Invesco Fixed Income

Multi-sector asset allocation outlook
Q1 2023

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IFI multi-sector asset allocation overview

Macro factor summary
Inflation is peaking and should decline steadily in the US and Europe in 2023. Growth remains slow in response to tightening policy, but easing energy prices and the reopening in China after the end of its Zero-COVID policy are supportive of growth and have mitigated the risks of recession in 2023. Central banks are likely to respond to easing inflation and slower growth by ending the current rate hike cycle. We expect the US federal funds rate to peak in the first quarter of this year and European rates to peak in the second quarter. As a result, we do not expect further significant tightening of financial conditions in 2023.

Asset allocation summary
Declining inflation and the end of the central bank rate hike cycle should provide a positive tailwind for fixed income assets in 2023. After rerating higher in 2022, real yields and high quality credit spreads offer value for investors, in our view. We favor allocations to high quality credits, which offer attractive yields on a historical basis, and should be supported by expectations of declining inflation and the end of the US and European rate hike cycle. The US dollar shows signs of having peaked, and should be expected to decline over the balance of the year as the US Federal Reserve (Fed) stops hiking rates and recession fears ease.

Risk position summary
We have a slightly overweight risk positioning. The end of the central bank tightening cycle and better than feared news on economic growth point to a soft landing for the global economy and should provide a tailwind for risky assets. Continued political and economic uncertainties argue for staying slightly cautious.

Senior Editor

Ann Ginsburg
Head of Thought Leadership
Fixed Income

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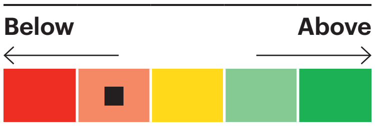
IFI macro factor outlook (three-month outlook)

Factors vs. market expectations

Global growth: Neutral
Recent news on global growth has been positive relative to our recent expectations. The post Zero-COVID recovery in China should see a strong recovery in Chinese growth over the balance of 2023. We expect Chinese growth above 5% in 2023. A warmer than usual winter in Europe and easing energy prices globally are also supportive of global growth as European economic activity is likely to remain more buoyant than expected. US growth continues on a slowing trend, but ongoing strength in the labor market is supportive.



Global inflation: Below expectations
Inflation has likely peaked, and recent inflation data have established a trend of declining inflation. We expect inflation to decline through the balance of 2023 in the US and Europe, allowing the US and European central banks to stop hiking rates and contemplate cutting rates as 2023 evolves.

Global policy and financial conditions: Neutral
The Fed and the European Central Bank (ECB) will likely continue tightening rates in the first quarter, but the end of rate hikes is near. The background of mild growth and falling inflation will allow the central banks to stop hiking rates to see how long the disinflation trend persists and to better assess the impact of the aggressive rate hikes of 2022 on their economies. Global financial conditions are transitioning from a headwind to a tailwind for financial markets.

IFI 2022 macro outlook

	Growth (%)		Inflation (%)		Policy	
	IFI Forecast	Consensus	IFI Forecast	Consensus	Next Move	Consensus
US	1.3	0.4	3.6	3.9	In the US, we expect the Fed to hike the policy rate to a 5.00-5.25% range and pause there for some time.	US market consensus is similar for the terminal rate. But it prices in rate cuts soon after reaching the peak policy rate, while we expect more persistence.
Europe	0.5	0.0	4.9	6.0	In Europe, we expect a peak terminal rate of 3.25%.	In Europe, we are in line with consensus.
China	5.3	4.8	2.0	2.3	In China, we expect a series of easing measures in 2023 to support economic recovery.	We are more optimistic than the market on China's support measures.
Japan	1.6	1.3	2.2	1.9	In Japan, we expect continued tweaks to the BoJ's YCC framework, leading to higher rates. A complete abandonment of YCC is possible later in the year, but such a change is not imminent in our base case.	In Japan, we are close to consensus.

Source: Invesco Fixed Income, Bloomberg L.P. Data as of Jan. 25, 2023. IFI forecasts are six-month trends. BoJ is Bank of Japan.

