In Credit

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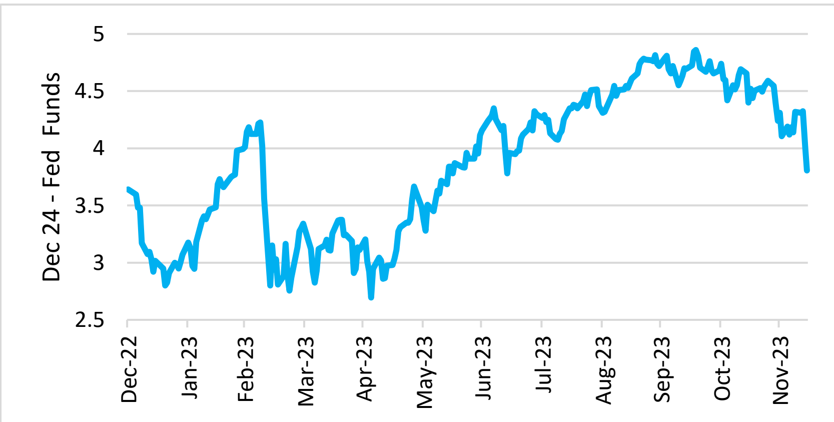
Dovish Fed, bullish markets.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	3.90%	-33 bps	5.4%	3.5%
German Bund 10 year	2.01%	-27 bps	6.3%	5.0%
UK Gilt 10 year	3.65%	-39 bps	7.4%	2.4%
Japan 10 year	0.68%	-9 bps	0.4%	0.0%
Global Investment Grade	115 bps	-5 bps	6.7%	7.8%
Euro Investment Grade	136 bps	-6 bps	5.1%	7.6%
US Investment Grade	104 bps	-6 bps	7.6%	8.1%
UK Investment Grade	116 bps	-2 bps	6.0%	7.3%
Asia Investment Grade	183 bps	9 bps	4.4%	6.9%
Euro High Yield	414 bps	-24 bps	5.0%	11.7%
US High Yield	351 bps	-24 bps	5.9%	12.3%
Asia High Yield	810 bps	-1 bps	4.5%	-0.4%
EM Sovereign	324 bps	-7 bps	8.5%	9.7%
EM Local	6.3%	-14 bps	6.4%	10.9%
EM Corporate	320 bps	1 bps	4.7%	8.2%
Bloomberg Barclays US Munis	3.3%	-19 bps	7.4%	5.9%
Taxable Munis	4.9%	-30 bps	8.3%	8.2%
Bloomberg Barclays US MBS	54 bps	2 bps	6.5%	4.1%
Bloomberg Commodity Index	227.40	1.2%	-4.6%	-7.9%
EUR	1.0913	1.2%	3.0%	1.8%
JPY	142.73	2.0%	5.1%	-7.8%
GBP	1.2659	1.1%	4.0%	4.9%

Source: Bloomberg, ICE Indices, as of 15 December 2023. *QTD denotes returns from 30/09/2023.

Chart of the week – December 2024, US Fed Funds Expectations



Source: Bloomberg, Columbia Threadneedle Investments, as of 14 December 2023.

Macro / government bonds

Although the US Federal Reserve kept interest rates on hold at 5.5% last week, there was a significant pivot in monetary policy as Fed Chair, Jay Powell, laid the groundwork for lower interest rates. The meeting had a different air to previous meetings in which the Fed had communicated a “higher for longer” message. During the press conference Powell admitted that they had discussed rate cuts and were happy with the the progress that had been made in bringing inflation down. The publication of the DOTS – the projections of individual members of the Federal Open Market Committee – revealed the shift in gear change. The median projections for where the Fed Funds rate was likely to be at the end of 2024 shifted down from 5.1% to 4.6% - only three members of the FOMC now thought interest rates likely to be higher than 5% at the end of 2024. Projections also revealed expectations of below trend growth in 2024 of 1.4% and a paring back of expectations for both headline and core inflation. Powell gave little push back to the notion that rates should start to fall to the assembled journalists, while admitting that they were very much focused on the risk of keeping rates too high for too long. The market increased its expectation of quarter point rate cuts from 4-6 in the US Treasury market for 2024, resulting in a bull flattening of the US Treasury yield curve, as investors felt increasingly comfortable taking duration risk.

