Global Fixed Income Strategy

Monthly report

Invesco Fixed Income

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Turgut Kisinbay
Chief US Economist

Mark McDonnell
Macro Analyst

Michael Siviter
Senior Portfolio Manager

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Global macro strategy

The US and Europe are diverging - what does it mean for macro and markets?

The US has pulled ahead of Europe in terms of economic growth. Europe has recovered only tepidly in the aftermath of the COVID crisis, while the US has expanded steadily. On the other hand, inflation has fallen faster in Europe; European inflation was initially more stubborn but is now almost back to target. Even the UK, which until recently was considered a "stagflation" outlier, will likely see headline inflation fall below US inflation for the rest of 2024. This macro divergence has implications for monetary policy, interest rates and currencies, as we discuss below.

What is driving US growth?

Three key factors have fueled the US economic expansion in recent quarters: gains in labor productivity, increased labor market participation and a surge in immigration. The pick-up in productivity growth has prompted debate over its origins. In particular, there is much hype about the positive impact of artificial intelligence (AI). However, recent strong productivity growth compares to weak growth over the past several years and could represent a reversion to historical trends. Though we are optimistic about improvements that AI can bring, historical experience suggests that it takes time for new technological developments to improve productivity. We believe cyclical factors are more likely driving US productivity growth; as economic growth improves, companies typically optimize their operations to derive more output from their workers and capital.

The growth trajectory of the US economy has been further bolstered by increased labor market participation and immigration levels. There has been an added boost from flexible work arrangements, including the widening adoption of remote and hybrid work. The post-pandemic period also seems to have led to larger flows within the labor market leading to a reallocation of workers across sectors and a redistribution of skills to new and potentially more labor-efficient roles.

Due to these drivers, US potential growth may now be higher than we have observed over the past ten years. Recent improvements in productivity and labor supply indicate that potential growth could be temporarily in the 2-2.5% range, above the US Federal Reserve's (Fed) longer-term estimates of just under 2%. This would mean that the US could potentially sustain growth around these levels without triggering an increase in inflation.

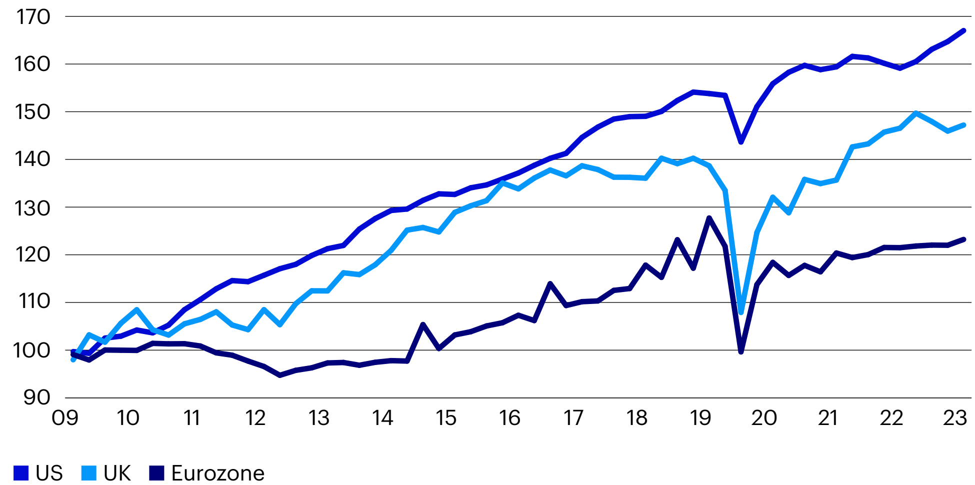
Why has European growth lagged?

Unlike its transatlantic peer, Europe has languished in the slow lane when it comes to productivity growth, and it remains unclear whether this weakness is cyclical or structural. The optimist would argue that it is cyclical and caused by a series of supply shocks. European companies responded to weak growth during the pandemic by hoarding labor and cutting back on hours. As shocks fade and growth headwinds turn into tailwinds, we believe firms will better utilize their workforces and productivity should recover.

Pessimists would argue that something structural and more permanent is at work. They might point to the weak recovery in capital expenditures following the global financial crisis. They may also decry Europe's rigid labor markets that can stifle innovation and prevent the market from reallocating resources to new and exciting businesses. These forces would potentially keep productivity - and growth - in check.

