COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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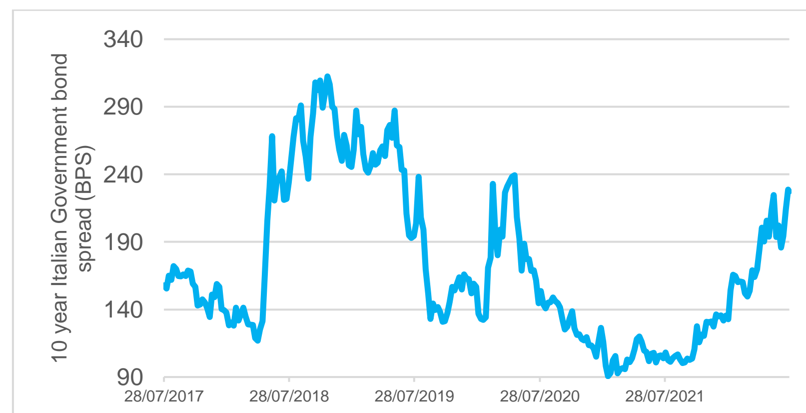
Arrivederci negative rates.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	2.83%	-9 bps	1.0%	-8.3%
German Bund 10 year	1.08%	-6 bps	2.8%	-8.8%
UK Gilt 10 year	1.97%	-12 bps	1.9%	-13.1%
Japan 10 year	0.20%	-4 bps	0.3%	-2.6%
Global Investment Grade	164 bps	-6 bps	2.2%	-11.1%
Euro Investment Grade	187 bps	-15 bps	3.3%	-9.2%
US Investment Grade	152 bps	-6 bps	2.1%	-12.1%
UK Investment Grade	158 bps	-4 bps	1.9%	-10.7%
Asia Investment Grade	265 bps	10 bps	-0.7%	-8.9%
Euro High Yield	607 bps	-54 bps	3.9%	-11.8%
US High Yield	496 bps	-43 bps	4.5%	-10.2%
Asia High Yield	1019 bps	12 bps	-4.4%	-22.8%
EM Sovereign	472 bps	-24 bps	0.9%	-18.1%
EM Local	7.1%	-13 bps	-1.8%	-16.1%
EM Corporate	440 bps	4 bps	-0.5%	-14.4%
Bloomberg Barclays US Munis	2.9%	-4 bps	1.7%	-7.4%
Taxable Munis	4.2%	-14 bps	1.6%	-14.8%
Bloomberg Barclays US MBS	37 bps	-4 bps	1.9%	-7.0%
Bloomberg Commodity Index	252.21	2.7%	-0.3%	18.1%
EUR	1.0242	1.3%	-2.6%	-10.2%
JPY	136.61	1.7%	-0.3%	-15.4%
GBP	1.2069	1.2%	-1.5%	-11.3%

Source: Bloomberg, Merrill Lynch, as at 22 July 2022.

Chart of the week: Italian 10-year government bond spreads.



Source: Bloomberg, Columbia Threadneedle Investments, as at 25 July 2022.

Macro / government bonds

We finally bid farewell to negative interest rates in Europe last week.

The European Central Bank tightened monetary policy for the first time in over a decade. This was expected in terms of timing (21 July) but was more than anticipated (0.5%). The move was also in contrast to the forward guidance presented as recently as last month (0.25%). So, forward guidance is gone. The ECB has become data dependent as it struggles with an 8.6% rate of inflation against a 2% policy target. The bank's second goal was to cement the fissures appearing in euro peripheral market, mostly notably Italian BTPs. The ECB launched an new 'anti-fragmenation' tool and invented a new acronym: the Transmission Protection Instrument (TPI). This is a technical term for unlimited bond buying support. The 'tool's' objective, as mentioned, is reasonably clear which is to avoid a threat to the transmission on monetary policy in the euro area. The conditionality for such support, as spelt out, might be difficult to achieve for several peripheral economies, most notably Italy. More clarity to come one imagines.

It has not been a quiet week in Europe's third largest economy. Italian Prime Minister and ex-head of the ECB Mario Draghi resigned. Why? He seemed to have lost the confidence of coalition partners So with ambiguous TPI support and no leader, Italian BTPS widened in yield spread significantly to German bonds. An early election has been called for 25 September with Mr Draghi staying as caretaker PM until then. A 'rocky road' until then one imagines.

In 'better' news, Russia resumed the flow of gas to Europe through the Nordstream pipeline at around 40%. For how long this remains is difficult to predict.

