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COLUMBIA THREADNEEDLE INVESTMENTS

EMEA Investment grade examined H1 2025

The importance of dispersion and credit quality

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Executive summary

Last year the big story was about when and by how much central banks would cut interest rates and whether keeping rates elevated for too long would cause a recession. As inflation cooled, central banks transitioned from rate rises to a rate cutting cycle, monetary policies loosened and growth gradually slowed. However, political uncertainty remains elevated.

Despite an eventful year for geo-politics, inflation and central banks, credit markets remained robust, supported by the all-in yield and strong credit fundamentals. Having seen a rally in credit spreads across regions and sectors since the post--Covid wides of late 2022, this year could see more dispersion.

Our investment grade outlook starts by assessing where we are in the cycle with a focus on fundamentals (economic and corporate), valuations and technicals (investor sentiment, demand and supply dynamics etc).

Historically, when several of these act as headwinds for credit spreads they tend to create the pre-conditions for a spread widening environment. For example, tight monetary policy, deteriorating corporate fundamentals and tight credit spreads would set the stage for a credit spread widening environment. It doesn't mean spreads widen immediately, but it does create an environment in which wider credit spreads are more likely than not.

> Monetary policy and valuations are headwinds for further spread tightening, but fundamentals remain broadly robust

Currently, we assess monetary policy conditions and valuations as being headwinds for further spread tightening, but importantly fundamentals remain broadly robust. We acknowledge that a potential rebound in mergers and acquisition (M&A) activity after a slow 2023 and 2024 could be a risk to our stable credit fundamental outlook. In addition, potential deregulation in the US could further challenge that base case.

The combination of slowing global growth, an uncertain geo-political backdrop, moderately restrictive monetary policies and rich valuations reduce the ability of the asset class to absorb external shocks or policy error. Valuations have moved a long way since the wides in 2022, but it is important to note that credit spreads can spend an extended period of time below their long-run average and median levels. However, given the asymmetry of the asset class the upside is increasingly limited.

Consequentially, we have reduced the overall credit risk in our funds – close to neutral – but the solid supply/demand backdrop and corporate fundamentals keep us from having a more negative outlook. A new terminal interest rate means a new environment for companies and investors to navigate. The rate cutting cycle should create a favourable backdrop for IG bonds, but we think a bigger theme for 2025 will be credit dispersion. Reflecting this, we have increased credit quality in terms of sectors and moved up the capital structure, as well as positioning more defensively.

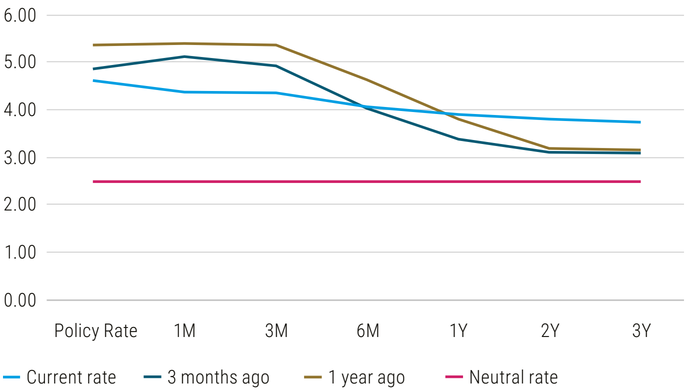
Macro backdrop

Monetary policy

Since early 2022, central banks have taken monetary policy into restrictive territory in an attempt to combat inflation after a decade of low interest rates and the reopening of the economy following the global Covid-19 pandemic.

Over the course of the past six months inflation has continued to cool, allowing central banks to pivot to a rate cutting cycle. Global financial markets are expecting more cuts in 2025 (Figure 1). However, the timing and size of those cuts is being challenged by political uncertainty.

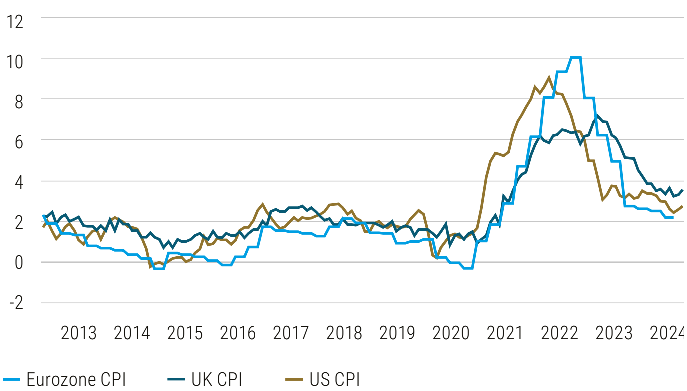
Figure 1: US dollar rate expectations



Source: Bloomberg and Columbia Threadneedle Investments, January 2025

Elevated interest rates also reduced money supply by making access to credit more expensive. Quantitative tightening (QT), the unwinding of quantitative easing, was also removing liquidity from the financial system. These policies were aimed at bringing inflation back to target. With inflation now closer to 2% (Figure 2), we have seen an easing in these policies including a rebound in money supply and a slow-down in QT.

Figure 2: Inflation on a downward trend



Source: Macrobond and Bloomberg, December 2024

By increasing interest rates, central banks pushed real yields (nominal interest rates minus inflation) above long-run averages from very depressed levels. As inflation started to fall, central banks were able to pivot to a rate cutting cycle, keeping real rates at or just above their long-run averages of around 2% in the US and 0.25% in Europe.

If inflation continues to fade, central banks should be able to continue cutting rates. This is due to the fact that if they keep rates unchanged, real yields would actually drift higher into a slowing growth and falling inflation environment – pushing even harder on the brakes as the economy slows.

Although monetary policy has eased over the past six months as inflation has slowed, we believe it remains in restrictive territory (rates above the neutral rate and real yields at long-run averages). Our base case is for US inflation to continue to decline towards the Federal Reserve's 2% target, and that the Fed will ultimately lower rates to below the neutral rate (we estimate around 3%) by the end of 2025. This is based on our view that there is more softness ahead in both the labour market and consumer demand.

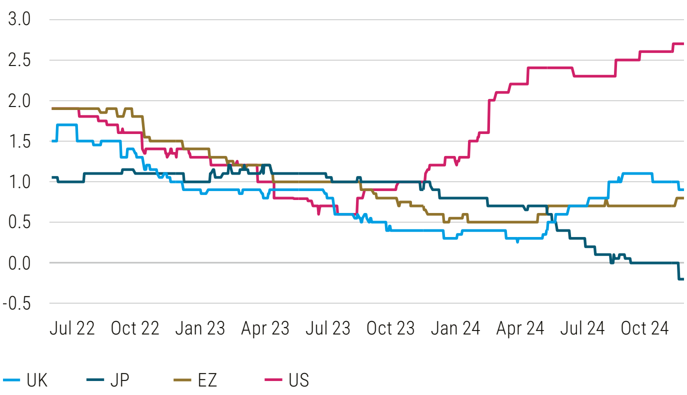
We identify two key risks to this view: first, sticky or rebounding inflation, particularly in core services, could prompt the Fed to pause their cutting cycle and stabilise rates in the 3%-4% range. Secondly, a demand shock – especially if coupled with labour market weakness – could cause the Fed to cut rates more aggressively, pushing them below the neutral level, as seen in traditional rate-cutting cycles.

