

In Credit

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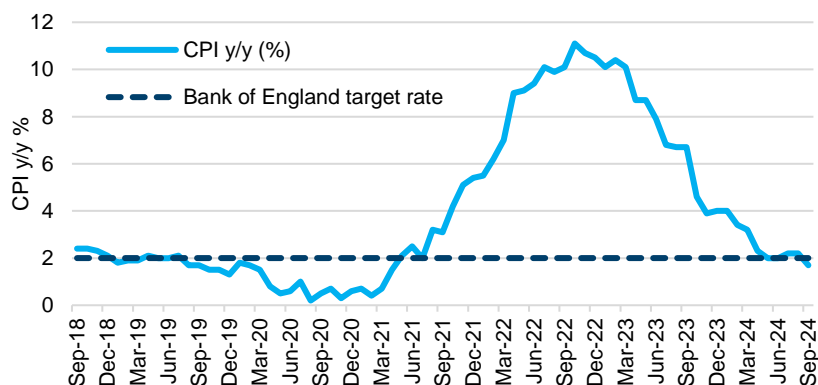
Dog days are over

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.12%	2 bps	-1.6%	2.3%
German Bund 10 year	2.24%	-3 bps	-0.2%	0.9%
UK Gilt 10 year	4.10%	-11 bps	0.0%	-0.5%
Japan 10 year	0.96%	1 bps	-0.6%	-2.4%
Global Investment Grade	90 bps	-2 bps	-0.6%	4.5%
Euro Investment Grade	105 bps	-3 bps	0.5%	4.3%
US Investment Grade	83 bps	-1 bps	-1.1%	4.6%
UK Investment Grade	88 bps	-3 bps	0.6%	2.8%
Asia Investment Grade	136 bps	-2 bps	-0.6%	6.0%
Euro High Yield	343 bps	-1 bps	0.5%	7.5%
US High Yield	288 bps	-10 bps	-0.1%	7.9%
Asia High Yield	503 bps	-5 bps	0.8%	15.4%
EM Sovereign	305 bps	-8 bps	-0.8%	7.1%
EM Local	6.3%	5 bps	-3.1%	1.7%
EM Corporate	250 bps	-1 bps	-0.3%	8.2%
Bloomberg Barclays US Munis	3.4%	-2 bps	-0.3%	2.0%
Taxable Munis	4.9%	-1 bps	-1.8%	2.8%
Bloomberg Barclays US MBS	43 bps	3 bps	-1.5%	2.9%
Bloomberg Commodity Index	237.06	-2.5%	-1.9%	3.9%
EUR	1.0847	-0.6%	-2.4%	-1.6%
JPY	150.05	-0.3%	-3.9%	-5.7%
GBP	1.3019	-0.1%	-2.4%	2.5%

Source: Bloomberg, ICE Indices, as of 18 October 2024. *QTD denotes returns from 30 September 2024.

Chart of the week – UK CPI



Source: Bloomberg, as of 18 October 2024.

Macro / government bonds

Last week was a story of European bond markets, which outperformed the US. The standout performer was the unloved UK gilt market, which has been trading cheap relative to US Treasuries and German bunds. The trigger for this was the better than expected inflation performance. UK CPI for the month of September came in at 0.0%, which translated into an annualised figure of 1.7% (see [Chart of the week](#)). Earlier this month, Bank of England governor, Andrew Bailey, acknowledged that the bank could be “a bit more aggressive” if inflation continued to slow. The fall in inflation was interpreted as cementing the prospect of a quarter point interest rate cut at the November meeting. Several leading asset managers talked up the prospects of the outlook for the gilt market. There is a growing consensus that the new Labour administration in the UK wants to avoid a ‘Truss moment’ in which yields spike higher due to greater than expected borrowing. The prospect of a more digestible October budget from the financial market’s perspective, coupled with the drop in inflation, resulted in the strong performance of the gilt market, which was especially pronounced at the front-end. A quarter point interest rate cut in November is now fully priced in by the market, while the probability of a further quarter point interest rate cut in December now stands at around 80%

The other big story was the meeting of the European Central Bank, which cut its deposit rate from 3.5% to 3.25%. Christine Lagarde, ECB president, pointed to disinflationary pressures and a weakening in the eurozone economy. She acknowledged that monetary policy was still in a restrictive space, and that while the ECB had made a lot of progress, it had still not broken the “neck” of inflation, which currently stands at 1.7%. Reflecting the cautious approach at this point in the monetary cycle, Lagarde told her audience that the ECB remained in data dependency mode i.e. it was not pre-committing to a particular interest rate path. She also warned that it expected inflation to rise in the short-term, as past falls in energy prices fell out of the annual price comparison. The yield curve steepened as a result, but the sensitivity of the market to the change in interest rates was relatively muted. The market had already fully priced in one quarter point interest rate cut for October ahead of the ECB decision and one for December.

