In Credit

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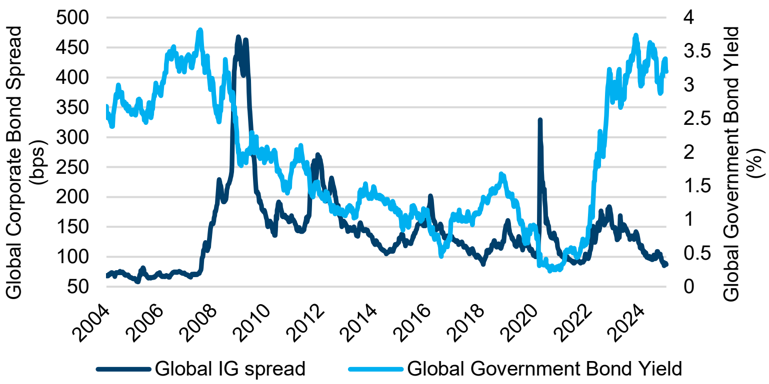
It's the end of the year as we know it

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.38%	23 bps	-2.7%	1.2%
German Bund 10 year	2.24%	13 bps	0.0%	1.1%
UK Gilt 10 year	4.38%	11 bps	-2.4%	-2.9%
Japan 10 year	1.07%	1 bps	-1.0%	-2.9%
Global Investment Grade	84 bps	-3 bps	-0.9%	4.2%
Euro Investment Grade	96 bps	-3 bps	1.3%	5.1%
US Investment Grade	78 bps	-3 bps	-1.9%	3.8%
UK Investment Grade	80 bps	-4 bps	0.0%	2.2%
Asia Investment Grade	119 bps	-5 bps	-0.6%	6.0%
Euro High Yield	312 bps	-8 bps	1.8%	8.8%
US High Yield	268 bps	1 bps	0.7%	8.8%
Asia High Yield	507 bps	-13 bps	0.7%	15.2%
EM Sovereign	290 bps	-10 bps	-0.8%	7.2%
EM Local	6.3%	2 bps	-5.3%	-0.6%
EM Corporate	238 bps	-12 bps	-0.2%	8.3%
Bloomberg Barclays US Munis	3.5%	15 bps	-0.3%	2.0%
Taxable Munis	5.1%	22 bps	-3.1%	1.4%
Bloomberg Barclays US MBS	43 bps	4 bps	-2.6%	1.8%
Bloomberg Commodity Index	237.19	1.3%	-0.7%	5.1%
EUR	1.0489	-0.6%	-5.7%	-4.9%
JPY	153.85	-2.4%	-6.5%	-8.2%
GBP	1.2643	-1.0%	-5.7%	-0.9%

Source: Bloomberg, ICE Indices, as of 13 December 2024. *QTD denotes returns from 30 September 2024

Chart of the week: Global Gvmt Bond Yield vs Global Corporate Bond Spread



Source: Bloomberg, as of 18 December 2024

Macro/government bonds

Concerns about the inflation outlook contributed to a sell-off among US Treasuries last week, with the 10-year yield up 24.4bps to 4.4% (+6.9bps Friday). This marks its biggest weekly jump since October 2023. The two-year yield was also up, by 14.2bps (+5.4bps Friday), to 4.25%. US inflation data were a trigger, raising fears that inflation could prove to be stickily above the Federal Reserve's target.

In Europe, government bond yields also moved higher. The European Central Bank cut rates by 25bps as expected, but there was some disappointment among investors that the tone wasn't more dovish, with President Lagarde describing inflation risks as "two-sided". Yields on 10-year bunds were up 15bps last week (+5.2bps Friday) in their biggest rise since March.

Moody's downgraded France late on Friday night to Aa3 from Aa2 with a stable outlook. Their commentary on future deficits was damning, but this move just brings the rating in line with S&P and Fitch.

