

# In Credit

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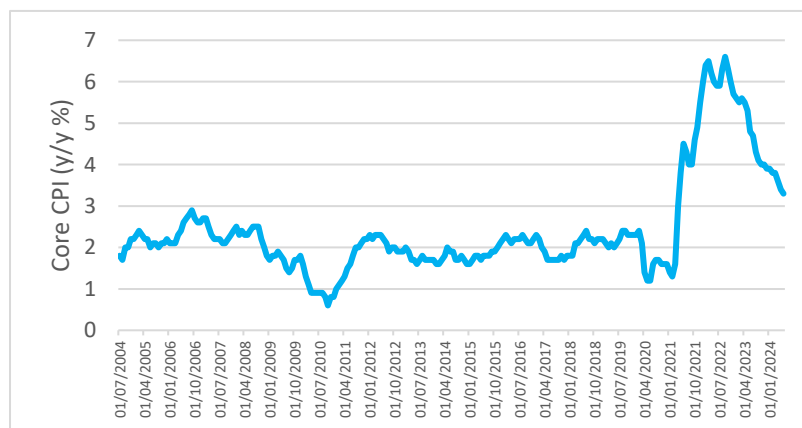
## A farewell to inflation.

### Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.21%	-7 bps	1.3%	0.5%
German Bund 10 year	2.48%	-7 bps	0.1%	-2.0%
UK Gilt 10 year	4.10%	-3 bps	0.7%	-2.3%
Japan 10 year	1.07%	-1 bps	-0.1%	-3.3%
Global Investment Grade	97 bps	0 bps	1.3%	1.6%
Euro Investment Grade	107 bps	1 bps	0.7%	1.2%
US Investment Grade	92 bps	0 bps	1.7%	1.8%
UK Investment Grade	95 bps	0 bps	0.8%	0.7%
Asia Investment Grade	149 bps	-3 bps	0.8%	3.3%
Euro High Yield	359 bps	0 bps	0.6%	3.9%
US High Yield	319 bps	-8 bps	1.1%	3.7%
Asia High Yield	598 bps	-3 bps	1.0%	10.9%
EM Sovereign	342 bps	-2 bps	1.6%	3.5%
EM Local	6.5%	-11 bps	2.9%	-1.0%
EM Corporate	273 bps	-1 bps	0.9%	4.8%
Bloomberg Barclays US Munis	3.6%	-10 bps	0.6%	0.2%
Taxable Munis	5.0%	-10 bps	1.6%	0.4%
Bloomberg Barclays US MBS	42 bps	-4 bps	1.8%	0.8%
Bloomberg Commodity Index	236.52	-1.6%	0.0%	5.1%
EUR	1.0910	0.6%	1.8%	-1.2%
JPY	157.93	1.8%	1.9%	-10.6%
GBP	1.2988	1.3%	2.7%	2.0%

Source: Bloomberg, ICE Indices, as of 12 July 2024. \*QTD denotes returns from 30/06/2024.

### Chart of the week – US Core CPI annual growth rate (2004-24)



Source: Bloomberg, Columbia Threadneedle Investments, as of 15 July 2024.

## Macro / government bonds

The fall in yields last week was most pronounced in the US.

The cause of this was a lower than expected reading from the Consumer Price Index (CPI). CPI fell 0.1% during June, on the back of falls in the price of energy and core goods. Core CPI (which excludes the volatile energy and food sectors) only rose by 0.1% ([see chart of the week](#)). Parsing the economic data there was good news on shelter, which only rose by 0.2%. It was as if the dominoes had started to fall for a first cut in US interest rates. All core markets saw yields gap lower on the news. However, Producer Price Index (PPI) data published subsequently did not follow the 'lower inflation' script. PPI Final Demand rose 0.2% in June. Breaking the data apart revealed the conundrum of all major economies – the gap between services and manufacturing. Final demand services rose 0.6% in June while final demand goods fell 0.5%. However, the impact on price action in the US treasury market was muted. The majority of the rise could be attributable to higher margins in a relatively narrow subset of the broader economy, machinery and vehicle wholesaling. The combination of the CPI and PPI outturns should translate into a favourable Personal Consumption Expenditure figure (the Fed's favoured inflation measure), which should provide it with scope to cut interest rates at its September meeting.

