Global Debt Outlook

2022 Outlook

Invesco Fixed Income

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Overview

- Financial markets have been dominated by market technicals often at odds with macro fundamentals. While the global growth story continues to evolve, extraordinary monetary and fiscal policies enacted over the past 18 months have created enough distortions to allow this incongruent price action to last longer than it would have under normal conditions.
- Forces driving current inflation are tied to supply-side bottlenecks in a period of global excess demand. Yet for inflation to be persistent, we believe fiscal policy in the US and developed markets globally would need to be engaged over the next two to three years – if anything, we expect it to wane significantly.
- We believe the factors contributing to US dollar strength are now behind us, and broad conditions for emerging market relative and absolute performance over a three-year investment horizon are currently falling into place.

Macro fundamentals vs market technicals

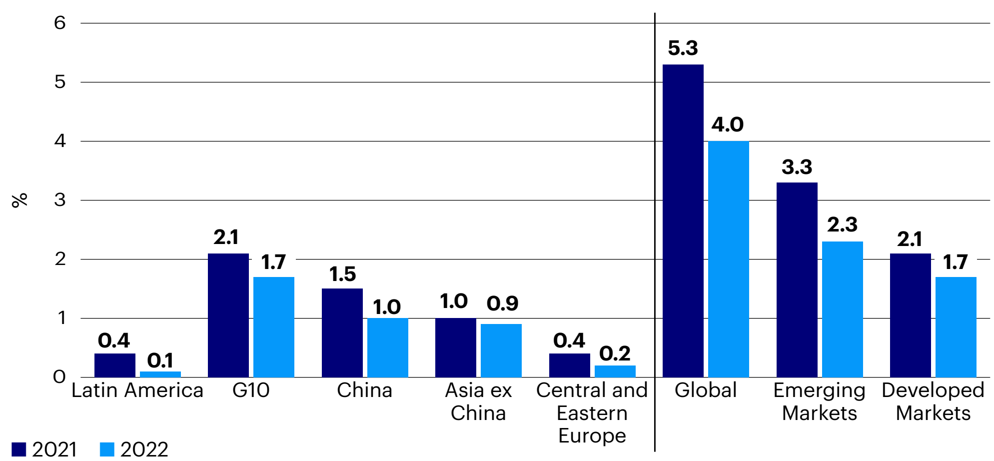
Over the past four months, financial markets have been dominated by market technicals – specifically, strong investment flows – that have often been at odds with macro fundamentals. While the global growth story continues to evolve, extraordinary monetary and fiscal policies enacted over the past 18 months have created enough distortions to allow this incongruent price action to last longer than it would have under normal conditions.

Macro backdrop

While the macro backdrop has evolved over the past six months, it remains consistent with a global economy that is growing above potential, supported by still very easy financial conditions, though facing some growing headwinds. The primary change in the macro backdrop concerns inflation, which was assumed to be purely transitory but is shaping up to be more persistent than expected, if still temporary. It is possible that, longer-term, the deflationary regime from the last decade has ended.

On the heels of extraordinary stimulus, supply chain constraints and (to a lesser extent) the ongoing global pandemic have emerged as the two primary forces shaping global economic growth. When combined with inflationary headwinds, our estimate for 2021 global growth has now fallen to 5.3% and 4.0% for 2022. The rapid normalization of monetary policy in emerging markets is expected to drag growth lower from prior estimates, but we still expect emerging market growth to remain higher than in developed economies. The monetary adjustments in Latin America are expected to be the primary cause for the growth drag in emerging markets. Ultimately, we anticipate a global growth trajectory that is flatter overall, but likely to remain higher for longer.

Figure 1: Contribution to global growth (%)



Source: Invesco forecasts and Bloomberg L.P. Data as of November 24, 2021

As the inflation debate has unfolded, one thing is for sure: transitory has never been adequately defined. Regardless of the exact timeframe of "transitory", markets appear to be more concerned with whether the US Federal Reserve (Fed) will waver in its framework and tighten policy in response to political or internal pressures. If the Fed does tighten policy, US asset prices will likely be negatively affected, although we would expect global asset prices to be less affected.

