COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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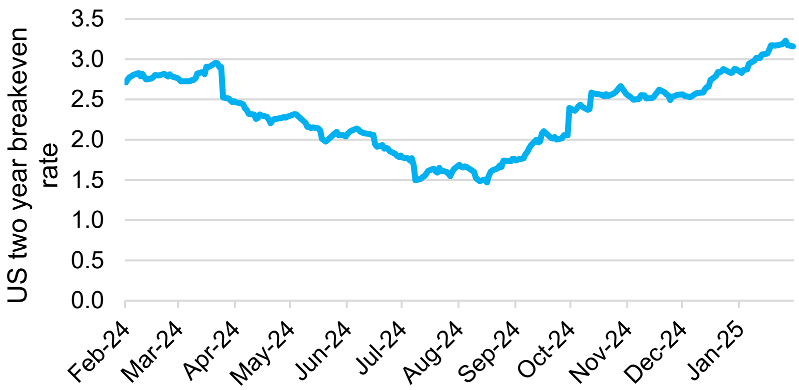
Inflating inflation fears

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.40%	-8 bps	1.4%	1.4%
German Bund 10 year	2.48%	5 bps	-0.3%	-0.3%
UK Gilt 10 year	4.56%	6 bps	0.7%	0.7%
Japan 10 year	1.43%	7 bps	-1.7%	-1.7%
Global Investment Grade	83 bps	0 bps	1.3%	1.3%
Euro Investment Grade	86 bps	-2 bps	0.8%	0.8%
US Investment Grade	81 bps	1 bps	1.6%	1.6%
UK Investment Grade	77 bps	0 bps	1.1%	1.1%
Asia Investment Grade	111 bps	-2 bps	1.2%	1.2%
Euro High Yield	295 bps	-13 bps	1.6%	1.6%
US High Yield	278 bps	16 bps	1.6%	1.6%
Asia High Yield	524 bps	-8 bps	1.5%	1.5%
EM Sovereign	292 bps	6 bps	2.0%	2.0%
EM Local	6.3%	0 bps	3.6%	3.6%
EM Corporate	244 bps	2 bps	1.7%	1.7%
Bloomberg Barclays US Munis	3.6%	-2 bps	0.9%	0.9%
Taxable Munis	5.1%	-5 bps	1.8%	1.8%
Bloomberg Barclays US MBS	32 bps	-2 bps	1.7%	1.7%
Bloomberg Commodity Index	257.42	1.0%	8.8%	8.8%
EUR	1.0483	-0.3%	1.0%	1.0%
JPY	149.51	2.0%	5.3%	5.3%
GBP	1.2646	0.4%	0.9%	0.9%

Source: Bloomberg, ICE Indices, as of 21 February 2025. *QTD denotes returns from 31 December 2024

Chart of the week: Rising short-term inflation expectations in the US



Source: Bloomberg, as of 24 February 2025

Macro/government bonds

A major story last week for the eurozone bond market concerned the outlook for monetary policy. In an interview with the Financial Times, senior European Central Bank policy maker Isabel Schnabel raised the question over just how restrictive monetary policy in the eurozone had become given the recent decline in eurozone interest rates. She pointed to the elevated and sticky level of eurozone services inflation and argued that now might be the time to think about pausing monetary easing. Eurozone bond yields moderately rose on the back of this, with the German 10-year oscillating within a 9bps trading range during the course of the week.

The dynamics for the eurozone bond market altered utterly last week as Germany reached another “zeitenwende” or historic turning point. In federal elections on Sunday, the conservative CDU/CSU came first on 28% of the vote. One of the themes in the election was the ‘debt break’. This was designed to limit structural deficits by forcing successive governments to target balanced budgets. The downside of the debt break, however, is that it has restricted infrastructure investment as well as spending in areas such as defence. The new conservative-led coalition government will have to get a two-thirds majority in the German parliament to overturn the debt break, but having once been unthinkable this is now a more likely outcome. Once overturned, the spigot of spending in Germany can open, leading to higher issuance and structurally higher yield levels. This trend is unlikely to be restricted to Germany, as other European countries will have to step up to the crease if they are to prepare to deal with an emboldened Russia. Comments from US president Donald Trump and other senior US policymakers that Europe would have to pay for its own defence and could not continue to rely on the US provided a backdrop for the election.

