

In Credit

3 June 2024



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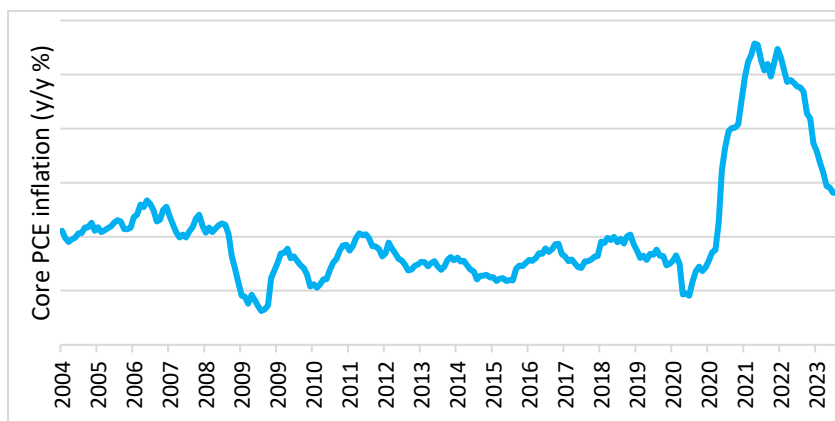
‘Indian summer sky’^{U2}

Markets at a glance

	Price / Yield / Spread	Change 1 week	Index QTD return*	Index YTD return
US Treasury 10 year	4.48%	1 bps	-0.9%	-1.8%
German Bund 10 year	2.64%	6 bps	-2.0%	-3.4%
UK Gilt 10 year	4.29%	3 bps	-2.4%	-4.2%
Japan 10 year	1.07%	6 bps	-2.9%	-3.4%
Global Investment Grade	95 bps	0 bps	-0.5%	-0.4%
Euro Investment Grade	107 bps	0 bps	-0.6%	-0.2%
US Investment Grade	88 bps	-1 bps	-0.5%	-0.6%
UK Investment Grade	96 bps	2 bps	-1.0%	-0.9%
Asia Investment Grade	139 bps	0 bps	0.2%	1.4%
Euro High Yield	351 bps	9 bps	0.9%	2.6%
US High Yield	320 bps	9 bps	0.1%	1.6%
Asia High Yield	596 bps	-44 bps	2.2%	8.2%
EM Sovereign	317 bps	17 bps	-0.2%	1.2%
EM Local	6.6%	5 bps	-0.6%	-2.7%
EM Corporate	262 bps	-2 bps	0.6%	2.9%
Bloomberg Barclays US Munis	3.9%	8 bps	-1.5%	-1.9%
Taxable Munis	5.3%	2 bps	-1.7%	-2.1%
Bloomberg Barclays US MBS	50 bps	-1 bps	-1.1%	-2.1%
Bloomberg Commodity Index	242.60	-1.8%	4.5%	6.8%
EUR	1.0836	0.0%	0.5%	-1.7%
JPY	157.08	-0.2%	-3.8%	-10.3%
GBP	1.2696	0.0%	0.9%	0.1%

Source: Bloomberg, ICE Indices, as of 31 May 2024. *QTD denotes returns from 31 March 2024.

Chart of the week – Ongoing decline in Core PCE inflation in USA



Source: Bloomberg, Columbia Threadneedle Investments, as of 3 June 2024.

Macro / government bonds

The US continued to set the tone for global government bond markets as yields rose and fell. The initial catalyst for weakness in the US treasury market was the sale of \$211bn in 2-year, 5-year and 7-year notes.

The moderately lower level of demand at the auctions raised concerns in the market about the 'higher for longer' narrative and the prospect of growing debt issuance regardless of who wins the next US presidency.

In the US, the slightly more supportive tone to economic data turned market sentiment, encouraging tactical buying of US treasuries. For the first quarter, data on GDP, personal income, and inflation was all revised lower. On Friday came inflation readings for April. To an extent, the market had already produced its own estimates of the likely inflation print based on the components of prior consumer price data and producer price prints. The inflation number for the Personal Consumer Expenditure (PCE) Deflator print – the Fed's favoured measure of inflation - came in at 0.3% for April, while the Core PCE Deflator Index, which excludes the volatile food and energy components, came in at 0.2% (**see chart of the week**). Both these figures were in line with market expectations. The data pointed to some weakness in goods and a slight moderation in the rate of growth of services. Last week also saw the publication of the Beige Book, which gives anecdotal evidence on economic conditions across the Federal Reserve districts. While the Beige Book pointed to a continued economic expansion in the US, it highlighted greater pressure on retail spending, and some easing in the labour market.

