In Credit

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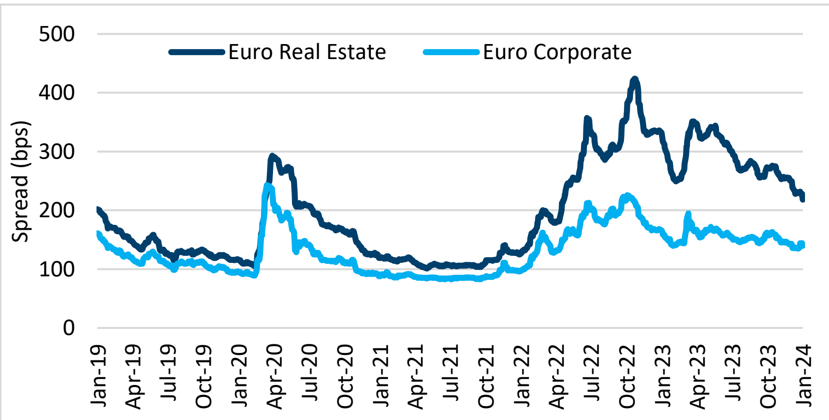
Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	3.94%	-11 bps	-0.3%	-0.3%
German Bund 10 year	2.25%	10 bps	-1.0%	-1.0%
UK Gilt 10 year	3.82%	4 bps	-2.4%	-2.4%
Japan 10 year	0.57%	-4 bps	0.6%	0.6%
Global Investment Grade	114 bps	-5 bps	-0.3%	-0.3%
Euro Investment Grade	137 bps	-6 bps	-0.6%	-0.6%
US Investment Grade	102 bps	-7 bps	-0.1%	-0.1%
UK Investment Grade	115 bps	-3 bps	-1.4%	-1.4%
Asia Investment Grade	188 bps	10 bps	0.0%	0.0%
Euro High Yield	401 bps	-26 bps	0.5%	0.5%
US High Yield	356 bps	-12 bps	-0.1%	-0.1%
Asia High Yield	770 bps	-9 bps	1.9%	1.9%
EM Sovereign	334 bps	-2 bps	-0.9%	-0.9%
EM Local	6.2%	-11 bps	-0.5%	-0.5%
EM Corporate	315 bps	5 bps	0.2%	0.2%
Bloomberg Barclays US Munis	3.3%	2 bps	-0.2%	-0.2%
Taxable Munis	4.9%	-11 bps	-0.9%	-0.9%
Bloomberg Barclays US MBS	45 bps	-5 bps	-0.2%	-0.2%
Bloomberg Commodity Index	225.32	-0.6%	-0.5%	-0.5%
EUR	1.0957	0.1%	-0.8%	-0.8%
JPY	145.83	-0.2%	-2.7%	-2.7%
GBP	1.2724	0.3%	0.2%	0.2%

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

Chart of the week – Real Estate & Market IG Index Spreads (€), 2019-2024



Source: ICE Indices, Bloomberg, Columbia Threadneedle Investments, as of 12 January 2024.

Macro / government bonds

The yield curve bull steepened last week, as yields on short-dated bonds fell more than yields on long-dated bonds. The reason for this was the changing inflation picture as CPI disappointed markets. CPI was marginally higher on the month at 0.3% for December while core CPI also remained unchanged on the month at 0.3%. There was little meaningful change to either hourly or weekly earnings while jobless claims remained static. The labour market matters, as the cost of labour is the weightiest component of services inflation. As such, labour market weakness is regarded as the last real remaining domino on the path to lower inflation, especially as goods, food, and energy price inflation (notwithstanding recent events in the Gulf) have fallen. There was an obligatory knee-jerk reaction in the US Treasury market to the higher CPI number, but yields would ultimately continue to oscillate round the 4% level at the 10-year maturity point.

The next piece of the jigsaw was PPI data on Friday. PPI Final Demand data fell -0.1% on the month. This was the third consecutive decline in PPI Final Demand, which could be attributable to lower energy prices and food prices. The trend of diminishing prices pressures is likely to be reaffirmed later this month in the publication of the PCE Deflator – the Fed's favourite measure of inflation. Components of the PPI calculation feed through to the PCE calculations for inflation. PPI data thereby helped justify the output of some bond valuation models, which indicated that inflation could reach 2% by March 2024, or even potentially undershoot it. The market shifted from pricing in just over five quarter point rate hikes at the start of the week to more than six hikes by its finish, with the first rate cut expected by March. There was some pushback from senior policy markers at the Fed, who throughout the week tried to keep their optionality and timing open. It was, however, difficult to rein the market back in.

While the easy trade recently has been to increase interest rate risk in portfolios, the level of issuance in the US last week, at more than $100bn, pointed to the importance of curvature strategies. The deteriorating fiscal situation in most developed markets is a reminder that term premia, although less commented upon recently, is an increasingly important consideration in the valuation picture. Europe replicated the price action in the US. Isabel Schnabel, ECB leading member and widely regarded hawk, told the market that it was too early to talk about interest rate cuts, but her exhortations fell on deaf ears. The market continued to price in a first rate cut in the eurozone for March / April and a total of six quarter point rate hikes by year end.

