

# In Credit

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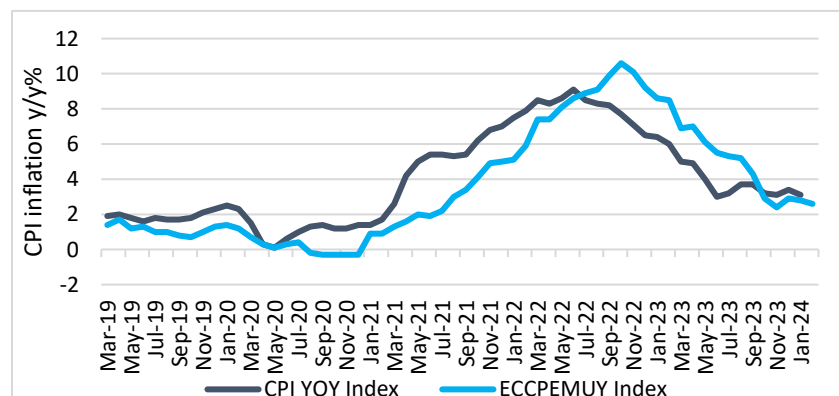
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## A farewell to inflation. Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.21%	-4 bps	-1.1%	-1.1%
German Bund 10 year	2.41%	5 bps	-2.3%	-2.3%
UK Gilt 10 year	4.12%	9 bps	-3.4%	-3.4%
Japan 10 year	0.72%	0 bps	-0.4%	-0.4%
Global Investment Grade	107 bps	5 bps	-0.8%	-0.8%
Euro Investment Grade	120 bps	3 bps	-0.7%	-0.7%
US Investment Grade	101 bps	6 bps	-0.9%	-0.9%
UK Investment Grade	101 bps	2 bps	-1.4%	-1.4%
Asia Investment Grade	156 bps	0 bps	0.6%	0.6%
Euro High Yield	361 bps	4 bps	1.3%	1.3%
US High Yield	332 bps	9 bps	0.5%	0.5%
Asia High Yield	702 bps	-1 bps	4.9%	4.9%
EM Sovereign	309 bps	-3 bps	-0.2%	-0.2%
EM Local	6.2%	-3 bps	-1.9%	-1.9%
EM Corporate	287 bps	5 bps	1.5%	1.5%
Bloomberg Barclays US Munis	3.4%	-1 bps	-0.4%	-0.4%
Taxable Munis	5.0%	-10 bps	-1.1%	-1.1%
Bloomberg Barclays US MBS	51 bps	1 bps	-1.7%	-1.7%
Bloomberg Commodity Index	226.04	2.0%	-0.5%	-0.5%
EUR	1.0841	0.1%	-1.8%	-1.8%
JPY	150.37	0.3%	-6.1%	-6.1%
GBP	1.2668	-0.1%	-0.6%	-0.6%

Source: Bloomberg, ICE Indices, as of 1 March 2024. \*QTD denotes returns from 31/12/2023.

### Chart of the week – Euro and US CPI inflation date – 2019/2024



Source: Bloomberg, Columbia Threadneedle Investments as of 4 March 2024.

## Macro / government bonds

The focus last week was on inflation ([see Chart of the week](#)).

European inflation numbers all came in to the downside, with inflation in Spain and Germany with a sub 3% 'handle.'

In the US, the PCE Core Deflator – the Fed's favoured measure of inflation came in at 0.4% MoM – higher than the previous month of 0.2%. On a YoY measure inflation declined from 2.9% to 2.8%. Atlanta Fed President, Raphael Bostic, reassured that there would be bumps along the way but that inflation was still going down. Within the PCE reading, the largest contributions were housing, utilities, and finance while the goods component fell.

The market had been able to construct an estimate of PCE from PPI and CPI data, which coalesced around 0.4%. The fact it was not higher led to a feeling of relief amongst traders.

The 10-year US treasury, which had briefly touched 4.32% (bumping close to the top of its recent rise), declined to 4.21% by the end of the week. There was an updraft to bond markets from higher than expected jobless claims, as well as a 'technical' impulse at work with the rebalancing of portfolios from stocks to bonds, as investors took profits after a strong recent run.

Aside from Bostic, San Fran Fed Mary Daly stated there was no urgent need to act given the current strength of the economy. It was the "patience" mantra.

## Investment grade credit

After the supercharged end to 2023, the first two months of the year have been somewhat lacklustre in terms of total returns for investment grade bonds. The Global IG index has recorded a 1% or so decline to the end of February (according to data from ICE Indices). This has, however, reflected higher government bond yields rather than wider credit spreads that have actually tightened in the last two months.

