In Credit

30 September 2024

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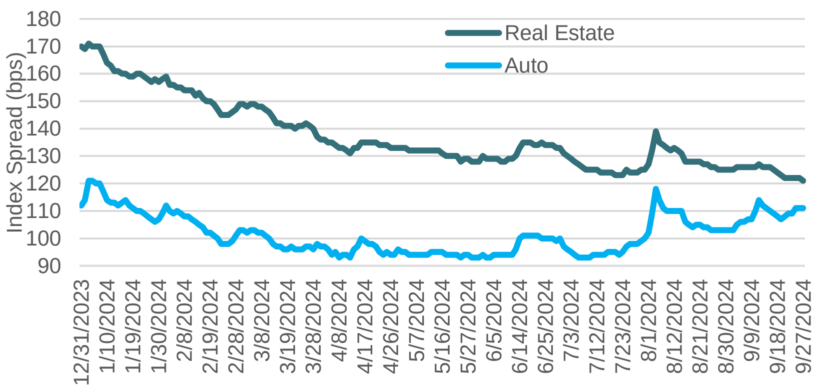
Emergency Stop!

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	3.76%	2 bps	5.1%	4.2%
German Bund 10 year	2.13%	-8 bps	3.1%	1.0%
UK Gilt 10 year	4.00%	9 bps	2.5%	-0.5%
Japan 10 year	0.86%	1 bps	1.7%	-1.6%
Global Investment Grade	99 bps	0 bps	4.9%	5.2%
Euro Investment Grade	115 bps	3 bps	3.2%	3.8%
US Investment Grade	92 bps	-1 bps	5.9%	6.0%
UK Investment Grade	97 bps	-1 bps	2.3%	2.3%
Asia Investment Grade	153 bps	0 bps	3.9%	6.5%
Euro High Yield	363 bps	5 bps	3.5%	6.9%
US High Yield	314 bps	-1 bps	5.2%	8.0%
Asia High Yield	533 bps	-22 bps	4.0%	14.1%
EM Sovereign	329 bps	-1 bps	6.0%	8.0%
EM Local	6.1%	0 bps	9.2%	5.1%
EM Corporate	270 bps	-3 bps	4.5%	8.5%
Bloomberg Barclays US Munis	3.3%	-1 bps	2.7%	2.2%
Taxable Munis	4.6%	3 bps	6.2%	4.9%
Bloomberg Barclays US MBS	40 bps	-1 bps	5.9%	4.8%
Bloomberg Commodity Index	238.54	2.2%	0.6%	5.7%
EUR	1.1175	0.0%	4.2%	1.1%
JPY	142.88	1.2%	13.1%	-0.8%
GBP	1.3386	0.4%	5.8%	5.1%

Source: Bloomberg, ICE Indices, as of 27 September 2024. *QTD denotes returns from 30 June 2024.

Chart of the week 1 – Auto and real estate spreads



Source: Bloomberg, as of 30 September 2024.

Macro / government bonds

Last week saw a broad yield curve steepening trend across core fixed income markets as investors looked towards further interest rate cuts.

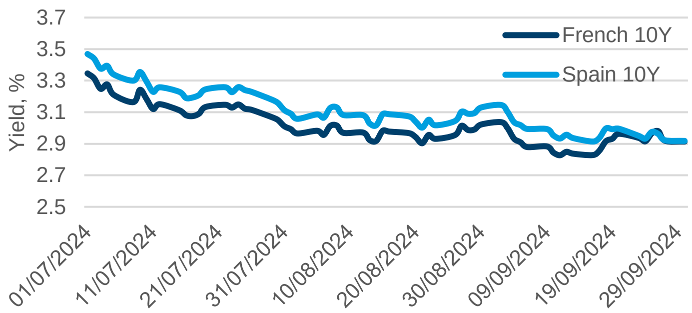
One debate that refused to go away was the probability of a further 50bps cut by year end. Pricing in the swaps market currently reflects 2.8 quarter point cuts by year end, split between the November and the December meetings. Consensus in the market grew around the narrative that the US Fed's decision to cut by 50bps at its September meeting was about supporting the labour market, which has shown signs of cooling. It was not a harbinger of recession. To justify current interest rate levels, the market needs a clearer picture on employment to emerge.

