In Credit

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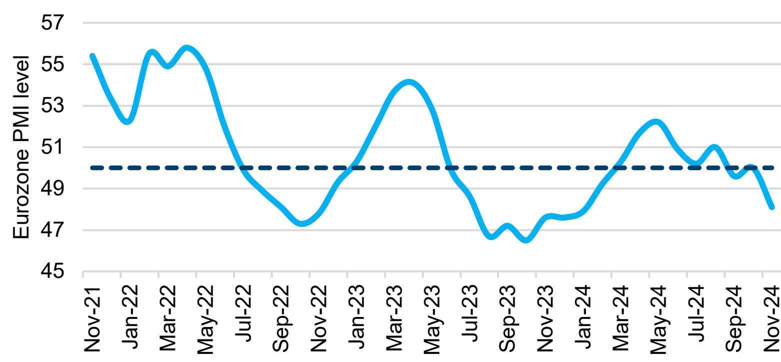
A tale of two economies

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.35%	-9 bps	-3.1%	0.8%
German Bund 10 year	2.24%	-12 bps	-0.2%	0.9%
UK Gilt 10 year	4.37%	-10 bps	-2.2%	-2.8%
Japan 10 year	1.08%	0 bps	-1.5%	-3.3%
Global Investment Grade	88 bps	2 bps	-1.6%	3.5%
Euro Investment Grade	105 bps	7 bps	0.6%	4.4%
US Investment Grade	80 bps	0 bps	-2.5%	3.1%
UK Investment Grade	87 bps	2 bps	-0.7%	1.5%
Asia Investment Grade	124 bps	5 bps	-1.0%	5.5%
Euro High Yield	349 bps	15 bps	0.9%	7.9%
US High Yield	261 bps	-11 bps	0.2%	8.2%
Asia High Yield	508 bps	10 bps	0.0%	14.5%
EM Sovereign	297 bps	-2 bps	-1.7%	6.2%
EM Local	6.3%	-4 bps	-5.8%	-1.2%
EM Corporate	241 bps	4 bps	-0.8%	7.6%
Bloomberg Barclays US Munis	3.6%	-3 bps	-0.6%	1.7%
Taxable Munis	5.1%	-1 bps	-3.4%	1.1%
Bloomberg Barclays US MBS	39 bps	-4 bps	-2.8%	1.6%
Bloomberg Commodity Index	239.06	3.1%	-0.7%	5.1%
EUR	1.0480	-1.2%	-6.4%	-5.6%
JPY	154.29	-0.3%	-7.2%	-8.9%
GBP	1.2564	-0.7%	-6.3%	-1.6%

Source: Bloomberg, ICE Indices, as of 25 November 2024. *QTD denotes returns from 30 September 2024

Chart of the week – Eurozone PMI slides ever lower



Source: Bloomberg, as of 25 November 2024

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Macro/government bonds

Last week, the US Treasury market experienced a yield curve flattening trend, as short-dated yields rose and longer-dated yields fell.

Following the Trump election, markets have adopted a “higher for longer” mentality as they look towards an agenda of lower corporate taxes, higher tariffs and a crackdown on illegal migration. Before last week, the market had already come a long way in terms of adjustment; longer-dated yields had the space to edge lower, as more clarity emerged over Trump’s economic team. Howard Lutnick, CEO of financial services firm Cantor Fitzgerald, became Commerce Secretary, while Scott Bessent, CEO of global macro investment firm Key Square Group, became Treasury Secretary. The market regarded both as befitting of the term “adults in the room” and more likely to adopt a more cautious approach to policy implementation.

The prospect of a pro-growth agenda at a time when the economy is already performing strongly caused the market to pare back its expectations of interest rate cuts, exerting upward pressure on front-end yields. The probability of a December quarter point interest rate cut fell from just over 40% to 36%. Federal Reserve speakers gave the collective impression of a cautious easing stance. Their key messages were that inflation, particularly in the services sector, remains too high, although interest rates should continue to fall throughout 2025 as policymakers seek out the neutral level – the point at which monetary policy neither stimulates nor dampens demand. We also had the publication of PMI data on the state of the US economy for November, with the services PMI figure reaching a 32-month high of 57 while the manufacturing PMI figure reached a four-month high of 48.8.

In Europe, in contrast, we saw a modest bull steepening as shorter-dated interest rates fell more than longer-dated rates. The market continues to price one rate cut by December in the eurozone, with the prospect of four further cuts by June 2025. The context for the eurozone bond market is a weakening economy: the PMI survey for the eurozone for November came in at 49.2 for services and 45.2 for manufacturing. Sharp increases in services’ input prices were partially mitigated by falling input prices in the manufacturing sector.

While the eurozone economy appears to be diving deeper into recession **(see Chart of the Week)**, political instability has also weighed on eurozone bond valuations. The French government remains unsteady given the fragility of its political coalition, while the German government has recently dissolved, with fresh elections due to take place in the new year. Messaging from European Central Bank policymakers was dovish – all are calling for an easing in the restrictive stance over the coming months. The unknown for the eurozone bond market remains the magnitude of US tariffs, which will have a particularly negative impact for export-orientated economies such as Germany, while ongoing euro weakness could risk importing inflation into the eurozone, thereby creating a headwind for any ECB easing strategy.

