COLUMBIA THREADNEEDLE INVESTMENTS

# In Credit

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**David Oliphant**
Executive Director,
Fixed Income

## Contributors

**David Oliphant**
Investment Grade Credit

**Simon Roberts**
Macro/Government Bonds

**Angelina Chueh**
Euro High Yield Credit

**Chris Jorel**
US High Yield Credit,
US Leveraged Loans

**Kris Moreton**
Structured Credit

**Justin Ong**
Asian Fixed Income

**Charlotte Finch**
Responsible Investments
Investment Grade Credit

**Gary Smith**
General Fixed Income

**Priyanka Prasher**
Emerging Markets

**Sarah McDougall**
General Fixed Income

# Trump, tariffs and trade tensions

## Markets at a glance

| | Price / Yield / Spread | Change 1 week | Index QTD return* | Index YTD return |
|---|---|---|---|---|
| US Treasury 10 year | 4.54% | -8 bps | 0.6% | 0.6% |
| German Bund 10 year | 2.39% | -18 bps | -0.4% | -0.4% |
| UK Gilt 10 year | 4.47% | -16 bps | 0.8% | 0.8% |
| Japan 10 year | 1.25% | 2 bps | -0.7% | -0.7% |
| Global Investment Grade | 85 bps | 1 bps | 0.6% | 0.6% |
| Euro Investment Grade | 90 bps | -2 bps | 0.5% | 0.5% |
| US Investment Grade | 82 bps | 2 bps | 0.6% | 0.6% |
| UK Investment Grade | 76 bps | -2 bps | 1.1% | 1.1% |
| Asia Investment Grade | 116 bps | 2 bps | 0.6% | 0.6% |
| Euro High Yield | 319 bps | 8 bps | 0.7% | 0.7% |
| US High Yield | 268 bps | 8 bps | 1.4% | 1.4% |
| Asia High Yield | 549 bps | -2 bps | -0.4% | -0.4% |
| EM Sovereign | 289 bps | -1 bps | 1.2% | 1.2% |
| EM Local | 6.3% | 0 bps | 2.1% | 2.1% |
| EM Corporate | 247 bps | 7 bps | 0.8% | 0.8% |
| Bloomberg Barclays US Munis | 3.7% | -8 bps | 0.5% | 0.5% |
| Taxable Munis | 5.2% | -4 bps | 0.3% | 0.3% |
| Bloomberg Barclays US MBS | 34 bps | -1 bps | 0.5% | 0.5% |
| Bloomberg Commodity Index | 250.55 | -1.0% | 4.0% | 4.0% |
| EUR | 1.0252 | -1.3% | 0.1% | 0.1% |
| JPY | 154.62 | 0.5% | 1.3% | 1.3% |
| GBP | 1.2318 | -0.7% | -1.0% | -1.0% |

Source: Bloomberg, ICE Indices, as of 31 January 2024. *QTD denotes returns from 31 December 2024

### Chart of the week: Euro-US dollar: parity within touching distance?

Source: Bloomberg, as of 3 February 2025

## Macro/government bonds

One story mattered, which broke over the weekend. Effective from 4 February, the US had threatened to impose a 25% tariff on all goods from Mexico and Canada, apart from Canadian energy which would be taxed at 10%. Chinese goods would also be taxed at 10%. President Trump's willingness to use tariffs became apparent the previous week when he had temporarily put a 25% tariff on Columbian goods, as he negotiated the return of illegal Columbian migrants.

After a phone call with Mexican president, Claudia Sheinbaum, Trump postponed tariffs with that country until 1 March. He and Scheinbaum agreed to work on trade and security, with Scheinbaum offering to put 10,000 national guard officers on the Mexican border to prevent the trafficking of people and drugs. Canada followed a similar path, agreeing to additional security measures in exchange for a month's delay, during which further negotiations could take place. Trump also remarked that Europe was firmly in his crosshairs on tariffs, while China responded to its 10% tariffs through a range of targeted retaliatory actions.

This type of transactional politics has upended the prior narrative of a steady decline in US rates to their neutral level as inflation falls. At its rate-setting meeting last week, the US Federal Reserve left rates on hold at 4.5%. Chair, Jay Powell, made it clear that the institution was in 'wait and see' mode and that it was too early to model trade policies that were still at an embryonic stage.

