COLUMBIA THREADNEEDLE INVESTMENTS

In Credit

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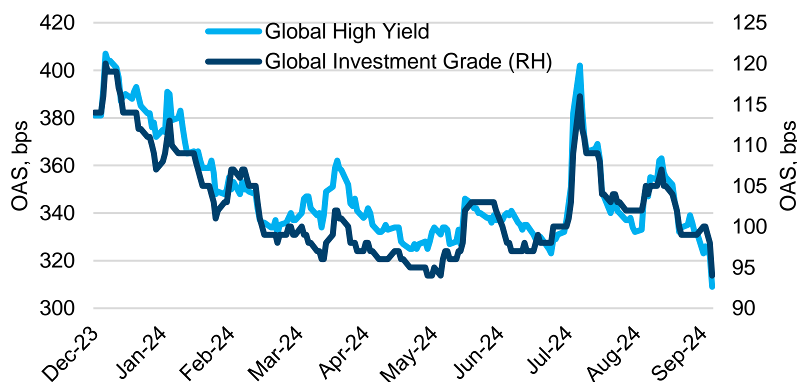
Surging job growth plunging bond prices

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.01%	26 bps	-1.1%	2.8%
German Bund 10 year	2.26%	12 bps	-0.5%	0.6%
UK Gilt 10 year	4.18%	21 bps	-0.9%	-1.5%
Japan 10 year	0.93%	8 bps	0.1%	-1.8%
Global Investment Grade	94 bps	-5 bps	-0.6%	4.5%
Euro Investment Grade	110 bps	-5 bps	-0.1%	3.7%
US Investment Grade	87 bps	-5 bps	-0.8%	4.9%
UK Investment Grade	93 bps	-4 bps	-0.4%	1.8%
Asia Investment Grade	135 bps	-18 bps	-0.1%	6.4%
Euro High Yield	347 bps	-16 bps	0.1%	6.9%
US High Yield	289 bps	-25 bps	-0.2%	7.8%
Asia High Yield	507 bps	-26 bps	0.6%	15.1%
EM Sovereign	313 bps	-16 bps	-0.4%	7.5%
EM Local	6.2%	11 bps	-1.7%	3.2%
EM Corporate	251 bps	-19 bps	-0.2%	8.2%
Bloomberg Barclays US Munis	3.3%	1 bps	0.0%	2.3%
Taxable Munis	4.8%	21 bps	-1.3%	3.3%
Bloomberg Barclays US MBS	41 bps	1 bps	-1.0%	3.5%
Bloomberg Commodity Index	243.91	1.9%	1.8%	7.7%
EUR	1.0966	-1.7%	-1.4%	-0.6%
JPY	148.38	-4.4%	-3.4%	-5.1%
GBP	1.3077	-1.9%	-1.9%	3.1%

Source: Bloomberg, ICE Indices, as of 4 October 2024. *QTD denotes returns from 30 September 2024.

Chart of the week – Credit spreads are at the tightest of the year



Source: Bloomberg, as of 4 October 2024.

Macro / government bonds

There was only one big story that mattered in macro land last week and that was the Non-Farm Payrolls (NFP) print on the state of the US labour market for September. The data mattered as it would set the tone and trajectory of the market, while also resolving the debate over the magnitude of the next interest rate cut from the US Fed.

The NFP came in at a bumper 254k, significantly above market expectations of 150k. Before the meeting, the market had still been pitching the case for three quarter point rate cuts by year-end, which would include a jumbo 50bps rate cut. The data changed the investment landscape abruptly. The 254k number pointed to a resilient US consumer, while we saw echoes of economic resilience in other data releases. The JOLTS job openings data release for August came in higher than expected. The ISM Service sector grew for the fourth month in a row rising from 51.5 to 54.9, reflecting higher business activity and new orders – an index number above 50 indicates economic expansion. The Prices Paid component of the ISM Services Index pointed to renewed inflationary pressure, while there was a marginal decline in employment. The S&P Global US Services PMI Index for September continued to tread water in the 55 area, delivering similar messages on employment, inflation and business activity. The other similarity between the two reports was anecdotal evidence of increasing political volatility, as the US moves towards presidential elections in November. When the new data came, it was simply too strong for the market to justify a 50bps cut. The market sold off immediately, repricing out three quarter point rate cuts in favour of two. This resulted in a bear yield curve flattening trend in the US Treasury market, as short-dated interest rates rose more than longer-dated interest rates. The rally in the US Treasury market was replicated globally. Against this background, the 10-year US Treasury yield moved north from 3.75% to just under 4%, although it remained short of resistance levels estimated at around 4.2%

