COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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Tighter and tighter and tighter yet.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.28%	10 bps	-2.0%	-2.0%
German Bund 10 year	2.40%	2 bps	-2.3%	-2.3%
UK Gilt 10 year	4.11%	2 bps	-4.3%	-4.3%
Japan 10 year	0.74%	1 bps	-0.6%	-0.6%
Global Investment Grade	105 bps	-4 bps	-1.3%	-1.3%
Euro Investment Grade	124 bps	-5 bps	-0.9%	-0.9%
US Investment Grade	96 bps	-4 bps	-1.5%	-1.5%
UK Investment Grade	102 bps	-3 bps	-1.9%	-1.9%
Asia Investment Grade	162 bps	-13 bps	0.1%	0.1%
Euro High Yield	366 bps	-15 bps	1.1%	1.1%
US High Yield	334 bps	1 bps	-0.2%	-0.2%
Asia High Yield	726 bps	-13 bps	3.7%	3.7%
EM Sovereign	318 bps	-8 bps	-1.4%	-1.4%
EM Local	6.2%	3 bps	-2.4%	-2.4%
EM Corporate	288 bps	-10 bps	0.9%	0.9%
Bloomberg Barclays US Munis	3.4%	3 bps	-0.7%	-0.7%
Taxable Munis	5.1%	10 bps	-2.2%	-2.2%
Bloomberg Barclays US MBS	46 bps	-1 bps	-2.3%	-2.3%
Bloomberg Commodity Index	222.53	-0.6%	-1.7%	-1.7%
EUR	1.0775	-0.1%	-2.4%	-2.4%
JPY	149.99	-0.6%	-6.1%	-6.1%
GBP	1.2620	-0.2%	-1.0%	-1.0%

Source: Bloomberg, ICE Indices, as of 16 February 2024. *QTD denotes returns from 31/12/2023.

Chart of the week – Global IG spreads (last three years)

Source: BofAML, Bloomberg, Columbia Threadneedle Investments as of 19 February 2024.

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Macro / government bonds

Last week saw a repricing of interest rate expectations. All the bond market gains since the Fed meeting in December, in which it pivoted monetary policy, evaporated. The fall in rates last quarter had been predicated on a swift path to monetary easing, potentially beginning in March. The repeated demonstrations of strength in the US economy, which has benefited from greater fiscal stimulus than either of its peers in Europe and the UK, increasingly challenged this view. To get to an early rate cut required compelling evidence that the disinflation process remained in play. Data last week did not fit the script. US Consumer Price Inflation came in stronger than expected at +0.3% month-on month for January. The majority of the increase came from a rise in the index for shelter – a factor that is unlikely to unwind in the short-term without a significant softening in the US economy.

In a double whammy for interest rate markets, US Producer Price Inflation also came in stronger than expected at 0.3% for January – the largest advance since August 2023. The biggest contribution to the rise in the PPI number came from services. Whether the upside surprises are one-off data points or part of a larger trend, they raise important questions about the nature and direction of inflation. Services inflation is the biggest component of inflation with wages, in turn, being the biggest component of services inflation. Data that points to consumer resilience and labour market tightness can only postpose any decision to cut interest rates. The market recognised the challenge that the economic backdrop has created for policymakers in the US, reining back its expectations of up to six quarter point rate cuts this year to just over three rate cuts – in line with messaging from the Fed through its dot plot. The higher inflation readings also led the market to reprice the probability of a May cut from 73% to 39%, with June now the most favoured probable start date. As yields rose at the front end, we saw a bear flattening trend emerge in the US. Throughout the week, Fed speakers delivered in lockstep a call for further confirmation of disinflation before they would act.

The scale of the repricing in the eurozone and UK was more muted. The eurozone market continued to price June as the most probable start date for interest rate cuts. Structurally, the eurozone economy is in different place to the US: economic growth is subdued, while inflation, notwithstanding its recent fall, remains elevated. The key data points ECB policymakers are waiting on are information on negotiated wage settlements and to what extent companies are willing to absorb higher wage costs through their profit margins.

