In Credit

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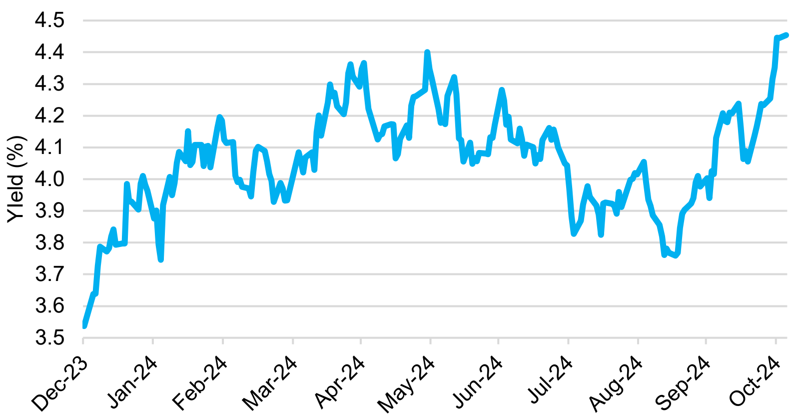
A little anarchy in the UK

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.28%	4 bps	-3.4%	0.4%
German Bund 10 year	2.40%	11 bps	-1.4%	-0.4%
UK Gilt 10 year	4.45%	22 bps	-3.0%	-3.5%
Japan 10 year	0.95%	0 bps	-0.6%	-2.4%
Global Investment Grade	91 bps	0 bps	-1.9%	3.1%
Euro Investment Grade	103 bps	1 bps	-0.3%	3.5%
US Investment Grade	86 bps	1 bps	-2.8%	2.8%
UK Investment Grade	87 bps	0 bps	-1.3%	0.9%
Asia Investment Grade	130 bps	-2 bps	-1.0%	5.5%
Euro High Yield	334 bps	-5 bps	0.6%	7.5%
US High Yield	283 bps	-6 bps	-0.5%	7.5%
Asia High Yield	499 bps	-2 bps	0.5%	15.0%
EM Sovereign	300 bps	-4 bps	-2.0%	5.8%
EM Local	6.4%	4 bps	-4.8%	-0.1%
EM Corporate	240 bps	-5 bps	-1.0%	7.5%
Bloomberg Barclays US Munis	3.7%	2 bps	-1.4%	0.8%
Taxable Munis	5.1%	11 bps	-3.8%	0.8%
Bloomberg Barclays US MBS	47 bps	-1 bps	-3.2%	1.1%
Bloomberg Commodity Index	236.69	-2.1%	-1.9%	3.9%
EUR	1.0904	0.4%	-2.7%	-1.9%
JPY	151.75	-0.4%	-6.1%	-7.8%
GBP	1.2963	-0.3%	-3.4%	1.5%

Source: Bloomberg, ICE Indices, as of 1 November 2024. *QTD denotes returns from 30 September 2024

Chart of the week – 10Y UK Gilt Yield



Source: Bloomberg, as of 4 November 2024

Macro/government bonds

The worst performing core fixed income market last week was the UK. The yield on the two-year gilt finished the week 27bps higher at 4.43%. The reason behind this was simple: the announcement of the first budget from a Labour government in 14 years. Spending is set to increase by £70 billion a year during this parliament, with two-thirds channelled to day-to-day spending and a third to investment. Just over half of this is to be funded by an increase in taxes, largely targeted towards business. Extra borrowing will finance the remaining spending needs.

Rachel Reeves, the chancellor, also changed the fiscal rules, switching the classification of debt from Public Sector Net Debt to Public Sector Net Financial Liabilities, a broader interpretation of assets that will provide her with greater fiscal headroom. The market looked to the pick-up in inflation of around +0.4% over the next two years, highlighted in the accompanying report from the Office of Budget Responsibility, paring back its interest rate expectations over the next year from five quarter point rate cuts to four.

Political volatility was also at work in the US. For much of last week, consensus thinking in the market had pointed to a Donald Trump presidency. Given his expansionary fiscal stance and desire for higher tariffs, this was regarded as bad for bonds and good for the dollar. The Trump trade in bond land was primarily expressed through yield curve steepening trades.

