In Credit

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General Fixed Income

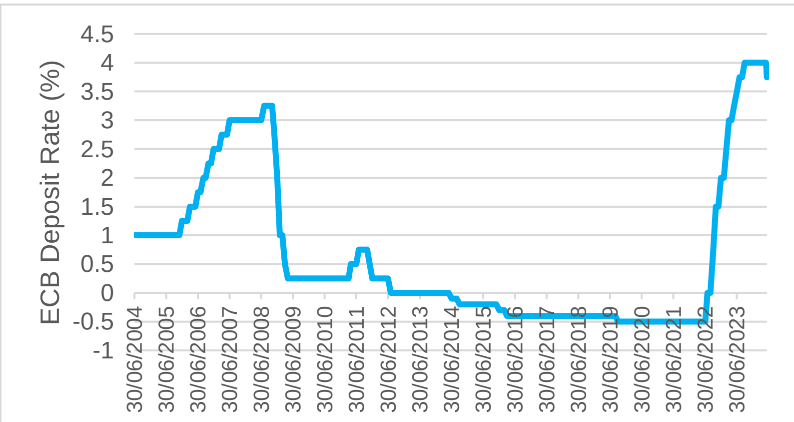
The first cut is the deepest.

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.46%	-4 bps	-0.5%	-1.4%
German Bund 10 year	2.68%	1 bps	-1.8%	-3.1%
UK Gilt 10 year	4.31%	0 bps	-1.8%	-3.6%
Japan 10 year	1.04%	-3 bps	-2.0%	-2.6%
Global Investment Grade	96 bps	1 bps	-0.2%	-0.1%
Euro Investment Grade	106 bps	-1 bps	-0.4%	0.0%
US Investment Grade	90 bps	2 bps	-0.2%	-0.2%
UK Investment Grade	94 bps	-2 bps	-0.7%	-0.6%
Asia Investment Grade	132 bps	-7 bps	1.1%	2.4%
Euro High Yield	335 bps	-16 bps	1.4%	3.1%
US High Yield	315 bps	-5 bps	0.5%	2.0%
Asia High Yield	598 bps	2 bps	2.8%	8.7%
EM Sovereign	323 bps	6 bps	-0.1%	1.3%
EM Local	6.6%	2 bps	-1.4%	-3.5%
EM Corporate	263 bps	1 bps	0.9%	3.3%
Bloomberg Barclays US Munis	3.8%	-16 bps	-0.5%	-0.9%
Taxable Munis	5.2%	-5 bps	-0.9%	-1.3%
Bloomberg Barclays US MBS	48 bps	-2 bps	-0.5%	-1.5%
Bloomberg Commodity Index	240.67	-1.0%	3.4%	5.7%
EUR	1.0742	-0.4%	0.1%	-2.2%
JPY	156.89	0.4%	-3.4%	-10.0%
GBP	1.2712	-0.2%	0.8%	-0.1%

Source: Bloomberg, ICE Indices, as of 7 June 2024. *QTD denotes returns from 31/03/2024.

Chart of the week – ECB Deposit Rate – last three years.



Source: Bloomberg, Columbia Threadneedle Investments, as of 10 June 2024.

Macro / government bonds

The big theme to dominate price action in fixed income markets last week was the state of the US labour market. A widely held perception that the labour market was becoming less of a threat to near-term inflation dynamics initially exerted downward pressure on US treasury yields, and by implication bond yields globally. In the lead-up to the publication of the Non-Farm Payrolls (NFP) data on US employment, positioning across the market had favoured increased exposure to US interest rate risk. The market expected a weak labour market reading would follow on the heels of recent softer inflation readings. Expectations in the market had been for a number that would coalesce around 180k. However, the actual number was 272k, with a downward revision of 10k for the outturn of the previous month. The NFP print is effectively a backward-looking number. The number highlighted the dichotomy between robust backward-looking data for the US economy and forward looking softer data, which points to a future cooling in demand. Market reaction was kneejerk, illustrated by a rise in yields. For market participants, important data points such as NFP are like buoys guiding them to the next expected shift in monetary policy and market interest rates. The implications of the data for the Fed are that it solidified the ‘higher for longer’ approach. As such, the window appeared to close on the prospect of any more than one quarter point interest rate cut in the US by year-end.

