COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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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

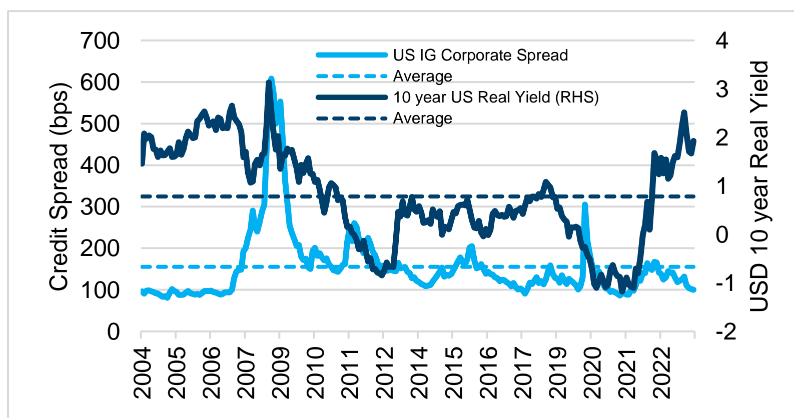
Nice yield – shame about the spread.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.30%	23 bps	-1.8%	-1.8%
German Bund 10 year	2.46%	19 bps	-2.5%	-2.5%
UK Gilt 10 year	4.10%	13 bps	-3.2%	-3.2%
Japan 10 year	0.77%	3 bps	-1.0%	-1.0%
Global Investment Grade	99 bps	-6 bps	-0.8%	-0.8%
Euro Investment Grade	111 bps	-7 bps	-0.4%	-0.4%
US Investment Grade	93 bps	-6 bps	-1.0%	-1.0%
UK Investment Grade	94 bps	-4 bps	-0.9%	-0.9%
Asia Investment Grade	156 bps	-12 bps	0.7%	0.7%
Euro High Yield	347 bps	-16 bps	2.0%	2.0%
US High Yield	316 bps	-10 bps	0.8%	0.8%
Asia High Yield	701 bps	-19 bps	5.3%	5.3%
EM Sovereign	298 bps	-11 bps	0.0%	0.0%
EM Local	6.3%	9 bps	-1.4%	-1.4%
EM Corporate	276 bps	-17 bps	1.7%	1.7%
Bloomberg Barclays US Munis	3.4%	4 bps	0.0%	0.0%
Taxable Munis	5.1%	20 bps	-1.7%	-1.7%
Bloomberg Barclays US MBS	48 bps	4 bps	-2.1%	-2.1%
Bloomberg Commodity Index	231.54	1.3%	1.7%	1.7%
EUR	1.0903	-0.5%	-1.4%	-1.4%
JPY	149.05	-1.3%	-5.4%	-5.4%
GBP	1.2741	-0.9%	0.0%	0.0%

Source: Bloomberg, ICE Indices, as of 15 March 2024. *QTD denotes returns from 31/12/2023.

Chart of the week – USD real yields and IG credit spreads, 2004-2024



Source: Bloomberg, Columbia Threadneedle Investments as of 18 March 2024.

Macro / government bonds

Last week was all about the rekindling of inflation expectations and what this could mean for monetary policy. In the US, we had Consumer Price Inflation and Producer Price Inflation data. February readings were higher than the market had been expecting for both: CPI rose 0.4% month-on-month while PPI Final demand rose 0.6% month-on-month. While a rise in energy prices had an impact on both CPI and PPI, the higher readings from these data series pointed to higher core PCE – the US Federal Reserve's favoured measure of core inflation. The data on US inflation raised two important questions for the market. First: would the Fed push back the expected timing of any rate cut; and second would the relative resilience of the US economy cause the Fed to scale back its forecasts of rate cuts for this year when it publishes its dot plot later this week? Only two policy makers would have to change their minds to cause the median level of rate cuts to decline from three to two for this year. The blackout period before the Fed meeting this week meant there were no verbal interventions from policy makers to give markets a steer. Other data points to matter were initial jobless claims and continuing claims, which were lower than the market expected, once again underlining the resilience of the US economy.