The other factor impacting yield levels was economic data. GDP came in at 2.8% on an annualised basis for Q3, while measures of confidence – such as that from the Conference Board – came in at the top end of expectations. The one number that should have shocked the market under more normal conditions was a Non Farm Payroll reading, which came in at 12,000 for October, relative to survey expectations of 100,000. The disruption caused by two major hurricanes and a number of large strikes explained the low level of net jobs created during the month. There was also a downward revision to the blockbuster September number of 254,000 to 233,000. Market price action, however, was overshadowed by the US election, the outcome of which is still impossible to discern given the margin of error. A poll favourable to Kamala Harris at the weekend in the swing state of Iowa helped upend thinking that a Trump outcome was a done deal.

Europe was largely overshadowed by events in the UK and the US. The eurozone bond market continues to price in the prospect of one quarter point rate cut at the next European Central Bank meeting in December, with sequential quarter point rate cuts at each meeting in the first half of 2025. Bank of Italy governor, Fabio Panetta, warned of the risk of inflation undershooting its 2% target, given the increasing sluggishness of the eurozone economy. Despite this, the yield on the two-year German bund still finished the week 13bps higher at 2.2%.

Investment grade credit

Though equities were lower and government bond yields a lot higher, October was a period of strong performance from a credit spread perspective.

Spreads in USD,euro and GBP IG credit were all tighter. The euro market continues to lead the charge. In percent terms, spreads in the region were 9% tighter compared to the dollar market, where that number was 7% (year-to-date euro spreads are 23% tighter while dollar spreads are 17% richer).

Sector wise, globally the outperformers remain Real Estate (-35%), Insurance (-28%) and Banking (-26%), while the laggards are Technology (-6%), Media (-6%) and Autos (-7%). Credit curves have steepened this year with short-dated (one to five year) bonds tightening more than longer dated debt. The tightening in spreads leaves all markets trading inside short- (five years) and longer-term (20 year) averages on an option-adjusted spread basis. Adjusted for volalatility, the euro market is less rich than the dollar market.

The outlook for spreads is fairly balanced and supported by robust credit quality, with historically low levels of leverage for corporates and high levels of capital for banks – both now and as forecast by our analyst team going forward. The economic outlook is projected to be one of low but positive growth into year-end and 2025, which would be a reasonable enough background for IG credit. Interest rates should continue to fall from the present restrictive levels as inflation falls. Hence, were it not for the rich valuations mentioned earlier, we would be more positive on the outlook for spreads.

High yield credit & leveraged loans

US high yield bond spreads tightened to new post-global financial crisis lows as third-quarter earnings generally met expectations and economic data remained resilient. The ICE BofA US HY CP Constrained Index returned 0.07% while spreads were 6bps tighter, ending at +307bps. The index yield-to-worst increased 0.11% to 7.32%. According to Lipper, US high yield bond retail funds saw an $814 million outflow for the week. This included the first outflow for actively managed funds in 11 weeks. The average price of the Credit Suisse Leveraged Loan Index was unchanged at $96.2 as investors navigated a still active primary market and resilient macro. Retail loan funds saw $402 million contributed for a sixth consecutive weekly inflow.

It was another sideways week for European HY with the asset class returning 0.02% as spreads tightened 5bps to 334bps, while yields rose 9bps to 6.34%. It was a calm finish for October, which saw a solid 0.6% return for the month as spreads narrowed 26bps to 331bps and yields held steady in the 6.3% range. A cross-credit rating breakdown showed that risk was back on, with CCCs outperforming the higher rated credits and finishing the month as the outperformer. Inflows were steady with €300 million last week – an eleventh week of inflows capping off a strong month of €3.2 billion inflows into the asset class, taking the year-to-date to €11.7 billion. This was across both ETFs and managed accounts, but with a greater amount into the latter.

New issuance was down versus the bumper crop of the previous week, but was still respectable at almost €3 billion over six issues, which were reasonably well received and show the resilience of the market. This brings the year-to-date gross issuance to €109 billion, the second highest per calendar year over the past eight years. However, investors remained discerning with one deal failing to come to market with the issuer withdrawing due to a lack of interest. This was the second time this has happened since the start of autumn. With the US presidential election this week, it is expected that the coming days will be quieter.