Employment data and housing numbers from the US both displayed weakness again last week. The initial jobless claims report pushed to an eight month high while housing starts and permits are struggling against a backdrop of higher mortgage costs and a slowing economy. The US Federal Reserve meets this week to deliver another rate rise.

The UK was not immune from economic weakness as retail sales data showed a near 6% y/y decline.

Core bond yields in the US, Germany and the UK all ended lower throught the week.

Investment grade credit

There was a constructive tone to investment grade markets last week with spreads tighter across the piste.

Euro-denominated markets have at last started to play catch-up with their US dollar cousins and outperformed this month, after significant underperformance so far this year. We continue to favour this market as being the cheapest of the major markets. As might be imagined, Italian credit underperformed given the political and monetray policy developments discussed above.

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 as $855m was withdrawn.

European High Yield had its third positive week, moving from strength to strength, as it posted 2.4% return with spreads tightening in 54 bps to 607 bps and yields falling 0.39% to 6.93%. Lower rated credits outperformed with CCCs returning 3.25% on the week. Flows, for the week ending 21 July were still negative as €241m exited, both via ETFs and managed accounts. Friday, however, was said to experience strong inflows, especially via ETFs as trading improved sharply. This was after a challenging first half of the week where demand was concentrated on high quality names while liquidity remained limited with trading very technical.

In M&A news, auto parts manufacturer Schaeffler, confirmed it is buying Ewellix group (tech products in the industrial division with 1.2k employees and revenue of €216m FY21 and €250m FY22E) for €582m plus €120m of assumed debt. In retail, Premier Food also announced the acquisition of The Spice Tailer for £43.8m saying it will use its existing liquidity to fund the deal.

In credit rating news, Moody's downgraded Telecom Italia to B1 with Negative Outlook, expecting negative FCF over the next two-three years. This is the second downgrade in less than six months since the issuer was last downgraded to Ba3 in March, earlier this year. More positively, Saipem was upgraded by Moody's from B1 to Ba3, following completion of the capital raise.

In company news, Ford announced it will cut 8,000 (mostly salaried, that is not manufacturing focused) jobs and primarily in the ICE (Ford blue) segment of its business. As Ford employs c31k salaried employees in the US, the cut is meaningful. Carnival, the cruise line, announced an equity raise of $1bn, largely for general purpose use but will also include tackling 2023 maturities. Regarding Adler, the German real estate group, it looks as though the management board is preparing to sell 95% of the remaining residential and commercial property assets.

Structured credit

The rally in interest rates catapulted returns in the US Agency MBS market to +1.07% on the week. Investors became more convinced that inflation will fall next year, a leading indicator for lower interest rates longer term. Meanwhile, sentiment for securitized credit was mixed at the largest sector conference in the world, held in Las Vegas, which brought in over 8,000 participants. Investors noted continued strong fundamentals in residential mortgages supported by record levels of home equity, while at the same time recognizing continued home price appreciation levels will be more moderate. Supply technicals are deemed to be more balanced brought on by lower purchase and refinancing activity. ABS investors were mindful of the rising delinquency trend for deep-subprime borrowers, a normalizing trend. The key question is will stress spread into higher FICO buckets, which has many investors seeing better relative value in up-in-quality deals.

Asian credit

The Macau government reopened on 23 July after a two-week lockdown. During this "limited opening phase" from 23 July to 30 July, business activity will remain low. For the non-essential sectors, while operations can resume, no more than 50% can go to work at the same time. Additionally, stringent travel restrictions are still in place for travel between Mainland China and Macau, which means that the footfall in casinos will be very low.

Due to the decline in crude oil prices, the Government of India has reduced the windfall tax to INR17,000/t (previous: INR23,250/t), equivalent to $212.6/t or $29/bbl. Over the last three weeks, Brent has dropped from around $115/bbl to $106/bbl. This implies that the government is largely targeting a price realization of $75-80/bbl (after the windfall tax) for the upstream companies (ONGC, Oil India, Cairn India and Reliance Industries). This latest adjustment will provide some relief to the companies because if the windfall tax is not cut, the price realization per-barrel could collapse well below $65-70, negative for the upstream producers.

The China State Council has approved a plan to set up a real estate fund to provide financial support to 12 distressed developers. China Construction Bank will contribute CNY50bn to the fund while the PBOC will extend a CNY30bn re-lending facility. The funds can be upsized to between CNY200bn-300bn.

