In Credit

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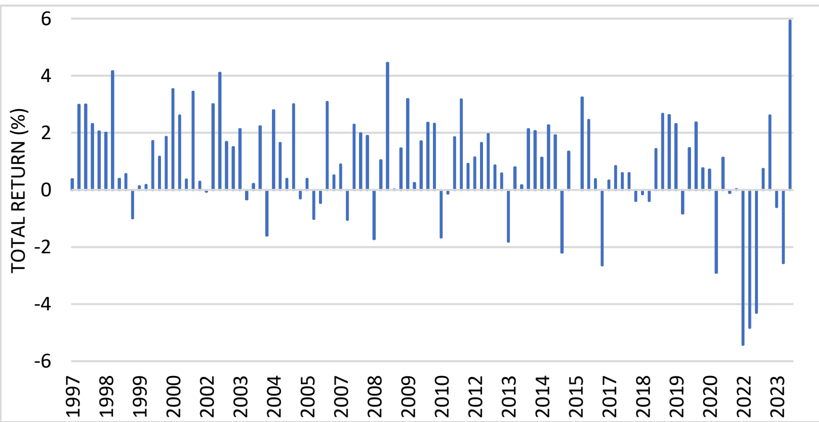
Markets at a glance

	Price / Yield / Spread	Change 1 week	Index YTD return*	Index 1 Year return
US Treasury 10 year	4.05%	20 bps	-0.9%	2.1%
German Bund 10 year	2.20%	25 bps	-0.8%	3.0%
UK Gilt 10 year	3.83%	34 bps	-2.0%	1.1%
Japan 10 year	0.59%	0 bps	0.2%	0.7%
Global Investment Grade	119 bps	4 bps	-1.1%	6.2%
Euro Investment Grade	144 bps	8 bps	-0.9%	6.3%
US Investment Grade	108 bps	4 bps	-1.3%	6.2%
UK Investment Grade	119 bps	5 bps	-1.4%	6.2%
Asia Investment Grade	184 bps	-2 bps	-0.5%	5.9%
Euro High Yield	425 bps	6 bps	-0.6%	10.7%
US High Yield	363 bps	31 bps	-1.1%	10.9%
Asia High Yield	784 bps	-25 bps	0.8%	-2.1%
EM Sovereign	344 bps	22 bps	-1.9%	8.1%
EM Local	6.3%	7 bps	-1.0%	11.5%
EM Corporate	314 bps	-1 bps	-0.4%	7.9%
Bloomberg Barclays US Munis	3.3%	5 bps	-0.3%	5.5%
Taxable Munis	5.0%	13 bps	-1.7%	4.9%
Bloomberg Barclays US MBS	46 bps	-1 bps	-1.3%	2.8%
Bloomberg Commodity Index	225.76	-0.8%	0.1%	-3.2%
EUR	1.0930	-1.1%	-0.9%	4.0%
JPY	144.16	-2.2%	-2.5%	-7.8%
GBP	1.2711	-0.1%	-0.1%	6.8%

Source: Bloomberg, ICE Indices, as of 05 January 2024. *YTD denotes returns from 31/12/2023.

Chart of the week – Global Broad Market Plus Index Returns



Source: ICE Indices, Bloomberg, Columbia Threadneedle Investments, as of 8 January 2024.

Macro / government bonds

The last quarter of 2023 delivered the best quarterly return for global fixed income markets since the 1990s **(see Chart of the Week)**.

The sense of euphoria in fixed income markets reflected a perception that the descent to looser monetary policy had begun. The relative expense of government bonds made market participants nervous as we opened the new year, especially as they would have to negotiate potentially volatile market events, such as the publication of the US Fed minutes and Non-Farm Payrolls. While we already had the decision to leave rates on hold, market participants worried about the potential for hawkish messaging from the Fed, which might have used its editing of the minutes to walk the market back from current valuation levels. In the end the minutes were broadly neutral in tone. While the minutes repeated the mantra that it was appropriate to maintain a restrictive stance for some time, there was a tacit acknowledgement that we had reached peak rates and that rates cuts would take place in 2024.

