This is a marketing communication. Please refer to the prospectus of the UCITS and to the KIID / KID before making any final investment decisions.

FUND COMMENTARY – Q4 2023

CT (Lux) European High Yield Bond

Gareth Simmons
Fund Manager
Since: 29/08/2018

Roman Gaiser
Fund Manager
Since: 01/10/2018

Fund Information

You are investing in a fund that is actively managed in reference to the benchmark below. Please refer to the Prospectus and KIID for the Fund objective.

Fund Benchmark: ICE BofA European Currency High Yield Excluding Subordinated Financials Constrained Index

Inception Date: 29/08/2018

Fund Currency: EUR

Fund Domicile: Luxembourg

SFDR: Article 8*

Summary

- European high-yield bonds posted strong gains over the fourth quarter.
- The fund outperformed its benchmark, gross of fees.
- Top relative contributors included the zero weight in Signa Development, while the average overweight in Heimstaden Bostad was among the detractors.
- We bought newly issued bonds from Veolia, Synlab and Loxam, among several others.

Market Background

The fourth quarter (Q4) of 2023 proved to be a strong period for most asset classes, and European high-yield (HY) bonds were no exception. Underlying core government bond yields fell sharply, and European HY bond prices were further boosted by a tightening in credit spreads.

The strong return for the asset class came despite a poor October. Treasury yields rose in response to surprisingly robust US economic data and concerns about increased Treasury issuance, while credit spreads widened as the terrible events in Israel and Gaza weighed on risk appetite. From late October onwards, however, yields and spreads trended lower as fears of a wider conflict subsided. As key measures of inflation continued to fall in the US, the UK and the eurozone, investors were also encouraged by the growing belief that the major central banks – led by the Federal Reserve – would start to cut interest rates sooner than previously thought.

Though the Fed continued to keep rates on hold during the quarter, its commentary became increasingly dovish. In November, Fed Chair Jerome Powell noted the tightening effect on the economy of higher Treasury yields and mortgage payments. December's policy meeting was seen as even more of a departure. Powell acknowledged slowing growth and progress on inflation, and the Federal Open Market Committee reduced its median rate projection for the end of 2024 from 5.1% to 4.6% – 75 basis points (bps) below the current level. Markets were even more optimistic and, by the end of the month, were pricing in more than twice that level of cuts before 2025, with the first arriving as early as March.

As in the US, key measures of inflation fell more than expected in Europe and the UK. The European Central Bank and Bank of England also held rates steady, but both maintained their 'higher for longer' rhetoric, even after the Fed's dovish pivot. Commenting on the ECB's December meeting, President Christine Lagarde insisted that there had been no discussion of rate cuts at all. The BoE's nine-strong Monetary Policy Committee – of which three members voted for a hike at both meetings in Q4 – reiterated in December that rates could still rise if necessary and were likely to be "restrictive for an extended period" as "key indicators of UK inflation persistence remain[ed] elevated". Nevertheless, markets appeared sceptical, perhaps reflecting the relative weakness of the eurozone and UK economies – both of which were reported to have contracted during Q3.

Having widened amid the risk aversion in October, HY credit spreads tightened in November and December as anticipation of central-bank rate cuts and growing hopes of a 'soft landing' for the US economy bolstered investor appetite for risk. Overall, spreads in the benchmark narrowed by 47 bps over the quarter to 417 bps, and the index returned 5.61%.

Net inflows into HY were strongly negative in October, but thereafter turned positive in November and remained so until the end of the year. In terms of performance by rating, the decompression trend that had dominated in Q3 persisted for much of Q4, before reversing in December. However, lower-rated bonds were unable to recover from their significant previous underperformance; spreads for CCC rated bonds widened substantially over Q4, while single Bs and BBs tightened materially.

Total European HY issuance in Q4 was €10.4bn, with BBs making up over 70% of the new notes. This took full-year issuance for 2023 to €56.9bn, an increase of 79% versus 2022 but still around a third lower than the 10-year average. Net issuance (excluding redemptions) for the full-year 2023 totalled €2.7bn. Issuers of note in Q4 included French telecoms firm Iliad, equipment rental company Loxam, clinical laboratory and medical diagnostic services provider Synlab, waste management firm Paprec, food packaging company Crown European Holdings and Italian gaming firm Lottomatica. The new issues were generally well received.

*The Fund is categorised an Article 8 under the EU Regulation 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR) and promote environmental or social characteristics as an objective. Please refer to www.columbiathreadneedle.co.uk for further disclosures. The decision to invest in the promoted fund should take into account all the characteristics or objectives of the promoted fund as described in its prospectus.