In Germany, meanwhile, Chancellor Scholz lost a vote of confidence, which will clear the path to elections that have been pencilled in for 23 February 2025. The key question is whether the CDU will formally signal an openness to reforming the debt brake at this stage. Rumours that CDU leader Merz is open to discussing this point might be intended to create optionality for potential compromises in coalition talks.

We expect to see the Fed cut rates by 25bps on Thursday. There is enormous uncertainty about forecasts for 2025 cuts, ranging from zero to four lots of 25bps. Of course, the incoming Trump presidency is the key to this dispersion.

In other central bank news, the Bank of Japan is meeting on Thursday, with most economists expecting no change, and only a 16% probability of a hike priced. Also on Thursday, in the UK we expect to see the Bank of England keeping the rate at 4.75%. Finally, the Riksbank is expected to cut rates by 25bps on Thursday.

Investment grade credit

Corporate bonds are ending the year characterised as offering little value from a spread perspective, but having yields that remain high enough to entice ongoing investor demand for those seeking income.

All corporate spread markets have seen a substantial compression in spreads this year, with the variance not especially meaningful. In investment grade, euro and GBP markets have tightened by around 28%-29% respectively, while USD spreads are 25% tighter. There is also little to choose from by rating: A and BBB spreads have slightly outperformed higher quality rating bands. Spread curves have steepened with short-dated spreads tightening by more than longer-dated bonds in all markets. By industry sector, we have seen them all tighten, but last year's laggards have become this year's leaders. So, real estate, banking, insurance and financial services have tightened the most, while autos and technology have underperformed.

As we end the year, spreads are between 0.9 (GBP and USD) standard deviations rich to the long-run average (20-years), and 0.5 standard deviations for Europe. When we adjust for changes in rating over the years, and use a common BBB rated global index, the valuation is still around 0.9 standard deviations rich. Some of this is ameliorated by the reduction in duration of bond indices since the sell-off in 2022.

If one adjusts perspective to that of income (cleally an important aspect for many investors) the story is somewhat more constructive. The yield of the global index is around 4.5%, which is nearly 1% higher than the average over the past two decades. If central banks achieve their target of 2% inflation then a 2.5% real yield for a relatively safe asset class ought to remain appealing for investors in our view.

High yield credit & leveraged loans

US high yield bond yields increased over the week amid a rise in US Treasury rates and stable spreads. The ICE BofA US HY CP Constrained Index returned -0.32%, while spreads were unchanged ending at +289bps. The index yield to worst increased 0.17% to 7.16%. According to Lipper, US high yield bond retail funds saw a $257 million outflow for the week, leaving year-to-date inflows at $19.8 billion. In leveraged loans, the average price of the Credit Suisse Leveraged Loan Index again increased slightly to $96.6 – at three-month highs – as the asset class saw continued inflows. This marked the nineteenth consecutive positive weekly return for the asset class.Retail loan funds saw $1.06 billion contributed for a twelth consecutive weekly inflow, increasing year-to-date net inflows to $20.1 billion.

European HY had a solid week returning 0.21% as spreads contracted -8 bps to 312bps, although yields fell only -2 bps to 6.04% (due to the rise in underlying government bond yields). Spreads are now 30bps tighter since the start of December. Decompression continued with CCCs returning a flat performance for the week, with single Bs the best performers. Flows returned to negative (-€116 million) after two weeks of strong inflows had brought +€1 billion into the asset class. Year-to-date, net inflows are €13.1 billion. Outflows were largely seen in ETFs, though managed accounts saw a modest outflow too. Only short-dated EHY experienced inflows. The primary market was subdued with only one syndicate deal, a £400 million green bond from Virgin Media. The big activity was in private placements with a £310 million offering by Motor Fuel and a €1.3 billion refinancing by Grifols (following the decision by Brookfield to not continue with its acquisition plans for Grifols). This brings gross issuance to €118 billion and net issuance to €28 billion.