The impact of tariff policies on the bond market was felt through yield curve flatteners. Yields at the short end increased as the market priced in a 'higher for longer' outcome from the Fed. The implementation of any tariffs is likely to prove inflationary, or at the very least keep inflation at sticky levels, as trade frictions increase. While the market is still pricing in just under two quarter-point rate cuts by year-end in the US, some market strategists have proposed a no-rate-cut scenario. As yields rose at the front end of the US yield curve, they fell at the back end, reflecting the growing view that trade frictions will likely result in slower growth.

Aside from the bond market, the 'higher for longer' scenario has also been reflected in currency markets. The US dollar initially strengthened against currencies such as the Mexican peso, the Canadian dollar, the Chinese yuan and the euro, until news of the postponement of tariffs for Mexico and Canada. The euro is currently trading at 1.03 versus the US dollar and parity appears within touching distance (see **Chart of the Week**).

The irony of US dollar strength is that it will make US goods more expensive in Europe, increasing its goods deficit with Europe. The expectation of slower growth, plus disinflationary pressures in major eurozone economies such as Germany and France, has resulted in bond market strength across the eurozone. In a well telegraphed move, the European Central Bank cut interest rates by 0.25% to 2.75%. ECB president, Christine Lagarde, was dovish in her appraisal of the eurozone economy, pointing to easing labour cost pressures, and said the bank should reach its 2% inflation target later this year. She also talked about policy uncertainty as the ECB tries to frame its response to a US president firmly on the front foot. Major tariffs against the eurozone are likely to result in a recession in the region. The market, though, still has to determine what this means in terms of the unobservable eurozone neutral interest rate.

## Investment grade credit

January was another month of stronger investment grade credit, with spreads tightening in all major markets. The euro and GBP markets saw spreads 11% and 5% tighter respectively, while US dollar spreads were unchanged in January. Shorter-dated credit tightened slightly more than longer-dated as credit curves steepened. In terms of sectors, data from ICE indices showed that autos (beleaguered last year) and banking led the global IG index tighter, with media and technology following to a lesser degree. Utilities actually widened in January, albeit marginally.

In terms of market outlook, valuations (spreads) remain tight compared with either short- or longer-run averages. This is somewhat mitigated by the reduction in benchmark duration seen

in recent years (spread/unit duration) and the relationship of corporate bond yields to swap rates – but, nonetheless, we mark corporate bond spreads as expensive. Although the ECB loosened rates for a fifth time and by 25bps in January, the Fed left policy conditions unchanged last month. Present and market-implied monetary policy conditions remain in restrictive territory in both regions. Meanwhile, the consensus view is for the European economy to expand by around 1% in 2025, with the US economy expected to grow by around 2%. In our view, this low but positive growth is a neutral environment for IG credit. Lastly, turning to corporate health, we anticipate that the present low levels of leverage will persist through this year. We note that banks are operating with record levels of capital – hence corporate quality remains robust.

In summary, we have a fairly neutral view of the prospects for the IG market, but we think the market remains attractive for 'yield' buyers.

## High yield credit & leveraged loans

US high yield bond valuations widened modestly over the week but continued to benefit from light new issuance and a continuation of fund inflows. The ICE BofA US HY CP Constrained Index returned 0.18%, while spreads moved 7bps wider to end at +283bps. According to Lipper, US high yield bond retail funds saw modest inflows of $196 million. Leveraged loans remained stable amid light new net issuance and ongoing inflows. The average price of the S&P UBS Leveraged Loan Index was stable at $96.6 over the week. Retail loan funds saw a $1.5 billion inflow with the asset class now seeing four consecutive inflows in excess of $1 billion.

European HY returned 0.64% for the first month of 2025. This was achieved on the back of tighter spreads (-6bps to 319bps) as yields held steady (-1bps to 6.17%). The last week of January saw the market supported by strong technicals as new issues – €1.9 billion for the week, bringing the month gross to €6.3 billion – were three to four times oversubscribed with the final price coming well inside initial price talk. Demand for EHY from managed accounts, which had been steady through the month, had a strong finish to the month resulting in total net inflows of €573 million, with ETFs also reverting and experiencing inflows. This resulted in around €125 million net inflows for January.