From a market perspective, the disappointing data on demand at the US treasury auctions suggested that the US 10-year could be at the point of breaking out of its current trading range. However, the gentler tone to subsequent economic data brought yields back to the midpoint of their current trading ranges. The guiding hand on the market tiller remains the Fed, as various policy makers continued to support a 'higher for longer' narrative in which there is no immediate need to make a change to monetary policy. New York Fed president, John Williams, in a speech to the Economic Club in New York said that the Fed, given the positive state of the US economy, could bide its time in making a decision. Neal Kashkari, President of the Federal Reserve Bank of Minneapolis, at a separate event in London reinforced this view, while he also made the point that he did not think anybody at the Fed had yet taken interest rate increases off the table.

Despite the oscillation in yield movements in the US treasury market, there was little effective change in market expectations regarding the number of interest rate cuts for 2024, with the market continuing to price in one quarter point rate cut for the end of December. The difficulty for the market is the reducing time span in which Fed action can take place. To justify an interest rate cut, the Fed will need to see at least three months of positive inflation data before it can countenance easing monetary policy, while the November US presidential election provides a further barrier to action. In this environment the market continues to tread water, as it waits for a definitive signal on US monetary policy. The gravitational pull of the US treasury market, as the largest and most liquid government bond market globally, meant that eurozone government bond yields and UK government bond market furrowed a similar yield path.

The European Central Bank published data on consumer inflation expectations. Median consumer expectations over the next one and three years fell moderately to 2.9% and 2.4% respectively. We had further confirmation from ECB policymakers that June remains a done deal in terms of an interest rate cut, but on what follows next there is no consensus. In Japan, currency weakness remains a concern, especially given the risk of imported inflation. This led to comments from Bank of Japan governor, Adachi, that there may be a case for a further rate hike to control price pressures.

Investment grade credit

Global investment grade spreads ended May at 95bps over government bond yields, marking the tightest valuation point of the year. The last month was a period of low spread volatility with a range of merely four basis points for the global IG index.

Spreads are now 17% tighter in 2024 led by euro-denominated credit, which is 21% tighter while the US market has lagged and is 'only' 15% better. Additionally, credit curves are steeper this year. Short-dated bonds have tightened more than longer maturity debt. Sector wise, all sectors are tighter but banking, insurance and real estate areas stand out as this year's best performing areas. Media, healthcare and utilities are the laggards (though all are tighter).

In terms of valuations, both euro and US dollar spreads trade inside short and longer term averages. This is more pronounced for the US market that is around 0.7 standard deviations (SDs) rich to its 20-year average, while euro IG spreads are around 0.3 SDs rich. As we noted in the last issue of **In Credit**, the duration of these indices is much shorter than it was as recently as 2021: so spreads per unit of interest rate risk are less expensive than mentioned above.

The market is supported by relatively high outright yields which seems to be attracting fund flows even amid high levels of primary issuance (notably from US companies issuing in euros last month). The global IG index, for example, had a yield of 5.1% at the end of last month. This compares favourably with an average of around 4% since 1997 and a low of 1.3% at the end of 2020 – according to data from ICE indices. The market is underpinned by robust credit fundamentals, with historically low levels of leverage for corporates and high levels of capital for banks. What has been more challenging for credit spreads has been the ongoing unwind of interest rate cut expectations – especially in the US where over 120bps of rate cuts have been removed from market pricing. Meanwhile, economic growth estimates remain on a rising trend reminiscent of what occurred in 2023. Consensus growth forecasts for 2024 have been revised higher by over 1% in the US and 0.2% in the euro area this year. Low but positive growth should present a reasonable investment background for IG credit. Present low levels of volatility will warrant some caution should they remain subdued for a lengthy period.

High yield credit & leveraged loans

US high yield bond valuations widened modestly over the week alongside higher interest rates, equity weakness, and fund outflows.

