COLUMBIA THREADNEEDLE INVESTMENTS

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In Credit

16 MAY 2022

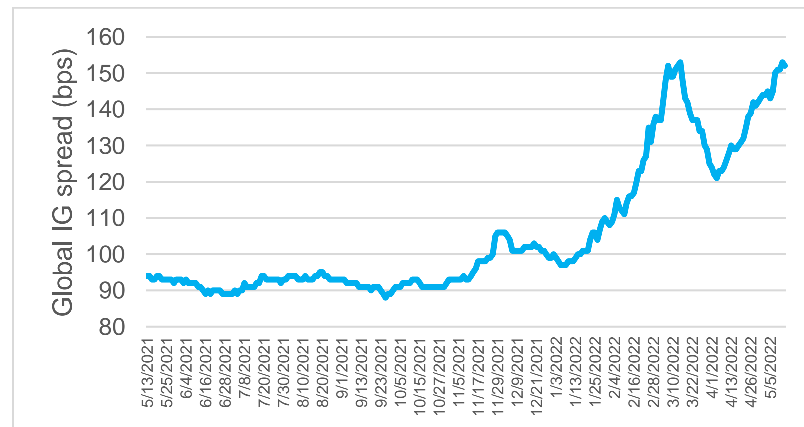
Gloom, doom and wider credit spreads.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return	Index YTD return
US Treasury 10 year	2.92%	-20 bps	-3.7%	-9.0%
German Bund 10 year	0.99%	-15 bps	-3.1%	-8.0%
UK Gilt 10 year	1.77%	-22 bps	-1.8%	-9.2%
Japan 10 year	0.25%	0 bps	-0.4%	-2.0%
Global Investment Grade	152 bps	7 bps	-4.8%	-11.4%
Euro Investment Grade	165 bps	8 bps	-3.3%	-8.4%
US Investment Grade	147 bps	7 bps	-5.9%	-13.2%
UK Investment Grade	142 bps	4 bps	-2.2%	-8.2%
Asia Investment Grade	226 bps	16 bps	-2.3%	-7.5%
Euro High Yield	513 bps	16 bps	-4.4%	-8.8%
US High Yield	463 bps	45 bps	-5.9%	-10.2%
Asia High Yield	813 bps	67 bps	-3.3%	-13.7%
EM Sovereign	404 bps	22 bps	-7.1%	-15.7%
EM Local	7.0%	11 bps	-8.5%	-14.4%
EM Corporate	356 bps	27 bps	-3.3%	-11.8%
Bloomberg Barclays US Munis	3.4%	11 bps	-4.2%	-10.1%
Taxable Munis	4.2%	-8 bps	-7.8%	-16.7%
Bloomberg Barclays US MBS	36 bps	-4 bps	-3.2%	-8.1%
Bloomberg Commodity Index	275.69	-1.5%	3.2%	29.6%
EUR	1.0412	-1.3%	-5.9%	-8.4%
JPY	129.36	1.0%	-5.8%	-10.9%
GBP	1.2223	-0.7%	-6.7%	-9.4%

Source: Bloomberg, Merrill Lynch, as at 16 May 2022.

Chart of the week: Credit spreads – Back to the wides – LTM



Source: ICE Bodn Indices, Bloomberg, Columbia Threadneedle Investments, as at 16 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

Macro / government bonds

It was a better week (at last) for core government bond markets. Perhaps not for the 'right' reasons. As equities struggled and credit spreads widened against a background of fear of economic slowdown or recession so 'risk-free' assets garnered appeal.

Evidence of a slowing global economy included very weak retail sales and industrial production data from China, a decline in the University of Michigan consumer sentiment indicator in the US and a negative GDP print in March in the UK. Meanwhile, the surge in energy prices and food costs continues.

This week brings a raft of key data points in the UK (CPI, Retail Sales and Employment data) CPI is expected to increase to above 9%! We also get retail sales information out of the US and Q1 GDP numbers from Europe. Meanwhile, the European Commission has downgraded growth and increased inflation expectations. It sees growth of 2.7% in 2022 (previously 4%) and inflation rising from a prior expectation of 3.5% to 6%.

On the geopolitical front, both Finland and Sweden seem set to apply to join NATO this week, which is bound to upset the Russian administration.

Investment grade credit

Credit spreads continued on a widening trend last week.

This took global valuations back out to the widest spread (153bps) for the year **(see chart of the week)**. Euro-denominated markets have underperformed this year with spreads wider on a percentage basis than either US dollar or sterling markets. Defensive areas of the market such as utilities continue to outperform on a sector basis while interesting CDS market spreads were actually tighter in the week.

In specific news, the strongly rated UAE Telecom company Etisalat has taken a nearly 10% stake in Vodafone making it the largest shareholder in the UK operator.