The S&P Global Flash US Composite PMI reports, which collects data on the US economy came in at 55.4 – still in expansionary territory. The report pointed to a decline in services jobs, which were largely linked to difficulties replacing leavers. Manufacturing jobs, in contrast, were cut at a pace not seen since June 2020. Similar echoes were found in the Conference Board Consumer Confidence report, which tracks consumer attitudes and expectations. The Consumer Confidence Index edged lower from 105.6 in August to 98.7 in September – a figure below 80 usually indicates a recession ahead. Consumers' appraisal of the labour market deteriorated in September; those who said jobs were harder to get rose from 17% to 18.3%, while those who said that jobs were plentiful declined from 32.7% to 30.9%. The report pointed to the 'goldilocks' scenario of a soft landing with low inflation, which the Fed has been trying so hard to engineer. Initial claims and continuing claims came in a little softer than expected.

With the market focused on the labour market, data on inflation – the battle that seems to have been largely won – continued to track closer to the 2% target. Headline inflation (PCE) came in at 0.1% for August, equating to an annualised rate of 2.2%; core inflation (Core PCE) also came in at 0.1% for August, equating to an annualised rate of 2.7%. Although the market focused last week on macroeconomic data, one factor that will increasingly impact positioning the US Treasury market is the upcoming US presidential elections. We saw a hint of this as long-dated US Treasury yields remained under upward pressure. As investors start to focus on the outlook for fiscal policy under either candidate, market chatter about term premia should increase.

In Europe, the Swiss National Bank (SNB) cut interest rates by 0.25% to 1%. SNB policymakers admitted that further cuts in SNB policy may become necessary to ensure price stability in the medium-term, as inflation continues to fall, while they also want to minimise upward pressure on the Swiss Franc versus other major currencies. The other big story in Europe concerned France. Spain's 10-year bond yield passed through that of France. The move while not quite historic marked a moving of the pieces in the eurozone bond jigsaw. Spain had previously been regarded as eurozone periphery by investors while France had been regarded as semi core – a higher-quality sector of the eurozone bond market. The relative strength of the Spanish economy, coupled with a rising deficit in France and political gridlock, accounted for the move.

Chart of the week 2: France vs. Spain 10-year government bond yields



Source: Bloomberg, as of 30 September 2024.

In Asia, we saw the opening of the monetary and fiscal policy spigots, as China tries to kickstart growth, and support its troubled property sector. This included liquidity support for stocks, a reduction in bank's reserve requirements, and talk of a potential 1 trillion yuan ($142bn) injection into its biggest state banks to increase their capacity to lend. The amount of stimulus, which could prove inflationary, had a negative impact on Chinese Government bonds.

Investment grade credit

Global investment grade spreads were little moved last week and as we head into quarter end.

September looks like being a modestly constructive month with spreads ending the month a few basis points tighter. Over the third quarter, spreads began at 103bps before widening to 116bps on worries about recession in the US, then tightening back below 100bps as interest rate cuts came through in both Europe and the US and growth seemed more assured – at least in the US. These moves leaves the market trading well below both five-and-20-year averages, all according to data from ICE indices.

Market wise, both euro and US dollar markets saw spreads around 3-4% tighter in Q3, although the euro market has tightened more in 2024 with spreads 15% tighter compared to 12% for the US dollar market. In both regions credit curves have steepened this year with shorter-dated bond spreads narrowing more than their longer maturity relatives.

Sector wise, this year has seen real estate spreads tighten by nearly 30% followed in strength by banking and insurance. It has been much 'harder yards' for media and auto sector bonds where spreads are barely moved compared to the end of 2023. Indeed, last week ended with VW, Stellantis and Aston Martin (HY) all issuing profit warnings. This follows on from rivals BMW and Mercedes who also both reduced margin expectations – **(spreads are detailed in chart of the week 1).**

High yield credit & leveraged loans

The rally in US high yield bond paused this week amidst mixed fund flows and a still active new issue calendar. The ICE BofA US HY CP Constrained Index returned 0.12% and spreads were unchanged. The index yield-to-worst was stable at just under 7%. According to Lipper, US high yield bond retail funds saw a $73m inflow for the week, a material slowdown from the prior week's $1bn+ inflow. The average price of the Credit Suisse Leveraged Loan Index declined slightly to $95.6 amidst an active new issue market and stable flows. Retail loan funds saw their first weekly inflow since late-July with a $313m contribution over the week.