The European Central Bank decided to cut interest rates by 0.25%. The lack of sensitivity of global bonds to the first interest rate cut by the ECB this cycle reflected how well telegraphed the rate cut had been. While June was effectively a done deal, there was less guidance on the forward sequencing of interest rate cuts. The ECB also released inflation projections, which were moderately revised up. This chimed with recent data on eurozone inflation, which highlighted the relative stickiness of certain inflation components, such as wages. Christine Lagarde, President of the ECB, delivered a message that the ECB would keep monetary policy restrictive for as long as necessary. She mentioned three times that they would not pre-commit to a particular interest rate path. The market interpreted the cut as a hawkish cut, given concern that the ECB would not wish to move too far ahead of the Fed in loosening monetary policy, for fear of unsettling the euro/US dollar FX rate. The probability of a rate cut in July was priced out, while the market reduced the probability of more than one quarter point rate hike by the end of the year.

The Bank of Canada cut rates from 5% to 4.75%, justifying its action on the back of a further fall in underlying inflation.

On the desk, we remain constructive on duration in the eurozone and the US. We have combined these positions with yield curve steepening positions in these markets. We also maintain a strategic short duration position in Japan.

Investment grade credit

Corporate bond spreads were again little changed last week ending Friday with a spread over government bonds of 96bps.

As we head into summer, a theme that seems to be developing in credit markets is that of dwindling spread volatility. As we noted last week, spreads had a range (wide to tight) of merely four basis points last month.

At the same time as a sign of investor confidence, there was a decent amount of new issuance last week centring on the banking sector. Banking has been one the best performing sectors this year after a more turbulent time last year (Credit Suisse and SVB). Interestingly new deals included more risky AT1 securities from Deutsche Bank, Coventry Building Society and BBVA, which were met with high levels of demand.

High yield credit & leveraged loans

US high yield bond valuations tightened modestly despite the increase in rate volatility over the week.

The ICE BofA US HY CP Constrained Index returned 0.39% and spreads were 4bps tighter while the yield-to-worst of the index declined 8bps to 7.90%. According to Lipper, retail high yield funds reported a $1.2bn inflow for the week – the sixth inflow over the last seven weeks. In loans, the average price of the Credit Suisse Leveraged Loan Index was unchanged around $96.1. Retail loan funds saw a $630m inflow, marking the 24th consecutive weekly inflow.

European high yield had a solid start for the first week of June, returning 0.5%. Spread compression continued with CCCs returning three times the market's performance in this one week (1.5%).

Inflows also continued though at a slower pace than the previous week. Managed accounts are still seeing inflows while ETFs experienced modest net outflows. The primary market was also relatively subdued compared to the last week of May as there were only two new issues (BBs) for a total of €1.1bn and another deal was actually pulled (Novelis) with weak market conditions being cited.

In rating news, Moody's downgraded Altice International to Caa1 from B3. There was better news for auto supplier Carlios Global, which was upgraded to BB- from B+ by S&P on back of its planned IPO where proceeds will be used to refinance most of the company's outstanding debt. In restructuring news, German real estate group Demire, with a bond maturing in October 2024, reached a restructuring agreement with the majority of bondholders. This included 10% early redemption, a maturity extension and a 5% cash interest. In M&A news, EG confirmed the disposal of its UK forecourt business to Zuber Issa for £228m. Mohsin Issa has now become the sole CEO of EG Group; he also happens to still be the acting CEO for ASDA.

Asian credit

The outcome of the Indian General Election was a surprise given that BJP (Bharatiya Janata Party) secured only 240 seats, below the majority mark of 272 in the Lok Sabha (lower house of the parliament). Exit polls had indicated that the National Democratic Alliance (NDA), led by the BJP, would win around 360 seats. Despite the underwhelming results, the BJP-led NDA is able to form a coalition government with 293 seats. The coalition partners are JDU (Janata Dal United) and TDP (Telugu Desam Party). Going into the third term of Prime Minister Narendra Modi, the continuity of existing economic policies is supported by the cabinet composition which continues to include around 60% of the previous cabinet.

Structured credit

The US Agency MBS sector was up 60bps last week on a short lived rally in rates.

