In Credit

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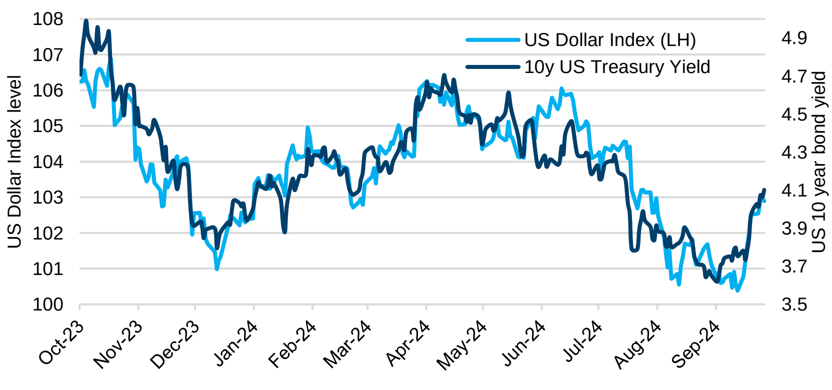
Dollar days

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.10%	13 bps	-1.7%	2.2%
German Bund 10 year	2.27%	6 bps	-1.0%	0.1%
UK Gilt 10 year	4.22%	9 bps	-1.5%	-2.0%
Japan 10 year	0.95%	7 bps	-0.5%	-2.3%
Global Investment Grade	92 bps	-2 bps	-0.9%	4.1%
Euro Investment Grade	108 bps	-2 bps	-0.3%	3.6%
US Investment Grade	84 bps	-3 bps	-1.2%	4.4%
UK Investment Grade	91 bps	-2 bps	-0.6%	1.6%
Asia Investment Grade	138 bps	4 bps	-0.7%	5.8%
Euro High Yield	344 bps	-3 bps	0.1%	7.0%
US High Yield	298 bps	9 bps	-0.5%	7.5%
Asia High Yield	508 bps	1 bps	0.4%	14.9%
EM Sovereign	313 bps	1 bps	-1.0%	6.9%
EM Local	6.3%	3 bps	-2.5%	2.4%
EM Corporate	250 bps	-1 bps	-0.5%	8.0%
Bloomberg Barclays US Munis	3.4%	11 bps	-0.6%	1.7%
Taxable Munis	4.9%	7 bps	-2.1%	2.5%
Bloomberg Barclays US MBS	40 bps	-1 bps	-1.4%	3.0%
Bloomberg Commodity Index	239.51	-1.2%	0.6%	6.5%
EUR	1.0929	-0.3%	-1.8%	-0.9%
JPY	149.43	-0.3%	-3.7%	-5.4%
GBP	1.3061	-0.4%	-2.3%	2.6%

Source: Bloomberg, ICE Indices, as of 11 October 2024. *QTD denotes returns from 30 September 2024.

Chart of the week – US 10-year Treasury yield vs US dollar index



Source: Bloomberg, as of 14 October 2024.

Macro / government bonds

We saw a bear steepening of yield curves last week in core markets, as longer-dated interest rates rose more than short-dated interest rates.

The trigger for the rise in yields had been the bumper Non-Farms Payrolls number, which reported a net 254k new jobs in the US economy. This fed through to a narrative of a soft landing, which has become an increasingly consensus view. The US economy continues to expand at a solid pace while consumption remains resilient. Although there has been evidence of some cooling in the US labour market, it has taken place within the context of high levels of employment. Traders in the swaps market scaled back their expectations of two further quarter point interest rate cuts by year end to less than two. Gone was the scope for another jumbo interest rate cut of 50bps. Aside from the swaps markets, the change in tone was also reflected through a rise in yields across the curve (**see Chart of the week**). Price action in short-dated interest rates reflected the potential paths for monetary policy, while the US presidential elections in November increasingly cast a shadow over the long end of the market.