Jay Powell, Fed Chair, spoke to Congress for the semi-annual monetary policy report. He said that elevated inflation was not the only risk, reinforcing the message that the labour market is of equal importance in determining monetary policy. Powell characterised the labour market as strong but not overheated and confirmed the Fed would need to see more evidence that inflation was moving sustainably towards 2% before it could take action. Pricing in the swaps market is almost fully pricing in a quarter point rate cut for September and the probability of a further quarter point rate cut by December 2024. On Sunday came the attempted assassination of Presidential Candidate Trump. Iconic pictures of his survival and a raised fist in the air look likely to underpin his support, underlining the attractiveness of yield curve steepening strategies in the US. This reflects an electoral programme that is likely to be fiscally expansionary.

In the UK, we had monthly GDP which rose 0.4% in June compared to a flat reading in May. One central takeaway from the data was that growth in services continued to outpace that of manufacturing. Context for the decision-making process at the Bank of England (BoE) was provided through a speech by BoE Chief Economist, Huw Pill. While admitting that there had been good progress on inflation, he highlighted the fact that services price inflation and wage growth continue to point to uncomfortable strength in underlying inflation dynamics. Pill's messaging, alongside the strength of recent data, made markets question the pace of monetary easing, resulting in the underperformance of UK government bonds versus other markets. Last week, we switched out of the UK into Australia, whose market has been trading at what we consider oversold levels, and the US, which is edging closer to its first cut in monetary policy.

There was not much macro news in Europe to move markets. One idiosyncratic story to remain in the news is France. The left and centre saw off the challenge from the far right in the final round of voting. But uncertainty remains. The French political system will either have to support an unstable minority left-wing government or a broader coalition of the centre and left. Either option is likely to prove fiscally expansionary. The EU has already triggered an excessive deficit procedure, which means the French government will have to agree a plan to reduce its deficit and lower spending. Ongoing political uncertainty meant that the yield spread on French bonds over Germany remains elevated at 0.66%. We retain a short position in France, although we have started to pare back the size of this position. Other positions on the Global Rates desk include a strategic short position in Japan and long duration tilts in both the US and the eurozone.

## Investment grade credit

It was a very quiet week for investment grade spreads ahead of the summer lull. Global spreads remained unchanged at 97bps only a few basis points wide of the year's tightest spreads.

The week ended with US bank results from JP Morgan, Wells Fargo and Citibank. Earnings remain strong but margins have peaked and are declining. Asset quality is weaker than normal as measured by Cost of Risk though the pace of deterioration has slowed. Markets businesses were resilient through the last quarter and high levels of capital are noted in the sector.

## High yield credit & leveraged loans

US high yield valuations tightened over the week following a benign CPI reading, fund inflows, and light new issuance.

The ICE BofA US HY CP Constrained Index Returned 0.88% and spreads were 8bps tighter. The yield-to-worst of the index declined 0.19% to 7.67%. According to Lipper, retail high yield funds reported a five-week high \$676m inflow following consecutive weekly outflows. In loans, the average price of the Credit Suisse Leveraged Loan Index was unchanged at \$95.8. Retail loan funds saw a \$444m contribution.

European high yield had another solid week of performance returning +28bps even as yields fell (-7bps to 6.88%), but spreads remained unchanged at 359bps. It was also another week of compression, though at the margin, as CCCs outperformed but modestly compared to the higher rated BBs and Bs. Flows reverted to positive after two straight weeks of outflows. A small inflow of about €80m was seen for both ETFs and managed accounts. The heavy primary market continued with €4.2bn coming to the market, a mix of both refinancings and acquisition financing, bringing the YTD gross figure to €71.9bn.

There was more negative news for the debt collector space as Lowell was downgraded to CCC+, with negative outlook, by S&P and to Caa1, negative outlook, by Moody's. The rating agencies cited high leverage and limited access to financial markets as well as concern about the increasing likelihood of a distressed debt exchange. During the same week a reorganization was reported for Intrum, the Swedish debt collector company.

In company news, Grifols, the Spanish health care company may be going private. The press reported that the family and Brookfield, a private equity group, were in discussions to launch a public take over to take the company private. The market responded positively to the news with both equity and bonds rallying. However, within 48 hours, the market gave back some of the gains as Moody's announced that it was withdrawing its rating (Caa2) for Grifols due to "insufficient or otherwise inadequate information to support the maintenance of the ratings." For now, Fitch and S&P (CCC+, B-, respectively) continue to provide a rating.

In LME (liquidity management exercise) news, it was announced that Altice had moved some of the proceeds of the Altice Media sale (€1.55bn) into an entity that "sits above Altice France's operations". This comes as talks between creditors and the corporate are supposed to officially start in the coming week. Watch this space.