On the credit rating front there were a number of changes, mostly to the downside. In the upgrade space, catering/culinary firm Gategroup was raised to B- by S&P on profitability and leverage improvement, while Medical Property Trust was moved higher to B3 by Moody's on a well-received new issue. In the downgrade space, Olympus Entertainment was lowered to CCC from B- by S&P on a refinancing risk. Flora Food Group's senior secured debt was moved to B at Fitch on the new issue. Zenith was downgraded to CCC+ by S&P on high leverage and refinancing risk concerns, and chemicals business Synthomer was moved to B+ by S&P on high leverage and muted demand in chemicals.

Concern for the auto sector continues, given the Trump tariff threats, although the sector rallied last week on strong technicals. The most immediate question is the exposure of European OEMs to the Canadian and Mexican market, with Stellantis having the biggest exposure to Canada, and Mahle and Forvia having exposure to Mexico.

## Structured credit

In a flight to quality last week, the US Agency mortgage-backed securities (MBS) sector posted a 52bps gain. Relative to risk assets, mortgages were deemed an attractive hedge and lower volatility in both spreads and rates supported the sector. Interestingly, the Fed's decision to hold rates barely moved the sector, as investors didn't hear much new news in the press conference. In the primary asset-backed securities (ABS) market, only $5.8 billion was priced across nine deals. This week appears to be busier with, so far, $10.3+ billion pre-marketing across 13 deals. Notably it is auto-focused with deals from Honda, BMW, Ford and GM. Spreads at the top of the capital stack were flat on the week, with compression continuing to be the main theme. Meanwhile, the primary collateralised loan obligations (CLO) market continued to pump out deals with spreads breaching 2018's tights. Post-reinvestment period refinances are getting

AAAs done in the high 80s/low 90s area. The rest of the credit stack has tightened as well. Given where spreads are, we will continue to see many deals being reset or refinanced, especially from early 2023 deals as that paper exits its two-year non-call window. AAA spreads were around +200 at the beginning of 2023, so even those deals that will price wider due to credit concerns have plenty of incentive. The secondary CLO market continues to be extremely liquid across the stack.

## Asian credit

The JACI ended the week positively with a total return of 38bps (IG: +40bps, HY: +26bps). Treasury returns were 51bps, offsetting the loss from wider spreads (-13bps). Over the weekend the Trump administration announced that it would impose a 10% tariff on imports from China. While this is less egregious than the 60% tariff in a bear-case scenario, the hike will accentuate economic pressure in China. China's PMI data for January was softer at 50.1, down 0.4 month-on-month.

The India government has announced its first full budget (fiscal year-end March 2026) for Prime Minister Modi's third term, with a focus on achieving further fiscal consolidation. The fiscal target of 4.4%, representing a 0.4 percentage point year-on-year reduction from FYE March 2025 of 4.8%, is ambitious. In order to meet the fiscal deficit target, the government plans to lower revenue expenditures and capex, and hopes that income tax cuts will boost domestic consumption.

In Macau, resort developer Sands China Ltd (SCL) posted a set of resilient Q4 2024 results, despite bearing some impact from renovation works at the Venetian Macau and Londoner Macau. The number of operational rooms across SCL's portfolio of hotels in Macau hit its lowest point of 8,700 keys in November/December 2024 (versus a high of 10,829). SCL expects to complete the Londoner Phase II works by Q2 this year. In terms of GGR (gross gaming revenue), SCL's share dropped to 22.8% in Q4 (-2.6 percentage points year-on-year). As this phase is ramped up, together with the refurbished facilities, SCL would be in a good position to regain market share over the next two or three quarters.

Adani Ports and SEZ performed well in Q4 2024, with revenue of INR79.6 billion (up 15% year-on-year) and EBITDA of INR48 billion (up 14.7% year-on-year). The Q3 results were underpinned by cargo growth, which was up 3.6% year-on-year, of which container volume accounted for 41% of the total volume.