While the Fed may have retired the term, "transitory", we continue to believe that inflation will be closer to its target if the time frame considered is about 12 months.

Forces driving current inflation are tied to supply-side bottlenecks in a period of global excess demand. How this imbalance will play out remains uncertain, but we believe the excess demand issue will be more critical to the longer-term inflation story. For inflation to be persistent, we believe fiscal policy in the US and globally in developed markets would need to be engaged in creating persistent excess demand over the next two to three years. We do not believe global fiscal policy will remain at its current level over the next three years and, if anything, we expect it to wane significantly.

The International Monetary Fund (IMF) expects fiscal deficits to narrow markedly in every major region other than the US and the emerging market countries in Europe. Even in the US, the budget deficit expanded from 5.2% in 2018 to 10.8% in 2020, but is declining despite recent deals, and is expected to fall back to 5.8% in 2026. In contrast, the reversal is faster in other regions. For example, in Europe, the deficit expanded from 0.4% to 6% in 2021 and is expected to fall back to 2% as early as 2024. In most emerging markets, we are likely to be back to pre-pandemic fiscal deficits by 2024, except in the European emerging markets, where deficits are likely to remain close to double the pre-pandemic levels for the foreseeable future. Even there, the fiscal impulse is likely to wane over time, reducing the excess demand pressure we are currently experiencing.

Once the current US budget and infrastructure deal is fully negotiated, the period of highest fiscal spend will likely be behind us. Indeed, consensus estimates of major global economies' fiscal deficits as a percent of GDP suggest declines over the next three years. In such an environment, we believe inflation will not be self-sustaining.

Technical backdrop

This year has seen extraordinarily strong demand for global equities, especially US equities. Bank of America Merrill Lynch has estimated that flows into global equities in the first nine months of this year exceeded USD1 trillion, more than the previous 20 years combined.[1] Flows of this magnitude can create their own dynamics. They have resulted in high returns on US equities with limited drawdowns and a dearth of flows into other assets.

In the current macro backdrop, with unpredictable inflation and slowing but above-trend growth, we believe term premia and the neutral interest rate should have been slowly rising. In an environment with easy monetary conditions, this environment would typically lead the US dollar lower and generate unspectacular equity market returns. This scenario has not played out. Rather, rising premia was accompanied by rising equity markets because of exceptionally large investment flows, as noted above. Equity market gains have allowed large duration-sensitive asset/liability managers to immunize their portfolios from the impact of future interest rate fluctuations, even at uneconomic prices. When combined with quantitative easing (QE) by the Fed and European Central Bank (ECB), any perceived change in policy that may affect equity prices creates a storm in markets where levels, particularly on interest rates, have limited impact and flows largely dictate asset prices. We saw this dynamic in the summer, when rates or the shape of the yield curve changed abruptly in large moves with high volumes.

In such a flow-driven environment, any attempt by the Fed to tighten financial conditions earlier than expected has had the opposite effect: encouraging duration-sensitive investors to move quickly to immunize their longer-term liabilities. Yet the real rate of return for long-term Treasuries is expected to be well-below zero for the next 30 years. This flow dynamic effectively pushes down the terminal rate, despite rising inflation and a Fed that is more concerned about inflation than it was expected to be earlier in the year.

This US exceptionalism narrative has created the conditions to keep the US dollar stronger, particularly versus other developed market currencies. The impact in emerging markets has been extreme, with little capital available to purchase assets or fund governments, leading to uncontrolled increases in interest rates. A reversal of this large equity flow, potentially as a result of inflation and the Fed's changing reaction function, remains the largest risk to global markets, in our view.

