In Credit

17 June 2024

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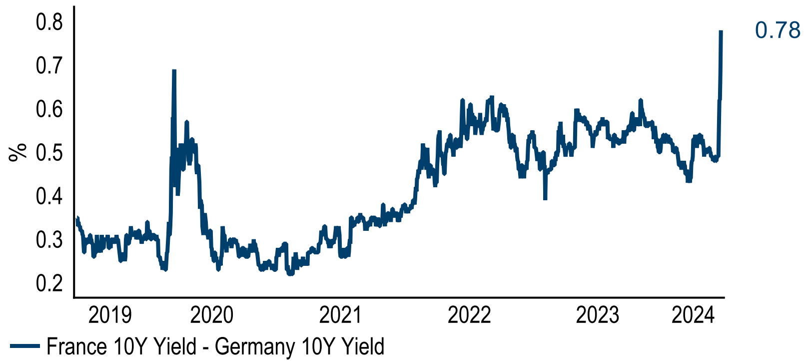
Snap election call jolts markets.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.24%	-19 bps	0.9%	0.0%
German Bund 10 year	2.41%	-21 bps	0.1%	-1.3%
UK Gilt 10 year	4.09%	-18 bps	-0.2%	-2.0%
Japan 10 year	0.94%	-4 bps	-1.8%	-2.4%
Global Investment Grade	102 bps	6 bps	0.8%	0.9%
Euro Investment Grade	120 bps	14 bps	0.3%	0.7%
US Investment Grade	95 bps	5 bps	1.0%	0.9%
UK Investment Grade	102 bps	8 bps	0.1%	0.1%
Asia Investment Grade	145 bps	13 bps	1.5%	2.7%
Euro High Yield	374 bps	39 bps	1.2%	2.9%
US High Yield	329 bps	14 bps	0.8%	2.3%
Asia High Yield	605 bps	7 bps	3.1%	9.1%
EM Sovereign	331 bps	7 bps	0.9%	2.3%
EM Local	6.6%	-1 bps	-2.1%	-4.2%
EM Corporate	273 bps	10 bps	1.5%	3.9%
Bloomberg Barclays US Munis	3.7%	-11 bps	0.2%	-0.2%
Taxable Munis	5.0%	-18 bps	0.8%	0.4%
Bloomberg Barclays US MBS	46 bps	-2 bps	0.9%	-0.1%
Bloomberg Commodity Index	239.64	0.7%	4.1%	6.4%
EUR	1.0716	-0.9%	-0.8%	-3.0%
JPY	157.77	-0.4%	-3.8%	-10.4%
GBP	1.2673	-0.3%	0.5%	-0.3%

Source: Bloomberg, ICE Indices, as of 14 June 2024. *QTD denotes returns from 31/03/2024.

Chart of the week – French vs German 10-year spread, 2019-2024



Source: Macrobond, Columbia Threadneedle Investments as of 17 June 2024.

CTEA67082883.1 Issued June 2024 | Valid to end August 2024

Macro / government bonds

There were two market moving events last week. First, the publication of softer than expected inflation readings in the US. Second, the pricing in of higher risk premia to eurozone semi-core and periphery bond valuations.

In the US, Consumer Price Inflation (CPI) came in better than expected at 0.0%, in contrast to the previous month's reading of 0.3%. This largely reflected a fall in energy prices although shelter costs continued to edge higher.

The US Federal Reserve's decision on interest rates was sandwiched between the publication of CPI and Producer Price Inflation data. There was no change to US interest rates, which remained in a target range of 5.25% to 5.50%. The messaging from the Fed was one of gradual change. While its bias remains to ease monetary policy, the Fed needs greater confidence from the economic data that inflation is moving sustainably towards 2%. In addition to its decision on interest rates, the Fed published its quarterly projections on growth, inflation, unemployment, and interest rates. The projections saw growth and unemployment remain unchanged from the March projections for 2024 at 2.1% and 4% respectively. However, headline and core inflation projections over the same period increased 0.2% to 2.6% and 2.8% respectively. Of greater interest to the market was how policymakers saw the evolution of interest rates and what this would imply for market pricing. The context for the projections was an economy that had continued to expand at a solid pace, although signs of cooling in the labour market and in consumer spending had begun to emerge.

