FUND COMMENTARY – Q1 2025
CT HIGH YIELD BOND FUND

David Backhouse
Fund Manager

Roman Gaiser
Fund Manager

Summary

- European high-yield (HY) bonds advanced modestly over the first quarter.
- Gross of fees, the fund underperformed its benchmark[1].
- Relative performance was impacted by the underweight in Elo and overweight in Antolin.
- The zero weight in Selecta and the overweight in Atos proved beneficial.
- We bought several newly issued bonds.

Market Background

European HY bonds posted modest gains in the first quarter (Q1), with the fund's benchmark returning 1.14%. Underlying German Bund yields rose but this was offset by coupon income and, for much of the period, a tightening in spreads (the yield premiums over 'risk-free government bonds). However, a sell-off in March resulted in spreads in the benchmark widening by 23 basis points (bps) over the quarter.

The major market drivers in Q1 were President Trump's executive orders, tariff announcements and the shifting geopolitical landscape – all of which contributed to heightened uncertainty and market volatility. Concerns that the impact of tariffs could derail global economic growth and push up inflation weighed on risk appetite towards the end of the quarter, driving European HY spreads wider. In the US, ongoing strong economic data and optimism around the new administration's pro-growth agenda initially supported risk appetite. However, the optimistic mood faltered amid uncertainty caused by Trump's tariffs announcements and worries about a resulting hit to growth from increasing trade tensions. These concerns were exacerbated by some weaker-than-expected economic data as the quarter wore on; for instance, non-farm payrolls fell short of expectations in February, and a key measure of US consumer confidence dropped to its lowest level in four years in March. At the same time, fears mounted that the tariffs could push up inflation. The Federal Reserve left interest rates steady at both its meetings over the quarter. In March, it raised its forecasts for inflation for 2025 and 2026.

In Europe, the conservative CDU/CSU took the largest share of the vote at the German federal elections in February, as expected. On the economic front, data released at the start of the quarter continued to indicate a slowdown in the eurozone; the bloc's economy failed to grow in Q4, according to a Eurostat flash report, missing forecasts of modest expansion. However, the flash composite purchasing managers' index (PMI) remained in expansionary territory in February, easing growth concerns somewhat. President Trump's subsequent shift away from traditional Western defence alliances prompted European countries to pledge increased government spending, particularly for defence. Notably, the new German government launched a historic fiscal stimulus package by easing a government debt brake that has been in place since the global financial crisis. As a result, Europe is now expected to see stronger growth in 2025 and 2026 than previously anticipated. This weighed on Bunds, with 10-year yields spiking to their highest level since November 2023 before ending the quarter 37 bps higher at 2.74%. On the monetary policy front, the European Central Bank lowered interest rates twice during the quarter though the annual inflation rate in the eurozone remained slightly above its 2% target.

In the UK, the government outlined plans to increase military aid to Ukraine and increase spending, which heightened concerns about the burgeoning deficit. The chancellor's Spring

[1] Past performance does not predict future returns. Please refer to the KIID document found on our website for further information on the fund performance.

Statement further highlighted the government's narrow fiscal headroom, with cuts to government spending, planning reforms, welfare reforms and measures to enhance tax compliance. In terms of monetary policy, the Bank of England cut interest rates in February but held fire in March with the governor stating that policymakers needed more data to assess the trade-off between the slowing UK economy and the persistence of wage and price pressures.

In terms of European HY, all rating categories delivered positive total returns, but CCCs were the by far the strongest category. They outperformed the broad market materially, benefiting from strong performance in January and February. Credits rated BB and B both lagged the market slightly. The European HY market experienced more balanced fund flows over Q1 compared with the final quarter of 2024, but still ended the period with a net inflow of close to €1.5 billion.

After a slow start to 2025, European HY issuance accelerated in March. Gross issuance totalled €22.6 billion in Q1, compared with €26 billion in the same period last year, but the figure was broadly in line with the 10-year average. Net issuance over the quarter was €6 billion, compared to €4 billion in Q1 2024. Refinancings accounted for most of the new deals. The majority were rated BB or B, as higher-rated issuers sought to take advantage of robust market demand. The new issues were generally well received by investors, with final prices typically coming well inside initial price talk.