The message from the Fed that the descent process for interest rates was now in motion was not relayed in Europe. The European Central Bank kept interest rates on hold at 4.5%, while enhancing its policy of balance sheet normalisation. From H2 2024, the ECB said it would start to reduce its Pandemic Emergency Purchase Programme by €7.5bn a month on average, whilst discontinuing re-investments under PEPP by the end of December 2024. It was an acceptance from the ECB that the risks of monetary policy fragmentation had diminished. The ECB contended that if rates were maintained at these levels for a sufficiently long period, it would make a significant contribution to its 2% inflation goal. In the accompanying press conference, Christine Lagarde, ECB President, reminded her audience that domestic inflation, largely predicated by wages, had hardly moved, despite the increasingly sluggish pace of domestic economic growth. The ECB was, she argued, in data dependency mode and now was not the time to lower rates. Lagarde revealed that there had been no discussion of rate cuts in stark contrast to the US. The rally in the US Treasury market was mirrored in the eurozone bond market, with market participants pricing in another 50bps of easing in the eurozone by December 2024.

The Bank of England adopted the same script as the ECB. In a split vote six members voted to keep rates on hold at 5.25%, while three voted for a quarter point rate hike. Andrew Bailey, BoE Governor, stated that monetary policy was likely to remain restrictive for an extended period of time and further tightening would be required if evidence of more persistent inflationary pressures were to emerge. With a nod to price action in the US, the market moved from pricing in 3 quarter point rate cuts in the UK to 4 quarter point rate cuts by the end of November 2024.

Aside the rally in interest rate markets, equities also rallied on the increased perception of a soft landing and easier monetary policy. This led one wag to call the market rally, the “everything rally.” It was certainly a good week for those that had positioned for a more constructive environment for interest rates. The current risk facing investors is that interest rate markets have come a long way in a short space of time. For markets to rally further investors need evidence of hard economic data, which points to recession rather than a soft landing. It has also increased the potential of higher volatility in interest rate markets, as market participants search out where fair value lies in this new market environment.

In the space of just one week global bonds, reflected through the Bloomberg Global Aggregate Index (US dollar hedged), and US equities through the S&P 500 Total Return Index returned 1.7% and 2.5% respectively in US dollar terms.

Investment grade credit

Investment grade bond markets headed into the holiday season in a buoyant mood. Investors have flocked to bond markets attracted by higher yields and the promise of strong returns. This comes at a time of seaonally low new issuance and light dealer inventory.

The combination of sharply lower government bond yields and tighter credit spreads are a ‘heady cocktail’ for market returns and are helping unwind some of the damage done in 2022 and early 2023. Returns for all IG markets are now strongly in positive territory (see ‘Markets at a glance’) for this year.

One of the chief headwinds to tighter spreads this year has been restrictive monetary policy conditions, both at present, and in terms of expectations **(see Chart of the Week)**. With the Fed seemingly ‘done’ and expecting to cut rates next year this particular barrier to tighter spreads is showing increasing signs of wear and tear. If the ‘soft landing’ forecast by the US central bank proves correct, the economic background is also fairly reasonable for IG spreads.

However, spreads end the year inside both shorter-term (five year) and longer-term (20 year) averages. So valuations appear at best average (e.g. euro IG) and more fully priced (e.g. US dollar IG).

High yield credit & leveraged loans

It was a positive week for European High Yield as the asset class returned 1.4% with spreads contracting 24bps to 414bps and yields fell 38bps to 6.9%. The demand for the risk asset was so strong that it helped to finally lift CCCs out of their doldrums and the high beta credit finally outperformed BBs and Bs (by 50% for the week). In spite of the strong market demand, flows were back to negative, exiting both ETFs and managed accounts.

The primary market saw what was probably the last deal for 2023 with Synlab issuing a 7-year bond €550m offering. There was good demand for the bond as the price moved from mid to high 8% to 8.25%. Given the low issuance and strong demand for paper it meant that pricing and trades were decidedly one-sided last week with buys constituting 90% of the interest. It was very much an “easy to sell / hard to buy environment”.

In credit rating news, Rolls Royce was upgraded by S&P to BB+, following Fitch’s upgrade a day earlier.