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IFI broad asset allocation (three-month outlook)

Global duration: Overweight
Cyclically, we favor duration in the current market. Growth is anemic, inflation is declining, and central banks are transitioning out of a rate hike cycle. Yield curves are already significantly inverted, however, showing that this is partly priced into bond markets. We favor a mild overweight to global duration, but also believe longer maturity bonds will be broadly range bound until the Fed actually stops hiking rates. We believe we have seen the high for 10-year yields for this cycle.

US dollar: Underweight
Better growth and a near-term end to rate hikes in the US should support non-US currencies. With more hawkish recent rhetoric from the ECB and Bank of Japan (BoJ), it also looks increasingly likely that the Fed will finish hiking rates before other major developed market central banks. That may be a headwind for the US dollar in 2023.

Global credit: Slight overweight
Credit valuations have tightened in recent months, but the fundamentals of more favorable financial conditions, positive growth, and declining inflation are positive for credit. We favor high quality credit in investment grade corporate, municipal and securitized asset classes.

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IFI risk position (three-month outlook)

Cautious **Positive**

We are cautious on risk taking. While the macro backdrop is increasingly supportive of global markets, there are still significant uncertainties, and markets are priced for an orderly transition from central bank tightening to easing later this year. More hawkish than expected central banks or weaker than currently expected growth could create headwinds for asset markets and keep us somewhat cautious. We also highlight the potential risks of a US government default as the path to an increase in the US debt limit is not clear in the current political landscape. A default, or near-term risk of default, by the US government would likely lead to underperformance of risky assets globally.

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IFI multi-sector asset allocation (three-month outlook)

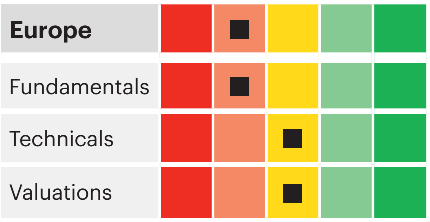
Underweight **Overweight**

US				■	
Fundamentals				■	
Technicals			■		
Valuations				■	

Long-term government interest rates

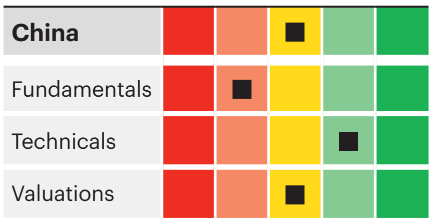
US

We remain underweight US duration in the near term. The US yield curve is very inverted in a historical context, and we expect the Fed to deliver more rate hikes in the first quarter. We expect Treasury yields to be in a roughly 3.5% to 4.0% range for the 10-year note for the near term until the Fed finishes its rate hike cycle. On the other hand, we expect inflation to steadily decline in 2023, and the 10-year Treasury is likely to price in the end of rate hikes and eventual cuts, which should protect the top side of our range. The market is not priced for the degree of rate hikes indicated by the Fed dot plot. This is likely to keep rate volatility somewhat elevated for now.



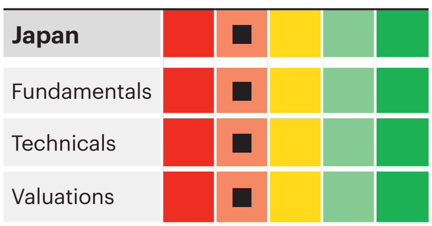
Europe

The outlook for the European economy has improved markedly over recent months as a warm winter, elevated energy storage and a sharp fall in energy prices have supported consumer confidence and economic growth in the region. As we look forward to 2023, the ECB faces a conundrum: falling headline inflation due to lower energy costs are being balanced by a boost to household and corporate balance sheets from lower energy prices, potentially fueling demand and keeping upward pressure on the broadening inflation complex. Our analysis indicates that the 'hawks' at the ECB will likely have the upper hand until a clear downward path to inflation becomes evident and interest rates will likely continue to rise over coming months, pushing bond yields higher. That said, we expect a positive environment for bond yields at the beginning of the year as investors look to lock in attractive yields. However, we would look to fade that move in anticipation of higher yields later in the year.