We are witnessing a bifurcation in the growth outlook between the US and Europe, with the resilience of the US contrasting to weaker conditions in Europe. Headline eurozone inflation fell by -0.1% on the month for September, equating to an annualised rate 1.8%, safely beneath the ECB's inflation target of 2%. One of the leading hawks at the ECB, board member, Isabel Schnabel pointed to further progress on inflation, but also warned about the increasing headwinds to growth in the eurozone. Her comments, alongside those of other senior policy makers at the ECB, increased the probability of a quarter point rate cut at the bank's October meeting. The fact that the US Fed had already moved by 50bps, as part of its "recalibration exercise" to support the US labour market, means that ECB can ease without placing undue pressure on its currency versus the US dollar.

In the UK, Bank of England (BoE) governor, Andrew Bailey, hinted in a media interview that the BoE could take a more activist position towards monetary policy if softer economic data were to justify such a stance. This led to support for UK Gilts, until the stronger NFP print from the US pummeled valuations.

Investment grade credit

Corporate bond spreads continued to edge tighter last week, ending the week with a spread of 94bps over equivalent dated government bonds. This marks the narrowest spread this year **(see chart of the week)**. Markets were assisted by stronger US economic data including a blockbuster employment report (see above) and strong service sector business sentiment news.

The global market spread is some 18% tighter than the end of last year, while there has been quite a disparity in sector performance this year. Globally, real estate, banking and insurance have tightened much more appreciably than other sectors. The beleaguered auto sector has seen spreads barely tighten this year in the wake of profit warnings at BMW, Mercedes, VW and Stellantis. Other weaker sectors include media and healthcare.

This week will end with the start of US earnings season. First out of the blocks will be some of the major banks.

High yield credit & leveraged loans

US high yield bond prices were again mixed over the week amidst a spike in interest rate volatility and better than expected economic data, notably in the form of a strong September employment report. The ICE BofA US HY CP Constrained Index returned -0.17% while spreads tightened 23bps. The index yield-to-worst was stable around the 7% area. According to Lipper, US high yield bond retail funds saw a $2.2bn inflow for the week, the second largest weekly inflow over the last four months. The average price of the Credit Suisse Leveraged Loan Index increased half a point to $96, supported by the prospect of a slower than expected US Fed easing cycle. Retail loan funds saw a small ($55m) inflow.

It was a constructive last week with European High Yield (EHY) finishing September with a 1.1% return as spreads held relatively firm, tightening only 4bps while yields tightened +20bps to 6.3%. The first days of October showed the asset class continuing to perform well with a steady return of 7bps from the first couple of days. Higher beta credits outperformed for the second month in the row with CCCs continuing their strong recovery. Demand for the asset class continues to hold steady with another €343m inflow last week, across both ETFs and managed accounts. Overall inflows are now 10x the inflows seen in 2023. The primary market had its largest issuance week since the start of the year with 11 issuers coming to the market for the amount of €5.7bn. This takes the gross YTD to €97bn. Most of the new offerings performed well, post launch, helped by a very strong market tone. Though refinancings continue to dominate, the week's issuance included a debut deal by Sammontana Italie while part of the proceeds from Belron (retailer) was used for shareholder dividends. Overall, there has been a real pick-up in offerings due to M&A and LBO deal with a third of last month's issuance coming from these deals.

Inspite of the positive week, the auto sector continued to show weakness with profit warnings and the move by the credit rating agencies to negative rating outlooks (e.g. Aston Martin, ZF). Given the size of the auto sector in the market (second largest in the market index at 9.3%) this has resulted in a relative drag for EHY vs US high yield resulting in an underperformance by EHY versus US high yield.

