In Credit

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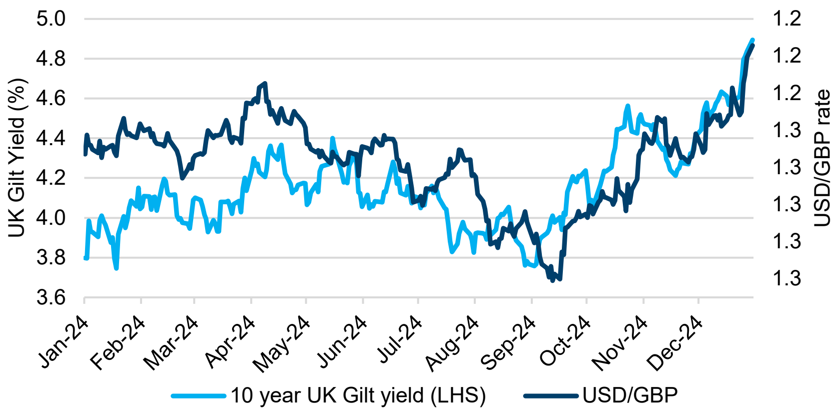
UK decay?

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.79%	19 bps	-0.9%	-0.9%
German Bund 10 year	2.62%	19 bps	-1.4%	-1.4%
UK Gilt 10 year	4.88%	28 bps	-2.0%	-2.0%
Japan 10 year	1.20%	10 bps	-0.6%	-0.6%
Global Investment Grade	88 bps	0 bps	-0.9%	-0.9%
Euro Investment Grade	99 bps	0 bps	-0.7%	-0.7%
US Investment Grade	83 bps	0 bps	-1.0%	-1.0%
UK Investment Grade	81 bps	1 bps	-1.2%	-1.2%
Asia Investment Grade	106 bps	-12 bps	-0.2%	-0.2%
Euro High Yield	325 bps	7 bps	-0.3%	-0.3%
US High Yield	281 bps	0 bps	0.0%	0.0%
Asia High Yield	525 bps	1 bps	-0.1%	-0.1%
EM Sovereign	292 bps	0 bps	-0.5%	-0.5%
EM Local	6.4%	5 bps	-0.4%	-0.4%
EM Corporate	234 bps	-6 bps	-0.2%	-0.2%
Bloomberg Barclays US Munis	3.8%	13 bps	-0.7%	-0.7%
Taxable Munis	5.4%	14 bps	-1.5%	-1.5%
Bloomberg Barclays US MBS	46 bps	3 bps	-1.2%	-1.2%
Bloomberg Commodity Index	249.65	4.1%	3.9%	3.9%
EUR	1.0193	-0.6%	-1.1%	-1.1%
JPY	157.06	-0.3%	-0.3%	-0.3%
GBP	1.2109	-1.7%	-2.5%	-2.5%

Source: Bloomberg, ICE Indices, as of 10 January 2024. *QTD denotes returns from 31 December 2024

Chart of the week: the sterling market – gilts and currency



Source: Bloomberg, as of 13 January 2025

Macro/government bonds

The major “story” last week was the continued steepening of global yield curves, as investors demanded greater risk premia for holding longer-dated debt. Over the course of the week the yield on the US 10-year Treasury rose 0.16% to 4.76%, while the yield on the 30-year US Treasury rose 0.13% to 4.94%. There were a number of reasons for this. First, the continuing resilience of the US economy, illustrated through the strength of PMI and ISM data on the state of the services sector, as well as buoyant labour market data. This raised questions about the need for any further loosening of monetary policy, and even the potential for higher interest rates while inflation remains sticky at current levels.

Also in the US, the monthly Non-Farm Payrolls figure came in at a blockbuster 256,000 for December, while the unemployment rate also edged lower to 4.1%. While the market could digest data prints, it had to estimate the impact of the flagship policies of the incoming administration under Donald Trump, such as tax cuts and the deportation of illegal migrants – both of which are expected to be inflationary.

We also had comments from Federal Reserve governor Michelle Bowman who expressed concern that current monetary policy in the US may not be as restrictive as some currently think. Adding to the bearish mood music was a 4% increase in the price of oil. As such, over the course of the week there was little to break either the rise in Treasury yields or the steepening of the US curve.

The close correlation between developed markets meant the rise in yields in the US was replicated globally. One bond market that looked increasingly vulnerable was the UK gilt market. The 10-year gilt yield rose 0.24% to 4.84%, while the pound continued to lose ground against the US dollar finishing the week at 1.23 (see **Chart of the week**). While the US Treasury cast a shadow over the gilt market, domestic factors were also at play. There is limited market conviction that UK government policies can deliver growth following a budget that significantly raised the cost of labour. The prospect of reduced tax revenues in a stalling growth environment is likely to translate into an expanding fiscal deficit, while the recent rise in gilt yields has reduced the fiscal headroom for the UK chancellor, Rachel Reeves. The government’s recent tone also suggested a lack of flexibility that may be tested in the near future, as it declared its fiscal rules were “non-negotiable”. There was also a speech from Deputy Bank of England Governor, Sarah Breedon, who while acknowledging that inflation was on a downward path, said the bank should continue to adopt a gradualist approach to easing monetary policy.

