In Credit

20 May 2024

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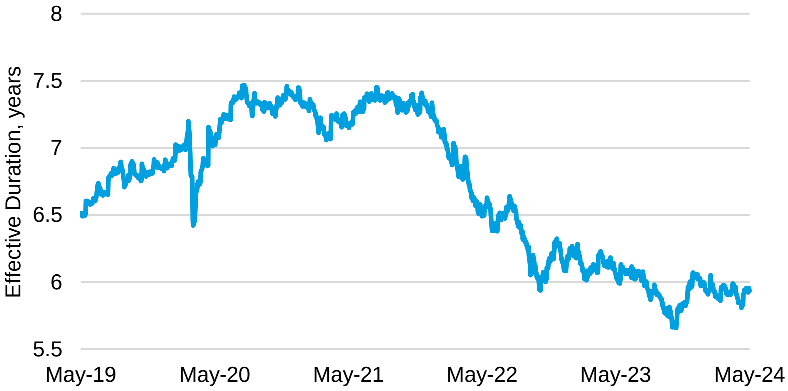
Spread rather thin.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.44%	-5 bps	-0.7%	-1.6%
German Bund 10 year	2.53%	1 bps	-1.2%	-2.6%
UK Gilt 10 year	4.16%	0 bps	-1.1%	-2.9%
Japan 10 year	0.98%	7 bps	-1.9%	-2.5%
Global Investment Grade	96 bps	0 bps	-0.3%	-0.2%
Euro Investment Grade	109 bps	0 bps	-0.3%	0.1%
US Investment Grade	89 bps	0 bps	-0.4%	-0.5%
UK Investment Grade	93 bps	-2 bps	-0.1%	-0.1%
Asia Investment Grade	142 bps	-1 bps	0.4%	1.7%
Euro High Yield	351 bps	-7 bps	0.8%	2.5%
US High Yield	309 bps	-3 bps	0.4%	1.9%
Asia High Yield	640 bps	-26 bps	1.9%	7.8%
EM Sovereign	293 bps	-3 bps	0.4%	1.8%
EM Local	6.5%	-5 bps	1.1%	-1.0%
EM Corporate	266 bps	-2 bps	0.6%	2.9%
Bloomberg Barclays US Munis	3.6%	3 bps	-0.2%	-0.6%
Taxable Munis	5.2%	-7 bps	-1.2%	-1.6%
Bloomberg Barclays US MBS	48 bps	1 bps	-0.7%	-1.7%
Bloomberg Commodity Index	250.48	3.0%	7.1%	9.4%
EUR	1.0860	0.9%	0.7%	-1.5%
JPY	156.12	0.1%	-2.8%	-9.4%
GBP	1.2704	1.4%	0.6%	-0.2%

Source: Bloomberg, ICE Indices, as of 17 May 2024. *QTD denotes returns from 31/03/2024.

Chart of the week – The reducing duration of IG credit markets



Source: ICE Indices, Bloomberg, Columbia Threadneedle Investments, as of 20 May 2024.

Macro / government bonds

The focus last week was all about US inflation readings and what this would infer not only for the direction of US monetary policy, but interest rates globally. The first release of data was for the US Producer Price Index (PPI). PPI Final Demand, and PPI ex Food ex Energy, rose 0.5% on the month in April. Higher producer prices reflected, in the main, higher services prices. PPI data failed to move the market, however, apart from an initial knee-jerk reaction, which led to a fleeting weakening of US treasury valuations.

There seemed to be a growing swell of confidence within the market that Consumer Price Index (CPI) data would be weaker. Headline and Core CPI came in softer than expected at 0.3% on the month. It was the smallest increase in CPI since December and broke the 3-month trend of higher than expected inflation readings. The majority of the rise for the headline CPI number could be attributed to shelter and gasoline. Items to decrease included used cars, trucks, and new cars – items that had been at the vanguard of the inflationary surge following Covid.

Adding to the lower than expected CPI data were US retail sales, which surprised to the downside. Retail sales were flat on the month, while the more conservative Retail Sales Control Group, which excludes volatile elements such as vehicle, food, and energy came in at -0.3%. Analysis of the data showed a pullback in spending on discretionary items such as sporting goods, hobbies, health, clothing and personal care. The data seemed to validate a market narrative that high borrowing costs and mounting debts were encouraging greater prudence amongst consumers. The combination of lower than expected CPI and retail sales data prompted a rally in the US treasury market, which would be replicated globally.
Jay Powell, Fed Chair, speaking at the Foreign Bankers' Association in Amsterdam, provided his audience with the context of a robust US economy and tight US labour markets, which necessitated a 'higher for longer' monetary policy approach. He did, however, help cap upward pressure on US treasury yields stating that it was unlikely that the next move in interest rates would be upwards. Other Fed policymakers repeated the call for 'patience', arguing that the central bank was in data dependency mode.