Investment grade credit

After a shaky first week, order was restored to the IG market last week. The deluge of new issuance seen at the start of the year has calmed ever so slightly while demand remains robust.

As we start 2024, the real estate sector stands out as one the top performing areas in IG credit in the last few months. Spreads have gapped tighter as the prospect of lower interest rates, demand for IG bonds and yield; a lack of supply in the sector; and attractive valuations underpins real estate bonds. As the **'Chart of the Week'** shows, this area had been particularly weak in early 2023 as rates rose. Two of the bigger issuers in Europe, Aroundtown and Vonovia have seen their 5-year euro bonds spread compress from levels around 950bps and 310bps to around 430bps and 180bps respectively, according to data from Bloomberg. Another reason for the strong perfomance would seem to be the 'opening' of the bond market for refinancing / funding. Vonovia issued a 12-year sterling bond last week that attracted considerable interest (estimates of £3.5bn for a £0.4bn issue) and saw the initial spread of 190bps tighten to 157bps to reflect this demand. Bonds also traded tighter still 'on the break' into secondary trading. Vonovia, a German residential real estate business, is rated BBB+/Baa1 by ratings agencies S&P and Moody's.

The big US banks (JP Morgan, Bank of America, Wells Fargo and Citibank) kicked off reporting season at the end of last week. Results showed a peaking if not decline in margins (excluding JP Morgan). Credit quality is normalising if not worse than average (JP Morgan and Wells). There was a deterioration seen in credit card and commerical real estate lending. Loans and deposits are flat to a small gain while capital levels continue as a small build (more to come). Markets businesses were resilient – aside Citibank.

High yield credit & leveraged loans

US high yield bonds recouped the bulk of the prior week's spread widening as the uncertainty remains around the timing of the Fed's first policy ease, the primary calendar began to reopen for the year, and the asset class saw modest fund inflows.

The ICE BofA US HY CP Constrained Index returned 0.98% and spreads were 13bps tighter. According to Lipper, the asset class saw a $523m inflow, the ninth inflow over the last 10 weeks. Meanwhile, the average price of the Credit Suisse Leveraged Loan Index was unchanged over the week at $95.6. Loan funds saw a small $87m inflow, marking the ninth inflow in 11 weeks.

European High Yield had a strong week, recovering its start of the year loss and some as the asset class returned +1%, bringing the MTD performance into positive territory. Spreads tightened in 26bps to 401bps while yields fell 22bps to the start of the year yield of 6.83%. It was a compression week as CCCs strongly returned more than double the performance of BBs and Bs. Flows were positive though they had slowed down to less than half of the previous week (€105m), largely active via ETFs. The primary market picked up last week with new corporate issuances from Schaeffler and QPark (total €1.53bn).

There was another short seller report, this time hitting the healthcare sector. Grifols, Spanish pharmaceuticals, was accused in a report by Gotham Research, on understating leverage and overstating profit by consolidating entities controlled by the founding family investment vehicle. This was refuted by the management and market comments suggested that the issues flagged are either an exaggeration or related to well-known / old issues. Spanish regulators are looking into it and will issue a report.

Asian credit

The outcome of the Taiwan Presidential election is in line with polling estimates. While the DPP candidate (William Lai) emerged as the new President with around 40% of the popular vote, the DPP fell short in securing a majority in the Legislature. The KMT party (Kuomintang), which favours closer engagement with China, won most of the seats in the Legislature. On balance, the election outcome could help to somewhat ease cross-strait tensions over the near-term.

The Adani Group has made some further positive progress in its refinancing plans. Adani Ports raised INR5bn through the domestic bond market. While the equivalent amount of around $60m is small, this is a positive development in re-accessing the domestic bond market after its last INR bond issuance in October 2021. Additionally, Adani Green provides further details about the sources of funds to cover the maturing $750m ADANIG bond in September 2024, which will come from its debt service reserve account, joint venture with Total Energies and the sales of preferential shares to the promoter family.

In the Philippines, Meralco received the best bids for its 1,800MW supply requirement from SMC Global Power and GNPower (a joint venture of Aboitiz Power, ACEN and Power Partners). The supply agreements, if approved by the regulators, will provide two subsidiaries of SMC Global Power with cash flow visibility for their respective supply of 300MW and 1200MW.

Emerging markets

Treasuries and EM spreads both moved in the right direction last week to generate positive performance. The JPM EMBI Global Diversified index posted a return of +1.10%. High yield bonds outperformed investment grade with particularly strong performance from Pakistan and Ukraine. The index spread is now just back under 400bps over treasuries, at 399bps.

Saudi Arabia came to the market last week with a $12bn deal across three tranches; 6, 10 and 30 years. There was also new issuance from South Korean semiconductor company SK Hynix as well as Colombian energy company Ecopetrol.

Guatemala's President Bernardo Arevalo was sworn into power despite his opponents delaying the inauguration. The new President was elected in August and is an anti-corruption campaigner who has vowed to make reforms. The news is positive for this small Central American country with low debt and stable growth.

In China, there was disappointment as policy makers left the medium-term rate unchanged. Markets expected a rate cut which would have led to currency weakness, something its central bank wanted to avoid.

Fixed Income Asset Allocation Views

15th 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