While the market wants to anchor pricing around a start date across core markets, policy makers wish to retain their optionality, while mindful of the risk that the cumulative effect of past tightening will increasingly bear down on the real economy.

The environment remains constructive for fixed income. In the US, we have an attractive combination of high nominal rate levels and high real interest rates, while high nominal interest rates in the eurozone and the UK have also created attractive levels to establish positions. Any temporary spike higher in interest rates on the back of stronger than expected data can create attractive opportunities to add to duration risk. We remain overweight duration risk, even as we continue to manage it tactically, as there is a clear path to a lower interest rate environment, even if that path is a little bumpier and takes longer to get there than anticipated.

Investment grade credit

The quiet grind tighter in investment grade credit spreads continued last week taking valuations to the tightest levels in around two years **(see chart of the week).**

Euro markets have fared slightly better than their US dollar cousins with spreads better by 9% in 2024, while the US market has tightened by 8% so far. The banking, insurance and real estate sectors are leading the rally in the global index. Media, healthcare and industrials are trailing though all sectors are tighter year-to-date.

What seems to be driving spreads is demand for bonds relative to net supply. In turn it seems likely this is being driven by the higher yields on offer in the market rather than the tighter spreads mentioned earlier.

High yield credit & leveraged loans

With the primary market shut last week and strong flows into the asset class (€550m with managed accounts receiving the bulk), European high yield had another positive week(+33bps) with spread contraction (-15bps) to 366bps and yields falling -8bps to 6.80%. Returns were similar across the credit rating buckets.

Earnings results last week had cyclical sectors showing modestly improving order books with destocking (a theme in 2023) appearing to have largely played out. However, companies are not pointing to tangible recovery until the second half of 2024 (notably in chemicals and packaging).

In the hybrid space, S&P surprised the market last week by removing equity content from Balder (Swedish real estate group) hybrids after the company announced it was going to raise equity to repurchase half of its outstanding hybrids. S&P appears to be concluding that the company is no longer committed to retaining hybrids as a permanent part of its capital structure. This was a surprise as other issuers have used a similar methodology to pay down hybrid debt without losing equity content.

Asian credit

The Lunar New Year holiday period in China was positive on the consumption front. According to the Ministry of Culture & Tourism, the domestic spending on tourism rose to CNY632.7bn (+47.3% y/y), which exceeded the level during the same period in 2019 by 7.7%. Overall, around 474m domestic trips were made by travellers during the eight-day Spring Golden Week, higher than the 2019 level by 19%. Notwithstanding this positive headline, it is worth noting that the average tourism spending per trip has declined around 9.5% compared with 2019.

Macau reported a strong rebound in arrivals with a daily average of 169,7000 visitors during the holiday period, reaching around 99% of the level in the 2019 Spring Golden Week. For context, the Macau Government Tourism Office had estimated an average daily arrival of 120,000.

The PBOC has injected CNY500bn into the banking system via the one-year MLF (medium-term lending facility) while keeping the MLF rate unchanged at 2.5%, in line with consensus. The PBOC also injected CNY105bn in short-term liquidity via the seven-day reverse repo (interest rate 1.8%) into the banking system.

With respect to the Chinese property market, the state-owned banks have reportedly allocated at least CNY60bn ($8bn) of loans for property projects that are eligible for support. The central government has been pushing the major state-owned banks to extend loans to "white lists" of property projects in various cities. That said, according to the National Financial Regulatory Administration, lenders have the autonomy to adopt market principles in their lending decisions. As of early February, according to Bloomberg, 170 Chinese cities had identified a total of 3,218 projects on their white lists.

The Indonesia election concluded last week with the landslide victory by Prabowo Subianto who secured around 58% of the votes, ahead of his two opponents – Anies Baswedan (25.3%) and Ganjar Pranowo (16.6%). Given that Prabowo has surpassed the 50% threshold for a one-round election victory, there would be no run-off election with the second-placed Anies Baswedan. Prabowo's election victory is largely attributed to the endorsement by President Jokowi who is stepping down after completing the constitutionally mandated maximum of two terms. Once Prabowo officially takes over as the new President in October 2024, the spotlight will be on whether he continues Jokowi's legacy of economic and infrastructure development.

