# Global Fixed Income Strategy

Monthly report

**Invesco Fixed Income**

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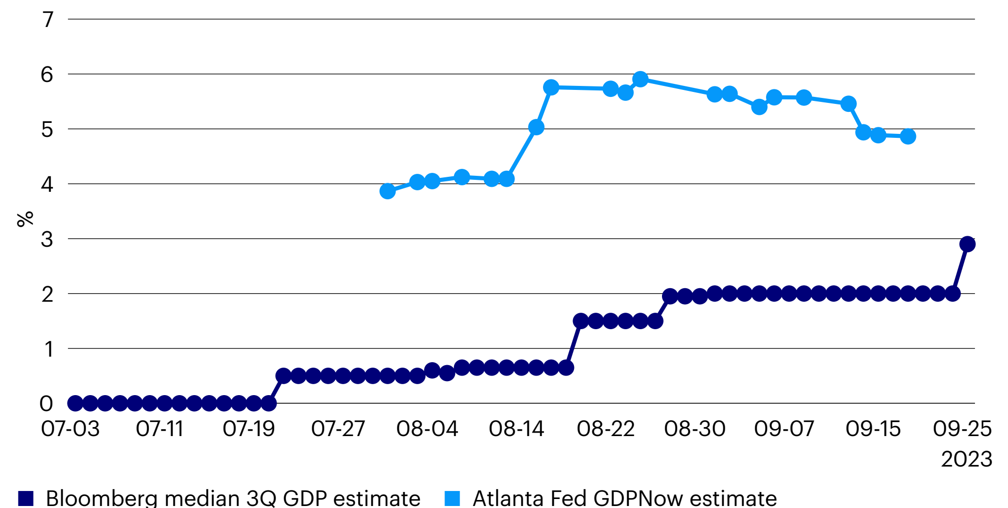
## Soft landing on the horizon, but growth acceleration further away

The US Federal Reserve (Fed) chose not to raise interest rates at its most recent meeting, but it adopted a relatively hawkish posture concerning future adjustments. This hawkish sentiment was exemplified by the Summary of Economic Projections (SEP), which pointed to a potential rate hike by the end of 2023. Yet, a closer examination of the Fed's statements reveals a commitment to a data-dependent approach going forward. Notably, the range of internal Fed estimates for future interest rates has broadened, suggesting a greater dispersion in views among the Federal Open Market Committee. This growing divergence underscores the heightened importance of upcoming economic data in shaping market expectations.

### Third quarter growth prospects have improved, signaling a soft landing

Recent forecasts for third-quarter economic growth show signs of improvement. The Atlanta Fed's GDPNow model currently projects a robust 4.9% growth rate. Bloomberg's median forecast of third quarter GDP, according to surveyed economists, has been revised up, from 1% at the end of the second quarter to a current estimate of 2.1%.[1] This positive trend in forecasts is largely attributable to the strong performance of consumer spending and housing starts during the summer months. As a result, the notion of a soft economic landing is becoming a near consensus view among analysts.

**Figure 1: Third quarter US GDP growth estimates have risen since the summer**




Source: Federal Reserve Bank of Atlanta, Bloomberg L.P. Data as of Sept. 25, 2023.

1. Source: Bloomberg L.P. Data as of Sept. 25, 2023.

Despite stronger-than-expected economic growth, we are witnessing a disinflationary trend. This suggests that fluctuating inflation rates are largely a byproduct of pandemic-induced imbalances rather than core economic forces. The pandemic caused shifts in demand from services to goods, disrupted global supply chains, and affected domestic labor supply. Fiscal policy measures further bolstered consumer spending, while external factors like the Ukraine-Russia war and fluctuations in food and energy prices added complexity to the inflationary landscape. However, these disruptive elements have largely stabilized, or are on the path to normalization, allowing inflation rates to decline without a corresponding significant reduction in output.