The next important market-moving event was the Non-Farm Payrolls number. Here, the market had to assess the ADP Employment number (a less well regarded labour market statistic) and US jobless claims. The former was higher and the latter lower than the market had expected. The data points raised a question about the resilience of the US economy and whether we would see sufficient softness in the US labour market to permit a dip in services inflation. Services inflation, which is impacted by the tightness of the labour market, is the missing part of the US inflation jigsaw. While goods inflation and energy inflation have retreated, services inflation has remained elevated.

Non-Farms Payroll were released on Friday, which covers the employment situation in the private sector and government agencies. The labour employment dataset, like ADP, came in stronger than expected: 216k new jobs for December versus 199k new jobs for November. This was not the number that market bulls were looking for. In looking further into the statistics, unemployment held steady at 3.7%, while average hourly earnings rose by 0.4% month-on-month. Market participants pushed back their expectations of when the first rate cut would occur, as well as the depth of any cutting cycle. At the end of December, the market had been pricing in a quarter point rate cut for March, and up to six quarter point rate cuts during 2024. By the end of the first week of 2024 in contrast, the market had pushed back the timing of the first rate cut to April and was now only pricing in five quarter point rate cuts for 2024. Similar pricing trends occurred in the eurozone and the UK government bond markets.

In a relatively quiet week for communications from central bank speakers, Thomas Barkin, Richmond Fed president, provided some colour on Fed thinking, saying the Fed should normalise rates, as the economy gets back to normal. The power of his words was limited, as the Fed dot plot meant the market had already switched to a lower interest rate framework.

Over the space of a week, the 10-year US treasury rose 17bps to 4.04%; the 10-year German bund 13bps to 2.16%; and the 10-year UK gilt 25 bps to 3.79%. On the desk, we have a long duration bias but shaved a little risk off, as we navigated this week, cognisant of the risk of temporary market weakness given the richness of current valuations.

Investment grade credit

Investment grade bonds enjoyed a period of strong performance in the last quarter of 2023.

After a more mixed first nine months, the catalysts for change were as follows: the delivery of lower inflation globally accompanied by forecasts of an economic soft landing (i.e. not a recession) prompted speculation of a change in direction in interest rates and lowered real yields. Meanwhile, from a 'technical' perspective (supply and demand) strong inward investment flows were met with light new issuance of corporate debt and light dealer inventory. This 'cocktail' helped lower bond yields across fixed income, including credit markets. Tighter credit spreads added to lower government bond yields to deliver very strong returns (e.g. around 7% for global IG in local currency terms – according to data from ICE indices).

So to the outlook for 2024? From a total return perspective, yields remain persuasive, albeit far less so than three months ago. For spreads, we have become more cautious. Why so? True, interest rates are expected to decline in 2024, but they are also expected remain restrictive – in other words higher than the neutral rate of interest and so this remains a headwind. Economic performance is likely to be positive but low in terms of growth – so fairly neutral for high quality credit. Credit quality should, from a strong start remain robust in both the US and Europe, which will be supportive. It is valuations (spreads) that are starting to appear more stretched after the robust performance of 2023 in general and Q4 in particular. This is more the case in the US dollar market (and consequently for global markets given the high footprint of US credit in benchmarks) than for euro credit.

High yield credit & leveraged loans

US high yield bond valuations retraced a portion of their significant decline in December over the week amidst higher US treasury rates and mixed labour market data. The ICE BofA US HY CP Constrained Index returned -1.09% and spreads were 32bps wider.

According to Lipper, the asset class reported a $438m outflow to begin the year, the first outflow over the last nine weeks. 2023 high yield bond fund outflows totalled $7.2bn. Meanwhile, the average price of the Credit Suisse Leveraged Loan Index rose $0.33 to $95.6, its highest level since May 2022. Retail loan funds saw a $64m inflow, the eighth inflow over the last ten weeks. 2023 loan fund outflows totalled $17.1bn.

It was a slow start for 2024 as markets paused after the strong year-end rally in December. European High Yield returned -0.5% as spreads widened 13bps to 388bps while yields rose 23bps to 6.89%. Interestingly, single Bs underperformed both BBs and CCCs. Start of the year flows were positive with a net inflow of €283m via both ETFs and managed accounts. The primary market was quiet though there was an announcement of the first new issuance for 2024. This comes from the auto sector with Schaeffler offering 2-year and 5-year issues expected to total around €1.2bn to go towards refinancings. Several other new deals are already waiting in the wings.