In the Henan Province, the local government-linked entities are getting more active in supporting the property sector. Henan Asset Management Co and the state-linked Zhengzhou Real Estate Group have pledged to fund unfinished construction in Zhengzhou. Additionally, the Central China Real Estate (Henan property developer) announced that the local government entity, Henan Railway Construction & Investment Group has acquired a 29% stake in the company through share purchase from the Chairman Wu Po Shum for $82.6m.

Emerging markets

Emerging market hard currency sovereigns finally posted a positive return for the week. The rally in treasuries combined with spread tightening, particularly in single B rated African names, resulted in a return of 2.64% for the week (as measured by the JP Morgan EMBI Global index). In Central Bank news, South African Reserve Bank raised its policy rate by 75bps to 5.50%, Nigeria hiked 100bps to 14%. Russia continued to lower its interest rate, moving from 9.5% to 8%, a larger cut than expected. Sri Lankan MP's elected Ranil Wickremesinghe as President to replace Gotabaya Rajapaksa who recently fled the country. Wickremesinghe, who has been Prime Minister six times, is largely unpopular amongst the public. The country is currently experiencing its worst economic crisis in history and the appointment of the new president is unlikely to stabilise social tensions. In Peru, far left president Pedro Castillo faces his third impeachment attempt, which is expected to be successful. The latest case focuses on allegations over obstructing course of justice. Castillo was elected last year in a closely fought battle and his removal would mean new elections and likely deteriorating political stability alongside a further period of instability.

Commodities

The BCOM index rallied 2.7% on the week driven by advances in Industrial metals (+6.3%) and energy markets (+6.0%).

In energy markets the Nord Stream 1 gas turbine that has been undergoing maintenance in Canada has now landed back on German soil but has yet to be re-installed in Russia as an ongoing paperwork dispute between Gazprom and Siemens Energy (the turbine manufacturer) is stalling progress. Gas flows have been at around 40% of capacity since the pipeline returned from maintenance last week with only two of six turbines operating on the Russian end. To make matters worse Russian president Putin said another turbine is due to undergo maintenance that could reduce flows to 20%. Germany's gas storage is currently at around 66% and is looking to sure up reserves ahead of the crucial winter season to 90%+ by the start of November.

The star performer of the BCOM index was US natural gas, which rallied by 18.3% due to enhanced air conditioning demand as the majority of the US experiences above average temperatures.

Turning to industrial metals, Nickel delivered a 14.2% gain followed by Aluminium rising 6.2%. In further positive news China's state council approved a fund to provide financial support for 12 developers alongside a few distressed developers that were recently nominated. The fund has initially secured 50bn yuan ($7.4bn) in funding but this could rise to 300bn yuan.The funding will be used to alleviate the debt crisis the sector is facing and crucially for commodity demand support the completion of unfinished home projects.

As regards agriculture, Russia, Ukraine, Turkey and the UN have signed a deal to allow Ukraine to safely export grain and fertiliser to curtail rising global food prices, targeting five million metrics tonnes exported every month. There will be no need for de-mining as Ukrainian pilots will escort ships along safe channels. Turkey will monitor ships leaving and entering the black sea to address Russian concerns of Ukraine importing weapons. Wheat prices declined by 2-4% last week.

Responsible investments

Last week in a former coal-fired power plant in Massachusetts, President Biden in a speech named climate change an "existential threat". Instead of formally declaring climate change an 'emergency' (which requires legal procedures) he said, "Climate change is an emergency…and in the coming weeks I'm going to use the power I have as president to turn these words into formal, official government actions through the appropriate proclamations, executive orders and regulatory powers that a president possesses." Along with these comments came an announcement that plans were in place to expand wind power generation development in new areas along the US coast. Areas included shores off of Florida, Georgia and North & South Carolina, as well as alongside existing oil drilling sites in the Gulf of Mexico. These plans play a huge part of Biden's promise to be aggressive against climate change.

EDF has updated its green bond framework that will now allow nuclear energy projects to be eligible for funding. In a controversial move, that other energy firms are looking at, EDF plans to have a separate pot of cash that will fund its nuclear energy projects, alongside an existing and future pot of cash that will separately not fund nuclear projects. By splitting the debt, this allows investors who explicitly screen out any tie to nuclear to still have the opportunity to invest in EDF green bonds. Some investors have noted that they will continue to blacklist nuclear as an energy source as any possible benefits outweigh the longer-term risks to society and the environment.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

25th 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 ▪ o/w Softs ▪ o/w Grains ▪ u/w Gold ▪ o/w Oil	▪ Global Recession

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