European high yield had another solid week, supported by lower underlying government bond yields. The asset class returned 0.3% as yields fell 7bps to 6.38% even as spreads widened 5bps to 363bps. Higher-rated BBs underperformed single Bs and CCCs (both of which returned 0.44%.) On a spread basis, interestingly, single Bs only widened 2bps versus the 7bps widening seen for both BBs and CCCs. Inflows continue to rise with this week seeing €342m come via both ETFs and managed accounts. In primary markets, it was another solid week with €2.45bn of new issuance across four issuers, a mix of BBs and single Bs, and well over subscribed.

In credit rating news, Fitch downgraded TalkTalk to RD (restricted default) from C after the grace period ran out on its missed interest payment in September. In other news, S&P downgraded Thames Water from BB to CCC+. Moody's was even more aggressive and downgraded the water utility 3 notches from Ba1 to Caa1. The rating agency also downgraded Valeo back to Ba1 rating which takes away its split rating.

In sector news, the outlook for autos continues to deteriorate. Forvia, the French auto supplier, and ZF, the German auto supplier, both announced they have cut their 2024 FY guidance on the back of an uncertain European market. Aston Martin reduced its outlook on supply chain issues.

In issuer news, Grifols may have a new problem. The Spanish regulator has made the company subject to sanction proceedings related to market manipulation involving Grifols shares for omitting financial information for the last three years. This refers to information already well known (Grifols used alternative performance measures calculations, which were earlier noted and mildly criticized by the regulator but did not warrant restatement).

Structured credit

The Agency MBS sector was flat last week alongside other high-quality fixed income sectors. Spreads and interest rates were relatively unchanged with 30-year MBS outperforming. In non-agency residential mortgages, the week got off to a slow start but ramped Wednesday and Thursday to about 200% of normal volumes. The short story is we are seeing better two-way flow. Levels were generally unchanged, and dealers were net sellers in both IG and non-IG bonds. This is to be expected going into quarter-end as the street tends to lighten up on risk. In new issues we had seven deals price this week for around $2bn with NQM and NPL/RPL deals making up a large majority of the issuance. New issues remain well bid with strong subscription across the capital stack. The primary ABS market has quieted down heading into month end with only $5.7bn priced compared to the $11bn+ from the previous week. These were all very well received across the board and pushed pricing levels slightly tighter. We should see this same trend continue next week with only eight deals in the mix so far. Secondary CMBS spreads rallied on improved sentiment. The new issue pipeline remains robust with five deals totalling $2.7bn pricing last week and four more deals in the market this week. Downgrades continue to dominate. Floating rate office remains the most troubled sector.

Asian credit

The People's Bank of China (PBOC), together with the National Financial Regulatory Administration and China Securities Regulatory Commission announced a major stimulus package that includes a combination of monetary easing, property support policies and liquidity provision for the stock market.

With respect to monetary easing, the PBOC announced cuts to the 7-day overnight market operations (OMO, -20bps to 1.5%), reserve requirement ratio (RRR, -50bps) and the medium-term loan facility (MLF, -30bps to 2%). The PBOC indicated that the RRR could be reduced further by 20-50bps later this year.

For the property sector, PBOC has guided banks to reduce interest rates of existing mortgages towards the rates of new mortgages. According to the PBOC, this will lower existing mortgage rates by an average of 50bps, equivalent to household annual interest expenses of CNY150bn or around 2.5% of the annual disposable income of eligible households. The floor for the downpayment ratio of second home purchases was lowered to 15% (previous: 25%). PBOC will ramp up the re-lending programme for banks to extend loans to SOEs to acquire unsold inventories in the property sector. Specifically, 100% of the principal bank loans (CNY300bn facility) can be used by SOEs to acquire unsold property inventories, up from 60%.

The PBOC and the government agencies also announced liquidity support for the stock market with a CNY500bn swap facility. Non-bank financial institutions (insurance companies, fund management, securities companies), with qualified collateral, can borrow money directly from PBOC through this facility to purchase stock. Furthermore, a relending programme of CNY300m is provided to banks to support listed companies in making share buybacks.

During its subsequent off-schedule meeting on 26 September, the Politburo called for measures to stop the decline in the property sector, which is the first time it has acknowledged the distress in the sector. This underscores a sense of urgency to address the distress in the property sector. In short order, the home purchase restrictions (HPR) in Guangzhou, Shenzhen and Shanghai were partially eased. The PBOC also announced that mortgage holders can renegotiate their mortgages with lenders from 1 November 2024.