Economic growth

Over the past 18 months, central banks appear to have engineered a soft landing with lower inflation accompanied by a gradual slowdown in growth. The challenge for 2025 will be whether the economic deceleration continues smoothly or evolves into a more severe downturn. The labour market will likely be a key factor, as will geopolitics. Further escalation of several tensions globally remains a distinct risk and could lead to the re-emergence of inflationary pressures and/or impact global growth. Economic nationalism is another increasing risk, with the possibility that further tariffs and sanctions elicit reprisals and escalation.

Restrictive monetary policies have been a headwind to growth (Figure 3). Consensus growth expectations remain lacklustre in Europe and the UK (around 0.85%) but in the US has pushed above 2.5% after a stronger than expected 2024. Low but positive growth is OK for IG credit, so we score this as broadly neutral for IG spread levels.

Figure 3: Growth expectations



Source: Macrobond and Bloomberg, December 2024

There is an interesting divergence between the US and Europe, with the former running hotter than the latter. In the fourth quarter of 2024, expectations for US interest rates in December 2025 moved up by 100bps but were unchanged in euros. We think the reasons for this are both monetary and fiscal.

Let's look at monetary first. In Europe, more than two-thirds of the economy is funded by the banking sector, predominantly via floating rate loans. This means that when the European Central Bank raised rates, European households and small and medium-sized enterprises immediately felt the pinch. Larger companies funded in Europe's debt markets will also have experienced this. The euro IG market has a five-year maturity. Since the ECB began to hike around two-and-a-half years ago, borrowing costs are beginning to have an impact on the numbers.

In the US, on the other hand, banks only fund about a quarter of the economy. The rest is funded in the capital markets, which is much longer dated. Household mortgages in the US are typically fixed for 30 years, so despite the Fed Funds rate moving up by more than 500bps, the average effective interest rate on mortgages has only increased by around 70bps. Therefore, the hiking cycle hasn't been as painful for US companies and consumers.

On the fiscal side, in 2025 we expect the US to run a deficit of around 7%, while in Europe we expect a deficit of around 3%. Moreover, Europe is facing political uncertainty in France and Germany, as well as questions over debt sustainability in France and Italy.

All of this means that we are somewhat more confident of a continued easing cycle in Europe relative to the US. A low growth, easing cycle is a good environment for credit spreads.

If US interest rates remain elevated, however, it is likely that this would have an impact on other developed markets and reduce the amount of rate cuts they can implement. In our opinion, that alone is not a key driver for global IG credit risk premium.

However, in such a scenario it would be reasonable to expect weaker issuers (those with little or no pricing power or those with more leveraged balance sheets) to be less able to weather the higher-for-longer financing costs, leading to more dispersion.

Fundamentals

Corporate fundamentals

We aggregate all our analysts' individual models to get an overall trend across our coverage universe – ie this is not based on an index, but rather our coverage and represents approximately 80% of the risk in EUR, GBP and Global IG indices.

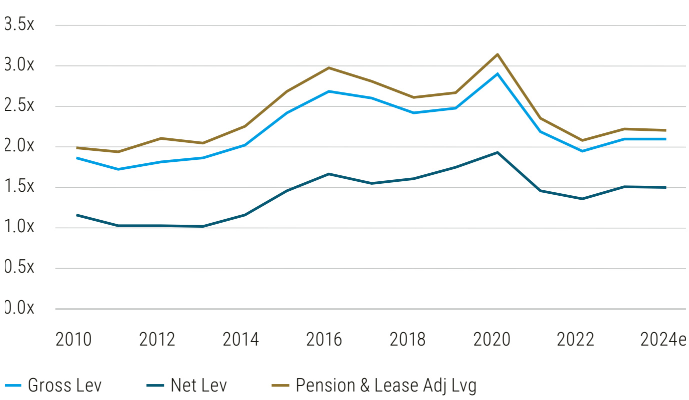
Broadly speaking, we continue to expect strong fundamentals with leverage expected to stay near decade lows. There are, however, some differences between the US and Europe, and across sectors.

In the US we have modestly upgraded the outlook for revenue growth and EBITDA (earnings before interest, taxes, depreciation and amortisation), and net leverage is forecast to be slightly lower than 2024. This includes negative revisions in transportation and capital goods and positive revisions in healthcare.

In the US we forecast revenue growth for this year of +2.9%, taking leverage (pension and lease adjusted) from 2.2x to 2x by the end of the year – the lowest in more than a decade.

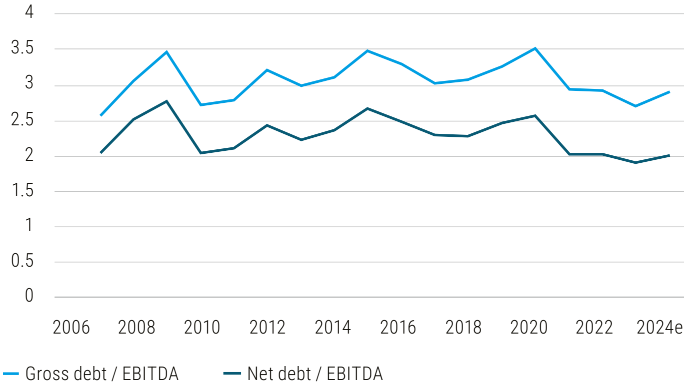
In Europe we made few changes to our revenue growth forecasts. In terms of EBITDA we expect weakness in the auto sector to be offset by upward revisions in industrials and, to a lesser extent, mining. Revenue growth is expected to increase from 1.2% in 2024 to 2.6% this year, and we also expect leverage at the aggregate sector level to stay around 2x. This remains low in the context of the past decade.

Figure 4: US coverage leverage



Source: Columbia Threadneedle Investments, January 2025

Figure 5: European coverage leverage



Source: Columbia Threadneedle Investments, January 2025

In 2024, interest coverage was around 12x in the US and 11x in Europe, down from 15x in 2021/22. It is expected to be flat in Europe and improve to just below 13x in the US throughout the year.

With leverage low and forecast to be flat, and interest coverage remaining high, this is supportive for credit spreads.

Here we drill down into what is driving this at a sector level:

Autos

↓ NEGATIVE The auto sector has built up large cash balances in recent years, and now holds more cash than it has debt. However, we believe fundamentals will deteriorate in 2025 as firms attempt to weather the four-pronged oncoming storm of labour relations, EV uptake, emissions regulations, and China.[1]

Telecoms

↑ POSITIVE The higher inflation environment helped telcos push through price increases in 2023 on phone and broadband contracts linked to consumer price inflation (CPI). Now that inflation has slowed, revenue growth is expected to be more modest.

However, the roll-out of fibre across Europe is closer to completion, which means future capex requirements will be lower. Lower capex means better free cashflows, which we believe management teams will use to reduce leverage.

Healthcare

↑ POSITIVE There has been a lot of M&A in big pharma recently. For example, Amgen's purchase of Horizon[2] and Pfizer buying Seagen.[3] These transactions included debt funding, which contributed to leverage at the sector level increasing from 1.2x at FY22 to 1.6x at FY23.

While there are still some pharma companies that need to supplement their product portfolios or pipelines, the sector is now in deleveraging mode. As such we expect leverage to fall by 0.4x to 1.2x by FY25.

Real estate

= NEUTRAL The real estate sector suffered throughout 2022 and 2023 as central banks increased interest rates. Property values declined and leverage increased sharply.

With the interest rate picture stabilising in 2024, the market for property transactions reopened. This allowed companies to make disposals, improve cash balances and reduce leverage. For 2025 we are forecasting revenue growth combined with modestly lower leverage and loan-to-values. We expect 2025 to be a much more stable year for the sector.

Media

↑ POSITIVE We continue to like the stability and resilience of cashflows at information service providers and advertising agencies. This sector is also well placed to unlock the benefits of artificial intelligence (AI), and should be able to generate new revenue streams and enhance productivity.

