Information for investment professionals

In Credit

1 July 2024

David Oliphant
Executive Director,
Fixed Income

Contributors

David Oliphant
Investment Grade Credit

Simon Roberts
Macro/Government Bonds

Angelina Chueh
Euro High Yield Credit

Chris Jorel
US High Yield Credit,
US Leveraged Loans

Laura Reardon
Emerging Markets

Kris Moreton
Structured Credit

Justin Ong
Asian Fixed Income

Charlotte Finch
Responsible Investments
Investment Grade Credit

Gary Smith
General Fixed Income

Sarah McDougall
General Fixed Income

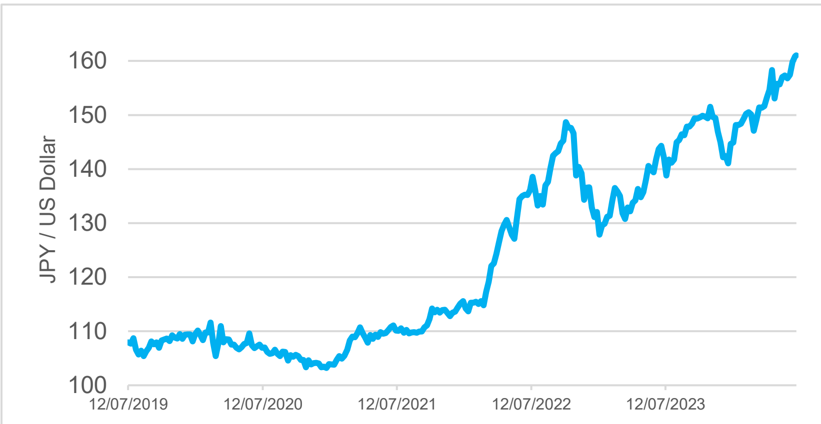
Half time

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.41%	15 bps	0.1%	-0.8%
German Bund 10 year	2.58%	16 bps	-0.7%	-2.1%
UK Gilt 10 year	4.22%	14 bps	-1.1%	-2.9%
Japan 10 year	1.06%	9 bps	-2.7%	-3.2%
Global Investment Grade	103 bps	0 bps	0.2%	0.3%
Euro Investment Grade	118 bps	-1 bps	0.1%	0.5%
US Investment Grade	96 bps	0 bps	0.1%	0.0%
UK Investment Grade	99 bps	-1 bps	-0.1%	-0.1%
Asia Investment Grade	151 bps	3 bps	1.2%	2.5%
Euro High Yield	373 bps	4 bps	1.5%	3.2%
US High Yield	321 bps	0 bps	1.1%	2.6%
Asia High Yield	602 bps	-3 bps	3.8%	9.8%
EM Sovereign	344 bps	14 bps	0.4%	1.8%
EM Local	6.6%	4 bps	-1.6%	-3.7%
EM Corporate	267 bps	-5 bps	1.5%	3.8%
Bloomberg Barclays US Munis	3.7%	5 bps	0.0%	-0.4%
Taxable Munis	5.2%	10 bps	-0.8%	-1.2%
Bloomberg Barclays US MBS	48 bps	4 bps	0.1%	-1.0%
Bloomberg Commodity Index	238.28	-0.6%	2.9%	5.1%
EUR	1.0766	0.2%	-0.7%	-3.0%
JPY	160.99	-0.7%	-5.9%	-12.3%
GBP	1.2671	0.0%	0.2%	-0.7%

Source: Bloomberg, ICE Indices, as of 28 June 2024. *QTD denotes returns from 31 March 2024.

Chart of the week: the falling yen, 2019-24



Source: Bloomberg & Columbia Threadneedle Investments as of 1 July 2024.

Macro/government bonds

US Treasury yields edged higher in the absence of any major market catalysts. We have had a mosaic of US economic data: goods orders, labour market strength, housing and inflation. While US Treasury markets are normally more sensitive to inflation data, the market had already digested consumer and producer price data earlier in the month and could therefore estimate what the outturns for Personal Consumption Expenditure (PCE) and Core PCE were likely to be. Core PCE month-on-month came in at 0.1% – in line with market expectations. This was the smallest increase since November 2020. Stripping out financial and transport services from the PCE figure, the so-called core-core measure of inflation came in at 0.29%, below the 0.40% average in Q1.

At this point in the economic cycle, there seems a reduced probability of a reacceleration of inflation, given accumulating labour market slack, flat commodity prices and increasing pressure on margins. This will be good news for policy makers at the US Federal Reserve, who want to demonstrate that the economic medicine is having an effect, before loosening monetary policy. We also had the first presidential debate between Joe Biden and Donald Trump, in which Biden was widely regarded as performing poorly. The election timetable points to increased volatility in the US Treasury market, as well as the attraction of steepening strategies. The expectation of lower future interest rates should push down yields at the front end, while the prospect of fiscally expansionary policies by either candidate is likely to exert upward pressure on long-end interest rates.