It has also been a period of high demand for bond funds and a corresponding deluge of new issuance, with February being a record month for issuance in the US market according to JP Morgan. The demand for IG bond funds seems likely to reflect the high yields on offer. The global index, for example, offered a yield of around 5% at the end of last month against a long run (since 1996) average of 4% and very different from the 1.4% yield seen at the end of 2020.

Credit spreads, however, appear rich in our view. Global IG spreads are around 0.7 standard deviations rich to a five-year average and 0.5 SDs to the 20-year mean. Geographically, euro denominated bonds look better value but even in this market spreads are inside short and longer-term averages.

Looking at industry sectors, healthcare and media have underperformed with spreads modestly wider this year while the best performers have been banking, real estate and insurance with spreads around 10%+ tighter. Adjusted for risk from a valuation perspective, autos, banks, real estate and utilities appear the cheapest industry sectors compared to two decades of data.

## High yield credit & leveraged loans

Though European high yield finished the month with a modest reversal in the last week (-14bps return, +4bps in spread to 361bps and +7bps in yield to 6.87%), February was still a solid month of performance with almost +40bps, bringing the YTD return to 1.3%. Compression remains the name of the game given February's euro CCC spreads contraction (-96bps) compared to BB's (-36bps). Technicals continued to be supported by flows into the asset class and the light primary market. Inflows remained steady last week (+€376m) though focused on managed accounts (bringing the YTD to almost €3.3bn). New issuance picked up modestly with two deals (€1.5bn total) but still running lower, YTD, compared to end of February 2023. In sector news, insurance and real estate were the big winners in February with both sectors returning 2%+ compared to the below 1% performance of other sectors (except for technology and financials, which had negative returns).

In IPO news, Douglas announced its IPO plans, targeting end of Q1, 2024. Proceeds will be used to deleverage, targeting 2.7x net.

## Structured credit

The US Agency MBS sector had a good week last week on the back of a better week for rates. The index was up 59bps with 30-year MBS outperforming on the bull flattener. Spreads were mostly unchanged but were slightly tighter down the capital stack. Fed Governor Waller's comments regarding balance sheet run-off and his desire to see "the Fed's agency MBS holdings go to zero" had little to no impact on the sector. Prepayment speeds across higher coupon mortgages quickened in February despite fewer business days as mortgage rates had a bit of a relief rally. New home sales came in +1.5% helped by lower rates in the fourth quarter of 2023. Home prices were also reported up 6.5% YoY. It was an active week in CMBS new issuance. All the new deals priced inside guidance. Secondary activity was lighter and spreads were relatively stable.

## Asian credit

In China, the National People's Congress (NPC), China's top legislative body, is scheduled to start its annual session on 5 March. The Chinese People's Political Consultative Conference (CPPCC) started on 4 March. The two most high-profile political gatherings usually referred to as the 'two sessions' will last for about a week. Last week, the Politburo meeting was held to discuss the draft government report that will be submitted by the State Council at the NPC. China will announce its annual growth target and outline its policy priorities and stimulus for a recovery amid the slowing economy with deflation, an ongoing property crisis, mounting debt burden and foreign capital exodus. Markets expect the 2024 target to be set at around 5%, the same as last year but on a much higher comparison base.

The Hong Kong government delivered its annual budget, with a notable move to cancel all measures to curb housing demand. The Buyer's Stamp Duty and New Residential Stamp Duty have been removed. Locals buying second flats and non-HK PR are only subject to Ad Valorem Stamp Duty up to 4.25%, compared to 7.5% and 15% previously. The Special Stamp Duty (SSD) has also been cancelled. SSD is imposed on sellers for resell flats with holding period less than 24 months. The authority also eased mortgage rules, e.g. suspend stress test for residential mortgages, higher LTVs, and allowing lower down payments. The removal of those 'spicy measures' as the locals refer to, will likely to boost the city's property transaction volume, although a more substantial recovery will be a function of lower interest rates.

Baidu released its Q4 results with Gen-AI and foundational models supported revenue growth, but higher operating cost resulting in weaker quarter on quarter margins. The growth driver for the following quarters will be more monetization of AI in the coming quarters.

## Emerging markets

Positive contributions from US rates as well as EM spreads resulted in a positive return of +0.74% for EM hard currency sovereigns over the week. Spreads tightened 5bps to 369bps and Egypt continued to be a strong performer as the high yield sub-sector outperformed investment grade, continuing the high yield / investment grade spread compression theme.

