COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

18 JULY 2022

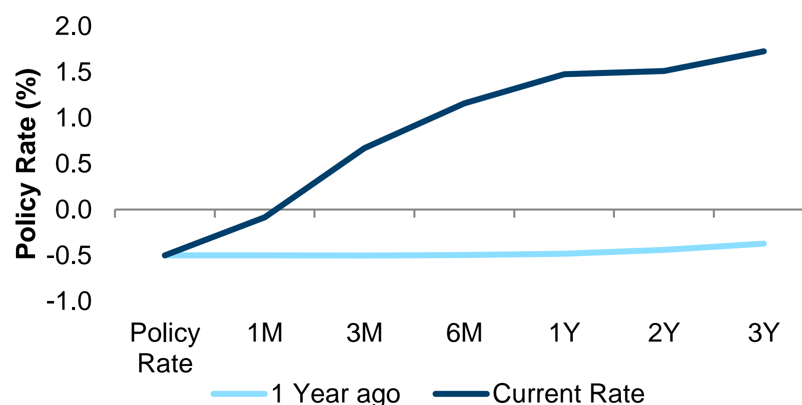
Ready for lift-off.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	2.99%	-9 bps	0.1%	-9.1%
German Bund 10 year	1.22%	-13 bps	2.2%	-9.3%
UK Gilt 10 year	2.16%	-8 bps	0.2%	-14.6%
Japan 10 year	0.24%	-1 bps	0.2%	-2.7%
Global Investment Grade	170 bps	1 bps	0.9%	-12.2%
Euro Investment Grade	202 bps	1 bps	2.1%	-10.4%
US Investment Grade	158 bps	1 bps	0.6%	-13.4%
UK Investment Grade	162 bps	0 bps	0.6%	-11.8%
Asia Investment Grade	256 bps	13 bps	-0.9%	-9.0%
Euro High Yield	661 bps	5 bps	1.5%	-13.9%
US High Yield	539 bps	3 bps	1.9%	-12.4%
Asia High Yield	1011 bps	71 bps	-4.6%	-23.0%
EM Sovereign	496 bps	43 bps	-1.7%	-20.2%
EM Local	7.2%	14 bps	-3.1%	-17.2%
EM Corporate	436 bps	23 bps	-1.2%	-15.0%
Bloomberg Barclays US Munis	3.0%	-5 bps	1.5%	-7.7%
Taxable Munis	4.3%	-10 bps	0.2%	-15.9%
Bloomberg Barclays US MBS	41 bps	-1 bps	0.8%	-8.0%
Bloomberg Commodity Index	250.85	-2.1%	-3.0%	14.9%
EUR	1.0176	-1.0%	-3.9%	-11.3%
JPY	138.12	-1.8%	-2.0%	-16.9%
GBP	1.1995	-1.5%	-2.7%	-12.4%

Source: Bloomberg, Merrill Lynch, as at 18 July 2022.

Chart of the week: Euro Interest rate expectations



Source: Bloomberg, Columbia Threadneedle Investments, as at 18 July 2022.

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Macro / government bonds

If the biggest worry for markets at present is inflation then last week's data did little to soothe such anxiety.

US consumer price inflation exceeded expectations and printed the highest level of inflation since the early 1980s at 9.1% y/y. The jump higher was due to an 11% rise in gas prices and 1% hike in food. The core number (ex food and energy) was also scary and rose 0.7% m/m, again ahead of expectations with housing rental rising by 0.8%. Car prices also surged higher by 1.6%. This inlfation report will make unconfortable reading for the US Federal Reserve and a further rate hike of 75bps at the next meeting might seem a best case scenario. As you might expect, the yield curve inverted further with the greatest damage being felt at the short end of the curve. Long yields were barely moved. The Bank of Canada also delivered an emphatic 1% rise in rates last week.

In Europe politics was in focus. For the UK, the ruling Conservative Party is in the midst of selecting a new leader and Prime Minister. The favourite seems to be ex-Chancellor Rishi Sunak or Penny Mordaunt. In Italy, never short of a political development either, Mario Draghi has threatened to resign in the event that the Five Star party refuses to support him in a confidence vote. Italian bond prices reacted poorly to the news. This week is likely to bring the first rate move by the European Central Bank. At Thursday's meeting we expect a 25bps move higher in rates as well as details of the anti-fragmentation tool, which is designed to offer support to peripheral government markets.

This week (aside the ECB) brings housing data and small business confidence numbers in the US. Europe has CPI inflation while it is a big data week in the UK with inflation, retail sales and employment data.

Investment grade credit

Investment grade credit markets traded more calmly in the last week. Spreads were unchanged largely last week and though liquidity conditions remain challenged there was a modest improvement. Likewise, there was more evidence of activity in the primary market.