Four participants of the Fed felt it would be appropriate to leave interest rates unchanged, given the tone of recent economic data. In contrast, seven participants thought that one rate cut would be appropriate while eight participants felt two rate cuts would be appropriate. The median projection was for interest rates to finish the year at 5.1%, implying one rate cut. One other factor to emerge from the projections was that policymakers now expected a shallower path for monetary loosening than they did in March. In the accompanying press conference, Jay Powell, Fed chair, acknowledged all participants would have had advance notice of the CPI data and that while some would have used the new data to update their projections, others would not have done. He admitted that while the Fed regards the current stance of monetary policy as restrictive, there is a degree of uncertainty over just how restrictive it is.

In Europe, we saw the fall-out from recent elections to the European Parliament. Gains in France for the Far Right, which were replicated elsewhere in the region, led French premier Emmanuel Macron to call a snap election. The prospect of a populist right wing government in France, which would be likely to implement more expansionary policies, translated into wider spreads for the core eurozone market over Germany. By the end of last week, the yield spread of French bonds over German bonds at the 10-year maturity point had reached 78bps **(see chart of the week).** This compared to a median figure of 53bps over the last two years. France was not the only country to be negatively impacted. The peripheral eurozone countries of Italy, Spain, Portugal, and Greece also saw yield spreads reach 3-month highs over Germany.

In the current geopolitical environment, we believe many central banks would be happy to preside over a growth in FX reserves. Central banks that do see their FX reserves grow will initially be buyers of US dollar assets in weights that reflect their existing currency allocation. The simple fact that the US dollar accounts for the lion's share of reserves at most central banks means the dollar will see the largest share of newly invested flows.

The respondents to the Official Monetary and Financial Institutions Forum survey may have been reflecting a hope / desire that FX reserves grow, rather than a planned tactical reallocation into US assets. In a growing FX reserve scenario, the second largest intended flow would be into euro-denominated assets, which is precisely what the survey suggests. Growth in FX reserves rather than relative interest rate differentials probably explain the survey results.

Investment grade credit

Corporate bond spreads had been trading in a very narrow range recently. That trend ended last week.

The news of a snap election in France (see above) and the risk of a more extremist government forced French government and corporate / banking issuer spreads wider. Euro swap spreads followed suit. Globally, the euro market has underperformed its US dollar cousin. New issuance was unsurprisingly light in the face of this rise in risk aversion.

Global spreads ended the week at 102bps over government bonds – a widening of six basis points in the last five trading sessions and the widest spread since mid April. As mentioned, the euro market saw spreads widen 14bps while US dollar spreads were only 5bps higher.

High yield credit & leveraged loans

US high yield bond returns were positive as interest rates moved lower following a benign US inflation report and rise in jobless claims.

The ICE BofA US HY CP Constrained Index returned 0.28%. Spreads widened 15bps to +346bps while the yield-to-worst of the index decreased 0.07% to 7.83%. Retail high yield funds reported a small $10m inflow for the week, according to Lipper. This marked the seventh inflow over the last eight weeks. The average price of the Credit Suisse Leveraged Loan Index declined $0.01 to $95.9 as the CPI report fueled a decline in the forward rate curve. That said, retail loan funds saw their inflow streak continue for a 25th week with a $547m inflow.

The European High Yield (EHY) market was softer last week (-0.23% return) on the back of a busy primary market with seven new offerings totalling €3.3bn. Spreads widened 36bps to 374bps. However, yields only rose 11bps to 6.97% given the fall in underlying government bond yields. CCCs outperformed higher rated credits and was the only positive returning rating band (+0.86%). Inflows accelerated over the previous week with +€316m added to the asset class, solely via managed accounts. ETFs saw a small net outflow as they moved to trade at a discount. That said, EHY has seen €6bn of assets added to the asset class year-to-date.

In credit rating news, Copeland (climate control systems) was downgraded to B1 on the back of the additional leverage due to a vendor PIK repurchase. It was better news for Telecom Italia which was upgraded by Moody’s to Ba3, outlook positive. JaguarLandRover also got the thumbs up from S&P. The credit rating agency placed the parent company, Tata, and its subsidiaries on credit watch positive with plans for an upcoming review to assess the possibility that the extraordinary support from Tata is greater than what it has currently factored.