## Emerging markets

Tariffs and US rates continue to dominate the story for emerging markets. On Friday, the Trump administration confirmed it will begin implementing 25% tariffs on Mexico and 10% tariffs on China. Despite the noise, EM sovereigns returned 0.52% in US dollars on the week – a change of 9bps. Local currency bonds took the brunt of tariff volatility, returning -0.73% in US dollars on the week. This came primarily from a weakness in the Mexican peso and South African rand.

Mexico's president, Claudia Scheinbaum, is expected to announce a 'Plan B' to defend against US tariffs, emphasising the importance of cooperation on security and migration. Trump's tariffs present a significant risk to Mexico, which sends more than 80% of exports to the US.

The central banks in Chile and Hungary maintained their rates of 5% and 6.5% respectively. South Africa's Reserve Bank lowered its policy rate by 25bps to 7.5% and is expected to hold until US foreign policy becomes clearer.

The Banco Central do Brasil raised its policy rate by 100bps in January to 13.25% following an above-target CPI outcome, and signalled another rise of that amount in March. Argentina cut its benchmark rate by 300bps to 29%. President Milei's unorthodox policy move of cutting rates in a high-inflation environment appears to be working so far due to tight currency controls and sharp fiscal adjustment.

Last week, Mexico and Egypt were the only EM sovereigns to come to market. Egypt issued a US dollar Eurobond with an oversubscription of five times, marking its first conventional Eurobond since September 2021.

In other news, Fitch affirmed ratings for Saudi Arabia at A+ and for Turkey at BB-, both with a stable outlook. The Reserve Bank of India bought INR200 billion in its first open-market auction in almost four years. This forms part of a wider initiative to increase liquidity in the Indian money market. The yield on 10-year bonds declined by 7bps over the month.

## Responsible investments

Some parts of the sustainable investment world have had a dreary start to 2025. New EU regulations have caused a large number of asset managers to remove ESG terms from their fund names to avoid breaching the new standard, according to a Morningstar report. And in the US, anti-ESG trends are causing immense outflows from ESG funds, while performance versus the market for ESG funds in reent years has not been great. That said, there is a slightly brighter outlook for the bond market. Issuance so far this year is slightly lower than the same time last year, but is still offering investors choice and demand remains high.

Last week, the market was dominated by French-based SSA raising billions for climate and social good. Ile de France Mobilities raised a €1 billion green bond that was almost six times oversubscribed, the Caisse d'Amortissement de la Dette Sociale (CADES) raised €2.5 billion in a new five-year social bond, and Ville de Paris bought a €350 million sustainability bond to the market priced at 16bps over French government bonds.