Figure 1: Gross fixed capital formation by region, rebased to 2009

GFCF, Constant Prices, Rebased 100 = 2009

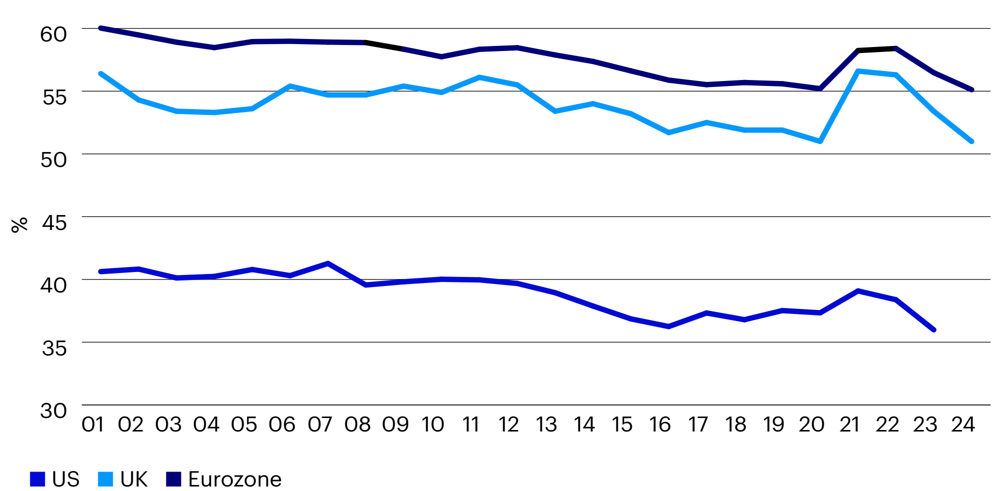


Source: ONS, Eurostat, BEA. Data from Jan. 1, 2009 to Oct. 1, 2023.

Europe is beating the US on inflation

One area where Europe is not languishing is the speed of disinflation. After initially lagging the US in the inflation fight, eurozone inflation is now close to target. Even the UK – which faced elevated inflation until recently - should see headline inflation fall below US consumer price (CPI) inflation for the rest of 2024. Some of this success boils down to methodology; unlike the US, neither the eurozone nor the UK includes "owner occupied housing" as a consumption good in its consumer price indices. Rental inflation, for example, is only 6% of eurozone CPI but makes up nearly 36% of US CPI.[1] Goods inflation – which is falling rapidly – is nearly 55% of eurozone CPI but represents only 36% of US CPI.[2] The European Central Bank (ECB) and the Bank of England (BoE) have said they would like to switch to inflation indicies that incorporate owner occupied housing costs in the future. Until that time, comparing European and American CPIs has an element of comparing apples to oranges.

Figure 2: Weight of goods in CPI basket by region



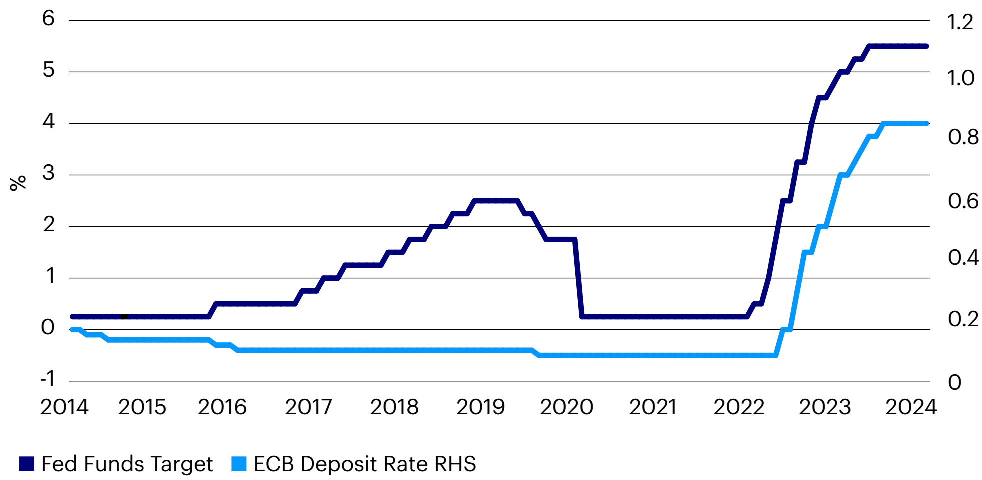
Source: ONS, Eurostat, BLS. Data from Jan. 1, 2001 to Jan. 1, 2024.

1. Source: Eurostat and BLS. Data as of Dec. 31, 2023.
2. Source: Eurostat and BLS. Data as of Dec. 31, 2023.

Implications for US, European and UK rates

Figure 3 shows the target federal funds rate and ECB deposit rate over the last 10 years.

