COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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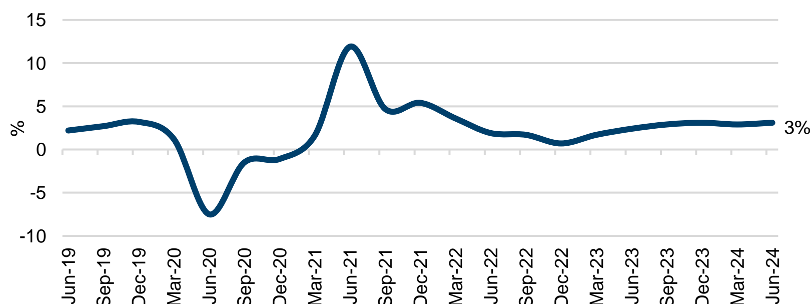
Back to school

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	3.90%	10 bps	3.6%	2.7%
German Bund 10 year	2.34%	12 bps	2.0%	-0.1%
UK Gilt 10 year	4.06%	15 bps	2.4%	-0.6%
Japan 10 year	0.91%	1 bps	1.1%	-2.1%
Global Investment Grade	102 bps	-1 bps	3.3%	3.6%
Euro Investment Grade	115 bps	0 bps	2.0%	2.6%
US Investment Grade	96 bps	0 bps	3.9%	4.0%
UK Investment Grade	98 bps	-1 bps	1.9%	1.8%
Asia Investment Grade	154 bps	-3 bps	2.9%	5.5%
Euro High Yield	361 bps	-18 bps	2.4%	5.7%
US High Yield	317 bps	-2 bps	3.6%	6.3%
Asia High Yield	537 bps	-62 bps	2.7%	12.8%
EM Sovereign	342 bps	-7 bps	4.2%	6.1%
EM Local	6.3%	2 bps	5.4%	1.5%
EM Corporate	269 bps	-12 bps	3.2%	7.2%
Bloomberg Barclays US Munis	3.4%	1 bps	1.7%	1.3%
Taxable Munis	4.8%	9 bps	4.3%	3.0%
Bloomberg Barclays US MBS	39 bps	-1 bps	4.3%	3.3%
Bloomberg Commodity Index	228.58	-0.3%	-4.0%	0.9%
EUR	1.1070	-1.3%	3.1%	0.1%
JPY	147.00	-1.2%	10.1%	-3.5%
GBP	1.3146	-0.7%	3.8%	3.1%

Source: Bloomberg, ICE Indices, as of 30 August 2024. *QTD denotes returns from 30 June 2024.

Chart of the week – US GDP beating expectations



Source: Bloomberg, Columbia Threadneedle Investments, as of 30 August 2024.

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Macro / government bonds

In the quiet summer lull, price action in the US treasury market continued to set the tone for bond markets globally. The major debate in bond markets was how aggressive the US Fedreal Reserve would be in cutting interest rates after Jay Powell effectively cemented a September rate cut with comments in his Jackson Hole keynote speech that the “time has come”. Two scenarios dominated trader thinking – one for a 50bps rate cut and one for a 25bps rate cut. The case for the 50bps rate cut had rested on evidence of a continuing deterioration in the labour market. With inflation under downward pressure, the focus on the Fed has shifted from inflation to the labour market. Unexpected weakness in Non-Farm Payrolls at the start of August, alongside uncertainty over the lagged impact of past cumulative tightening led to concerns that conditions had become overly restrictive. There was also the political consideration as to whether the Fed may wish to act in September to avoid acting in the politically charged month of November when the US presidential election occurs. The case for 25bps was for a more gradualist approach, which appeared to chime with recent comments from Fed speakers, who continued to deliver a message of data dependency, as well as caution that while progress has been made on inflation, the battle has not yet been won.

The narrative of weaker growth was challenged by economic data. US Q2 GDP came in stronger than expected, rising from 2.8% to 3%. Key themes to emerge from the data were the relative strength of the US consumer, as personal consumption grew by 2.9%, a pick-up in corporate capex amid a recovery in inventory investment, and continuing weakness in residential consumption (see **Chart of the week**).