Structured credit

The US Agency MBS sector was down 1.31% last week as rates sold off in response to an unexpectedly strong NFP print (more above).

The possibility that growth is powering a strong labour market, and the US Fed might actually navigate a soft landing came more into view. Investors responded by selling off safe-haven, duration sensitive asset classes. As the 10-year US Treasury approached 4%, spreads on agency MBS widened. 15-year mortgages outperformed 30-year and higher coupon mortgages did best as the curve bear flattened. Prepay risk also took a breather on lower refi probabilities. In the agency mortgage derivative space, there has been an increase in inverse IO buyers since the Fed cut. It will be interesting to see if Friday's NFP print and subsequent sell-off affects this increase in demand. In ABS, the primary market saw solid issuance to start off Q4. 13 deals priced for a total of $7.2bn+. These were all very well received with most pricing at or through guidance. This brings the YTD total to over $283bn passing 2023's $282bn. The secondary market has seen very balanced two-way flows for the week, and TRACE flows were right around the daily average. Secondary selling has been lighter, and combined with the demand for new issue this has kept spreads in a tight range.

Asian credit

China Investment Corp, CIC (sovereign wealth fund) has commenced due diligence on the potential acquisition of the three state-owned asset management companies (AMCs): China Cinda Asset Management, China Orient Asset Management and China Great Wall Asset Management. Currently, the Ministry of Finance (MoF) holds a majority stake in these AMCs. The potential acquisition by CIC is consistent with the reform of the financial system and the government's move to address the issue of regulatory agencies, which presently play the dual roles of regulating and operating the AMCs.

For the first six days of the October Golden Week (1 October – 6 October inclusive), the average number of daily visitors to Macau rose 32.5% y/y to almost 153,000, which is above the pre-Covid 2019 level. The average daily visitors from Mainland accounted for some 84% of the total visitor volume. The key drivers are the implementation of the multiple-entry visa policy (Hengqin to Macau), more group tours from China as well as higher same-day visitors.

In India, Adani Enterprises Ltd (AEL) is planning to launch a qualified institutional placement (QIP) to raise around $1.3bn. This would be a revival of AEL's equity fund raising plans. AEL's initial QIP in January 2023 was withdrawn due to allegations of stock manipulation and other financial malpractices by a short-selling report.

Emerging markets

Emerging market bond spreads finished the week 16bps tighter.

Despite escalating tensions in the Middle East, markets largely ignored these concerns with rising oil prices helping EM oil exporters. High yield spreads compressed to investment grade spreads as higher yielding credits outperformed. However, total returns were negative 40bps as the positive spread performance was offset by higher US Treasury yields over the week.

Several countries saw rating upgrades. Serbia gained its first investment grade rating following S&P's upgrade from BB+ to BBB-. Mongolia was also upgraded by S&P to B+ on the back of strong growth and continued export momentum.

In the restructuring space, Ghana made progress with over 90% of bondholders voting to agree to restructure almost $13bn of eurobonds, paving the way for completion soon. Sri Lanka also received formal IMF approval for its bondholder exchange, targeting year-end to complete the restructuring process. This marks a major policy shift for the President who had campaigned for amended restructuring terms during elections.

Overall, emerging markets have made significant strides in completing restructuring deals this year, providing a boost to several defaulted credits.

Inflows continued into the asset class, albeit at a slower pace than the prior week. With higher expected primary issuance ahead of the US elections next month, this supply may be more easily absorbed by the market, providing technical support.

Responsible investments

Last week, the UK switched off the last coal-fired electricity site, meaning they have completely phased out coal as a energy source.

Over the last decade work has begun to close down various sites, but ensure all workers have a fair deal with either voluntary reduntancy, retraining or redeployment opportunities (otherwise known as the Just Transition). Most the coal-fired energy has been replaced with wind as a renewable source, whilst gas remains the main source of energy in the UK.

Labelled bond sales remain on track for record issuance at year end, currently amounting to over $850bn in total, with around $479bn labelled green bonds.

