# In Credit

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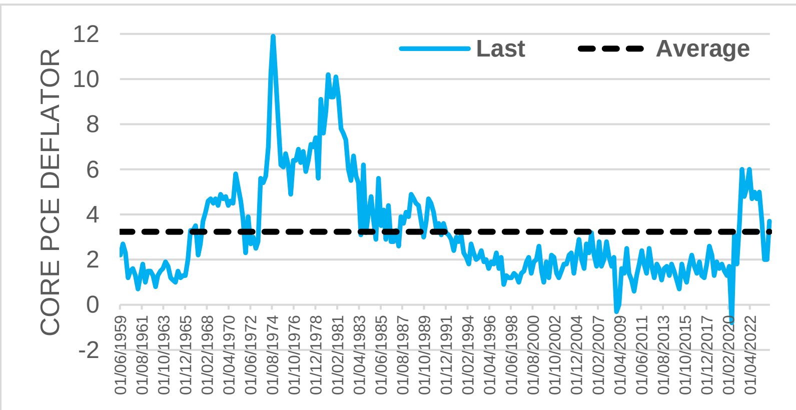
## Inflation still too high for comfort.

### Markets at a glance

| | Price / Yield / Spread | Change 1 week | Index QTD return* | Index YTD return |
|---|---|---|---|---|
| US Treasury 10 year | 4.63% | 1 bps | -2.4% | -3.3% |
| German Bund 10 year | 2.55% | 5 bps | -1.7% | -3.1% |
| UK Gilt 10 year | 4.31% | 8 bps | -3.0% | -4.8% |
| Japan 10 year | 0.89% | 4 bps | -1.5% | -2.1% |
| Global Investment Grade | 97 bps | -4 bps | -1.8% | -1.7% |
| Euro Investment Grade | 111 bps | -3 bps | -0.8% | -0.4% |
| US Investment Grade | 90 bps | -4 bps | -2.3% | -2.4% |
| UK Investment Grade | 98 bps | -2 bps | -1.8% | -1.8% |
| Asia Investment Grade | 148 bps | 2 bps | -1.1% | 0.1% |
| Euro High Yield | 375 bps | -10 bps | -0.1% | 1.6% |
| US High Yield | 316 bps | -21 bps | -1.1% | 0.4% |
| Asia High Yield | 690 bps | 6 bps | -1.1% | 4.6% |
| EM Sovereign | 284 bps | -2 bps | -2.1% | -0.7% |
| EM Local | 6.6% | 4 bps | -2.2% | -4.3% |
| EM Corporate | 266 bps | 0 bps | -1.0% | 1.3% |
| Bloomberg Barclays US Munis | 3.8% | 7 bps | -1.3% | -1.7% |
| Taxable Munis | 5.4% | 4 bps | -3.6% | -4.0% |
| Bloomberg Barclays US MBS | 50 bps | -5 bps | -2.7% | -3.7% |
| Bloomberg Commodity Index | 240.89 | 0.0% | 3.9% | 6.2% |
| EUR | 1.0721 | 0.3% | -0.9% | -3.1% |
| JPY | 155.86 | -2.3% | -4.4% | -10.9% |
| GBP | 1.2538 | 1.0% | -1.0% | -1.9% |

Source: Bloomberg, ICE Indices, as of 26 April 2024. *QTD denotes returns from 31/03/2024.

### Chart of the week – US Core PCE deflator, 1958-2024




Source: Bloomberg, Columbia Threadneedle Investments as of 29 April 2024.

## Macro / government bonds

We continued to see a paring back of interest rate cut expectations, as well as steepening of global yield curves, as higher than expected inflation readings in the US exerted upward pressure on longer-dated bond yields globally.

In the black-out period ahead of the Fed meeting this week, the market last week had to content itself with parsing economic data. In the US, GDP (annualised for the first quarter), came in weaker than expected at 1.6% p.a. versus 3.4% p.a. for the previous quarter. The data chimed with PMI data for the US, which while remaining in expansionary territory showed that the rate of expansion in the US had begun to moderate. The PCE Deflator, the Fed's favoured measure of inflation came in at 0.3% for March, translating into a year-on-year increase of 2.7% (**see Chart of the week**). The Core PCE Deflator, excluding the volatile food and energy components, also came in at 0.3% month-on-month, translating into a year-on-year figure of 2.8% – a figure that still remained far from the Fed's inflation target of 2%. The majority of the rise in inflation could be accounted for by price rises in the services sector. The ongoing tightness in the labour market showed this trend was unlikely to unwind in the short term. The market responded to elevated inflation pressures in the US by further pricing out its expectations of quarter point interest rate cuts for this year from 1.5 to 1.3.