Financial markets responded by adjusting pricing to reflect a higher probability that the Fed would stay its hand a little longer, while also reducing its expectations of the number of quarter point interest rate cuts rates this year from 3.8 to 2.9. As a result, the yield on the 10-year US treasury rose by +0.23% to settle at 4.31% over the course of last week, as macro and real money accounts pared back interest rate risk. This new level for 10-year US treasuries equated to the upper end of its current trading range, which if broken might have resulted in another lurch higher for US treasury yields. Yields, however, appeared to stabilise at this level given opportunistic demand from dip buyers. Selling momentum in the US treasury market spilled over into global fixed income markets. By way of example, the yield on 10-year German bonds rose +0.18% to 2.44%.

In contrast to the US a raft of policymakers in Europe spoke on monetary policy. These ranged from Christine Lagarde, ECB President, to Phillip Lane, ECB chief economist. There was a common theme to all comments; namely, that by June policymakers should have sufficient information on wages and corporate profits to facilitate a cut in rates. The market continued to price in June as the most likely month for the first cut in eurozone interest rates.

Japan remained in the crosshairs of market participants. The Rengo Confederation of Unions secured wage increases of around 5% for the coming fiscal year, contrasting to the 3.8% figure the unions had won in the previous year. In addition, Kazuo Ueda, Bank of Japan governor, signalled that the central bank remains on track to end its negative interest rate policy this year. Market consensus pointed to an interest rate rise this week, equivalent to a +0.10% increase. Any rise in Japanese interest rates will be a significant event in global bond markets. It remains to be seen whether Japanese life assurance companies will repatriate capital from the US to Japan, so that they can benefit from higher domestic rates and a strengthening yen.

Positioning across portfolios combines a short duration in Japan with a long duration position in core developed markets. The other key position is a strategic yield curve steepening position.

Investment grade credit

Global investment grade spreads edged tighter by around six basis points last week.

The spread is now inside 100bps for the first time since early 2022. The move tighter in spreads has been led this year by euro and sterling markets, which are both 18% tighter while the US dollar market is 'only' 11% better. Credit curves have steepened after flattening last year. Short-dated bonds (1-5 years) have tightened by over 20% in euros and 15% for US dollars in the first two and half months of 2024.

In terms of sector performance all global sectors are tighter YTD but banking, insurance and real estate have performed most strongly in risk-adjusted terms.

From a valuation perspective all markets are trading inside short and longer-term averages and consequently are considered to be expensive, while the euro market seems to offer more value (or is less expensive). The global index is aorund 0.9 standard deviations expensive to its five year average and 0.6 SDs to a 20-year history.

The market continues to experience high volumes of new issuance that is being easily absorbed. It seems investors like the yield offered in the market even though the spread is so tight (**see Chart of the week).**

High yield credit & leveraged loans

US high yield returns were negative over the week as as investors absorbed above consensus readings on inflation and solid labour market data.

The ICE BofA US HY Cash Pay Constrained Index returned -0.28% and spreads were 10bps tighter. According to Lipper, US high yield retail funds reported a $289m inflow, the 16th inflow over the last 19 weeks. Meanwhile, the average price of the Credit Suisse Leveraged Loan Index rose $0.13 to $96.15 with the asset class benefiting from steady retail fund inflows, heavy CLO origination, and light new supply. Retail loan funds saw a third consecutive $400m+ weekly inflow with $458m contributed, marking the 16th inflow over a 20 week period.

European high yield had a solid week (+0.20% return) coming from spread tightening (-16bps to 347bps) as the yield remained basically unchanged at 6.8%. There was more market compression with a strong performance from Euro CCCs (returned 1.2%), which outperformed higher rated credits. Single Bs performed especially poorly, actually returning a negative performance for the week (-0.1%). Flows into the asset class accelerated with €500m+ ‘joining the party’ last week, equally via both ETFs and managed accounts. It was a busy primary market, with increased issuance over the previous week (four bonds issued for the euro equivalent of €2.7bn), even posting a larger issuance than US high yield market. This brings new issuance on par with 2023 for the same period.