By the end of the week, much of the rally in the US treasury market that had followed the publication of the CPI and PPI data had ebbed away in the absence of any further catalysts to take yields lower. The UK market, which has a higher level of sensitivity to the US market than the eurozone at this point in the market cycle, broadly mirrored price action in the US treasury market. While there was no real data of note in the UK, we had speeches by the Bank of England's Chief Economist, Huw Pill, and Megan Greene, external member of the BoE's Monetary Policy Committee. Both gave a similar message that they expect to see a decline in inflation persistence, potentially opening the door to monetary easing later this summer. In the eurozone, we had data on wages from the Indeed Wage Growth Tracker. This showed a decrease in the pace of wage growth in the eurozone, which rose 3.35% on a year on year basis. The highest pressure on wages came from the Netherlands while the lowest pressure on wages came from Italy and France. The data continued to make the case for a June rate cut by the European Central Bank, although there was still no consensus on the sequencing of interest rate cuts that would follow.

Investment grade credit

Global IG spreads ended the week at 96bps over government bond yields again at the tightest valuation point of the year and in a period of very low market volatility.

We have noted several times now that spreads appear tight at present levels. However, the shape of the market has changed somewhat in the last few years. The sharp rise higher in bond yields in 2022 has meant that the duration of indices has fallen sharply. **Chart of the week** shows that the effective duration of the ICE global IG corporate index has fallen from around 7.5 years at the end of 2021 to below six years today. So spread per unit duration is now somewhat more appealing than outright spread.

After a holiday shortened prior seven days, last week was all about new issuance, lots of new issuance. This was especially evident in Europe where so called Yankee issuance (US companies issuing in euros) was particularly notable. The Yankee issuance has been driven by the fact that it cheaper to issue in euros than US dollars, in part because the euro market has done better than its US cousin this year. Spreads in euros are around 20% tighter in 2024 while the US market is tighter but only by around 10%. According to JP Morgan US dollar issuance is up around 30% year on year compared to a 20% rise for the euro market. This issuance has been easily digested indicative of the fact that investors are interested in IG markets from a yield, if not spread, perspective.

In specific news, Dutch Utility's talks to sell its German business to the German government (KFW) have broken down. It seems likely the company willl now look to list the entity separately. Meanwhile, Ping An insurance noted it will divest of the 8% of HSBC it holds. Ping An had been lobbying for a break up of the global bank.

High yield credit & leveraged loans

US high yield bond valuations declined modestly over the week amid ongoing retail fund inflows, supportive earnings reports, and lighter capital market activity.

The ICE BofA US HY CP Constrained Index returned 0.40% and spreads were 3bps tighter. The yield-to-worst of the index declined 12bps to 7.79%. According to Lipper, retail high yield funds reported a $771m inflow. Meanwhile, the average price of the Credit Suisse Leveraged Loan Index was unchanged amid ongoing retail fund inflows and elevated CLO origination. Retail loan funds saw an $815m inflow. This marks the 21st consecutive inflow for the asset class.

European high yield had another solid week returning 0.30%. Rate compression returned with CCCs strongly outperforming (+1.04%) higher-rated credits as spreads tightened (-7bps to 351bps) and yields fell (-8bps to 6.88%). Flows reverted to negative on the back of outflows from managed accounts. There was still a robust primary market (seven new issues totalling around €3.4bn), mostly refinancings, with issues ranging from B2 (Iliad) to split rated Centrica (Baa3/BB+), which were generally well received by the market.

In rating news, there were a number of downgrades last week. Medical Properties Trust, the healthcare REIT was downgraded two notches to B- and B1 by S&P and Moodys, respectively. The main reason given was the chapter 11 filing by Stewart Healthcare, MPT's largest tenant and the inevitable impact on rent collection. The optical solutions manufacturer, ams-Osram AG, was also downgraded to B by S&P as the rating agency expects a further decline on EBITDA margins and a weaker business risk profile overall. In more positive news, International Airlines Group, British Airway's parent company, was upgraded two notches to Baa3 by Moody's, bringing it on par with S&P's rating. The issuer finally returns to IG, about four years since its arrival into high yield.

In other news, Codere, the much beleaguered gaming company, saw its shareholders and creditors agree to write off almost 100% of its debt of €1bn (plus interest).

First quarter reporting is so far showing firms largely in line with generally a cautiously optimistic outlook.

Asian credit

The PBOC and NAFR (National Financial Regulatory Administration) announced more policies to support the property sector. These measures include the removal of mortgage floor rate nationwide for homebuyers, the reduction of downpayment floor and the reduction of housing provident fund rate.