In M&A news, Entain the gaming company, announced it is buying a Swedish online gaming company while Stonegate, the pub owners, was reported to be considering a deal for £630m against a portfolio of 1,000 pubs. In telecoms, Digi was said to be in talks to sell its Spanish fibre network in whole or part to a group of funds.

Stories in the leisure sector show companies going from strength to strength. David Lloyd, the gym operator has been able to increase membership fees 25% without any fall in demand. In food services, volume numbers for pubs and restaurants are up 5%.

US high yield spreads collapsed to an 18-month low as markets exited Wednesday’s FOMC meeting pricing in earlier and more aggressive easing over the coming year. The ICE BofA US HY CP Constrained Index returned 1.94% and spreads were 24bps tighter, ending at +370bps. According to Lipper, the asset class saw a $759m retail fund inflow. Meanwhile, the average price of the J.P. Morgan Leveraged Loan Index lagged during the rate-driven rally but still increased $0.33 to a 3-month high of $95.94. Retail loan funds saw an $83m contribution, the sixth inflow over the last seven weeks.

Structured credit

Mortgages had a year's worth of returns in 1-week last week. The sector was up 2.08% as rates rallied and investor appetite resumed. The FOMC's message was strongly in the camp of inflation is now under control and future rate hikes are off the table. Spreads tightened and fair value for the sector is getting closer. As expected, 30-year agency MBS and lower coupon outperformed 15-year paper and higher coupons with a bid for duration were strongly in play. The decline in rate volatility is exactly what this sector has been waiting for. Spreads in CMBS were tighter across the capital stack on continued risk-on trading. As it relates to consumer performance, the increase in delinquencies continues especially for the lower FICO score borrowers. Subprime auto numbers came in for November which showed further deterioration with DQs rising to 8.6% versus 6.25% at the same time last year for the deeper subprime universe and 4.75% versus 3.8% for higher quality.

Asian credit

The annual Central Economic Work Conference (CEWC) is a closely watched event in China during which the Central Committee of the Communist Party of China lays out the economic priorities for the year ahead. During the recent CEWC (11-12 December 2023), the Chinese government continued to emphasize its commitment to economic growth and security with the pledge of more economic support for technological innovation, expanding domestic demand, promotion of urban-rural integration and renewable low-carbon developments.

There were several ratings actions in Asian credit. At the positive end, Fitch upgraded the ratings of the notes issued by Mong Duong Finance Holdings from BB to BB+, following the sovereign ratings upgrade of Vietnam. Mong Duong's credit profile is supported by its take-or-pay power purchase agreement (PPA) with the state-owned Vietnam Electricity till 2040. For SK Hynix, S&P affirmed its BBB- ratings and lifted its outlook to stable (previous: negative). S&P expects SK Hynix to benefit from a meaningful improvement in operating results over the next six to 18 months, thanks to the expansion of the generative AI memory chip market. On another hand, Moody's affirmed SK Hynix's Baa2 ratings but kept the outlook at negative to reflect the company's elevated debt levels and the uncertainty over the earnings recovery and deleveraging progress.

In India, Vedanta Resources Ltd (VRL) has launched a consent solicitation and debt exchange programme. VRL has offered to make an upfront payment of $779m for three bonds that are maturing in 2024 and 2025, with the bulk of the payment ($530m) for the VEDLN 13.875% bond that matures in January 2024. S&P has downgraded VRL's ratings from CCC to CC and maintained the ratings outlook of CreditWatch with negative implications. S&P highlighted the likelihood of downgrading VRL to "selective default" if the distressed debt exchange is completed.

Emerging markets

Emerging market hard currency sovereigns enjoyed another strong week as treasuries rallied and spreads tightened 8bps. This resulted in a return of 2.6% for the week. Year-to-date the index has returned 10.2% with the high yield sub sector really driving performance.

The disinflation theme in emerging markets continues and we have seen EM central banks pause or cut interest rates, which should be supportive for the EM growth story next year. Last week Peruvian policy makers cut rates from 7% to 6.75% and in Brazil the Selic was reduced 50bps to 11.75%. In Mexico, interest rates were held at 11.25% for the sixth consecutive time.