EHY finished 2023 with a total return of 12.1%, as November and December contributed to almost half of the calendar year performance. This was driven by the improved market tone for risk assets as expectations rose that the rate hike cycle had ended. Credit spreads also tightened in as many EHY firms showed solid financials and made efforts to refinance early to avoid any market funding concerns. The exception to this was CCCs, largely focused in the real estate sector, which strongly underperformed higher-rated credits as these suffered greatly from the disappearance of low funding opportunities and structural changes hitting the sector.

Overall, we are cautious but constructive. We are cautious, due to the potential for inflation risks – particularly for lower-rated issuers facing near-term maturity walls – amid elevated levels of economic and geopolitical uncertainty. We are constructive as we continue to forecast moderate earnings growth for FY 2024 and see an overall healthy cash flow picture with deleveraging returning in 2024. Higher funding costs are putting downward pressure on interest coverage, but the recent rally in core yields has made refinancing risk look more manageable. As such, we favour defensive names but also sectors where post-Covid demand remains robust and where issuers have been able to pass on higher costs due to inflation, for instance, transportation and leisure. We continue to favour higher-rated credit while underweighting real estate and CCCs. Given our outlook of a modest uplift in defaults this year and opportunities from refinancings and early bonds calls, we forecast a return of around 6.0% for the asset class in 2024.

Structured credit

Following historic performance in the final months of 2023, the US Agency MBS market pulled back in the first week of 2024 alongside interest rates.

There was no change in fundamentals to warrant the -1.3% return over the week and most news on the technical front was generally positive. Prepayment speeds for December showed continued deceleration. Fed paydowns came in lower than November at $14.6bn vs $16bn, both of which are markedly below the Fed's $35bn monthly cap. Net issuance decreased to $15bn in December, approximately $6.6bn lower than in November. Over the course of the week, 15-year MBS outperformed 30-year and higher coupons did best as the curve bear steepened. In CMBS, there was a reprieve in delinquencies for December in both conduit and SASB. The office sector saw the biggest shift with MoM DQs falling 20bps to 5.1%. While spreads rallied alongside risk going into year-end, the sector has lagged corporates, particularly at the lower tiers of the capital structure. In ABS, spreads were mixed last week. One point to note is the continued decline in used auto prices. The December Used Vehicle Value Index posted its lowest level since March 2021.

Asian credit

The main theme for China over the near-term is the government's efforts to stabilise its macro environment through policies that support infrastructure development, technology and innovation and advanced manufacturing while managing the challenges of the property downturn and household deleveraging. The leadership has been focused on security issues at the expense of economic growth and the market is watching whether China can indeed execute on its goals of achieving high-quality development while managing the dual priorities of economic growth and security.

With respect to geopolitics, the appointment of a new defence minister in China will likely facilitate the ministerial communication and bilateral military talks between US and China albeit the overall impact on the path of the US / China relations would be limited. Over the very near-term, the spotlight is on the outcome of the Taiwan Presidential Election (13 January 2024) and the ramifications for China / Taiwan relations. Based on polling data, the Democratic Progressive Party (DPP) candidate Mr William Lai could triumph over the Kuomintang (KMT) candidate. For context, KMT is viewed as being more supportive of cross-straits relations and a DPP victory is likely to stoke more tension between China and Taiwan.

The technical picture continues to be favourable for Asian credit given the muted supply and with Asian quasi-sovereigns and corporates continuing to benefit from access to their local funding markets.

Emerging markets

Emerging market hard currency assets did not get off to the best start for 2024 as US treasury yields rose higher and EM spreads widened 20bps. The index return for the week was -1.92%.

The sharp retracement lower in US yields benefited Emerging Market Debt in the final months of 2023. A decline in rates volatility would be supportive for EMD. EM growth is expected to be fairly stable this year but interruptions to the EM disinflation narrative (via energy cost spikes or food supply tightness) have the potential to limit central bank easing cycles. Geopolitical risks remain pertinent, and we closely monitor development around the globe. Technical support remains strong, despite continued outflows from the asset class. After an initial surge at the start of the year, we expect net new bond supply to remain modest in 2024. Valuations are now screening somewhat tight to long-term averages, particularly in the IG sub-sector. Our focus remains on exploiting market dislocations across the EM bond universe as part of our research process to surface relative value ideas and find the best risk-adjusted returns.