The apparent resilience of the US economy made the market reassess its outlook for interest rates. A reversal of the recent enthusiasm for duration risk led to a yield curve bear steepening trend, as longer-dated interest rates rose by a greater magnitude than shorter-dated rates. The yield on the US 10-year rose to 3.9%, leaving the instrument trade at the midpoint of its current range. Given a reduced emphasis on inflation the next big market moving piece of data will be the Non-Farm Payrolls number, which will set the scene for the Fed’s interest rate decision.

European markets were quiet during the last week of the traditional holiday season. The political risk premium on German bonds rose slightly following the success of the far right Alternative for Germany (AfD) party, which won a big victory in the large eastern state of Thuringia, while coming a close second in the more populous state of Saxony. This raised questions about the political longevity of the current ruling coalition, and whether more mainstream political parties can create a firewall of sufficient strength, as in France, to limit the potential electoral success of the AfD. A rise in political risk premia was expressed through marginally wider country spreads relative to other eurozone countries. There was also some caution on interest rate policy from ECB executive board member Isabel Schnabel, who warned against proceeding too quickly in easing monetary policy, given the elevated level of services inflation. This followed comments from ECB chief economist, Phillip Lane, who warned that the return to 2% is not yet secure.

Investment grade credit

August ended with spreads unchanged from where they started the month. Global IG bonds now offer a spread of 102bps over government bond yields. This lack of spread change hides the volatility that marked the early part of the month when spreads widened to 116bps. This reflected fears of recession in the US that subsided as the month progressed. It felt like ‘back to school’ in terms of the ‘reopening’ of the primary market. New issuance was heavy following the results season and the normal summer lull; issuers included Diageo and Telstra.

The outlook for corprorate bonds appears more favourable from a yield than spread perspective. The global IG index offer a yield of around 4.5%, which is well above the average 3.6% seen in the last 20 years. Spreads, however, remain rich to the average (143bps) over the same period. Some of the spread richness is mitigated by the reduction in index duration seen in the last few years. The present index duration of 6.1 years is much lower than the 7.5 years seen in the summer of 2020. Credit markets are supported by robust credit fundamentals such

as low leverage for corporate issuers and high levels of capital for banks. The decline in interest rates being delivered in most developed markets is welcome though present assumed ‘terminal’ rates appear to be above the so-called neutral rate of interest in both the US and Europe. Economic outlook estimates point to a low but positive rate of expansion with a reasonable macro backdrop for investment. All in all, when fundamentals are compared to valuations and structural considerations (supply and demand) the outlook looks fairly neutral for spreads.

High yield credit & leveraged loans

It was a risk on, spread compression week as European High Yield experienced strong positive return in higher beta CCCs, returning 1.2% for the period, 3x the week’s market return (0.44%). This brings the month’s performance to 1.2% and YTD to 5.6%. August finished with good demand for the asset class as inflows continued, posting €273m for the last week of the month, seen both via ETFs and managed accounts. This brings the YTD figure for net inflows to €7.1bn. The primary market remained subdued with only one hybrid issue from Accor, the French hotel chain. The issue was well subscribed with the final price coming in at 4.875%, 62bps inside of initial price talk. Market talk is for September to be a strong month in the primary market with potentially €9bn of new offerings (including LBO-related issues) in the pipeline.

The reporting season continues with packaging finally showing some turnaround (e.g. Canpack EBITDA beat and report of capacity expansion). Leisure space is looking positive with PurGym reporting good Q2 results. Real estate is also continuing to show signs that it is stabilising: numbers are looking solid with occupancy stable at 91%, rental growth of +4.4% with net leverage coming down (though still overall high at 12%, down from 13%). Overall, financial figures continue to show a meeting and beating of expectations.

In credit rating news, JaguarLandRover was upgraded to BBB- by S&P. This followed the earlier August upgrade to Ba2 by Moody’s.

In M&A news, the potential Grifols takeover is taking shape with private equity firm Brookfield supposedly in talks with sovereign wealth funds about joining the bid. In telecoms, Virgin Media was reported as looking to sell a 20-40% minority stake in its Netco to raise £1bn.

Asian credit

The Chinese real estate sector could continue to see ongoing pressure through the rest of 2024. The August sales volume of the top 100 developers in China fell by 27% against a low prior-year base, according to China Real Estate Information (CRIC). Additionally, the property sales performance in August was weaker than the decline of 20% y/y and 17% y/y in July and June respectively. The YTD attributable sales to end August 2024 of the top 100 developers fell 36% y/y to around CNY1,893bn, according to CRIC. This underscores the lack of positive impact from various supportive policies that were announced in May (removal of mortgage floor rate, lower downpayment, reduction of housing provident funds).

