COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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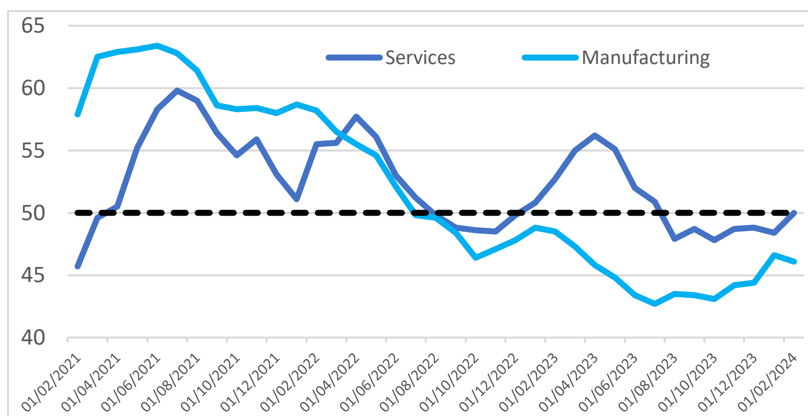
A game of two halves.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.24%	-4 bps	-1.7%	-1.7%
German Bund 10 year	2.38%	-2 bps	-2.1%	-2.1%
UK Gilt 10 year	4.11%	0 bps	-3.8%	-3.8%
Japan 10 year	0.69%	-5 bps	-0.4%	-0.4%
Global Investment Grade	102 bps	-3 bps	-0.9%	-0.9%
Euro Investment Grade	117 bps	-7 bps	-0.6%	-0.6%
US Investment Grade	95 bps	-1 bps	-1.1%	-1.1%
UK Investment Grade	99 bps	-3 bps	-1.4%	-1.4%
Asia Investment Grade	157 bps	-5 bps	0.2%	0.2%
Euro High Yield	357 bps	-9 bps	1.5%	1.5%
US High Yield	323 bps	-11 bps	0.3%	0.3%
Asia High Yield	703 bps	-24 bps	4.7%	4.7%
EM Sovereign	311 bps	-7 bps	-0.8%	-0.8%
EM Local	6.2%	0 bps	-2.4%	-2.4%
EM Corporate	282 bps	-5 bps	1.2%	1.2%
Bloomberg Barclays US Munis	3.4%	-2 bps	-0.6%	-0.6%
Taxable Munis	5.1%	-2 bps	-1.9%	-1.9%
Bloomberg Barclays US MBS	50 bps	4 bps	-2.2%	-2.2%
Bloomberg Commodity Index	220.72	-0.8%	-2.5%	-2.5%
EUR	1.0854	0.4%	-2.0%	-2.0%
JPY	150.58	-0.2%	-6.3%	-6.3%
GBP	1.2691	0.6%	-0.5%	-0.5%

Source: Bloomberg, ICE Indices, as of 23 February 2024. *QTD denotes returns from 31/12/2023.

Chart of the week – Eurozone PMI data (2021-2024)



Source: Bloomberg, Columbia Threadneedle Investments as of 26 February 2024.

Macro / government bonds

The major story for fixed income markets last week was the speech from Fed Governor, Christopher Waller, and what it would say about the future direction of US monetary policy. What he had to say dovetailed with what nearly every other central banker has been forthright in communicating recently – namely the need for patience in ascertaining whether the disinflation process remains in place. The title of Waller's speech delivered its essence in three simple words: "What's the rush?" He posed a question that the Fed has yet to answer: was the uptick in inflation in January an aberration or proof that inflation was stickier than thought? An answer to this question he suggested will be found in upcoming data on wages and compensation.

In recommending a pause, Waller made the point that monetary policy operates with a lagged impact and that given the current strength of the US economy, there is time to evaluate the strength of disinflationary trends. His comments had little discernible impact on fixed income markets, which had already traversed higher than expected consumer and producer price data, pricing out the buoyant optimism of late December and early January in favour of a pricing profile, which is more reflective of the Fed's December projections of three quarter point rate interest rate cuts by year end.

Last week also saw the publication of PMI data for the US and Europe (Germany, France, and the eurozone). The data showed the US in expansionary territory (>50), while Europe remained in contractionary territory (<50) **(see Chart of the week).** There was one common theme to all the PMI measures – relative strength in services, alongside evidence of a shallowing of the dip in manufacturing. Echoing the Fed, the European Central Bank remains concerned about the strength of services inflation, and wishes to see evidence of disinflation in the current round of negotiated wage settlements.

The degree of macro uncertainty has pushed interest rates to key technical levels. So far there has been an insufficient shift in market sentiment to cause yields at the 10-year maturity point across core markets to break out of current trading ranges, as market participants balance the negative of potential inflation persistence with the positive of future monetary easing, even if the timing of this has been pushed further out.