In Argentina, the government unveiled a set of major economic measures that aim to tackle hyperinflation (at 143%) and the fiscal deficit (at 5.5% of GDP). Measures include reducing energy/transport subsidies, cutting social security/pensions, halving the number of government ministries, and cancelling tenders of public works. These measures were welcomed by the IMF. Argentina's 2030 US dollar bonds rallied by 2 points to 38 cents on the dollar last week.

In Europe, the EU released €10bn in frozen support funds to Hungary. Despite this, Hungary has threatened to veto a €50bn EU support package to Ukraine unless it receives a further €30bn in frozen EU funds that were withheld due to Hungary's lacking judicial and anti-corruption reforms. Hungary's 10-year EUR bond rallied by 3 points to 106 cents on the US dollar last week.

Commodities

The BCOM index delivered 1.2% in total returns last week with industrial metals (+3.3%) and precious metals (+1.6%) outperforming.

Within industrial metals aluminium (+5.1%) and copper were outperformers (1.6%) and beneficiaries of the more optimistic outlook for US rate cuts in 2024. In industrial metals news, Peru released its copper output numbers which notched a 1.9% YoY increase. In the UK, new sanctions were announced prohibiting British citizens from trading in a wide array of Russian metals. However, sanctions did not include Russian palladium that rallied 26.4% on the week.

In crude news, US oil inventories decreased by 2.35m barrels last week, a larger drawdown than expected. WTI finished the week up 1%.

Responsible investments

Over $900bn has been raised in labelled bonds this year, just shy of the 1 trillion dollars eagerly anticipated and 3% up on this time last year. As expected, well over half of this has been in green bonds as companies and nations are all trying to fund their net zero transition. Around a third has been issued by governments predominantly in Europe, second to the financial industry. Although the trajectory of issuance has stalled somewhat, there is some stability in total issuance over the last few years, with Barclays expecting next year's issuance to total $825bn (in line with FY 2022).

Fixed Income Asset Allocation Views

18th December 2023

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	▪ Valuations are within historic ranges, tightening back in over the past month. Technicals seem stable; fundamentals show modest pockets of weakness, but no thematic deterioration. **The group stands neutral on credit risk overall, with no changes to underlying sector views.** ▪ The CTI Global Rates base case view is no cuts in 2023, with one more possible hike left in the hiking cycle. Focus remains on wages, labor market, financial conditions, and inflation expectations. ▪ Uncertainty remains elevated due to geopolitical tension, stricter lending, monetary policy tightening, persisting inflation, and weakening consumer profile.	▪ Upside risks: the Fed achieves a soft landing with no labour softening; 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 15bps tighter than last month, benefiting from lower global rates. Technicals are slower, outflow and weak issuance. ▪ Conservatively positioned with most idiosyncratic opportunities in lower quality portion of index, focus on relval opportunities. ▪ 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.	▪ 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 have tightened since last month. ▪ Fundamentals have proved resilient with decent earnings. Global portfolios prefer EUR IG over USD on relval basis. ▪ Fundamental concerns remain focused on commercial real estate, unrealised losses for 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 over the past month, while technical and high – quality HY fundamentals remain stable. October brought more rising stars, but also more defaults. Financial conditions continue to punish destressed names. ▪ Conservatively positioned, but open to attractive buying opportunities in short HY, BBs and higher quality loans. ▪ US HY defaults remain below historic averages, with greater default expectations for 2024. ▪ Bank loan market volatility has improved in the past month. Themes: neutral retail fund flows, slow primary deal flow, improving CLO issuance, increasing burden, credit concern in lower quality loans. 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. ▪ Loans see retail fund outflows once Fed starts lowering rates.
Agency MBS	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Mortgage index tightened in the past month; spreads still wide of historic medians. ▪ The group has reduced position sizing, but still overweight. Constructive view over longer time horizon. ▪ Supply is manageable as higher rates and fall seasonals kick in. ▪ Performance has been driven by the Fed's hiking cycle, with MBS widening into a bear steepener.	▪ 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 risk-adjusted valuations in select high quality Non-Agency RMBS, CLOs and ABS. ▪ RMBS: September saw spreads tighten. 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: New issue steadily continues. Defaults remain low but CCC buckets continue to rise slowly with lower recoveries. ▪ ABS: Attractive relval in some senior positions. Higher quality borrowers remain stable, lower quality borrowers underperform. Fairly strong start to student loan repayment.	▪ 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, denting housing market strength. ▪ 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

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