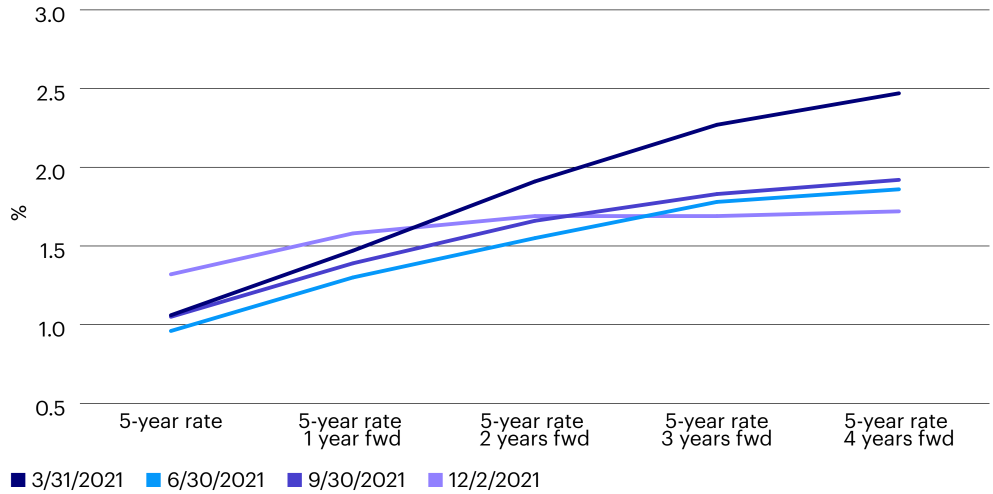
In this environment, how are we thinking about our levers of risk?

Rates

Rates in developed markets are fairly priced, in our view. In March, the US bond market priced in six rate hikes by the Fed by 2024.[2] As the Fed has changed its messaging, those rate hikes have been brought forward, but the cumulative level of hikes priced in has not changed. Figure 1 shows the evolution of the five-year swap rate and changes in its expected forward path this year.

1. BAML, September 2021.
2. Bloomberg L.P., March 2021.

Figure 2: Evolution of 5-year US swap rate in 2021



Source: Bloomberg L.P. Data from March 31, 2021 to December 2, 2021.

In the beginning of the year, when inflation was expected to be transitory with no response from the Fed, significant term premia was priced into markets. However, since the June meeting when the Fed expressed concern about current levels of inflation, term premia have fallen as markets perceived that the long-term inflation risk was reduced. As inflation has been more persistent since then, the market has brought rate hikes forward, while the terminal rate has not changed. This reflects a redistribution of expected rate hikes but not additional hikes. We believe this view will persist and, once markets have priced in the maximum number of rate hikes possible in 2022, the volatility in rates markets should decline.

Looking across the major developed markets, we believe the maximum number of rate hikes in 2022 are one by the ECB, three by the Fed, four by the Bank of England, and almost five by the Bank of Canada, which are currently priced into yield curves. The recent volatility in markets, particularly the significant flattening of yield curves, has been a result of flow pressures combined with miscommunication from various central banks, such as the Bank of England and Bank of Canada. We still believe the cost to these central banks of hiking earlier and more aggressively than expected is higher than letting inflation persist for a few more quarters, although the political pressure on them is rising.

The impact on emerging market rates has been dramatic, as they have priced in a significant rate hiking cycle. The inflationary impulse has been particularly acute in Latin America, followed by the Central and Eastern European countries, while it has been much more muted in Asia. Pricing of policy rates in a significant number of countries has moved from accommodative at the start of the year to restrictive territory currently. In Brazil, we started the year with the central bank's overnight rate at 2%, and it is now priced to peak at 13.7% by December 2022.[3] Similarly, Russia started the year with its policy rate at 4.5%. It has now risen to 7.5%, and is priced to peak at 9.25% in the middle of next year.[4] Other emerging market central banks have joined the rate normalization cycle, including Poland, the Czech Republic and several Latin American countries, including Mexico. Asia has not needed to join in raising rates, as inflation has remained less volatile.