We are in results season which kicked off with the large US banking institutions. JP Morgan, Citibank, and Wells Fargo reported notable increases in net interest margins (especially Wells), increased capital ratios and return on equity back close to levels seen in 2019. Markets businesses (eg, Citi) were also robust. There was little sign of a significant increase in credit losses.

High yield credit & leveraged loans

US high yield bond prices were volatile over the week as investors absorbed a number of catalysts including a much firmer than expected CPI, a mixed slate of bank earnings, better than feared retail sales, and a fairly large decline in the median 5-year ahead inflation expectations component of Friday's consumer confidence survey. The ICE BofA US HY CP Constrained Index returned 0.27% and spreads were unchanged over the week. According to Lipper, the asset class experienced a $652m withdrawal, largely reversing the prior week's $900m inflows and leaving YTD outflows at $45bn. Meanwhile, US leveraged loan prices recouped July's declines in the past week (+$0.21 w/w to $92.31) with outperformance up in quality as investors continue to debate the pace of policy hikes and its impact on growth. Retail loan funds saw their 8th outflow over the last 10 weeks with $1.2bn withdrawn, leaving YTD inflows at $13bn.

European High Yield (EHY) had another positive week (+41 bps) of performance even as spreads moderately widened last week (+5bps) but with yields falling (-7bps) due to the fall in underlying government yields. BBs were again the strong outperformers, posting a positive gain, more than double the performance of Bs, while CCCs actually posted a negative performance. Flows were still net negative, largely due to managed accounts as ETFs actually experienced inflows suggesting that there is cash being put to work in EHY. The primary market was quiet last week. Market talk is that there is at least €30bn that needs to come to the market though expectation is that September is the earliest date for the next new issue. Raising finance is challenging.

In issuer specific news, Saipem was able to complete its €2bn rescue package. However, the bank leads had to take down a sizeable amount of the package with much of the rescue being mainly supported by two major shareholders.

Some signs of caution regarding M&A deals going through given the market and current financing challenges. TTB announced it will not be bidding for Playtech after all, citing current challenging market conditions (read they saw the price that 888 had to pay for its debt financing). Observers will recall that Aristocrat put in an earlier €2.7bn bid for Playtech, which was rejected. This was followed by TTB, a HK consortium, working with the Playtech CEO to come up with a valuation to bid for Playtech to now decide to not go ahead. In other news, Spectrum Brands, which is selling its hardware division to Assa Abloy (Swedish consumer goods company), has just said that due to ongoing review by the US regulator, completion of the acquisition is now pushed out to deadline June 2023 (as versus original 2022 completion). The week finished with rumours of Virgin Media possibly acquiring TalkTalk, for £3bn.

In rating news, DKT Holdings (Danish telecoms) experienced a one notch downgrade to B3, by Moody's, bringing it in line with other agencies. The credit rating agency cited the pending refinancing of upcoming bonds and the rising interest costs. Tereos, the sugar producer saw S&P upgrade it to BB- stable. A new fallen angel to the EHY universe with Atos (ATOFP), a digital services company being downgraded 2 notches by S&P to 'BB'; outlook negative. This follows the announcement to split the company into two publicly listed companies and with the news that the ATOS CEO will be leaving the firm earlier than planned. In sector news, cancellation rates in the building sector are starting to tick up as more people are either not qualifying for mortgages or pulling out given how high mortgage rates have risen.

Structured credit

It was a good week for the US Agency MBS market on the back of an interest rate rally. The sector posted a gain of 97bps, topping the broad bond market represented by the Bloomberg Aggregate Bond Index by approximately 10bps. Spreads stabilised as supply, on both a gross and net basis, continued to drop. Higher interest rates have slowed prepayment and purchase activity. One trend of note is declining bank participation; something to watch as the US Fed steps out on the demand side of the equation.

In Non-agency MBS, supply has been heavy and the general risk off tone has weighed on spreads. Fundamentals remains solid but a normalisation trend is expected, meaning higher delinquencies. CMBS has weakened on continued Covid outbreaks resulting in impacts to travel and return to office. In ABS, the US consumer is relatively well positioned to weather a potential recession; however, persistent inflation and higher rates are concerning. There is some weakness re-emerging in lower fico score borrowers.

Asian credit

MGM Resorts International recently approached the Lim family (controlling shareholder in Genting Berhad) for a potential deal related to Genting Singapore, which operates Resorts World Sentosa. However, the discussion did not result in any agreement. Other potential bidders are also reportedly in the preliminary stages of assessing Genting Singapore (source: Bloomberg). In our view, any transaction related to Genting Singapore would not be straightforward given stringent regulatory oversight. For context, the Casino Regulatory Authority of Singapore sets various conditions for the two gaming operators (Sands and Genting) and, hence, any transaction is subject to regulatory approval. The duopoly in the Singapore gaming sector will last till 2030, during which both operators will be investing in the expansion of their gaming assets.