Performance

12M Rolling Period Return in (EUR) - as at 31 December 2023

Past performance does not predict future returns and future returns are not guaranteed.

	12/22-12/23	12/21-12/22	12/20-12/21	12/19-12/20	12/18-12/19	12/17-12/18	12/16-12/17	12/15-12/16	12/14-12/15	12/13-12/14
Fund (Gross) %	11.98	-10.89	3.00	3.82	10.67	-1.83	6.67	8.53	2.49	5.29
Index (Gross) %	12.14	-11.75	3.25	2.82	10.95	-3.34	6.22	10.07	0.85	4.62

Source: Columbia Threadneedle Investments as at 31/12/2024. Gross of fee fund returns are time-weighted rates of return net of commissions transactions costs and non-reclaimable taxes on dividends interest and capital gains using pricing of investments which is either the last traded price or a bid basis. Cash flows are factored as of the end of the day and exclude entry and exit charges. Index returns include capital gains and assume reinvestment of any income. The index does not include fees or charges and you cannot invest directly in it. The return of your investment may change as a result of currency fluctuations if your investment is made in a currency other than that used in the past performance calculation.

The past performance information for the period prior to 29 August 2018 is from the European High Yield Bond Fund (a UK authorised UCITS fund launched on 25 May 2007), which merged into this Fund on 06 October 2018.

For detailed information on Fund Changes please see Significant Events - Threadneedle (Lux) Funds PDF available on www.columbiathreadneedle.com/en/changes

The fund outperformed the benchmark over the quarter, gross of fees. We maintained a cautious risk profile relative to the fund's benchmark. In our view, a cautious outlook for HY remains prudent at this stage given the risks posed by geopolitical uncertainty, high interest rates and weak economic growth. However, we acknowledge that the European HY market offers an attractive yield of 6.8%. Our positioning is becoming more constructive; we are targeting a neutral stance in core HY but remain underweight in CCCs.

At the sector level, key contributors to the relative return included the underweight in real estate and exposures in capital goods and automotive. Conversely, exposures in financial services, media and telecoms detracted.

At the issuer level, positioning within Ardagh Packaging bonds was beneficial as bonds issued by Ard Finance and Ardagh Packaging Finance, which the fund did not own, were pressured by concerns over Ardagh's liquidity given upcoming maturities and an $85 million drop in the firm's cashflow metric. Relative performance was also boosted by the zero weight in real estate group Signa Development, which declared insolvency in November. Underweight exposure to French technology group Atos also proved beneficial. The bonds underperformed after S&P downgraded Atos's credit rating from BB to BB- due to concerns over the company's weakening liquidity profile.

Notable detractors included the average overweight in real estate firm Heimstaden Bostad. The bonds suffered as doubts rose around the likelihood of a capital injection from Swedish pension fund group Alecta following the bribery investigation by Sweden's Financial Supervisory Authority into Alecta's investment in the real estate group. Relative performance was also impacted by the off-benchmark positions in lenders Belfius Bank and Santander UK, which lagged lower-rated peers in the market rally.

Activity

In the primary market, we took part in several new issues despite the quarter getting off to a very slow start in terms of issuance. We bought the aforementioned bonds from Paprec, Synlab, Iliad and Loxam. Elsewhere, we bought new issues from lenders AIB and Eurobank, low-priced retailer B&M, International Design Group, chemicals firm Ineos and waste management company Veolia.

In the secondary market, we added further to Veolia and initiated a new position in Atos, as mentioned above. We also opened new positions inDutch telco Ziggo and Spanish automotive supplier Antolin. We reinitiated a position in plastic building materials manufacturer HT Troplast (Profine), as the bonds had reached our preferred pricing. In addition, we scaled up exposure to several holdings, including International Airlines Group, homeware essentials business Spectrum Brands, British supermarket Wm Morrison and telcos Matterhorn, PPF and Telecom Italia. We also increased our holdings in automotive supplier Valeo and Italian payments business Nexi, among others.

Turning to sales, we exited the holding in German airline Lufthansa. Lufthansa bonds will leave the HY universe after S&P upgraded the issuer's rating from BB+ to BBB- in December; this follows Fitch's upgrade to BBB- in early November. Similarly, we exited the position in Ford after the company left HY indices following its upgrade to investment grade. Elsewhere, we sold real estate firm SBB and reduced exposure to industry peers Heimstaden Bostad and Peach Property. Other outright sales included restaurant group Boparan, Occidental Petroleum and Rolls-Royce.