According to Bloomberg, China is weighing up a plan that allows homeowners to refinance their mortgage loans to lower their interest rate burden. As background, China reduced the 5-year LPR (loan prime rate) to 3.85% in July 2024 to the benefit of new home buyers. However, existing homeowners did not benefit from this lower LPR as existing mortgages will only be repriced by their respective bank lenders in 2025. This drives a disparity between rates for existing homeowners and new home buyers, which has resulted in an increase in mortgage prepayment risk. By enabling the refinancing of mortgage loans, existing homeowners could renegotiate with their bank lenders ahead of the usual mortgage repricing period in January.

With regards to positive ratings actions, Moody’s has revised AACTEC’s outlook to stable (previous: negative) while S&P has revised Xiaomi’s outlook to positive (previous: stable). For Xiaomi, its solid performance in its core businesses (smartphones and internet services) continues to generate positive free cash flow that allows Xiaomi to fund its investments in EVs.

Emerging markets

Emerging Market hard currency sovereign bonds posted modestly positive returns (0.1%) last week owing to slightly tighter spreads and a flat contribution from US treasuries. Spreads now stand at 388bps with high yield and investment grade compressing 8bps.

The big news of the week was Ukraine completing its restructuring / consent solicitation with creditors. Despite a minor technical delay that led to an extension of the early tender deadline, 97.4% of bond holders consented to the restructuring.

One big theme from last week was supply as issuers took advantage of the post Jackson Hole stability in US treasuries to come to market. Bulgaria and the Philippines priced large multi-tranche issues. Bulgaria priced €3bn and $1.5bn across two tranches, which came at a discount of 10-15bps and performed well post issuance. The Philippines was a bit of different story pricing $2.5bn across three tranches, but pricing was on top of the existing curve and bonds struggled in the secondary market. With the market reopening post summer holidays, we expect supply to be a common theme in the coming weeks.

Moody's gave Pakistan a 1-notch upgrade from Caa3 to Caa2, outlook positive. Moody's cited improving macroeconomic conditions and moderately better government liquidity and external positions for the upgrade. This comes after the government secured a staff level agreement with the IMF for a 37-month extended fund facility in the middle of July. S&P upgraded Montenegro from B to B+ as improved budgetary performance helped reduce net general government debt from a peak of 78% of GDP in 2020 to a projected 53% of GDP in 2024.

In terms of flows, positive momentum continued as EM bonds enjoyed net inflows over the week thanks to hard currency bonds while local currency continued to witness outflows.