In the US, Treasury yields finished the week broadly unchanged. Retail sales came in stronger than expected; 0.7% for the month of September. The data pointed to a robust consumer and a healthy economy. Initial claims fell, supporting the view that the previous rise had been hurricane-related and also due to a strike at Boeing. We also had the Atlanta Fed nowcast, which pointed to real GDP growth of 3.4%. The data fitted the narrative of a solid US economy, benefiting from a full labour market and declining inflation. In a speech Fed governor, Chris Waller, raised the question rhetorically as to how fast the Fed should ease monetary policy. He advised caution on the pace of rate cuts, which is in broad accordance with a market downplaying recession risk. The other factor to influence price action has been anecdotal reports of ‘Trump’ steepening trades, as investors position for a more protectionist and fiscal expansionary US administration. The market continues to price in a quarter point rate cut for November and the around 60% probability of another quarter point rate cut in December

Investment grade credit

Investment grade spreads remain on a tightening trend.

Last week saw global spreads end the week at 90bps over government bond levels. Indeed, looking over the Atlantic, US spreads touched the tightest level since before the Global Financial Crisis. So, it is hard to look at spreads and argue there is much value. Even if you adjust for changes in index duration and credit quality, markets are all through long-term averages by a fair margin. This comes at a time of attractive yields creating inflows into the market while primary market activity remains light.

Results season is upon us and so far banks have reported solid earnings with decent profitability at a time of peaking / falling margins and normalised or higher cost of risk. What is comforting, at least from the US, is signs that credit card charge-offs seem to have plateaued if not started to fall. Meanwhile, investment bank businesses are performing well and capital

levels are high. The banking sector has performed strongly this year – outpacing industrials and utilities in an environment of tightening spreads.

High yield credit & leveraged loans

US high yield bond spreads tightened to near post-GFC lows amidst receding labour market concerns and supportive retail spending data over the week. The ICE BofA US HY CP Constrained Index returned -0.33% while spreads tightened 10bps to +312bps. The index yield-to-worst decreased to 7.06%. According to Lipper, US high yield bond retail funds saw a \$664m inflow for the week. The average price of the Credit Suisse Leveraged Loan Index increased another \$0.1 to \$96.3, supported by the prospect of a slower than expected Fed easing cycle and resilient macro data. Retail loan funds saw their second largest inflow since May with \$1.1bn contributed.

It was a strong week for European high yield with higher-rated debt outperforming. The asset class returned +44bps with the yield falling 13bps to 6.23%, largely due to the fall in underlying government bond yields given spreads were steady at 343bps. It was a decompression week as higher-rated credits outperformed lower-rated credits. Inflows jumped by 4x that of the previous week at €1.54bn, largely ETF driven (+€1.1bn). It was not only the largest inflow YTD, it was the largest weekly inflow of the last almost 20 years. This takes the YTD to +€10.3bn, 25% up from the end of September. This was even as this week's corporate primary market was relatively subdued last week with only €1.2bn of new issuance, mainly BB+ rated. The upcoming week is expected to be busier for the primary market given the number of deals in the pipeline.

In rating news, Kemone was downgraded two notches to B3 by Moody's. This reflects the extended period of soft demand in European PVC, accompanied by ongoing strong competition. The auto sector was hit as Moody's downgraded Forvia's CFR (corporate family rating) to Ba2 (from Ba3) and then downgraded the senior unsecured notes to B1 (from Ba2). Though the credit has been under pressure (with the rest of the auto sector), it was surprising that the rating agency downgraded the bonds even lower than the CFR. Up to now, bonds had carried the same credit rating as the CFR.

Structured credit

The US Agency MBS sector was down roughly 7bps last week on the back of higher interest rates. 15-year MBS outperformed 30-year and higher coupons did best given their lower duration risk sensitivity. Spreads continued their march wider, which has been the pattern over the past five weeks. The relative underperformance of the sector has opened up an attractive entry point and opportunity for potential tightening for investors that might be underweight. There was good news on the prepay front with slower speeds posted for September. While mortgage rates have come down in-line with interest rates, affordability remains challenged by the lack of housing stock. Non-agency RMBS new issuance remained active with nine deals pricing and another five coming this week. Spreads tightened by about 5bps in CRT last week as risk continued to rally. In commercial risk, downgrades remained the theme with 62 bonds / 14 deals being downgraded and zero being upgraded.