The initial weak data was quickly unwound on Friday by a stronger than consensus NFP report. In mortgages, the notable news in mortgages was the prepay report which was fairly bullish and good for the convexity story. There was also new data released on home prices which seem to have paused, at least temporarily, at roughly 6.5% YoY. May was the first of the last 10 months not showing a further acceleration. That could be the result of the supply of homes which increased for the fifth month in a row. While there is strong seasonality, there are currently more homes on the market than at any time since autumn 2022. This sounds encouraging, however, the overall supply environment remains incredibly constrained and affordability is very poor. Mortgage rates are up roughly 25bps since the middle of March.

In non-agency, gross supply was up 70% vs 2023 YTD. Delinquencies have been rising over the last year but the pace has slowed more recently. Interestingly, the largest contributor to loss severities has shifted from collateral value (given home price appreciation) to interest expenses, legal costs and other related expenses.

Emerging markets

Emerging market hard currency sovereign bonds posted a positive return last week of +0.21%. Spreads widened 6bps, while the US treasury rally that was experienced for most of last week was able to drive EM performance, despite treasuries selling off on Friday on the back of NFP data. Investment grade countries outperformed high yield ones and Latin America was the weakest performing region.

Inflows into the EM hard currency asset class increased sharply over the week while outflows from local currency funds continued. The EM local currency index struggled last week and EMFX was weak, particularly in Mexico with both rates and FX both underperforming. The Mexican peso fell dramatically following the election result where the ruling party experienced a much larger than expected victory. Investors are concerned about reforms that could now be passed which would remove checks on government power. The Brazilian Real also sold off following comments made by finance minister Fernando Haddad who worried investors when he expressed concerns over the country’s fiscal framework.

Policy makers in Poland and Kenya kept rates on hold at 5.75% and 13% respectively. This week the Peruvian central bank meets.

Responsible investments

The Australian government issued its first every green bond last week, with investor demand coming in at three times oversubscribed. The 10-year bond raised the desired AUD 7bn, coming at a premium (around 1.5bps according to Bloomberg) compared to the benchmark 2034 bond. Proceeds will fund projects on renewable energy, a key investment given per capita Australia is currently one of the top carbon emitters in the world.

Green bond issuance in May was the largest May on record, with over $70bn raised between sovereigns and corporates. Signs of ‘greenium’ (green premium) are country and issuer dependent but with investor interest picking up, and new countries joining the green bond market, we may see it return.

Fixed Income Asset Allocation Views

10th June 2024

COLUMBIA THREADNEEDLE INVESTMENTS

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 a downgrade in High Yield Credit to -2.** ▪ 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. ▪ Uncertainty remains elevated due to sensitive monetary and fiscal policy schedules, increased and potentially new 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 ▪ 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)	A$ ¥ EM Short -2 -1 0 +1 +2 Long $ € £	▪ 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))	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 improvement in distressed credit and stability in GCC despite geopolitical risk. ▪ Investment Grade spreads are at historical tights while High Yield still offers some value. ▪ Tailwinds: Stronger growth forecasts, Central bank easing, potential China stimulus, IMF program boost for distressed names. ▪ Headwinds: higher debt to GDP ratios, wider fiscal deficits, geopolitical and domestic political uncertainty, 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	▪ 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. ▪ Due to the tight spreads across the board, the compensation for taking on additional risk, in seeking higher yields, seems unattractive. ▪ 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 remained stable but tight since last month. ▪ Anticipate credit selection will be the performance differentiator in 2024. Looking to avoid defaults/distress, focusing on credit recovery and deleveraging theses. ▪ 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. ▪ Default forecasts for lower rated issuers, particularly in Europe, is deteriorating with default rates projected to go up.	▪ 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	▪ Spreads are still flat to wide of historic long-term averages. ▪ 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. ▪ Constructive view on fundamentals over longer time horizon.	▪ 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	▪ Neutral outlook because of decent fundamentals and relval in select high quality Non-Agency RMBS, and ABS. ▪ RMBS: MoM spreads remain tight. 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, floating rate, and near-term maturities. Non-office sectors, however, perform as expected with the overall market sentiment improving. ▪ CLOs: Despite new issue, spreads remain tight. Defaults remain low but CCC bucket defaults are rising with lower recoveries. ▪ 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.	▪ 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	▪ o/w Copper ▪ o/w Soybean Meal ▪ o/w Cocoa ▪ o/w Oil ▪ o/w Lead ▪ o/w Zinc	▪ Global Recession