In Credit

4 December 2023

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

Jake Lunness
Commodities
Emerging Markets

Sarah McDougall
General Fixed Income

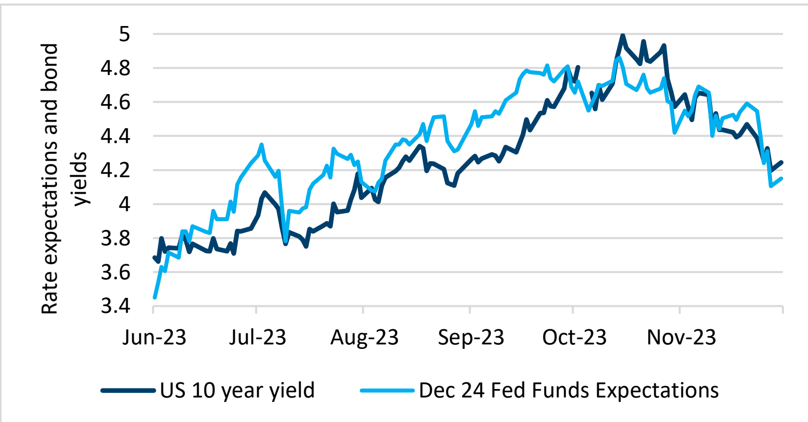
Rates fever, rates fever.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.24%	-23 bps	3.1%	1.2%
German Bund 10 year	2.36%	-28 bps	3.5%	2.3%
UK Gilt 10 year	4.16%	-13 bps	2.8%	-2.0%
Japan 10 year	0.70%	-8 bps	0.4%	-0.1%
Global Investment Grade	122 bps	-2 bps	4.1%	5.2%
Euro Investment Grade	145 bps	0 bps	3.2%	5.6%
US Investment Grade	111 bps	-3 bps	4.6%	5.0%
UK Investment Grade	120 bps	-3 bps	3.0%	4.2%
Asia Investment Grade	186 bps	0 bps	2.5%	4.9%
Euro High Yield	452 bps	9 bps	2.9%	9.4%
US High Yield	387 bps	2 bps	3.6%	9.8%
Asia High Yield	816 bps	95 bps	3.2%	-1.7%
EM Sovereign	345 bps	3 bps	4.7%	5.8%
EM Local	6.4%	-12 bps	5.1%	9.6%
EM Corporate	333 bps	9 bps	2.6%	6.1%
Bloomberg Barclays US Munis	3.5%	-28 bps	5.6%	4.1%
Taxable Munis	5.2%	-27 bps	4.3%	4.2%
Bloomberg Barclays US MBS	52 bps	-11 bps	4.2%	1.8%
Bloomberg Commodity Index	229.75	0.2%	-2.3%	-5.7%
EUR	1.0868	-0.5%	2.9%	1.7%
JPY	146.87	1.8%	1.7%	-10.7%
GBP	1.2666	0.8%	4.2%	5.2%

Source: Bloomberg, ICE Indices, as of 1 December 2023. *QTD denotes returns from 30/09/2023.

Chart of the week – US interest rate expectations & bond yields



Source: Bloomberg, Columbia Threadneedle Investments, as of 4 December 2023.

Macro / government bonds

In the US last week, we saw the tilting of language towards a greater acceptance that peak rates may have been reached.

While yields fell across the curve, the strongest gains were in the US two-year sector. This resulted in a bull steepening of the yield curve when short-term rates fall at a faster pace than longer-dated interest rates – a trend that was replicated in core fixed income markets globally. Christopher Waller, Governor of the US Federal Reserve, gave a speech at the American Enterprise Institute entitled ‘Something appears to be giving’. Regarded as a hawk and one of the more intellectual voices at the Fed, the speech was widely interpreted in the market as signalling a change in direction. While Waller kept the Fed’s optionality open, he focused on emerging trends in inflation, noting that housing services inflation and goods price deflation had both decelerated. The missing part of the jigsaw was services price inflation, a major component of which is the cost of labour. Yet he could see grounds for optimism that this was set to give through data on declining job vacancies, rising unemployment, and a deceleration in average hourly earnings. There was also an acknowledgement that monetary policy was firmly in restrictive territory following the sharpest increase in rates in more than 40 years.

In another contribution, Raphael Bostic, President of the Atlanta Fed, delivered an essay, entitled ‘Rorshach test coming into focus’. He said that the market is giving conflicting signals and while some may see a dragon, others may see a butterfly – a metaphor he chose to give to himself. He argued that despite the current resilience of the economy, wages are slowing, pandemic savings are dwindling, and companies’ pricing power is diminishing. He also argued that the strong growth we saw in Q3 in the US as a result of inventory growth was unlikely to be repeated.