Investment grade credit

Investment grade credit markets have been a little weaker in the last week and post the US election result.

Weakness has been more pronounced in the euro market where spreads widened by seven bps last week (the US dollar market spread was unchanged), according to data from ICE Indices.This in turn reflected higher issuance levels against a background of weak business confidence (PMIs), which remain in recessionary territory especially in France and Germany. The European auto sector also remains in the doldrums with Bosch’s auto division reporting job losses and the industry facing strike action.

High yield credit and leveraged loans

European high yield had a sideways week, even as credit spreads widened 15bps to 349bps, since yields only rose 3bps to 6.3% due to the sharp fall in underlying government bond yields. Demand for EHY returned after the previous week's pause, with €557 million added to the asset class, all into managed accounts. The primary market also restarted with €2.52 billion in new issues, including into the HY universe (food/pharamceutical firm Roquette Freres).

Credit rating news was sombre with a number of downgrades announced, including a default. MPW was downgraded to CCC+ from B by S&P given the continued uncertainty on the refinancing options and the real estate firm's ability to raise capital to cover upcoming maturities. Meanwhile, Ardagh Metal Packaging was downgraded by Moodys, with the senior secured moved from Ba3 to B2 and subordinated moved from Caa1 to Caa2. The rating agency cited the slower than expected deleveraging trajectory and increased debt. Kem One was also downgraded two notches to CCC+ by S&P. The credit rating agency anticipates the company will need an equity injection to cover 2025's cash needs. In default news, debt collector Intrum was downgraded to D by Fitch following the previous week's bankruptcy filing. Fitch also said it would likely re-rate Intrum at CCC or a low B rating following the upcoming restructuring. Finally, there was news of more utility sector weakness as Southern Water received another downgrade, taking it only one notch away from HY.

There was some positive news for the auto sector as European car sales for were up 1.1% in October, after three straight months of lower sales. This brought European year-to-date car sales up 0.7%. Also, there was more progress in disposals in the real estate sector as Citycon announced the sale of an asset in Tallinn, Estonia. The all cash deal comes at a 9% discount to book, coming in largely in line with expectations. In other real estate news, £900 million of new equity was offered by Brookfields for Canary Wharf to help refinance a number of upcoming bond maturities.

Asian credit

The JACI index posted almost flat returns over the week, with positive Treasuries offsetting wider spread levels.

The US Department of Justice (DoJ) and Securities and Exchange Commission indicted eight individuals on charges of involvement in making bribes to Indian government officials for power purchase agreements in solar energy projects of Adani Green Energy Limited (AGEL). The individuals include Gautam Adani (Chairman and promoter of the Adani Group), Sagar Adani (Executive Director at AGEL), and Vneet Jaain (former CEO of AGEL, July 2020-2023). The other five were related to Azure Power and its major shareholder (CDPQ). For now, only the individuals are indicted, not the two companies.S&P has lowered the outlook on multiple Adani entities to negative given the potential impact of the indictment on the funding access and the governance risks for the larger Adani Group. The revision impacts Adani Electricity Mumbai, Adani Ports and Adani Green Energy Restricted Group 2 (AGEL RG2).

Elsewhere, Xiaomi reported good Q3 results. While the gross margin in the smartphone business was soft due to component costs, there remains scope for improvement around lower input costs. Additionally, the quarterly losses of its new businesses, specifically around EV, have narrowed. Xiaomi raised its EV delivery target for 2024 to 130,000, up from 120,000).

Baidu reported a weak Q3 due to slow monetisation of generative AI content and the softness in advertisement revenue. Baidu continues to focus on user experience and engagement in pushing out this content, instead of prioritising monetisation and profitability.

Emerging markets

Despite volatility in the global economy, emerging market debt remained relatively resilient last week, with spreads ending 4bps tighter. This was supported by credit ratings upgrades for sovereigns including Brazil, South Africa and Turkey.

Momentum in the primary market continued as Turkey, South Africa, Egypt and Indonesia tapped the markets. Global monetary easing continues, and many EM governments are expected to cut in December. Following the lowest inflation print in four years, South Africa cut rates by 25bps for the second consecutive time, taking the key rate to 7.75%. This follows the country’s annual inflation rate falling to 2.8% in October, below the central bank’s inflation target of 3%-6%.

As mentioned above, the Adani Group's $600 million bond sale was scrapped following bribery allegations against the CEO, Gautam Adani. The $250 million bribery case has once again brought the Adani name into the spotlight. The credit had actually bounced back impressively following the January 2023 Hindenburg short-selling report.

In the Middle East, Saudi Aramco announced plans to undertake more debt to fund company growth, signalling weaker technicals for bonds in 2025. Aramco is grappling a slump in crude oil prices while oil production is almost nearing 2021 lows.

Following its budget last week, Mexico is targeting significant fiscal consolidation for 2025 with a fiscal deficit target of 3.9%. Banxico may have room to cut interest rates for a fourth consecutive meeting in December. However, investors remain cautious on the name in the face of Trump's impending presidency.

Fixed Income Asset Allocation Views

25th November 2024

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 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)	¥ £ $ 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, 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	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. ▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ 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	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: 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.

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