In Credit

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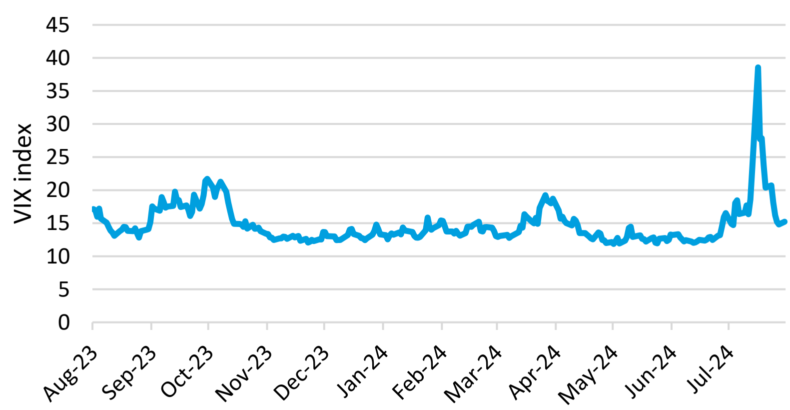
What goes up must come down

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	3.88%	-6 bps	3.5%	2.7%
German Bund 10 year	2.26%	3 bps	2.1%	0.0%
UK Gilt 10 year	3.94%	-1 bps	2.7%	-0.3%
Japan 10 year	0.89%	4 bps	1.3%	-2.0%
Global Investment Grade	104 bps	-5 bps	3.1%	3.4%
Euro Investment Grade	116 bps	-4 bps	1.8%	2.4%
US Investment Grade	98 bps	-7 bps	3.7%	3.8%
UK Investment Grade	99 bps	-2 bps	2.0%	1.9%
Asia Investment Grade	158 bps	-4 bps	2.3%	4.9%
Euro High Yield	379 bps	-19 bps	1.7%	5.0%
US High Yield	329 bps	-20 bps	2.6%	5.3%
Asia High Yield	595 bps	-5 bps	2.1%	12.1%
EM Sovereign	351 bps	-8 bps	3.4%	5.3%
EM Local	6.3%	-2 bps	5.2%	1.3%
EM Corporate	281 bps	-5 bps	2.5%	6.4%
Bloomberg Barclays US Munis	3.5%	-2 bps	1.6%	1.2%
Taxable Munis	4.8%	-4 bps	4.3%	3.0%
Bloomberg Barclays US MBS	42 bps	-2 bps	4.0%	3.0%
Bloomberg Commodity Index	229.02	0.3%	-4.6%	0.4%
EUR	1.1069	1.0%	2.9%	-0.1%
JPY	146.31	-0.7%	9.0%	-4.5%
GBP	1.2989	1.4%	2.4%	1.7%

Source: Bloomberg, ICE Indices, as at 16 August 2024. *QTD denotes returns from 30 June 2024.

Chart of the week: The rise and fall of market volatility – LTM.



Source: Bloomberg & Columbia Threadneedle Investments as at 19 August 2024.

Macro/government bonds

Last week saw a shift in the market narrative from one of recession to greater economic resilience in the US. The Producer Price Index came in weaker than expected at 0.1% for July, while headline CPI for July came in at 0.2%, which was in line with market expectations. The rise in CPI over the previous month reflected an increase in core services inflation, and in particular housing costs. The data at this point did little to challenge the market narrative that recession remained a distinct possibility. Rather, debate in the market focused on whether the Federal Reserve would stick to a 25bps interest rate cut at its September meeting, or whether a 50bps cut could even be warranted.

The steady drift lower in US Treasury yields, which had so far characterised market price action, was interrupted by the publication of stronger than expected US retail sales, causing Treasury yields to gap wider across maturities. These came in at 1%, with the market expecting 0.4%. The data painted a picture of a resilient US consumer, and parsing through it the biggest increases in retail sales were in general merchandise and food and beverage stores, pointing to spending on essentials rather than luxuries.