Fixed Income Asset Allocation Views

2nd September 2024

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	▪ Spreads have widened in recent macro volatility but remain on the tighter side of history. ▪ Credit fundamentals have remained stable despite rising volatility and early signs of slowing in macro data and issuer expectations. ▪ **The group remains negative on credit risk overall, despite an upgrade to High Yield Credit to -1.** ▪ The CTI Global Rates base case view is that the hiking cycle is over, and the start of the cutting cycle is expected to be the next Fed meeting. Uncertainty about the pace remains elevated due to sensitive monetary and fiscal policy schedules and US elections looming closer.	▪ Upside risks: the Fed achieves a soft landing with no labour softening; lower quality credit outlook improves as refinancing concerns ease; consumer retains strength; end to Global wars ▪ Downside risks: Fed is not done hiking and unemployment rises, or the Fed pivots too early and inflation spikes. Restrictive policy leads to European recession. China property meltdown leads to financial crisis. 2024 elections create significant market volatility.
Duration (10-year) ('P' = Periphery)	¥ £ $ Short -2 -1 0 +1 +2 Long P €	▪ 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	▪ 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 € £ $	▪ Dollar has been supported by US growth exceptionalism and depricing of the Fed while the ECB looks set to embark on a cutting cycle. ▪ Dollar likely to continue to be supported into year end, where a Trump presidency looks most likely, and with it a return to tariffs and America First policy.	▪ Central banks need to keep rates at terminal for much longer than market prices, to the detriment of risk and growth and to the benefit of the Dollar
Emerging Markets Local (rates (R) and currency (C))	R Under-weight -2 -1 0 +1 +2 Over-weight C	▪ Disinflation under threat but intact; EM central banks still in easing mode. ▪ Real yields remain high. ▪ Selected curves continue to hold attractive risk premium.	▪ Global carry trade unwinds intensify, hurting EMFX performance. ▪ Stubborn services inflation aborts EM easing cycles. ▪ Uptick in volatility. ▪ Disorderly macro slowdown boosts USD on flight-to-safety fears
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ EMD spreads have also widened this month, following the escalation in potential risk. Especially given the ongoing geopolitical and economic uncertainties. Fundamentals have been downgraded after improvements in distressed areas. ▪ Investment Grade spreads are near historical tights while High Yield still offers idiosyncratic value. ▪ Tailwinds: Stronger growth forecasts, Central bank easing, potential China stimulus, IMF program boost for distressed names. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical and domestic political uncertainty, restructurings slow.	▪ Global election calendar (US, LATAM) ▪ Weak action from Chinese govt, no additional support for property and commercial sectors ▪ China/US relations deteriorate. ▪ Spill over from Russian invasion and Israel-Hamas war: local inflation (esp. food & commodity), slow global growth. ▪ Potential for the start of a new war in the conflict between Israel and Iran.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads have widened, especially short and intermediate, but long IG spreads remain near record tights. ▪ Due to the tight spreads across the board, the compensation for taking on additional risk, in seeking higher yields, seems unattractive. ▪ Global portfolios prefer EUR IG over USD on relval basis.	▪ Tighter financial conditions lead to European slowdown, corporate impact. ▪ Lending standards continue tightening, even after Fed pauses hiking cycle. ▪ Rate environment remains volatile. ▪ Consumer profile deteriorates. ▪ Geopolitical conflicts worsen operating environment globally.
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads have widened but stabilised since last month. Spreads are still implying lower defaults than the Columbia Threadneedle research team. ▪ Anticipate credit selection will be the performance differentiator in 2024. Looking to avoid defaults/distress, focusing on credit recovery and deleveraging stories. ▪ Increased lender on lender violence and aggressive liability management exercises further increase the risk in the distressed and highly leveraged segment. We expect this to , accelerate in the coming months. ▪ Default forecasts for lower rated issuers, particularly in Europe, is deteriorating with default rates projected to go up.	▪ Lending standards continue tightening, increasing the cost of funding. ▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks ▪ Rally in distressed credits, leads to relative underperformance ▪ Volatility in the short end of the curve, eroding potential upside where we are positioned for carry.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads are still wide of historic long-term averages. ▪ The decline in interest rate volatility since Fed signalled a definite end to the hiking cycle has been a tailwind for MBS. ▪ Fed's position on cuts, in relation to the recent CPI prints, is expected to be cautious. ▪ Constructive view on fundamentals over longer time horizon.	▪ Lending standards continue tightening even after Fed pauses hiking cycle. ▪ Fed fully liquidates position. ▪ Market volatility erodes value from carrying. ▪ More regional bank turmoil leads to lower coupons to underperform.
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Neutral outlook because of decent fundamentals and relval in select high quality Non-Agency RMBS, and ABS. ▪ RMBS: Spreads remain tight. Delinquency, prepayment, and foreclosure performance remains. ▪ CMBS: There is ongoing pressure even on AAA securities. Outside of office and multifamily housing, however, performance has remained healthy. ▪ CLOs: Despite heavy new issue, spreads remain tight. Defaults remain low but CCC bucket defaults are rising with lower recoveries. ▪ ABS: Spreads tighter MoM, prefer senior positions. Higher quality borrowers have deteriorated somewhat, while lower quality borrowers underperform. Federal student loan payments remain a key uncertainty with continued legal noise.	▪ Weakness in labour market ▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening. Consumer (retail/travel) behaviour fails to return to pre-covid levels ▪ Student loan repayments weaken consumer profile more than anticipated, affecting spreads on a secular level. ▪ High interest rates turn home prices negative, punishing housing market. ▪ Cross sector contagion from CRE weakness.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w sugar ▪ o/w Zinc ▪ o/w Gasoline ▪ o/w Distillates ▪ o/w Cocoa ▪ u/w natural gas ▪ u/w corn ▪ o/w lead ▪ o/w silver ▪ o/w soybean meal	▪ Global Recession

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