There were credit rating downgrades this week as Moody's changed pharmaceutical firm Cheplepharm to B3 from B2. Fitch downgraded floor company Victoria to B from B+ saying it reflected the significant deterioration of EBITDA relative to expectations.

There was good news for the real estate sector as Heimstaden said it would be looking to refinance its balance sheet without selling subsidiary Heimstaden Bostad. In other sector news, leisure continues to perform strongly with cruise line RCL, TUI showing strong EBITDA and reporting strong bookings into 2025. Gym centres like Lloyds also continue perform well. The only area with some softness is local theme parks such as those that are part of Merlin group.

In acquisition news, McLaren showed that there is always cash for trophy assets as Bahrain sovereign wealth fund sold its holdings to the Abu Dahbi government's investment company CYVN. The good news is that McLaren has more financial support and now appears to have a plausible business plan.

Structured credit

The US Agency mortgage-backed securities (MBS) sector took a hit last week producing a -1.56% return. Data generally came in line with expectations, however rates bear steepened meaningfully and spreads in current production mortgages gapped a few basis points wider as a result. 15-year MBS outperformed 30-years given less sensitivity to the move. At this point, prepay speeds for December are projected to be around 8% slower given higher mortgage rates and seasonalities, which is good for the sector. We also have the final Federal Open Market Committee meeting of the year this week with an expected 25bps cut in the price. With mortgage valuations fair and mortgages trading with long durations, another cut should be positive but more emphasis will be on the comments made by Chair Powell and the dot plot.

In terms of housing, home price growth slowed for the seventh straight month, falling from 4.3% to 3.9% year-on-year. Inventories continue to grow with mortgage rates around 50bps above recent lows. The homes for sale inventory is now at its highest level since the final quarter of 2020, which will likely cause a slowdown in home price growth in 2025.

Asian credit

In China, the CEWC (Central Work Economic Work Conference) concluded with a readout that reiterates the shift in the monetary and fiscal policy stance. Prior to the conference, the Politburo raised its stance on monetary policy to “moderately accommodative” (versus “prudent”) and its fiscal policy to “more proactive” (versus “proactive”). As background, the “prudent” monetary policy has been in place since 2010 and the “more proactive” fiscal policy was last used in July 2020 during the Covid pandemic. The CEWC readout highlights that more central and local government special bonds will be issued, the fiscal deficit ratio will be raised and more pledges to lower the RRR (reserve requirement ratio) and other policy rates. The government also communicated more emphasis on driving up domestic demand and consumption in 2025. The numerical targets (GDP, fiscal budget) will be released during the “Two Sessions” in March, ie the annual NPC (National People’s Congress) and CPPCC (Chinese People’s Political Consultative Conference).

Axiata Group will merge its 66.2%-owned XL Axiata with SmartFren, owned by Sinar Mas. The new company, XLSmart, will be jointly owned by Axiata Group and Sinar Mas with a 34.8% stake each, with the rest (30.4%) publicly owned. As part of this transaction, Axiata Group will receive proceeds of up to US$475 million, comprising $400 million at the close of transaction, which is expected by 15 April 2025, and $75 million at the end of year one. Through this merger, Axiata Group will strengthen its market position as the third largest mobile operator, with around 27% of local market share, and larger spectrum holdings.

In South Korea, Moody’s downgraded LG Chem’s ratings a notch to Baa1 and maintained its negative outlook, which reflects the elevated financial leverage over the next one to two years. Moody’s also affirmed the Baa1 rating (negative outlook) of LG Energy Solutions (82% owned by LG Chem), which accounts for the one-notch ratings uplift on the possibility of parental support from LG Chem in times of distress.

Emerging markets

Emerging market bond spreads ended the week 9.41bps tighter and returned -0.76% in US dollar terms. EM local returned -0.19% over the week. New issuance came from China, Sri Lanka, Chile, Bangladesh and Romania.