The Fed will need to see at least three sequential lower inflation readings to gain greater confidence that inflation is moving in the right direction. It is also unlikely that the Fed will cut leading up to the US presidential election. Although the Fed has long said that it is independent of politics, it has long tried to avoid politicising monetary policy by avoiding adjusting policy during peak election periods. This has reduced the window within which the Fed can act this year. While shorter-dated yields remained anchored at 5%, longer-dated yields came under continued upward pressure, settling at 4.7%. Surprisingly, term premia remained unchanged despite the extent of the fiscal impulse in the US.

Price action in the US set the tone for global bond markets. German bond yields rose 7bps at the 10-year tenor to 2.58%. There was no significant data of note in Europe. Although ECB speakers continued to make the case for an interest rate cut in June, there was still no consensus about what follows next in terms of sequencing. We also had PMI readings for Europe, which showed a robust recovery in services, accompanied by signs of a further moderation of the downturn in manufacturing. One red flag for policy makers was the strength of input price inflation in the services sector linked to higher wages. There was also continuing evidence of a two speed Europe, as the larger economies of Germany and France lagged the rest of the eurozone.

While the UK bond market remained sensitive to events in the US, Huw Pill, the Bank of England's Chief Economist, caused indigestion in the UK market as he voiced concerns over the persistence of inflation and the risk of cutting interest rates too early. The PMI for the UK, like the eurozone, pointed to strength in services and weakness in manufacturing. Stronger input price inflation in services reflected the introduction of the national living wage. There was a steepening trend in this market with the 10-year settling the week at 4.3%.

There was no major activity on our Global Rates desk last week. We remain neutral in the US with tactical longs in Europe and the UK where conditions remain more constructive for policymakers to start the process of easing monetary policy.

## Investment grade credit

Investment grade spreads tightened to end the week at 98bps (some 3bps tighter). This means the market is back close to the year-to-date tightest spreads of 96bps.

Euro-denominated bond spreads are 18% tighter this year and well ahead of the US dollar market that is 12% better. In both cases credit curves have steepened meaning that shorter dated debt has tighened more than longer duration bonds. Sector wise, banking, insurance and real estate have performed best with media spreads the weakest alongside healthcare and telecoms.

It was result week for banks in Europe and though there wasn't a huge amount to report it was noticeable that margins are under pressure in the Nordics while holding up better in the UK. As mentioned banking has performed well this year – after a more challenging period last year (SVB and Credit Suisse).

Over in industrials, BHP (A rated) approached rival Anglo American (BBB rated) about a takeover. This seems to reflect recent weakness in Anglo's share price but from a credit perspective has been good for Anglo bonds (lower rated) where spreads tighened by around 15-20bps on the news. Anglo has rejected the approach so watch this space for further updates including whether there are any other interested parties.

## High yield credit & leveraged loans

US high yield bond valuations reversed a portion of the prior week's widening over the week amid a constructive start to earnings season, a return to inflows, and muted primary issuance.

The ICE BofA US HY CP Constrained Index Returned 0.60% and spreads were 21bps tighter. The yield-to-worst of the index declined 18bps to 8.05%. According to Lipper, retail high yield bond funds saw a $604m inflow following a large outflow the prior week. Meanwhile, the average price of the Credit Suisse Leveraged Loan Index increased slightly to $95.9 as technicals remained supportive. Retail loan funds saw their 18th consecutive inflow with $436m contributed over the week.

European High Yield had its second straight week of outflows with spread decompression still in place. This was even as EHY spreads tightened in 10bps to 375bps and yields fell 4bps. Outflows were focused on managed accounts as ETFs were largely flat last week. The asset class returned a modest +18bps as BBs outperformed higher beta rating buckets. It was another busy week for the primary market with four new issues (€1.5bn) and a €1bn private placement from Grifols, the Spanish healthcare company.

In credit rating news, debt collectors saw their ratings lowered by S&P due to changes in the rating agency's methodology. As a result, Arrow and Lowell (Garfunkelux) were both downgraded to B. Lowell also saw its Moody's rating lowered to B3 on concerns for the 2025 maturity wall as well as the higher rate refinancing challenges.

In other sector news, earnings reports for the auto sector show car manufacturers to be a bit of a mixed bag but largely in-line with H2, 2024 expected to be better than H1, 2024. A drop in electrical vehicle demand is feeding into the results.

## Asian credit

Moody's has downgraded China Vanke's ratings to Ba3 (previous: Ba1) and the senior unsecured bond rating to Ba1 (previous: Ba2) while the ratings outlook of both entities is revised to negative (previous: review for downgrade). The negative ratings action reflects Moody's expectation that China Vanke's financial metrics and liquidity buffer will weaken further over the next 6-12 months. According to Moody's forecast, China Vanke's contracted sales will decline by around 25% year-on-year in 2024.

Indika Energy is the first Indonesia high yield company to return to the US dollar bond market by issuing $350m of a 5-year bond. The proceeds will be used to partially redeem the INDYIJ 8.25% '25s and to fund other investments in non-coal projects such as renewable energy and electric vehicles.