## Asian credit

The June export growth in China came in above expectation while import growth was negative. Exports rose 8.6% y/y in June (May: +7.6%), which was partly explained by a low base and the resilient exports for motor vehicles. However, the imposition of EU duties from early July could impact the export volume over the coming months. The negative import growth reflects the prevailing environment of soft domestic consumption. In June, the CPI reading was tepid with a print of +0.2% y/y (May: +0.3%), lower than market expectations of a larger increase in inflation. PPI remained in deflation territory at -0.8% y/y (May: -1.4% y/y), weighed down by weak domestic demand.

The Chinese real estate sector continued to be challenging despite various policies to ensure the delivery of pre-sold homes and to shore up homebuyers' confidence. New home prices in 70 cities (excluding state-subsidized housing) fell 0.67% m/m in June. That said, this is a marginal improvement from the decline of 0.71% m/m in May, helped by home prices in Tier-1 cities.

## Emerging markets

US data once again provided some relief for emerging market hard currency bonds last week. The index returned +1.04% with US treasuries the main driver of positive performance. EM spreads also helped tightening 3bps to 389bps. High yield sovereign bonds outperformed investment grade with Venezuela and Ukraine seeing the highest returns. As US CPI came in slightly lower than expected, market participants believe a Fed cut will happen in September, which gives EM central banks more confidence to either commence or continue their easing cycles. This week policy makers in South Africa and Indonesia meet where expectations are that rates will be held.

The renewed positive sentiment has fed into fund flow data with EM bond funds enjoying +\$208m in inflows over the week, led by hard currency funds as local currency funds continue to see outflows.

Pakistan secured a Staff Level Agreement with the IMF for a \$7bn 3-year EFF programme. This will be welcome news for the government following the implementation of unpopular, but much needed, reforms in order to satisfy the IMF's criteria. Some of the reforms included higher taxes and increased energy prices.

Saudi Arabia's oil giant Saudi Aramco issued \$6bn of debt across three tranches, 10, 30 and 40 years. In the UAE, there was an inaugural euro issuance of €500m from the emirate of Sharjah, who issued a sustainable 6.5 year bond. Outside of the Middle East, Turkey issued a \$1.75bn 8-year bond yielding 7.3%.