China

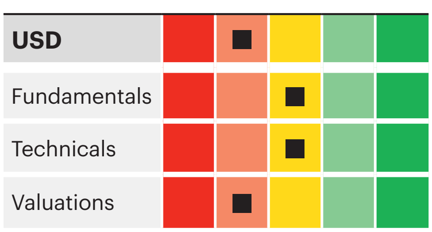
China's reopening and a series of industry-related relaxing measures are expected to lift economic growth in the coming quarters. The onshore market has started to reprice on the back of a potential economic rebound. In the meantime, we think the central bank is likely to maintain a relatively stable interbank liquidity environment, which could facilitate bond financing and growth recovery. With inflation expected to be benign in the months ahead, we see overall rates well anchored with potential curve steepening.



Japan

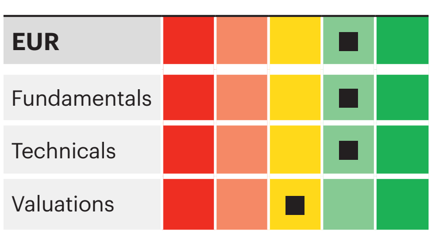
The BoJ surprised the market in December by shifting the yield cap on the 10-year Japanese government bond from 0.25% to 0.50%. Although, the BoJ has insisted it remains committed to defending the new yield cap, and that the adjustment was to aid market functioning not tighten monetary policy, the scale of JGB purchases necessary to limit a further rise in yields appears unsustainable in the context of rising inflation pressures. It is likely that the BoJ will ultimately drop Yield Curve Control completely later this year. The choice of Governor Kuroda's successor, which should be known shortly, and the pace of wage gains agreed at the annual spring wage negotiations, will likely determine the speed of the policy change. International considerations will likely also play a role. A more hawkish Fed and a weaker yen may put further pressure on the BoJ to tighten policy.

Currencies



USD

We are neutral on the US dollar, as its valuation is rich, in our view. But we do not expect to see significant further dollar weakness until the Fed finishes its current rate hike cycle, allowing financial conditions to ease. For now, the dollar should probably be considered to be in a range, much like bond yields.



EUR

The US dollar has weakened across the board since peak US inflation and hawkish Fed rhetoric. The euro has benefited from the move, and we expect upward pressure to be maintained as the ECB continues to press for higher rates and the US rate hiking cycle comes to an end. The move thus far has been very sharp, and we expect a retracement in Q1, providing potentially attractive entry points for a long-term euro bullish move.

RMB					
Fundamentals				■	
Technicals				■	
Valuations			■		

RMB

On a currency basket basis, the renminbi has been strong relative to historical levels. We expect it to continue to outperform versus the basket, even though the USD/RMB pair is still influenced by US dollar performance. China's recent changes to policies related to COVID control and the property sector have increased market optimism regarding Chinese assets, including the renminbi, and have led the currency to outperform. We expect capital flows to turn more positive and the potential for exporters to increase their conversion of dollar receipts is likely to add to the strength.

JPY			■		
Fundamentals			■		
Technicals			■		
Valuations				■	

JPY

The BoJ's gradual shift toward exiting Yield Curve Control should help limit the downside for the yen. In addition, slowing US growth, a likely Fed pause and lower commodity prices are likely supportive of yen appreciation going forward. The major headwind for the yen is the still wide interest rate differential versus the US. Hence, we believe long positions need to be timed for a clearer sign of a turn in the US rates cycle toward easing.

Credit

Investment grade

US			■		
Fundamentals			■		
Technicals			■		
Valuations			■		

US

Investment grade bonds performed well during the fourth quarter of 2022, as yields fell due to declines in both rates and spreads. Buyers stepped into the market and as a result we are now neutral regarding technical factors, which is an improvement from our previously negative stance. We believe all-in corporate bond yields currently reflect recession risks, although valuations on a spread basis may not. We have reduced our view on current spread levels to neutral from a more positive position as a result. We remain neutral on fundamentals. We believe companies are well prepared for what is the probably the most anticipated recession we have ever seen should it transpire. Consumers and companies have locked in substantial financing in the last few years at very low rates and are now repaying those debts with inflated dollars. There does not appear to be evidence of over-leverage in the market, therefore we do not expect significant credit events in the coming quarters. If we avoid a hard landing, which is our base case, we believe the economy and the corporate landscape is well-positioned for a slowdown. From a longer-term perspective, we still believe US investment grade offers a compelling alternative for income-seeking investors.