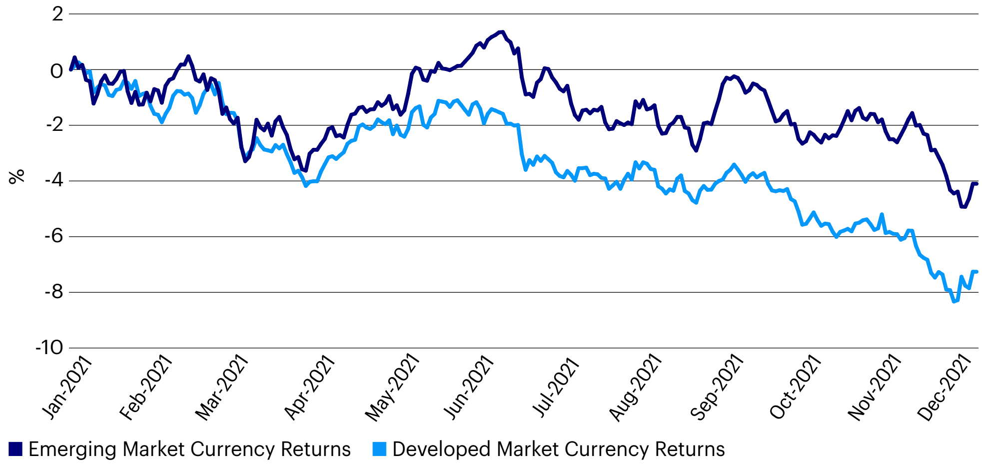
As these rates have moved to being restrictive, we have not only been bringing down our growth forecasts, but we also expect inflation to be close to the target range in most countries by the end of 2022. In Brazil, for example, we expect growth to slow from 5.2% in 2021 to no growth in 2022, while inflation will likely fall from almost double digits to 5%. Over the next nine to 18 months, we believe emerging market rates offer the best risk/reward opportunity in markets.

Currencies and the US dollar

We believe this year's strength in the US dollar falls into three regimes. The first in Q1 was a result of the repricing of longer-term rate expectations. The second in Q3 was caused by lower growth, especially versus expectations, due to the COVID-19 delta variant. The third in Q4 developed as rate hikes were brought forward in the US. During the latter period, emerging market currencies have performed well, and in aggregate have outperformed developed market currencies.

3. Source: Bloomberg L.P. Data as of November 24, 2021.
4. Source: Bloomberg L.P. Data as of November 24, 2021.

Figure 3: Relative performance of emerging vs developed market currencies



Source: Bloomberg L.P. Data from January 1, 2021 to December 2, 2021. Past performance is not indicative of future results.

As seen in Figure 3, emerging market currencies had been relatively stable this year, until November, as the carry has compensated for volatility. So far this year, developed market currencies have underperformed by a larger amount, falling by over 8% at the worst point in November (Figure 3). With no carry, and somewhat US dollar-positive fundamentals, they have had no cushion to absorb volatility.

We believe the factors contributing to US dollar strength are now behind us. The direct economic impact of COVID-19 has passed, even as we deal with the aftermath of the crisis, namely supply chain disruptions and inflation. We believe we have reached the peak in terms of disparate policy expectations in developed versus emerging markets. While we see the peak priced in to most developed markets, such as Canada, Norway, and Australia, we believe the euro and yen may struggle in this environment if no further rate premia can be priced into those markets. As rates markets stabilize, high US twin deficits will likely continue to weigh on the US dollar.

Within emerging markets, the rate path in most high yielding markets offers sufficient excess premia to provide stability, in our view. In addition, we expect China to provide the policy support needed for renminbi stability, while maintaining a gentle appreciation path. China's slowdown in the middle of this year, the result of refocusing on inclusive growth and favoring redistributive policies, has been one of the primary drivers of the instability in global growth in the last six months. While fiscal and monetary policies are being eased, refocusing on external trade will likely also be in China's policy mix. Trade surpluses are running close to record levels, which we believe will continue. This should benefit the renminbi. Its level has become the key barometer of US dollar strength or weakness. Trade-related flows have been one of the primary reasons for the stability and recent strength of the renminbi during a very volatile period for Chinese fundamentals.

