In Credit

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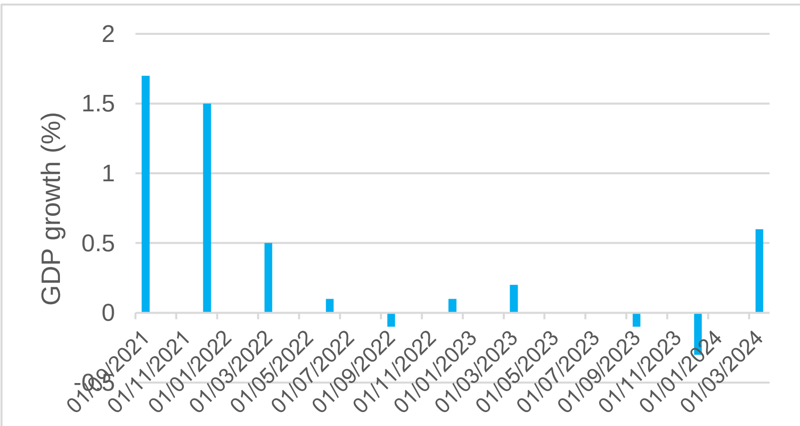
Goodbye recession, hello summer

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.48%	-2 bps	-1.2%	-2.2%
German Bund 10 year	2.51%	1 bps	-1.3%	-2.7%
UK Gilt 10 year	4.15%	-7 bps	-1.6%	-3.4%
Japan 10 year	0.94%	4 bps	-1.5%	-2.1%
Global Investment Grade	96 bps	-1 bps	-0.8%	-0.7%
Euro Investment Grade	109 bps	-2 bps	-0.3%	0.1%
US Investment Grade	89 bps	0 bps	-1.0%	-1.1%
UK Investment Grade	95 bps	-2 bps	-0.5%	-0.4%
Asia Investment Grade	143 bps	-15 bps	0.1%	1.3%
Euro High Yield	358 bps	-13 bps	0.5%	2.2%
US High Yield	312 bps	4 bps	-0.1%	1.5%
Asia High Yield	666 bps	-10 bps	0.7%	6.5%
EM Sovereign	296 bps	-7 bps	-0.4%	1.0%
EM Local	6.5%	0 bps	-0.4%	-2.5%
EM Corporate	268 bps	-5 bps	0.0%	2.3%
Bloomberg Barclays US Munis	3.6%	-7 bps	-0.2%	-0.6%
Taxable Munis	5.3%	0 bps	-2.0%	-2.4%
Bloomberg Barclays US MBS	47 bps	-1 bps	-1.2%	-2.3%
Bloomberg Commodity Index	240.82	1.5%	4.0%	6.2%
EUR	1.0784	0.1%	-0.2%	-2.4%
JPY	155.87	-1.8%	-2.8%	-9.5%
GBP	1.2529	-0.2%	-0.8%	-1.6%

Source: Bloomberg, ICE Indices, as of 10 May 2024. *QTD denotes returns from 31 March 2024.

Chart of the week – UK GDP growth, 2021-2024



Source: Bloomberg, Columbia Threadneedle Investments as of 13 May 2024.

Macro / government bonds

There was a flattening trend in fixed income markets last week as central bankers continued to call for patience around further information on disinflation.

The Bank of England (BoE) left interest rates on hold at 5.25% at its May meeting. Governor Andrew Bailey sent a gentler message to markets, reaffirming that the Bank would need more data before it could begin the process of withdrawing restrictive monetary policy. He also contended that a change in rates in June could neither be ruled out nor made a fait accompli. This makes the June meeting a live date, whereas previously the market had coalesced around August as the most likely starting point for a rate cut. Bailey told markets the Bank had made two important adjustments to its thinking on monetary policy, which enhanced his more constructive message on markets. First, it felt a much greater proportion of the impact of past cumulative monetary tightening had already passed through to the consumer. Second, the Bank now thought the second round effects of higher prices would fade faster than initially assumed. Bailey reminded his audience that the BoE would need to make monetary policy less restrictive over coming quarters, possibly more so than is currently priced into markets. The market had already been positioning for more dovish messaging, with gilt valuations firming in the lead up to the policy decision. Gilt yields fell across the curve, while pricing in the swaps market indicated a greater probability of more than two quarter point rate cuts by year-end.

In terms of data, we also had the BoE's Decision Maker Panel and annualised GDP for the first quarter. The DMP report showed that output price growth remained elevated, but that there had been a moderation in wage growth and employment expectations. UK GDP came in a little stronger than expected at 0.6% as the country exited a shallow recession. The structure of activity in the UK economy largely mirrored that of the global economy, with growth in the services sector outpacing that in the manufacturing sector.

The Reserve Bank of Australia similarly left its cash target on hold at 4.35%. Although inflation in Australia continues to moderate, it has declined more slowly than anticipated. This is due in part to continuing excess demand and elevated wage growth. The RBA called for patience. Unlike the BoE there was less guidance on when a cut might occur. This was reflected in the swaps market where there is still no consensus on the direction of Australian rates in 2024.

