

Invesco Fixed Income

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Global macro strategy

Macro conclusions from the November IFI Summit

Twice a year, investors from across the Invesco Fixed Income platform gather at the IFI Global Investors' Summit to discuss and debate their views on global macroeconomic trends. Macro themes play an important role in IFI's investment process and our framework of "macro factors", focused on growth, inflation and policy, helps us project macro trends and interpret market movements. At our November 19 – 20 Summit, a panel of investors provided their views on global macro developments. Below we share their main conclusions.

US

Key Summit takeaways

- **Economic outlook for 2025:** Economic momentum remains strong heading into 2025, but we anticipate potential volatility and uncertainty due to policy changes under the new Trump administration. Our outlook considers two scenarios: a pragmatic approach by the administration, leading to a continued soft landing, or an aggressive stance that could result in trade wars and large-scale deportations, significantly affecting labor market dynamics.
- **Short-term growth:** In the short-term, we expect continued strong US GDP growth, after averaging close to 3% since 2023. Easing financial conditions, the declining tail risk of a hard landing, the resolution of election uncertainty and less regulation under the new administration should drive dynamism.

- **Medium-term growth:** We expect a slowdown in GDP growth to 1.5% in the second half of 2025 due to potential tariffs on China and other countries, as well as a slowdown in labor force growth due to reduced immigration and deportations.
- **Long-term growth:** Long-term economic growth in the US is determined by technological growth, which tends to be stable, and labor force growth. We expect a return to historical trends, with potential growth of 1.7 – 1.9% in the coming years.
- **Disinflation story:** We believe inflation will decline further in the winter, thanks to ongoing help from falling global goods prices, commodity prices, and moderation in shelter inflation. However, we expect inflation to move sideways toward the end of 2025, as labor market slack is absorbed and the supply side becomes less supportive.
- **Federal Reserve policy:** We expect the Federal Reserve (Fed) to deliver a rate cut in December and possibly skip in January to take stock of the impact of cuts that have been delivered and incoming policy changes. We expect fewer rate cuts in 2025 due to strong economic growth and slowing progress on disinflation.
- **Fiscal policy:** We expect fiscal policy to primarily involve extending existing tax cuts rather than introducing significant new stimulus. There is limited room for significant spending cuts due to the

composition of the federal budget, which is largely comprised of non-discretionary spending.

- **Market risks and inflation expectations:**

Long-term inflation expectations and new Fed appointments will be important to monitor, in our view. Stable inflation expectations would likely indicate institutional credibility, but changes could impact the interest rate trading environment.

Macro outlook — Pragmatic versus dramatic approach

Economic uncertainty and market volatility could be important themes in 2025, as companies and consumers anticipate policy changes under the new Trump administration. In our view, economic and market outcomes will depend on which of two scenarios play out: a pragmatic approach by the Trump administration, enabling a soft landing, or an aggressive approach, resulting in disruptive trade wars and large-scale deportations. We divide our outlook into three parts: a near term, medium term and a long-term view. In our baseline we do not expect policy changes to have immediate effects, and therefore, expect economic momentum to continue in the near-term.

In the medium term, however, the outlook is more uncertain, as it will likely take time for policy changes to materialize. In the long term, we expect key macro variables to converge to their long-term trends. US long-term growth has proven to be historically stable, regardless of the party in power. Over the long term, growth has been determined largely by technology and labor force growth, and we expect this pattern to continue.

Short-term growth outlook

The US has grown impressively over the past two years. Since early 2023, quarterly GDP growth has averaged 2.9%, compared to potential growth of around 1.8%, as estimated by the Fed.¹ With growth currently tracking at around 2.5%, and disinflation intact, the US is close to achieving a soft landing.² In the coming quarters, we expect several factors to stimulate even more growth.

- **First, the Fed cutting cycle has begun.**

Even beforehand, the market's anticipation of cuts had caused financial conditions to ease. Bank lending has

also picked up, which is not captured in some financial condition indices. We expect bank lending to continue to improve.

- **Second, election uncertainty is now behind us.** Some of the recent slow-down in hiring has likely been due to companies' wait-and-see attitude ahead of the election, given the political and policy uncertainty. Capital expenditure has also been lackluster, likely for the same reason.

- **Third, the lingering risks of a hard landing keep diminishing.**

- **Finally, we expect less regulation under a Republican government.** Less regulation on non-financial and financial companies should boost business confidence and lift "animal spirits," boosting growth.

The bottom line is that we expect the economy to accelerate modestly over the next couple of quarters. However, we do not anticipate overheating, as some slack has emerged in the economy over the past year. Indicators, such as the rising unemployment rate, and, importantly, declining wage growth, support this view. That said, with strong growth, this slack is likely to diminish in 2025.

Medium-term growth outlook

In the second half of 2025, we expect policy changes to have a more visible impact. We expect GDP growth to slow modestly to 1.5% in the third and fourth quarters, driven by two primary factors:

- **Tariff impacts:** Although increased tariffs on imports from China and other countries will likely be implemented earlier, we expect their economic impact to be more pronounced in the second half of the year. Tariffs act as a tax on trade, creating a drag on growth as their effects ripple through the economy.

- **Immigration and labor force dynamics:** We also anticipate a focus on deportations and reduced new immigration. While currently labor market slack allows the economy to grow above its potential in the short term, this slack would be absorbed with sustained growth. Reduced immigration and increased deportations would likely tighten the labor market, ultimately slowing growth to its potential.

1. Source: Bureau of Economic Analysis, Data as of Nov. 27, 2024. Federal Open Market Committee, Summary of Economic Projections. Data as of Sept. 18, 2024.

2. Source: Bureau of Economic Analysis. Data as of Nov. 27, 2024.

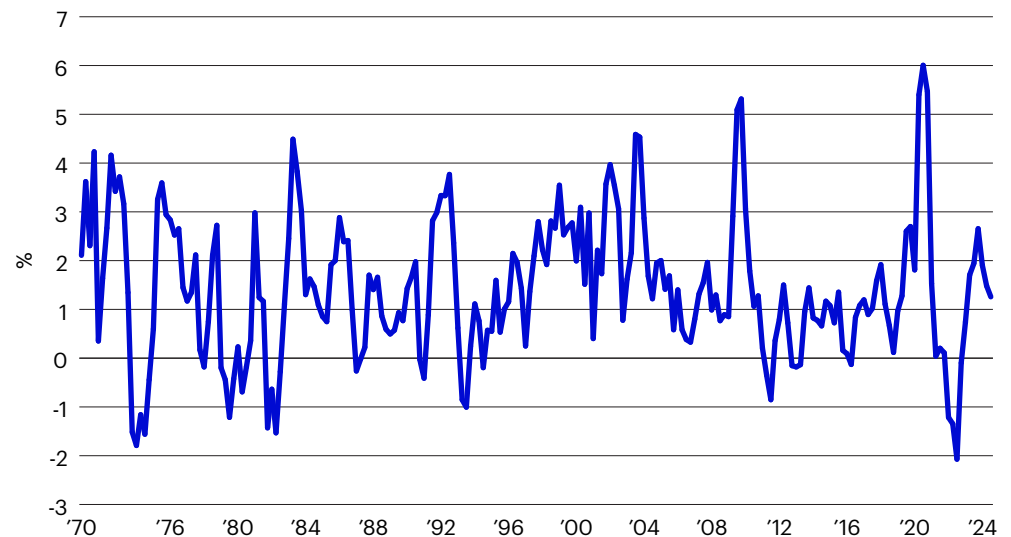
Long-term growth outlook

A key driver of long-term economic growth is productivity growth, which has remained relatively stable in the US, oscillating around a long-term trend. Recently, productivity growth has been tracking above this trend.³ While this momentum could persist in the short term, a standard assumption is that productivity will revert to its historical mean.

We remain optimistic about productivity prospects in the long run, driven by investment and advancements in artificial intelligence (AI). However, historical evidence suggests that the diffusion of transformative technologies into the broader economy takes time to yield significant aggregate-level benefits. Our long-term outlook incorporates a modest view of productivity growth, tempered by realistic adoption timelines for AI.

- Taking a conservative approach and not assuming an immediate AI-led boom, we expect US productivity growth to revert to a range of 1.5% – 1.7% in the next few years. This level surpasses the previous decade’s average, potentially boosted by the gradual adoption of AI. However, it may be offset by a shrinking labor supply due to reduced immigration.
- As productivity growth aligns with historical trends, we expect potential GDP growth to settle at 1.7% – 1.9%, just below the long-term trend of around 2%. New policies—such as tariffs, deregulation, and immigration restrictions—are unlikely to have a significant impact on this trajectory, which is ultimately driven by technology.