The publication of the September FOMC minutes provided further reflection on the meaning of the word "recalibration." The 50bps cut was seen as sustaining strength in the labour market, while the minutes stressed that the jumbo move did not herald economic weakness nor signalled a further 50bps cut. The minutes were not a market mover, but did provide support for the soft landing narrative. The big data releases in the US last week were on headline and core inflation. Core inflation surprised to the upside, rising by 0.3% MoM for September, translating into an annualised figure of 3.3%. We had a chorus of Fed speakers, John Williams, President of the New York Fed, Austan Goolsbee, President of the Chicago Fed, and Thomas Barkin, President of the Richmond Fed, all of whom were prepared to look through the uptick in inflation, given their confidence that the broader disinflationary trend remained in place.

In Europe, another quarter point interest rate cut at the next ECB meeting in October seems a foregone conclusion. The market is currently pricing in a 95% probability of a cut. The eurozone economy is in a different place to the US economy. Inflation has been falling while growth continues to weaken. Isabel Schnabel, ECB board member, regarded as being on the more hawkish wing of policymakers, raised concerns about growth, while Frank Elderson, ECB board member, who rarely makes public comments, pointed to the risks of undershooting inflation. A more idiosyncratic story concerned news from France. Its new prime minister, Michel Barnier, will try to push through a mix of spending cuts and tax rises to help restore stability to French public finances. Spain and Portugal, part of the eurozone periphery, and previously regarded as riskier than France, now trade through it. This suggests that France's status as a eurozone semi-core country is increasingly at risk.

In the UK, Bank of England chief economist, Huw Pill, warned about the risk of moving too quickly on cutting interest rates, while services inflation remains elevated. Sentiment towards UK gilts remains edgy, as we approach budget day towards the end of October. The magnitude of the rise in longer-dated gilt yields relative to Germany continued to cement the UK's position as a higher beta European bond market.

Investment grade credit

The creep tighter in corporate bond spreads continued last week.

The global corporate bond spread is now around 92bps over equivalent dated government bonds. This marks the tightest spread level this year and the narrowest spread in three years.

Compared to historic levels spreads look rich. Over the last two and a half decades the credit quality and duration of the benchmark index has changed. Adjusting for the change in market credit quality (by using BBB spreads), variations in index duration and using asset swap rather than government bond spreads, the market is around 0.5 standard deviations expensive to a 25-year history according to data from ICE Indices.

Most recently, the market has been supported by stronger US economic data including the ISM service sector business confidence numbers as well as resilient employment data. This has seen the risk premia for potential recession reduced.

A low but positive rate of growth is a reasonable background for investment grade corporate investment. Meanwhile, interest rates are expected to fall further which is directionally positive for the market though the present terminal rates of interest priced into bond markets rests around or above the so-called neutral rate of interest. Our own expectations for corporate and banking health are positive with low levels of leverage and high levels of capital respectively.

High yield credit & leveraged loans

US high yield bond prices were again mixed over the week with resilient economic data and a firm CPI print. The ICE BofA US HY CP Constrained Index returned -0.28% while spreads widened 9bps. The index yield-to-worst increased to 7.17%. According to Lipper, US high yield bond retail funds saw a small $146m outflow for the week, just the fourth outflow over the last 14 weeks. The average price of the Credit Suisse Leveraged Loan Index increased another $0.2 to $96.2, supported by prospects of a slower than expected Fed easing cycle and resilient macro data. Retail loan funds saw their largest inflow in 12 weeks with $682m contributed.

For European High Yield (EHY), it was a pretty firm week as spreads continued their tightening trend, this time coming in 3bps to 344bps while yields rose 5bps to 6.36% on the back of higher underlying government bond yields. Though CCCs outperformed higher-rated credits, this was due to their outsized yield rather than any relative spread tightening as CCC spreads held steady while BB spreads tightened 4bps. Demand remains strong for the asset class as flows into EHY rose last week to +€400m, largely via managed accounts as ETF inflows were more subdued. The new issuance market was lighter versus the previous week's bumper crop but still healthy with €2.75bn coming via three issuers. Notably, United Group's new issue priced at the wider end of guidance indicating that investors remain vigilant on valuations.