In specific issuer news, Grifols, the Spanish healthcare company, continued its roller coaster ride, more down than up, with S&P downgrading it to CCC+ while Fitch downgraded it to B-. This followed the previous week’s downgrade by Moody’s to Caa1. Intrum, the Swedish debt collector, appears to be coming to terms that an overhaul on its debt structure is needed as the company announced it has picked advisors to advise on their options. Bonds and equity sold off on the news.

In credit rating news, S&P followed Moody’s in the recent upgrade of RollsRoyce, taking a step further, improving the rating from BB+ to BBB- and making the issuer a ‘rising star’. Gestamp, the Spanish auto parts company, was also upgraded from Ba3 to Ba2 by Moody’s, narrowing the gap to S&P’s rating of BB+.

In M&A news, Altice France confirmed it had entered into an exclusivity agreement with the CMA CGM Group and Merit France to sell 100% of Altice Media to them for a total cash consideration of €1.55bn. This sale confirms Patrick Drahi’s message that everything is up for sale as this specific holding previously was always said to be not for sale.

Structured credit

Rising interest rates led to weak performance for the US Agency MBS sector last week. Posting a negative total return of -1.51%, the sector underperformed the broad IG market as spreads widened a few basis points. 15-year Agency MBS outperformed 30-year and higher coupons did best. While supply remains constrained relative to historical levels, the asset class is largely dependent on money managers who fortunately have been allocating. The catalyst to significant tightening in spreads is mostly tied to getting banks back into the sector. In the interim, it remains a carry opportunity at these all-in yields. In ABS, the new issue market remains wide open. $10.8bn priced last week and spreads were generally tighter across the board. YTD new issuance is up 56% versus last year and yields remain attractive up in the capital stack. In CMBS, investor appetite and optimism on current CRE valuations supported tighter spreads. New issue supply was steady with four new deals pricing last week, all mostly inside guidance.

Asian credit

China released a set of weak credit data. The February total social financing flow amounted to CNY1.6trn, below consensus. The sharp decline in household loans was driven by the distressed property sector and poor consumer sentiment. Credit growth was also dragged by the slow issuance of government bonds, which came in at CNY601bn in February 2024 (-26% y/y). The long-term credit to corporates, however, rose to CNY1,290bn (+16.2% y/y), reflecting the investment support for infrastructure and manufacturing.

In the property sector, the data on home prices for February was underwhelming. New home prices in 70 cities fell 1.9% y/y, worse than the January drop of 1.2%. The prices of existing home were weaker too in February, down 5.2% y/y from -4.5% in January. At the local government level, some tier-2 cities have started to remove the restriction on second-home purchases and tax exemption on the resale of long-held properties.

India has announced the specific dates for upcoming general elections. The general election will run for six weeks from 19 April. This will stretch over seven phases with different states voting at different times. The election results will be announced on 4 June.

Emerging markets

Emerging market hard currency sovereign spreads tightened 10bps over the week to 355bps, the move higher in US treasury yields though detracted from returns overall meaning the index posted -0.72% for the week. Following strong rallies recently from recent idiosyncratic outperformers in the lower rated bucket, the high yield / investment grade compression theme actually reversed last week with IG outperforming HY for the first time in several weeks.

In ratings news, Uruguay was upgraded by Moody's to Baa1, in line with Peru, citing the recent approval of a set of measures aimed at boosting economic reforms.

In China, industrial production rose by 7% y/y beating expectations and growing at the fastest rate in two years, thanks in part to exports rising by 7.1% in January and February. Additionally, fixed asset investment grew by 4.2% and retail sales rose 5.5%. Whilst the retail sales print was disappointing, strong growth in recreational goods (+11.3%), alcohol and tobacco (+13.7%) and autos (+8.7%) are encouraging within the context of the weak consumer confidence seen in China. Property investment was down 9% y/y but improved from -24% in December.

