps	4.1%	-8.6%
US Investment Grade	141 bps	-8 bps	2.3%	-11.9%
UK Investment Grade	152 bps	-2 bps	1.7%	-10.9%
Asia Investment Grade	267 bps	-5 bps	-0.7%	-8.9%
Euro High Yield	539 bps	-21 bps	6.9%	-9.3%
US High Yield	425 bps	-19 bps	7.6%	-7.5%
Asia High Yield	954 bps	-15 bps	-2.1%	-20.9%
EM Sovereign	403 bps	-17 bps	5.2%	-14.6%
EM Local	6.6%	-12 bps	3.4%	-11.6%
EM Corporate	386 bps	-11 bps	2.1%	-12.1%
Bloomberg Barclays US Munis	2.9%	3 bps	2.4%	-6.8%
Taxable Munis	4.3%	3 bps	0.7%	-15.5%
Bloomberg Barclays US MBS	28 bps	-7 bps	2.2%	-6.8%
Bloomberg Commodity Index	257.59	4.6%	5.5%	25.0%
EUR	1.0199	0.7%	-2.1%	-9.8%
JPY	132.74	1.2%	1.7%	-13.7%
GBP	1.2088	0.5%	-0.3%	-10.3%

Source: Bloomberg, Merrill Lynch, as of 12 August 2022.

Chart of the week: US Inflation – last five years.



Source: Bloomberg, Columbia Threadneedle Investments, as of 12 August 2022.

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Macro/government bonds

US inflation as measured by the consumer price index (CPI) has rocketed from 0.1% year-on-year in Spring 2020 to 9.1% last month and is the key fear for policy makers globally at present. Both consumer and (later) producer price index (PPI) data surprised to the downside last week, however. A sharp decline in energy prices in recent weeks was the chief reason for this reduction. CPI came in at 8.5% y/y (core 5.9%) which was lower than the expected 8.6% and below last month's 9.1%. PPI actually fell on the month by 0.5% taking the annual rate to 9.8% from 11.3% in June (see **Chart of the week)**.

These encouraging readings for inflation prompted a modest reduction in expected rate rises, with December Fed Funds priced at around 3.4% with a "terminal" rate of close to 3.6% by March 2023. Interestingly, market expectations are for a reduction in interest rates later in 2023, which with inflation still miles above target seems a little optimistic and perhaps explains why bond markets struggled to make any ground in the past five days.

In the UK, GDP contracted by 0.6% month-on-month in June, less than the expected -1.2%. On a quarter-on-quarter basis GDP fell by 0.1% in Q2, after a 0.8% expansion in Q1. The UK trade deficit also increased to £11.4 billion in June which was worse than last month and worse than expectations. Both the GDP and trade numbers were affected by the Queen's jubilee holiday.

Searingly hot weather in Europe and the UK has seen water levels drop and makes the passage of cargo down the Rhine river more difficult. This artery for European transport is all the more important during an energy supply crisis and in part explains why consumer sentiment is at an all-time low in the region and why shipping costs have ballooned.

Investment grade credit

Global investment grade spreads continued to tighten – as has been the trend since the start of this quarter. After significant underperformance, the European market is leading the tightening with spreads around 16% tighter since early July, whereas the market as a whole is around 13% better (or 24bps tighter).

For context, and from a valuation perspective, global spreads are now around one standard deviation (SD) cheap to the five-year average and 0.2 SDs cheap to the 20-year equivalent. If we adjust for the modest deterioration in index credit quality and the increase in duration over the past couple of decades, spreads are close to bang-on that long-term average.

The economic outlook globally is one of low but positive growth, which is a fairly benign environment for the IG market. Strong growth can often be accompanied by more aggressive/credit negative corporate behaviour and a deep or protracted recession brings the risk of downgrades and defaults. The risk of recession seems more heightened in Europe and the UK, wherein the former is affected most by the energy supply crisis.

Meanwhile, interest rates continue to tighten with policy conditions now around neutral in the US and even tight in the UK. In Europe 0% rates remain supportive for markets. Further increases are to be expected though the presumed terminal rate in the US is only around 15 higher than today's rate, and rate cuts area already priced for later next year.

In terms of corporate health, we see some signs of bifurcation in credit metrics between the US and European issuers. The former is still expected to delever despite a slower growth outlook. In Europe, however, the greater recessionary risk and more significant supply-chain disruptions are leading to leverage forecasts rising.

Lastly, heightened volatility/lower liquidity in markets is often seen as a good entry point to the market, for example, post the global financial crisis, post-Covid-19 and post the eurozone crisis.

All in all, a reasonably balanced background for global IG markets – though European credit still stands out as offering the greatest value in our view.

High yield credit & leveraged loans

US high yield bond spreads tightened to a multi-month low over the past week (+427bps) amid softer than expected inflation data. Receding recession fears are also producing compression among ratings as well as outperformance among 2022's industry laggards (ie retail, housing and autos). The ICE BofA US HY CP Constrained Index returned 0.94% and spreads were 19bps tighter. According to Lipper, inflows for the asset class were modest with just $27 million contributed following nearly $8 billion of inflows over the previous two weeks. Meanwhile, the average price of the JP Morgan Leveraged Loan Index increased $1.08 over the week to $95.28 – $3.27 above the early-July low. Outflows continued for the floating rate with $307 million withdrawn over the week. This was the ninth consecutive weekly outflow, albeit the smallest over the period.