Turkish inflation reached a 15-month high coming in at 67% as core inflation accelerated faster than expected. Last month the new central bank governor left interest rates unchanged for the first time after eight months of consecutive hikes.

In Pakistan, Shehbaz Sharif was named as Pakistan's new Prime Minister. The market will now watch closely to see how negotiations with IMF go and who he will appoint to his new cabinet.

Moody's upgraded Ivory Coast to Ba2 and changed its outlook from stable to positive citing increased economic resilience. The upgrade reflects this improving credit story where politics is stable, commodities exports are diversified, and reserves are increasing.

Costa Rica was also upgraded: Fitch moved the country one notch higher from BB- to BB with stable outlook as the government's commitment to meeting fiscal deficit targets and robust economic growth continues.

## Responsible investments

There's been over \$250bn of new labelled bond issuance in the fixed income market so far this year, up by 14.5% year on year according to Bloomberg. February wasn't as fruitful as January, albeit there were still plenty of opportunities for investors to fund projects targeting various green, social and sustainability projects. As usual, there was plenty of Government and Agency issuance in February, totalling \$30.5bn, closely followed by industrials and banks (\$16bn and \$13bn respectively).

Among the largest issues last week included UK water companies seeking ring-fenced finance to fund repairs and upgrades to existing water networks, a hot topic in the headlines over the last few weeks. Anglian Water and Severn Trent were part of that list, both raising labelled bonds last week, Anglian with a £375m Green bond and Severn Trent with a €500m Sustainability bond. Elsewhere, utility company Engie came to the market with a €1.4bn Green bond issue.