## Fixed Income Asset Allocation Views

3rd February 2025

| 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 remain near generational tights to start the year. Volatility remains below the early November peak and fundamentals remain stable.<br>▪ **The group remains negative on credit risk overall, with no changes to underlying sector outlooks.**<br>▪ The Federal Reserve has decreased to policy rate by 100bps since September. The CTI Global Rates base case view is that the pace and magnitude of additional cuts is uncertain and dependant on inflation data and labor market conditions.<br>▪ The group is monitoring Donald Trump's fiscal policy proposals and personnel appointments to anticipate 2025 policy rate path and industry differentiation. | ▪ 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<br>▪ 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)**<br>('P' = Periphery) | $ ¥ £<br>Short -2 -1 0 +1 +2 Long<br>P € | ▪ Longer yields to be captured by long-run structural downtrends in real yields<br>▪ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures | ▪ Inflationary dynamics become structurally persistent<br>▪ Labour supply shortage persists; wage pressure becomes broad and sustained<br>▪ Fiscal expansion requires wider term premium<br>▪ Long run trend in safe asset demand reverses |
| **Currency**<br>('E' = European Economic Area) | EM<br>A$<br>¥<br>Short -2 -1 0 +1 +2 Long<br>€ £<br>$ | ▪ Dollar has been supported by US growth exceptionalism and depricing of the Fed while the ECB looks set to embark on a cutting cycle.<br>▪ 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<br>Under-weight -2 -1 0 +1 +2 Over-weight<br>C | ▪ Disinflation under threat but intact; EM central banks still in easing mode.<br>▪ Real yields remain high.<br>▪ Selected curves continue to hold attractive risk premium. | ▪ Global carry trade unwinds intensify, hurting EMFX performance.<br>▪ Stubborn services inflation aborts EM easing cycles.<br>▪ Uptick in volatility.<br>▪ 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 | ▪ Index spreads rallied following the US election, despite Trump's protectionist platform, and remain at those cycle tights.<br>▪ The Group remains conservatively positioned and disciplined regarding valuations, reducing exposure where risk premium has compressed materially.<br>▪ Tailwinds: Strong primary market and growth outlook, disinflation, IMF programs.<br>▪ Headwinds: US trade policy & USD strength, variation in monetary policy paths, Middle East tensions, higher debt to GDP ratios, wider fiscal deficits, slow restructurings. | ▪ US trade policy aggression strengthens USD against EM currencies.<br>▪ EM policy makers constrained by currency pressure; rates remain tight.<br>▪ Fiscal concerns leak into local risk premia. |
| **Investment Grade Credit** | Under-weight -2 -1 0 +1 +2 Over-weight | ▪ Spreads are at the tightest levels since 1998. Current valuations limit spread compression upside and provide little compensation for taking additional risk.<br>▪ 2024 earnings and ungrades have been above expectations. Results and commentary from issuers do not indicate fundamental deterioration.<br>▪ IG analysts expect strong fundamentals and decade-low leverage for 2024 / 2025.<br>▪ The Group is keeping an eye on post-election industry differentiation. | ▪ Tighter financial conditions lead to European slowdown, corporate impact.<br>▪ Lending standards continue tightening, even after Fed pauses hiking cycle.<br>▪ Rate environment remains volatile.<br>▪ Consumer profile deteriorates.<br>▪ Geopolitical conflicts worsen operating environment globally. |
| **High Yield Bonds and Bank Loans** | Under-weight -2 -1 0 +1 +2 Over-weight | ▪ The current rich valuations are misaligned with a cautious fundamental outlook.<br>▪ Earnings season performed within expectations; however, the group still has a cautious view of fundamentals given management guidance, CTI default forecasts, and the increase in lender-on-lender violence and liability management exercises.<br>▪ Weaker outlook for cyclical industrial and consumer sectors.<br>▪ The Group is conservatively positioned but remains open to attractive high quality relval opportunities, particularly sectors experiencing near-term volatility. Prefer loans due to cheaper relative valuations and strong market technicals. | ▪ Lending standards continue tightening, increasing the cost of funding.<br>▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks<br>▪ Rally in distressed credits, leads to relative underperformance<br>▪ 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 | ▪ Agency MBS ended 2024 with positive excess return and spreads 11bps tighter YoY.<br>▪ The Group remains positive on Agency MBS because the carry and convexity are still attractive, and prepayment risk is low because of elevated mortgage rates. Valuations are still cheap relative to longer term averages.<br>▪ Prefer call-protected Inverse IO CMOs, a large beneficiary of aggressive cutting cycle. Difficult to increase position sizing as few holders are willing to sell into the current rate environment. | ▪ Lending standards continue tightening even after Fed pauses hiking cycle.<br>▪ Fed fully liquidates position.<br>▪ Market volatility erodes value from carrying.<br>▪ 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 issues.<br>▪ RMBS: Spreads near 2024 tights. Fundamental metrics, such as delinquencies, prepayments, and foreclosures remain solid overall. Pockets of weakness emerging.<br>▪ CMBS: Spreads tighter MoM. Stress continues, particularly in office, floaters, and near-term maturities. SASB delinquencies are rising and there are pockets of opportunity in SFR.<br>▪ CLOs: Demand remains high given relative spread to other asset classes; strong technicals. Defaults remain low, but CCC buckets are rising with lower recoveries.<br>▪ ABS: 60+ Day delinquencies are elevated, driven by inflation and credit score drift. Spreads tighter over the past month; the group prefers higher quality, liquid securities. | ▪ Weakness in labour market<br>▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening. Consumer (retail/travel) behaviour fails to return to pre-covid levels<br>▪ Student loan repayments weaken consumer profile more than anticipated, affecting spreads on a secular level.<br>▪ High interest rates turn home prices negative, punishing housing market.<br>▪ Cross sector contagion from CRE weakness. |

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