Figure 1: Productivity growth typically reverts to its long-term trend of 1.5% – 1.7% y-o-y



Source: Bureau of Labor Statistics. Data from Oct. 1, 1970 to June 30, 2024. Nonfarm Business, Labor productivity (Output per Hour), Seasonally Adjusted Index.

Inflation outlook

We expect inflation to decline further in the winter thanks to strong base effects, but then move sideways in 2025. Due to the three factors discussed below, we expect core personal consumption expenditures (PCE) inflation to move sideways in the mid 2% range in 2025.

- **Global goods prices are coming down but most of the decline is behind us.** Supply chains have improved and demand has softened amid high interest rates and a normalization of pandemic-related demand. China is currently exporting deflation, but this will likely

be offset by tariffs. Global commodity inflation has largely normalized two years after the shock of the Russia-Ukraine war. As a result, the goods price deflation story is slowing.

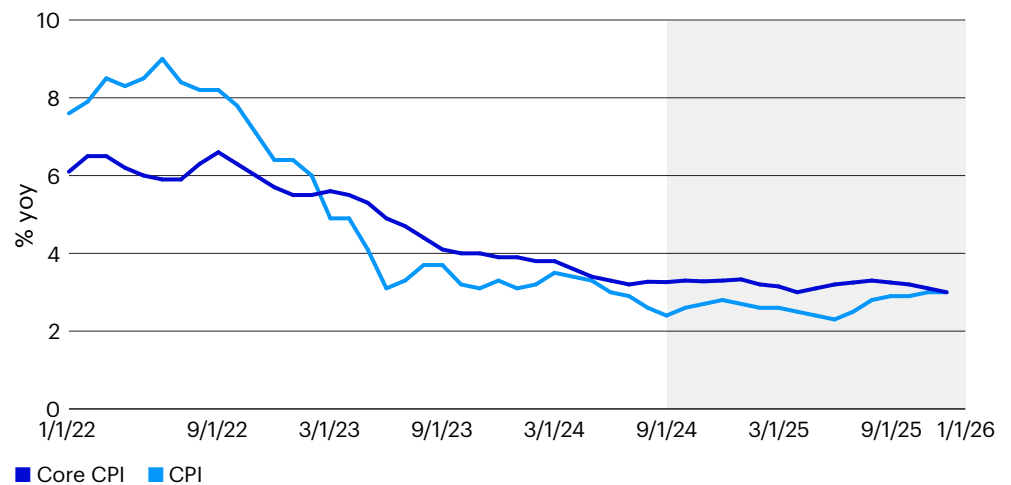
- **Shelter inflation persists as another key component of inflation but should normalize.** New rents have largely returned to pre-pandemic levels, though official measures of shelter inflation remain high. We believe official measures will converge to pre-pandemic levels in the next six to nine months but stabilize at a level that is moderately higher than the pre-pandemic norm.

3. Source: Bureau of Economic Analysis. Data as of Nov. 27, 2024.

Wage growth has moderated but should stabilize with labor market tightening. We expect slack in the labor force to be absorbed next year. Slower immigration and more deportations should ultimately cause the labor market to tighten. While wage growth

has slowed this year, we would expect it to stabilize next year based on tighter labor market conditions. Less support from falling wage growth should slow disinflation and lead to more steady inflation readings in 2025.

Figure 2: We expect inflation to remain steady in the near term, with a slight decline in early 2025 due to base effects. We expect a rise later in 2025 due to strong economic growth, a tightening labor market, and the impact of tariffs



Source: Bureau of Labor Statistics, Nov. 13, 2024. Invesco projections. There can be no assurance that projections shown will be realized.

Monetary policy outlook

What does this mean for the Fed? We believe the Fed will deliver a December rate cut, as insurance against any further slowdown, and then take stock on where the economy is going. Based on our base case, we do not believe there is a need for aggressive cutting and believe the Fed will skip January and assess conditions in March. If our baseline scenario is correct, and the economy is growing well and companies are hiring, we would expect a cut in March, and one in June. Inflation risks could rise after that, as the economy returns to full potential, and we would expect the Fed to pause. The risk is toward fewer cuts.

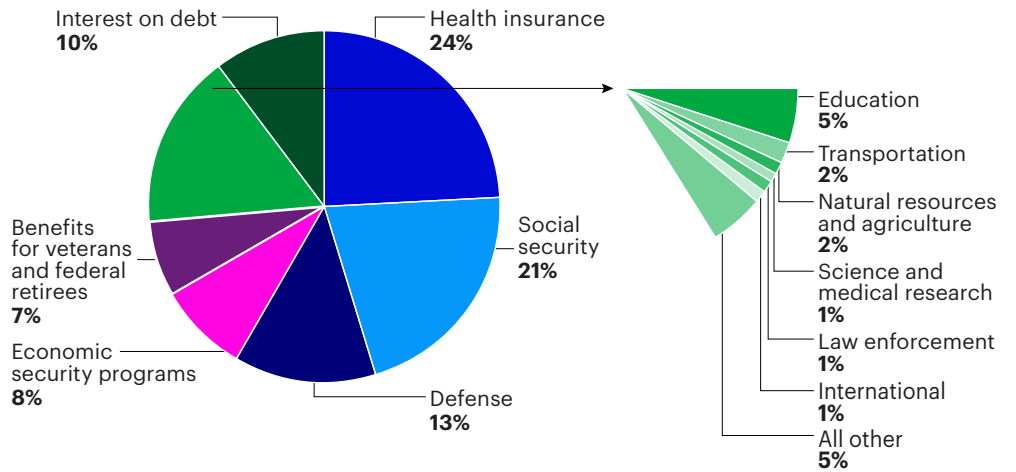
In terms of cuts to federal spending, we do not believe there is much room to cut. Total federal spending is USD6.7 trillion, of which 24% is health insurance, 21% is Social Security, 13% is defense, followed by various economic security programs, veterans benefits, etc. Combined with interest payments, more than 80% of the federal budget is essentially fixed (Figure 3). Given these budget constraints, we believe it will be very difficult to cut as much as currently promised — roughly USD2 trillion.⁴

Fiscal policy outlook

We expect some modest fiscal easing under the Trump administration, but no major stimulus. Our baseline expectation is that most of the fiscal measures will be merely an extension of existing tax measures under the Tax Cuts and Jobs Act. The timing of any additional measures would likely not be before 2026, given the political processes to authorize tax and spending changes.

4. Source: US Treasury. Data as of Nov. 13, 2024.

Figure 3: The majority of the budget goes for health, Social Security, and defense



Note: Figures differ from OMB's for technical reasons related to the shifting status of the Administration's 2022 student loan forgiveness policy and its effect in 2023. Percentages do not add to 100 due to rounding.

Source: 2023 figures from the Office of Management and Budget, March 11, 2024.

Interest rate outlook — Short term versus long-term view

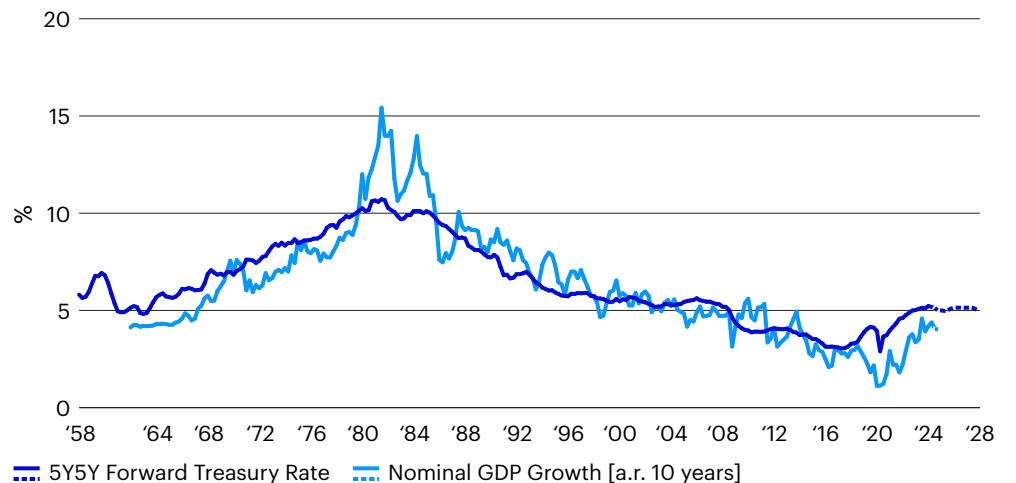
Our interest rate outlook is also framed in terms of our short, medium and long-term views. We believe short-term expectations are already in the price. In our view, markets are most likely to be focused on medium-term policy, which is highly uncertain. For our long-term view, we look to the risks currently implied by the market.