Europe				■	
Fundamentals			■		
Technicals			■		
Valuations				■	

Europe

European credit spreads staged a meaningful recovery in Q4 as near-term macroeconomic concerns related to Europe's energy supply abated. Nevertheless, we still see current spread levels as attractive. The energy situation is volatile, but the authorities have done a good job of maintaining high levels of gas storage. Although a weak consumer poses potential risks to corporate fundamentals in 2023, we believe that company balance sheets are in good shape. The ECB's pursuit of quantitative tightening will likely weigh on technicals, but higher yields are likely to open the asset class to new segments of the investor base. We have a constructive view on European investment grade credit, given index yields that are back to levels last seen in the 2011 sovereign crisis.

UK			■	
Fundamentals			■		
Technicals			■		
Valuations				■	

UK

We have a constructive outlook on sterling investment grade credit. Spreads rallied in Q4 and we should see some of the risk premium associated with 2022's brief dalliance with fiscal unorthodoxy further abate in the new year. Valuations are at attractive levels, in our view, and we think current yield levels are attractive for pension schemes looking to de-risk. Given the global diversification of the sterling investment grade universe, fundamentals should prove largely immune to domestic turbulence, in our view, but could face pressure from the global macroeconomic slowdown. The Bank of England appears committed to the reduction of the Asset Purchase Facility, which will likely weigh on technicals in the credit market, but this has so far met steady demand.

Asia			■		
Fundamentals			■		
Technicals			■		
Valuations			■		

Asia

We believe Asian and Chinese investment grade continues to provide attractive value compared to global peers. China's pivot away from its Zero-COVID policy should open the way for medium-term recovery in Chinese economic growth and the government's policy stance regarding the Chinese property sector has also turned decisively, though signs of a sustained recovery in home sales needs to be monitored. Macro fundamentals among Asian sovereigns have been more constructive, with inflation under control and strong foreign exchange reserve buffers. However, the sharply higher short-term US dollar deposit rate still provides little incentive for investors to buy Asian US dollar denominated bonds, in our view.

High yield

US			■		
Fundamentals				■	
Technicals			■		
Valuations			■		

Europe			■		
Fundamentals			■		
Technicals			■		
Valuations			■		

US and Europe

We are cautiously optimistic on high yield going into 2023. High yield offers several built-in cushions, including strong fundamentals, higher yields and lower dollar prices that potentially improve the total return outlook. We believe the carry from going down in quality can generate positive outcomes but are wary of the lowest quality risk ahead of a more difficult economic backdrop. Therefore, we like the yield offered by higher quality high yield, but we don't like the risk of extending to CCC-rated and speculative situations until there is either improved value or greater visibility into a Fed pivot and a peak in the default cycle. Currently, the lowest quality valuations don't offer sufficient opportunity, in our view, given that a Fed pivot appears to be many months in the future and the default cycle has yet to start. Since the high yield curve is negatively sloped, the yield per unit of duration stands out in the shorter end of the high yield opportunity set. Long-dated lower dollar price bonds are also attractive, in our view, since most are higher quality. They offer not only up-in-quality exposure, but less downside risk due to their discounted bond prices and potential for strong returns once the market stabilizes and the "pull-to-par" impacts bond prices. We believe bouts of volatility should offer trading opportunities. We believe we are close to the end of a Fed rate hiking cycle and a pivot could result in a sustained rally, especially if valuations present upside.

Asia			■		
Fundamentals				■	
Technicals			■		
Valuations			■		

Asia

We view Asian high yield as a good investment for carry. Chinese policy makers have rolled out easing measures for the property sector and funding is available to high yield real estate names, as long as they have good asset bases for guarantee use. China's Zero-COVID policy pivot continues to be a key fundamental change for Chinese high yield industrial names. Nevertheless, outflows have continued from Asian high yield despite the market rebound, and the primary market remains closed to Asian high yield issuers.