We are not expecting the sector to deleverage but think management teams are committed to their leverage targets.

Industrials

↑ POSITIVE The outlook for this sector is strong owing to secular trends like electrification and digitalisation, as well as tailwinds from onshoring and massive infrastructure spending. We expect IG industrials under our coverage to deleverage from 1.9x at FY23 to 1.3x by FY25.

Capital goods

= NEUTRAL We have revised EBITDA margins down and leverage up a little in the capital goods sector. Anti-conglomerate winds continue to blow for the likes of Honeywell and 3M. There is potential here for significant corporate change and the companies could conceivably look materially different in 18-24 months' time.

Consumer goods and retail

↓ NEGATIVE We are more cautious here. Most households are still doing well, although lower income cohorts are struggling more so. Consumers in the higher income cohorts have so far been impervious to the headwinds of higher rates and benefitted greatly from financial and real estate asset inflation. We are wary that if wealthier consumers reduce their level of spend it could have an outsized impact on consumer company earnings across the board – from staples to all sorts of discretionary items. What is more, many companies in these sectors are at target leverage levels, so we are not expecting further balance sheet improvement.

1. Columbia Threadneedle Investments, Slow-speed crash? Problems for the European auto sector pile up, 7 October 2024
2. Amgen, Amgen completes acquisition of Horizon Therapeutics PLC, 6 October 2023
3. Pfizer, Pfizer Completes Acquisition of Seagen, 14 December 2023

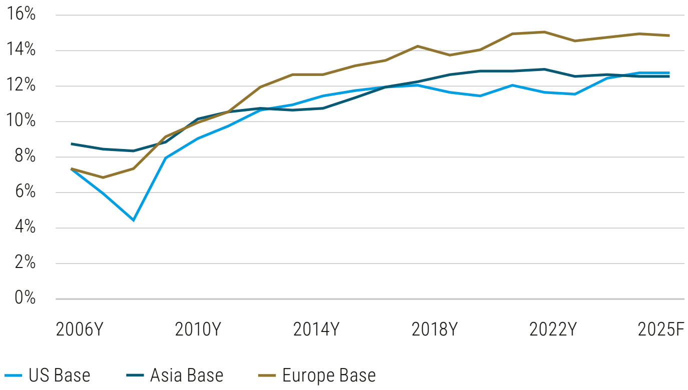
Bank fundamentals

Banks account for about 35% of the risk in the credit index. Capital is plateauing at multi-decade highs, driven by regulation (Figure 6). European banks are around 400bps ahead of regulatory minimums and US banks and running healthy buffers.

Asset quality remains benign. In our forecasts, we expect the global average for cost-of-risk (a forward-looking measure of losses from lending), to remain steady at slightly above normalised levels. The primary driver of future credit losses is unemployment. Labour markets are forecast to remain robust, so expectations of losses from bad lending are benign.

If you look closely, the consequence of the divergence in the interest rate and fiscal pictures between the US and Europe can be seen. In Europe, we expect better cost of risk, slower loan growth and lower margins. In the US the forecast is higher cost of risk, better loan growth and higher margins.

Figure 6: Banks' Common Equity Tier 1



Source: Columbia Threadneedle Investments, January 2025

What about M&A?

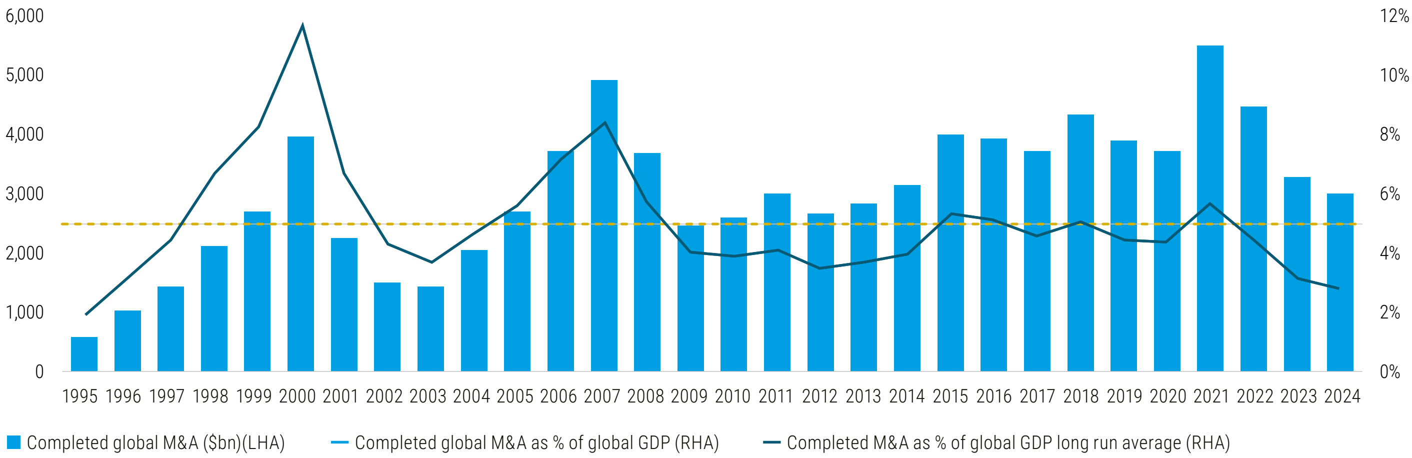
M&A is often difficult to predict. A useful way to look at it is to measure the completed deal volumes relative to nominal GDP (Figure 7). On this metric, transactions dropped to 2.7% of GDP in 2024 relative to a long-run average of 4.8%. As the interest rate picture becomes more stable, we are alert to the possibility of a cyclical upswing in M&A. We have already seen a flurry of activity since the US election.

Several conditions are in place to support a rebound in M&A, particularly in the US, which could lead to deterioration in credit fundamentals. However, the key question is how that would be funded. With higher yields compared to pre-2022, the cost of big debt-funded M&A has also increased. Looking at LBO data[4] we have noticed a rise in equity contributions in this interest rate hiking cycle to around 50%, compared with a long-term average closer to 38% (note that the long-term historical trend has been increasing since 2011).

Moreover, management teams in more cyclical sectors, for example mining and autos, have built up cash buffers to protect the balance sheet should the cycle turn. It is not our base case that these will be used up to fund big transactions. Talking to management teams, we do not get the sense that they are likely to releverage in a higher yield environment to fund M&A. We would therefore expect to see a sizable portion of deals funded with equity, perhaps offset by reducing buy-backs.

To conclude on corporate fundamentals, while we acknowledge the potential for a rise in M&A and challenges in the auto sector, we think corporate fundamentals are strong. In several sectors, balance sheets are improving.