The ICE BofA US HY CP Constrained Index returned -0.03% and spreads were 9bps wider. The yield-to-worst of the index increased 0.08% to 7.98%. According to Lipper, retail high yield funds reported a \$407m outflow following five consecutive weekly inflows. Despite this, inflows for the month (\$4.9bn) were the largest since November. Meanwhile, the average price of the Credit Suisse Leveraged Loan Index was effectively unchanged around \$96.1 amid moderate inflows and continued CLO origination. Retail loan funds saw their 23rd consecutive weekly inflow with \$386m contributed over the week. May inflows totalled \$3.8bn.

European High Yield (EHY) finished May on a subdued note, returning 0.04% for the week, but allowing for a solid month's performance of 0.90%. Compression returned vigorously as last week saw CCCs strongly outperform BBs and Bs, returning 0.98%. This was almost half of the 1.9% May performance for the high beta rating. The asset class continued to see strong flows with €239m coming in across ETFs and managed accounts, though especially into the latter. The primary market was solid with fixed and floating offerings from two issuers, resulting in €2.1bn of new bonds to the EHY universe.

Q1 earnings reporting continues with numbers coming in line or better than expected albeit with a few exceptions. Leverage is generally falling with improving EBITDA. Where destocking was an issue, that appears to be dissipating.

In credit rating news, Adler Pelzer, a German auto parts company, was upgraded by Moody's to B2 from B3. The rating agency said that improved operating performance and a solid balance sheet supports this upgrade.

The third default this year with Safari Holdings, a gaming name, as the corporate announced a restructuring. S&P downgraded LPLAYG (Safari) to D from CCC+ following the confirmed (90% consent) lock-up agreement to A&E its senior secured notes and PIK.

There was a second restructuring for Adler as the German real estate company proposed a restructuring on the back of Q4 results. The issuer is looking to convert first lien debt into perpetual notes and PIKs.

Though the EHY market overall is yielding 7%, the underlying breakdown by credit rating is quite bifurcated. BB and B rated issues are yielding around 5% and 7% with bonds pricing close to 100. In comparison, the yield on CCCs is around 20% with bonds pricing around 60.

Asian credit

The official results of the Indian General Election will be released on 4 June and exit polls indicate that the National Democratic Alliance, led by the Bharatiya Janata Party, will win more than the 272 seats required for securing a majority in the lower house of Parliament. Prime Minister Narendra Modi is set to continue his premiership into a third term.

SnowCap Research published a report that criticizes Adani Green Energy Ltd (AGEL) on the company's EBITDA calculation, deterioration in project returns, funding gaps, related-party power sales and mixed operating performance. AGEL disputes the factual accuracy of the Snowcap report while India Ratings and Research has upgraded the long-term issuer rating of AGEL to IND AA- (previous: IND A+). The ratings upgrade reflects AGEL's strong execution scale-up, positive operating performance, diversified counterparties and receivables reduction.

In Indonesia, the trade ministry will extend the approval for the export of copper concentrate to 31 December 2024. This is positive for PT Freeport Indonesia which is in the midst of ramping up the commissioning of its new smelter. The export permits for five mining commodities expired on 31 May.

Structured credit

The US Agency MBS sector ended the week flat on a total return basis as rates and volatility remained temperate.

15-year agency MBS outperformed 30-years on the shifting yield curve: short rates rallied and longer rates sold off. Spreads were mostly wider with demand from banks still on the sidelines awaiting more clarity on possible rate cuts. CMBS spreads have stabilized. SASB office continues to be under pressure but broadly speaking the CMBS buyer base is firmer than Agency MBS given YTD performance relative to other fixed-income assets. We had five new issue CMBS deals totaling \$4.3bn priced last week that all got done in-line or tighter than expected. In non-agency RMBS, the new issue deals also priced inside guidance and secondary spreads tightened by about 10bps in CRT. May data showed faster speeds and lower delinquencies in non-agency credit.

Emerging markets

It was another decent week for EM credit, with spreads performing well despite appearances to the contrary (the latest step in Venezuela's phased reintroduction into EM Hard Currency indices took place at the end of May, boosting the EMBI Global spread by 19bps). Assisted by the tailwind of moderating US treasury yields, star performers were those inhabiting higher-yielding corners of the EMD universe where investors rediscovered their appetite for idiosyncratic risk in the likes of Argentina, Egypt and Ukraine.