On the credit rating front, Kockner Pentaplast, was downgraded, to Caa1 (from B3). Moody's said this reflected "KP's challenged performance over a number of quarters which, combined with a material debt burden, led to the company's capital structure becoming unsustainable." In the energy sector, the Mexican government said it is thinking to reclassify Pemex as a public company. Fitch said that depending on the reclassification is done, this could raise the issuer's rating from B+ to as high as BBB-.

In M&A news, one day after Stada Arzneimittel issued €1.25bn of fixed and floating bonds, there was the announcement that it is in advanced talks on being acquired by buyout firm GTCR. Stada is owned by private equity groups Bain Capital and Cinven.

Last week we updated our default forecast outlook, moving the needle on our 12-month forecast from 4% to 3.8% (24-month forecast from 8.3% to 7.2%). The lower default forecast is because a number of over levered issuers that we thought were at risk of liability management exercises have already completed their LMEs / recapitalization transactions. The pick-up in refinancing activity has also helped in the improved outlook. The fundamental back drop appears generally stable and even the the deteriorating outlook in the autos sector is set against a very well capitalised issuer base.

Structured credit

The US Agency MBS sector generated -43bps of total return on the back of more volatility in interest rates and uncertainty surrounding monetary policy. Spreads were relatively stable with good news on the prepayment/refi front as speeds declined 4% versus the prior month. Total gross issuance was $8bn lower MoM and net issuance was also down $10bn with a heavy 86% originated in the Ginnie Mae market. Reduced issuance can largely be explained by terrible affordability despite lower mortgage rates given the structural lack of housing supply. An additional technical support for the sector came from reduced US Fed paydowns, from $17.7bn in August to $16.2bn in September, as turnover slowed.

It was another busy week in ABS. 17 deals priced for over $14bn in sales, most of which saw very strong demand and eventually upsized and / or tightened. With primary deals well oversubscribed, investors have continued to turn to the secondary space. There has been relatively light selling and spreads continued to tighten. Both Conduit and SASB commercial markets were well bid last week, particularly at the top of the capital stack. The rise in US Treasury yields has brought all-in AAA CMBS yields to 5% versus the 4.65% just a week ago. This has brought the generic yield buyer back into the market. Light dealer inventories coupled with stronger demand for fixed rate AAAs should provide a nice catalyst for spread tightening in the near term.

Asian credit

In China, the Ministry of Finance (MoF) highlighted four fiscal measures, albeit without disclosing the size of the fiscal stimulus. The scale of the fiscal stimulus as well as more details could be revealed later this month during the NPC (National People's Congress) and Standing Committee sessions. Broadly, the four fiscal measures are related to: (1) state-owned banks; (2) local governments; (3) special assistance programme for specific groups of people; and (4) property sector. Special government bonds will be issued to replenish the core Tier-1 capital of state-owned banks. The MoF said that the debt limit for local governments will be raised to replace the hidden debt in local governments and contain their leverage risk. Special assistance and funding will be extended to low income and vulnerable groups. For the property sector, the MoF stated that fiscal policy support could include the issuance of local government special-purpose bonds and tax relief to stablise the sector.

In India, Adani Enterprises Ltd raised $500m through a qualified institutional placement (QIP) that was oversubscribed by around four times. SBI Life Insurance, other domestic insurance and mutual fund companies as well as GQG Partners have reportedly participated in the QIP. In the renewable energy sector, GIC (sovereign wealth fund of Singapore) is weighing options to sell its majority stake (c57%) in Greenko Energy Holdings, which could be worth around $5bn.

Ares Management Corp will acquire the international operations of GLP Capital Partners (GCP) outside of China for up to $5.2bn. GCP is the fund management business of GLP that manages logistics centres, digital infrastructure (data centres) and renewable energy assets. Ares Management will acquire GCP's operations in Japan, US, Europe, Brazil and Vietnam with an initial payment of $3.7bn, comprising cash of $1.8bn and $1.9bn in Class A common shares. GLP plans to use the cash proceeds to pay down debt and liabilities as well as for capex.

Emerging markets

EM debt spreads were range-bound last week finishing 1bp wider, but with the move higher in US rates the total return of the EMBIG was down -0.57%.

The EM Local index lost -0.81% on the week with nearly all the losses coming from fx as EM rates were relatively resilient to the move higher in US Treasuries.