A tenet of our valuation model argues that interest rates tend to track nominal GDP. However, the growth outlook is highly uncertain at the current juncture, as Trump administration policies take shape. To manage this uncertain landscape, we distinguish between near-term and long-term policy. We believe the policies that are likely to be implemented first include tariffs and immigration. The effects of those policies are similar to a tax hike and a reduction in the labor supply — measures that tend to be negative for growth. The impact on future monetary policy is, however, uncertain. We could see a short-term bump in inflation followed by a long-term return to trend, and perhaps a decline in productivity as companies face higher labor costs. But those effects are too uncertain to extrapolate to Fed policy.

Near-term market drivers

Interest rate markets were up and down in 2024 — largely due to a lack of clarity about whether monetary policy is tight enough to slow the economy. During 2024, some data points suggested yes — but others suggested no.

Figure 4: The big picture in rates: Over the long-term interest rates follow nominal GDP



Source: Bloomberg L.P. Data from Jan. 1, 1958 to Oct. 1, 2027.

Short-term rates outlook

Against this backdrop, recent market pricing has moved to the top of the yield range — i.e., markets have priced in a relatively good growth outcome. However, as markets absorb more information on potential tariff and immigration policy, rates could rally, as these measures may not be viewed as positive for the country's long-term growth prospects. Deregulation, tax cuts and other growth-friendly measures may also be implemented, but these policies remain highly uncertain, especially as political dynamics in Congress play out. Overall, we expect rates to decline in the near term, as the medium-term policy outlook is priced in.

Long-term rates outlook

Our long-term rates view takes a cue from long-term, market-implied inflation expectations. The five year, five year forward breakeven inflation rate has traded between 2.0% and 2.5% percent

since March 2021 (Figure 5). Actual inflation, on the other hand has ranged between 2% and 7%.⁵ This means that the market price of inflation five years from now, over the subsequent five years, has stayed within a 50 basis point range, while actual inflation has spanned a 500 basis point range. This speaks to the institutional credibility of monetary policy. Stable long-term inflation expectations — despite actual inflation pressures — speaks to market confidence in the Fed. Absent this faith in the Fed and its policies, the risk of higher inflation would be priced in, and the breakeven rate would likely become elevated.

We will be monitoring this rate. If long-term inflation expectations challenge the upper end of the interest rate range and move beyond it, it may signal a shift in the trading environment. For now, it has not, which suggests that we remain in a relatively similar environment to the last of couple years.

Figure 5: Risk: institutional confidence



Source: Bloomberg L.P., Goldman Sachs. Data from Jan. 4, 2021 to Dec. 6, 2024.

Importance of the Fed

Going forward, we are monitoring the Fed, especially new appointments. We believe Fed leadership will be the most important factor driving long-term inflation credibility, and we anticipate a wide range of expectations as the Trump term unfolds.

are difficult to predict without more information on upcoming fiscal policy. But the market consensus seems to point to a continued increase in supply. To that extent, we believe increased supply is already in the price, but we will be watching for more detailed information on Trump administration fiscal policy.

Treasury supply outlook

Supply and supply expectations have not been major factors in the market this year. There were a few weak auctions, but, in general, supply has been absorbed well. Future supply-demand dynamics

Lessons from history

Looking back over the past 50 years, the US has experienced several volatile macro environments and uncertain policy regimes, including rampant inflation, price controls and an oil embargo.

5. Source: Bureau of Labor Statistics. Data from March 1, 2021 to Nov, 15, 2024.

But throughout, labor productivity, growth and other macro drivers have remained relatively stable. This history reinforces our strategy of keeping an eye on long-term market risk premia as a guide to rates markets. Currently, risk premia are stable, which leads us to favor certain types of mean version trades, such as being long duration in the near term. However, we favor caution over the medium term, as policy uncertainty develops on a macro scale.

Europe

Key Summit takeaways

- **Eurozone growth and resilience:** Europe has grown only modestly since the pandemic, but has shown resilience, despite the Russia-Ukraine war and energy concerns. While inflation is high, it is no longer policymakers' main issue. The focus has now shifted to slow growth, which should lead the European Central Bank (ECB) to continue to cut rates in 2025.
- **Loan growth and real incomes:** Loan growth has resumed in the eurozone, driven by ECB rate cuts. Real incomes are also growing, as wage growth outpaces inflation. These factors should contribute to resilience going forward.
- **Surveys and consumer confidence:** Surveys suggested a weak economy in recent months, but hard data fared better, with actual GDP performance often better than survey indications. This disconnect is important for understanding eurozone resilience.
- **Fiscal policy and ECB cuts:** Fiscal policy in the eurozone is tight, with no major expected changes that would meaningfully change the growth outlook. The ECB is, therefore, the main driver of economic support, and we anticipate further rate cuts.
- **European interest rates and yield curve:** There is potential for a rally in European rates and yield curve steepening due to increased supply and ECB quantitative tightening. Cross-market spreads with the US are likely to remain wide.
- **Intra-eurozone spreads and France:** France is a key country to watch due to its weak government and fiscal challenges. The risk of a government collapse in 2025 could impact interest rate spreads and economic stability.

- **Impact of tariffs on the eurozone:** Tariffs could negatively impact eurozone growth, which could lead to a more dovish ECB response and rally in rates.
- **Euro outlook and policy mix:** Our outlook for the euro is negative, due to a policy mix of tight fiscal policy and easy monetary policy. Geopolitical risks and positioning dynamics may also weigh on the euro.

Macro outlook: Slow but resilient growth

The eurozone has grown slowly since the pandemic, and new tariffs under the Trump administration, if implemented, could prove onerous. However, the eurozone economy has been more resilient than anticipated during this period and we expect this performance to continue. We also believe inflation is now a problem of the past. Although services sector inflation remains somewhat high, we expect continued disinflation, as slow growth is the main problem facing Europe now. In terms of policy tools, the European Central Bank (ECB) holds the reins, as fiscal policy is constrained by strict fiscal rules. We expect the ECB to keep cutting rates, but we do not expect aggressive 50 basis point cuts unless there is a major growth shock.

With inflation under control, there is a focus on growth

Eurozone growth has been sluggish, growing just below one percent over the past year, below its potential rate of 1.0 to 1.5%.⁶ In 2022, the Russia-Ukraine war shocked Europe, especially Germany, given its heavy dependence on Russian energy. At the time, recession was considered all but assured. There were fears of shortages and a dark winter without energy. However, none of that transpired and Europe's resilience surprised to the upside. Fast-forward to today, and structurally slow growth is now a key problem. We expect continued mediocre growth of 0.7% – 0.8% in 2025 but believe that pessimism around Europe is overdone. We believe the region could exceed growth expectations for the following reasons:

- **Loan growth is recovering in Europe.** Europe is a bank-centric system and therefore transmission from central bank policy to the economy is strong and rapid. Bank lending survey data suggest that this trend will continue. Demand for consumer credit and mortgages has

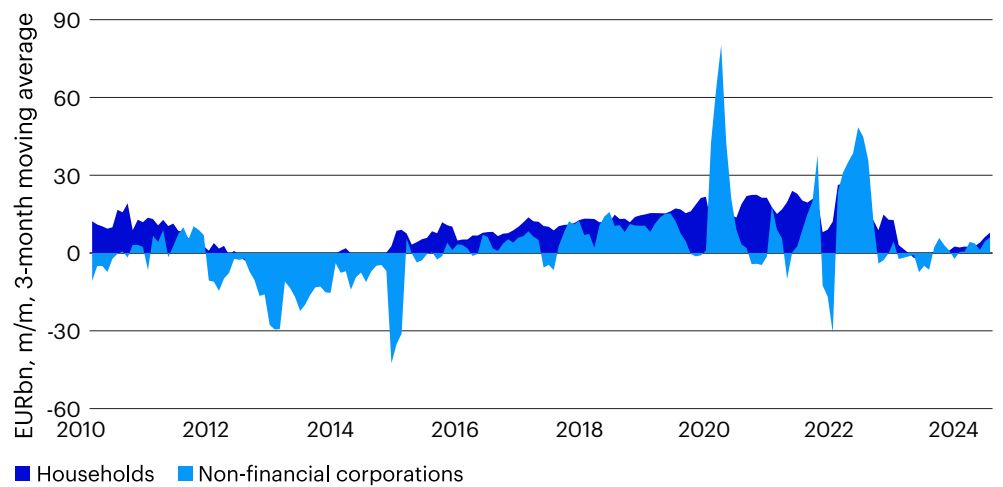
improved, and while companies may be more cautious, corporate loan demand is also picking up. As the ECB continues to cut rates, we expect overall loan demand to continue to improve, which should be a source of eurozone growth.