## Growth unlikely to accelerate until later next year

While third-quarter growth has shown promise, forward-looking indicators suggest a slowing trajectory beyond that period. Key barometers, such as the three-month moving average of payrolls, have been on a steady decline throughout the year. Although labor demand remains robust, as evidenced by sustained job openings, other labor market metrics like hiring and quit rates have returned to their 2019 levels. The labor market remains tight but has cooled off from the fervor of 2022. Layoffs continue to be infrequent, indicating that firms are increasingly selective in their hiring practices. This selectivity suggests a preference for retaining existing employees, making labor hoarding a likely scenario for the immediate future. As total employment figures inch closer to pre-pandemic trends, both hiring and nominal income growth appear to be decelerating.

Against this backdrop, we believe a reacceleration of growth is unlikely in the near term. As inflation slows, existing monetary policy tightening will likely impact the economy more strongly. This is because, regardless of whether the Fed hikes again, the inflation-adjusted level of interest rates should increase as inflation falls. Higher inflation-adjusted financing rates are typically associated with tighter financial conditions. In addition, credit spreads and other indicators of financing rates have risen since the Fed meeting. The combination of potentially slower to stable growth in the fourth quarter and additional financial conditions tightening means the economy is unlikely to reaccelerate in the next couple of quarters.

Slowing growth and inflation combined with tighter financial conditions suggest that the Fed is unlikely to tighten further and may need to ease at some point next year. In interest rate markets, this points to potentially steeper yield curves. Longer-term interest rates may continue to exhibit high levels of volatility until near-term estimates of growth begin to fall. With interest rates at 16-year highs, we believe that, over the long-term, interest rates at current levels offer value to investors.

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# Interest rate outlook

**US: Overweight.** US Treasury yields have risen, and the yield curve has steepened over the past month. We have moved well beyond the top of our expected range which was 4.25%. The market is being driven by technical factors and by concerns that the US economy will accelerate from here. We continue to believe we are in a low growth, disinflationary environment, which should limit the upside in yields and should be positive for Treasury performance going forward. We remain overweight at current levels.

**Europe: Overweight.** We are positive on the European rates market in the medium term, despite the recent rate hike in the region and continued hawkish rhetoric by European Central Bank (ECB) governing council members. While European inflation remains elevated and well above target, forward looking inflation indicators have begun to slow sharply and economic data have deteriorated, spreading from the manufacturing sector to the service side of the economy. The recent rate hike, which took the deposit rate to 4%, will likely be the last in this cycle, even if inflation remains above the ECB's target, given the slowdown in economic activity. While timing is a challenge, the European bond market offers an attractive opportunity, in our view, for investors willing to look past short-term volatility. Our analysis indicates that inflation will likely continue to moderate over the coming months and quarters, while the economy could deteriorate further, allowing the ECB to lower interest rates sooner than market expectations.

**China: Overweight.** We expect Chinese government bond yields to decline, especially at the front end of the yield curve. Hence, we continue to see the potential for the yield curve to steepen. With positioning relatively crowded in long rates positions earlier in the year, uncertainty over the market reaction if fiscal measures are announced has led to some volatility recently. The first-half earnings results of Chinese banks showed net interest margin pressure and hence an impact on capital ratios. To further lower funding costs for the economy and enable banks to extend loans on a sustainable basis, one of the least resistant paths would likely be to sharply lower front-end rates to reduce banks' funding costs in both the deposit and wholesale markets. Although fiscal measures and property relaxation policies have weighed on onshore bond performance, we think the Chinese central bank's monetary actions are the most important factor to consider for onshore bond market positioning and performance going forward.

**Japan: Underweight.** Although the Bank of Japan (BoJ) left policy unchanged at its September meeting, its direction of travel is increasingly toward less intervention in the Japanese government bond (JGB) market and a potential exit from zero interest rates. Inflation data remain strong, and wages appear to be more responsive to price pressures. Sequential inflation momentum is above the pace implied by the BoJ's July forecasts, suggesting the bank will have to revise up its forecast at the October meeting. The BoJ currently forecasts core inflation at 1.7% year-over-year in FY2024 and 1.8% in FY2025. The closer the forecasts get to 2% the more likely Governor Ueda can declare the inflation target met, justifying a complete end to Yield Curve Control and negative interest rates. Ueda intimated in a recent interview that this could happen late this year or early next year. The recent depreciation of the yen and higher commodity prices will likely stoke further imported inflation, potentially placing further pressure on the BoJ to change policy.