Credit

After 15 months of exceptional performance, credit remains expensive by all metrics, in our view. In most markets, spreads are at all time tight levels, or close to them. Easy financial conditions, active funding markets and exceptional equity performance have helped drive strong credit performance. Led by US high yield and resurgent energy prices, emerging market credit has also performed well.

Notably, there has been a performance divergence among emerging market rates, currencies, and credit. Even in countries such as Brazil, where rates have risen by almost 600 basis points, credit default swaps have only widened from 150 to 230 basis points this year.[5]

We expect credit to generate low excess returns going forward, given current tight spread levels. However, we do not expect the default cycle to pick up any time soon, given easy financial conditions and the buoyant equity market. As a result, in credit, we continue to favor taking default risk over spread risk. Higher default risk comes with higher required interest rates, and, since we believe the macro backdrop remains supportive for companies, we see an opportunity to capture this excess compensation for our investors. Spread risk, by contrast, implies lower yields, and therefore cushion, against marginally higher credit spreads.

5. Bloomberg L.P., as of October 31, 2021.

Outlook: A medium-term case (two to three years) for increasing allocation and maintaining maximum exposure to emerging markets

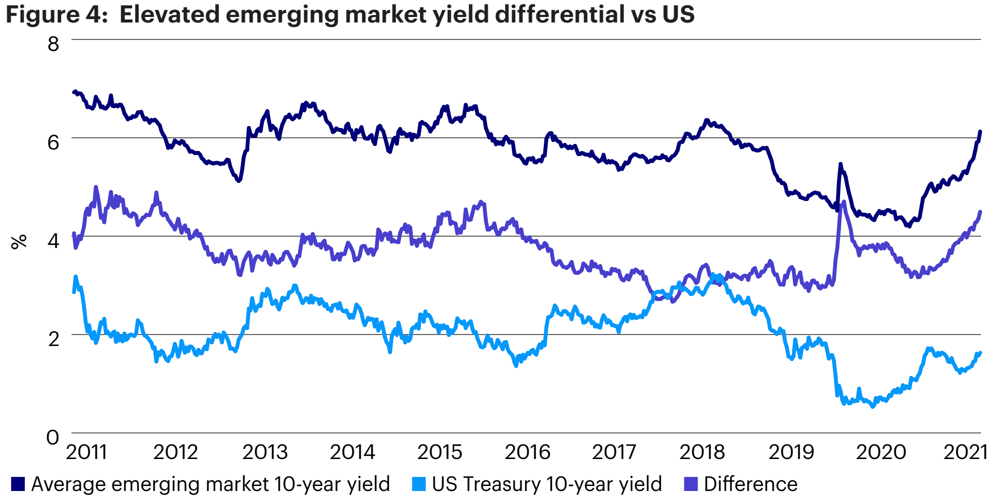
For most countries that are classified as emerging, including China, there are some broad conditions that, if met, we believe could set the stage for better relative and absolute performance over a three-year investment horizon:

1. High nominal emerging market interest rates, with potentially high real interest rates in the near future – provided inflation, the reason for high nominal rates, ultimately declines
2. US dollar weakness, or at least stability
3. Stable to higher commodity prices and improving terms of trade
4. Attractive valuations
5. Extreme bearishness toward emerging market assets
6. Predictable path for US financial conditions, especially interest rates

Many of these criteria are already being met, with the greatest uncertainty around US financial conditions.

1. Nominal interest rates in emerging markets have been rising since the beginning of the year. Most emerging market central banks have moved aggressively to build premia into their currency and interest rate curves, as inflation has increased globally. In a normal "risk-off" environment with rapidly falling currencies, emerging market central banks would have responded by tightening financial conditions. In 2020, however, the global shutdown combined with the extraordinary stimulus in the US allowed most emerging market central banks to dramatically reduce interest rates. More recently, however, weaker currencies and pass-through inflation, plus demand-driven and supply chain concerns, have led emerging market central banks to tighten policy before developed market central banks, in order to restore the normal countercyclical balance. As a result of this earlier tightening cycle, emerging market rates have risen sharply versus US rates. Interest rate spreads, when adjusted for structurally lower rates in Central and Eastern Europe, are at their widest level in a decade.