Following Saturday's impeachment vote, South Korea's Constitutional Court will decide whether to approve President Yoon's removal from office. Yoon has stated he intends to retain power and fight in court. Korea's financial authorities vowed to insulate its markets from political turmoil as the Korean won initially rallied after Yoon's impeachment before correcting its earlier gains.

Following China's much-awaited annual CEWC last week (see Asian credit), investors craved more detail on how the economy will be boosted. As usual, key growth and policy targets will be released at the NPC meeting in March. China's recovery remains fragile following stimulus measures. Retail sales strengthened by 3% thanks to subsidies but remained below the 5% target.

Brazilian markets fell on Friday, capping a turbulent week after the real posted some of its sharpest gains (rising 1.6% after a 100bps interest rate hike) and losses (-1.4% after a cabinet member confirmed 79-year-old President Lula's re-election bid in 2026). As the central bank battles accelerating inflation, and following the president's sudden health crisis and brain surgery, the central bank stepped in with its first FX spot auction since August and sold $845 million.

This week, 22 central banks will meet across the globe to discuss interest rates and monetary policy. Key meetings will be in Mexico, Chile and Colombia. Markets expect a 25bps cut from Banxico as inflation continues to ease, albeit remaining above target. Chile's central bank, Banco Central de Chile, is likely to maintain its pace of easing with a 25bps cut alongside Colombia's BanRep which is expected to cut by 50bps.

Responsible investments

Last week, Goldman Sachs Group announced it was leaving the UN Net-Zero Banking Alliance. And earlier this year it was announced that the asset management arm of Goldman Sachs would be leaving the Climate Action 100+ initiative. Reasons weren't publically given, but it is presumed that it is due to the regulatory reporting requirements put upon those companies involved in each group.

Growth in the labelled bond market this year has been immense, with the total issuance comfortably over $1 trillion, according to Bloomberg. Despite the anticipated volatility being felt when entering 2024, issuers continued to bring new green, social, sustainable and sustainability-linked bonds to the fixed income market around the world. Since their existence, there are now more than $5.8 trillion of labelled bonds.

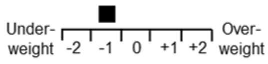
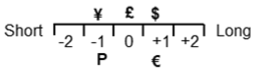
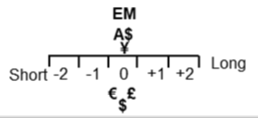
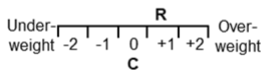
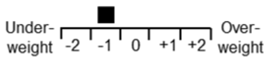
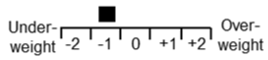
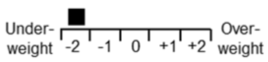
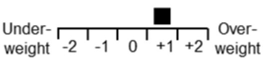
This is the last **In Credit** publication of the year.

We wish our readers Season's Greetings

Fixed Income Asset Allocation Views

16th December 2024

COLUMBIA THREADNEEDLE INVESTMENTS

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk		▪ Post-election enthusiasm has moved spreads to generational tights. Volatility has decreased since October and fundamentals remain stable. ▪ **The group remains negative on credit risk overall and downgraded High Yield Corporates to the most negative outlook due to rich valuations.** ▪ 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)		▪ 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 rallied following the US election, despite Trump's protectionist platform. ▪ The Group remains conservatively positioned and disciplined regarding valuations, reducing exposure where risk premium has compressed materially. ▪ 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		▪ Spreads are at the tightest levels since 1998. Current valuations limit spread compression upside and provide little compensation for taking additional risk. ▪ The group is keeping an eye on post-election industry differentiation. ▪ 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.	▪ 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		▪ The group has downgraded High Yield because the extremely 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.	▪ 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		▪ Spreads have backed up following the election and November FOMC ▪ 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 near YTD tights. Fundamental metrics, such as delinquencies, prepayments, and foreclosures remain solid overall. Pockets of weakness emerging. ▪ CMBS: We are in the early stages of the office deterioration story. Outside of office, floaters and near-term maturities, 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 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.