COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

23 MAY 2022

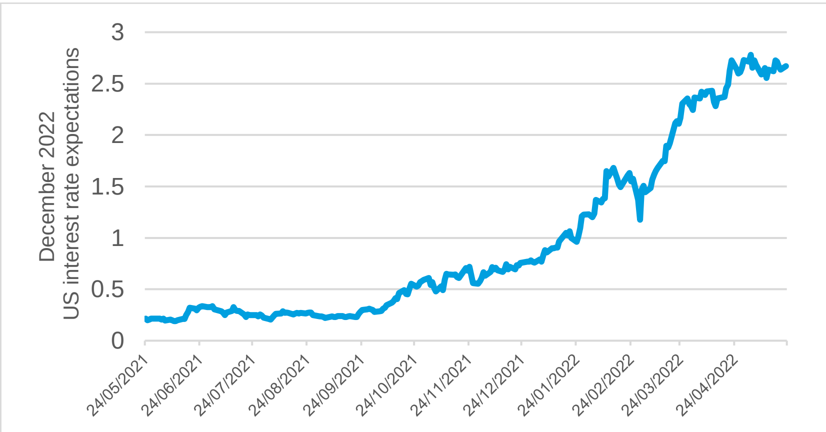
Something recessionary this way comes?

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	2.82%	-10 bps	-2.9%	-8.3%
German Bund 10 year	0.98%	3 bps	-3.2%	-8.1%
UK Gilt 10 year	1.91%	17 bps	-3.3%	-10.5%
Japan 10 year	0.24%	-1 bps	-0.3%	-1.9%
Global Investment Grade	157 bps	5 bps	-4.7%	-6.9%
Euro Investment Grade	165 bps	0 bps	-3.5%	-8.6%
US Investment Grade	155 bps	8 bps	-5.6%	-12.9%
UK Investment Grade	144 bps	2 bps	-3.2%	-9.2%
Asia Investment Grade	228 bps	2 bps	-2.2%	-7.4%
Euro High Yield	513 bps	0 bps	-4.7%	-9.1%
US High Yield	491 bps	28 bps	-6.6%	-10.8%
Asia High Yield	835 bps	22 bps	-3.9%	-14.3%
EM Sovereign	420 bps	16 bps	-7.3%	-15.8%
EM Local	6.8%	-19 bps	-6.0%	-12.0%
EM Corporate	375 bps	20 bps	-3.6%	-12.1%
Bloomberg Barclays US Munis	3.4%	-1 bps	-4.2%	-10.2%
Taxable Munis	4.1%	-9 bps	-6.7%	-15.7%
Bloomberg Barclays US MBS	41 bps	5 bps	-2.7%	-7.5%
Bloomberg Commodity Index	280.51	1.8%	5.1%	31.9%
EUR	1.0670	1.5%	-4.5%	-7.1%
JPY	127.41	1.1%	-4.8%	-10.0%
GBP	1.2569	1.8%	-5.0%	-7.8%

Source: Bloomberg, Merrill Lynch, as at 23 May 2022.

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



Source: Bloomberg, Columbia Threadneedle Investments, as at 23 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

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Macro / government bonds

At last, the traditional inverse relationship between equity and bond prices is starting to re-establish itself. Indeed, in the last couple of weeks bond yields are significantly lower as the equity market continues to decline (S&P -19% YTD). All the while, US interest rate expectations have remained fairly static all month at around 2.7% for December of this year **(see chart of the week).**

Thematically, markets continue to focus on the possibility of recession in the coming year. Housing data from the US suggests higher interest / mortgage rates are starting to dent confidence in the sector. In the UK, consumer confidence plunged to the lowest level since the survey (GfK) began in 1974. Turning to Europe, car registrations fell by 21% y/y in April, extending March's decline.

For the consumer a combination of rising interest rates, food and energy prices are denting demand. However, the accumulated savings accrued during Covid suggests panic may be overdone. Labour market data from the UK showed yet another decline in the unemployment rate to 3.7% with more vacancies than unemployed in the country. On the other side of the coin, inflation data in UK shocked in its 9% y/y increase – but this was no worse than expected – with three quarters of the increase accounted for by surging gas and electricity prices.

