In Credit

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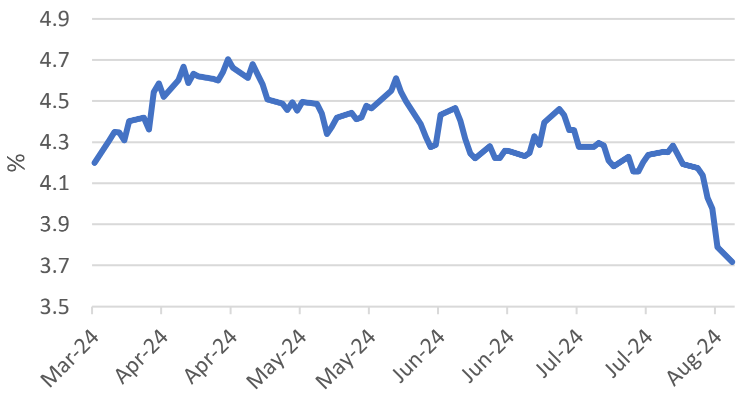
We've been waiting for you Mr Bond…

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	3.73%	-47 bps	4.0%	3.2%
German Bund 10 year	2.12%	-29 bps	2.6%	0.5%
UK Gilt 10 year	3.78%	-32 bps	3.1%	0.1%
Japan 10 year	0.79%	-28 bps	0.6%	-2.6%
Global Investment Grade	109 bps	9 bps	3.1%	3.3%
Euro Investment Grade	118 bps	9 bps	2.1%	2.6%
US Investment Grade	106 bps	11 bps	3.6%	3.7%
UK Investment Grade	97 bps	0 bps	2.3%	2.2%
Asia Investment Grade	173 bps	22 bps	2.0%	4.6%
Euro High Yield	399 bps	30 bps	1.1%	4.3%
US High Yield	372 bps	62 bps	1.6%	4.2%
Asia High Yield	600 bps	2 bps	2.1%	12.1%
EM Sovereign	372 bps	23 bps	2.4%	4.3%
EM Local	6.3%	-19 bps	3.0%	-0.9%
EM Corporate	293 bps	18 bps	2.1%	6.0%
Bloomberg Barclays US Munis	3.4%	-17 bps	1.9%	1.5%
Taxable Munis	4.6%	-38 bps	5.2%	4.0%
Bloomberg Barclays US MBS	42 bps	-2 bps	4.5%	3.5%
Bloomberg Commodity Index	219.57	-1.2%	-5.7%	-0.9%
EUR	1.0953	0.5%	1.8%	-1.2%
JPY	142.87	4.9%	9.8%	-3.7%
GBP	1.2754	-0.5%	1.2%	0.5%

Source: Bloomberg, ICE Indices, as of 2 August 2024. *QTD denotes returns from 30/06/2024.

Chart of the week – US 10-Year Treasury Yield



Source: ICE Indices, Bloomberg, Columbia Threadneedle Investments, as of 5 August 2024.

Macro / government bonds

A weak Non-Farms Payroll number of 114k triggered an enormous market move. The number was below the 12-month average monthly gain of 215,000. Unemployment also ticked up to 4.3%, its highest level since October 2021. The number triggered an immediate rally in the US Treasury market. During the week, the yield on the US 2-year Treasury fell 50bps, while the US 10-year Treasury broke through the important 4% level to end the week at 3.8%. The swaps market moved from pricing in two quarter point rate cuts by year-end to more than four quarter point rate cuts. The rally in the US Treasury market exerted downward pressure on bond markets globally, with the yield on 2-year German and UK bonds declining 30bps over the course of the week.

In a busy week for central banks, the Bank of England and the Bank of Japan both took interest rate decisions. The Monetary Policy Committee (MPC) cut UK interest rates by 0.25% to 5% in what was termed a finely balanced decision (5/4 split on the committee). The divergence of opinions within the MPC pointed to a modest sequencing of interest rate cuts. Market pricing in the swaps market continued to point to two quarter point rate cuts by year end in the UK.

The Bank of Japan raised its benchmark interest rate from 0.1% to 0.25%. It also announced it would halve the amount of bond purchases from six to three trillion yen by April 2026. As central banks in developed markets reduce, or get set to reduce, interest rates, Japan remains the outlier. The changing view on the outlook for interest rates in the US translated into a significant strengthening in the yen, which appreciated 5% versus the US dollar.

In terms of positioning on the global rates desk, we remain constructive on duration, tactically increasing duration on Non-Farm Payrolls Day before taking some profits on Monday. We also still have yield curve steepening positions in place, and a strategic short position in Japan.

Investment grade credit

Corporate results were well under way last week in review of the second quarter and first half of the year, with a general sense that corporates are performing well with a handful coming in better than expected. There is still a few more weeks of results to come so it’s difficult to draw a conclusion just yet.

