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In Credit

7 MARCH 2022

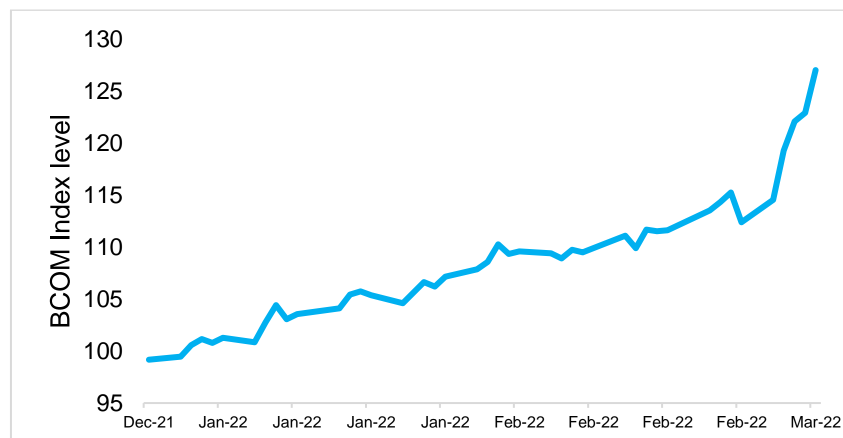
Food and energy prices surge higher.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index MTD return	Index YTD return
US Treasury 10 year	1.75%	-21 bps	0.4%	-2.2%
German Bund 10 year	-0.02%	-25 bps	2.3%	-0.1%
UK Gilt 10 year	1.30%	-16 bps	2.1%	-3.4%
Japan 10 year	0.15%	-6 bps	0.3%	-1.0%
Global Investment Grade	142 bps	11 bps	0.3%	-4.5%
Euro Investment Grade	154 bps	13 bps	1.0%	-2.9%
US Investment Grade	138 bps	11 bps	0.0%	-5.3%
UK Investment Grade	127 bps	7 bps	1.0%	-4.0%
Asia Investment Grade	238 bps	31 bps	-0.1%	-3.2%
Euro High Yield	482 bps	49 bps	-0.5%	-5.0%
US High Yield	390 bps	28 bps	-0.3%	-3.9%
Asia High Yield	914 bps	115 bps	-2.9%	-11.1%
EM Sovereign	441 bps	61 bps	-1.6%	-9.7%
EM Local	6.7%	47 bps	-2.8%	-7.7%
EM Corporate	418 bps	56 bps	-0.7%	-7.1%
Bloomberg Barclays US Munis	1.9%	3 bps	-0.2%	-3.3%
Taxable Munis	2.8%	-13 bps	-0.2%	-4.7%
Bloomberg Barclays US MBS	28 bps	1 bps	0.2%	-2.2%
Bloomberg Commodity Index	279.06	13.0%	10.9%	28.1%
EUR	1.0875	-3.0%	-2.6%	-3.9%
JPY	115.38	0.6%	0.1%	0.3%
GBP	1.3133	-1.3%	-1.4%	-2.2%

Source: Bloomberg, Merrill Lynch, as at 4 March 2022.

Chart of the week: Bloomberg Commodity Index - YTD



Source: ICE BoML, Bloomberg, Columbia Threadneedle Investments, as at 4 March 2022.

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Macro / government bonds

The path to higher bond yields has been in existence since yields bottomed out at 0.5% in mid-2020. The initial sell-off was driven first by a normalisation in inflation expectations then a fear that a short-term inflationary phenomenon had become more ingrained and warranted a monetary policy response. This second phase from later 2021 until recently took real yields higher and, in so doing, undermined 'risk-assets' with equity prices falling and credit spreads widening. Most recently, the war in Ukraine has pushed fears of stagflation or recession to the fore. This has meant that the policy response is expected to be less emphatic than previously imagined and with commodity prices surging, once again, inflation returns as a key worry and breakeven rates are back to levels not seen since last November. What a conundrum for policy makers and what a difficult background for investment as can be seen on 'Markets at a glance'.

Last week, weakness in risk markets provided a support for core government markets with, for example, German 10 year yields back below 0% again and 25bps lower in only a few days. This recent rally is being led by a reversal, back lower in real yields which in the US are barely changed now this year. Meanwhile, the US yield curve continues to flatten with 2–10 years around 25bps. An inversion in the curve is often seen as a harbinger of upcoming recession.