# Fixed Income Asset Allocation Views

## 15<sup>th</sup> July 2024



Strategy and positioning (relative to risk free rate)	Views	Risks to our views
<b>Overall Fixed Income Spread Risk</b> 	<ul style="list-style-type: none"> <li>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 potential market volatility. <b>The group remains negative on credit risk overall, with no changes to the scorecard.</b></li> <li>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.</li> <li>Uncertainty remains elevated due to sensitive monetary and fiscal policy schedules and elections in various countries.</li> </ul>	<ul style="list-style-type: none"> <li>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</li> <li>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.</li> </ul>
<b>Duration (10-year)</b> (P' = Periphery) 	<ul style="list-style-type: none"> <li>Longer yields to be captured by long-run structural downtrends in real yields</li> <li>Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures</li> </ul>	<ul style="list-style-type: none"> <li>Inflationary dynamics become structurally persistent</li> <li>Labour supply shortage persists; wage pressure becomes broad and sustained</li> <li>Fiscal expansion requires wider term premium</li> <li>Long run trend in safe asset demand reverses</li> </ul>
<b>Currency</b> ('E' = European Economic Area) 	<ul style="list-style-type: none"> <li>Dollar has been supported by US growth exceptionalism and deprecating of the Fed while the ECB looks set to embark on a cutting cycle.</li> <li>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.</li> </ul>	<ul style="list-style-type: none"> <li>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</li> </ul>
<b>Emerging Markets Local (rates (R) and currency (C))</b> 	<ul style="list-style-type: none"> <li>Disinflation under threat but intact, EM central banks still in easing mode.</li> <li>Real yields remain high.</li> <li>Selected curves continue to hold attractive risk premium.</li> </ul>	<ul style="list-style-type: none"> <li>Global real rate reversal challenges EM easing cycles.</li> <li>Geopolitical strife rekindles inflation</li> <li>US macro-outperformance strengthens US dollar.</li> </ul>
<b>Emerging Markets Sovereign Credit (USD denominated)</b> 	<ul style="list-style-type: none"> <li>EMD spreads tightened this month, supported by improvement in distressed credit and stability in GCC despite geopolitical risk amid changes after elections.</li> <li>Investment Grade spreads are at historical tightness while High Yield still offers some value.</li> <li>Tailwinds: Stronger growth forecasts, Central bank easing, potential China stimulus, IMF program boost for distressed names.</li> <li>Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical and domestic political uncertainty, restructurings slow.</li> </ul>	<ul style="list-style-type: none"> <li>Global election calendar (US, LATAM)</li> <li>Weak action from Chinese govt, no additional support for property and commercial sectors</li> <li>China/US relations deteriorate.</li> <li>Spill over from Russian invasion and Israel-Hamas war: local inflation (esp. food &amp; commodity), slow global growth.</li> <li>Potential for the start of a new war in the conflict between Israel and Iran.</li> </ul>
<b>Investment Grade Credit</b> 	<ul style="list-style-type: none"> <li>Spreads have continued to move tighter and are near record lows. The group is taking down credit risk because of flat spread curves and less spread compression upside.</li> <li>Due to the tight spreads across the board, the compensation for taking on additional risk, in seeking higher yields, seems unattractive.</li> <li>Global portfolios prefer EUR IG over USD on reval basis.</li> </ul>	<ul style="list-style-type: none"> <li>Tighter financial conditions lead to European slowdown, corporate impact</li> <li>Lending standards continue tightening, even after Fed pauses hiking cycle.</li> <li>Rate environment remains volatile.</li> <li>Consumer profile deteriorates.</li> <li>Geopolitical conflicts worsen operating environment globally.</li> </ul>
<b>High Yield Bonds and Bank Loans</b> 	<ul style="list-style-type: none"> <li>Spreads have remained stable but tight since last month.</li> <li>Anticipate credit selection will be the performance differentiator in 2024. Looking to avoid defaults/distress, focusing on credit recovery and deleveraging these.</li> <li>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.</li> <li>Default forecasts for lower rated issuers, particularly in Europe, is deteriorating with default rates projected to go up.</li> </ul>	<ul style="list-style-type: none"> <li>Lending standards continue tightening, increasing the cost of funding.</li> <li>Default concerns are revised higher on greater demand destruction, margin pressure and macro risks</li> <li>Rally in distressed credits, leads to relative underperformance</li> <li>Volatility in the short end of the curve, eroding potential upside where we are positioned for carry.</li> </ul>
<b>Agency MBS</b> 	<ul style="list-style-type: none"> <li>Spreads are still flat to wide of historic long-term averages.</li> <li>The decline in interest rate volatility since Fed signalled a definite end to the hiking cycle has been a tailwind for MBS, however the recent increase following hotter than expected CPI has started to undo this process.</li> <li>Constructive view on fundamentals over longer time horizon.</li> </ul>	<ul style="list-style-type: none"> <li>Lending standards continue tightening even after Fed pauses hiking cycle.</li> <li>Fed fully liquidates position.</li> <li>Market volatility erodes value from carrying.</li> <li>More regional bank turmoil leads to lower coupons to underperform.</li> </ul>
<b>Structured Credit Non-Agency MBS &amp; CMBS</b> 	<ul style="list-style-type: none"> <li>Neutral outlook because of decent fundamentals and reval in select high quality Non-Agency RMBS, and ABS.</li> <li>RMBS: MoM spreads remain tight. Delinquency, prepayment, and foreclosure performance remains strong for prime borrowers, seeing small increase in delinquencies for non-prime borrowers.</li> <li>CMBS: The group is cautious, especially on office, floating rate, and near-term maturities. Non-office sectors, however, perform as expected with the overall market sentiment improving.</li> <li>CLOs: Despite new issue, spreads remain tight. Defaults remain low but CCC bucket defaults are rising with lower recoveries.</li> <li>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.</li> </ul>	<ul style="list-style-type: none"> <li>Weakness in labour market</li> <li>Consumer fundamental position (especially lower income) weakens with inflation and Fed tightening. Consumer (retail/travel) behaviour fails to return to pre-covid levels</li> <li>Student loan repayments weaken consumer profile more than anticipated, affecting spreads on a secular level.</li> <li>High interest rates turn home prices negative, punishing housing market</li> <li>Cross sector contagion from CRE weakness.</li> </ul>
<b>Commodities</b> 	<ul style="list-style-type: none"> <li>o/w sugar</li> <li>o/w Zinc</li> <li>o/w Gasoline</li> <li>o/w Distillates</li> <li>o/w Cocoa</li> <li>o/w natural gas</li> <li>o/w corn</li> <li>o/w lead</li> <li>o/w silver</li> <li>o/w soybean meal</li> </ul>	<ul style="list-style-type: none"> <li>Global Recession</li> </ul>



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