On a sector basis, it was reaffirmed last week that cyclicals have started to see signs of improvement as destocking comes to an end. Improvement is expected to pick up more in the second half of the year.

Asian credit

Chinese house prices remain under pressure despite the launch of various government policies to support the sector. In May, the prices of new homes in 70 cities, excluding public housing, dropped 0.71% m/m, the largest decline since October 2014. Additionally, the prices of secondary homes fell 1% m/m, marking the worst drop since 2011.

The European Commission has imposed tariffs of up to 30% on Chinese electric vehicles (EVs) after its probe revealed that Chinese EV manufacturers benefited from subsidies in their supply chains. The European Commission has notified BYD, Geely and SAIC on the tariffs that will be implemented in early July.

In India, six companies in Tata Group were placed on Creditwatch with positive implications by S&P, thanks to higher operational and management linkages within the group. The potential scope for a ratings upgrade for the six companies, which include Tata Steel and Tata Motor, is driven by the increased flexibility of Tata Sons to support the companies as well as a more balanced cash flow generation within the group.

Structured credit

US Agency MBS surged last week with a 1.45% total return and 12bps in excess return.

Despite an unemployment report that edged rates higher the prior Friday, lower than expected PCI and PPI data overwhelmed the relatively hawkish FOMC dot-plot causing yields in Agency MBS to drop about 20bps. As bidders came back into the Agency MBS sector, spreads rallied and ended the week squarely in the middle of their 6-month trading range. Coupons in the belly of the curve did best with investors more apprehensive on prepay risk for higher coupon bonds. Broadly speaking, mortgages are following Fed policy expectations and should continue to push tighter as volatility simmers down. In ABS, spreads held mostly firm, and sentiment at last week's annual CREFC New York conference was more upbeat versus last year's regional bank stress overhang. While concern is still focused on the office sector, property types like retail and lodging are performing well, and the peak in the Fed funds rate should be a positive for cap rate re-pricing.

Emerging markets

There were positive returns for the EM hard currency sovereign index last week (+0.83%). Despite spreads widening 8bps, the tailwind from declining treasury yields contributed positively to returns. Consequently longer-dated paper performed strongly and investment grade outperformed high yield.

Political instability in South Africa subsided as a new government of national unity was confirmed. The coalition combines the ANC and the centre-right Democratic Alliance as well as other smaller parties. The Economic Freedom Fighters (EFF) and uMkhonto weSizwe (MK) parties were not included, which gave investors comfort as it looks more likely now that the reform agenda can continue under the leadership of re-elected President Cyril Ramaphosa.

Argentinian President Javier Milei's significant reform package won a narrow majority victory in the senate. Reforms include changing labour laws and privatising some state-owned enterprises. Bonds performed well on the back of the approval; however, violent protests erupted in Buenos Aires.

Sri Lanka completed its second IMF review which unlocked $336m. The IMF is satisfied with the country's compliance with the programme so far but cautioned for the need to maintain reform momentum.

Policy makers in Thailand and Peru met last week where they both opted to hold rates at 2.50% and 5.75% respectively. Many emerging market central banks had embarked on a proactive tightening of monetary policy back in 2021, hiking rates before the Fed, meaning they have had space to commence their easing cycles. We are now seeing a renewed hawkishness with central bankers holdings rates due to concerns over persistent inflation.

Responsible investments

In the fall out from the snap election called by the French Government, SFIL (French Development Bank) pulled its imminent green bond issue from the market, despite already arranging the book runners. It is assumed the market was too volatile post-election news as to why the offer was pulled, but this is yet to be confirmed. In contrast, French based utility firm, EDF did manage to issue three individual green bonds last week, totalling €3bn. One bond will focus on renewables, one on energy transmission and one on nuclear power. Nuclear is a controversial topic when it comes to ESG, as it’s often not listed as ‘sustainable’. EDF sold its first nuclear related green bond last November clearly outlining that all nuclear projects are financed separately from the broader list of green projects in its framework.

Fixed Income Asset Allocation Views

17th June 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 a downgrade in High Yield Credit to -2.** ▪ 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, increased and potentially new 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 and are near record lows. 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 further increase the risk in the distressed and highly leveraged segment. We expect this to , accelerate in the coming months. ▪ Default forecasts for lower rated issuers, particularly in Europe, is deteriorating with default rates projected to go up.	▪ 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	▪ 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 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