## Fixed Income Asset Allocation Views 4<sup>th</sup> March 2024



Strategy and positioning (relative to risk free rate)	Views	Risks to our views
<b>Overall Fixed Income Spread Risk</b> 	<ul style="list-style-type: none"> <li>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 market volatility. <b>The group remains negative on credit risk overall.</b></li> <li>The CTI Global Rates base case view is that the hiking cycle is over, and the start of the cutting is uncertain. The timing and magnitude of cuts will be dictated by the amount and speed of disinflation.</li> <li>Uncertainty remains elevated due to sensitive monetary and fiscal policy schedules, geopolitical tensions, persisting inflation, and weakening consumer &amp; labor profiles.</li> </ul>	<ul style="list-style-type: none"> <li>Upside risks: the Fed achieves a soft landing with no labour softening, lower quality credit improves as refinancing concerns ease; consumer retains strength; end to Global wars</li> <li>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.</li> </ul>
<b>Duration (10-year)</b> (P = Periphery) 	<ul style="list-style-type: none"> <li>Longer yields to be captured by long-run structural downtrends in real yields</li> <li>Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures</li> </ul>	<ul style="list-style-type: none"> <li>Inflationary dynamics become structurally persistent</li> <li>Labour supply shortage persists; wage pressure becomes broad and sustained</li> <li>Fiscal expansion requires wider term premium</li> <li>Long run trend in safe asset demand reverses</li> </ul>
<b>Currency</b> (E = European Economic Area) 	<ul style="list-style-type: none"> <li>Rising expectations around a soft landing and peak Central Bank rates have weakened the dollar</li> <li>EM disinflation to be more rapid than DM</li> <li>Drop in global rate volatility supports local flows.</li> </ul>	<ul style="list-style-type: none"> <li>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</li> </ul>
<b>Emerging Markets Local (rates (R) and currency (C))</b> 	<ul style="list-style-type: none"> <li>Disinflation under threat but intact. EM central banks still in easing mode.</li> <li>Real yields remain high.</li> <li>Selected curves continue to hold attractive risk premium.</li> </ul>	<ul style="list-style-type: none"> <li>Global real rate reversal challenges EM easing cycles.</li> <li>Geopolitical strife rekindles inflation</li> <li>US macro outperformance strengthens US dollar.</li> </ul>
<b>Emerging Markets Sovereign Credit (USD denominated)</b> 	<ul style="list-style-type: none"> <li>EMD spreads tightened this month, supported by macro stabilisation and market-wide spread rally. Technicals have modestly improved, continued outflows but stronger issuance.</li> <li>Conservatively positioned in select high quality reval names, most idiosyncratic opportunities are in lower quality portion of index.</li> <li>Tailwinds: Stronger growth forecasts. Central bank easing, potential China rebound, IMF program boost for distressed names.</li> <li>Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical and domestic political uncertainty, restructurings slow.</li> </ul>	<ul style="list-style-type: none"> <li>Weak action from Chinese govt, no additional support for property and commercial sectors.</li> <li>China/US relations deteriorate.</li> <li>Spill over from Russian invasion and Israel-Hamas war; local inflation (esp. food &amp; commodity); slow global growth.</li> <li>Persisting COVID growth scars hurt economies &amp; fiscal deficits.</li> </ul>
<b>Investment Grade Credit</b> 	<ul style="list-style-type: none"> <li>Spreads have continued to move tighter since last month. The group is taking down credit risk because of flat spread curves and less spread compression upside.</li> <li>Strong 2024 start for fundamentals and technical. Per ratings agencies, index credit quality has improved y/y. Inflows are exceeding net supply despite record IG new issuance in January.</li> <li>Global portfolios prefer EUR IG over USD on reval basis.</li> </ul>	<ul style="list-style-type: none"> <li>Tighter financial conditions lead to European slowdown, corporate impact</li> <li>Lending standards continue tightening, even after Fed pauses hiking cycle.</li> <li>Rate environment remains volatile.</li> <li>Consumer profile deteriorates.</li> <li>Geopolitical conflicts worsen operating environment globally.</li> </ul>
<b>High Yield Bonds and Bank Loans</b> 	<ul style="list-style-type: none"> <li>Spreads have continued to tighten since last month. Modest weakness in fundamental outlook with sector bifurcation.</li> <li>Anticipate credit selection will be the performance differentiator in 2024. Looking to avoid defaults/distress, focusing on credit recovery and deleveraging theses.</li> <li>Conservatively positioned, looking to reduce and diversify credit risk because spreads are likely near their cycle lows.</li> <li>Bank loan market continued to see tight spreads, improving technical. Underlying credit backdrop unchanged.</li> </ul>	<ul style="list-style-type: none"> <li>Lending standards continue tightening, increasing the cost of funding.</li> <li>Default concerns are revised higher on greater demand destruction, margin pressure and macro risks</li> <li>Rally in distressed credits, leads to relative underperformance</li> <li>Volatility in the short end of the curve, eroding potential upside where we are positioned for carry.</li> </ul>
<b>Agency MBS</b> 	<ul style="list-style-type: none"> <li>Mortgage index remain at tight levels; however, spreads are still flat to wide of historic long-term averages.</li> <li>Lower coupons have underperformed driven by rate move and regional bank headlines.</li> <li>In late 2023 the group reduced position sizing into spread tightening but remains overweight the sector.</li> <li>Constructive view on fundamentals over longer time horizon.</li> </ul>	<ul style="list-style-type: none"> <li>Lending standards continue tightening even after Fed pauses hiking cycle.</li> <li>Prepayments normalise as rates rise without reducing mortgage servicing.</li> <li>Fed continues to shrink position.</li> <li>Market volatility erodes value from carrying.</li> </ul>
<b>Structured Credit Non-Agency MBS &amp; CMBS</b> 	<ul style="list-style-type: none"> <li>Neutral outlook because of decent fundamentals and reval in select high quality Non-Agency RMBS, and ABS.</li> <li>RMBS: MoM spreads have tightened. Delinquency, prepayment, and foreclosure performance remains strong for prime borrowers; seeing small increase in delinquencies for non-prime borrowers.</li> <li>CMBS: The group is cautious, especially on office and near-term maturities, however non-office sectors perform as expected and overall market sentiment improving.</li> <li>CLOs: Despite new issue, spreads grind tighter. Defaults remain low but CCC bucket defaults are rising with lower recoveries.</li> <li>ABS: Spreads tighter MoM, prefer senior positions. Higher quality borrowers remain stable, lower quality borrowers underperform.</li> </ul>	<ul style="list-style-type: none"> <li>Weakness in labour market</li> <li>Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening. Consumer (retail/travel) behaviour fails to return to pre-covid levels</li> <li>Student loan repayments weaken consumer profile more than anticipated, affecting spreads on a secular level.</li> <li>Rising interest rates turn home prices negative, punishing housing market.</li> <li>Cross sector contagion from CRE weakness.</li> </ul>
<b>Commodities</b> 	<ul style="list-style-type: none"> <li>o/w Copper</li> <li>o/w Grains</li> <li>u/w Gold</li> <li>o/w Soybean Meal</li> <li>o/w Oil</li> <li>o/w Lead</li> <li>o/w Zinc</li> <li>o/w Palladium</li> </ul>	<ul style="list-style-type: none"> <li>Global Recession</li> </ul>



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