European high yield had another week of positive performance, the sixth in a row, returning +0.72 as spreads narrowed another 21bps to 539bps. Lower credits out performed as CCCs returned almost twice the performance of BBs. Flows were positive for the first time in many months with almost €200 million into the asset class via both ETFs and managed accounts.

In M&A news, Ladbrokes announced the planned acquisition of SuperSport Group, a Croatian sports betting firm, for £600 million. In real estate, Adler, the German real estate group, announced completion of the sale of two development projects in Frankfurt for €166 million, higher than the valuations reported in Q1. These are the first of 27 planned disposals so there is still much to go.

In the potentially changing landscape for EHY financing, Apollo Group, the private equity group, announced its first Large Cap, Direct Loan Fund. This would allow EHY issuers to bypass the primary market, with private lending being provided by the private equity groups. It is said this type of private credit could replace 10%-15% of the HY loans and bond market.

Asian credit

Alibaba's operating results for the quarter ended June 2022 were better than expected, thanks to its focus on cost control and optimisation 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 1H 22 (down 5 points), 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 HKD2 billion shareholder loan from its shareholder (STDM) and a HKD3 billion rights issue. The shareholder loan has a six-year term with an interest rate of 4%. These additional funds, together with the HDK19 billion of new loan facilities in June, will allow SJM to operate for five to 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 $19 billion of spectrum, higher than market expectation. Reliance Jio leads with its $11.1 billion bid for spectrum that includes the expensive 700MHz frequency band. Bharti Airtel put in the second largest bid worth $5.4 billion. Altogether, around 91% and 87% of the bids by Reliance Jio and Bharti Airtel are for the 5G frequency bands (700MHz, 3300MHz, 2.6GHz).

Emerging markets

The EMBI diversified index returned 2% on the week echoing the strong rally in global stocks. The top performers were Pakistan (+14%), Tunisia (+11%) and Nigeria (+10%), with laggards Ecuador and Venezuela both delivering a 6% loss. Lower rated African spreads were the main beneficiaries of the market rally, tightening by 116bps on aggregate.

Dispite hopes of US rate hiking easing, EM countries delivered a barrage of rate rises with 75bps hikes from Mexico and Romania, 50bps hikes from India, Peru and Uganda, and 25bps hikes from Thailand and Serbia.

In China there was a series of unfavourable July data releases with industrial production, retail sales and fixed asset investment rising y/y but coming in below expectations. Unemployment ticked down to 5.4% but youth unemployment (16-24) rose to an all-time high of 19.9%. Crucially, property investment has declined 6.4% year-to-date with new home sales down 28.9% and new home starts falling 45.4%. The government has been able to restart only a portion of stalled housing projects following mortgage holders (who pre-pay in China) refusing to make payments. In response, China has cut the one-year prime loan rate 10bps, which is used as a benchmark for mortgages, alongside the seven-day lending rate which is -10bps also.

In Pakistan, Saudi Arabia have vowed support via plans to renew its $3 billion deposit with the Pakistani state bank providing $100 million a month for 10 months in petroleum products. The move will support Pakistan's IMF loan approval at the end of the month.

Commodities

The commodity index had a strong week rallying 4.6%, taking YTD returns to 25%. This was led by a combination of energy, agriculture and softs.

Energy prices were driven higher as Brent retraced back towards $100, while US natural gas was elevated by hotter weather. The IEA hiked its 2022 oil demand outlook by 380,000 barrels a day driven by gas to oil switching, while OPEC cut its forecast for oil demand by 260,000 barrels a day.

In softs, cotton prices rose 13% after selling off heavily since mid-June. The market is concerned about demand in a recessionary environment given the discretionary nature of clothing purchases.

In corporate news, Saudi Aramco posted the largest quarterly profit of any listed company ever. Net income rose to $48.4 billion from $25.5 billion this time last year. The company will use this windfall to reduce debt and invest in a huge expansion of production capacity.

Responsible investments

Hosepipe bans were in force across the UK last week and into this week as Europe suffered yet another heat wave. It was the driest July since the 1930s, causing water companies such as Thames Water to bring in a ban and encourage people to conserve as much water as possible. Elsewhere in Europe, transport via rivers for grain, diesel and coal among other trades struggled as rivers such as the Rhine and the Danube became almost impassable.

Fixed Income Asset Allocation Views

15th August 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 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)	Short -2 ¥-1 P€0 $£+1 +2 Long	▪ Carry offered by front end yields now attractive in UK ▪ Longer yields to be captured by long-run structural downtrends in real yields ▪ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures ▪ Hiking cycles may be curtailed by weakening growth, as risk of a policy error increases	▪ Inflationary dynamics become structurally persistent ▪ Labour supply shortage persists; wage pressure becomes broad and sustained ▪ Fiscal expansion requires wider term premium ▪ Long run trend in safe asset demand reverses
Currency ('E' = European Economic Area)	Short -2 -1 ¥ A$ EM $ € £ 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))	Under-weight -2 -1 R C 0 +1 +2 Over-weight	▪ 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 ▪ u/w Silver	▪ Global Recession

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