Diverging from the "patience" messaging, the Swedish Central Bank, the Riksbank, cut interest rates by 0.25% to 3.75%. It argued that inflation is approaching target, while economic activity has continued to weaken. If the outlook for Swedish inflation holds, there could be two further quarter point cuts in 2024. While the Riksbank is a less systematically important bank for the global economy, it plays an important role in terms of signalling. It will not want to move too far from the European Central Bank in terms of monetary policy to avoid unnecessarily weakening the Swedish currency, which would increase the risk of importing inflation.

Although the ECB was relatively quiet during the week, it did publish the minutes of its last interest rate meeting. It repeated the call for patience in awaiting further information on disinflation, with June a plausible start date for monetary easing. While there is widespread consensus in the market for this, there is less consensus on what will follow, especially as the US Federal Reserve seems further apart from the ECB on monetary easing.

Meanwhile, the PMI Composite report for the eurozone pointed to a services-driven expansion, with growth in Spain continuing to outpace that of Germany, France and Italy. Greater upward pressure on eurozone short-dated yields during the week reflected the gravitational pull of the US Treasury market. The US economy remains resilient, despite some signs of loosening in the labour market. Last week we saw a broad swathe of US policy makers deliver the same message that it was too early to think about cutting rates given disappointing inflation data. Market participants continued to push back their expectations of when US interest rate cuts would begin. Although pricing in the swaps market pointed to one and a half rate cuts by year end, the probability of a "no rates cut" scenario for 2024 has increased.

In terms of positioning on the Global Rates desk, we retain an overweight in the UK and the Eurozone, a relatively neutral position in the US, and a strategic short position in Japan.

Investment Grade credit

Global Investment Grade spreads ended the week at 96bps over government bond yields, the tightest spreads this year thus far. In spite of volatility in government bond markets, spread markets have been notably calm with little movement in the past few weeks. Indeed, the range of spreads this quarter has been only five basis points from tightest to widest.

Recent economic data from the euro area and UK has been better than feared. This is supportive for the market as it has prompted an upgrade to consensus expecations for growth in 2024. Meanwhile, the likelihood of imminent interest rate cuts in both these areas seems to have risen – again supportive for markets and underlined in central bank rhetoric. Although spreads are tight, when compared to shorter- and longer-term averages yields are high and this seems to be attracting demand from investors.

There was little specific credit news last week as we reach the tail end of earnings season. Corporate and Banking results have been fine/ahead of expectations in both the US and Europe.

High yield credit & leveraged loans

US high yield bond valuations were stable over the week amid large inflows, supportive earnings and an active primary market.

The ICE BofA HY CP Constrained Index returned 0.02% and spreads were 5bps wider. The yield-to-worst of the index increased 6bps to 7.91%. According to Lipper, retail high funds reported a $2.4 billion inflow, largely driven by ETFs. This was the largest weekly inflow since November, helping to balance the largest week of new issuance in more than two years. Meanwhile, the average price of the Credit Suisse Leveraged Loan Index increased $0.15 to $96.2, a two-year high. Retail loan funds saw their 20th consecutive inflow, and largest in more than two years, with $2 billion contributed.

European HY returned a solid performance (+0.38%) inspite of the shortened week due to holidays. This was even as decompression continued with CCCs still sharply underperforming higher rated credits. Spreads tightened (-13bps to 358bps) while yield fell (-11bps to 6.96%). Flows were positive, and largely into managed accounts, although a small amount was seen in ETFs. The primary market marginally slowed down, despite the shorter working week, with €1.5 billion equivalent via three new deals.

In ratings, there was negative news in real estate as S&P cut German real estate developer Adler to CCC-. The firm signed a non-binding agreement with bond holders for restructuring. It appears the developer is having trouble selling assets at the expected levels. Peach Property is also not faring well as Moody's cut its rating to Caa2 on the expectation that Peach will likely have to restructure. There was bad news in the construction materials sector as Consolis was downgraded to C by Moody's after it announced a balance sheet restructuring transaction including a debt-for-equity swap of its €300 million, 5.75% 2026 bonds. In telecom news, Altice International was downgraded on the back of fundamentals from B to B-.

Q1 earnings reports are coming through. The chemical sector appears to be in line with expectations with more evidence of destocking and with H2 improvement expected. Leisure is also looking positive as International Consolidated Airlines Group (British Airways) reported a small beat in expectations with bookings going strong. BA has increased the numbers of flights in preparation for a good summer on the expectation of strong capacity demand.

Asian Credit

The Biden administration will reportedly quadruple tariffs on Chinese electric vehicles (EVs) and sharply raise tariffs for other sectors this week. The total tariff on Chinese EVs will increase to 102.5% from 27.5%. The timing of further tariff announcements is not a surprise because the US Trade Representative is concluding its statutory four-year review to determine whether the tariffs on Chinese products, under Section 301, will be extended beyond the four-year period (2018-2022). The conclusion will pave the way for the Biden administration to adjust existing tariffs or impose new levies.