US economic data appeared to support the dovish interpretation of the economy. Core inflation fell from 3.7% to 3.5% in October while personal consumption also fell back from 4% to 3.6% in the third quarter. In Europe, pricing in the swaps market showed that market participants expect rate cuts to begin from March, given the increasing sluggishness of the eurozone economy. Manufacturing PMIs in the eurozone remain in contractionary territory, while inflation in Germany, France, Spain and Italy edged lower.

One core market where the rally in the government bond market was more subdued was the UK. The UK government’s mild fiscal loosening before an election year makes it harder for the Bank of England to make an ‘about turn’ in monetary policy. Bank Governor, Andrew Bailey, repeated his line that it would be inappropriate to talk of rate cutting. This contrasted to the US where the ground was clearly being prepared for a future shift in monetary policy, as policy makers looked to the lagged impact of past cumulative tightening, which has yet to be fully felt on economic activity. The aggressive pricing in of rate cuts last week, with the 2-year sector in the US and Germany falling around 0.4% and around 0.2% in the UK means that in the absence of a significant recession, the bond market looks relatively fair value at current levels.

In fixed income portfolios, our position has been to be long duration and to express yield curve views through yield curve steepening positions in core markets in anticipation of a pivotal switch in monetary policy.

Investment grade credit

It was a very strong month for market total returns and spread tightening in November.

The combination of excitement in macro markets about lower interest rates next year combined with lower inflation in the US and Europe helped all risk markets to rally. Total returns across the ‘IG piste’ were strong. US credit managed a very credible 5.6% MTD return that buoyed the global market, which in turn returned 4.5% – all according to data from ICE indices. This is the highest monthly US dollar market total return since 1985.

Spreads edged inwards and to the tightest level this year at 122bps for the end of November. These valuations had been as wide as 170bps in the midst of March's banking crisis. This leaves spread valuations inside both the shorter-term (five year) and longer-term (20 years) average. The US market saw spreads tighten by 17% in the month, which outperformed the euro market (-8%) and sterling market (-12%). We consider present global spreads to be broadly neutral but note the trend and that the market is getting more expensive.The euro market continues to offer spreads that are wide of these short and long-term averages so looks the cheapest major market globally. We note that short-dated corporate bonds look attractive against a background of flatter credit curves.

Market conditions reflect light broker inventory and higher demand as investors seek to 'lock-in' higher yields before rate cuts come in the New Year. So the 'technical' backdrop would seen to be supportive of further market gains.

Structured credit

The US Agency MBS market was up a whopping 2.5% last week. Lower rates, and lower rate volatility, with Fed governor comments pointing to progress made on the inflation front gave legs to the rally. Investors pushed down the coupon stack with renewed appetite. 30-year Agency MBS outperformed 15-year paper and lower coupons accelerated as the curve bull steepened. Positive data for home prices, some stabilization in consumer confidence and lower home sales data all supported the sector. We will soon get prepay data for November which is expected to be around 25% lower given a shorter day count as well as weaker seasonals. In Non-agency MBS new issuance was more robust last week with $900m pricing. Spreads tightened across sectors: CRT was tighter by 5-25bps and Non QM tighter by 10bps. There was also decent demand for Commercial risk. Spreads were generally tighter across the capital stack on lower yields and improved outlook.

High yield credit & leveraged loans

US high yield valuations continued to decline over the week as benign inflation data, dovish Fed rhetoric, and resilient growth resulted in further US treasury yield declines.

The ICE BofA US HY CP Constrained Index returned 1.39% and spreads were unchanged. According to Lipper, the asset class reported a $296m retail fund inflow, capping the third largest monthly inflow on record ($11.3bn). Meanwhile, the average price of the J.P. Morgan Leveraged Loan index continued to lag the rate-driven rally, increasing $0.22 over the week to $95.39. Retail loan funds saw a $124m inflow, the fourth inflow over the last five weeks.

November ended strongly (+2.9%) for European High Yield, returning almost as strong a performance as January and taking the YTD performance to 9%. For the week, performance was strong (+0.96%) but with the return of decompression as CCCs sharply underperformed the strong performance of BBs and Bs. The difference in performance was partially due to the general longer duration of higher rated credits as last week so little spread change but a 28bps fall in yield (to 7.4) on the back of the fall in underlying government bond yields (as expectations were brought forward to April 2024 for the first rate cut by the ECB). Technicals were supported by another strong week of inflows (+€358m) with managed accounts leading ETFs by 2:1.

In rating news, there were more downgrades than upgrades last week starting with Fitch downgrading Morrison's to BB-, from BB; SBB to B from B+; and Ardagh packaging's long-term issuer default rating to B- from B. S&P downgraded Atos to BB- from BB; Goodyear to B; and Tele Columbus to D (in the case of the latter, this was in spite of restructuring announcements made the day before the downgrade). Reasons given focused on refinancing concerns / poor expectations on debt reduction.