In Pakistan, the country's senate approved a resolution seeking to delay the general election, which is scheduled for 8 February. The decision cites "prevailing security concerns" particularly relating to threats to the lives of politicians. The move has been branded unconstitutional by major political parties with a counter resolution seeking not to delay elections being posted less than 24 hours later.

Commodities

The BCOM index had a muted start to the year with a +0.1% total return. Gains in energy (+4.5%) were offset by declines in almost all other asset classes. Industrial metals saw the sharpest losses at -3% on aggregate.

In energy market news, Libya has been forced to shut its largest oilfield following protests last week, with the shutdown causing Libyan production to decline over 200,000 barrels on Friday. Elsewhere, Saudi Arabia cut the selling prices of its Arab Light crude to Asian countries to a 27-month low. This follows concerns from rival suppliers and excess supply.

In base metal news, aluminium prices slumped by 4.9%. This follows December gains that were driven by the news of an explosion in Guinea that was initially reported to have disrupted the supply of bauxite. It has now become clear there will be no prolonged disruption to bauxite supply as a result of the explosion. Downside pressure has also been exerted by surging inflows into LME warehouses following sanctions on the Russian metals industry causing traders to offload stock.

Responsible investments

It was a good year in 2023 for ESG bond issuance, albeit not a new record for total issuance. A total of $922bn was issued via green, social, sustainability and sustainability-linked bonds, according to Bloomberg. A little far from the water mark of 2021 where we saw $1.2trn, but far more in line with the prior year where we saw $993bn issued. The trend is promising, and consistency is always nice; however, for a new and exciting market the lack of growth does bring some disappointment. The slowdown was primarily due to a reduced amount of labelled issuance from US, in addition to corporates not issuing as much as expected. Next year is anticipated to be similar total, with a continued focus on green bonds.

Fixed Income Asset Allocation Views

8th January 2024

COLUMBIA THREADNEEDLE INVESTMENTS

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	▪ Spreads have tightened over the past month, with an especially dramatic repricing since FOMC meeting. Technicals have improved in this environment; fundamentals are relatively unchanged with no thematic deterioration. **The group has moved negative on credit risk overall, downgrading corporate and structured credit outlooks.** ▪ 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. ▪ Uncertainty remains elevated due to sensitive monetary and fiscal policy schedules, geopolitical tensions, persisting inflation, and weakening consumer & labor profiles.	▪ Upside risks: the Fed achieves a soft landing with no labour softening; fundamentals for lower quality credit improve as refinancing concerns ease; 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 have tightened this month, benefitting from lower global rates and the market-wide spread rally. Technicals remain challenged, with continued outflows and weak issuance. ▪ Conservatively positioned in select high quality relval names, most idiosyncratic opportunities are in lower quality portion of index. ▪ Tailwinds: Stronger growth forecasts, Central bank easing, potential China rebound, IMF program boost for distressed names. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical and domestic political uncertainty, restructurings slow.	▪ Weak action from Chinese govt, no additional support for property and commercial sectors. ▪ 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 are significantly tighter than last month. The group is taking down credit risk because of flat spread curves and less spread compression upside. ▪ Fundamentals are supportive of technical strength. Global portfolios prefer EUR IG over USD on relval basis. ▪ Fundamental concerns remain focused on commercial real estate, event risks in 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 significantly over the past month. ▪ Modest weakness in fundamentals from bearish earnings outlooks, see bifurcation between sectors. Following a dovish FOMC meeting, easing financial conditions could benefit distressed names struggling to refinance. ▪ Conservatively positioned, looking to reduce and diversify credit risk because spreads are likely near their cycle lows. ▪ Bank loan market in the past month saw spread compression, improving technical. 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.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index tightened marginally in the past month; however, spreads are still wide of historic LT averages. ▪ The group has reduced position sizing into spread tightening, but still overweight. ▪ Constructive view on fundamentals over longer time horizon.	▪ 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 fundamentals and relval in select high quality Non-Agency RMBS, CLOs and ABS. ▪ RMBS: MoM spreads have tightened. 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: Despite new issue, spreads grind tighter. Defaults remain low but CCC bucket defaults are rising with lower recoveries. ▪ ABS: Spreads tighter MoM, prefer senior positions. Higher quality borrowers remain stable, lower quality borrowers underperform.	▪ 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, punishing housing market. ▪ 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