**UK: Overweight.** Gilt yields have declined in the last month, in contrast to US Treasury and German bund yields, as weaker domestic labor market conditions, growth and inflation have led to a reversal in much of the gilt's underperformance between April and July. The Bank of England's (BoE) decision to pause its rate hiking cycle at 5.25% highlights its dovish reaction function. The bar to further tightening appears relatively high. However, long-term interest rates remain vulnerable to an increase in supply due to likely fiscal slippage and the BoE's decision to raise the pace of quantitative tightening to £100 billion over 12 months from £80 billion. This combination of factors should support a further steepening of the yield curve. After the recent cross-market outperformance, gilts no longer look attractive relative to US Treasuries, in our view.

**Australia: Overweight.** Australian government bond yields spiked higher in September, largely tracking the move in US Treasury yields. Australian yields rose despite the Reserve Bank of Australia's (RBA) decision to pause its hiking cycle at the September meeting at 4.10%. Recent growth data have been relatively mixed, while inflation is showing signs of

moderating. In this context, a long period of unchanged short-term rates appears the most likely scenario, especially as the new RBA Governor, Michele Bullock, will likely be reluctant to shock the market early in her tenure. 10-year yields at 4.30%, therefore, offer some value at current levels, in our view.[1] However, at current spreads relative to US Treasuries, we believe there is limited scope for Australia to outperform idiosyncratically.

1. Source: Bloomberg L.P. Data as of Sept. 21, 2023.

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# Currency outlook

**USD: Overweight.** We are positive on the US dollar and have broadened our positive outlook beyond developed markets. The relative outperformance of the US economy vis-a-vis the rest of the world, coupled with a somewhat hawkish bias by the Fed, has provided support for the dollar and, unless we see a deterioration in the US economy, that dynamic is likely to persist. Also, the increase in US bond yields in recent weeks, coupled with the stronger dollar, has begun to impact the global risk backdrop. A further deterioration in risk appetite could be a catalyst for further dollar strength against emerging market currencies, as we enter the final quarter of the year.

**EUR: Underweight.** We are negative on the euro, given the weakness of the euro area economy in contrast to the relative strength of the US. The US exceptionalism narrative has continued to drive the US dollar higher and, given our expectations for both regions, we expect that dynamic to continue in the near future, unless the US economy begins to falter.

**RMB: Neutral.** We think the main driver of the USD/RMB exchange rate's performance continues to be the US dollar's strength against the major currencies. Although China's growth trajectory and rate differential have weighed on the renminbi's performance, recent rhetoric from policymakers and a series of fixing deviations showed a tendency to contain USD/RMB moves when seen as excessive. We think the purpose of policymakers' recent actions has been to contain the acceleration of speculative positioning, rather than reversing a trend. We note that the renminbi appreciated against the basket of currencies after the central bank used various tools to stem its weakness against the US dollar during the dollar's recent strengthening moves.

**JPY: Neutral.** The Japanese authorities have shown growing discomfort with the yen's depreciation, with recent Ministry of Finance commentary hinting at possible intervention around current levels. However, a sustained appreciation of the yen, particularly against the US dollar, will likely require a significant narrowing of the interest rate differential, which would most likely come from the start of a Fed interest rate cutting cycle. The recent resilience of US growth has reduced the short-term probability of this scenario. Nevertheless, pressure on the yen might abate as most developed central banks have now paused their hikes. This means the interest rate differential is at least not growing, and the BoJ may change policy over the next six months. It is also questionable how sustainable the recent bounce in US growth will be, given the tightening of financial conditions and other headwinds, including the restarting of student loan payments. Aside from interest rates, the recent rise in commodity prices will likely also be a headwind for the yen, if sustained.