Emerging markets

The move higher in US treasuries last week was negative for EM hard currency returns but EM spreads demonstrated resilience and tightened 8bps, meaning the overall return for the index over the week was -0.05%. The spread compression theme between investment grade and high yield is evident as we saw the majority of tightening in the lower-rated buckets.

In the primary market Kenya issued a $1.5bn 7-year bond yielding 10.375%. Romania issued a €4bn deal across two parts; a 7-year bond as well as a 12-year green bond.

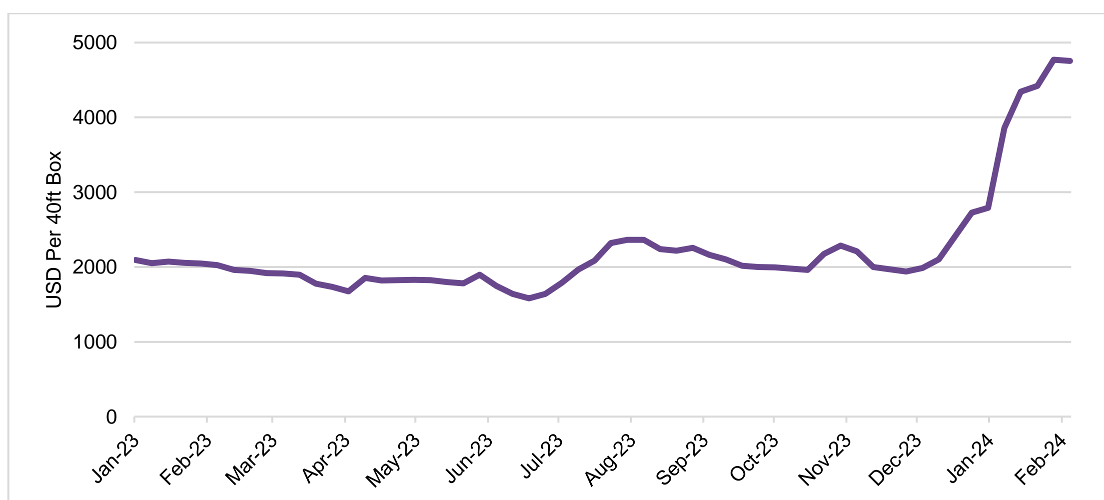
In Mexico, 90,000+ protestors took to the streets in opposition to a proposed institutional overhaul of the country's independent election body (the INE) by president Obrador, which critics say will weaken checks and balances. Obrador's left wing 'Morena party' is currently leading opinion polls by double digits thanks to minimum wage hikes and his 'man of the people' image but calls of rule breaking by protestors and the opposition could jeopardise this.

Commodities

The BCOM index delivered total returns of -0.6% on the week with gains in industrial metals (+2.5%) being offset by losses in energy (-1.7%) and agriculture (-2.5%).

Brent rallied from $82.2 to $83.5 on the week. Prices were supported by continued tension in the Middle East with Israel on the cusp of invading southern Gaza. Another unfortunate consequence of the conflict has been rising shipping rates. The cost of container shipping between Shanghai and Los Angeles has more than doubled since the end of 2023 **(see chart of the week 2)**, and there is concern at the risk this will pose for earnings and producer inflation. In negative news for crude, the IEA revised down its 2024 demand growth forecast to 1.2m barrels per day on the back of a slowdown in Chinese demand, this compares to growth of 2.3m seen last year. Elsewhere, the EIA reported a higher-than-expected US inventory build as a result of a rebound in US crude imports.

Chart of the week 2 – WCI Shanghai to Los Angeles Container Freight Rate per 40 Foot Box



Source: Bloomberg, as of 15 February 2024.

In copper news, data from the Shanghai metals exchange showed Chinese refined copper production falling by 3% in January. Data from the LME showed investors increased their net bullish positions on copper to the highest level since February 2021. In Peru, domestic copper output rose 12.7% YoY in 2023 to record high levels.