On top of this unexpected data point, continuing claims and new jobless claims surprised to the downside. This added to a narrative of economic resilience and away from recession. A range of Fed speakers made comments, from Raphael Bostic at the Atlanta Fed to Mary Daly at the San Francisco Fed, who reiterated a similar message that new information on inflation and employment would inform their discussion at their next meeting. This allowed the Fed to maintain some optionality despite near-market unanimity on a September rate cut.

Price action in the US set the tone for bond markets globally. The traditional summer lull in European markets meant there was no market moving data or comments of note last week in the region. In the UK , CPI fell -0.2% on the month, underlining disinflationary forces at play in the UK economy. UK retail sales, although higher than the previous month, were still lower than the market had expected at 0.5%. UK GDP for Q2 came in 0.6%, causing no surprises. Strength could largely be attributed to the services sector. The UK economy in Q2 grew faster than European economies, only underperforming the US and Japan. The data also hinted at the need for a more cautious approach from the Bank of England MPC as it continues to weigh the trade-off between dampening inflation and slowing growth. The market has priced in the next UK rate cut for November with a 70% probability of a further cut in December.

Outside of core markets, the Reserve Bank of New Zealand (RBNZ) cut interest rates from 5.5% to 5.25%. It justified its actions based on falling services inflation and declining economic growth.

Investment Grade credit

After the excitement of early August and fears of a US recession post the employment data, we have had another week of realtive calm in credit markets. Global IG spreads ended July with a spread of 100bps over government bonds, before spiking wider to 116bps in the first week of the month. But last week saw spreads nearly back to levels seen at the end of July at 104bps.

This year spreads remain tighter, by around 14%-15% in Euros and Sterling. The US market has lagged with spreads merely 6% better. Shorter-dated credit has also outperformed as credit curves have steepened. Sector wise, Real Estate, Banking and Insurance have led the way globally with Media spreads actually wider and Healthcare unchanged.

Valautions remain on the rich side in aggregate, with spreads trading inside both short- and longer-term averages. This is more pronounced for the US dollar market than for euro-denominated credit.

High yield credit & leveraged loans

US high yield valuations continued to rebound from the early-August volatility as economic data were generally supportive. Meanwhile, July's CPI report was in line with expectations, essentially locking in a cut at the September FOMC. The ICE BofA US HY CP Constrained Index returned 0.77% and spreads were 21bps tighter. The index yield to worst declined to 7.42%, its lowest level since February 2022. According to Lipper, US high yield bond retail funds saw a $1.2 billion outflow for the week, which was entirely driven by ETFs.

In floating rates, the average price of the Credit Suisse Leveraged Loan Index increased slightly to $95.6 having recovered most of the drawdown from early August. Retail loans fund outflows moderated with a $670 million withdrawal following a $3.1 billion outflow over the prior week.

European HY benefitted from a "risk on" atmosphere last week as risk assets rallied. EHY spreads contracted 19bps back to 378bps, while yields fell – albeit only by 11bps to 6.77%. Compression returned to the market as CCCs outperformed higher rated credits, yielding almost two times the return of the overall market's 0.53% return for the week. Market flows were modest with a small outflow (€67 million) across both ETFs and managed accounts. The primary market was closed for the second week in a row with the expectation that it will remain shut until September.

In credit rating news, S&P upgraded Warner Music Group to BBB-, making it the latest rising star. The credit rating cited that the company is "well positioned to benefit" from the music industry's "strong growth fundamentals". The business is still rated Ba2 by Moodys. There was, however, bad news as building materials manufacturer Pfleiderer was downgraded by Moody's to SD (Selective Default), with the rating citing that the corporate "has not given 'adequate compensation' to lenders for a maturity extension on its high yield bonds."