**GBP: Underweight.** The British pound has been supported this year by higher relative interest rates and improved terms of trade. However, these factors have reversed somewhat over the past two months. Slower domestic growth and a weaker labor market have effectively capped the selloff in short-term UK interest rates, with the BoE pausing its hiking cycle at 5.25% at its September meeting, despite inflation being the highest among the major economies. Ex-ante real interest rates remain too low to support the pound in the near term, in our view. In addition, the rise in oil prices threatens the recent improvement in the UK's terms of trade.

**AUD: Neutral:** Recent optimism about a bottoming in Chinese economic data has led the price of iron ore to bounce, which, if sustained, should support the Australian dollar. However, the persistent negative yield differential versus the US remains a major headwind for the Australian dollar. Until we get a combination of better global, particularly Asian, growth sentiment and a less hawkish Fed, or a more hawkish RBA, we don't expect the Australian dollar to outperform the US dollar. The Australian dollar could appreciate against European currencies if the recent rally in commodity prices continues.

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# Top five reasons why US municipals are compelling now

Between the regional banking crisis, debt ceiling melodrama that led to a further US sovereign rating downgrade, heavy US Treasury issuance and now a looming government shutdown, 2023 has been a tumultuous year in markets. It follows an even more challenging 2022 that was marked by rising interest rates and daunting inflation. Despite these headwinds, the municipal bond market has demonstrated stability and resilience. We believe the asset class's diversification benefits are worth considering based on their low or even negative correlation to stocks and other risky assets. We believe an allocation to this relatively sleepy, but potentially attractive, asset class may be warranted.

## Why municipals now?

Five key reasons argue for considering municipals at the current juncture:

**1. The macroeconomic environment should be less volatile ahead**

The timeline and severity of a potential recession in the US has been downgraded amid low unemployment and strong consumer activity and inflation has trended downward. While Fed officials remain concerned about the pace of price increases, their fight to tame inflation has generally worked. Market expectations are mixed, but point to potentially one more Fed rate hike in November or possibly none at all. A macroeconomic backdrop of low growth and decreasing inflation is attractive for the municipal asset class, especially at today's high yield levels.

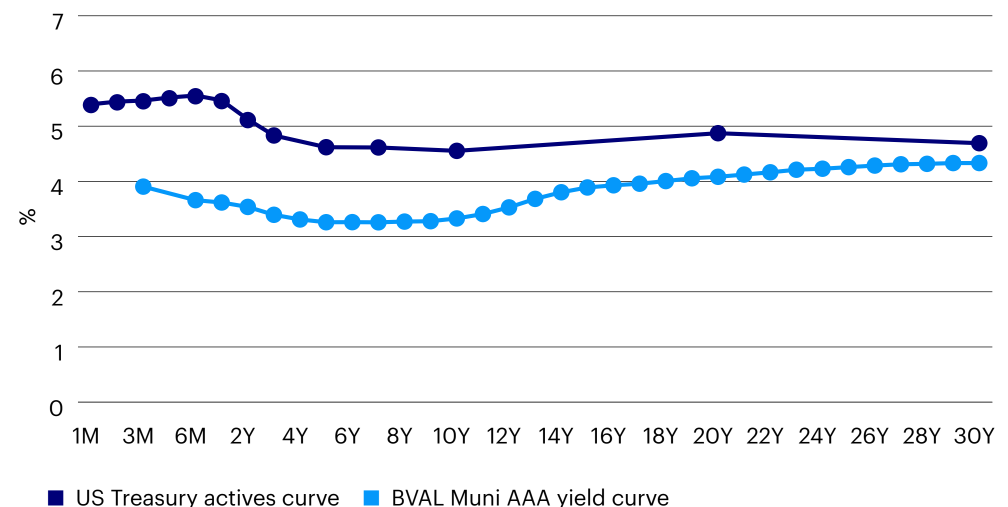
**2. Absolute and relative municipal yields look attractive**