We also saw increased volatility in France around its ongoing election following increased support for the far right, which is also seen as adopting a fiscally expansive stance. French assets sold off from government bonds to equity. The spread on French sovereign bonds relative to German sovereign bonds continued to widen, reaching 0.82% at its height last week, as investors raised questions about the viability and durability of a right-wing French government led by Marine Le Pen's National Rally movement.

Elsewhere we had a spike in the JPY-USD exchange rate yen to 167 last Friday – a 37-year peak **(see Chart of the week)**. The predominant driver of yen weakness remains the significant interest rate differential between these markets. While the Bank of Japan appears to have no immediate plans to adjust interest rates meaningfully, it looks set to alter its government bond purchases. Across the Global Rates desk we are constructive on duration in US and eurozone interest rate markets, have a bias to yield curve steepening positions, as a well as a short position in Japan.

Investment grade credit

It was a quiet quarter for investment grade credit markets. At the end of March, global corporate bond spreads were trading with a spread of 101bps over government bonds, and ended the second quarter at 103bps according to data from ICE indices. The quarter can be split into two sections: the first two months of modest spread tightening then a small "jump" wider in June – led primarily by political uncertainty in France. Through the second quarter the range of spreads was from 94bps-103bps, which is very tight indeed. Sector wise, this year the "winners" have been real estate and banking bonds (last year's losers), plus insurance company debt. Globally, all sectors, bar media, are tighter spread-wise, though healthcare spreads are barely moved in 2024. Credit curves have steepened with shorter-dated bonds in USD, Euro and GBP markets all outperforming longer-dated debt this year, tightening by a greater percentage.

The outlook for IG credit spreads is fairly mixed. We see a more positive economic outlook than was the case six months ago with low but positive growth expected for the rest of the year in the US and Europe. This "not too hot, not too cold" environment should be a reasonable background for IG credit. High interest rates and policy expectations remain a challenge, but as inflation continues to fall we expect to see lower rates in the next six months (the ECB has cut once already) and UK inflation is back at target (2% year-on-year) giving the Bank of England the opportunity to move rates at upcoming meetings.

Market valuations/spreads remain somewhat stretched against both shorter- (five years) and longer-term (two decade) norms. This seems more the case for the US dollar market than for euro-denominated bonds. We note that market durations are much lower today than was the case in 2021, after the sharp rise in yields, so spreads per unit interest rate risk ameliorate some of the valuation concerns.

Our assessment of corporate/banking fundamentals remains positive. We see supportive low levels of leverage in the coming year for corporates and historically high levels of capital for banks. Spread volatility was low through April and May, but the rise in in June has helped sooth fears of rising market complacency.

High yield credit & leveraged loans

US high yield bond valuations were largely unchanged over the week amid light capital market activity and limited fund flow activity.

The ICE BofA US HY CP Constrained Index returned 0% and spreads were 3bps tighter. The yield-to-worst increased 0.07% to 7.90%. Retail high yield bond funds reported a $78 million outflow, leaving flows for June at +$1.4 billion. Meanwhile, the average price of the Credit Suisse Leveraged Loan Index declined another $0.01 to $95.7. Retail loan funds saw a small $48 million inflow, leaving the month's inflow at $1 billion. While high yield bonds (0.97%) outperformed loans (0.27%) in June, loans (4.44%) retained their year-to-date outperformance edge versus bonds (2.60%).

European HY had a soft week as it finished June with a modest positive return (+0.06%), closing the month with a solid +0.59% as spreads widened both over the week (+4bps) and the month (+22bps). Yield continues to remain around 7%. Flows turned sharply negative with €573 million out, all via ETFs, as managed accounts posted a small inflow. June still finished with a net €100 million inflow for the month, bringing the year-to-date inflow to €5.5 billion for the asset class. The primary market picked up in the last week of the month with €4.2 billion across six issuers. This brings the year-to-date gross issuance to €64 billion, surpassing the total issuance for 2023, with net issuance at €8 billion.