In general, 2Q reporting was generally "meeting and beating" expectations. The Real Estate sector is looking like things may have finally bottomed. Heimstaden Bostad reported that unsolicited interest in disposals are now reaching valuations that management may be willing to consider. Rent growth and occupancy are also showing improvement. There was also similar news for Grand City Properties.

However, there is some softness in other areas with Leisure starting to show some signs of consumer weakness as Merlin reported 2Q revenue down 6% and EBITDA down 16%, even as the number of visitors rose. Travel continues to hold up well with Tui Group experiencing an acceleration in bookings resulting in the firm beating EBIT expectations with revenue up 9.5%.

We are hearing that investment bankers are being kept busy over summer working on M&A transactions. For the HY sector this is usually an early indicator of bonds coming to market. However, this time around this may not be the case as we understand that issuers are looking to finance via the private market and in size. This was seen in the recent Stonegate financing where the corporate raised £1.6 billion via private credit. This shows issuers have alternative ways to do financing.

Structured Credit

It was another good week for US Agency Residential mortgage-backed securities (RMBS). The sector was up 47bps on slightly lower rates and tighter spreads. The available mortgage rate drifted back to May 2023 levels, around 6.9%, creating some incentive for the highest cohort of mortgagees at circa 8% to submit their refinancing applications.

Non-agency RMBS experienced more new issuance than expected with five deals pricing for $1.8 billion. BWIC volumes were less than $800 million and dealers net sold credit as of Friday morning. Gross RMBS issuance year-to-date has reached around $82 billion, and in line to beat last year's total issuance by more than $30 billion – largely coming from higher issuance in Non-Qualified Mortgages, Closed-End Seconds, Jumbo Prime Mortgages and HELOCs (Home

equity lines of credit). Spreads in the secondary market were largely unchanged across sub-sectors of residential on relatively light volumes. New issuance in asset-backed securities is beginning its August tapering, as we priced just $7.2 billion last week, which were well-absorbed. Spreads also firmed up in the secondary market.

Asian Credit

In China, Q3started with a weak tone as demonstrated by the July activity data. Industrial production (IP) growth decelerated to 5.1% year-on-year in July, compared with 5.3% in June year-on-year, with the property-related sector the key overhang on steel and cement output. The production of crude steel shrank to 82.9mt, according to the National Bureau of Statistics, which was down 9.5% month-on-month and down 9% year-on-year. Most of the decline materialised in the second-half of July as the expectation for more government support was tamped down after the Third Plenum. Cement production also decreased by 12.4% year-on-year in July. Additionally, FAI (fixed asset investment) growth eased to 1.9% year-on-year in July, compared to 3.6% year-on-year in June, with weakness in the manufacturing and property sector. This was partly compensated by a pick-up in infrastructure investment. Headline retail sales growth was better at 2.7% year-on-year in July, up from 2% in June. Overall, the consumption environment continues with retail sales growth hovering below 3% for the second consecutive month.

In Thailand, the Constitution Court dismissed SretthaThavisin (Pheu Thai Party) as prime minister after ruling he violated moral and ethical standards by appointing a minister with a previous criminal conviction. Paetongtarn Shinawatra of the same political party has been elected PM by the House of Representatives. While further turmoil is averted for now, the political landscape in Thailand remains tense. The reformist opposition party (Move Forward Party), which was also dissolved by the Constitution Court last week, has regrouped as the People's Party.

Bharti Global, which is the international investment entity of Bharti Enterprises, will acquire a 24.5% stake in BT Group from Altice UK. Bharti Enterprises will first buy a 9.99% stake, followed by an additional 14.5% after it obtains regulatory approvals.

Emerging markets

It was a week of relative calm for EM hard currency debt markets, as is expected in mid-August. Spread tightening of 9bps (EMBIG) and 7bps (CEMBI) was driven by top performers Ecuador, Argentina and Kenya, with weakness from Lebanon and Ukraine.