In the US, we had publication of the Federal Reserve minutes. However, there were few morsels of interest for market participants. The report pointed to a stable labour market and robust consumer spending. The central message was one of caution as policymakers struggle to understand the likely evolution of US inflation (see **Chart of the Week**) and the impact of the policy agenda purised by the new US administration. One area of focus for market participants was the recommendation that the pace of balance sheet run-off should slow until the US debt limit has either been raised or suspended. We also saw the publication of the flash PMI estimate for the US, which revealed a downturn in services and an upturn in manufacturing. Rather than renewed growth in manufacturing, it appeared to reflect front-running by firms before the implementation of tariffs. Overall, US Treasury yields were lower, but volatility remained muted with yields at the 10-year sector trading within a 12bps range.

In the UK, inflation came in stronger than expected at 3% annualised for January due to higher transport and food costs. The flash PMI report pointed to stalling growth and rising price pressures, which raised the prospect of stagflation. The report also revealed upwards selling pressures in goods and services, as firms increase prices to take account of higher labour costs. Thanks to this inflation spurt the UK underperformed Europe and the US, while its curve continued to steepen.

Investment grade credit

Global investment grade spreads were little changed over the past week but are 6% (or 5bps) tighter so far this year.

In 2025, the euro market has significanly outperformed its US dollar cousin, with spreads around 15% tighter compared to just a 1% tightening in the US market, according to data from ICE indices. These moves reflect changes in swap spreads in the respective markets, as both attempt to absorb significant investor demand at present yields.

At an industry level, the stand out sector has been banking, where spreads are 10% tighter globally amid strong earnings. Credit curves have steepened this year with shorter-dated bonds outperforming longer-maturity debt.

High yield credit & leveraged loans

US high yield bond valuations were stable over the week as the market absorbed a heavy earnings calendar, ongoing fund inflows and limited new issuance. The ICE BofA US HY CP Constrained Index returned -0.01%, while spreads were 13bps wider and ended the week at +293bps. According to Lipper, US high yield bond retail funds saw a $1.2 billion inflow over the week. This marked a fifth consecutive weekly inflow and brought year-to-date net flows to $3.7 billion. Leveraged loan prices were unchanged at $96.4 over the week with light capital market activity and strong fund inflows supporting the market. Retail floating rate funds saw a seventh consecutive inflow of more than $1 billion, with $1.6 billion contributed. Year-to-date floating rate fund inflows now total $13.1 billion.

European HY returned 0.13+% last week. Spreads contracted most since the start of the year, tightening 13bps to 295bps, while yields held steady at 6%. Technicals were the main driver given the absent corporate primary market, which is expected to remain quiet for another two weeks, and continued large flows into the asset class. Managed accounts continued to see net inflows while ETFs saw net outflows. Another force supporting European high yield has been fewer fixed income alternatives for yield as deposit rates due to ECB rate cuts, while rising hedging costs make overseas investments less attractive. The latter point is likely to continue given the expectation of further ECB rate cuts, while the Fed looks set to hold.

It was a busy week on the credit rating front. UK gaming company Evoke (888) was cut by Moody's to B2 from B1 on the back of weaker than expected financial performance and the rating agency's comment of a constrained UK consumer. Levi Strauss became the latest rising star as Fitch upgraded the firm's IDR to BBB- from BB+. Victoria, the flooring company, was downgraded by Moody's to Caa1 from B3 due to increased refinancing risk considering two maturities due in 2026. Finally, French board game company Asmodee received its official Fitch rating of BB, which was better than the expected BB- rating.

In other news, the much-beleaguered Thames Water was thrown a lifeline as a £3 billion rescue loan was approved by a UK judge. The money will come from existing senior creditors and allows the business to continue operations beyond the end of March. The issuer has £16 billion of debt. This came as private equity firm KKR made a £4 billion equity bid for Thames Water.

Structured credit

The agency mortgage-backed securities market posted a 47bps gain last week, with the 30-year outperforming the 15-year week-on-week as rates rallied on weaker consumer sentiment. Spreads were flat to slightly tighter and volatility modestly declined.

In commercial mortgage-backed securities, the bid for duration started to evaporate over the week. A 10-year conduit deal widened 6bps on the AAA bond, which pushed the market to new recent wides. We are still seeing decent demand for 5-year paper in the secondary market, but 10-year trading remained quiet. There has been a material increase in fixed rate SASB new issuance, which likely accounted for the money that would have been allocated to generic conduit CMBS, forcing conduit paper to widen. Three conduit deals in a row have had to widen the AAA from initial price talk in order to get done.

In related news for the mortgage sector, we expect that Mark Calabria, the newly appointed interim head of the Consumer Financial Protection Bureau and former FHFA head, will bring another voice advocating for FSE privatisation, a topic we will be hearing a lot about in 2025.

