# In Credit

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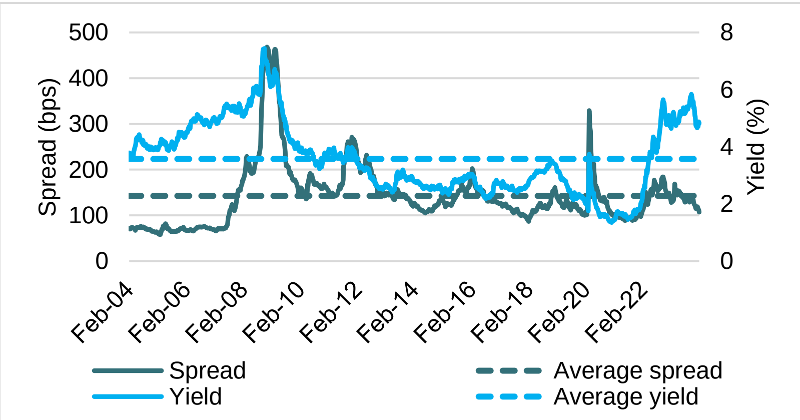
## Never mind the spread, look at the yield.

### Markets at a glance

| | Price / Yield / Spread | Change 1 week | Index QTD return* | Index YTD return |
|---|---|---|---|---|
| US Treasury 10 year | 4.15% | 13 bps | -1.4% | -1.4% |
| German Bund 10 year | 2.33% | 9 bps | -2.2% | -2.2% |
| UK Gilt 10 year | 4.03% | 11 bps | -4.2% | -4.2% |
| Japan 10 year | 0.73% | 5 bps | -0.6% | -0.6% |
| Global Investment Grade | 109 bps | -1 bps | -1.1% | -1.1% |
| Euro Investment Grade | 129 bps | -1 bps | -1.0% | -1.0% |
| US Investment Grade | 100 bps | -2 bps | -1.1% | -1.1% |
| UK Investment Grade | 105 bps | -2 bps | -2.0% | -2.0% |
| Asia Investment Grade | 175 bps | 4 bps | 0.3% | 0.3% |
| Euro High Yield | 381 bps | -9 bps | 0.8% | 0.8% |
| US High Yield | 333 bps | -14 bps | 0.2% | 0.2% |
| Asia High Yield | 740 bps | 1 bps | 3.3% | 3.3% |
| EM Sovereign | 326 bps | -3 bps | -1.3% | -1.3% |
| EM Local | 6.2% | 3 bps | -2.3% | -2.3% |
| EM Corporate | 297 bps | -3 bps | 0.9% | 0.9% |
| Bloomberg Barclays US Munis | 3.4% | 9 bps | -0.6% | -0.6% |
| Taxable Munis | 5.0% | 12 bps | -1.5% | -1.5% |
| Bloomberg Barclays US MBS | 47 bps | -1 bps | -1.7% | -1.7% |
| Bloomberg Commodity Index | 223.36 | 0.4% | -1.1% | -1.1% |
| EUR | 1.0770 | 0.0% | -2.3% | -2.3% |
| JPY | 149.03 | -0.6% | -5.5% | -5.5% |
| GBP | 1.2617 | 0.0% | -0.8% | -0.8% |

Source: Bloomberg, ICE Indices, as of 9 February 2024. *QTD denotes returns from 31/12/2023.

### Chart of the week – Global IG spreads and yields (last 20 years)




Source: Macrobond, Columbia Threadneedle Investments as of 8 February 2024.

## Macro / government bonds

One theme dominated price action in global rates markets last week: push-back from central bankers on the start point of the first rate cut. Jay Powell appeared on CBS in which he emphasised the need for further confirmation on the downward path of inflation. A host of Fed policy makers followed, reiterating his message. US data confirmed the resilient US economic story: Services and Composite PMI – measures of US economic strength remained above 50 – while jobless figures surprised to the downside. Annual CPI revisions had limited impact with core CPI rising at an annualised rate of 3.3% in Q4, 2023. In the US, we saw significant bond issuance with $121bn of 3-year, 10-year and 30-year bonds pointing to higher term premia for this market over the longer term. Despite the more challenging environment for US fixed income, as the market straddles conflicting forces of resilient growth and disinflation, all the issues at auction were well bid. Idiosyncratic risk continued to percolate in the background as regional bank, New York Community Bancorp, exhibited further price weakness on the back of commercial real estate losses. Market pricing in the US continued to coalesce round May as the most probable date for the first rate cut, while yields tracked the more cautious rhetoric of US policymakers higher.