In India, Fitch upwardly revised its expectations for Indian GDP growth to 7.8% for fiscal year 2024 (the Indian government expects 7.6%) and 7% for fiscal year 2025. The bullishness is on the back of strong domestic demand and investment alongside strong levels of business and consumer confidence.

Commodities

The BCOM index delivered total returns of 1.3% with copper (+6.0%) and energy (+2.1%) the best outperformers.

The copper market was supported a group of 19 Chinese smelters pledging to control capacity via measures such as delaying the start-up of new projects. The news follows the recent shutdown at a Panamanian mine operated by First Quantum, as a result of protests regarding social and environmental issues. Copper ore grades at existing mines are also declining, resulting in higher costs to extract copper. Prices breached $9,000 a tonne for the first time since April 2023, Goldman Sachs currently has a $10,000 price target by the end of 2024.

In the energy complex, crude prices were supported by Ukrainian drone strikes on Russian oil refineries last week and over the weekend. Pricing was further supported by the IEA changing its forecast of a supply surplus (+0.8m barrels per day) in 2024 to a deficit (of -0.3m barrels per day). The most impactful change from the IEA was the assumption of reduced supply growth (+800k barrels a day down from +1.7m in February) in anticipation that voluntary cuts from OPEC+ will remain in place for H2 2024.

In the softs market, (off benchmark) cocoa prices have rallied by 25% on the week to record highs and are now up 100% YTD. Pricing has been supported by weather extremes (El Niño) and disease hitting West African growing regions.

Responsible investments

The labelled bond market has made decent headway so far in 2024 to indicate it could be a record-breaking year for green, social, sustainable, and sustainability-linked bond issuance.

The watermark is currently the $1.1trn raised in 2021, but issuance so far this year is the largest we have seen yet for YTD numbers, according to Bloomberg. We have seen nations like Canada come to the market for the first time under a new green bond framework, as well as hear about Rwanda and Qatar consider issuing ringfenced bonds. With a potential turbulent year ahead (elections etc), the pace may slow but with new nations in the market, and better-quality guidelines and regulations, we will hopefully see an equal, if not better, year ahead.

Fixed Income Asset Allocation Views

18th March 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.** ▪ 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; lower quality credit 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 ¥ $ (above); P £ € (below)	▪ 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)	Short -2 -1 0 +1 +2 Long EM A$ (above); ¥ € $ £ (below)	▪ 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))	Under-weight -2 -1 0 +1 +2 Over-weight R (above); C (below)	▪ 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 macro stabilisation and market-wide spread rally. Technicals have modestly improved, continued outflows but stronger 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. ▪ 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	▪ 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. ▪ Strong 2024 start for fundamentals and technical. Per ratings agencies, index credit quality has improved y/y. Inflows are exceeding net supply despite record IG new issuance in January. ▪ 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 continued to tighten since last month. Modest weakness in fundamental outlook with sector bifurcation. ▪ Anticipate credit selection will be the performance differentiator in 2024. Looking to avoid defaults/distress, focusing on credit recovery and deleveraging theses, ▪ Conservatively positioned, looking to reduce and diversify credit risk because spreads are likely near their cycle lows. ▪ 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. ▪ Lower coupons have underperformed driven by rate move and regional bank headlines. ▪ In late 2023 the group reduced position sizing into spread tightening but remains overweight the sector. ▪ 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	▪ Neutral outlook because of decent fundamentals and relval in select high quality Non-Agency RMBS, and ABS. ▪ RMBS: MoM spreads have tightened. 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 and near-term maturities, however non-office sectors perform as expected and overall market sentiment improving. ▪ 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 ▪ u/w Grains ▪ o/w Soybean Meal ▪ o/w Cocoa ▪ o/w Oil ▪ o/w Lead ▪ o/w Zinc	▪ Global Recession

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