This week brings global PMI data for May and will provide more insight as to whether business confidence has also been affected, during a time of supply chain disruption. There are also minutes of the US Federal Reserve meeting on Wednesday and PCE inflation data on Friday.

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Investment grade credit

Investment grade credit markets continue to weaken. Indeed, the global market credit spread reached a new 'wide' for this year thus far (157bps). 'Interestingly' euro markets outperformed for the first time in a while as swap spreads stabilised.

The primary / new issue market remains held hostage to sentiment but has been busy in terms of volume of late. Though earnings have been good in general and the ability to pass on higher input costs to consumers seems evident, there were a few profit warnings last week. These came from, for example US giants Walmart and Target and luxury global brand Richemont.

Depending on the time horizon considered, credit spreads are wide of average and becoming more attractive and, in our estimation, price in around a one-in- three chance of recession.

High yield credit & leveraged loans

US high yield bond valuations continued to widen over the week as investors question the ability of corporate profits and consumers to withstand high inflation, rates and tighter monetary policy. The ICE BofA US HY CP Constrained Index returned -0.66% and spreads were 28bps wider. According to Lipper, the asset class experienced a $2.6bn outflow for the week, the largest in five weeks, leaving YTD outflows at $36bn. The sell-off in leveraged loans moderated week-over-week with the average price of the J.P. Morgan Leveraged Loan Index $0.32 lower (to $94.73) versus a $2.02 decline in the prior week despite the largest weekly retail withdrawals since March 2020. Retail loan funds experienced a $1.6bn outflow over the week leaving YTD inflows at $23bn.

Market volatility continues for European High Yield (EHY) with another week of poor liquidity and subdued issuance. Trading has been challenging with trading costs climbing higher and bids often missing from the market pricing. Though EHY spreads finished unchanged for the week, the asset class still returned a negative performance on the back of higher underlying government yields, especially in the shorter end of the yield curve. Flows were net negative, but had slowed down relative to the previous week, with all outflows coming from managed accounts as ETFs actually posted positive inflows, the first time in many weeks. This was even as ETFs were pricing as a discount. The primary market remains subdued as again the market only saw one new issue come to the market: Elis, a French commercial services company, a €300m deal. It was well received (10x oversubscribed) with the final price coming in from initial price talk.

In credit rating news, Co-op was downgraded to BB- by S&P. It was said to be a result of exceptionally high pressure on profitability and cash generation in fiscal year 2021, which is expected to continue over the next 12-24 months. Diebold Nixdorf was also downgraded to Caa2 (from B2) by Moody's. This follows the S&P downgrade, earlier in May to CCC+ from B-. Moody's commented on how Diebold's operating performance has been impacts by the higher costs due to supply chain challenges, which have been exacerbated by geopolitics (China, Ukraine/Russia).

In M&A news, the 888 acquisition of William Hill has obtained shareholder approval and though it was originally expected to complete by end of June, it has now been delayed as new audited earnings numbers have to be prepared as the old ones expired. The numbers are needed before any debt financing can be launched. In the telecoms sector, KKR announced it is buying Contour Global for £1.7bn at a 36% premium ($6.14bn equivalent value).

Structured credit

It was a good week for the Agency MBS market. A nice rally in rates on the back of higher equity volatility allowed fixed income to resume, even for a short period of time, its volatility-buffering characteristics. The mortgage sector was up 58bps, on par with the broader high-quality bond market. 30-year mortgages outperformed 15s and lower coupons outperformed as the curve bull flattened. Refis continue to slow and are forecasted to decrease by roughly 11% on higher rates. In Non-Agency RMBS, spreads were mostly wider last week alongside risk assets. The same held true for ABS spreads, which also contended with an active new issue market totalling about $10bn across diverse sectors which the market had trouble absorbing.

Asian credit

Bharti reported a strong set of Q4 results (quarter ended March 2022), driven by the increase in ARPU (INR178 versus 3Q INR163) and higher mobile subscribers in India. Management does not rule out another potential tariff hike in 2022, which can eventually take the ARPU up to INR200. With regards to the spectrum auction, Bharti said that the recommended reserve price for the 5G frequency continues to be expensive.