In Europe, Isabel Schnabel, senior ECB member, talked about the last difficult mile to get inflation back to its 2% target. Resilient labour markets, sticky services inflation, and potential Red Sea supply blockages raised the risk that inflation could flare up. She repeated the call for caution and patience. Eurozone data was relatively limited and held few surprises. Eurozone and German PMI data came in under 50 although Italy and Spain reported PMI readings just in excess of that number. Eurozone bond yields tracked the US higher, although there was little real change to the timing of the expected first rate cut by the ECB, which the market expects to take place between April and June.

In the UK, there was a repeat of the Bank of England Governor, Andrew Bailey's, message by Huw Pill, chief economist, that they need to look through an expected temporary dip in inflation, if they wish to get it back to target of 2%. Other policy makers at the bank gave the same message. The pushing back into the long grass of the first rate cut meant that short and long dated interest rates rose by a much greater extent than either US treasuries or German sovereign bonds. The market pushed the timing of the first rate cut back from June to August. In contrast, the central bank in Australia delivered a slightly more hawkish message when it left rates on hold at 4.35%. It warned that inflation remained elevated and might yet require tightening. It was a gentle reminder that the path back to target inflation in Europe and the US could not be taken as a given.

Across our portfolios, we have combined a constructive view on interest rate risk with a yield curve steepening bias. The one anomaly to this position is Japan where we continue to hold a short position.

## Investment grade credit

After a strong period of tightening since March of last year corporate bond spreads are now inside short and longer-term averages across both investment grade and high yield markets and in Europe as well as the US. This makes us less optimistic about the direction of credit spreads in the coming months from today's starting point.

However, what seems to be attracting ongoing interest, at least in the funds space, is the market yields on offer. According to data from ICE indices, Global All maturity IG offers a yield of around 4.8%. This compares to a long-run (20 year) average of closer to 3.6% and 1.4% on offer at the end of 2020. Meanwhile, data from Goldman Sachs compares inflows into funds with the supply of new debt into the market. Its analysis presents a very positive imbalance between high client demand and market supply. The high yields are also attracting demand from insurance and pension funds at the longer end of the curve.

As we head through earnings season we see the credit quality of the IG index continue to improve. For example, in the US dollar market around 43% was rated BBB at the end of 2023, down from 46% two years previously, according to data from Bloomberg. This statistic is all the more impressive when one considers the volume of rising star issuers seen in 2022 and 2023. It has not been all good news. Heavy-weighted exposure to troubled commercial real estate has been a focus, with the weakness in New York Community Bancorp shares well documented and some mirroring seen in certain German Pfandbrief institutions.

A chart placing global IG spreads and yields in their long-term context is represented in **Chart of the week.**

## High yield credit & leveraged loans

US high yield bond spreads revisited 20-month lows over the week as the market absorbed better-than-expected earnings and an active new issue calendar. The ICE BofA US HY CP Constrained Index returned 0.16% and spreads were 15bps tighter. According to Lipper, retail high yield funds reported a $549m inflow, extending the consecutive inflow streak to fourteen weeks totalling $20bn over the period. Meanwhile, the average price of the Credit Suisse Leveraged Loan Index remained unchanged at $95.5 over the week amidst ongoing refinancing / repricing activity and heavy CLO origination. Retail loan funds saw a $273m outflow, the largest weekly outflow since October.

European high yield had a more or less flat week (down -23bps) as yields rose (+5bps to 6.88%) due to underlying rising government bond yields, even as credit spreads tightened in (-9bps to 381bps). The compression theme continued especially for single Bs. It was another week of inflows with managed accounts receiving the larger share relative to ETFs. The primary market was light with only two new issues (c€800m equivalent) even as market demand remains strong with oversubscription as final pricing came in tighter than initial price talk.

In rating news, S&P downgraded the beleaguered French telecom ATOS to CCC from B-, its second downgrade in less than 12 months. The rating agency cited the challenges the issuer faces in addressing its liquidity shortages. The firm has yet to reach agreement with its banks on refinancing.

Overall, technicals remain quite supportive given the light issuance YTD against a backdrop of strong demand for the asset class experienced since the start of 2024.