Fixed Income Asset Allocation Views

7th October 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 (■ at -1)	▪ Spreads are modestly tighter since last month and fundamentals remain stable, despite elevated volatility and slowing of macroeconomic data. ▪ **The group remains negative on credit risk overall, with no changes to underlying sector views.** ▪ The CTI Global Rates base case view is that cutting cycle will start at the September FOMC. The pace and magnitude of additional cuts is uncertain and dependant on inflation and labor market conditions.	▪ 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 ▪ 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 (¥ at -1, £ at 0, $ at +1; P at -1, € at +1)	▪ 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)	Short -2 -1 0 +1 +2 Long (EM, A$, ¥ at 0; € £, $ at 0)	▪ Dollar has been supported by US growth exceptionalism and depricing of the Fed while the ECB looks set to embark on a cutting cycle. ▪ 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))	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. ▪ Real yields remain high. ▪ Selected curves continue to hold attractive risk premium.	▪ Global carry trade unwinds intensify, hurting EMFX performance. ▪ Stubborn services inflation aborts EM easing cycles. ▪ Uptick in volatility. ▪ Disorderly macro slowdown boosts USD on flight-to-safety fears
Emerging Markets Sovereign Credit (USD denominated)	Under-weight -2 -1 0 +1 +2 Over-weight (■ at -1)	▪ Spreads are within 10bps of historical average; spread volatility has increased. ▪ Investment Grade credit demand remains strong from crossover investors, which absorbed the post-summer issuance. Waiting for High Yield issuance to see how market digests lower quality credit. ▪ Tailwinds: Stronger growth forecasts, Central bank easing, IMF program boost for distressed names. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, US election, geopolitical and domestic political uncertainty (especially Venezuela & Mexico), restructurings slow.	▪ Global election calendar (US, LATAM) ▪ 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. ▪ 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 (■ at -1)	▪ Earnings season saw solid results from IG issuers, no fundamental deterioration. ▪ Spreads have tightened back near year-to-date tights, are rich to long-run averages. ▪ Issuance has been strong (80 deals in first two week of September totalling ~$100b) and is expected to be a tailwind for the market until the November election. ▪ Current valuations limit spread compression upside and provide little compensation for taking on additional risk.	▪ 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 (■ at -1)	▪ Spreads have widened so far in September but are still rich in long-term averages. ▪ Earnings season did not indicate broad deterioration; however, the group still has a cautious view of fundamentals given management guidance, CTI default forecasts and the increase in lender-on-lender violence and liability management exercises. ▪ Weaker outlook for cyclical industrial and consumer sectors	▪ 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 (■ at +2)	▪ Spreads are at the year-to-date tights but still wide of historical long-term averages. ▪ Prefer call-protected Inverse IO CMOs, large beneficiary of aggressive cutting cycle. ▪ 30-year MBS outperforming the shorter (15 year and below) MBS ▪ The decline in interest rate volatility since the Fed signalled a definite end to the hiking cycle has been a tailwind for MBS.	▪ Lending standards continue tightening even after Fed pauses hiking cycle. ▪ Fed fully liquidates position. ▪ Market volatility erodes value from carrying. ▪ 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 (■ at 0)	▪ Neutral outlook because of decent fundamentals and relval in select high quality RMBS. ▪ RMBS: Spreads have continued to tighten. Fundamental metrics such as delinquencies, prepayments, and foreclosures, remain solid. ▪ CMBS: We are in the early stages of the office deterioration story. Outside of office and multifamily housing. However, performance has remained healthy. ▪ CLOs: Demand remains high given relative spread to other asset classes; active new issue market. Defaults remain low, but CCC buckets are rising with lower recoveries. ▪ ABS: 60+ Day delinquencies are rising. Spreads wider MoM, the group has been reducing positions in consumer and auto sectors.	▪ 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. ▪ High 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 (■ at +1)	▪ o/w sugar ▪ o/w Zinc ▪ o/w Gasoline ▪ o/w Distillates ▪ o/w Cocoa ▪ u/w natural gas ▪ u/w corn ▪ o/w lead ▪ o/w silver ▪ o/w soybean meal	▪ Global Recession

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