The PBOC cut the 5-year LPR (loan prime rate) by 15bps to 4.45%, which marks the second cut in 2022 after the 5bps reduction in January, in order to support the demand of housing This is also the largest reduction since the LPR was introduced in August 2019.

Chinese regulators were also reported, according to REDD, to support the privately owned developers (Country Garden, Longfor Group and Midea Real Estate) to issue onshore bonds with credit default swaps (CDS) and credit risk mitigation warrants (CRMW). These onshore bonds are reportedly subscribed by Chinese banks.

Emerging markets

Weakness in EMD continued, as sovereign and corporates spreads widened further. However, with mid-to-longer maturity US treasury yields lower for the week, the asset class's negative performance was relatively marginal. Weekly outflows remain unchanged, this time at $5.1 bn with $1.2bn exiting hard currency and $4.9bn leaving local currency with the majority being China focused funds ($2.7bn).

Sri Lanka looks to default on its debt as the government announced it will halt payment on all foreign debt until after the government has restructured the debt. Funds are to be saved for food and energy payments. This was expected as the country made noises in this direction, last month, as it entered the 30-day grace period post April's non-payment.

The US raised the stakes further for a Russian default as Treasury secretary Yellen said that it is set to block Russian debt payments to US investors. In India, the government is in talks about raising its stake in Russian oil fields (Sakhalin-II and Sakhalin-I projects.) The government also unveiled a $26bn fiscal package over the weekend, which will include items such as lower fuel taxes, fertilizer subsidies and import duty reduction on raw materials. A strong attempt to fight inflation by the Modi government, there is concern as to the level of fiscal slippage it will mean as this could push the budget deficit higher (from budgeted 6.4% to 6.8%). China also reported that it was looking to add to its strategic crude oil stockpiles with discounted Russian oil.

In central bank news, Egypt raised its benchmark rate by 200bps, far above the 100bps hike expected, taking the rate to 11.25%. In South Africa, SARB (South African Reserve Bank) raised rates by 50bps to 4.75%.

Commodities

It was another pretty strong week for commodities with the index up 1.7%, bringing YTD performance to 32%. Energy led, up 1.5% on the week. Oil remains strong, with WTI up 1.5% hitting $113/barrel mid-week, before retreating to $110/barrel by Friday's close. There are signs that the high oil prices are starting to bite as there has been a significant drop in consumption of petrol and diesel showing that consumers are starting to adjust their demand given the high prices.

Grains finished mixed last week, at a much smaller change higher than has been seen for a while as wheat prices were lower but largely offset by soybean prices, which finished higher.

Base and precious metals were both higher (4.1% and 2.2%, respectively) with 6% rise in prices for aluminium, zinc and lead. Gold was up almost 2%, its largest weekly gain since the first week of March on the back of a weakening US dollar and the overall weak global equity markets.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

23rd May 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 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.** ■ 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. ■ 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 $ E £	■ 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	■ Russia/Ukraine conflict cautions against aggressive positioning ■ 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 have given back most of recent rally, technicals weaker with heavy EM outflows and little HY new issuance ■ 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 and 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 very poor, 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. Risks for EMEA HY are heightened because of proximity to and economic impact of Russian invasion. ■ Primary market slow and weak liquidity in secondary ■ Bank loan market drifted lower since April highs; overall sentiment more negative over slowing economy and higher interest cost, focus on de-risking ■ Bonds & loan defaults set to remain near historic lows	■ Default concerns are focused on demand destruction, margin pressure and macro risks ■ Loan technical and flows ■ 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	■ The risk/reward mix in Agencies is at fair value; MBS Basis spreads now look cheap to long-term averages. ■ 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.	■ 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: Housing continues to perform well but expect normalization coming from heavy supply, extension concerns, and general risk off. Selectively reducing risk. ■ CMBS: Most segments maintain strong fundamentals but widening has shifted relval preferences to other sectors. ■ CLOs: Spreads have been widening in sympathy with structured product credit; new issue supply slowed by wider spreads ■ 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 ■ u/w Livestock ■ u/w Gold ■ o/w Oil	■ Global Recession

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