- **Real income growth is rising.** Europe was hit hard by the inflation shock caused by the pandemic. Wage growth, on the other hand, was slow to catch up, unlike in the US. In the last year, however, wage growth has risen above inflation, which should be another source of growth resilience.
- **Monetary policy is easing.** Fiscal policy in the eurozone is tightening and we do

not expect a significant shift in 2025. With no support from the fiscal side, policy impetus will likely need to come from the ECB. We expect the terminal rate to reach 1.5% or lower.

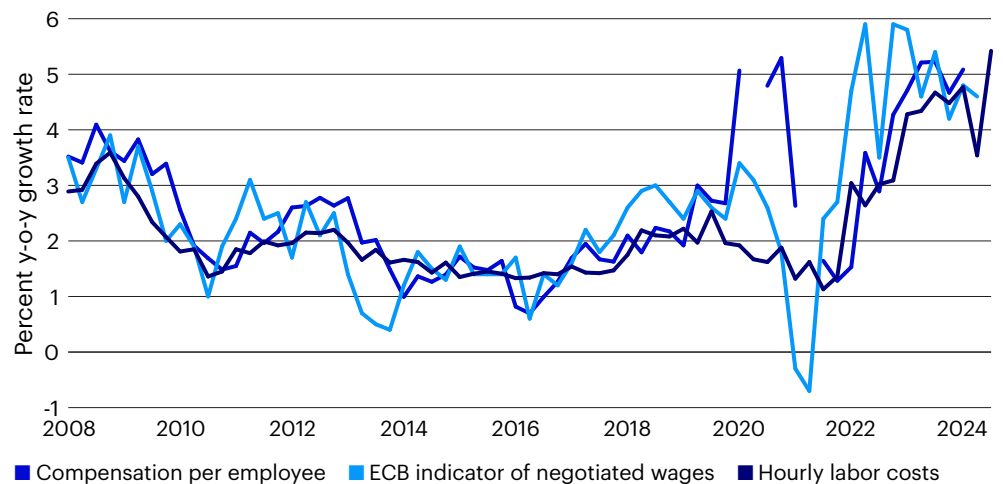
- **Recent surveys suggest that confidence may be picking up outside of manufacturing.** Since the pandemic period, actual GDP performance has exceeded survey results. Consumers and firms may report poor sentiment but spending patterns have remained solid. We believe this disconnect will be important to watch going forward as surveys have indicated negative sentiment, but macro performance may be better.

Figure 1: Loan growth has resumed in the eurozone



Source: ECB. Data as of Dec. 3, 2024. Data from Jan. 1, 2010 to Oct. 31, 2024.

Figure 2: Wage growth has accelerated, catching up with past inflation. Rising real incomes should provide a floor for growth and be a source of economic resilience



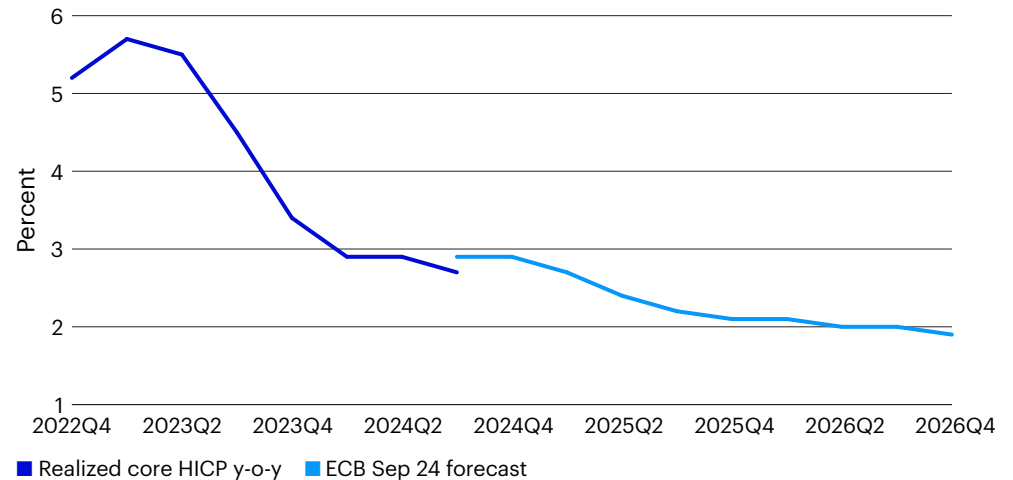
Source: ECB and Eurostat. Data as of Dec. 3, 2024. Data from Jan. 1, 2008 to June 30, 2024.

Interest rate outlook: A faster and deeper ECB cutting cycle

As discussed above, the decline in core inflation relative to the ECB's forecast plus a moderation in inflation expectations, will likely shift the ECB's focus from controlling inflation to supporting growth in 2025, resulting in a faster and deeper ECB cutting cycle. Eurozone growth

has been lackluster in recent years, and leading indicators point to downside risks to the ECB's expectations. Leading indicators also point to a loosening of the labor market, which to-date has been very tight, despite below-trend growth. Simple Taylor rule models would be consistent with the ECB cutting below 2%, with a 1.5% terminal rate being a realistic possibility by year-end 2025.⁷

Figure 3: Realized and projected inflation



Source: Bloomberg L.P. Data from Dec. 31, 2022 to Sept. 30, 2024. Forecasts thereafter.

Inflation linked: Real yields to lead the rally

Over the last year, the rally in eurozone interest rates has largely reflected lower market-based inflation expectations. However, given that inflation forwards are now consistent with inflation that is 20 – 30 basis points below the ECB's target, it appears likely that a further rally in eurozone rates will be led by real yields rather than lower breakeven inflation.⁸

Yield curve: Steeper yield curves ahead

A faster and deeper ECB cutting cycle that pushes down front end yields, combined with the shift to a full run-off of the ECB's quantitative easing (QE) holdings in 2025, which would increase the net supply of longer-term duration, should result in a steeper yield curve, as price sensitive buyers will likely account for a large percentage of bond holders. The shift to balance sheet run-off in the eurozone and Japan should put upward pressure on term premium going forward, which currently remains relatively

compressed compared to the pre-ECB QE period. In addition, forward swap pricing anticipates very little steepening ahead, with 2s – 30s 1-year forward priced to remain below 20 basis points.⁹

Cross market spreads: Wider for longer eurozone vs. US interest rate spreads

Since September, spreads between US and eurozone interest rates have widened significantly. Five-year five-year forward swap spreads have widened by close to 80 basis points (Figure 4). Although these spreads are unlikely to widen significantly, we do not expect a narrowing dynamic going forward.

Underlying inflation in the eurozone is likely to converge downward toward US core inflation in 2025, as base effects from administered prices fall out of the data. In contrast, stronger US growth and tariffs raise upside risks to US inflation in 2025. Tariffs are likely to weigh on eurozone growth more than offsetting any inflationary impact.

7. Source: Invesco. Data as of Dec. 4, 2024.

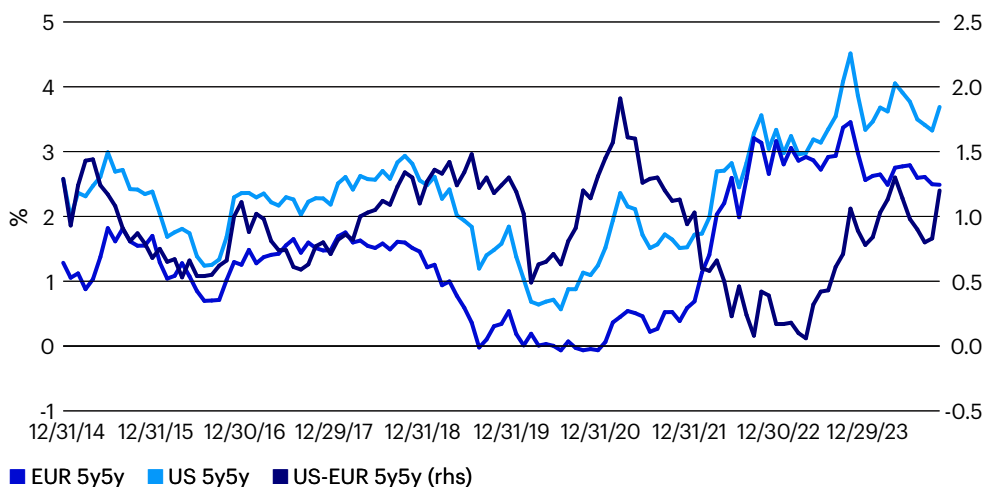
8. Source: Bloomberg L.P. Data as of Dec. 4, 2024.