In credit rating news, S&P Global Ratings downgraded Victoria PLC to B-, on a negative outlook. This follows Moody's similar action last week – a downgrade to B3. Eramet, meanwhile, was downgraded by Moody's to Ba3 from Ba2 with a negative outlook. The rating agency cited that this reflected sharply reduced sales (manganese and nickel) as well as 2024 prices, and an expectation of only moderately improving volume and price forecasts for 2025. They see leverage in 2025 in excess of 4x, which is above the Ba3 ratings threshold.

In M&A news, PureGym announced it had acquired Blink Fitness assets for $121 million. The chain is based in the US and was funded via a September tap of euro and GBP bonds.

In the default space, the 12-month rolling default rate fell to 2.63% by end of October.

Structured credit

The US Agency mortgage-backed security (MBS) sector was down again last week, by 60bps. It has been a rough ride for the sector this quarter on better-than-expected data, more likelihood of a soft landing and a possible Red sweep in the US elections all driving interest rates and volatility higher. Shorter maturity and higher coupon bonds performed best, given their lower interest rate sensitivity. There is no question the sector is trading with a high correlation to the rates markets. Spreads had been on a widening trend, but tightened week-on-week for the higher coupon segment as prepay risk declined. Overall, spreads continue to be supported by low supply given declining originations at a mortgage rate that is approaching 7%.

In Non-agency MBS, new issuance remained very active with $5.5 billion pricing over the past two weeks and year-to-date issuance at $117 billion. Spreads were resilient against heavier primary volumes. The same can be said for Commercial mortgaged-backed securituies. Nine single asset deals were brought to market and one conduit totalling $5.2 billion. The downgrade cycle continued with the vast majority of bonds downgraded heavily invested in office properties.

Asian credit

The JACI index posted another week of negative returns (-22bps) impacted by losses in both spread (-14bps) and Treasuries (-8bps).

Property sales in China registered the first positive year-on-year growth in October 2024, based on data from CRIC (the China Real Estate Information Corp). On an attributable sales basis, which takes into account the percentage of ownership in projects (joint ventures or co-developed), the October 2024 sales for the top 100 property developers increased to CNY343 billion (+10% year-on-year). The property sales volume was supported by various measures announced since September 2024. These include mortgage rate cuts, easing of home purchase restrictions in Tier-1 cities, and the higher availability of relending facilities. The focus this week would be on the much-anticipated meeting of the Standing Committee of the National People's Congress (4 November to 8 November) which, as the top legislative body in China, may disclose further details about the country's fiscal package and stimulus measures.

In India, Bharti Airtel reported strong Q3 numbers thanks to the tariff hikes implemented in July. Both Bharti Airtel and Jio, however, saw an erosion of their subscriber base due to SIM consolidation. On the back of tariff hikes, subscribers are increasingly keeping their primary mobile numbers and forgoing the use of additional SIM cards.

LG Energy Solutions (LGES) reported a good set of Q3 results, but management expects a softer Q4 due to year-end inventory adjustments by auto OEMs and the lag effects of input costs. LGES is also taking a more conservative view of electric vehicle demand and will focus on maximising utilisation by converting idle EV battery lines to produce ESS (energy storage systems).

GLP withdrew its USD bond issuance given lacklustre investor reception to its three-year paper, despite having an initial pricing guidance of 10.375%, which is relatively high for a short-dated paper. While GLP stated it will receive around $1.5 billion in cash from Ares through the divestment of its GCP ex-China business (fund management in logistic centres, digital infrastructure etc), the cash receipt will only materialise in early 2025 following regulatory approvals. Accordingly, investors continue to be concerned about GLP's tight liquidity position.