With all eyes on the unfolding conflict in the Ukraine, economic data releases took a bit of a backseat. Eurozone unemployment fell to an all-time low of 6.8% while similar data for the US also showed strength with 678k jobs created last month (expectations were for 420k) and a fall in the rate of unemployment to 3.8%. There was more bad news on inflation with eurozone consumer prices rising by 5.8% y/y. Commodity prices surged last week (**see chart of the week**) with wheat, for example, up around 67% this year (Ukraine and Russia account for more than a quarter of global wheat production).

Investment grade credit

Credit spreads continue to move wider. The weakest of the major markets is euro-denominated credit where spreads are now above short and longer-term averages after widening by around 57% this year thus far. This makes valuations more appealing though hardly especially cheap.

Meanwhile, as might be expected with the recent volatility, primary market activity is light while flows out of the asset class appear to be accelerating. Market fears seem to be focusing on a conflict-related slowing in economies with financials underperforming. Shorter-dated credit is also underperforming into this growth scare as credit curves flatten.

High yield credit & leveraged loans

US high yield bonds were surprisingly resilient over the last week despite an escalating crisis in Ukraine that produced weaker equities, lower Treasury yields and a spike in commodity prices.

The ICE BofA US HY CP Constrained Index returned -0.09% and spreads were 27bps wider. New issuance remained light while outflows continued. According to Lipper, the asset class reported a $482m outflow. While still negative, this represents the lightest outflow over the last eight weeks and leaves YTD outflows at $20.4bn. Meanwhile, leveraged loan prices recovered over the week with the average price of the J.P. Morgan Leveraged Loan Index rising $0.18 despite moderating inflows and lower Treasury yields. The asset class reported its lightest weekly inflow since the first week of December with a $179m contribution, leaving YTD inflows at $16.4bn.

It was another difficult week for risk assets and European high yield was no exception. The Russian-Ukraine crisis pushed through a complete risk capitulation by Friday with relentless ETF selling / and general better selling in high yield. Much of the week, apart from Tuesday, saw negative performance and poor market liquidity given the flight to safety, with BBs outperforming. Returns were down for the week, but the negative numbers were somewhat cushioned by the fall in core government bond yields, especially in the very short end with yields returning to January 2022 and even December 2021 levels for the US Treasury 2-year.

High yield funds domiciled in Europe suffered the worst outflows since March 2020 last week, for an equivalent of $2.34bn, according to EPFR data cited by Bank of America analysts. High yield ETFs also experienced their worst outflows in a year in the week ending 4 March ($482m), which included any outflows given the Russian invasion of Ukraine the previous week.

Market dispersion is becoming more pronounced as corporates with a Russian connection performed markedly worse while sectors like telecoms and health were not as severely impacted.

In the auto sector, firms continued to announce suspension of production in Russia and barring Renault, pointed to Russian revenue being a small (max low single digit % of revenue) part of group. As yet, there has not been any meaningful quantification on the impact of supply chain disruptions from Russian/Ukrainian sourcing. It is likely to have an impact similar (but not to the same scale) to chip shortages with stop/ start. That is, so long as this war is short lived, so that supply can be resumed. In the telecom sector, press articles mentioned that Telecom Italia is trying to get KKR to drop its bid and instead have them join a new plan to split the company. Separate articles also mentioned a plan to stop dividends too.

Asian credit

In China, the food delivery sector has been under regulatory pressure to lower the service fees that are charged on merchants and to prioritise the well-being of their gig employees (delivery riders etc), in line with the overarching common prosperity theme. Both Meituan and Ele.me (Alibaba's online food delivery platform) have taken steps to calibrate the reduction of commission fees. One of the initiatives taken by Meituan is to cap the commission rates for SME merchants in the mid-high risk pandemic areas during lockdowns.

In the Chinese property sector, several companies have been implementing bond repurchases to shore up confidence on their ability to redeem bonds maturing in March/ April 2022. Based on its respective Hong Kong filings, Times China has repurchased around $82.2m of the bonds maturing in April 2022 while Agile Group has repurchased $67m of a bond maturing in March 2022. Shimao Group has obtained a three-month grace period for $950m in trust products.