9. Source: Bloomberg L.P. Data as of Dec. 4, 2024.

While fiscal policy is likely to remain tighter in the eurozone than in the US due to EU rules, the new US administration will likely have a freer hand to pursue easier fiscal policy. This will likely lead to greater bond supply in the US than the eurozone,

particularly on a duration-adjusted basis, as the US Treasury will likely need to raise coupon issuance, whereas eurozone treasuries face no such pressures to extend average maturities.

Figure 4: Five-year five-year forward swap spreads have widened



Source: Bloomberg L.P. Data from Dec. 31, 2014 to Oct. 31, 2024.

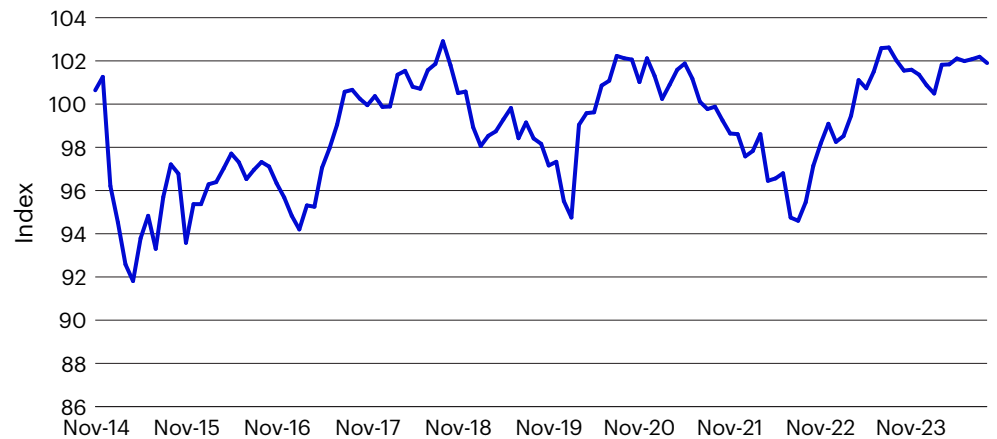
Intra-eurozone spreads: France is the epicenter of fiscal and political issues

The shift in focus to France and away from Italy and Spain reflects a deterioration in underlying fundamentals, as the French deficit and current account has deteriorated toward the level of the large peripheral economies. Since the June European Union (EU) elections and subsequent French elections in July, the market has priced increased idiosyncratic risk premium in French spreads, which have markedly diverged from other eurozone spreads.

Valuations are not very supportive for euro outperformance, in our view. The trade-weighted real effective exchange rate is close to record highs, as shown below. Although the euro seems relatively cheap versus the US dollar, this is largely consistent with the interest rate differential and does not reflect much in the way of additional risk premium for eurozone political issues or US tariffs. Furthermore, the euro appears expensive on a real basis, and relative to interest rate differentials, compared to currencies such as the Japanese yen.

Eurozone currency outlook: Euro is the best funder among the major currencies

We believe there is little scope for the euro to outperform developed market or emerging market currencies in the current environment. The combination of tight fiscal policy and looser monetary policy will likely lead to lower eurozone interest rates than elsewhere, resulting in downward pressure on the euro exchange rate. Unlike the US, China and Japan, the eurozone's tighter fiscal path leaves the ECB to support growth alone.

Figure 5: Euro index

Source: BIS, Bloomberg L.P. Data from Nov. 30, 2014 to Sept. 30, 2024.

Geopolitical developments are potentially more negative for the euro than other currencies. The fiscal crisis in France will probably limit the appetite for French assets, while uncertainty about the German political situation will likely rise ahead of the February 2025 election. The prospect of US tariffs on the EU poses a downside tail risk to eurozone growth, and the fallout from any escalation in the Ukraine war and a possible hardening of the US stance toward Iran could pose a greater risk for the eurozone than elsewhere, given its proximity and reliance on imported energy.

China

Key Summit takeaways

- **Baseline growth projections:** We expect 5% growth in 2024 and 4.5% next year. Our baseline projection does not include the potential impacts of Trump administration tariff policies.
- **Impact of Trump's tariff policies:** Depending on their magnitude, tariffs could reduce China's growth by their direct impact on exports, but also via lower investment demand due to weak business sentiment. This impact may not be confined to China. During the 2018 – 2019 period, policy uncertainty led to weak capital expenditure and industrial production globally.
- **China's response to tariffs:** Depending on the magnitude of the tariffs, China's response could include a 10% – 15% depreciation of the renminbi and a more forceful fiscal policy to support the economy. Should a 5% growth target be maintained for 2025, achieving it under tariffs would likely require significant fiscal measures, which the Chinese central government may address cautiously, due to debt concerns.

- **Current economic measures:** Several measures have been announced since September to stabilize the economy, including a local government debt swap, bank recapitalization and real estate market support. These measures are starting to show signs of stabilizing the real estate market and improving retail sales.

- **Negotiations with Trump administration:** Negotiations between China and the Trump administration could prove transactional, meaning that while some geopolitical issues like Taiwan may be non-negotiable for China, the two sides may find room for deals on trade.

- **Medium-term growth expectations:** Over the next five years, we expect China to grow in the 3% – 4% range, though the potential impacts of Trump's policies could hold it closer to 3%. A growth crisis could prompt the Chinese leadership to implement material economic reforms, which could be a game changer and a foundation for future growth.

Macro outlook: Moderate growth and inflation

Short-term growth outlook

We expect China to grow around 5% in the current year, driven by recent stimulus measures and signs of stabilization in the real estate market. The government has announced several policies, including a local government debt swap and bank recapitalization, and implemented several measures to stabilize the real estate market. These efforts have shown some positive results, such as improved real estate transaction volumes and better retail sales numbers.

Medium-term growth outlook

Chinese growth is not an output, but rather a political input to macroeconomic decision-making. The target is set, then depending on the economy's inherent strength, the slack is filled with policy support to close the gap. Over the next five years, we expect China to grow around 3% to 4% if there is no policy support. This forecast takes into account China's demographic challenges, productivity growth, and the unbalanced nature of the economy. The potential impact of external factors, such as US tariffs, could lower this forecast. If the Chinese leadership does not consider these levels of growth politically acceptable, it may need to implement significant economic reforms to achieve higher growth rates. We estimate the baseline growth rate in the absence of additional external pressures at around 4.5% for next year, but this could be adjusted based on the evolving global trade environment and internal policy decisions.

Long-term growth outlook

In the long term, China's growth prospects are more uncertain and heavily dependent on structural reforms and global economic conditions. The potential for significant economic rebalancing and reforms could be a game changer, but there are no clear signs of such reforms being implemented at the moment. The long-term outlook would also need to take into consideration the impact of global trade dynamics, which are uncertain, and the need for China to adapt to a changing economic landscape.

Fiscal policy outlook

We expect fiscal policy to play a larger role next year to support growth, but we expect the government to take a cautious approach, with a focus on maintaining financial stability and avoiding excessive debt accumulation. The government has implemented measures such as a local government debt swap and announced plans for bank recapitalization and we are expecting more details on support for consumers. However, there is a strategic intent to keep some fiscal tools in reserve, depending on how external factors, such as US tariffs, evolve.

Monetary policy outlook

The interest rate outlook for China is likely to be influenced by the need to support economic growth while maintaining financial stability. The government may resort to looser monetary policies, including a potential 10% to 15% depreciation of the renminbi, to mitigate the impact of external pressures such as

increased tariffs from the US. However, the extent of these measures will likely be carefully calibrated to avoid triggering financial instability.

Inflation expectations

Inflation in China is currently running very low, and this trend is expected to continue in the near term. It reflects weak consumer demand and pumped-up domestic production by government policies. Without addressing this unbalanced nature of the economy and the weak consumption, the trend is unlikely to reverse.