Her remarks echoed the “higher for longer” messaging all central banks have recently delivered as they seek to break the back of sticky inflation. In the eurozone, the yield on the German 10-year bund rose 0.17% to 2.6%. In the absence of any other major eurozone data, price action in the bloc reflected that of the US.

Investment grade credit

While the government bond market gently implodes, credit spreads are resolutely unchanged thus far this year, remaining at historically expensive levels.

At this time of very tight spreads it can be easy to lose sight of the fact that credit fundamentals remain extremely robust. JP Morgan notes that the amount of US dollar debt downgraded in 2024 was the least since 2007, despite the market being more than four times larger. In fact, the upgrade/downgrade ratio of 4.7 times is at record levels. Indeed, the share of the lowest-rated investment grade debt (BBB-) has fallen below 10% of the market for the first time since 2012. There is a similar story in Europe with net leverage at historical lows and expected (by our analysts) to remain so through this year. All the while, bank capital is at all-time high levels and we expect asset quality and those capital ratios to move broadly sideways in 2025.

Meanwhile, inflows into the asset class (demand) both in the US and Europe remain robust at a time when yields offer investors an attractive level of income – especially when compared to levels seen as recently as a couple of years ago. The primary market (supply) remains heavy, as is normal at this time of year, with high levels of new issuance both in terms of quantity and number of issuers. The US earnings season will kick off at the end of this week with the "big six" banks the first to report.

High yield credit & leveraged loans

US high yield bond spreads were unchanged over the week, while higher interest rates weighed on total returns as investors absorbed solid economic data and await next week's inflation report.

The ICE BofA US HY CP Constrained Index returned -0.32% through the week, while spreads were 1bps tighter to end at +295bps. According to Lipper, US high yield bond retail funds saw a fifth consecutive (if modest) weekly outflow, with $27 million withdrawn. Leveraged loans are off to a stable start to the year, as firmer economic data reduced the prospects for additional Fed easing and capital market activity is yet to fully return. The average price of the S&P UBS Leveraged Loan Index was stable at $96.6 over the week. Retail loan funds saw a $2.2 billion inflow, the largest since February 2022.

European HY, like other risk assets, was hit last week by the sell-off in core government bond markets. Spreads widened 7bps to 325bps, while yields rose 15bps to 6.3% by the end of the first full week of 2025. Single Bs were the best performing rating band and GBP high yield outperformed EUR high yield. Flows for the start of the year were positive for managed accounts, although ETFs were still posting negative figures almost daily last week. The primary market opened 2025 with €2 billion of corporate issuance from the likes of Lufthansa (hybrids), La Poste (French postal service), Tereos (sugar production) and Kapla Holdings (equipment rental). All were refinancings. Market demand easily absorbed the supply without concern.

In M&A news, tire company Goodyear announced it was selling its Dunlop Brand to Sumitomo Rubber for $701 billion. Proceeds will be used to reduce leverage. Separately, Nidda Health care (Stada) announced they are considering an IPO and have established a Board of Directors to investigate the possibility. Another potential IPO was also mentioned by security firm Verisure with 2026 the mostly likely year for the offering.

Food service company Selecta (CCC+/Caa1), which defaulted during Covid, looks like it will risk restructuring again. They did not pay a semi-annual coupon due on 2 January on its first lien bonds. There is also a maturity wall issue as all of their €1.4 billion bond debt matures in 2026.

Early trading updates have generally confirmed that results are in line with consensus or improved. Exceptions were very market specific, such as Tereos suffering from lower sugar prices.

Structured credit

The US Agency Mortgage-backed Securities (MBS) sector was down 1.06% last week, proving once again that mortgages are primarily trading as a rates product. On the positive side, valuations are compelling on production MBS and extension risk is likely limited such that the convexity profile remains attractive. Demand remains the big question. With fewer Fed rate cuts expected, broad demand may be negatively impacted until there is more certainty around the terminal rate. The story in supply is also likely to remain constrained. The weekly mortgage applications number last week was down 3.5%, which is no surprise with a mortgage rate near 7%.

In the US Asset-backed Securities primary market, four deals priced for around $2.25 billion last week. We expect this to grow in coming weeks with an expected $10+ billion to price this week. All the deals appeared to be well received with robust subscription levels and pricing well through the initial price talk. Secondary activity has been limited versus the elevated volumes we saw in November/December. Credit spreads are expected to remain rangebound as account demand will likely remain focused on primary markets.

Commercial mortgage-backed securities (CMBS) has had a quiet start to the year, which is the norm for this sector due to a large industry event (the CRE Finance Council annual conference) in mid-January. Secondary volumes were low and most of the selling was simply to fund new issue purchases. The only AAA conduit deal that priced this week barely got done at the initial price talk of +85, which is right where 2024 finished. The bid for shorter paper at 5.4% yields is still strong for “buy and hold money” but the “total return” bid was quiet this week following the holiday season.