Figure 4: Elevated emerging market yield differential vs US

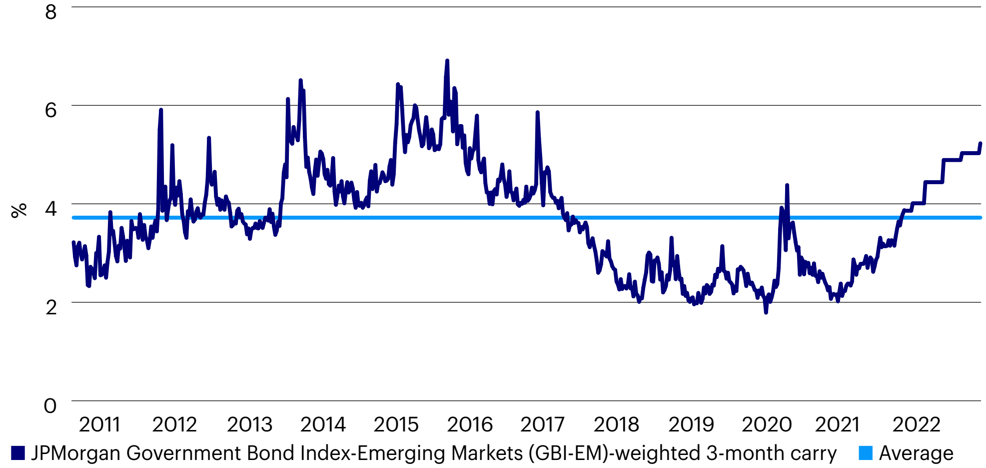


Source: Bloomberg L.P. Data from June 24, 2011 to October 22, 2021. The average emerging market 10-year yield is the weighted average 10-year government bond yield of 15 emerging market countries, weighted according to their weights in the JPMorgan Government Bond Index-Emerging Markets (GBI-EM). The countries represented are Thailand, South Africa, Russia, Romania, Poland, Mexico, Malaysia, Indonesia, Hungary, Czech Republic, Colombia, China, Chile, Brazil, India.

While real interest rates (based on current inflation) are not at the highest levels of the last decade, we expect inflation in emerging market countries to decline significantly next year and real rates to be at, or near, record highs. As such, the first condition is either already being met, or will likely be met by the middle of next year.

2. With the exception of the Brazilian real, emerging market currencies have been generally stable this year. We believe that, as developed market currencies stabilize (as peak policy differentials are priced in and interest rate volatility declines), emerging market currencies will likely benefit disproportionately, as a significant amount of currency premia have been built into markets. Given current interest rate expectations, we believe currency premia will be attractive by early 2022.

Figure 5: JPMorgan Government Bond Index-Emerging Markets (GBI-EM) weighted 3-month currency carry with market pricing for 1-year look forward



Source: Bloomberg L.P. Data from July 23, 2010 to November 18, 2022.

With the US trade deficit at USD73 billion per month (all-time record), record budget deficits and easy financial conditions, we believe the stage is set for the US dollar to decline significantly over the next three years.[6] While the US current account deficit is not at a record level, it has widened sharply, from 1.8% of GDP to 3.2%.[7] Any reduction of capital flows into US equities would likely exacerbate a fall in the US dollar.

3. Prices for most commodities, not just energy, have been rising since the start of the COVID pandemic. Fiscal expansion has created excess demand, as has changing consumer behavior. Figure 6 depicts this relentless rise as the index approaches its post-Global Financial Crisis China-induced high. The predominant dynamic in the commodity market currently has evolved from what it was a decade ago. Fewer imbalances are observed, but capacity is also not being expanded rapidly in light of increased shorter-term demand. In addition, with the increased emphasis on sustainable investing, capital is not as readily available for industries that do not meet the criteria. For emerging markets, stable prices are key to terms of trade that will likely be important for stability in the medium term.