Asian credit

In China, the Ministry of Housing and Urban-Rural Development, together with the National Financial Regulatory Administration, Ministry of Natural Resources and PBOC announced further incremental measures to support the property sector. The government agencies will expand the 'white list' of residential projects that qualifies for funding. The funding will be expanded to CNY4trn (\$562bn) by end-2024 from the current level of CNY2.23trn (as of 16 October). A funding programme to drive the urban village renovation (one million projects) was also launched, with funding to come from policy banks and local government special bonds. Additionally, China is planning whether to allow banks to extend loans to eligible corporates for the acquisition of idle land.

In India, Adani Green Energy Ltd (AGEL) called off the issuance of its \$1.2bn 20-year bond due to a weak order book. Investors are demanding more additional yield for long-tenor bonds while AGEL was looking to print the bond at under 7% yield.

Emerging markets

The EM hard currency sovereign bonds registered positive returns (0.27%), driven by both US Treasuries gains and spread performance. Spreads were 14bps tighter with high yield performing strongly led by the distressed and semi-distressed cohorts.

The EM local index lost 0.64% on the week due to duration losses from the 9bps move higher in yields and EM FX losses, which dominated roughly two-thirds of the negative performance.

Focus this week was around China's key economic data releases. While Q3,24 GDP growth slowed further to 4.6% y/y, it was slightly better than market expectations while other major data indicators (retail sales, industrial output and fixed asset investments) beat estimates. However, the latest data showed the property sector still relatively depressed as prices for new and existing homes fell faster than a year ago and continues to be a drag. The recent slew of stimulus roll-outs have been aimed at addressing the property sector weakness with the hope that it be sufficient to lift economic activities in the last quarter of the year and push overall headline GDP figure closer to the government's 5% target.

Recent positive flow momentum into EM bond funds took a pause this week with a return to a marginal outflow, ending four consecutive weeks of inflows.

Responsible investments

Last week, the Central American Bank of Economic Regeneration launched a social bond the market is calling the world's first 'Mother Health Bond' as proceeds from the AUD\$210m new issue will target socially vulnerable mothers and pregnant women in the Latin America region. Projects will include providing food security and nutritious food to people suffering from nutritional deficiencies, aiming to extend the healthy life expectancy of mothers and pregnant women. It's expected to support around 7.4 million people.

Total ESG labelled bond sales are up 12% compared to last year, according to Bloomberg data, with issuance so far this year amounting to \$887bn.

Fixed Income Asset Allocation Views

21st October 2024



Strategy and positioning (relative to risk free rate)	Views	Risks to our views
Overall Fixed Income Spread Risk 	<ul style="list-style-type: none"> 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 and downgraded Agency MBS to a modestly positive outlook. The Federal Reserve began the easing cycle in September with 50bp rate cut. The CTI Global Rates base case view is that the pace and magnitude of additional cuts is uncertain and dependant on inflation and labor market conditions. 	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> Dollar has been supported by US growth exceptionalism and depriving 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. 	<ul style="list-style-type: none"> 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)) 	<ul style="list-style-type: none"> Disinflation under threat but intact; EM central banks still in easing mode. Real yields remain high. Selected curves continue to hold attractive risk premium. 	<ul style="list-style-type: none"> 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) 	<ul style="list-style-type: none"> Index spreads are close to 5-year tightens while spread volatility remains elevated. The Group remains conservatively positioned and disciplined regarding valuations, reducing exposure where risk premium has compressed materially. Tailwinds: China stimulus, stronger growth, central bank easing, IMF programs. Headwinds: Escalating tensions in Middle East, higher debt to GDP ratios, wider fiscal deficits, US election, geopolitical uncertainty, slow restructurings. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> Spreads have tightened back near year-to-date tightens, are rich to long-run averages Results and commentary from issuers do not indicate fundamental deterioration. IG Analysts expect strong fundamentals and decade-low leverage for 2024/2025. Current valuations limit spread compression upside and provide little compensation for taking on additional risk. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> Spreads have continued tightening and are rich to 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 The Group remains conservatively positioned given valuation backdrop but is open to attractive high quality reval opportunities. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> The Group downgraded Agency MBS because spreads are closer to fair value following the September FOMC and the housing market remains pressured. The Group remains positive on Agency MBS because the carry and convexity are still attractive, and prepayment risk is low because of elevated mortgage rates. Prefer call-protected Inverse IO CMOs, a large beneficiary of aggressive cutting cycle. Difficult to increase position sizing as few holders are willing to sell into the current rate environment. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> Neutral outlook because of decent fundamentals and reval in select high quality issues. RMBS: Spreads have continued to tighten. Fundamental metrics such as delinquencies, prepayments, and foreclosures, remain solid overall. 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 unchanged MoM, the group has been reducing positions in consumer and auto sectors. 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> o/w sugar o/w Zinc o/w Gasoline o/w Distillates o/w Cocoa o/w natural gas o/w corn o/w lead o/w silver o/w soybean meal 	<ul style="list-style-type: none"> Global Recession

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