Meituan is planning to launch its food delivery platform with its KeeTa app in Saudi Arabia, which will be its first international expansion outside of Greater China.

## Emerging markets

EM hard currency returns were broadly flat over the week at -0.09%. EM spreads have been resilient but the move higher in US treasuries once again had a negative impact on the asset class. From a spread perspective we see the high yield versus investment grade compression theme in play as high yield names outperformed investment grade. Latin American countries contributed the most on a regional basis.

S&P downgraded Peru one notch to BBB-, putting it on the cusp of high yield territory. Moody's and Fitch rate the country Baa1 and BBB respectively with a negative outlook. There has been some tension between the government's fiscal targets and the country's growth prospects, especially with the volatile political backdrop. Staying in Latin America, Bolivia was downgraded two notches by Moody's to Caa3 with the ratings agency citing ongoing governance challenges as well as a decline in FX reserves, which threatens a balance of payments crisis.

Pakistan held interest rates at 22% as policy makers remain cautious about inflation risks arising from higher oil prices as well as potential tax hikes, the latter being one of the IMF's conditions in order to secure further loans as Pakistan continues to implement structural reforms as part of its IMF deal. Turkey kept interest rates unchanged at 50% and Indonesia hiked 25bps to 6.25% in a bid to support the currency.

# Fixed Income Asset Allocation Views

29th April 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, with no changes to underlying sector views.**<br>■ 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 timing and magnitude of cuts have been pushed back.<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 outlook improves 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) | ¥ $<br>Short -2 -1 0 +1 +2 Long<br>P € £ | ■ Longer yields to be captured by long-run structural downtrends in real yields<br>■ Inflation likely to normalize over medium term, although some areas will see persistent pricing pressures | ■ Inflationary dynamics become structurally persistent<br>■ Labour supply shortage persists; wage pressure becomes broad and sustained<br>■ Fiscal expansion requires wider term premium<br>■ Long run trend in safe asset demand reverses |
| **Currency**<br>('E' = European Economic Area) | A$<br>EM<br>¥<br>Short -2 -1 0 +1 +2 Long<br>€ £<br>$ | ■ Dollar has been supported by US growth exceptionalism and depricing of the Fed while the ECB looks set to embark on a cutting cycle.<br>■ 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. | ■ 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<br>Under-weight -2 -1 0 +1 +2 Over-weight<br>C | ■ 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. | ■ Global real rate reversal challenges EM easing cycles.<br>■ Geopolitical strife rekindles inflation<br>■ 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 improvement in distressed credit and stability in GCC despite geopolitical risk.<br>■ Investment Grade spreads are at historical tights while High Yield still offers some value.<br>■ Tailwinds: Stronger growth forecasts, Central bank easing, potential China stimulus, IMF program boost for distressed names.<br>■ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical and domestic political uncertainty, restructurings slow. | ■ Global election calendar (US, LATAM)<br>■ Weak action from Chinese govt, no additional support for property and commercial sectors<br>■ China/US relations deteriorate.<br>■ Spill over from Russian invasion and Israel-Hamas war: local inflation (esp. food & commodity), slow global growth.<br>■ Potential for the start of a new war in the conflict between Israel and Iran. |
| **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.<br>■ Due to the tight spreads across the board, the compensation for taking on additional risk, in seeking higher yields, seems unattractive.<br>■ Global portfolios prefer EUR IG over USD on relval basis. | ■ 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 | ■ Spreads have remained stable but tight since last month.<br>■ Anticipate credit selection will be the performance differentiator in 2024. Looking to avoid defaults/distress, focusing on credit recovery and deleveraging theses.<br>■ Increased lender on lender violence and aggressive liability management exercises furth increase the risk in the distressed and highly leveraged segment. We expect this to accelerate in the coming months.<br>■ Bank loan market continued to see tight spreads, 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 | ■ Mortgage index remain at tight levels; however, spreads are still flat to wide of historic long-term averages.<br>■ 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.<br>■ Constructive view on fundamentals over longer time horizon. | ■ Lending standards continue tightening even after Fed pauses hiking cycle.<br>■ Fed fully liquidates position.<br>■ Market volatility erodes value from carrying.<br>■ More regional bank turmoil leads to lower coupons to underperform. |
| **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.<br>■ RMBS: MoM spreads remain tight. 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, floating rate, and near-term maturities. Non-office sectors, however, perform as expected with the overall market sentiment improving.<br>■ CLOs: Despite new issue, spreads remain tight. 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. Federal student loan payments near '18 / '19 levels with ~75% of borrowers active. | ■ 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>■ High 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 | ■ o/w Copper<br>■ o/w Soybean Meal<br>■ o/w Cocoa<br>■ o/w Oil<br>■ o/w Lead<br>■ o/w Zinc | ■ Global Recession |