Additionally, the PBOC launched a re-lending facility of CNY300bn for 21 eligible financial institutions that include policy banks and state-owned banks. The total facility could rise up to CNY500bn because the PBOC relending facility covers up to 60% of the principal of the bank loans. The interest rate is 1.75%, lower than the 2.25% of the Pledged Supplementary Lending. Local governments can access the funding to acquire housing inventory for conversion to affordable rental housing. The PBOC and NAFR also called upon the banks to increase the lending support for whitelist projects and to drive the completion and delivery of uncompleted projects. The Ministry of Finance China also launched the issuance of CNY1trn ultra-long special government bonds by selling CNY40bn of 30-year special CGB (China Government Bonds) at an average yield of 2.57%.

The Biden Administration has announced an increase of tariffs on a number of Chinese imports, which include steel, aluminium, electric vehicles (EV), lithium-ion EV batteries, solar cells and medical protective equipment. According to the factsheet released by the White House, the amount of Chinese imports targeted by the tariffs is $18bn.

Structured credit

The US Agency MBS sector has a solid week on lower rate volatility. The sector was up 56bps alongside other core bonds. Prepayment speeds came in faster, up 11%. 30-year bonds outperformed as did lower coupons as the curve bull flattened. Current coupon spreads tightened and the outlook has brightened given stronger technicals. In ABS, the primary market was active. We digested 16 deals totalling around $13bn. Autos were the primary driver of volume followed by student loans, equipment, railcar and consumer loans. Demand was solid across the board as most deals price a handful of basis points inside of initial price thoughts. Floating classes saw better execution by a couple of basis points than their fixed rate counterparts. We have about a dozen deals announced for next week already. The secondary market remained firm on modest volume for the week and did not put supply induced pressure on spreads in the secondary market. The CMBS AAA market has quietly tightened over the past week. Most of what is trading tighter this week are names / deals with ‘cuspy’ credit profiles (heavy office with potential extension scenarios) that have lagged the broader move tighter over the last 6-8 weeks. The story is the lack of supply which is at about 50% the volume year on year. Dealer inventories are now the lightest they have been in months.

Emerging markets

Emerging market assets were buoyed last week as US treasury yields declined following encouraging data prints out of the US. The return on the hard currency sovereign index was 0.82%, predominantly driven by US rates but EM spreads were also positive as spreads tightened to 364bps. The investment grade sub-sector outperformed high yield owing to the longer duration nature of this sub-component, which fared better as US treasury yields fell.

As a result of the improved sentiment the asset class saw a renewed appetite for EM bonds and over the week flows were positive at +$90m after three weeks of consecutive outflows. EM hard currency funds have been enjoying better flows than local currency portfolios.

Argentina cut interest rates again, the sixth time since President Milei took power and embarked on his ‘shock therapy’ tactics to improve the economy. The central bank cut rates 10% to 40% as inflation printed at 8.8% for the month of April, below the expected 9% and much lower than the 25% rate it was when Milei took over. Annual inflation is just below 300%.

Commodities

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

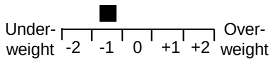
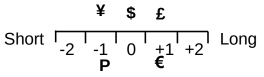
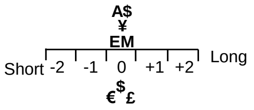
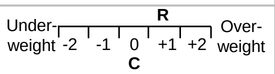
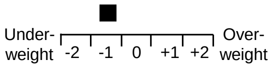
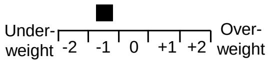
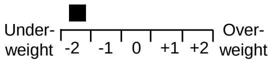
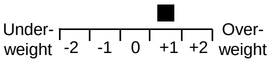
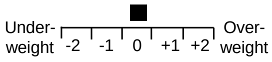
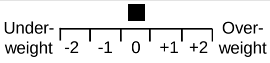
Gold rallied by 2.9% and is once again close to all time highs: the continued rally has been supported by expectations of base rate cuts alongside geopolitical tensions and continued momentum in central bank buying, with the likes of Turkey, China and India doing the heavy buying in Q1. Despite this,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

Silver prices also had a strong week, rallying by 6.8% to 3-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.

Fixed Income Asset Allocation Views

20th May 2024

Strategy and positioning (relative to risk free rate)		Views	Risks to our views
Overall Fixed Income Spread Risk		■ 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)		■ 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)		■ 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))		■ 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)		■ 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		■ 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		■ 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		■ 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		■ 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		■ o/w Copper ■ o/w Soybean Meal ■ o/w Cocoa ■ o/w Oil ■ o/w Lead ■ o/w Zinc	■ Global Recession

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