## Structured credit

The US Agency MBS sector was down 79bps as rate volatility increased. Prepays have bounced off their lows a bit as refinancings rise. The primary cause is less about "in the money" economics to refi and more about home price appreciation and lender incentives. On a positive note, banks have started to add back, albeit it at a modest pace. Ginnie Mae MBS is back in vogue after a period of fairly negative technical pressure. For the first time since 2021, Bank of America, the single largest holder of MBS after the Fed, was a net buyer of $15bn gross. In consumer fundamentals, most lenders reported higher delinquencies and defaults as well as rising credit card balances. That said, tax refunds are expected to cure some of those past due balances and spreads across most sectors are tighter on the year. The outlier is subordinate traches of prime and subprime auto loans, which are wider by 55-65bps.

CMBS, meanwhile, has had a fairly remarkable start. Capital is available and looking for distressed opportunities at attractive valuations.

## Emerging markets

EM hard currency spreads were 4bps tighter on the week to 391bps. Higher US treasury yields, however, detracted from performance and the overall return on the index for the week was almost flat at -0.05%. The current index yield is 8.2% in US dollar terms. Within regions Africa generated the most performance. Despite Senegal being the worst EM performer last week due to the social unrest as a result of the delay to elections, Egyptian bonds performed very well in light of an IMF deal getting closer.

Moody's downgraded Israel one notch to A2 having put the country on negative watch in October, and Mexican oil and gas company two notches. There are concerns that the government's willingness to support Pemex's debt burden may decline due its deteriorating fiscal position. Pemex also has poor ESG scores and increased liquidity requirements.

The Czech central bank cut rates 50bps to 6.25% in a surprisingly dovish move. In Peru there was a 25bps cut, while in Mexico Banxico once again held rates at 11.25%.

Turkey came to the market with a $3bn deal for a 10-year bond. Bahrain issued a dual-tranche deal; a 12-year bond as well as a 7-year sukuk; and Benin had an inaugural deal of $750m for a 14-year bond.

In Pakistan, independent parties loyal to incarcerated former president Imran Khan took the most seats in Thursday's election but fell short of securing a majority. Two establishment parties are now in talks to form a coalition, which looks the most likely outcome. There is now concern of protests following Khan's PTI party accusing officials of vote rigging alongside the prospect of a weaker coalition government lacking the political firepower to push through the much-needed IMF reforms. Spreads on Pakistan's government bonds widened just shy of 100bps on Friday.

## Responsible investments

After weeks and months of seeing next to nothing issued from the US in form of green, social or sustainability bonds, last week we saw a jump of 48% in issuance versus this time last year from issuers across the pond, according to Bloomberg. Dow Inc., chemicals maker, came to market with its first ever green bond last week raising $1.25bn to put towards reducing its plastic waste and carbon emissions. Initial thoughts in January were that upcoming elections in the US would steer focus away from this type of issuance growing – but the data is saying otherwise – especially as companies progressively approach net zero checkpoints.