Spreads ended July pretty much where they started, but in reaction to macro events we did experience some widening at the end of the week. Global and European investment grade markets moved 8bps, whilst the UK remained broadly flat.

Thames Water officially left a number of investment grade indices last week as we hit month end, due to liquidity concerns. Moody’s moved first and S&P followed as Thames’ Class A and Class B debt was downgraded and flushed down to high yield (pardon the pun). This double hit means Thames could be in breach of its operating licence. However, a downgrade to high yield is not an automatic trigger of SAR (Special Administration Regime) and is a decision to be made by Ofwat based on the Company’s remedial plan.

High yield credit & leveraged loans

US high yield bond spreads widened sharply over the week given a string of weak labour market data reports. The ICE BofA US HY CP Constrained Index returned -0.14% and spreads were 62bps wider. Spreads widened to +394bps, their highest level since December 2023. The yield-to-worst of the index increased 0.15% to 7.71%. According to Lipper, retail high yield funds saw a $438m contribution. In leveraged loans, the average price of the Credit Suisse Leveraged Loan Index declined slightly to $95.6. While prices were stable, the yield-to-3-year takeout declined nearly 50bps to 8.50% over the week given the pull forward of Fed cut expectations. Retail loan funds saw a $59m withdrawal, just the second outflow over the last 32 weeks.

European High Yield (EHY) returned a strong July performance of 1.25% largely from income and a fall in underlying yields (-0.12% to 6.82%) as spreads were close to unchanged with just a modest widening (+3bps) over the month. CCCs sharply underperformed the market (0.79%) as spreads widened 196bps, breaching 1,500bps on the upside (based on ICA BoA index HE30). The month finished with a jumbo week of issuance (€3.7bn equivalent) from four issuers, due to a jumbo offering from the pubs owner group, Stonegate. It came to the market with two issues – £1.645bn in sterling and €470m in euros – both with yields over 10%. This brings YTD gross issuance to €79bn, far surpassing full year issuance in 2022 and 2023. Flows were also strong with €426m largely from managed accounts, while ETFs also experienced inflows.

In credit rating news, Ineos Quattro was downgraded by Moody's to B1 from Ba3. This reflects elevated leverage and an expectation that any earnings recovery will be gradual, particularly in light of the softening macro picture. Not surprising at this stage, with net leverage currently >7x (>9x per Moody's). There was more bad news in the retail sector as another French retailer, Auchan (ELO) was downgraded to BB from BB+ by S&P. The rating agency cited "continuous performance deteriorating, especially in France, poses a long term threat to the group's creditworthiness…." In the building sector, Pfleiderer was downgraded to CCC from B on the likelihood of a distressed exchange. This followed a similar recent downgrade from Moody's to Caa1. The rating change announcement was swiftly followed by an announcement from Pfleiderer that it had achieved a 99% approval for its A&E plan, so will be able to implement it via the indenture, without going through a court process.

In sector news, Q2 earnings announcements appear to be presenting a mixed bag of numbers for the auto sector with OEMs seemingly in a better place than auto suppliers at the moment. In some cases, sales forecasts are being cut. Still, for the most part, margins and FCF have been affirmed (albeit towards the lower end of the expectations range).

Structured credit

Last week, the US Agency MBS sector was up a whopping 2.72%. On Friday morning, Non Farms Payroll came in at 114k, which was 61k lower than expectations and the unemployment rate came in at 4.3% vs 4.1% expectations. This led to a large bull steepener with the 2-year rallying around 27bps and the 10-year rallying some 19bps. Mortgages saw some softness during the sharp move in rates in the morning but found their footing midday and spreads ended the week roughly 8bps tighter. In CMOs, even before the large rally on Friday there was increased demand for mortgage derivatives, specifically inverse IO. With the number and speed of cuts increasing, we expect this demand to remain strong.

CMBS spreads widened into the end of the month across the stack on increased supply from both primary and secondary markets and a reduction in investor appetite. Dealer balance sheets are building and could extend the risk off tone we're witnessing. There is still demand for seasoned paper on the 2-4 year part of the curve, but that profile is finding its home in insurance / buy and hold money.

Asian credit

The State Council of China has laid out 20 key measures to drive consumer spending in the country. The framework includes the enhancement of financing support to eligible small and micro enterprises in the service industry, the implementation of additional personal income tax deductions to offset childcare costs, education expenses and elderly care. There are also plans to launch promotion activities for culture and tourism consumption, expedite the resumption of flights, provide various payment services and expand visa-free policy to more countries.