Emerging markets

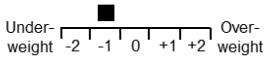
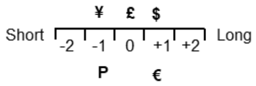
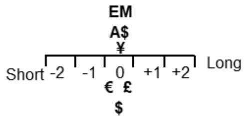
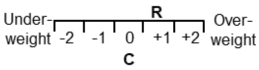
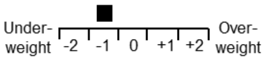
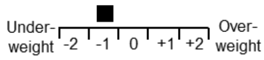
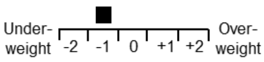
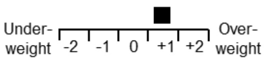
As mentioned above, reports of the demise of the Chinese economy may have been greatly exaggerated, according to data published last week which suggested the manufacturing sector is starting to respond to stimulus measures announced since the end of September. Even the much-maligned property market displayed year-on-year volume growth for the first time this year in October. Markets await the Standing Committee of the National People's Congress for a substantial fiscal support announcement.

Such glimmers of hope may in part explain the remarkable performance of Emerging Market Hard Currency spreads last week, though in truth that resilience in the face of rising US treasury yields and looming political risks has been a market feature for several months. Despite moderated expectations of Fed easing, EM investors have demanded ever lower risk premia, thanks to a combination of light positioning and steadily improving EM fundamentals. Another swathe of sovereign credit rating upgrades corroborates the latter. Last week's top students include Turkey (where S&P raised its rating by a notch to BB- on positive reserve accumulation and steady progress on external imbalances), and Egypt (where Fitch's move from B- to B leaves Moody's Caa1 rating looking increasingly isolated). The IMF returns to Cairo this week to conduct the fourth review of its outstanding programme, which could unlock a further $1.2 billion of funding.

With the US election upon us, the risks to EMs of a Red sweep and a protectionist trade shift are clear. With spread compensation so thin, we maintain a cautious overall market stance.

Fixed Income Asset Allocation Views

4th November 2024

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk		▪ Spreads are modestly tighter since last month and fundamentals remain stable, despite elevated volatility and slowing of macroeconomic data. ▪ **The group remains negative on credit risk overall and downgraded Agency MBS to a modestly positive outlook.** ▪ The Federal Reserve began the easing cycle in September with 50bp rate cut. The CTI Global Rates base case view is that the pace and magnitude of additional cuts is uncertain and dependant on inflation and labor market conditions.	▪ 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)		▪ 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)		▪ 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))		▪ 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)		▪ Index spreads are close to 5-year tights while spread volatility remains elevated. ▪ The Group remains conservatively positioned and disciplined regarding valuations, reducing exposure where risk premium has compressed materially. ▪ Tailwinds: China stimulus, stronger growth, central bank easing, IMF programs. ▪ Headwinds: Escalating tensions in Middle East, higher debt to GDP ratios, wider fiscal deficits, US election, geopolitical uncertainty, slow restructurings.	▪ 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		▪ Spreads have tightened back near year-to-date tights, are rich to long-run averages ▪ Results and commentary from issuers do not indicate fundamental deterioration. ▪ IG Analysts expect strong fundamentals and decade-low leverage for 2024/2025. ▪ Current valuations limit spread compression upside and provide little compensation for taking on additional risk.	▪ 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		▪ Spreads have continued tightening and are rich to long-term averages. ▪ Earnings season did not indicate broad deterioration; 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. ▪ Weaker outlook for cyclical industrial and consumer sectors ▪ The Group remains conservatively positioned given valuation backdrop but is open to attractive high quality relval opportunities.	▪ 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		▪ The Group downgraded Agency MBS because spreads are closer to fair value following the September FOMC and the housing market remains pressured. ▪ 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. ▪ 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. ▪ 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		▪ Neutral outlook because of decent fundamentals and relval in select high quality issues. ▪ RMBS: Spreads have continued to tighten. Fundamental metrics such as delinquencies, prepayments, and foreclosures, remain solid overall. ▪ CMBS: We are in the early stages of the office deterioration story. Outside of office and multifamily housing, however, performance has remained healthy. ▪ CLOs: Demand remains high given relative spread to other asset classes; active new issue market. Defaults remain low, but CCC buckets are rising with lower recoveries. ▪ ABS: 60+ Day delinquencies are rising. Spreads unchanged MoM, the group has been reducing positions in consumer and auto sectors.	▪ 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.

Important information: For use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients). Source for all data and information is Bloomberg as at 21.10.2024, unless otherwise stated.