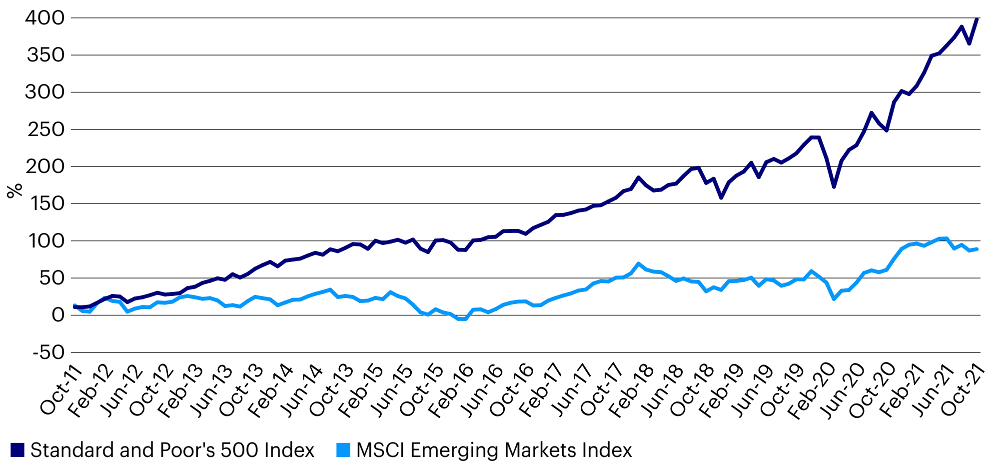
Figure 6: Standard and Poor's GSCI Commodity Index

Source: Bloomberg L.P. GSCI is Goldman Sachs Composite Index. Data from December 31, 1999 to November 23, 2021.

6. US Department of Commerce, October 2021.
7. US Department of Commerce, September 2021.

4. Given the high degree of correlation between assets in emerging markets, it is often observed that all assets offer value or none do. Similar to fixed income, emerging market equities currently offer attractive relative valuations, having underperformed the US market for a decade by record margins. While there may be some structural factors driving the outperformance of the US, emerging market equities are currently cheap by most valuation metrics. In addition, individual stocks in emerging markets generally screen significantly cheaper than their developed market counterparts.

Figure 7: Cumulative total return of Standard and Poor's 500 Index vs emerging market equities over 10 years



Source: Bloomberg L.P. Data from October 31, 2011 to October 29, 2021.

5. Market sentiment toward emerging markets is the worst we've seen in the last 20 years – since they have become a mainstream investment. The negativity is evident in the bearishness exhibited by most analysts on both the sell and buy sides. In addition, most model portfolios are allocating 0% to emerging market rates and currencies, and weightings of emerging market equities are at their lowest in a decade. We have seen many institutional clients hold off on new allocations to emerging market fixed income and the entire emerging market fixed income category remains in outflows. We see this view as overdone, and for the reasons mentioned, believe that emerging market assets may offer exceptional opportunity from a valuation perspective.

6. The recent volatility in emerging markets is coming from the tremendous uncertainty over the future path of US financial conditions. Figure 8 shows that current financial conditions are exceptionally easy and generally commensurate with emerging market assets performing well. Given the current inflationary scare, the future path of conditions is particularly uncertain and forward-looking indicators are pricing in some tightening of these conditions. It remains our belief that while conditions may tighten moderately, they will likely remain accommodative for an extended period of time.

Figure 8: US financial conditions

Source: Bloomberg L.P. Data from January 5, 2001 to November 19, 2021.

If the anticipated volatility in US financial conditions materializes in similar magnitude to what is priced in, then emerging market assets may offer an exceptional investment opportunity over the next three years. Valuations remain attractive, but as fundamentals continue to hold, we expect that value to be unlocked.

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. Past performance is not a guide to future returns.

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.

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.