Emerging markets

Emerging Market bond spreads were little changed on the week, with slight outperformance among distressed or semi-distressed names offsetting modest weakening among BB-rated sovereign credit. Escalation of the conflict in the Middle East was largely ignored by the region's US dollar bond markets, with the news flow instead dominated by the steady stream of stimulus headlines flowing from China's central bank and politburo meetings.

Softer Chinese manufacturing PMI data, reflecting ongoing weakness in both domestic and external demand, underlined the need for central government support, which arrived in the form of interest rate cuts, stock market liquidity support and a raft of measures designed to rebuild confidence in the country's bruised property markets. While domestic equity performance was euphoric, fixed income assets displayed a more measured response, with local yields some 15bps higher, IG corporate credits up to 30bps tighter and high yield real estate development bonds up to 10pts higher.

There is some evidence that flows into the EMD asset class may (finally) be turning: bond funds saw their biggest weekly inflow for over a year and a half. With a month left before the primary market likely closes for the US election, the bond-buying cavalry has arrived in the nick of time.

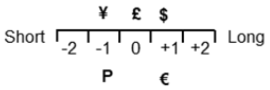
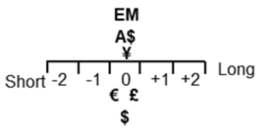
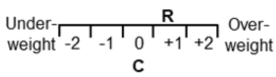
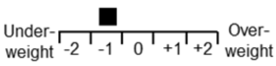
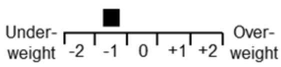
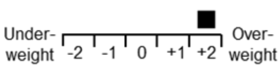
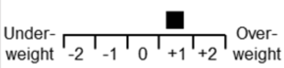
Responsible investments

The labelled bond market boomed in September with over $100bn issued as markets came back to life post a brief summer lull, accordng to data from Bloomberg. Just over half of that was attributable to Green bonds (the markets' most popular flavour of ESG debt), and a decent chunk came in Social bond issues, approximately $20bn.

In negative news, a Sustainability-linked bond failure came to light from a UK based housing association London & Quadrant Housing Trust. Its annual sustainability report detailed how a scope 1+2 carbon emissions target had not been met, resulting in the 2% coupon on the £300m sustainability-linked bond issuance to be increased to 2.125%. The core structure to a sustainability-linked bond is for the issuer to achieve certain enivronmental or social targets at a point in the future, and where those targets are not met, typically a coupon step-up must be applied as the issuer repays. London & Quadrant Housing Trust cites energy prices of renewables soaring and the cost-of-living crisis as the main reasons for the target being missed.

Fixed Income Asset Allocation Views

30th September 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, with no changes to underlying sector views.** ▪ The CTI Global Rates base case view is that cutting cycle will start at the September FOMC. 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)		▪ Spreads are within 10bps of historical average; spread volatility has increased. ▪ Investment Grade credit demand remains strong from crossover investors, which absorbed the post-summer issuance. Waiting for High Yield issuance to see how market digests lower quality credit. ▪ Tailwinds: Stronger growth forecasts, Central bank easing, IMF program boost for distressed names. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, US election, geopolitical and domestic political uncertainty (especially Venezuela & Mexico), restructurings slow.	▪ 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		▪ Earnings season saw solid results from IG issuers, no fundamental deterioration. ▪ Spreads have tightened back near year-to-date tights, are rich to long-run averages. ▪ Issuance has been strong (80 deals in first two week of September totalling ~$100b) and is expected to be a tailwind for the market until the November election. ▪ 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 widened so far in September but are still rich in 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	▪ 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 are at the year-to-date tights but still wide of historical long-term averages. ▪ Prefer call-protected Inverse IO CMOs, large beneficiary of aggressive cutting cycle. ▪ 30-year MBS outperforming the shorter (15 year and below) MBS ▪ The decline in interest rate volatility since the Fed signalled a definite end to the hiking cycle has been a tailwind for MBS.	▪ 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 RMBS. ▪ RMBS: Spreads have continued to tighten. Fundamental metrics such as delinquencies, prepayments, and foreclosures, remain solid. ▪ 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 wider 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.
Commodities		▪ o/w sugar ▪ o/w Zinc ▪ o/w Gasoline ▪ o/w Distillates ▪ o/w Cocoa ▪ u/w natural gas ▪ u/w corn ▪ o/w lead ▪ o/w silver ▪ o/w soybean meal	▪ Global Recession