International Container Terminal Services (ICTSI) reported a positive set of Q4 results, supported by its diversified geographical footprint across Asia (45% of revenue), Americas (23%) and Latam (32%). The impact of the Russian/Ukrainian crisis is limited by way of ICTSI's concession for the Port of Batumi in Georgia, which handles around 20% of Ukraine's throughput. The Port of Batumi only accounts for around 1% of ICTSI's TEU (twenty—foot equivalent) capacity.

Structured credit

The US Agency MBS market had a strong week, up 78bps and in line with other duration sensitive asset classes, which rode the rate rally. Spreads tightened as investors reduced expectations for Fed hikes in 2022 to roughly 5.5 vs. 6.5 two weeks ago and Powell suggested potential caps on balance sheet run-off. Updated housing data indicated continued pressure on existing inventories and affordability. Home price appreciation held at 18.8% y/y. CMBS rallied last week as well, though mostly in the AAA tranche on a pause in new issuance, which had challenged the sector in February.

Emerging markets

Emerging markets continued selling off as a result of the Russian/Ukrainian conflict. The JP Morgan emerging market debt index (EMBIG) is now 110bps wider YTD and is trading at the highest spread level since June 2020.

Spreads have been impacted to a varying degree across the globe, European names have seen spreads widen 182% YTD in aggregate this includes both Russia, Ukraine, and issuers with a high degree of dependence on Russian energy such as Hungary. Elsewhere, Middle Eastern issuers are only 7% wider YTD because of their energy independence and thus a degree of insulation from the Russian conflict and potential energy sanctions taking Russian crude off the market.

In rating news, Russia was downgraded by S&P from BB+ to CCC-. Fitch also downgraded the credit rating from BBB to B. This follows the previous downgrade by Moody's to high yield.

In China, the government set a 5.5% GDP growth target for 2022. China grew by 8.1% last year and the market currently expects 5.2% growth in 2022. The announcement signals support for the real estate sector with expected cuts to the medium-term lending facility and further cuts to the RRR rate.

In Argentina, the government published a plan to reduce its fiscal deficit and central bank financing as required by the pending IMF bailout deal. If approved by Argentina's congress this will release $9.8bn in IMF funding.

Commodities

The Bloomberg commodity index is now up 28.1% YTD as of the end of last week (**see chart of the week).** Brent rallied 25% last week and prices increased to just shy of $140 a barrel as the market reacted to a potential ban on Russian crude exports. Russian crude is already trading at a discount as many would-be buyers are refusing to buy Russian crude.

Russia produced around 10m barrels per day in 2021, approximately 10% of the global supply. The bulk of Russia's crude exports goes to Europe.

There are ongoing efforts to increase supply, as two senior US officials recently visited Venezuela to discuss global oil supplies. Iran is also making progress on nuclear deal talks with the US, which could see sanctions lifted in Iranian crude exports later this year. Iran produced 2.4m barrels a day in 2021, but plan to increase this to 3.8m if sanctions are lifted. However, Iranian production is notoriously inefficient due to the lack of modern equipment.

Wheat rallied by 41% because of the ongoing Ukrainian conflict, with Russia and Ukraine accounting for 30% of the world's traded wheat. Analysts are particularly concerned about the planting of this year's spring crop, as Russia and Belarus are also key producers of fertiliser. President Biden is being encouraged to relax the current biofuel blending mandates that result in competition for agricultural products grown for food vs. for fuel and have been exacerbating rising agriculture prices.

Responsible investments

Last week Ford Motor Co. reported it would be increasing it's spending on electric vehicles (EVs) by $20m, on top of the $30m already earmarked last year. This comes just after CEO, Jim Farley, announced they would be splitting the engine and EV businesses to be managed separately. A target has been set to sell two million EVs per year by 2026.

Chile raised $2bn last week in a sustainability-linked bond issue (SLB). Order books reached $7.7bn according to Bloomberg, for the bond maturing in 20 years. The country already tops the leader board in Latin America for most ESG issuance to date, with this latest issue linked to key emissions targets and renewable energy generation. SLBs are now the fastest growing part of the ESG bond market, with issuance 130% higher than this time last year.