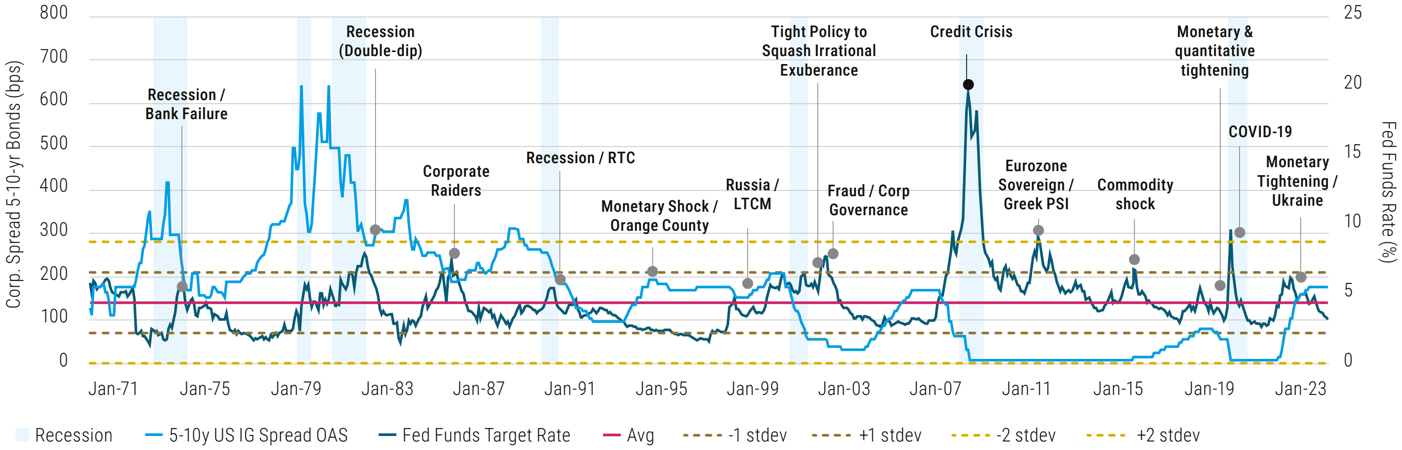
Figure 7: Global completed M&A relative to GDP



Source: Bloomberg/Autonomous, Q3 2024

4. Apollo, January 2025

Figure 8: Long-term US dollar IG spread with associated recessionary periods



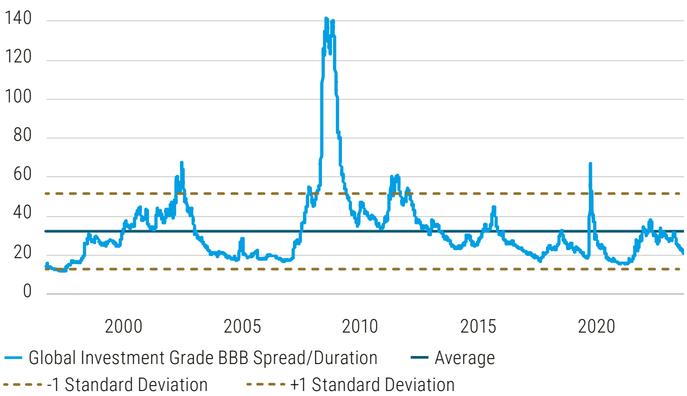
Source: Bloomberg, Merrill Lynch, C6A0 index, December 2024

Valuations

There are many ways to assess the relative value of credit spreads. Given the mean-reverting nature of the asset class, looking back through history is typically the starting point. We have 50 years of data for US dollar IG spreads (Figure 8). Over time global corporate credit spreads over government bonds average around 125bps. However, note that credit spreads spend most of their time trading through their long-run average, with periods of aggressive widening (2008-09, 2011, 2015, 2020, 2022), which highlights the asymmetric nature of credit.

A better way to look at it, in our opinion, is to adjust for composition changes over time to take into account that the credit quality and the duration of the index changes over time (Figure 9). One way to do this is to look at the spread per unit of duration on the BBB sub-segment of the index (which you can think of as the break-even spread that would cancel out the carry from investing in credit over government bonds, 109/5.7 = 19bps). On this metric, global IG is about 0.7 standard deviations rich, driven by US dollar IG spreads 0.8 standard deviations rich and euro spreads about 0.5x rich.

Figure 9: Global BBB spread/duration



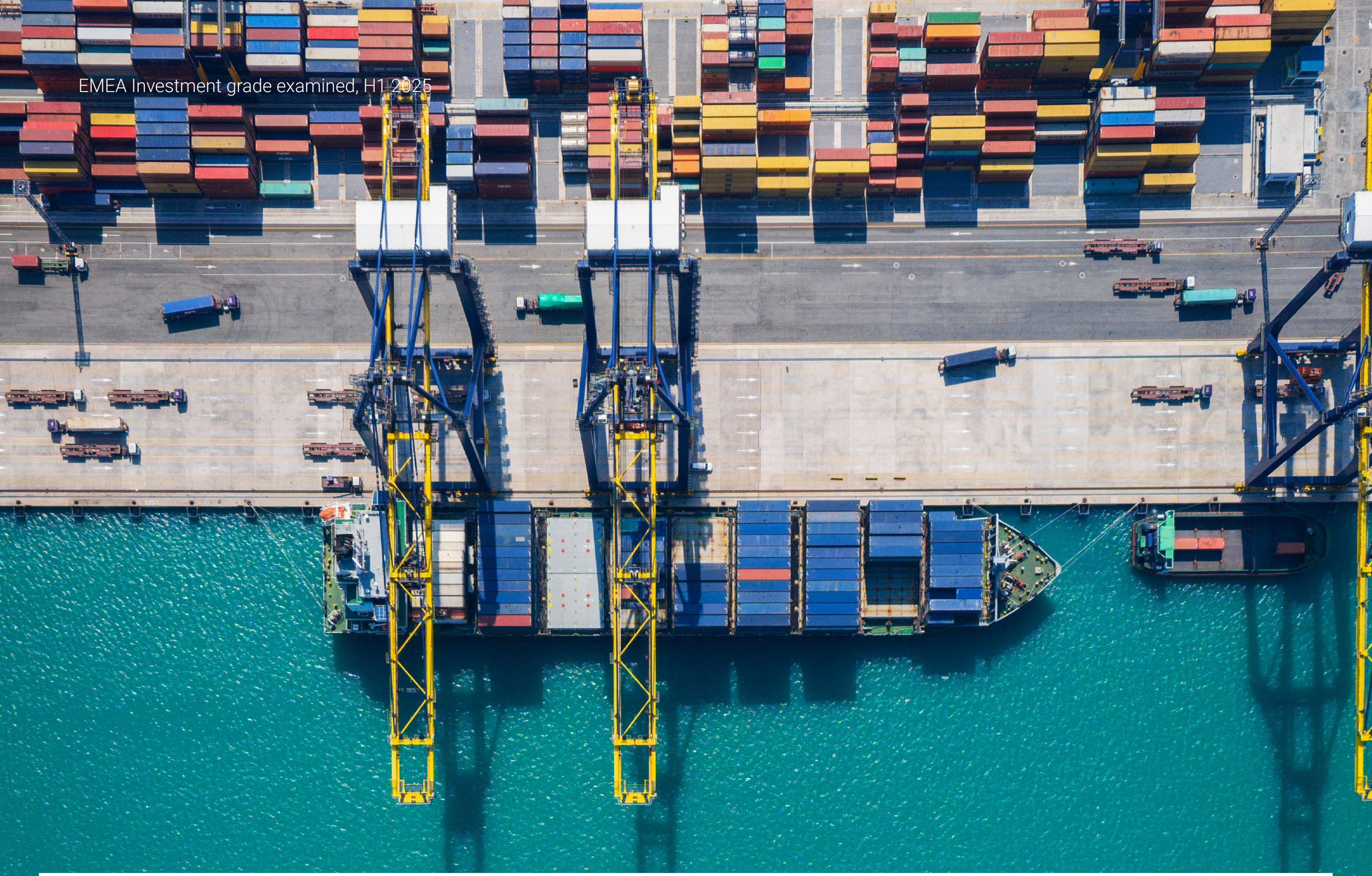
Source: Macrobond, BofAML Indices and Columbia Threadneedle Investments, December 2024

The purest expression of corporate credit spreads, however, is to look at credit spread to swaps (the yield differential between corporate bonds and swap rates). This is partly because this excludes the difference between swaps and government bonds, which is somewhat driven by systemic risk and expected supply/demand of government bonds, which in turn are impacted by QE, QT, repo markets etc and not "pure credit risks". On this metric, global BBB-rated credit spreads by unit of duration are 0.6 standard deviations rich.