MGM China reported positive Q2 results with a market share of 16% in the Macau gaming sector. Thanks to the higher allocation of gaming tables and slot machines as well as the recovery in visitor numbers, Q2 revenue rose to HK$8bn (+37% y/y) and EBITDA increased to HK$2.4bn (+39.8% y/y). The company's liquidity position remained solid with $668mn of cash and available revolving credit facility ($1.4bn) as of June 2024.

Adani Ports provided a strong set of guidance for FYE March 2025 with its expectation that cargo will increase to 460-480mmt (prior year: 420mmt), which will drive revenue to INR280bn-310bn (prior year: INR267bn) and EBITDA to INR170-180bn (prior year: INR158.6bn).

Emerging markets

Risk-off momentum in EM debt built steadily over the week before lurching into a highly dislocated post-payrolls crescendo. Spreads widened some 25bps with the usual high-beta suspects driving the move.

For the most part, EM bonds were responding to dynamics in the macro environment. But idiosyncratic weakness played its part too: Kenya's troubled journey towards an IMF-friendly fiscal consolidation was disrupted by the Supreme Court's ruling that last year's tax reform was unconstitutional; elsewhere the fallout from Venezuela's disputed election result continues to undermine prices.

On a brighter note – early in the week Peru was able to bring its first issue in three years, a $3bn dual-tranche new issue at a reasonably tight spread. Primary market activity may now be dampened until stability is restored.

EM central banks are reluctant cutters at this stage in the cycle, with food and services inflation still a concern for many. Chile's was the latest central bank to disappoint market hopes of a 25bps cut. Moreover, several EM currencies found themselves under pressure from the unwinding of carry trades funded out of Japanese yen.

Market prospects depend on broader macro risk sentiment and, for some names, escalating tensions in the Middle East. A correction in spreads from especially tight levels has not been a surprise, and investors may require a return to a more stable global environment before re-engaging.

Responsible investments

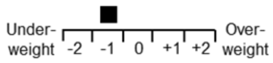
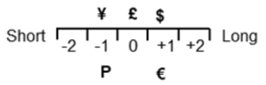
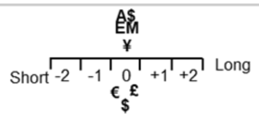
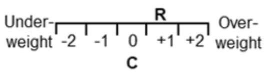
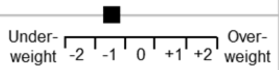
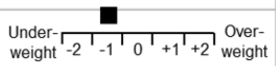
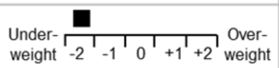
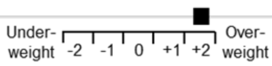
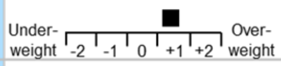
There was a steady flow of new issuance into the labelled bond market in July, approximately $80bn+ according to Bloomberg. Despite issuance slowing in the last few months, the expectation remains for a record (or near to record) level of annual issuance by year end.

NatWest sought to raise €750m via an 'Electric Vehicle' Green Bond last week, where use of proceeds will focus on supporting the transition to low carbon transportation of people and materials through funding electric passenger and commercial vehicles. Lloyds followed with a green bond issue of €1bn, with use of proceeds seeking to fund residential and commercial green buildings, alongside a smaller allocation to renewable energy and clean transport loans.

Fixed Income Asset Allocation Views

5th August 2024

COLUMBIA THREADNEEDLE INVESTMENTS

Strategy and positioning (relative to risk free rate)	Views	Risks to our views
Overall Fixed Income Spread Risk 	▪ Spreads have widened a bit but still remain at tight, unattractive levels. Economic data has weakened but hasn't yet translated into any significant spread widening. Current valuations limit the spread compression upside and are misaligned with potential market volatility. ▪ **The group remains negative on credit risk overall, with an upgrade to Agency MBS 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 impetus is on the fed to bring the timing and the magnitude of cuts forward. ▪ Uncertainty remains elevated due to sensitive monetary and fiscal policy schedules and elections in various countries.	▪ 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 carry trade unwinds intensify, hurting EMFX performance. ▪ Stubborn services inflation aborts EM easing cycles. ▪ Uptick in volatility. ▪ Disorderly macro slowdown boosts USD on flight-to-safety fears
Emerging Markets Sovereign Credit (USD denominated) 	▪ EMD spreads have remained stable this month, following the improvement in distressed credit and stability in GCC despite geopolitical risk amid changes after the elections. ▪ 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 remained stable but 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. ▪ 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: There is ongoing pressure, particularly on AAA securities. 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 sugar ▪ o/w Zinc ▪ o/w Gasoline ▪ o/w Distillates ▪ o/w Cocoa ▪ u/w natural gas ▪ u/w corn ▪ o/w lead ▪ o/w silver ▪ o/w soybean meal	▪ Global Recession