In credit rating news, a number of downgrades were announced last week. Grifols was downgraded two notches by Moody's to B2 for secured debt and one notch to Caa2 for unsecured debt, as the rating agency cited the higher leverage and expectation of flat free cash flow this year. Governance concerns were also mentioned, which is interesting given the steps already taken by the firm to address this issue. It should be noted that S&P moved the issuer from "negative watch" to "stable" last month. In other negative news, Intrum was also downgraded by Moody's to Caa2 and to CCC by S&P. In this case this comes on the tail of the debt collector's restructuring plan, which is expected to go through. However, it was also noted that this plan will not change the capital structure and there is an increased likelihood of a distressed exchange. Arrow Global, the financial services group, was downgraded to B+ at Fitch on continued "material leverage, which amid higher interest rates increases pressure on its financial metrics". This brings it in line with Moody's and S&P ratings of B1/B. Lastly, HSE Finance, the teleshopping group, was downgraded to CCC+ by S&P who stated that they see the issuer's capital structure as unsustainable in the long term.

Structured credit

It was a tough week for bonds including Agency MBS. The sector ended down 88bps on higher interest rates and wider spreads. The 15-year MBS outperformed 30 years as the curve bear steepened. Spreads widened across maturities and the coupon stack. Meanwhile, mortgage applications were higher for the third consecutive week, despite S&P Core Logic posting a record high year-on-year increase at 7.2%. In non-agency, RMBS issuance was $3.3 billion last week, bringing the year-to-date volume to $62 billion. Most deals priced wider than expected. CRT spreads widened 5bps-20bps while AAA Non QM widened 5bps. In CLOs, AAA CLO spreads are in the fifth percentile over the past 12 months given the voracious appetite for CLO risk. Across the stack, CLO bonds are equally rich while loans are trading closer to median. In commercial real estate markets there was heavy new issue supply for both the SASB and CMBS Conduits, with poorly underwritten deals trying to get done at aspirational levels. There were two conduit deals that had to widen materially to get traction in the book. What was different about last week was secondary joined the party and moved 5bps-7bps wider week-on-week on relatively light supply. With low customer demand, dealers have been put in a position of providing liquidity on second tier names into month-end.

Asian credit

For the China property sector, S&P revised its expectation lower for residential property sales in 2024 to a decline of 15% year-on-year (against a previous estimate of a 5% decline). Fitch also reduced its sales expectation lower, to a drop of 15%-20% year-on-year (versus a previous estimate of a 5%-10% drop). In Beijing there was further easing in the policies on home purchases. The minimum downpayment ratio for a first home was lowered to 20% (down from 30%) while the minimum mortgage rate was reduced by 55bps to 3.5%.

In India, the major telecom mobile operators have announced tariff hikes which will be implemented in early July. Reliance Jio was the first to announce its plans, followed by Bharti Airtel and Vodafone Idea. This development will bring positive upside to the sector ARPU (average revenue per user), depending on the flow-through of the tariff hikes – albeit partly offset by the potential downtrading in certain subscriber segments. Positively, too, the telecom operators were not aggressive in bidding for more spectrum in the latest auction, which reflects their financial discipline. Collectively, they spent INR113.4 billion (around US$1.36 billion) for 141.MHz of spectrum. For context, India’s Department of Telecommunication was auctioning 10GHz of spectrum for INR962.4 billion (base price).

Emerging markets

The quarter-end treasury sell-off negated the positive return from EM spreads last week, resulting in a return of -0.35% for the EM hard currency sovereign index. Europe was the only region which was positive, aided by Ukrainian bonds which retraced some of their weakness from the prior week.

Protests erupted in Kenya against the government’s proposed 2024 Finance Bill, which included unpopular reforms. At least 23 people died and President William Ruto conceded to demands and withdrew the bill which included tax rises. The removal of the bill will make needed fiscal consolidation more challenging and puts the current IMF program at risk.

In South Africa, following the formation of a new government of national unity, the president announced his cabinet which allocated six of the 32 ministerial positions to opposition politicians from the Democratic Alliance (DA).

The combination of the lower volatility backdrop and the upcoming typically quieter summer months provided an opportunity for EM countries to come to market. Last week saw a flurry of new issuance, almost $6 billion, following what had been a fairly quiet month. Encouragingly, high yield issuers such as the Dominican Republic have been able to partake in primary market activity. Alongside this, the asset class saw the largest weekly inflows since January, led by EM hard currency bond funds which enjoyed +$843 million of flows.

In central bank news, Turkish policy makers opted to hold rates at 50%. Mexico also held at 11% having finally started their easing cycle in March as the last country in Latin America to start cutting. However, since then inflation readings have printed higher over three consecutive months; moreover the decline in the peso since the election at the start of June has also added to pressure. The Czech Republic cut rates by 50bps to 4.75%.