Asian credit

The JACI posted negative returns of 29bps for the week (IG was -33bps and HY -6bps), largely due to wider Treasuries (-84bps).

The US Department of Defence (DoD) has designated several Chinese companies, including Tencent and CATL (Contemporary Amperex Technology Co Ltd), as being affiliated with the Chinese military. As such, the DoD updated its Section 1260H List to include them.

The inclusion of companies on this list does not impact US investors who can continue to remain invested in them. However, the overhang is that the US Department of Treasury may additionally scrutinise these businesses through the lens of military affiliation. This raises a risk that certain names could be added to the NS-CMIC list (Non-SDN Chinese Military Companies), which would compel US investors to divest from affected companies within 12 months.

Tencent publicly responded by stating it is not a Chinese military company or a supplier to the Chinese military. It plans to work with the DoD to remove any misunderstanding. It is possible that other new entrants to the Section 1260H List might be dropped in the future. There are various precedents: in 2021, the DoD designated Xiaomi as a Chinese Military Company. Xiaomi countered with a lawsuit against the DoD and was eventually removed from the list.

In China, a weak recovery in primary market property sales is leading to another round of liquidity distress for property developers. Certain companies are struggling to generate sufficient cash flow to service the payment of their restructured offshore debt. Sunac, which restructured its offshore notes in 2023, has not ruled out a second restructuring of its offshore debt. Additionally, Logan has revised its restructuring terms with lower cash payouts and entered into an agreement with an ad hoc group of creditors.

Emerging markets

Following Friday's stronger-than-expected US jobs report, emerging market sovereigns were down 70bps in terms of return on the week. Sharply higher US yields triggered a global selloff across EMs. EM local suffered, returning -40bps in US dollar terms for the week.

Key political developments came from Lebanon and Venezuela. High-yield and defaulted government bonds from both nations have been in focus following double-digit returns in 2024. Lebanon led EM gains last week after electing US-backed army commander Joseph Aoun as president, their first president in more than two years. After the record rally on its defaulted bonds in 2024, investors are confident this tentative move towards stability will sustain further gains in highly discounted bonds, which have surged to 16 cents on the dollar from six cents in September.

Meanwhile, thousands of Venezuelans protested the inauguration of Nicolás Maduro as president, which went ahead despite the lack of evidence that he won the vote of July 2024. Questions about the legitimacy of the Maduro presidency are hampering bond prices, which have decreased by 8% (US$9) over the weekend.

Meanwhile, the People's Bank of China has temporarily suspended treasury purchases amid concerns about the rapid slide in treasury yields, which reached a record low of 1.6%.

EM new issuance hit $61 billion last week as many emerging economies seek to lock in current yields ahead of the inauguration next week of Donald Trump. Poland is offering T-bills for the first time since 2020 to help meet record government borrowing needs. Saudi Arabia, Mexico, Slovenia and Hungary have also issued paper in 2025.

Fixed Income Asset Allocation Views

13th January 2025

COLUMBIA THREADNEEDLE INVESTMENTS

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	▪ Post-election enthusiasm has moved spreads to generational tights. Volatility has dramatically fallen since early November and fundamentals remain stable. ▪ **The group remains negative on credit risk overall, with no changes to underlying sector outlooks.** ▪ The Federal Reserve has decreased to policy rate by 75bps since September. 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. ▪ 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 ▪ 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)	EM A$ ¥ 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	▪ Index spreads rallied following the US election, despite Trump's protectionist platform. ▪ The Group remains conservatively positioned and disciplined regarding valuations. ▪ Tailwinds: China stimulus, stronger growth outlook, disinflation, IMF programs. ▪ Headwinds: US trade policy & USD strength, Middle East tensions, higher debt to GDP ratios, wider fiscal deficits, 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	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. ▪ 2024 earnings have been above expectations. Results and commentary from issuers do not indicate fundamental deterioration. ▪ IG analysts expect strong fundamentals and decade-low leverage for 2024 / 2025. ▪ The Group is keeping an eye on post-election industry differentiation.	▪ 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	▪ The current rich valuations are misaligned with a cautious fundamental outlook. ▪ 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. ▪ Weaker outlook for cyclical industrial and consumer sectors. ▪ The Group is conservatively positioned but remains open to attractive high quality relval opportunities, particularly sectors experiencing near-term volatility.	▪ 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	▪ Strong performance in November as volatility fell and broader risk assets rallied. ▪ 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. ▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Neutral outlook because of decent fundamentals and relval in select high quality issues. ▪ RMBS: Spreads near YTD tights. Fundamental metrics, such as delinquencies, prepayments, and foreclosures remain solid overall. Pockets of weakness emerging. ▪ CMBS: Stress continues, particularly in office, floaters, and near-term maturities. SASB delinquencies are rising and there are pockets of opportunity in Single Family Rental. ▪ 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 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 ▪ 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.

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