Primary markets remain quiet after the flurry of Middle Eastern issuance last month, although there are rumours that Kazakhstan may be coming back to the market before the end of the year with a US dollar-denominated bond for the first time since 2015.

Ukraine's new debt service profile significantly eases the external repayment burden, and a post-war recovery secenario would see a rapid growth rebound driven by reconstruction and EU access, leaving us cautiously optimistic. Ukranian corporates, however, are highlighting increased power import costs due to a weather-induced demand spike in Europe. This is dampening the improvement seen from the reopening of the Black Sea ports routes.

Elsewhere, China is reducing steel output due to a steep drop in domestic demand. This has been cited by Baowu Steel, the country's largest steel producer, as a steel sector downturn that could be worse than that seen in 2008 and 2015. If this is a correct reading, it is something to keep an eye on with regards to the implications for the broader Asia steel complex.

Responsible Investments

Goldman Sachs Asset Management business has disclosed it is leaving the Climate Action 100+ initiative (CA100+). In February this year, JP Morgan, BlackRock, State Street Global Advisors and PIMCO all left the initiative as, broadly, they felt their own internal engagement initiatives were more aligned to their investment activities.

The Goldman Sachs decision centres around a similar feeling, in addition perhaps to overwhelming pressure as a US bank from Republican Party comments and the anti-ESG movement that has ramped up in light of the upcoming presidential election.

The CA100+ initiative focuses on collective engagement efforts targeting corporates around the world to better their climate strategies. Currently, the initiative has more than 600 members with approximately $50 trillion AUM, according to CA100+.

Fixed Income Asset Allocation Views

19th August 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 (■ at -1)	▪ Spreads have widened in recent macro volatility but remain on the tighter side of history. ▪ Credit fundamentals have remained stable despite rising volatility and early signs of slowing in macro data and issuer expectations. ▪ **The group remains negative on credit risk overall, despite an upgrade to High Yield Credit to -1.** ▪ The CTI Global Rates base case view is that the hiking cycle is over, and the start of the cutting cycle is expected to be the next Fed meeting. Uncertainty about the pace remains elevated due to sensitive monetary and fiscal policy schedules and US elections looming closer.	▪ 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 (¥ at -1, £ at 0, $ at +1; P at -1, € at +1)	▪ 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 (A$, EM, ¥ at 0; €, £, $ at 0)	▪ 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))	Under-weight -2 -1 0 +1 +2 Over-weight (R at +1; C at 0)	▪ 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 (■ at -1)	▪ EMD spreads have also widened this month, following the escalation in potential risk. Especially given the ongoing geopolitical and economic uncertainties. Fundamentals have been downgraded after improvements in distressed areas. ▪ Investment Grade spreads are near historical tights while High Yield still offers idiosyncratic 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	Under-weight -2 -1 0 +1 +2 Over-weight (■ at -1)	▪ Spreads have widened, especially short and intermediate, but long IG spreads remain near record tights. ▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight (■ at -1)	▪ Spreads have widened but stabilised since last month. Spreads are still implying lower defaults than the Columbia Threadneedle research team. ▪ Anticipate credit selection will be the performance differentiator in 2024. Looking to avoid defaults/distress, focusing on credit recovery and deleveraging stories. ▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight (■ at +2)	▪ Spreads are still 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. ▪ Fed's position on cuts, in relation to the recent CPI prints, is expected to be cautious. ▪ 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	Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0)	▪ Neutral outlook because of decent fundamentals and relval in select high quality Non-Agency RMBS, and ABS. ▪ RMBS: Spreads remain tight. Delinquency, prepayment, and foreclosure performance remains. ▪ CMBS: There is ongoing pressure even on AAA securities. Outside of office and multifamily housing, however, performance has remained healthy. ▪ CLOs: Despite heavy 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 have deteriorated somewhat, while lower quality borrowers underperform. Federal student loan payments remain a key uncertainty with continued legal noise.	▪ 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 (■ at +1)	▪ 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

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