Emerging markets

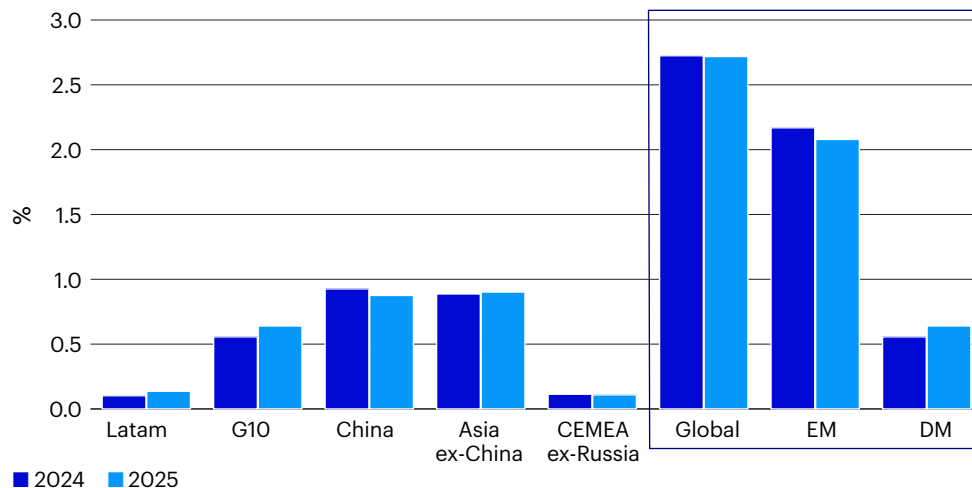
Key Summit takeaways

- **Global and EM growth:** Overall global growth has been better than expected in 2024, due mainly to US economic exceptionalism, while EM growth has been flat or slower.
- **Fiscal and monetary policy room:** There is limited room for policy action in EMs, particularly on the fiscal front, with potential for more action on the interest rate front. EMs face constraints vis-a-vis the Fed, which may scale back its own easing stance, and EMs' need for fiscal consolidation in the aftermath of the COVID crisis.
- **EM disinflation has likely bottomed:** Several disinflationary forces are now behind us, including energy and commodity price declines and supply chain normalization. But soft global demand should keep inflation at bay.
- **China's response to increased tariffs:** Previously, China allowed its currency to depreciate against the US dollar to mitigate the impact of tariffs. This strategy could influence other EMs, increasing volatility in their currencies, as they absorb the effects of trade uncertainties and tariffs.

Macro outlook: EM growth flat to slower

Global growth has been better than expected in 2024, due mainly to US economic exceptionalism. But growth in the emerging market (EM) world has been flat or a little slower in 2024. China's growth performance has been sporadic quarter by quarter. Our outlook is that global growth should remain relatively flat, EMs will likely slow somewhat and developed market (DM) economies should accelerate slightly, led by the US. We expect the global outlook to be held back slightly by China.

Figure 1: Global growth forecast: US trade policy and reaction could alter the outlook meaningfully



Source: Invesco estimates. Data as of Dec. 10, 2024.

Our 2025 global growth outlook maintains the US exceptionalism story, with EMs a bit weaker or flat. But the outlook is still a differentiated one, with some negative impacts coming mostly from China. There are many moving parts, as the Trump administration takes office, especially when it comes to tariffs, many of which will likely be focused on China, but other trading partners, including the European Union (EU), Canada and Mexico are also on the list. We do not expect a dramatic trade war as our baseline, but conditions could change, altering the global growth outlook meaningfully.

We would expect most differentiation in global growth performance to come through China and Asia ex-China where we most expect to see potential trade tensions translate into growth headwinds. In Latin America, we believe the growth story will be more nuanced. The exception is Argentina, which is staging a significant recovery, but we expect the rest of the region's growth to be flat or weaker. In 2018, Latin America benefited from trade diversion under the first round of Trump administration tariffs, but the impact of the new tariff regime remains uncertain. EMs' largest export market is the EU. A broader tariff regime that dampened already tepid EU growth would likely have broader negative implications for EM growth in general. Recognizing the uncertainty of the moment, we are expecting flat global growth, continued US exceptionalism and EM growth to be a little weaker or flat.

EM policy response

How can EMs respond in this environment? We argue that room for policy action is limited, especially on the fiscal front. There are few exceptions but for the most part, most EMs are on a fiscal consolidation path following the COVID-19 shock. This path could change, the scope would likely be limited and very selective. On the monetary policy front, there is significantly more room, given high real policy rates and we do expect further monetary easing. But central bank rate cuts will also likely be constrained. If the outlook for Fed rate cuts becomes less benign than current market pricing, EM central banks will likely also be constrained. We would hope that EMs would find a balanced way to ease in the face of potential shocks, but we believe there will be pressure on the fiscal side, even if that means slower fiscal consolidation and some fiscal deterioration.

Inflation

The disinflation story in EMs and globally is bottoming out, in our view. Several inflation shocks, to the energy sector, other commodities, and global supply chains, for example have dissipated. Given that we are forecasting softer global growth, we do not believe there is enough global demand pressure — barring a supply shock that may arise through tariffs — to push inflation significantly higher. A shift in US policy toward increased oil production under the new administration, a similar shift elsewhere, could help depress energy prices and feed further disinflation, but that is not our base case.

Impact of tariffs

A major question for EMs will be China's response to increased tariffs. In the previous round of Trump administration tariffs, China allowed its currency to absorb the bulk of the shock, but also reoriented its market more toward EMs.

This strategy may have its limits this time around. Several large EM countries have imposed tariffs of their own on Chinese goods and they may allow more currency depreciation to protect their own industrial bases. This question spans beyond Asia and could spill over to other exporting EMs, depending on the range of trade uncertainty and tariffs imposed.

In this environment of flat to weaker EM growth, and little room for policy responses without accepting further fiscal deterioration — which some countries may do — EM currencies may turn out to be the biggest shock absorber. This outcome could lead to increased volatility in EM currencies in 2025, as tariff-related announcements are digested in the marketplace.

Market outlook

EM sovereign hard currency debt

Our stance was underweight before the US election and that remains unchanged as potential policy changes remain uncertain. President-elect Trump appears to control most of the levers of policymaking, and he has some major emerging markets directly in his crosshairs, such as China and Mexico. Most other EMs would also likely suffer indirectly in a prolonged trade war. The technical picture in EM is equally difficult, with 7% returns year-to-date and 16% returns in the last 12 months.¹⁰ Combined with the prospects of a potential trade war, it is hard to expect new inflows into the asset class.

Trump has been consistent on tariffs throughout his public life, and he appears to view trade wins and losses through the lens of current account balances with individual countries. In EM, that means Mexico, the ASEAN countries, and China are directly impacted. Markets appear to be certain that Trump will attempt to address trade imbalances vis-à-vis the US, but what he does and when he does it is uncertain. Until there is more clarity, a discount in EM would seem to make

sense. The other major policy issue is immigration, which would likely impact countries with large populations living in the US and paying remittances.

On the geopolitical front, there could be some relief on the Russian-Ukraine front, with Trump pushing Ukraine to give up territory and NATO membership, or risk losing US support. In the Middle East, Trump faces more of a dilemma with the regional attitude toward Iran different than during his first term and at odds with some of his initial comments and appointments on Iran. The US-China relationship, already testy, will likely be made even worse by trade tensions and mutually exclusive positions on Taiwan. Finally, a wave of elections that peaked in 2024 is set to continue in 2025, with several major countries voting in national elections.

EM corporate hard currency debt

EM corporates have enjoyed healthy performance in 2024. The asset class has delivered a total return of 7.6% year-to-date, with high yield outperforming investment grade, and returns of 11.4% and 5.1%, respectively.¹¹ Fears that a Trump win would trigger a sell-off of the asset class have not materialized. Overall spreads tightened by 12 basis points after the election.¹² Valuations remain rich on an absolute and a relative basis, in our view — the spread pick-up over US investment grade and high yield is 23 and 51 basis points, respectively, which are not very compelling levels, in our view.¹³

The technical picture remains mixed. Gross issuance has been robust, but net issuance remains negative, providing support to the asset class. On the flip side, the asset class continues to experience outflows, which have been more pronounced following the US election.

Similar to EM sovereigns, we are assessing what new Trump administration policies could mean for EM corporates. We analyze the implications of these policies by sector, identifying potential winners and losers. We outline eight themes or policies below and their sector implications:

- i) **US dollar strength:** Good for EM exporters, challenging for importers and manufacturers.
- ii) **Higher US growth:** Positive for selected commodities.

10. Source: Bloomberg L.P. Data from Jan. 1, 2024 to Nov. 13, 2024 and Nov. 13, 2023 to Nov. 13, 2024. Based on JPM EM Bond Global Diversified Index Total Return.

- iii) **Higher US deficit:** Gold may benefit, long duration bonds may suffer.
- iv) **Curb on immigration:** Could present headwinds for consumer sector.
- v) **Tariffs:** Could impact companies operating in countries with high trade surplus versus the US.
- vi) **Revision of trade agreements:** Could challenge countries that have been positioning to capture the benefits of nearshoring.
- vii) **Energy policy:** Could pose challenges to lithium producers, as there could be less support for an energy transition. Higher US oil supply could put pressure on independent producers.
- viii) **Foreign policy:** Cease fire agreements in ongoing conflicts present upside potential for corporates in those countries.

EM local debt

Over the last 12 months, the performance of EM local rates and currencies has been closely linked to core US and European markets. However, we must now consider the geopolitical uncertainty stemming from the election of President Trump. With that in mind, we prefer to take most of our risk in markets closely tied to Europe or idiosyncratic stories like Turkey or Egypt. We like markets like Poland and the Czech Republic as duration plays and we believe they should outperform if the ECB delivers more monetary policy

easing than is currently priced. These are small open economies with attractive valuations relative to core Europe. We prefer to express our views in the five-year part of the curve. Separately, we continue to be bullish on the positive reform momentum in South Africa. We believe the global unity coalition between the African National Congress and the Democratic Alliance will provide upside growth potential for the country while improving the fiscal story. We believe that market participants are underpricing this positive momentum, and expect the long end of the yield curve to flatten from current levels.