Asian credit

The Trump administration has released a memorandum that lays out various actions against China on investments, trade and strategic sectors. Among the key points was news that the Committee on Foreign Investment in the United States (CIFUS) will restrict Chinese investments in strategic US sectors such as technology, healthcare, critical infrastructure, energy, raw materials and others. The US will also review whether adequate financial auditing standards are maintained for companies covered under the Holding Foreign Companies Accountable Act (HFCAA). The variable interest entity and subsidiary structure that Chinese companies use to trade on US stock exchanges will also be reviewed.

The USTR (United States Trade Representative) also announced potential trade actions related to the Section 301 investigation of China's attempt to dominate the maritime, logistics and shipbuilding sectors. The proposed trade actions include the levy of fees on Chinese-operated vessels or Chinese-built vessels that enter US ports.

Alibaba's strong Q4 results were supported by its core business Taobao/Tmall, while AI-related demand drove steady momentum in its cloud business. Alibaba will continue to invest heavily in cloud and AI infrastructure with its guidance that capex over the next three years will be more than that of the past 10 years. For context, Alibaba spent around CNY270 billion in capex over the past decade, which implies it could spend at least CNY90 billion (around $12.5 billion) annually over the next three years. By contrast, Baidu's quarterly results were weak due to its online marketing business and slow approach in monetising AI-generated results in its search functionality.

Emerging markets

The key news in emerging markets focused on a potential ceasefire deal between Russia and Ukraine. Sovereign bonds returned 0.02% in US dollar terms this week, while local markets returned 0.10%. Local currency debt underperformed and contributed -0.02% to EM local returns.

Last week, US secretary of state, Marco Rubio, met with Russian foreign minister, Sergey Lavrov, to discuss a potential settlement on Ukraine – despite there being no Ukrainian or European representation at the meeting. Ukraine-US relations appear tenuous after Ukraine rejected President Trump's request to transfer 50% of their mineral rights to the US as compensation for the military and financial aid provided by the Biden administration. This led to a social media dispute between Ukraine president, Volodymyr Zelenskiy, and Trump. Ukraine's US dollar bonds underperformed by 3% on the week as markets followed the rapid pace of new developments.

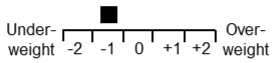
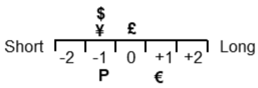
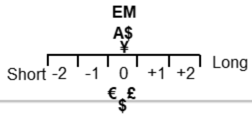
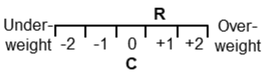
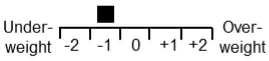
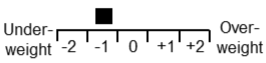
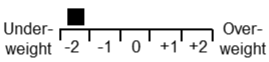
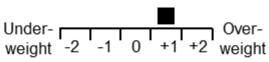
In an unusual move, South Africa delayed its 2025 budget by three weeks to 12 March. This comes after a reported disagreement between members of the coalition government over a 2% VAT increase. Bonds and FX remained mostly unchanged in the aftermath.

There was a host of new issuance last week, with Qatar, Brazil, Mongolia, Uzbekistan and the Dominican Republic issuing sovereign bonds. Key central bank meetings will be held by three countries, all of whom are expected to hold rates: Hungary (expected to hold at 6.5%), Thailand (expected to hold at 2.25%) and the Dominican Republic (expected to hold at 5.75%).

Fixed Income Asset Allocation Views

20th February 2025

COLUMBIA THREADNEEDLE INVESTMENTS

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk		▪ Spreads remain near generational tights to start the year. Volatility remains below the early November peak 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 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. ▪ 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, and remain at those cycle tights. ▪ The Group remains conservatively positioned and disciplined regarding valuations, reducing exposure where risk premium has compressed materially. ▪ Tailwinds: Strong primary market and growth outlook, disinflation, IMF programs. ▪ 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. ▪ EM policy makers constrained by currency pressure; rates remain tight. ▪ Fiscal concerns leak into local risk premia.
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. ▪ 2024 earnings and ungrades 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		▪ 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. Prefer loans due to cheaper relative valuations and strong market technicals.	▪ 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		▪ Agency MBS ended 2024 with positive excess return and spreads 11bps tighter YoY. ▪ 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		▪ Neutral outlook because of decent fundamentals and relval in select high quality issues. ▪ RMBS: Spreads near 2024 tights. Fundamental metrics, such as delinquencies, prepayments, and foreclosures remain solid overall. Pockets of weakness emerging. ▪ 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. ▪ CLOs: Demand remains high given relative spread to other asset classes; strong technicals. 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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