A light but well received primary market saw new issues from Crown Euro (Fixed) and Lottomatica (FRN) for a total of €1bn. Interestingly, Lottomatica originally planned to also issue a fixed bond but pulled the issue at the last minute.

Earnings reports were positive overall, in line or beating expectations though areas like packaging (e.g. ProGroup) and building materials (e.g. Pfleider) still showed signs of weakness or were cautious on the outlook while leisure (e.g. Pure Gym) performed strongly.

Asian credit

Adani Electricity Mumbai Ltd (AEML) has completed the tender offer to purchase $120m of the ADANEM '30s bonds, which leaves an outstanding amount of $880m.

The AES Corporation reached an agreement to sell its entire 51% stake in Mong Duong Power (MDP) to Sev.en Global Investments (Sev.en GI), which is in line with AES's intent to divest the majority of its coal assets by end 2025. Sev.en GI stated that it is a Qualified Transferee as defined in the bond documents of the 5.125% Senior Secured notes due 2029 (issued by Mong Duong Finance Holdings BV).

Meituan reported a set of decent Q3 results albeit it saw weaker operating margin in core local commerce due to the provision of higher incentives and promotions, while the New Initiatives segment continues to see an improvement in operating losses.

Emerging markets

Emerging market hard currency bonds ended the month with a strong finish returning 1.51% over the week (measured by the JP Morgan EMBI Global Diversified Index), aided by rallying US treasuries as EM spreads were unchanged.

Higher quality longer-dated bonds benefitted most from the move in US treasuries. November was a strong month for EM debt, spreads tightened over 30bps and the index returned 5.66%.

Turkish inflation printed slightly lower than expected at 61.98% following a series of significant rate hikes by the central bank. South Korea held interest rates at 3.5%.

In India, incumbent prime minister Modi's party has won three key state elections, including winning two states from rivals. This market friendly result has exceeded expectations and makes a third term for Modi look increasingly likely.

In Venezuela, the government held a referendum that voted in favour of a large portion of neighbouring Guyana (2/3) becoming a Venezuelan state. This follows a major oil discovery off Guyana's coast back in 2015 that has increased the prosperity of the nation, while the issue is also currently being evaluated by the International Court of Justice. In recent months, Guyana has made a further significant oil discovery whilst Venezuela had its longstanding oil industry sanctions eased by the US.

Commodities

The BCOM index was flat on the week with gains in precious metals (+3.6%) being offset by losses in the energy complex (-3.1%).

US natural gas was once again the biggest negative contributor, with a 6.2% decline on the week, and a 25% decline over the past 28 days. Gas prices saw further downside following the EIA reporting utilities adding 10bn cubic feet of storage thanks to warmer weather.

In the oil market, Crude Brent, declined by just under $1.5 to $78.9 with pricing being the victim of expectations of a deeper OPEC+ cut. OPEC+ followed through with a cut, totalling 2.2MMbbls/d for Q1 24, which included the widely expected roll-over of Saudi and Russia cuts.

Additionally, instead of acting as a group it was left to individual group members to decide if they would make additional cuts. This follows dissatisfaction from Nigeria and Angola with their lower output quotas. Angola remained a dissenter and will not follow through with its new lower quota. In summary, evidence of a lack of cohesion within the group raises concern that OPEC will find it difficult to respond to future surpluses.

In precious metals, Gold hit an all time of $2,111 as of Monday morning (4th). Prices have seen further support from the declining US dollar, which has fallen by 2.7% over the past 28 days. Expectations of falling interest rates next year are also supportive for non-interest-bearing gold.

Responsible investments

The first commercial flight to use 100% sustainable aviation fuel took place on Tuesday last week, flying from London Heathrow to New York JFK. Virgin Atlantic 'Flight 100' (a Boeing 787) used fuel made from waste products that has been made completely compatible with today's engines and aviation infrastructure. In partnership with Virgin Atlantic, Boeing, Rolls-Royce and top engineers from a number of UK based universities have spent the past year accelerating the pathway to a sustainable aviation fuel. Currently, only a 50% blend of the fuel is permitted by fuel standards, and only 0.1% of global jet fuel is sustainable.

COP28 is now underway, lasting until 12 December in Dubai. Many world leaders are taking to the stage to present thoughts and updates on what is next for climate change. Controversially, the head of OPEC producer's state oil company, Sultan Al Jaber, is also president for the summit. Just a few days before, OPEC published a strongly worded statement in defence of the oil and gas sector stating that the International Energy Agency (IEA) has "unjustly vilified" the sector over its participation in the climate crisis.