Outlook

Headline inflation appears to have peaked in many countries, aided by easing supply bottlenecks and the significant retracement in prices of numerous raw materials. Core inflation is proving to be more 'sticky' and has become the primary concern for central banks, which have tried to shift the narrative from how high rates will go, to how long they might remain elevated. Despite growing confidence that interest rates have reached terminal levels, investors are likely to remain edgy as central bankers emphasise that policy decisions will largely depend on the strength of incoming economic data.

While economic data has shown surprising resilience so far, there are increasing signs of softening as the lagged impact of rate hikes feeds through. Heightened geopolitical risks add to the uncertain outlook, with the new war between Israel and Hamas, the ongoing conflict in Ukraine and continued tensions in US-China relations.

Company earnings, while mixed, have shown that many corporates remain in good financial shape, with robust balance sheets and liquidity following strong issuance in 2020 and 2021. However, the third-quarter earnings season has revealed an ongoing cyclical slowdown in industries such as chemicals, construction and consumer durables due to continued customer demand weakness. Softer consumption is also beginning to show in results from corporates in consumer-led sectors, with management reporting reduced demand.

Overall defaults, which were at 0.4% for 2022, have already risen from these very low levels. As of the end of October, our default rate forecast for the next 12 months is 1.5%. Higher-rated issuers have been able to maintain healthy liquidity levels but deteriorating earnings outlooks, high leverage and challenged market access have contributed to materially higher default expectations for lower-rated issuers. Consensus estimates show default rates in low single digits, increasing over the remainder of the year and through 2024, with markets remaining most concerned about issuers facing maturity walls over the next 12 to 18 months. With borrowing costs remaining near their highest levels in over a decade, issuers have been forced to seek alternative sources of finance such as bank loans, private equity, rights issues, syndicated loans and maturity extensions with existing investors.

Still, new issuance in 2023 is much higher than at this point last year, largely due to higher-rated issuers bringing refinancing deals to the market, albeit at significantly elevated yields, to avoid upcoming maturities becoming current. There is already talk that 2024 may be another year of low net supply as private equity companies look to monetise their investments rather than attempt new acquisitions. Financing for leveraged buyouts has played a big part in the growth of the HY market, both in overall size and number of issuers.

While the relatively subdued level of new issuance over the year to date is supportive of European HY, uncertainty regarding the interest-rate backdrop remains a headwind. The recent trend of asset outflows reversed in November, with flows turning positive across managed accounts and ETFs as the combination of attractive yield levels and the possibility of a peak in rates brought interested parties back to the asset class. The European HY market continues to be supported by the substantial number of rising stars, credit upgrades and flows from tenders, maturities and coupons. So far in 2023, the number of rising stars, which include Ford, utility TVO and French hospitality groups Accor and Elis has outpaced the number of fallen angels, which include real estate companies Canary Wharf Group and SBB as well as satellite operator Eutelsat. The real estate sector has shown significant stress given the higher financing costs and the structural changes hitting the sector, including reduced commercial demand. Given the weakness of the sector, we expect to see more fallen angels in the coming months.

We believe spreads, which are around the long-term average, offer compensation for the expected rise in default levels due to higher borrowing costs and economic downturn concerns. Yields have been reset and look attractive at these levels. At the same time, we acknowledge that the additional risk premium is warranted in light of liquidity, economic and geopolitical uncertainties.

Key Risks

The value of investments can fall as well as rise and investors might not get back the sum originally invested.

Where investments are in assets that are denominated in multiple currencies, or currencies other than your own, changes in exchange rates may affect the value of the investments.

The fund invests in securities whose value would be significantly affected if the issuer refused, was unable to or was perceived to be unable to pay.

The fund holds assets which could prove difficult to sell. The fund may have to lower the selling price, sell other investments or forego more appealing investment opportunities.

Changes in interest rates are likely to affect the fund’s value. In general, as interest rates rise, the price of a fixed rate bond will fall, and vice versa.

The fund’s assets may sometimes be difficult to value objectively and the actual value may not be recognised until assets are sold.

The fund may invest in derivatives (complex instruments linked to the rise and fall of the value of other assets) with the aim of reducing risk or minimising the cost of transactions. Such derivative transactions may benefit or negatively affect the performance of the fund. The Manager does not intend that such use of derivatives will affect the overall risk profile of the fund.

The fund applies a range of measures as part of its consideration of ESG factors, including the exclusion of investments involved in certain industries and/or activities. This reduces the investable universe, and may impact the performance of the fund positively or negatively relative to a benchmark or other funds without such restrictions.

The fund may exhibit significant price volatility.

The risks currently identified as applying to the fund are set out in the "Risk Factors" section of the prospectus.

CTEA6136676.1 (12/2023)