We are approaching the tail-end of what has been a relatively good earnings season and anticipate that (if we get some market stability) there should be an increase in primary market activity.

High yield credit & leveraged loans

US high yield bond spreads widened 45bps over the past week to +464bps amid concern restrictive central bank policy will send the global economy into a recession.

The ICE BofA US HY CP Constrained Index returned -1.12%. According to Lipper, the asset class reported a $168m retail fund inflow, snapping a four-week withdrawal streak. After exhibiting relative stability for much of the year as compared to other fixed income sectors, leveraged loans experienced a notable drawdown over the last week given the heightened risk-off tone across markets. The average price of the J.P. Morgan Leveraged Loan Index declined $2.02 to $95.05, a low since November 2020. Loans experienced their first outflow in eight weeks. $598m was withdrawn from retail loan funds over the week, the largest redemption since April 2020.

The European High Yield (EHY) market experienced another volatile week but with an overall better tone. The asset class produced a positive turn for the period largely due to the rally in Bund yields as credit spread widening continued. Outflows from EHY increased with over €600m out of the asset class, this time driven less by ETFs and more by managed accounts. The primary market remains subdued with only one issue, by La Liga (€850m, fixed and floating tranches), which was placed but just.

There is talk in the market that issuers are looking to refinance in the US dollar market rather than in the euro market also potentially moving from unsecured debt into secured loans.

In rating news, NH hotel was upgraded, by S&P, to B from B-. CMA CGM, the shipping company, was upgrade two notches to BB+ from BB-, by S&P.

In M&A news, Renault announced the sale of its Russian operations (Avtovaz Holdings) to NAMI (a Russian auto research group). The allows the French auto company to crystalise a €2.2bn write down and exit the Russian market, avoiding potentially future sanctions. At the same time, Renault retains the right to buy back its stake within six years' time. In the media sector, it was announced that Banijay, the French TV production company, would be acquired by a SPAC, backed by Tikehau Capital and Bernard Arnault. This is part of an overall deal valued at €4.1bn.

Structured credit

On the back of a bond market rally last week, the US Agency MBS sector posted a 1.19% total return besting its high-quality peers. With spreads now looking cheap to long-term averages money managers are stepping back in. As the US Fed readies its balance sheet for Agency RMBS run-off, lower coupon securities appear most vulnerable to further widening. In Non-agency RMBS, spreads have been more stable of late and fundamental performance remains strong despite some normalization trends. CMBS risk has weakened more recently. Trading has been lighter with a pause in conduit new issuance and lower secondary BWIC volume in investment grade. Meanwhile, lower in the stack mezzanine bonds saw 4x the weekly average of secondary supply. Yield buyers at the BBB/BB level have kept that market well-bid.

Asian credit

Hon Hai reported above-consensus Q1,22 results and the completion of its acquisition of the Lordstown's EV (electric vehicle) plant in Ohio. Its net cash position was strong at TWD271.5bn ($9.7bn), while the cash conversion cycle was longer (49 days versus 35 days in December 2021) because the company maintained higher inventory levels to manage through supply chain issues. For 2022, management expects flat y/y revenue growth with relatively stronger growth in cloud networking and computing products, compared with flat growth in smart consumer electronics products.

The Zambian government has agreed to suspend its legal action against Vedanta Resources' KCM (Konkola Copper Mine) in order to revive mining activities in the country. In May 2019, the previous Zambian government under Edgar Lungu placed KCM on provisional liquidation on the back of taxes and licensing issues. Vedanta Resources has reportedly indicated its willingness to invest $1bn in KCM if it gains back control of the latter.

Emerging markets

Chinese April data came in worse than expected driven by the strict "Zero Covid" policy. Industrial output and retail sales have fallen 2.9% and 11.1% respectively year on year. Unemployment has also risen to 6.1%, with youth unemployment hitting a record high.

In more positive news Ecuador has reached an agreement with the IMF on economic policies. On completion of the current review Ecuador will receive a $1bn disbursement. Ecuador has now vaccinated over 80% of its population allowing a sustained re-opening of the economy.

In central bank news, Mexico (+0.5%), Romania (+0.75%), Malaysia (+0.25%), Serbia (0.5%) and Peru (0.5%) all delivered base rate hikes.

Commodities

The commodity index declined 1.7% last week driven by a broad-based sell-off in industrial metals driven by the economic slowdown in China.

Nickel declined by 9.4% and is now trading at more normalised levels, following the Tsingshan Holding "short squeeze" price spike in March.

India has announced it will suspend wheat exports to most countries to maintain food security after a record-breaking heatwave parched crops. Exports will be approved for select struggling countries that need wheat for food security. A recent purchase of 500,000 tonnes for Egypt will be exempt from the ban. Winter wheat planting has also been hampered by adverse weather conditions in both the US and European growing regions. Wheat contracts rallied 9.5% (Kansas) and 6.2% (Chicago) last week.