Fixed Income Asset Allocation Views

4th December 2023

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	▪ Valuations are within historic ranges, tightening back in over the past month. Technicals seem stable; fundamentals show modest pockets of weakness, but no thematic deterioration. **The group stands neutral on credit risk overall, with no changes to underlying sector views.** ▪ The CTI Global Rates base case view is no cuts in 2023, with one more possible hike left in the hiking cycle. Focus remains on wages, labor market, financial conditions, and inflation expectations. ▪ Uncertainty remains elevated due to geopolitical tension, stricter lending, monetary policy tightening, persisting inflation, and weakening consumer profile.	▪ Upside risks: the Fed achieves a soft landing with no labour softening; consumer retains strength; end to Ukraine and Israel-Hamas wars. ▪ Downside risks: Fed is not done hiking and unemployment rises. Another banking crisis, this time from unrealised losses on securities and CRE, supply chain disruptions, inflation, volatility, commodity shocks re-emerge.
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 ¥ €$£	▪ Rising expectations around a soft landing and peak Central Bank rates have weakened the dollar ▪ EM disinflation to be more rapid than DM ▪ Drop in global rate volatility supports local flows.	▪ 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.	▪ Sustained high core rates thwart EM easing cycles. ▪ Energy persistence derails disinflation trend. ▪ US outperformance strengthens US dollar. ▪ Structurally higher global real rate environment subdues risk assets
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ EMD spreads 15bps tighter than last month, benefiting from lower global rates. Technicals are slower, outflow and weak issuance. ▪ Conservatively positioned with most idiosyncratic opportunities in lower quality portion of index, focus on relval opportunities. ▪ 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.	▪ China/US relations deteriorate. ▪ Issuance slows. ▪ Spill over from Russian invasion and Israel-Hamas war: local inflation (esp. food & commodity), slow global growth. ▪ Persisting COVID growth scars hurt economies & fiscal deficits.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ US and EMEA spreads have tightened since last month. ▪ Fundamentals have proved resilient with decent earnings. Global portfolios prefer EUR IG over USD on relval basis. ▪ Fundamental concerns remain focused on commercial real estate, unrealised losses for banking sector, tight labor supply, and changing consumer behaviour.	▪ Lending standards continue tightening, even after Fed pauses hiking cycle. ▪ Rate environment remains volatile ▪ Mass layoffs spike, worsening consumer profile. ▪ Geopolitical conflicts worsen operating environment globally
High Yield Bonds and Bank Loans	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads have tightened over the past month, while technical and high – quality HY fundamentals remain stable. October brought more rising stars, but also more defaults. Financial conditions continue to punish destressed names. ▪ Conservatively positioned, but open to attractive buying opportunities in short HY, BBs and higher quality loans. ▪ US HY defaults remain below historic averages, with greater default expectations for 2024. ▪ Bank loan market volatility has improved in the past month. Themes: neutral retail fund flows, slow primary deal flow, improving CLO issuance, increasing burden, credit concern in lower quality loans. Market performance mostly reflects idiosyncratic credit stories, not wider industry themes.	▪ 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. ▪ Loans see retail fund outflows once Fed starts lowering rates.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index tightened in the past month; spreads still wide of historic medians. ▪ The group has reduced position sizing, but still overweight. Constructive view over longer time horizon. ▪ Supply is manageable as higher rates and fall seasonals kick in. ▪ Performance has been driven by the Fed's hiking cycle, with MBS widening into a bear steepener.	▪ Lending standards continue tightening even after Fed pauses hiking cycle. ▪ Prepayments normalise as rates rise without reducing mortgage servicing. ▪ Fed continues to shrink position. ▪ Market volatility erodes value from carrying.
Structured Credit Non-Agency MBS & CMBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Positive outlook because of decent risk-adjusted valuations in select high quality Non-Agency RMBS, CLOs and ABS. ▪ RMBS: September saw spreads tighten. Home prices resilient, expect higher rates will slow growth. Delinquency, prepayment and foreclosure performance remains strong. We expect fundamentals to hold in as long as labor market strength remains. ▪ CMBS: The group is cautious, especially on office and multifamily, however non-office sectors perform as expected. Delinquencies increasing as maturities come due. Credit curve remains steep. ▪ CLOs: New issue steadily continues. Defaults remain low but CCC buckets continue to rise slowly with lower recoveries. ▪ ABS: Attractive relval in some senior positions. Higher quality borrowers remain stable, lower quality borrowers underperform. Fairly strong start to student loan repayment.	▪ 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. ▪ Rising interest rates turn home prices negative, denting housing market strength. ▪ Cross sector contagion from CRE weakness.
Commodities	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Soybean Meal ▪ o/w Oil ▪ o/w Lead ▪ o/w Zinc	▪ Global Recession