Emerging markets (USD)

Sovereign			■		
Fundamentals			■		
Technicals			■		
Valuations			■		

Corporate		■			
Fundamentals			■		
Technicals		■			
Valuations		■			

Despite improving data, several factors continue to drag down emerging markets, even after the 2022 selloff: global financial conditions; rising global growth risks; and the emergence of more attractive yields across developed markets. Meanwhile, inflation remains very high among emerging markets, despite easing of global supply chain restrictions and some normalization in food and gas prices. Most emerging market central banks are looking to end their tightening cycles, but easing is not on the horizon. Emerging market corporate fundamentals remain solid but have been weakening with declining global trade volumes, weakening growth and downward earnings expectations, alongside early re-leveraging and capital expenditure reduction. While yields are attractive by historical standards, credit spreads are far less appealing both on a historical basis and relative to other asset classes. Investment grade spreads are neutral to expensive, in our view, especially if benchmarked against global credit markets. High yield appears to have more value as single B credit valuations are not stretched versus long-term averages, in our opinion. However, higher yields have exposed vulnerabilities of weaker credits, and a high yield-to-investment grade compression trade must be executed with careful country selection, in our view, especially when dealing with the distressed segment of the market. Retail fund flows turned modestly positive during December and in early 2023 following a strong rally to end the year. A low expected supply of new issues in 2023 should also be supportive of the asset class.

Municipals

Tax-exempt municipals

IG				■	
Fundamentals				■	
Technicals				■	
Valuations			■		

HY				■	
Fundamentals			■		
Technicals				■	
Valuations			■		

We believe the municipal market is well-positioned for a strong rebound on the back of the rate and flow-related underperformance of 2022. Muni fundamentals remained strong throughout the 2022 selloff, and now real yields have turned positive for the first time since 2013. Our view is that the Fed has contained inflation and bolstered its credibility, and we believe that future inflation will continue to trend down. In addition, we forecast below-trend growth, which should be a tailwind for fixed income assets generally. As the technical picture improves and investors return to the municipal market, we envision a strong start to the year for both investment grade and high yield tax exempt municipals.

Taxable municipals

Taxable			■		
Fundamentals				■	
Technicals			■		
Valuations			■		

We are selectively constructive on the taxable municipal market. Fundamentals remain strong and valuations appear fair relative to history. Hedging costs seem to be keeping foreign investors from participating in taxable municipals, but limited supply is offsetting the negative impact. We are finding pockets of value, particularly in the healthcare industry, but prohibitive hedging costs and the downstream technical impact are keeping us from moving to a positive allocation on taxable municipals.

Structured*

Agency MBS			■		
Fundamentals			■		
Technicals		■			
Valuations				■	

Agency MBS

Agency MBS bounced back after a difficult 2022 to post a positive excess return in the fourth quarter. Interest rate volatility subsided during the quarter as the future path of Fed rate expectations became less steep and more predictable due to moderating inflation risks. Additionally, valuations had become attractive, enticing buyers to step into a cheap high quality asset class. Nominal spreads on current production coupon MBS are historically cheap versus US Treasuries and investment grade corporate bonds. Option-adjusted spreads (OASs) on the same coupons are attractive, in our view, despite elevated interest rate volatility. Discount coupons, which represent the majority of the Agency MBS market, however, are unattractive from both a nominal and OAS basis, in our view. Net supply of Agency MBS declined sharply in the second half of 2022 and should remain low in the first half of 2023. The demand picture is mixed with the Fed continuing to be a headwind to the market with balance sheet runoff continuing, while overseas demand from Europe and China remains strong. Overall, we are neutral on our mortgage allocation but prefer higher coupon 30-year MBS relative to lower coupons given significantly cheaper valuations.