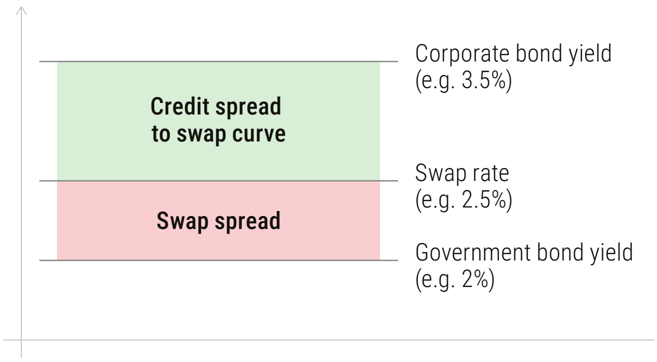
When looking at IG valuations, some investors focus on spreads over government bonds while others focus on spreads over swaps. Generally speaking, although the swap spread does go through periods of structural change, it is relatively stable over time. So whether an investor looks at spreads over government bonds or swaps, the credit spread changes and valuation conclusion would likely be similar. Over the past three years, however, that has not been the case. A rise and fall in systemic risk in Europe, coupled with a potential structural shift in supply and demand dynamics in government bonds, be it German, US or UK, has caused significant relative moves between swaps and government bond yields.

In Europe, this started with a rise in systemic risk pushing five-year swap spreads up from 30bps to 100bps. The cooling of inflation and the natural gas crisis in late 2022 helped reverse this, taking swap spreads back down to 40bps by the end of 2023. In 2024, the prospect of an increase in German government bonds, via either QT, fiscal stimulus, politics, energy transition etc, pushed swap spreads all the way down to 10bps. Similarly, in the US and UK the prospect of more government bond borrowing has led swaps to outperform government bonds.

These moves are large and looking at IG valuations versus government bonds or swaps will be different. In choosing one measure over the other, it ultimately comes down to how an investor funds their positions in credit and manages duration



risk. As we manage duration in the majority of our funds using government bonds, this is the spread we prefer to focus on. Our rationale: if the spread over government bonds is very tight, you are not being paid much for the additional risk, so why take it? You can earn most of the yield with no credit risk. However, we do acknowledge that some investors will look at spreads versus swaps and can explain why credit spreads are rich despite slower economic growth, restrictive monetary policy and an uncertain political backdrop.



At an asset class level, spreads make up only part of the all-in yield in IG. With the yield on Global IG around 4.5%, this is clearly more attractive than four years ago when it was 1.3%. These higher yields make it more likely the asset class can retake its role as a diversifier within multi-asset portfolios after a decade of low yields limited that ability.

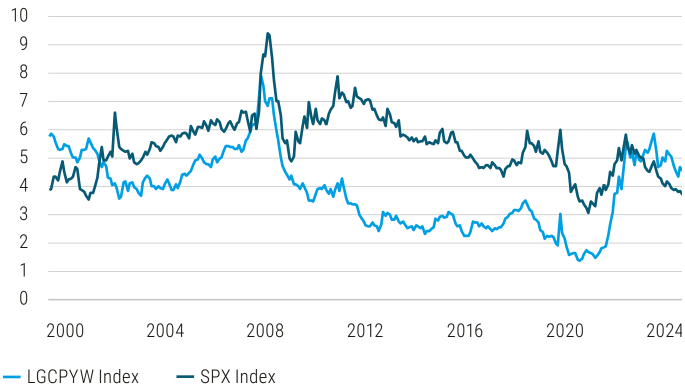
Sentiment and technicals

Supply/demand

A useful measure of the supply-demand balance is to look at net issuance of IG bonds in the primary market (as a measure of supply) minus fund flows into IG ETFs and mutual funds (a measure of demand). On this metric, things look good relative to history: there has been more cash coming into the IG asset class than new bonds to invest the cash into.

Probably the most important metric to demonstrate the technical picture is the yield offered by IG credit relative to equities. The picture here is as good as it has been for 20 years. Yields on global credit are around 4.5% versus an earnings yield on the S&P 500 of around 4% (Figure 10).

Figure 10: Global IG yield vs S&P 500 earnings yield



Source: Bloomberg and Columbia Threadneedle Investments, December 2024

Another useful measure is to look at demand for duration assets from pension funds. Figure 11 demonstrates that pension funds are now fully funded, with assets greater than liabilities. As such, managers will now want to lock-in that funding ratio. To do this they either buy short-dated credit and receive fixed-on long-dated swaps, or they buy long-dated credit. This has the effect of making swaps and credit tighter relative to Treasuries, providing a strong technical support to IG.

Figure 11: Pension fund funded status

Source: Bloomberg and Columbia Threadneedle Investments, December 2024

Finally, if the yield curve continues to steepen, this could have a positive impact on demand for credit, in so far as the yield pick-up on IG versus cash could widen. An investor might question investing in IG when the yield pick-up is insignificant, for example at the start of 2024 the yield on global IG was around 4.75% compared to the Fed Funds Target rate of 5.5%. But that picture is starting to reverse, with the Fed Funds rate and global IG yields now at roughly the same level. If central banks cut rates further and the yield curve continues to steepen, this could be an added technical support for the asset class if investors move out of money markets and bank deposits into credit. This alone would not be enough to argue that supply/demand dynamics are supportive for IG, but it is another potential supportive aspect of a steeper yield curve.

Volatility indicators

We look at various volatility indicators to assess the premium investors are willing to pay for protection from adverse market movements and use this as a gauge of the broader investor risk appetite. This is also because owning a corporate bond can conceptually be seen as economically equivalent to owning a risk-free bond and having sold a put-option on the assets of that same company.

On this basis, we note that implied volatility in IG credit and equity markets are below their respective long-run averages and elevated in US Treasuries. This is likely because the outlook for interest rates remains uncertain – although still in line with levels before QE started. We view these conditions as indicative of a lower-than-average risk aversion and supportive for IG spreads. Note, that long periods of low volatility could be seen as a contrarian indicator that encourages leverage and more risk-seeking behaviour.

Credit themes

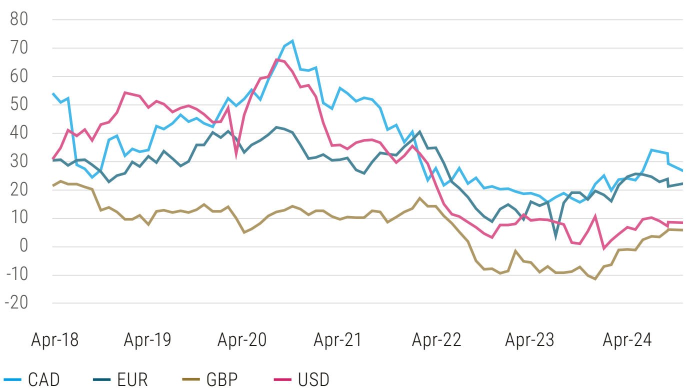
Shape of credit spread curves

An interesting theme within IG has been the flattening of the credit curves, or the spread differential between bonds of different maturities from the same issuer in the same currency. You would normally expect credit curves to be upward sloping to compensate for the additional uncertainty of investing in longer-dated bonds.