Responsible investments

The UK issued the next tranche of its 'Green Gilt' last week. The issue was for a sizeable £2.25bn and was 2.37 times oversubscribed. This is the third issue after the first in September 2021 and proposed further issuance should total around £10bn for the 2022-23 financial year.

VW Group CEO, Herbert Diess, commented last week that it has essentially 'sold out' of EVs in Europe and the US this year, as the order backlog now stands at 300,000. Production has been slowed by supply chain bottlenecks and chip shortages. Any clients in those areas wishing to place an order are not likely to see their new car before 2023. During its automotive conference last week, Diess stated 'we are not sold out because we can't build cars…we are really sold out for electric cars because demand is higher than expected". EV sales are up 65% QoQ, with its most popular models including ID.3, ID.4 and the Audi e-tron.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

16th May 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 (■ at 0)	▪ Credit spreads have tightened from recent volatility- driven widening, technicals are neutral to worsening and fundamentals remain stable in most sectors. This, along with potential rates-driven credit vulnerability keep the group neutral to credit risk. ▪ We are past the peak of economic growth, with first hike announced at the March FOMC meeting and expectations for many more. Pullback in forecasted 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: more spillover from Russian invasion, sanctions difficult to remove post-conflict. Lockdowns from Covid variants. Supply chain disruptions and inflation persist to H2 2022. Simultaneous low unemployment, hiking and slowing growth could cause a recession. Persisting commodity shocks
Duration (10-year) ('P' = Periphery)	Short -2 -1 0 +1 +2 Long (¥ at 0; P, $ at +1 above; € at -1, £ at +1 below)	▪ 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 0 +1 +2 Long (¥, A$, EM at 0 above; $, E, £ at 0 below)	▪ 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 0 +1 +2 Over-weight (R at 0 above; C at 0 below)	▪ 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 (■ at 0)	▪ Spreads have tightened since invasion blow-out and many of the main stories are playing out (defaults, invasion impacts, commodity price moves, new covid shutdowns) ▪ Fundamental consequences of invasion are unevenly distributed via trade links and commodity exposure. Commodity prices provided nice tailwind, however continued higher prices will hurt large resource importers. ▪ Fundamental headwinds: elevated fiscal deficits, significant inflation, Chinese growth, idiosyncratic political risks ▪ Flows recently turned positive however risk aversion keeps primary issuance slow; focus on select relval opportunities	▪ 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 ▪ Weakening technicals with large fund outflows and slower supply
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	▪ US and EMEA spreads have tightened since last month with an improved carry profile. Fundamental view remains strong, however inflation, monetary tightening and technicals remain headwinds. ▪ 2021 saw better-than-forecasted revenue growth in nearly every industry. Focus during Q1 earnings: margins, customer retention with price increases, status of supply chains and labor availability. ▪ Good fundamentals with strong balance sheet management and deleveraging from capital management & free cash flow growth.	▪ Supply dynamics remain a headwind ▪ Investors return to government bonds from IG as their risk/return preference for safe assets is changing in new environment ▪ Russian Invasion worsens operating environment globally ▪ M&A and shareholder enhancing activities pick up, but most are leverage neutral.
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	▪ Spreads no longer at attractive levels. Rising star opportunities remain attractive; however, risk management is increasing along with volatility. ▪ Risks for EMEA HY are heightened because of proximity to and economic impact of Russian invasion ▪ Bank loans have bounced back from Ukraine-driven lows, and we expect tailwinds will continue retail fund flows, strong issue calendar, CLO demand. ▪ Bonds & loan defaults set to remain near historic lows	▪ Default concerns are focused on demand destruction, margin pressure and macro risks ▪ 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 (■ at 0)	▪ 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. ▪ Specified Pools have repriced- prefer lower coupons. In CMOs, preference is shifting to IIO over IO	▪ 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 (■ at +1)	▪ Our preference remains for Non-Agency RMBS ▪ RMBS: Housing continues to perform well but expect normalization coming from heavy supply and extension concerns. Selectively adding to positions at wider spreads. ▪ CMBS: Most segments maintain strong fundamentals but widening has shifted relval preferences to other sectors ▪ CLOs: Spreads hold in well vs other sectors with strong flows and liquidity. Secondary spreads recovered to fair value vs new issue as the new issue supply is lower ▪ ABS: US consumer looks well positioned, watching performance given inflation & rates. Select opportunities in de-levered structures in consumer loans or subprime auto	▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening ▪ Changes in consumer behavior in travel and retail fail to return. ▪ Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS). ▪ SOFR deals slows CLO new issue ▪ Rising interest rates may dent housing market strength but seems unlikely to derail it
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	▪ o/w Copper & Lead vs Zinc ▪ u/w Livestock ▪ u/w Gold ▪ o/w Oil	▪ Global Recession

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