Throughout the week the market was focused on China's Ministry of Finance press briefing on Saturday, where expectations for the size of the fiscal stimulus centred around 2-3trn RMB. In the event, the Minister did not detail the size of the measures but outlined four main areas of fiscal policy aimed at stabilizing the growth outlook: 1) an increase in local government debt limits to refinance shadow debts; 2) increased funding for local governments to encourage the purchase of unsold properties for conversion into affordable housing; 3) recapitalization of the banks; and 4) an increase in financial aid to students. While the acknowledgement of the problems is a positive sign, the steps outlined fail to mark a major break with prior efforts and do not suggest any meaningful attempt to stimulate consumption. For now, the market will reserve judgement until the size the fiscal stimulus becomes clear over the next few weeks and months.

Over the weekend the IMF announced a recalibration of its surcharge policies which will lower the interest rates charged to high volume borrowers from its Fund. The changes effective 1 November will reduce the number of countries that fall under the surcharge policy from 19 to 11 and will lower the cost of IMF borrowing due to surcharges by 36%, or about $1.2bn annually.

There were a couple noteworthy developments on the restructuring front last week. New Ghana bonds began trading on Wednesday after the government secured a 98.6% participation rate in the debt exchange. In contrast to the new President's campaign rhetoric, the Sri Lankan adminstration affirmed its commitment to the debt restructuring deal inked by the outgoing government, a welcome relief for bondholders.

Finally, the asset class saw inflows for the fourth consecutive week, a welcome reversal from the consistent outflows since 2022.

Fixed Income Asset Allocation Views

14th October 2024

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	▪ Spreads are modestly tighter since last month and fundamentals remain stable, despite elevated volatility and slowing of macroeconomic data. ▪ **The group remains negative on credit risk overall, with no changes to underlying sector views.** ▪ The CTI Global Rates base case view is that cutting cycle will start at the September FOMC. The pace and magnitude of additional cuts is uncertain and dependant on inflation and labor market conditions.	▪ 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)	EM A$ ¥ 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 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)	■ Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads are within 10bps of historical average; spread volatility has increased. ▪ Investment Grade credit demand remains strong from crossover investors, which absorbed the post-summer issuance. Waiting for High Yield issuance to see how market digests lower quality credit. ▪ Tailwinds: Stronger growth forecasts, Central bank easing, IMF program boost for distressed names. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, US election, geopolitical and domestic political uncertainty (especially Venezuela & Mexico), 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	▪ Earnings season saw solid results from IG issuers, no fundamental deterioration. ▪ Spreads have tightened back near year-to-date tights, are rich to long-run averages. ▪ Issuance has been strong (80 deals in first two week of September totalling ~$100b) and is expected to be a tailwind for the market until the November election. ▪ Current valuations limit spread compression upside and provide little compensation for taking on additional risk.	▪ 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 widened so far in September but are still rich in long-term averages. ▪ Earnings season did not indicate broad deterioration; however, the group still has a cautious view of fundamentals given management guidance, CTI default forecasts and the increase in lender-on-lender violence and liability management exercises. ▪ Weaker outlook for cyclical industrial and consumer sectors	▪ 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 at the year-to-date tights but still wide of historical long-term averages. ▪ Prefer call-protected Inverse IO CMOs, large beneficiary of aggressive cutting cycle. ▪ 30-year MBS outperforming the shorter (15 year and below) MBS ▪ The decline in interest rate volatility since the Fed signalled a definite end to the hiking cycle has been a tailwind for MBS.	▪ 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 RMBS. ▪ RMBS: Spreads have continued to tighten. Fundamental metrics such as delinquencies, prepayments, and foreclosures, remain solid. ▪ CMBS: We are in the early stages of the office deterioration story. Outside of office and multifamily housing. However, performance has remained healthy. ▪ CLOs: Demand remains high given relative spread to other asset classes; active new issue market. Defaults remain low, but CCC buckets are rising with lower recoveries. ▪ ABS: 60+ Day delinquencies are rising. Spreads wider MoM, the group has been reducing positions in consumer and auto sectors.	▪ 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 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