Fixed income markets have returned to value, with nominal yields near or at their highest levels in decades (Figure 1). Investment grade municipal yields are around 4.17% and high yield municipals yield 6.13%, or 7.04% and 10.35%, respectively, on a taxable equivalent basis.1

Relative value has also returned to the municipal market. The commonly quoted municipal-to-Treasury ratio is currently 72% in 10 years and 89% in 30 years, indicating value for most US taxpayers, especially toward the longer end of the yield curve since the municipal curve is steeper than the US Treasury yield curve.2

This section highlights the views of Invesco Fixed Income's credit analysts across a broad range of fixed income assets managed by Invesco.

**Figure 1: US municipal yield curve vs. US Treasury yield curve**




Source: Federal Reserve Bank of Atlanta, Bloomberg L.P. Data as of Sept. 25, 2023.

1. Source: Assuming a top tax rate of 40.8% (37% Federal Tax Rate + 3.8% NIIT) effective as of January 1, 2023. Irs.gov, as of October 18, 2022. Top marginal tax rate for single taxpayers with more than USD578,125 in taxable income or couples with USD693,750 or more. NIIT is the Net Investment Income Tax of 3.8% on investment income for single taxpayers with more than USD200,000 in taxable income or couples with USD250,000 or more.
2. Source: Refinitiv. Data as of September 25, 2023.

**3. Technicals peaked in the summer but remain supportive**

The summer season was highly supportive to municipals from a technical perspective, characterized by negative net supply. While the fall season may bring heavier issuance and less cash flow to the municipal market via coupon payments and bond maturities/calls, we expect 2023 net issuance to total around negative USD50 billion, enough to support an orderly market while maintaining attractive municipal-to-Treasury ratios.

New issuance for 2023 year-to-date through August is on pace to be down 12% from last year, which was also lower than the previous year.[3] As expected, issuers with ample cash on their balance sheets have been reluctant to issue at higher interest rates. We expect the trend of negative net supply to continue into late 2023 and early 2024.

**4. Cash going back to work**

Many retail investors have parked their money in money market instruments, as they wait until the hiking cycle is officially over to consider longer-term investments. But signs that the hiking cycle is close to being over should encourage investors to put cash back to work, and we believe municipals would be likely beneficiaries. Many investors are already extending duration in the current environment as they feel more comfortable with the path of interest rates moving forward. Some are employing a barbell strategy, making allocations to both the short and long ends of the municipal market. This strategy has likely paid off because the municipal yield curve has been inverted since December 2022.

**5. Overall municipal credit fundamentals remain robust**

Even as the economy has moved toward the later stages of the credit cycle, municipal credit fundamentals have generally remained strong due to fiscal stimulus and strong revenue collections. Municipal credit upgrades have outpaced downgrades over the past nine quarters by a ratio as high as 6:1.[4]

However, the supply of pandemic cash that helped many state and local governments maintain their balance sheets is starting to wane. While pandemic savings will likely eventually disappear, default risk in the municipal market remains extremely low, in our view. Historically, high yield municipals have held up well in past recessions versus their corporate counterparts.

## Conclusion

Municipal bonds are compelling in the current environment, in our view, especially as market participants become more constructive on interest rate and credit risk. We believe a more favorable macroeconomic environment, historically attractive yields, positive market technicals and fundamentals and a potential return to longer-term investments as investors migrate out of cash, all combine in the current moment to present positive performance potential for municipals going forward.

3. Source: Bloomberg L.P. Data as of August 31, 2023.
4. Source: Standard & Poor's. Includes rating actions during the second quarter of 2023 and the eight prior quarters.

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# The bottom line: Shifting balance of risks favors legging into duration and high grade credit

Bond yields are at historically attractive levels. Investors can lock in prevailing yields by investing in high grade bonds before interest rates decline. Because the US Treasury yield curve is inverted, locking in high yields for longer requires taking on some duration and credit risk. In our view, high grade credit is a good way to achieve this objective. We believe investment grade should perform well in either a soft landing or recession scenario. In a soft landing, rates should come down more slowly. In a recession, the Fed is likely to cut rates faster and accelerate bond returns. Plus, investment grade bonds should outperform growth sensitive assets like equities in this scenario. We speak with portfolio managers Matt Brill and Todd Schomberg about their market views and investment strategies in this environment.