Such a constructive backdrop is now threatened by EM's contribution to this year's busy global election calendar. South Africans delivered the first major shock by restricting the ANC to its first minority of the vote of the post-Apartheid era. The political conundrum now becomes challenging for President Cyril Ramaphosa, who must choose between a market-friendly coalition with the opposition Democratic Alliance and a leftward pivot into the arms of either old foe Jacob Zuma or would-be usurper Julius Malema. In any case, ANC unity (and thus political stability) appears in peril; having banked on continuity, markets beat a hasty retreat as results were announced.

Mexico's election concluded decisively by comparison but offered no more comfort to markets, which now fear the consequences of a super-majority in congress for the ruling Morena party after Claudia Scheinbaum's landslide victory. The peso opened under severe pressure on Monday morning.

Responsible investments

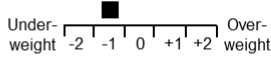
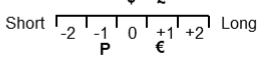
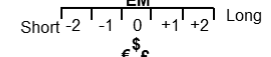
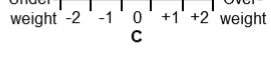
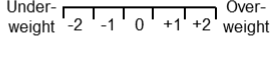
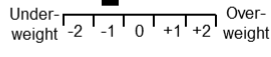
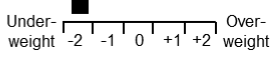
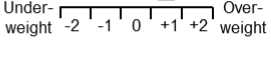
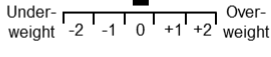
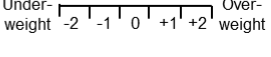
The UK's Financial Conduct Authority enforced an Anti-Greenwashing rule upon the financial sector last week. All public facing documents, from company websites to fund prospectuses, will be reviewed for any misleading content around ESG or sustainability claims. Images included in materials are also under scrutiny if the image itself, such as trees, forests, or wildlife for example, does not represent the true level of ESG of the product it is promoting.

Labelled bond issuance rebounded in May after a slightly lower level in April. According to Bloomberg, just over \$90bn was issued last month, where around two thirds were Green bonds. Barclays have recently published research on the levels of 'greenium' present in the market, evaluating that there is around 3bps currently, particularly in the US where issuance has slowed. The 3bps is only up from 2bps measured in October last year and not at the 5bps seen in 2021 / 2022.

Fixed Income Asset Allocation Views

3rd June 2024



Strategy and positioning (relative to risk free rate)	Views	Risks to our views
<p>Overall Fixed Income Spread Risk</p> 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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.
<p>Duration (10-year) (P' = Periphery)</p> 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> 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
<p>Currency (E' = European Economic Area)</p> 	<ul style="list-style-type: none"> Dollar has been supported by US growth exceptionalism and deprecating 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. 	<ul style="list-style-type: none"> 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
<p>Emerging Markets Local (rates (R) and currency (C))</p> 	<ul style="list-style-type: none"> Disinflation under threat but intact, EM central banks still in easing mode. Real yields remain high. Selected curves continue to hold attractive risk premium. 	<ul style="list-style-type: none"> Global real rate reversal challenges EM easing cycles. Geopolitical strife rekindles inflation US macro-outperformance strengthens US dollar.
<p>Emerging Markets Sovereign Credit (USD denominated)</p> 	<ul style="list-style-type: none"> EMD spreads tightened this month, supported by improvement in distressed credit and stability in GCC despite geopolitical risk. Investment Grade spreads are at historical tight 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. 	<ul style="list-style-type: none"> 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.
<p>Investment Grade Credit</p> 	<ul style="list-style-type: none"> 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 reval basis. 	<ul style="list-style-type: none"> 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.
<p>High Yield Bonds and Bank Loans</p> 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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.
<p>Agency MBS</p> 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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.
<p>Structured Credit Non-Agency MBS & CMBS</p> 	<ul style="list-style-type: none"> Neutral outlook because of decent fundamentals and reval 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. 	<ul style="list-style-type: none"> 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.
<p>Commodities</p> 	<ul style="list-style-type: none"> o/w Copper o/w Soybean Meal o/w Cocoa o/w Oil o/w Lead o/w Zinc 	<ul style="list-style-type: none"> Global Recession



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