On the currency front, we continue to see opportunities in Turkey and Egypt, as both markets tend to be uncorrelated to broader US dollar moves. Both economies are benefiting from solid economic reform policies after mistakes made in the past few years. While we do not expect significant nominal appreciation of either the Turkish lira or Egyptian pound, we believe both offer significant upside through the carry embedded in the forward market. We are cautious on the rest of the EM currency complex due to potential Trump administration tariffs and prefer to fund long positions through euros or Swiss francs, rather than US dollars. By removing the dollar leg, we believe the Sharpe ratios on these positions will look much better and offer upside over the short term. Once there is more clarity around the new administration's economic policies, we can begin to identify the winners and losers of potential trade policy changes.

11. Source: J.P. Morgan. Data from Jan. 1, 2024 to Nov. 15, 2024. Based on J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified, J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified – High Grade, J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified – High Yield.

12. Source: See footnote 6.

13. Source: See footnote 6. J.P. Morgan US Liquid Index. J.P. Morgan High-Yield Bond Index.

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Interest rate outlook

US: Overweight. We believe US interest rates will decline through year-end and the beginning of 2025. Recent strength in US growth data has led the market to price fewer interest rate cuts and a higher terminal rate. We believe the market has mispriced the risk of near-term expansionary fiscal policy; the effects of expanded fiscal policy will likely not be felt until later in 2025. Initial policy changes will likely focus on trade and immigration and these policies should help drive interest rates lower in the short term. The longer-term picture will likely remain unclear until the market receives more clarity on the direction of fiscal policy.

Europe: Neutral. Core European bond yields have fallen sharply over the past month, and with the market now pricing terminal rates close to 1.5%, we have moved to a more neutral stance.¹⁴ We expect interest rates to fall next year as inflationary pressures in the region decline and the economy faces headwinds from weaker global demand and potential trade tariffs from the new US administration, but the scope for a further decline in yields is limited, in our view. ECB participants have pointed to the elevated level of wages and service inflation as obstacles for rapid rate cuts, and those pressures are likely to persist in the coming months.

China: Neutral. We expect the Chinese onshore interest rate environment to remain accommodative in the near and medium term. We are closely watching macro targets for 2025 and the Ministry of Finance's long-term bond issuance. Potential tariffs to be imposed by US President Trump in 2025 and their impact on the exchange rate will likely complicate moves in front-end yields. In addition, easing measures by the central bank, given already low rates in the onshore market, will likely drive potential asset reallocation by local investors. We expect more proactive guidance from the central bank through its open market operations and window guidance for the long-term segment of the bond market.

Japan: Underweight. Recent inflation, wage and growth data have all pointed toward a likely Bank of Japan (BoJ) rate hike at the December meeting. Inflation data have shown a sequential reacceleration in both the national and Tokyo series since the summer, pointing to underlying inflation of around 2%. Significantly, services prices are now contributing to the rise in overall prices,

suggesting wage growth is having an increasing influence on price setting. Early indications from major trade unions point to a record high wage demand in the annual negotiations due in Spring 2025, and near-term wage data have shown gradual upward pressure on underlying base pay. Importantly, Japanese growth has rebounded in the second and third quarters, driven by rising consumption, supporting the BoJ's assessment that the economy will recover in 2025. Although, this has partially reversed over the last month, due in part to expectations that the BoJ will hike, the yen's depreciation since the summer has also added upward pressure on prices. The resilience of the US economy appears to point to a higher Fed terminal rate than investors had anticipated in the summer, which could put further downward pressure on the yen if the BoJ fails to tighten. In addition to tightening monetary policy, fiscal policy is also likely to ease relative to the pre-Japanese election base line, putting further upward pressure on Japanese government bond yields.

UK: Overweight. The gilt market has retraced most of the post-October budget sell-off, however, data still appear consistent with growth undershooting the Bank of England's (BoE) expectations and inflation roughly consistent with its forecasts. Given that pricing is now close to the levels used to calculate the November BoE forecasts, there is still some modest downside to yields, in our view, particularly in the front end. Long-end yields may struggle to rally due to the threat of higher supply in early 2025 but they could be supported in the short term by the seasonal pause in supply and year-end LDI-related demand. Looking cross-market, UK rates provide good value relative to euro rates, in our view, with the market pricing spreads at close to record wide almost across the whole yield curve. Unless UK inflation meaningfully diverges from eurozone inflation in 2025, this appears to embed a substantial risk premium, leaving attractive risk-reward in cross market over-weights.

Australia: Overweight. Domestic growth data have been mixed. Survey data have pointed to a pick-up in activity since the summer, but hard data still point to anaemic private sector demand, particularly on a per capita basis, and slowing employment growth. Government subsidy programs have

14. Source: Bloomberg L.P. Data as of Dec. 6, 2024.

made recent inflation data difficult to interpret, but the overall picture appears consistent with disinflation toward the Reserve Bank of Australia (RBA) target for 2025. Slowing wage data have reinforced the impression of limited upside risks to prices, despite the still resilient labor market. Front-end RBA pricing now appears fair, in our view, but the yield curve is relatively steep, leaving long-term forwards elevated on an absolute and relative basis versus developed market peers.

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Currency outlook

USD: Overweight. The outcome of the US election and the incoming Trump administration's determination to accelerate growth has been a key driver of recent dollar strength. With the US economy continuing to eclipse most other regions, the likely path for the dollar is higher in the short term. That said, we will need to see more detail on the new administration's policies on trade, taxes and immigration before we can make an accurate assessment of their longer-term impact on the US economy and ultimately, the dollar.

EUR: Negative. The euro has weakened significantly in recent months, as the region's economy has faltered, and political uncertainty in France and Germany — the driving forces behind European integration and stability — has unnerved investors. With the ECB lowering rates faster than its peers, the pressure on the euro is likely to continue, especially if the economic stagnation that has taken hold in recent months continues.

RMB: Overweight. We remain overweight the renminbi, as we expect it to be resilient relative to peers amid market volatility, despite moves in the USD/RMB exchange rate. The market has been showing concerns about potential trade tariffs under a new US administration. We nevertheless expect the renminbi to deliver relatively strong performance against peers, partly helped by stimulus measures, higher export receipt conversion to renminbi, as seen since September, and potentially higher inflows to onshore capital markets. We acknowledge that some international investors remain skeptical about potential policy effectiveness and current renminbi positions are relatively light.

JPY: Overweight. We believe the yen can continue to make gains relative to European and Asian currencies, even if it remains rangebound relative to the US dollar. The yen looks particularly likely to appreciate against the euro, as the policy divergence between the

BoJ and ECB is becoming more marked, with the BoJ likely to hike at the same time the ECB is accelerating its easing cycle. Forwards now price a negligible interest rate differential, reducing the negative carry of shorting euro or Swiss franc versus the yen. Lower European yields and French political turmoil might also incentivize the selling of European assets by Japanese investors. In addition, the threat of tariffs from the US appears greater for the EU than Japan. In fact, Japan might be willing to appreciate the yen as a way of heading off the threat of US protectionism.

GBP: Underweight. The BoE's gradual cutting cycle has left the British pound as the highest yielding major currency. However, recent data point to downside growth risks, particularly relative to the US, which are likely to weigh on UK short-term rates on an absolute and relative basis, undermining the pound's high yield status. Furthermore, if recent fiscal easing fails to boost growth while stoking inflation, it will likely raise further questions about the UK's policy credibility, potentially expanding risk premia in the pound and UK assets more generally.

AUD: Neutral. The Australian dollar is unlikely to outperform the US dollar in the near term, as resilient US growth and inflation appear likely to cause the Fed to end its cutting cycle at around a 4% terminal rate in 2025. At the same time, the RBA is likely to start cutting below 4% in the first half of 2025. However, relative to many Asian and European currencies, the Australian dollar might outperform, as its smaller trade exposure to the US limits the threat from tariffs, and Australia's strong fiscal fundamentals give it scope to use fiscal policy to support growth to a greater degree than elsewhere. It is also possible that greater Chinese stimulus aimed at offsetting the impact of US tariffs might lead to higher commodity prices, supporting Australia's terms of trade. The Australian dollar might lag the US dollar, but it could appreciate versus the euro and renminbi.