# Fixed Income Asset Allocation Views

12th February 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 (■ at -1) | ▪ 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.**<br>▪ The CTI Global Rates base case view is that the hiking cycle is over, and the start of the cutting is uncertain. The timing and magnitude of cuts will be dictated by the amount and speed of disinflation.<br>▪ Uncertainty remains elevated due to sensitive monetary and fiscal policy schedules, geopolitical tensions, persisting inflation, and weakening consumer & labor profiles. | ▪ Upside risks: the Fed achieves a soft landing with no labour softening; lower quality credit improve as refinancing concerns ease; consumer retains strength; end to Global wars<br>▪ 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)**<br>('P' = Periphery) | Short -2 -1 0 +1 +2 Long (¥ at -1, $ at +1; P at -1, € and £ at +1) | ▪ Longer yields to be captured by long-run structural downtrends in real yields<br>▪ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures | ▪ Inflationary dynamics become structurally persistent<br>▪ Labour supply shortage persists; wage pressure becomes broad and sustained<br>▪ Fiscal expansion requires wider term premium<br>▪ Long run trend in safe asset demand reverses |
| **Currency**<br>('E' = European Economic Area) | Short -2 -1 0 +1 +2 Long (EM, A$ at 0; ¥, €, $, £ at 0) | ▪ Rising expectations around a soft landing and peak Central Bank rates have weakened the dollar<br>▪ EM disinflation to be more rapid than DM<br>▪ Drop in global rate volatility supports local flows. | ▪ 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.<br>▪ Real yields remain high.<br>▪ Selected curves continue to hold attractive risk premium. | ▪ Sustained high core rates thwart EM easing cycles.<br>▪ Energy persistence derails disinflation trend.<br>▪ US outperformance strengthens US dollar.<br>▪ Structurally higher global real rate environment subdues risk assets |
| **Emerging Markets Sovereign Credit (USD denominated)** | Under-weight -2 -1 0 +1 +2 Over-weight (■ at -1) | ▪ EMD spreads have widened this month, benefitting from lower global rates and the market-wide spread rally. Technicals remain challenged, with continued outflows and weak issuance.<br>▪ Conservatively positioned in select high quality relval names, most idiosyncratic opportunities are in lower quality portion of index.<br>▪ Tailwinds: Stronger growth forecasts, Central bank easing, potential China rebound, IMF program boost for distressed names.<br>▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical and domestic political uncertainty, restructurings slow. | ▪ Weak action from Chinese govt, no additional support for property and commercial sectors.<br>▪ China/US relations deteriorate.<br>▪ Issuance slows.<br>▪ Spill over from Russian invasion and Israel-Hamas war: local inflation (esp. food & commodity), slow global growth.<br>▪ Persisting COVID growth scars hurt economies & fiscal deficits. |
| **Investment Grade Credit** | Under-weight -2 -1 0 +1 +2 Over-weight (■ at -1) | ▪ Spreads are unch to modestly tighter since last month. The group is taking down credit risk because of flat spread curves and less spread compression upside.<br>▪ Fundamentals are supportive of technical strength. Global portfolios prefer EUR IG over USD on relval basis.<br>▪ Market pricing indicates investors are at ease with credit risk, with more optimistic views on fundamentals and US banking risk (CRE exposure, interest rates). | ▪ Tighter financial conditions lead to European slowdown, corporate impact.<br>▪ Lending standards continue tightening, even after Fed pauses hiking cycle.<br>▪ Rate environment remains volatile.<br>▪ Consumer profile deteriorates.<br>▪ Geopolitical conflicts worsen operating environment globally. |
| **High Yield Bonds and Bank Loans** | Under-weight -2 -1 0 +1 +2 Over-weight (■ at -1) | ▪ Spreads remain at historically tights levels. Modest weakness in fundamentals from bearish earnings outlooks, see bifurcation between sectors.<br>▪ Anticipate credit selection will be the performance differentiator in 2024. Looking to avoid defaults/distress, focusing on credit recovery and deleveraging theses,<br>▪ Conservatively positioned, looking to reduce and diversify credit risk because spreads are likely near their cycle lows.<br>▪ Bank loan market continued to see spread compression, improving technical. Underlying credit backdrop unchanged. | ▪ Lending standards continue tightening, increasing the cost of funding.<br>▪ Default concerns are revised higher on greater demand destruction, margin pressure and macro risks<br>▪ Rally in distressed credits, leads to relative underperformance<br>▪ 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 +1) | ▪ Mortgage index continued tightening over the past month; however, spreads are still wide of historic long-term averages.<br>▪ In late 2023 the group reduced position sizing into spread tightening but remains overweight the sector.<br>▪ Constructive view on fundamentals over longer time horizon. | ▪ Lending standards continue tightening even after Fed pauses hiking cycle.<br>▪ Prepayments normalise as rates rise without reducing mortgage servicing.<br>▪ Fed continues to shrink position.<br>▪ Market volatility erodes value from carrying. |
| **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, CLOs and ABS.<br>▪ RMBS: MoM spreads have tightened. Delinquency, prepayment, and foreclosure performance remains strong for prime borrowers; seeing small increase in delinquencies for non-prime borrowers.<br>▪ CMBS: The group is cautious, especially on office and multifamily, however non-office sectors perform as expected and overall market sentiment improving. Delinquencies increasing as maturities come due.<br>▪ CLOs: Despite new issue, spreads grind tighter. Defaults remain low but CCC bucket defaults are rising with lower recoveries.<br>▪ ABS: Spreads tighter MoM, prefer senior positions. Higher quality borrowers remain stable, lower quality borrowers underperform. | ▪ Weakness in labour market<br>▪ Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening. Consumer (retail/travel) behaviour fails to return to pre-covid levels<br>▪ Student loan repayments weaken consumer profile more than anticipated, affecting spreads on a secular level.<br>▪ Rising interest rates turn home prices negative, punishing housing market.<br>▪ Cross sector contagion from CRE weakness. |
| **Commodities** | Under-weight -2 -1 0 +1 +2 Over-weight (■ at 0) | ▪ o/w Copper<br>▪ o/w Grains<br>▪ u/w Gold<br>▪ o/w Soybean Meal<br>▪ o/w Oil<br>▪ o/w Lead<br>▪ o/w Zinc | ▪ Global Recession |