To measure and monitor this we have matched 10-year bonds with 20-year bonds from the same issuer and currency and tracked the spread differential over time.

Part of this flattening is driven by corporate treasurers preferring to issue shorter-dated bonds to avoid locking-in elevated yields for longer and preferring to wait for yields to fall. The opposite is true of investors: we have noticed a desire to increase duration to capture higher yields for longer, and a way to do that is to invest in longer-dated bonds. Moreover, following the rise in yields since these bonds were issued, a big portion of long-dated bonds now trade at much lower cash prices than more recently issued short-dated bonds. All else being equal, investors would prefer a low cash price bond over one priced at par. This is because in the case of default the loss-given-default is lower, and in bond maths lower cash price bonds are more sensitive to changes in interest rates (higher convexity). As a result, we have seen demand for long-dated bonds outstrip supply. Last year we noticed tentative signs of that reversing (Figure 12), but curves remain flat compared to history.

Figure 12: 10s and 20s credit spread curves

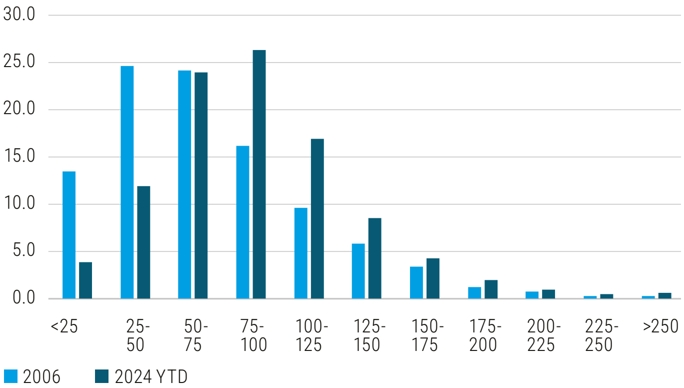


Source: Bloomberg, BofAML Indices and Columbia Threadneedle Investments, December 2024

Dispersion

Even though credit spread indices look a little rich versus their long-run averages, having compressed a little further in 2024, under the hood there is still some dispersion. Figure 13, shows there are more opportunities available than back in 2006, for example. (Figure 14).

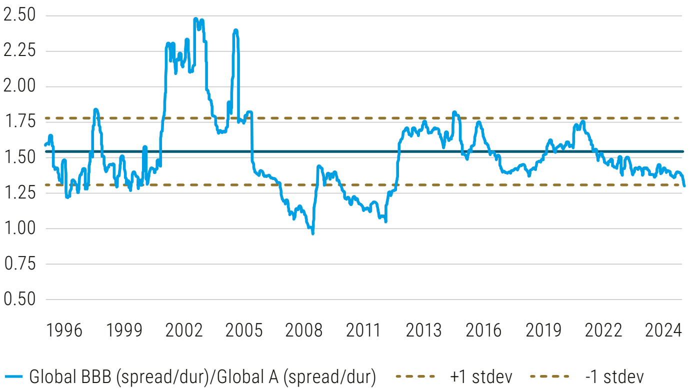
Figure 13: Dispersion across the index



Source: Bloomberg, BofAML Indices and Columbia Threadneedle Investments, December 2024

Another useful way to look at compression and dispersion is to measure how close BBB spreads are to those of single As. We think the best way to do this is to look at how much we are being paid per unit of duration to hold BBBs relative to single As. Figure 14 below expresses this as a ratio and looks at the long-run history. On average, BBBs pay 1.6x single As. Currently, BBBs are paying 1.4x and the ratio is 0.7 standard deviations lower than average. Therefore, looking at it through this lens, spreads are quite compressed. However, if we look at the late 1990s or from 2006-2012 they can squeeze further together and remain there for some time.

Figure 14: Global IG spread distribution

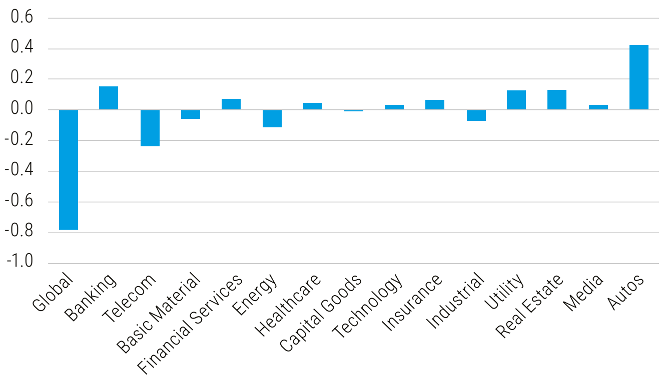


Source: Bloomberg/ICE Indices, January 2025

This is supportive for bottom-up-driven investment processes looking to capture alpha opportunities between sectors and issuers, and even between bonds from the same issuer.

If we zoom in one step further we can see dispersion at a sector level as well. The autos sector is 0.4 standard deviations cheap to the broader index, while banking, utilities and real estate are all somewhat cheap, around 0.1 standard deviations (Figure 15). Clearly, corporate fundamentals in those sectors are different and expected to evolve differently, but just because IG spreads are trading tight doesn't mean all sectors and all issuers within that are rich as well (see Sector thoughts).

Figure 15: Sector G-spread (sector z-score vs index z-score)



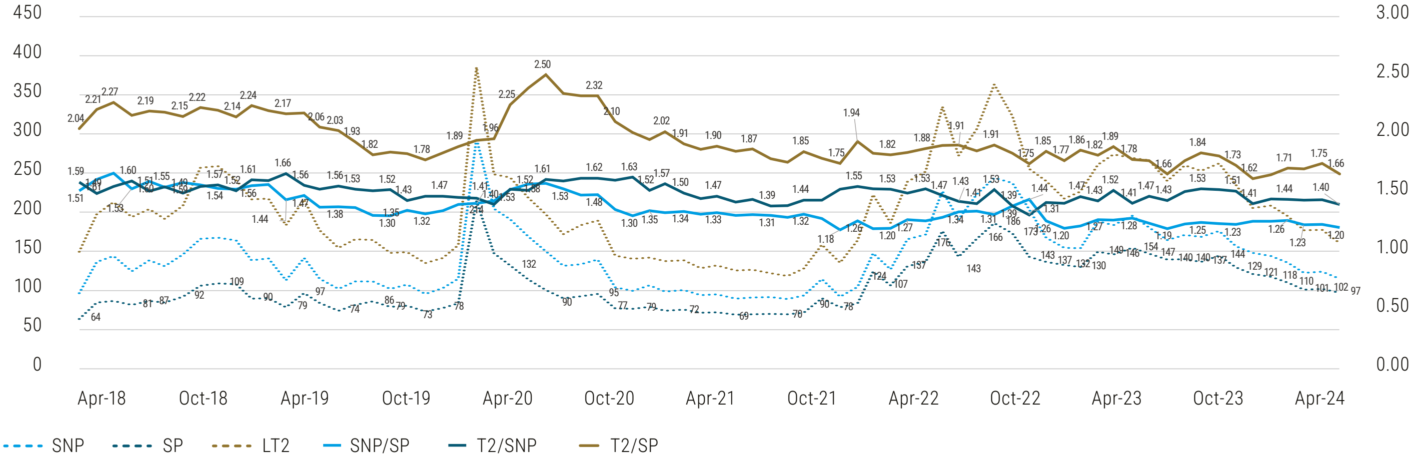
Source: Bloomberg, BofAML Indices and Columbia Threadneedle Investments, January 2025

Capital structure thoughts

Another source of alpha is exploiting differences between bonds of varying subordination (ie across the capital structure). This is most common within banks as they are required by regulation to build out layers of bonds of varying subordination. Most corporate issuers stick with senior unsecured bonds, but banks have senior preferred (SP), senior non-preferred (SNP), subordinated and junior subordinated bonds. The default probability and recovery rates vary greatly between these layers.