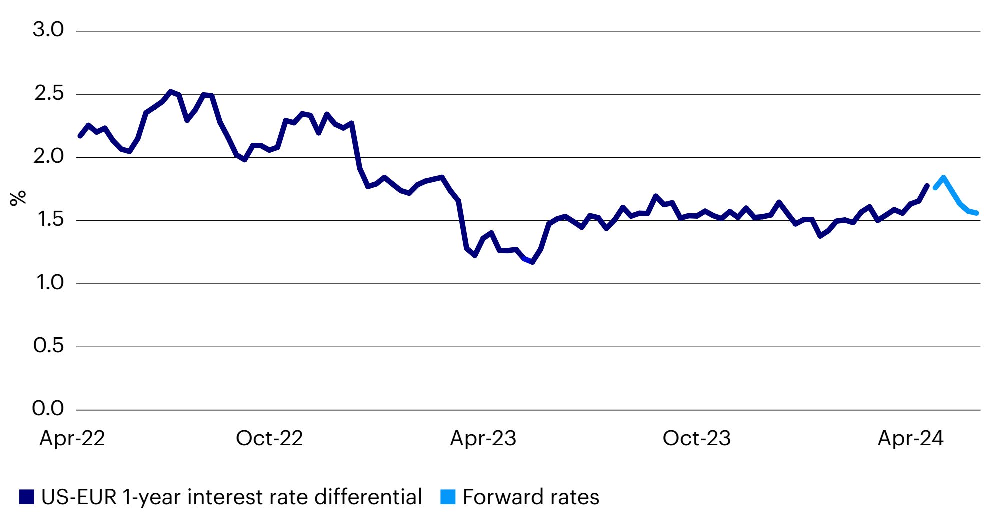
Figure 3: Relative central bank interest rates



Source: Bloomberg L.P. Data from April 30, 2014 to March 29, 2024.

Given diverging macro outcomes, markets have been increasingly pricing a divergence between Fed and ECB interest rate policies. Figure 4 shows the difference between the 1-year US dollar swap rate and the euro overnight index swap (OIS) rate, where the light blue line represents the forward pricing for the next five years. The US-Europe interest rate differential has widened by about 30 basis points year-to-date, as Fed rate cuts have been priced out and market pricing of ECB policy has remained largely unchanged. However, forward markets are not pricing much interest rate divergence in the future, with much of the divergence reverting over the next five years. In this context, risk appears to be skewed toward a widening of short-term interest rate differentials to around the levels seen during the pre-pandemic 2018-2019 cycle, if eurozone inflation continues to moderate relative to US inflation.

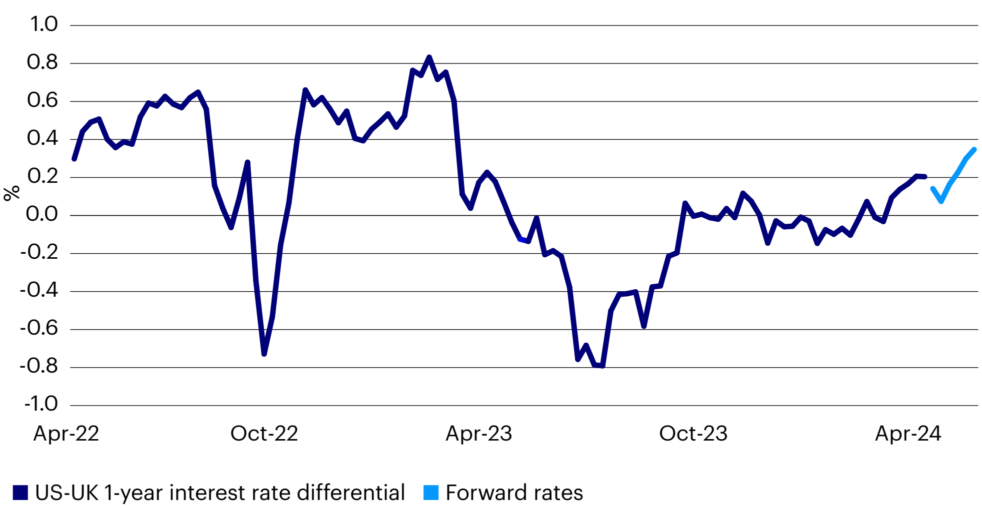
Figure 4: US-Europe 1-year interest rate differential



Source: Bloomberg L.P. Data from April 22, 2022 to April 12, 2024. Forward rates for five years thereafter.