Panelists



Bixby Stewart
Senior Analyst



Mike Magee
Senior Portfolio Manager



David Lyle
Co-Head of Structured
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Norbert Ling
Portfolio Manager

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

Global credit strategy

Credit trade ideas from the November IFI Summit

At the November 19 – 20 Summit, a panel of Invesco Fixed Income investors shared their views on credit markets and where they see opportunities across sectors. We include some highlights of their conversation here, moderated by Senior Analyst, Bixby Stewart.

Q: Mike, could you provide your thoughts around the state of municipal fundamentals and technicals this year?

Mike: This year, we have seen twice as many rating upgrades as downgrades from Moody's, so, overall, munis are in strong fundamental shape. We do see some cracks in certain sectors of the high yield space, for example, in the higher education space. We are particularly concerned about higher education institutions that have 3000 students or fewer. Given the demographics of the US, we expect a smaller number of high school graduates over the next few years. So, we will need to carefully dig into these credits on a case by case basis, which is where we rely on our active fundamental strategy, especially as new issues come to market with interesting spreads.

In terms of market technicals, 2024 has been a strong year for muni flows, with around USD40 billion going into muni products.¹⁵ Most of the flows have been into muni mutual funds, versus exchange traded funds (ETFs), and they have gone toward longer duration funds. Altogether, we have seen 22 consecutive weeks of in-flows.¹⁶ On the supply side, the new issue calendar has also been heavy, with new issuance up by 37% versus last year.¹⁷ The good news is that most of the planned 2024 issuance was brought forward ahead of the US election, so we think munis should perform well in the near term. We expect continued strong issuance into 2025, matching this year's level, or exceeding it somewhat. However, if we get additional Fed rate cuts, we think demand from retail investors could be strong, as they seek yield, especially at the longer end of the duration spectrum.

Q: Agency mortgage-backed securities (MBS) have stood out as one of the cheaper asset classes for quite a while. Do you still see the asset class as cheap?

Dave: We do still see a lot of value in agency MBS. Agency spreads versus corporates are among the cheapest 1% of observations over the past 10 years, so they look very attractive at current levels.¹⁸

We generally like the up-in-coupon segment within agency MBS, specifically, 5% to 6% coupons that stand to gain the most from a decline in interest rate volatility. Additionally, we like the 3.0% coupon versus the 1.5% and 2.0% coupons. We like some specified agency pools versus up-in-coupon to-be-announced (TBA) securities because the specified pools should benefit in a moderate interest rate rally, which is our base case expectation. However, the risk is that, if we do see rates sell off from here, the prepayment protection in these specified pools loses value.

Q: As we think about the credit side of securitized, where do you expect out-performance and where are you more cautious heading into 2025?

Dave: Within residential mortgage credit, our favorite part of the sub-sector is prime jumbo loans, and to a lesser extent non-qualified mortgages (non-QM). Within prime jumbo, we like the top of the capital structure, i.e., AAA's. Borrowers in this product are pristine with relatively low loan-to-value ratios on the collateral. The credit performance of the underlying borrowers is very strong, and we still get a nice carry for very high-quality bonds. Non-QM offers more protection against extension risk than prime jumbo pass throughs and agency MBS. Within asset-backed securities (ABS), we like prime auto loans and private student loans. They also offer pristine borrowers, low loan-to-value ratios, low borrower defaults and are less exposed to used car prices. The product that is more at risk is subprime auto securitizations, which have lower quality borrowers. On the student loan side, we see attractive valuations, though they offer less liquidity because it is a smaller sector. In commercial real estate, we like double-A rated conduit commercial mortgage-backed securities (CMBS), as well as certain senior and middle credit quality single asset, single borrower deals. The attractive thing about single-asset, single-borrower deals is that they offer the ability to target specific property types and we can be selective about exposures to different commercial property sectors, which is important in this environment. Last, within CMBS hyperscale data centers, which is a newer asset class, we see strong demand from investors since it provides exposure to the AI theme and high-quality tenants, such as highly rated tech companies.

15. Source: J.P. Morgan, LSEG Lipper. Data as of Dec. 2, 2024.

16. Source: J.P. Morgan. Data as of Nov. 27, 2024.

17. Source: J.P. Morgan. Data as of Dec. 3, 2024.

18. Source: Invesco, JPM DataQuery. Data as of Nov. 15, 2024.

Panelists



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Senior Analyst

Overall, we believe there is still abundant cheapness in securitized markets within a broader fixed income market in which valuations are generally tight.

Q: Norbert, could you discuss income opportunities in the Asia-Pacific region?

Norbert: Given the recent spread compression in Asia-Pacific credit markets, our focus is now on income generation. We favor credits with attractive carry that we can hold through the market cycle. Currently, we like owning three-year and four-year paper, especially in some of the double B names, and the high yield space in general. Double Bs are yielding in the 6%–7% range while single B and triple C names currently yield around 9%–10%.¹⁹ One factor that is unique in the Asia space is that many Asian issuers enjoy financing support from banks and local currency investors. As a dollar investor, this makes us feel more comfortable because there are alternative sources of funding that firms can tap.

Another interesting feature of the Asia credit space is its low default rate. If we strip out China, where much of the default activity has been centered in the real estate sector, the Asia high yield default rate is only about 0.4%, which is very low compared to other major markets.²⁰ Looking to 2025, we expect an overall default rate of around 3%, but we expect to see most of the defaults in the Chinese real estate space, and in the names that have undergone restructuring in the last few years.

Q: Rahim, how can investors implement the AI thematic trade in high yield?

Rahim: I would argue that a theme that stands out when thinking about investing in AI is electrification. To understand this theme, it helps to understand where we are in the AI build-out cycle. We believe we are squarely in the second phase, which is focused on infrastructure development. The subsequent phases will be focused on AI applications, then the AI adopters. But in this phase, the big tech players, the so-called hyperscalers, have spent hundreds of billions of dollars to build out AI data centers.

What will be the impact on power generation? AI needs three components: data, computation and power — a lot of power. The growth curve of power demand before the COVID pandemic had been flat for a decade. Now we are seeing a significant spike. Conservative estimates suggest that power generation will need to at least double by 2030 to fulfil this demand. A full-scale rollout

of AI could send the needed amount to potentially three to five times current levels. So, there are very strong tailwinds behind power generation, and half of this demand is from data centers alone. Another factor that might contribute to power demand, especially under the Trump administration, is a potential reshoring drive, which might lead to a manufacturing renaissance stateside.

Q: Todd, could you continue the AI theme and discuss the utility hybrid space and how you are positioning in this asset class?

Todd: Sure. The story around energy demand that Rahim laid out in the high yield space plays out well in the investment grade space too. To express the AI theme in investment grade, we focus on utilities. There are several utility names, and they have abundant capital expenditure needs. There has been a tremendous amount of issuance in the utility space this year, including unsecured bonds, and we are now seeing utility companies round out their capital structures by issuing hybrid bonds. Hybrid bonds combine characteristics of bonds and equities, including some equity treatment by the rating agencies. We have seen these investment grade-rated bonds issued with yields of 6.5% to 7%, which is relatively attractive, in our view.²¹ While we expect more issuance, we would expect these bonds to perform well once the issuance headwind is out of the way. In an environment in which interest rates stabilize or even fall, issuance slows, and the demand for energy keeps rising, we think these high yield-type yields on investment grade bonds will look attractive.

Q: Finally, Jessica, could you discuss the technicals and fundamentals in the European high yield market, and how you are positioning in some of the higher beta names?

Jessica: The technical picture for European high yield is very strong. We have seen large inflows into the asset class and spreads are near historical tightness. There is a large dispersion in terms of quality and yield within the rating buckets, so credit selection is very important. Last year's limited new issuance was supportive, and the European high yield sector has been shrinking due mainly to rising stars.

Fundamentals are still relatively sound, but there are cracks in some sectors and some sectors are weaker than others. We also think we have not seen the full effect of the higher interest rate environment,

19. Source: Bloomberg L.P. Data as of Nov. 20, 2024.

20. Source: JP Morgan Research, Default Monitor. Data as of Oct. 22, 2024.

21. Source: Bloomberg L.P. Data as of Dec. 2, 2024.

but will, as companies seek to refinance in the coming years. We have seen the triple C bucket expand, which could mean that 2025 default rates may increase modestly, depending on how these situations play out. So, what does this mean for the investment narrative when spreads are tight and yields are still relatively OK?

To us, it means we are more focused on carry and income rather than spread compression. We pick names that we are comfortable with in a potentially weaker macro environment, and we are selective regarding new issues. That said, there are names in some of the weaker sectors, such as autos and chemicals, where we believe the risk-reward is attractive.

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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 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 risk of the issuer and meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Non-investment grade bonds, also called high yield bonds or junk bonds, pay higher yields but also carry more risk and a lower credit rating than an investment grade bond.

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.

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