**Q: 2023 was meant to be "The year of the bond," but it seems to have stalled. What has happened in the macro environment that has caused a headwind for bonds?**

**Todd:** One of the reasons we haven't seen outsized returns in the bond space is that yields have stayed elevated amid better economic growth than a lot of people were expecting. Our base case since the beginning of the year has been centered on a soft-landing scenario, and we are seeing that play out.

The job market remains strong, and we are now seeing inflation decline from its peak of 9% last year to the 3% range. Rates remain elevated, so we are seeing good income, but that is not showing up in the total return numbers yet. We think a Fed pause and rate cuts in 2024 should result in the positive total return outcome we have been anticipating.

**Q: Are we finally at the end of the Fed's hiking cycle?**

**Matt:** We feel like we are at the end. Futures markets are suggesting a 50-50 chance of a rate hike later this year. But even with no hike, the current federal funds rate of 5.25%-5.50% is restrictive. We don't believe the Fed needs to hike again. We expect cuts to begin in mid-2024, which seems like a long way off, but it will be here before we know it. The fact that inflation is declining should enable the Fed to cut because they want to, not because they have to.

**Q: Where are you seeing the biggest opportunities? Do any sectors stand out?**

**Todd:** We are finally at a point where we can get decent yields without adding much incremental credit risk. Yields are attractive across the board, in our view, in sectors like investment grade corporate credit, agency mortgage-backed securities, and BB-rated high yield. A current focus of ours is the banking sector. Three of the largest bank failures in history occurred in March, which heightened volatility in the banking space. For us, this type of volatility creates potential opportunity. Banking rules have changed to make banks safer, but many banks are still trading at wide spread levels. We think the "Big 6" banks (Bank of America, Wells Fargo, Goldman Sachs, Citi, JP Morgan, and Morgan Stanley) as well as the super-regional and high quality regional banks offer attractive opportunities, as they are still trading wide to their historical averages. We expect spread tightening to take place in the banking sector, which should generate additional alpha for our clients.

We also favor agency mortgage-backed securities at current levels. From a homeowner perspective, mortgage rates north of 7% are painful, but as investors, we find these levels attractive. We haven't seen mortgage-backed yields this high in a long time.

**Q: Thinking about downside risks - your base case is for a soft landing but that's not a 100% probability - if growth accelerates, the Fed could hike more. How are you positioning portfolios for that possibility?**

**Matt:** This question comes down to the "breakeven" math. Because yields are so high, they would need to increase by a lot for fixed income total returns to turn negative. If the economy stays hot, we should see yields in the 6%-7% range for the next six to nine months. If the economy hits a rough patch, total returns should be great. The key is to not be short duration. We realize it's tempting to stay at the front end of the yield curve and earn the attractive yields, but that carries risk. Locking in yields for longer is a way to avoid scrambling for duration when the Fed begins to cut.

**Q: It's been a long time since we've seen yields this high, i.e., in the 6%-6.5% range. What is your overall strategy?**

**Todd:** Reinvestment and planning risks are the key factors we focus on. We need to go back to 2009 or 2000 to see yields in the 6.5% neighborhood. Yes, we are seeing attractive yields at the front end of the yield curve right now, but when the Fed starts cutting rates, those yields are going to be gone.

**Q: In terms of market drivers, what are you seeing on the horizon?**

**Todd:** When the Fed cuts rates, we believe there is going to be a "wall of cash" rushing to get in – the amount of cash sitting in money market funds is at multi-decade highs. Typically, investors in this type of scenario are too late to the trade. We want to get in front of that because when the Fed cuts and cash moves off the sidelines, the whole market will likely move lower. As we have seen in previous cycles, being a little early is a better option than being late.

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