Performance

Gross of fees, the fund underperformed the benchmark over the quarter[1]. 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, still-elevated interest rates and weak economic growth. Our positioning is becoming more defensive; we are targeting an underweight stance in core HY and remain underweight in CCCs. However, we acknowledge that the European HY market offers an attractive yield of 6.4%.

At the sector level, our selections and underweight position in retail detracted the most from relative performance. Selections in basic industry and autos were also unhelpful. On the other side, our choices in services, technology and real estate added value.

At the issuer level, the below-benchmark stance in Elo (owner of French supermarket chain Auchan) weighed on relative returns. The issuer's full-year 2024 results showed a wider net loss versus the prior year, but investors were reassured by stable year-on-year net debt levels and robust liquidity, as well as a stabilisation in the firm's results and operating performance in the second half of 2024. Management said it expects to raise €1 billion in cash from a real estate disposal programme over 2025 and 2026. The overweight in car-interiors manufacturer Antolin was also unfavourable amid ongoing worries about soft demand in the auto sector, exacerbated by the announcement of tariffs on imports of vehicles and components into the US. A lack of exposure to Intrum was detrimental too. The Swedish debt management firm reached an agreement with a minority creditor group helping it to progress with a recapitalisation plan.

On the other side, the zero weight in vending-machine operator Selecta was advantageous. The issuer was downgraded to "selective default" by S&P after missing an interest payment of about €30 million. The average overweight in French technology firm Atos – which was added to the fund in January – also proved advantageous; the bonds rebounded on improving sentiment following the firm's successful restructuring in December 2024 and investors' ongoing hunt for yield. Atos reported mixed full-year 2024 results in March, with lower annual revenues, but an uptick in commercial activity on improving client confidence. The overweight in real estate firm Heimstaden was beneficial too. The bonds rallied after the issuer successfully placed new euro and Swedish krona bonds in January to help address recent liquidity issues that had led the company to suspend interest payments on hybrid bonds (not held by the fund) in December.

Activity

We participated in several new issues, particularly after the primary market picked up towards the end of Q1. These included a new hybrid deal from laboratory testing company Eurofins Scientific; the firm plans to use the proceeds to repay older hybrid bonds that are callable this November. In the industrials sector, we took part in the inaugural HY offering from French waste recycling company Séché Environnement, as well as purchasing new bonds from facilities manager Rekeep and equipment-rental company Loxam. In consumer sectors, we participated in offerings from sugar producer Tereos, catering company Elior, auto-parts maker Schaeffler and RCI Banque – the financing subsidiary of carmaker Renault. In other sectors, we bought new issues from Deutsche Bank, Swiss telecoms firm Salt, Alstria Office REIT, Heimstaden, clean energy company XPLR Infrastructure (formerly NextEra Energy), and chemical firms Ineos and Celanese.

In the secondary market, we established new positions in the aforementioned Atos and Elo, as well as telco BT Group and Infrastrutture Wireless Italiane (INWIT). We topped up holdings including chemical maker

Solenis, property company Vivion, French utility EDF, auto-glass repairer Belron and mortgage lender Together.

We exited healthcare REIT (real estate investment trust) Medical Properties Trust and telco Altice International. We also trimmed positions in UK supermarket chain Morrisons, telco United Group, drugmaker Nidda, technical services provider Assemblin Caverion, Portuguese utility EDP and energy company Enel.

Outlook

Headline inflation continues to broadly ease towards central-bank target levels in many countries, but inflationary pressures linger, and the macroeconomic outlook has become much more uncertain due to Trump's aggressive tariff policies. This has led major monetary authorities to adopt a more data-driven approach to interest-rate decisions, and the timing of rate cuts this year has therefore become less clear – particularly in the case of the Federal Reserve. New broad-ranging US tariffs are expected to weigh on US economic growth but also global growth, given reduced international trade and disruptions to supply chains. But the new levies are also likely to be inflationary, which has prompted fears of "stagflation" – low economic growth, high inflation and high unemployment. So far this year, US labour-market data has been resilient, but other data is becoming more mixed, especially consumer-related indicators. In contrast, the growth outlook in Europe has picked up following recently announced German stimulus measures, though concerns remain about the impact to the eurozone from US tariffs. In China, there are signs of an improvement in economic activity, but, overall, the picture remains subdued, and the troubles in the country's property sector persist despite the government's ongoing efforts to boost growth through stimulus measures. Elevated geopolitical risks add to the uncertain outlook, including the ongoing conflict between Israel and Hamas, and the war in Ukraine. Trade tensions also continue to escalate, with Trump announcing a further raft of duties on countries with trade surpluses with the US in early April.