Responsible investments

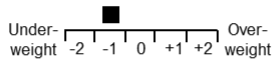
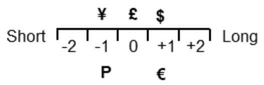
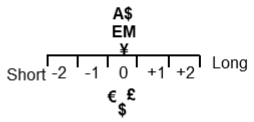
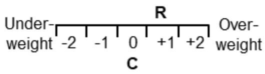
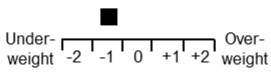
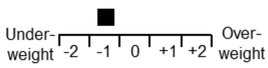
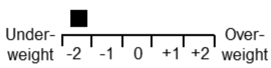
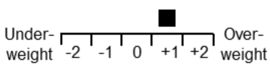
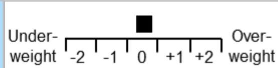
The ESG debt market has had a record breaking start to the year in issuance to-date. According to Bloomberg, labelled bond issuance totalled more than $600 billion on Friday last week, up 7.2% versus the same period last year. The expectation is that, despite the second half of this year poised for a slightly slower pace, we should still see a record total level of issuance in six months' time. There is now more than $5 trillion that has been raised in the labelled bond market since 2007 when this market really began, where use-of-proceeds are mainly targeting green-based projects via green bonds, while other bonds are funding social or transition-related developments.

Iceland launched a gender bond last week, via a private placement to an asset manager. The use of proceeds will include helping give women in vulnerable positions access to essential social services and decent living standards, as well as funding state services to look after elderly relatives, acknowledging the burden of unpaid care and domestic work. The €50 million raised is the first of its kind from a Sovereign, where Iceland already excel as the most gender equal country in the world. The hope is for other Sovereigns to take note and bring similar examples to the market for more investors to partake.

Fixed Income Asset Allocation Views

1st July 2024

COLUMBIA THREADNEEDLE INVESTMENTS

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk		■ Spreads remain at historically tight, unattractive levels. Technicals and fundamentals are relatively unchanged with no thematic deterioration. Current valuations limit the spread compression upside and are misaligned with potential market volatility. **The group remains negative on credit risk overall, with no changes to the scorecard.** ■ The CTI Global Rates base case view is that the hiking cycle is over, and the start of the cutting cycle is uncertain. With the recent CPI prints, the impetus is on the fed to bring the timing and the magnitude of cuts forward. ■ Uncertainty remains elevated due to sensitive monetary and fiscal policy schedules and elections in various countries.	■ 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 real rate reversal challenges EM easing cycles. ■ Geopolitical strife rekindles inflation ■ US macro-outperformance strengthens US dollar.
Emerging Markets Sovereign Credit (USD denominated)		■ EMD spreads tightened this month, supported by improvement in distressed credit and stability in GCC despite geopolitical risk amid changes after elections. ■ Investment Grade spreads are at historical tights while High Yield still offers some value. ■ Tailwinds: Stronger growth forecasts, Central bank easing, potential China stimulus, IMF program boost for distressed names. ■ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical and domestic political uncertainty, 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		■ Spreads have continued to move tighter and are near record lows. The group is taking down credit risk because of flat spread curves and less spread compression upside. ■ Due to the tight spreads across the board, the compensation for taking on additional risk, in seeking higher yields, seems unattractive. ■ Global portfolios prefer EUR IG over USD on relval basis.	■ 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 remained stable but tight since last month. ■ Anticipate credit selection will be the performance differentiator in 2024. Looking to avoid defaults/distress, focusing on credit recovery and deleveraging theses. ■ Increased lender on lender violence and aggressive liability management exercises further increase the risk in the distressed and highly leveraged segment. We expect this to , accelerate in the coming months. ■ Default forecasts for lower rated issuers, particularly in Europe, is deteriorating with default rates projected to go up.	■ 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 still flat to wide of historic long-term averages. ■ The decline in interest rate volatility since Fed signalled a definite end to the hiking cycle has been a tailwind for MBS, however the recent increase following hotter than expected CPI has started to undo this process. ■ Constructive view on fundamentals over longer time horizon.	■ 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 Non-Agency RMBS, and ABS. ■ RMBS: MoM spreads remain tight. Delinquency, prepayment, and foreclosure performance remains strong for prime borrowers; seeing small increase in delinquencies for non-prime borrowers. ■ CMBS: The group is cautious, especially on office, floating rate, and near-term maturities. Non-office sectors, however, perform as expected with the overall market sentiment improving. ■ CLOs: Despite new issue, spreads remain tight. Defaults remain low but CCC bucket defaults are rising with lower recoveries. ■ ABS: Spreads tighter MoM, prefer senior positions. Higher quality borrowers stable, lower quality borrowers underperform. Federal student loan payments near '18 / '19 levels with ~75% of borrowers active.	■ 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 crude oil ■ u/w corn ■ u/w live cattle	■ Global Recession