Responsible investments

A handful of top global asset managers have made the controversial decision to leave the Climate Action 100+ initiative. PIMCO jumped on the band wagon over the weekend alongside JP Morgan, BlackRock and State Street Global Advisors who have all decided to revoke their involvement over the last few days with one of world's largest climate change initiatives. Climate Action 100+ aims to leverage from the 700+ signatories to engage with companies on improving climate change governance, cutting emissions and strengthening climate-related financial disclosures.

The release of Phase 2 of the programme at the end of January, which will run from 2023 to 2030, seems to have triggered some asset managers to stop and think about whether the initiative 'aligns' with their own sustainability aims and goals. Those who have chosen to leave have stated they intend to focus on their own engagement efforts internally.

Fixed Income Asset Allocation Views

19th February 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	▪ 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.** ▪ 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. ▪ 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 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 ¥ €$£	▪ Rising expectations around a soft landing and peak Central Bank rates have weakened the dollar ▪ EM disinflation to be more rapid than DM ▪ 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))	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 real rate reversal challenges EM easing cycles. ▪ Geopolitical strife rekindles inflation ▪ US macro outperformance strengthens US dollar.
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight	▪ EMD spreads tightened this month, supported by macro stabilisation and market-wide spread rally. Technicals have modestly improved, continued outflows but stronger issuance. ▪ Conservatively positioned in select high quality relval names, most idiosyncratic opportunities are in lower quality portion of index. ▪ Tailwinds: Stronger growth forecasts, Central bank easing, potential China rebound, IMF program boost for distressed names. ▪ 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. ▪ China/US relations deteriorate. ▪ Spill over from Russian invasion and Israel-Hamas war: local inflation (esp. food & commodity), slow global growth. ▪ Persisting COVID growth scars hurt economies & fiscal deficits.
Investment Grade Credit	Under-weight -2 -1 0 +1 +2 Over-weight	▪ Spreads have continued to move tighter since last month. The group is taking down credit risk because of flat spread curves and less spread compression upside. ▪ Strong 2024 start for fundamentals and technical. Per ratings agencies, index credit quality has improved y/y. Inflows are exceeding net supply despite record IG new issuance in January. ▪ 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	▪ Spreads have continued to tighten since last month. Modest weakness in fundamental outlook with sector bifurcation. ▪ Anticipate credit selection will be the performance differentiator in 2024. Looking to avoid defaults/distress, focusing on credit recovery and deleveraging theses. ▪ Conservatively positioned, looking to reduce and diversify credit risk because spreads are likely near their cycle lows. ▪ Bank loan market continued to see tight spreads, improving technical. Underlying credit backdrop unchanged.	▪ 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	▪ Mortgage index remain at tight levels; however, spreads are still flat to wide of historic long-term averages. ▪ Lower coupons have underperformed driven by rate move and regional bank headlines. ▪ In late 2023 the group reduced position sizing into spread tightening but remains overweight the sector. ▪ Constructive view on fundamentals over longer time horizon.	▪ Lending standards continue tightening even after Fed pauses hiking cycle. ▪ Prepayments normalise as rates rise without reducing mortgage servicing. ▪ Fed continues to shrink position. ▪ Market volatility erodes value from carrying.
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 Non-Agency RMBS, and ABS. ▪ RMBS: MoM spreads have tightened. Delinquency, prepayment, and foreclosure performance remains strong for prime borrowers; seeing small increase in delinquencies for non-prime borrowers. ▪ CMBS: The group is cautious, especially on office and near-term maturities, however non-office sectors perform as expected and overall market sentiment improving. ▪ CLOs: Despite new issue, spreads grind tighter. Defaults remain low but CCC bucket defaults are rising with lower recoveries. ▪ ABS: Spreads tighter MoM, prefer senior positions. Higher quality borrowers remain stable, lower quality borrowers underperform.	▪ 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. ▪ Rising 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 Copper ▪ o/w Grains ▪ u/w Gold ▪ o/w Soybean Meal ▪ o/w Oil ▪ o/w Lead ▪ o/w Zinc ▪ o/w Palladium	▪ Global Recession

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