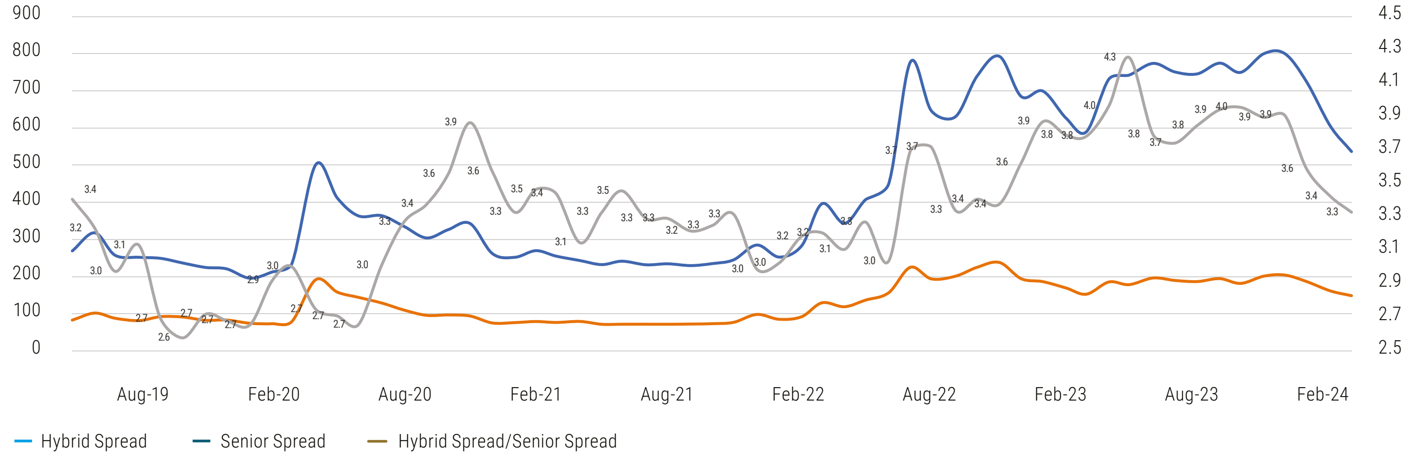
From 2016 to 2023, the banking sector was building out a layer of "bail-inable" debt. Typically, these bonds were SNP or senior holding company (SHC) debt. Over the eight-year period the sector added about €650 billion of these sorts of bonds to the capital structure. As SNP was being built out there was a negative technical effect due to the weight of net supply. Figure 16 shows how the ratio of the spread of SNP over the spread of SP has compressed over time, from 1.6x in 2018 to 1.2x now.

Figure 16: Spread ratio across capital structure



Source: Bloomberg, BofAML Indices and Columbia Threadneedle Investments, December 2024

Figure 17: Spread ratio of hybrids vs closest senior bond



Source: Bloomberg, BofAML Indices and Columbia Threadneedle Investments, December 2024

We believe bail-in buffers are now fully built out and the negative technical effect is over. We therefore expect net supply at each layer of the capital to be low – but growing in line with nominal GDP growth.

Currently, we think the both the T2/SNP ratio and the SNP/SP ratio is around fair value at 1.5x and 1.2x respectively. This is reflected in our portfolio construction.

In terms of corporate hybrids, we assess their relative value by looking at the spread ratio to senior spreads. During the rally in the second half of 2023 that ratio compressed significantly from 4.3 to 3.3. This was due to the additional compensation demanded by investors to own subordinated corporate credit (relative to senior debt) falling sharply. We are now back at levels last seen before the Covid-19 pandemic and before the risk-off in late 2022 (see Figure 17).

Sector thoughts

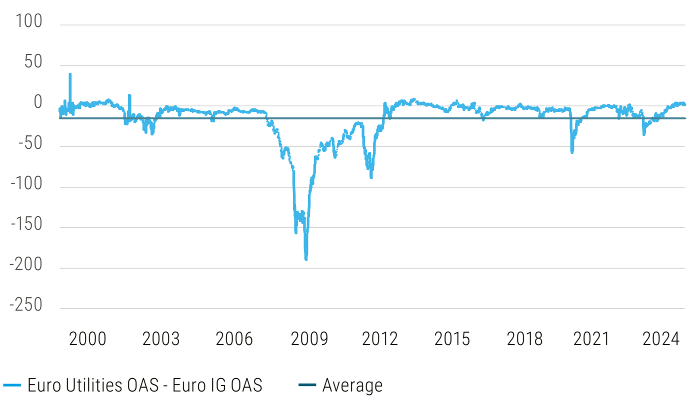
Utilities

Partly driven by regulation, but also by the fundamental needs of society, utilities have more stable earnings and better cashflow visibility than unregulated corporations. This makes them more defensive (less cyclical). As a result, regulated utilities tend to outperform the broader index in recessionary environments. Investors might be less confident about a luxury goods company's earnings or the number of new cars sold in a recession, but the demand for electricity, water and waste management is unlikely to materially change.

Figure 18 shows EUR utility spreads trading through the broad index in 2008-09, 2011, 2020 and in early 2023. Interestingly, utilities today trade cheap to their long-run average versus the broader index. More recently, the underperformance of utilities is likely driven by an increased need to invest as part of the energy transition. To fund the investment we expect gross debt at European utility businesses to increase by around 40% between now and 2030. Over that period we forecast utility debt to move from representing around 10% of the euro IG index to closer to 12%. To offset this, regulators across Europe have improved the quality and speed with which utilities can recover these investments in increased asset base.

As we enter a period of lower growth, still restrictive monetary policy and an uncertain macro outlook this is a sector we think is an attractive opportunity with which to add defensiveness to our funds. We want to own the right issuers, but to us it makes sense to also be overweight the sector.

Figure 18: EUR utilities minus EUR index



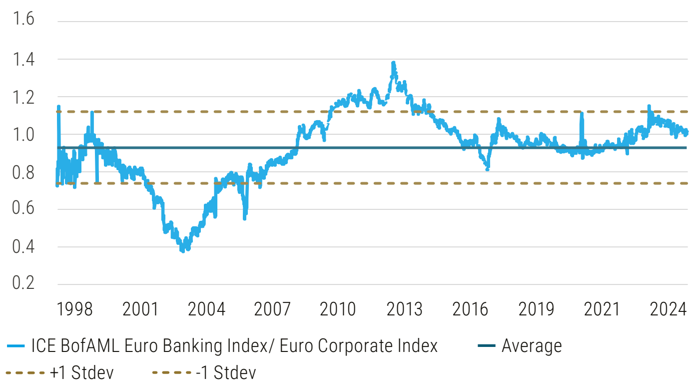
Source: Bloomberg, BofAML Indices and Columbia Threadneedle Investments, December 2024. EUR utilities = ICE BofA Euro Utilities. EUR index = ICE BofA Euro Corporate OAS

Senior bank bonds

Figure 19 looks at bank bonds relative to senior corporate bonds of similar credit rating. During 2022-23, bank bonds underperformed the wider EUR index, driven by concerns over US regional banks, commercial real estate, and Credit Suisse. Banks spreads have not yet recovered to levels seen in 2020-21 and still trade at a discount (0.5 standard deviations).