On our Global Rates desk, we retain a constructive view on duration risk, and view higher yields as offering tactical opportunities to add to risk.

Investment grade credit

The high grade credit market contined to tighten in the face of high demand / fund flows even as new issuance remained heavy last week.

JP Morgan note that the US market has seen 17 consecutive weeks of inflows. This seems to be driven by ongoing demand for the yield the asset class offers and an expectation that once rates fall yields will follow suit. Credit markets have also benefitted from ongoing strength in other risk markets such as equities, with the Japanese Nikkei Index reaching the highest level in its history last week.

The global IG index spread is 11% tighter this year (ending last week at 102bps). Euro and sterling markets are both 14% tighter while the US market is 9% better. In all cases short-dated bonds (1-5 years) have outperformed and are 14% tighter in the US dollar market; the euro market is 17% tighter; and the sterling market is 19% tighter at this part of the credit curve (source: data from ICE indices). So steeper credit curves after last year's flattening. Sector wise, banks, insurance and real estate are the best performing – at least globally. Adjusted for duration, media and healthcare are the laggards though all sectors are tighter this year.

High yield credit & leveraged loans

US high yield spreads tightened over the week amidst resilient earnings reports and improving capital market access. The ICE BofA US HY CP Constrained Index returned 0.45% and spreads were 10bps tighter.

According to Lipper, US high yield retail funds saw a small $11m inflow over the week, marking 15 inflows over the last 16 weeks and leaving YTD inflows at $3.6bn. Meanwhile, the average price of the Credit Suisse Leveraged Loan Index increased slightly to $95.7 amid a record pace of CLO origination ($28bn thus far YTD) and elevated refinancing / repricing activity. Retail loan funds experienced a $210m inflow, bringing YTD inflows to $863m.

The firm tone in European high yield continued another week providing solid performance (+35bps), even as spread contraction softened -9bps to 3.57% with an even smaller fall in yield (-6 bps to 3.74%). Single Bs outperformed BBs and CCCs. Technicals continue to be very supportive of the asset class as the primary market remained subdued with only one new 5-year issue from AVIS, the car rental company (€600m at 7%). The market remained strongly supported by inflows though this was mainly from managed accounts as ETFs had modest outflows for the week. The theme of limited new issuance continues with more announcements (e.g. Mahle) indicating a move to the loan market over coming to the bond market for financing.

The earnings season continues with cyclicals, coming off previous weaker quarters and starting to show some demand improvement with an expectation that this will accelerate in the H2,2024.

In M&A news, in the telecom sector, Bouygues Telecom has entered an exclusive agreement to acquire 100% of La Poste. Also moving forward is the joint venture of MASMOVIL and Orange with European Commission clearance given. In auto news, Volvo announced it is planning to distribute 62.7% of its stake in Polestar to shareholders, retaining only an 18% stake.

Asian credit

The People's Bank of China lowered the 5-year loan prime rate (LPR) by 25bps to 3.95% but kept the 1-year LPR unchanged at 3.45%. The cut to the 5-year LPR, which is the reference rate for mortgage loans, was larger than consensus. The government is looking to support the demand for properties but the positive impact of the rate cut would be limited given weak consumer confidence and concerns about the timely delivery of properties under construction.

JSW Steel is reportedly interested in acquiring a 20% stake in the Blackwater coal mine for around $1bn from Whitehaven in Australia. This is part of JSW Steel's long-term plan of improving its backward integration and self-sufficiency in sourcing raw materials such as coking coal and iron ore for its domestic operations.

Emerging markets

Emerging market hard currency sovereigns posted a positive return of +0.66% last week, as spreads tightened 9bps to 374bps Spread levels are now at their tightest level since 2021 and the index offers a yield of 8.1%. High yield outperformed investment grade while Africa was the best performing region, aided by strong performance from Egypt.

The new Turkish central bank governor opted to hold interest rates at 45%, in line with expectations. This marked the first pause since last May. The policy rate in Indonesia was also left unchanged, at 6% and GDP rose in Q4 owing to higher exports.

South Africa presented its budget last week and while the Rand and bonds initially strengthened, the gain were short-lived. Finance Minister Enoch Godongwana announced that the country's gold and FX reserves would be utilised to control rising debt levels.

Egypt has secured $35bn in investment from Abu Dhabi to develop a 170sq km coastal area into a tourism and financial hub. The funding is both nearer term and larger in magnitude than the market was expecting. Up until now, Egypt's foreign currency shortage has meant it has been reluctant to allow the currency to freely trade, due to a lack of funds to prevent a severe decrepitation. However, moving to a freely traded FX regime has been a condition of a pending IMF loan, which will help resolve this problem. The combination of funding from Abu Dhabi and the IMF loan would go a long way to covering Egypt's financing gap over the next few years.

Fixed Income Asset Allocation Views

22nd 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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