At the macro front, China will start selling the first batch of its CNY1 trillion ($138 billion) of ultra-long special sovereign bonds, starting with the 30-year tranche this Friday. Over the coming weeks it will also sell the 20-year and 50-year tranches too. China is stepping up its fiscal spending to support growth. The issuance of these bonds is quite rare. This is only the fourth time China has sold them – the last time it did so was a CNY1 trillion issue in 2020.

Structured Credit

Calmer financial markets led to a bit of a rally in Agency Mortgage Backed Securities (MBS), which closed the week up 20bps.

With supply and prepays still muted, lower volatility and historically wide spreads were beneficial to the sector. Spreads have moved modestly tighter and tend to trade long into rallies. Banks and overseas buyers are also improving the demand picture. On the week, 30-year bonds outperformed 15-year, and lower coupons also outperformed.

Weekly mortgage applications came in up 2.5%. This week we will get more news on the housing market such as new home sales, which are expected to be higher. Broadly speaking, the fundamentals remain strong for both agency and non-agency Residential MBS. On the Commercial MBS side it was a relatively active week in private labels. There ae 15-30 new issue SASB deals in the near-term pipeline and spreads have tightened. The downgrades continue on a 7:1 scale versus upgrades, while the Senior Loan Officer Survey reported continued tightening in lending standards.

Emerging markets

Emerging market hard currency sovereigns posted positive returns last week, predominately driven by tighter spreads. The index return was 0.55% and all regions posted positive numbers.

The Peruvian central bank cut rates 25bps to 5.75% and has cut 200bps in total since it commenced its easing cycle. April's inflation figure printed at 2.4%, falling from 3.05% the prior month and supporting the central bank's case for rate cuts. In Mexico, policy makers held rates at 11% having made the first cut in its cycle last month. Colombia's easing cycle is well underway, but policy makers opted to keep rates at 11.75%. Poland held again at 5.75% having already delivered 100bps of cuts last year.

Ratings news has been positive for emerging markets over the past couple of weeks. Turkey was upgraded to B+ by S&P following a return to orthodox monetary policy. In Africa, the outlooks for Egypt and Nigeria were lifted to positive by Fitch; Egypt's change was aided by the recently confirmed $8 billion IMF support package, and in Nigeria reform progress continues following the President's Tinubu's appointment last year.

Commodities

The commodity index delivered returns of 1.5% on the week with outsized gains in precious metals (3.8%) and grains (2.4%) driving the rally.

Gold rallied by 2.9% and is once again close to all-time highs. It has been supported by expectations of base rate cuts alongside geopolitical tensions and continued momentum in central bank buying, with the likes of Turkey, China and India doing the heavy buying in Q1. Despite this, gold ETF’s have seen consistent outflows following strong demand during the pandemic.

Silver prices also had a strong week, rallying 6.8% to three-week highs. Prices have been supported by easing US Treasury yields and stronger import and export data from China.

In grains, corn (+2.1%) and wheat (+6.6% for Chicago contracts) had a strong week following the US WASDE report, from which both corn and wheat-ending stocks are expected to be lower.

Responsible Investments

As an issuer, the downside to raising debt via a sustainability-linked bond is the risk of missing a KPI and having to provide a coupon step-up to investors. Last week saw Italian utility company Enel issue a statement explaining that it would have to do exactly that after missing a greenhouse gas emissions target. The energy crisis has meant emissions are not on the desired downward trajectory across the sector, meaning we could see more coupon step-ups as a result of failed targets. Enel will increase coupons on five of its bonds by 25bps, which means a coupon step-up on €5.75 billion of debt, according to Bloomberg.

Issuance for labelled bonds has been steady and consistent since the beginning of the year, with around $3.5-$4.5 billion issued each month.

Fixed Income Asset Allocation Views

13th May 2024

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 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. **The group remains negative on credit risk overall, with no changes to underlying sector views.** ▪ 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 timing and magnitude of cuts have been pushed back. ▪ 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; 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)	¥ $ 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)	A$ EM ¥ Short -2 -1 0 +1 +2 Long € £ $	▪ 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))	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.	▪ Global real rate reversal challenges EM easing cycles. ▪ Geopolitical strife rekindles inflation ▪ US macro-outperformance strengthens US dollar.
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ EMD spreads tightened this month, supported by improvement in distressed credit and stability in GCC despite geopolitical risk. ▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ 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. ▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ 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 furth increase the risk in the distressed and highly leveraged segment. We expect this to accelerate in the coming months. ▪ Bank loan market continued to see tight spreads, improving technical. Underlying credit backdrop unchanged.	▪ 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 remain at tight levels; however, 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ 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 remain 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	Under-weight -2 -1 0 +1 +2 Over-weight	▪ o/w Copper ▪ o/w Soybean Meal ▪ o/w Cocoa ▪ o/w Oil ▪ o/w Lead ▪ o/w Zinc	▪ Global Recession