We think there is still room for this ratio to compress. Banks have traditionally been seen as cyclical – geared to the economy – but we think there are several reasons they should be less cyclical going forward. The sector is now more regulated, boasts a stronger capital base, has stronger asset quality and better profitability supported by higher yields. While there are certainly fewer bottom-up opportunities available than in 2024, there are still some interesting improvement stories in the German, Irish, Greek and Spanish banking sectors.

Figure 19: Banking index and corporate index



Source: Bloomberg, BofAML Indices and Columbia Threadneedle Investments, December 2024

Real estate

As inflation cooled, interest rates fell and liquidity returned to the real estate market in 2024, several issuers were able to refinance bonds and dispose of assets. Some have now announced that their deleveraging strategy is complete and they will once again focus on growth. Reflecting this easing in financial conditions for IG real estate issuers, real estate was the best performing sector in EUR IG in 2024 and is now back in line with its historical relationship to the broader Euro IG index (Figure 20). Reflecting this, we have taken profit on our overweight and moved up in quality. Some idiosyncratic opportunities still remain, but they are much fewer.

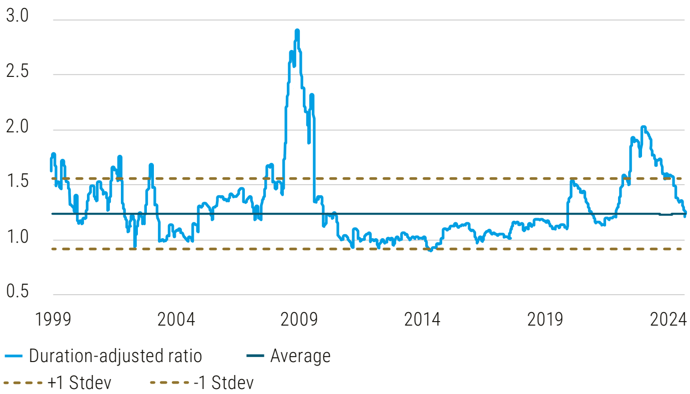
In terms of fundamentals, most real estate sectors (outside of datacentres and offices) have normalised since the pandemic. Occupancy has remained stable given limited supply thanks to development constraints. Rent increases are back in line with pre-pandemic historical levels, while cost inflation has reduced. This has supported margins. Cash flows have been impacted by higher funding costs, but companies have mitigated those by reducing leverage, especially in Europe.

Balance sheets have benefited from asset valuation stabilisation, while debt funding channels have reopened restoring access to IG, high yield and even hybrid bond markets. This has led to improving liquidity profiles and an increase in asset unencumbrance as a number of secured loans, raised in 2022-23 when markets de facto shut for unsecured bond issuance, have been refinanced. Q4 2024 also saw a small number of inaugural real estate issuers in the IG GBP and EUR market, including an office REIT and a storage REIT (a fairly new sector for EUR IG investors).

As balance sheets have improved and loan-to-values stabilised, the focus is shifting to prospective interest coverage ratios in a higher interest rate environment. The sector will also grapple with a large maturity wall in 2025-26.

With the balance sheet repair years in European real estate behind us for the most part, management teams have shifted their focus to earnings growth and are adopting a more equity-friendly narrative. Talk of multi-year capex plans, of separately funded vehicles for external growth, and dividend restoration were 2024 themes which will play into 2025-26, especially among listed REITs.

Figure 20: Real estate/EUR IG spread (per unit of duration)



Source: Bloomberg, BofAML Indices and Columbia Threadneedle Investments, December 2024

Autos

The global automotive industry is undergoing a significant transformation driven by the shift towards electric vehicles (EV), and specifically battery electric vehicles (BEVs). This is being shaped by many factors including government incentives, regulatory changes and consumer demand. However, government incentives aimed at promoting EV adoption have disrupted free market dynamics, making it challenging for automakers with long product cycles to plan effectively.

The industry faced a complex landscape, with various factors influencing the trajectory towards electrification and sustainable mobility solutions. This is partly reflected in the underperformance of automotive credit spreads (Figure 21). Given the cyclical nature of the sector, management teams have built up large cash balances. However, our view is that this downturn is likely to last longer than a typical cycle due to the stated challenges.

Credit spreads are not cheap enough given the expected fundamental deterioration for us to be overweight the sector, and we currently prefer to remain in shorter-dated bonds benefitting from the large cash balances. We also have to acknowledge the potential for more government interventions to ease the situation.

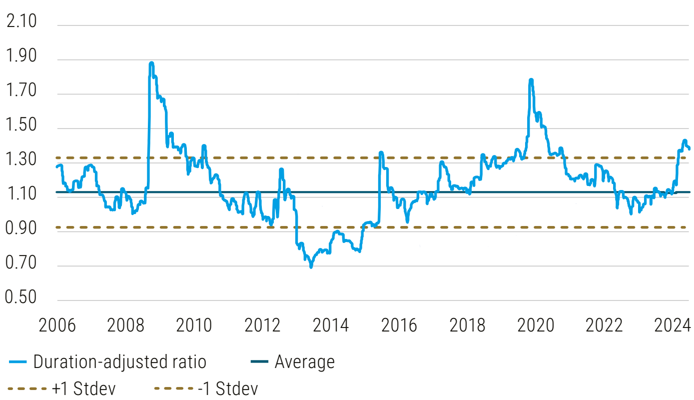
Regional market dynamics vary widely. For example, in the US, constantly changing government incentive structures and pricing volatility from manufacturers around BEVs, and Tesla specifically, have impacted new BEV demand and destroyed residual values. as a result, demand for plug-in hybrid electric vehicles(PHEVs) and hybrid electric vehicles (HEVs) have driven growth. This has been a positive for Toyota given their reticence to pursue BEVs and their PHEV and HEV dominance. In emerging markets, Chinese BEVs are becoming very popular and are much less expensive than western offerings. This is presenting a near-term risk that could threaten critical market shares in areas of the world seen as future growth opportunities.

Legacy automakers also face a significant challenge with respect to the evolution of technology versus their newer unburdened competitors. In a recent interview, Ford CEO, Jim Farley, mentioned that modern Fords have 150 different modules developed by 150 different companies, none of which communicate with one other[5]. This creates multiple levels of complexity and cost that has bloated modern cars. Legacy OEMs will need to figure out how to free themselves from such complexity if they want to square off effectively with their new competition on technological features and price.

The capital strategy of automakers plays a significant role in navigating these challenges and as a result we have seen cash balances rise at all major global automakers.

The bottom line is that the global automotive industry is facing a complex landscape, with various factors influencing its trajectory towards electrification and sustainable mobility solutions.

Figure 21: European autos/IG index



Source: Bloomberg/ICE Indices, January 2025

5. Fully Charged Podcast, Episode with Jim Farley, CEO of Ford,, June 2023

Meet the Investment grade team

At Columbia Threadneedle Investments we pride ourselves on a robust investment process based on high-quality independent credit research. This is carried out by a large and experienced team of sector specialists dedicated to IG who work together to leverage more than 20 years of average experience. Our investment process embeds downside risk management at the outset, which is paramount in an asymmetrical asset class.

Feel free to contact us if you have any feedback or questions on the outlook or wish to understand more about our views or capabilities.

Global Investment Grade Portfolio Management Team	Investment Grade Research Team
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21 years average experience	**20 years average experience**
12 professionals	**16 research professionals**

Source: Columbia Threadneedle Investments, as at 31 December 2024. Certain team members may be employees of affiliated companies acting under the Columbia Threadneedle Investment brand.

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