Renew Power called the RPVIN 6.67% 24s ($525m), which will be refinanced with an amortising project financing debt (5-year) from an Indian non-bank institution. This refinancing will lower its INR interest cost by 200bps and push the maturity to March 2027. This refinancing channel is positive for ReNew Power albeit it is unclear whether we could see more refinancing via project debt across the rest of the renewable energy sector.

The Government of India is reportedly considering the reduction of the windfall tax due to the recent decline in oil prices. As background, in early July, the government imposed a windfall tax on crude oil and levied export duties on petrol, diesel and aviation turbine fuel. For crude oil, the windfall tax is INR23,250/t (4294/t), which translates to around $41/bbl. The windfall tax is subject to review every 15 days.

The Chinese property sector continues to see further turmoil. Homebuyers have suspended mortgage payments to banks due to their concerns about unfinished homes. As at 14 July, the mortgage payment suspension has affected more than 200 projects in 75-80 cities. There is significant media coverage and homebuyers' discontent could morph into wider social unrest while mortgage suspension will drive up the NPLs in the banking sector. There could be more intervention from local governments with pressure from the central government to support under-construction projects albeit there is an uphill challenge in shoring up homebuyers' confidence.

Emerging markets

Emerging market hard currency sovereigns (as measured by the JP Morgan EMBI Global index) posted a negative return over the week of -1.75% as spreads widened 43bps; however, we did see an improvement in tone towards the end of the week with stronger performance coming from African countries (Senegal, Nigeria and South Africa).

Ratings agency Fitch downgraded Turkey from B to B-, outlook negative owing to deteriorating fundamentals. Inflation is spiralling, the Turkish lira is deteriorating and the central bank refuses to raise interest rates. Mexico was downgraded one notch to Baa2 from Baa1, outlook stable by Moody's, citing cautious fiscal policy, weak growth outlook, and a weak institutional environment; however, the change had very limited impact in the market. Croatia was upgraded by all three ratings agencies to Baa2/BBB+/BBB+ as expectations that economic growth will remain steady as it prepares to join the eurozone in 2023.

Indonesian state-owned aluminium smelter Inalum has announced cash offers for the repurchase of three notes maturity in 2023, 2028 and 2048 with a total face value of $3bn. Elsewhere electronics company Lenovo has offered to buy its outstanding 2023 notes ($686.8m principle) financed with the new issuance of a larger value US dollar bond, which will also provide a working capital injection. The company will also issue green bonds tranches for the purpose of financing green buildings and renewable energy projects.

In central bank news, Chile hiked 75bps as expected to 9.75%, the Hungarian Central Bank also raised rates to 9.75%, a 200bps increase. There were surprises in Asia as the Philippines key rate was increased by 75bps, the biggest move in over 20 years, and Singapore also surprised with off-cycle monetary policy tightening.

Commodities

The commodity index sold of 2.6% last week driven by declines in industrial metals (-6.9%) and agriculture (-6.8%). US natural gas was the strongest performer rising 16.1% on the week.
Brent sold off 6.1% last week as US president Joe Biden visited Saudi Arabia as part of his middle eastern tour. The US will now commit $1bn in food security aid for the Middle East, North Africa region. Additionally, the leaders of the gulf co-operation council will also commit $3bn towards global infrastructure and investment initiatives in partnership with the US. Furthermore, in what is regarded as the main objective of Biden's visit to the Middle East, Saudi Arabia will now boost crude production capacity by 1m barrels a day.

Nickel prices declined by 10.2% and are currently trading just north of the $19,000 a tonne level, a far cry away from the $100,000 prices seen during the Tsingshan crisis levels seen back in March. Recessionary fears are driving negative price action in the market Nickel prices have been hurt by tepid demand from steel plants with steel mill production cuts planned, the production off season approaching and higher fuel prices from north American plants.

Chicago wheat contracts sold off 12.9% last week and have now given back all gains since the invasion of Ukraine, offering global respite from rising food prices. The supply outlook has been buoyed by strong harvests from Europe and the US.

Responsible investments

Last week we saw PepsiCo come to the market with its second green bond, the last issued back in October 2019. Along with a refreshed green bond framework, use of proceeds are now linked to specific UN SDGs (Sustainable Development Goals) including SDG 6: Clean Water and Sanitation, SDG 12: Responsible Consumption and Production, and SDG 7: Affordable and Clean Energy. Eligible green projects include sustainable plastics and packaging, decarbonisation of the operation and supply chain, and water sustainability.

According to a spokesperson from General Electric, the demand for offshore wind-turbine blades has been lower than expected, resulting in plans to build a factory in the Northeast of England being cancelled. The promise of around 750 of jobs being created has been blown away.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

18th July 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 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

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