RMBS				■	
Fundamentals		■			
Technicals			■		
Valuations				■	

RMBS

Housing fundamentals have deteriorated rapidly as a result of historically low affordability driven by the dramatic rise in mortgage rates. Monthly home price appreciation has turned negative in many markets. We expect delinquencies to increase as the labor market slows, yet we have seen no meaningful change to borrower behavior thus far. Despite these challenging fundamentals, we expect loan losses to remain contained given strong underwriting in place for the past decade and high levels of borrower equity. Additionally, the low supply of homes for sale, positive demographic trends and shifts in housing preferences favor single family homes. There are a number of subsectors of the non-agency mortgage market that currently look attractive, in our view, including non-qualified mortgage (non-QM) senior bonds, single-family rental bonds and prime jumbo passthroughs.

CMBS			■		
Fundamentals		■			
Technicals				■	
Valuations				■	

CMBS

Lending standards are tightening while loan demand is declining in the commercial real estate sector. We expect fundamental improvement to halt as financial conditions tighten. While stimulative fiscal and monetary policy helped property valuations to increase previously, we expect appreciation to cease in the quarters ahead. CMBS is cheap to corporate bonds, in our view, but fundamental risks are elevated. We favor top of the capital structure conduit CMBS and targeted single-asset single borrower (SASB) exposure collateralized by property types that are positioned to outperform post-pandemic.

ABS			■		
Fundamentals		■			
Technicals			■		
Valuations					■

ABS

We expect moderately weaker fundamentals for several ABS asset classes heading into the first quarter of 2023. Currently favorable employment conditions are expected to weaken. Given the pressures on certain consumers, we are monitoring the growth of revolving debt and a falling personal savings rate. Offsetting some of these shifts in fundamentals are strong ABS structures to support weaker collateral expectations. Many ABS sectors performed better relative to the investment grade corporate market late in 2022 after lagging badly. However, we believe many benchmark and non-benchmark ABS continue to look attractive relative to corporate bonds. Technical conditions in the ABS market are balanced and improving net flows into fixed income mutual funds should benefit the sector.

*MBS is mortgage-backed securities. RMBS is residential mortgage-backed securities. CMBS is commercial mortgage-backed securities. ABS is asset-backed securities.

Bank loans

US				■	
Fundamentals			■		
Technicals				■	
Valuations				■	

US

Waning inflation and increasingly patchy economic data support a view that the Fed's hiking cycle is nearing an end, fueling hope for a soft landing. That said, corporate earnings are likely entering a much more challenging environment in 2023. Fortunately, loan issuers remain in good shape from the perspective of cash balances, debt service coverage, leverage and maturity profiles. While defaults are expected to increase off historic lows, the increase should be manageable. Meanwhile, loan investors have begun to benefit from sharply higher interest rates via floating rate coupons. The dearth of new issuance in 2022 will likely persist in 2023, while CLO origination is poised to resume following a holiday-induced lull; this technical dynamic should support trading levels.

Europe				■	
Fundamentals			■		
Technicals				■	
Valuations				■	

Europe

Energy concerns, geo-political risks and ECB action continue to dominate. On the positive side, natural gas prices are significantly below their summer peaks and storage levels across the region are encouraging. Slowing economic data have not deterred the ECB from its continued hawkish monetary policy and further rate hikes are expected in the medium term as inflationary pressures remain elevated, though they have likely peaked. Borrowers in general have interest rate hedging plans in play and have entered this rate hiking cycle with supportive liquidity profiles. Loan defaults have remained low, although rating agencies have begun a general downgrade bias, reflecting macro developments. The primary pipeline remains muted, with deal flow (at attractive levels) occurring during periods of lower market volatility. Lack of new supply should help support secondary loan prices. Collateralized loan obligation liability costs remain high, challenging the arbitrage calculus.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/ or interest.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

Mortgage- and asset-backed securities, which are subject to call (prepayment) risk, reinvestment risk and extension risk. These securities are also susceptible to an unexpectedly high rate of defaults on the mortgages held by a mortgage pool, which may adversely affect their value. The risk of such defaults depends on the quality of the mortgages underlying such security, the credit quality of its issuer or guarantor, and the nature and structure of its credit support.

Asset-backed securities are subject to prepayment or call risk, which is the risk that the borrower's payments may be received earlier or later than expected.