Company earnings releases have shown that many corporates remain in good financial shape, with robust balance sheets and liquidity following a period of strong issuance in recent years and well received refinancings. So far, reported Q4 2024 corporate earnings have mostly met or exceeded expectations. Leverage is improving, specifically for BB and B rated issuers. Destocking issues appear to be dissipating, and many corporates are seeing some improvement in orders. However, companies in some industries – notably chemicals and packaging – remain weak but stable. We still see a mixed outlook among cyclical industries, such as automotive and aerospace, further weighed down by tariff announcements. In the autos sector, manufacturers and original equipment manufacturers (OEMs) had already begun to mark down their guidance (or in some cases remove guidance) for 2025 due to the uncertain European market; the introduction of a 25% levy on imports of cars to the US will add further to pressure. We have also seen pockets of balance-sheet strain, and, among over-leveraged corporates, some issuers are considering or have undertaken liability management exercises (LMEs). The negative sentiment surrounding LMEs has eased somewhat, given that the impacts to bondholders of transactions already completed have, overall, been less severe than feared. Though some LMEs have already taken place, we still perceive an increased risk in balance-sheet restructuring activity in the shorter term (due to specific names). We therefore forecast that defaults will rise from current levels over the next 24 months, as is already reflected in market pricing.

The default rate increased through 2024 and peaked in January 2025 at 3.7%. The default rate retreated to 3.6% by the end of March. At the same time, the recovery rate rose sharply, above its historical average, to 55%. We view the longer-term outlook for defaults as benign; our default forecast of 3.8% for the 12 months from October 2024 has come down from our April 2024 forecast of 4.0%. Although retreating from recent peaks, borrowing costs are still near their highest levels in over a decade. The improved outlook reflects the high level of refinancing activity undertaken in recent months, as well as the fact that several LMEs or recapitalisation transactions have already been completed without any new candidates on the horizon. Some corporates, especially those with higher leverage, are seeking to meet their refinancing needs in alternative ways. For instance, companies may also consider private equity, rights issues and maturity extensions with existing investors.

The primary market was robust in 2024, and included a number of new issuers coming to the HY market. After a slow start to 2025, primary market activity picked up sharply in Marchand is expected to be brisk in 2025. New refinancing deals continue to dominate and be met with robust demand, enabling even challenged issuers to access the primary market. While we saw an expansion in new-issue activity related to M&A or leveraged buyouts (LBOs), IPOs and other corporate activity in late 2024, this activity has now tailed off as issuers adopt a wait-and-see approach given heightened market volatility and macroeconomic uncertainty. Nevertheless, we have continued to see new issuers coming to the HY market over the year to date.

In 2024, the European HY market was supported by net inflows, credit upgrades and flows from tenders, maturities and coupons. The asset class also benefited from a significant number of rising stars, which outpaced the number of fallen angels. So far this year, this trend has continued (for example, Nexi received a rating upgrade), while market flows have been more balanced. Nevertheless, as the year progresses, we expect fallen angels to begin to outpace rising stars. We still anticipate some fallen angels among property names, given the significant recent stress within the real estate sector due to higher financing costs and structural changes, including reduced commercial demand. However, the number of potential fallen angel candidates within property has declined as sentiment towards the sector has improved on the back of falling interest rates and the start of asset disposals.

Spreads are low, but yields remain near historical highs. Additionally, the higher coupons offered on newly issued bonds have enhanced breakeven rates (how much spreads can rise before the total return of a bond becomes negative), offering a meaningful cushion in the event of spread widening. Nevertheless, we acknowledge that current valuations price in little room for error from escalating geopolitical tensions or an economic downturn. We believe the elevated default risk for over-leveraged credits is largely reflected in market pricing.

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 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.

Benchmark index is the ICE BofAML European Currency High Yield (3%) Constrained index excluding sub financials hedged to £ (HPS2). Performance attribution source FactSet, calculated using a daily time-weighted methodology based on gross returns as at global close on the last working day of the month.
columbiathreadneedle.com