Summary of fixed income asset allocation views

Fixed Income Asset Allocation Views

7th March 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 during recent volatility, which has been paired with neutral to worsening technicals and stable fundamentals in most sectors. This has created more pockets of opportunity, along with the deleveraging & upgrade stories. ■ We are past the peak of economic growth, with high expectations for tightening at March FOMC. The pullback in forecasted liquidity has left opportunity for market volatility. ■ Uncertainty remains elevated due to fears surrounding central bank hiking, inflation, supply disruptions, and the escalating Russia-Ukraine situation	■ Upside risks: the unique COVID recovery in fundamentals allow spreads to rocket past all-time tights. Spreads have spent extended periods near tights in other periods as well. ■ Downside risks: Covid variants worsen. Supply chain disruptions and inflation persist to H2 2022. Simultaneous low unemployment, hiking and slowing growth could cause a sell off or recession.
Duration (10-year) ('P' = Periphery)	P $ ¥ Short -2 -1 0 +1 +2 Long £ €	■ Carry offered by front end yields now attractive ■ Longer yields continue to be capped by long-run structural downtrends in real yields ■ Inflation likely to normalize over medium term ■ Hiking cycles to be shortened by easing inflation and moderating demand	■ 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)	¥ EM A$ 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 associated impact of higher inflation on central banks is uncertain, but is more likely to see a dovish repricing of the ECB than the Fed, we turn neutral on the Euro	■ The ECB becomes concerned around potential second round effects and presses on with policy normalisation
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	■ Valuations are getting more attractive, although for reason ■ DM tightening financial conditions will unevenly impact EM credit and EMFX as many countries have already responded to inflation through hikes ■ Dispersion in outlooks across EM is rising as the recovery begins at different paces. Countries with commodity exposure and better fiscal adaptability rise to the top. ■ Index composition changes over the last 5 years have added a lot of duration to the sector, leaving especially IG EM vulnerable. We prefer HY EM (selectively).	■ Spillover from China's credit woes or Russia-Ukraine aggression ■ A replay of 2013 occurs with a taper tantrum or swift appreciation of the USD ■ Growth scars from COVID persist and hurt commodity prices & ability to grow out of deficits. ■ Weakening technicals with large fund outflows and slower supply
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	■ US spreads are 25bps off tights of last year and near 5y average. EMEA spreads have also widened but remain rich to long-run averages. ■ IG has been historically resilient in the face of inflation, which has been broadly supported by earnings ■ Good fundamentals with strong balance sheet management, M&A and deleveraging from capital management & sales growth.	■ IG bonds further cement their place in global investors' portfolios as safe assets, replacing government bonds. ■ 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	■ Spreads have widened relative to 2021, creating buying opportunities for high conviction and rising star trades. This volatility is expected to continue ■ Bank loans are attractive as they have shown better performance relative to corporates, with 2022 expectations of strong new issuance and strong demand from CLO formation and retail fund inflows. ■ Defaults are set to continue near historic lows due to the rapid recovery and ability to remove near-term maturities by companies across the credit spectrum, a theme seen across HY/loans sectors.	■ The reach for yield continues to suppress spreads, although mounting negative headwinds (inflation, supply disruptions) are increasing pressure for higher yields. ■ Waves of ratings upgrade continue into this year. ■ There are few exogenous shocks that shake the tight spread environment.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ The risk/reward mix in MBS Basis remains asymmetric. ■ Specified Pools and CMOs have cheapened into market sell-off with fair fundamentals: buy opportunities. ■ Valuations have widened since November, recently stabilizing in wider range like 2018-2019 levels. Elevated 2022 supply projections remain a headwind.	■ Housing activity slows considerably and rising rates move prepays to normal levels without denting households' ability to service mortgages. ■ Uncertainty the Fed taper schedule and long-term position
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	■ Our preference remains for Non-Agency RMBS and CLOs ■ Have seen modest widening across the set, keeping an ■ eye on sentinel slight upticks in defaults ■ RMBS: Housing continues to outperform in the recovery with improving supply and strong balance sheets & demographics. Affordability waning but near average. Has attractive spread for the risk, with good carry and relval opportunities. ■ CMBS: Most segments maintain strong fundamentals with retail & hospitality improving. Spreads slightly wider YTD. ■ CLOs: Spreads mostly wider, with attractive fundamentals and technicals, less new issue has helped new issue outperform while seeing some weakness in secondary	■ Attractive shorter duration deals coming into market, provide less carry ■ Changes in consumer behavior in travel and retail last post-pandemic. ■ Work From Home continues full steam-ahead post-pandemic (positive for RMBS, negative for CMBS). ■ SOFR transition slows CLO new issuance ■ Rising interest rates may dent housing market strength but seems unlikely to derail it
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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