In the UK, the market is pricing the BoE policy cycle to be closer to the Fed's than the ECB's, even though eurozone growth dynamics are more similar to the UK's.[3] This is partly justified by the higher starting point of UK inflation. But to the extent that UK inflation reflects past supply shocks, as in the eurozone, it is possible that UK inflation will converge toward lower eurozone levels, justifying interest rates below US rates. Monitoring the UK's labor supply trends will be especially important in predicting the extent of inflation convergence. Figure 5 shows the differential between the US and UK 1-year overnight index swap (OIS) rates. The light blue line shows forward pricing for the next five years.

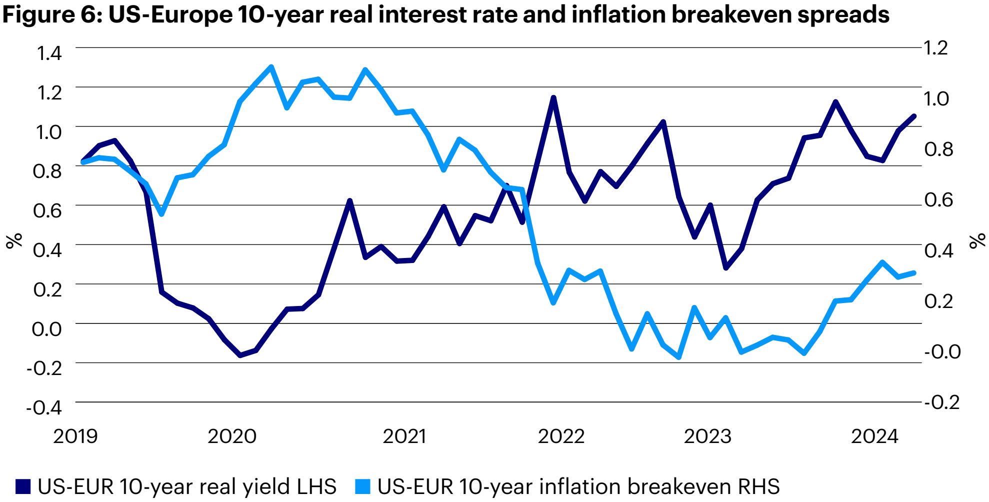
Figure 5: US-UK 1-year interest rate differential



Source: Bloomberg L.P. Data from April 22, 2022 to April 12, 2024. Forward rates for five years thereafter.

Figure 6 shows the differences in US-European real yields and inflation expectations. Markets are currently pricing a significant divergence between US and European real interest rates (US-EUR 10-year real yield) but inflation breakevens have priced a very similar path for US and European inflation (US-EUR 10-year inflation breakeven spread).[4] In our view, there is room for the inflation breakeven differential to widen, as markets potentially price US inflation higher relative to European inflation. Much of the recent widening in the overall US-eurozone interest rate differential has been driven by real yields. This makes sense since higher US productivity has shifted up US trend growth relative to eurozone trend growth. However, higher US growth might suggest that US inflation breakevens should be wider than eurozone equivalents, especially if US owner occupied housing inflation remains sticky, since it does not appear in eurozone inflation indices.

Figure 6: US-Europe 10-year real interest rate and inflation breakeven spreads



Source: Bloomberg L.P. Data from Oct. 31, 2019 to March 29, 2024. The data in Figure 6 are derived from the nominal OIS swap market (secured overnight financing rate (SOFR) in US dollars, euro short-term rate (ESTR) in euros) versus the inflation swap market (CPI in the US, HICP ex-tobacco in Europe).

3. Forward-looking statements are not a guarantee of future results. They involve risks, uncertainties and assumptions. There can be no assurance that actual results will not differ materially from expectations.
4. Inflation breakevens are the difference in the yield of nominal bonds versus inflation linked bonds. They are essentially the market pricing of average inflation for the period.

Implications for currencies

Widening interest rate differentials in favor of the US, stronger relative US growth, higher commodity prices and rising geopolitical risks heading into the US election support the US dollar versus the euro and British pound, in our view. It is hard to see the euro and pound outperforming the US dollar unless the Fed accommodates higher inflation and cuts rates more than expected or US growth slows more than expected while European growth accelerates. Both scenarios appear unlikely in the near term. In fact, Europe's greater proximity to geopolitical flash points in the Middle East and Ukraine and the potential negative consequences of a Trump presidency for US-European cooperation within NATO add downside tail risks to the euro and pound, in our view.

Rob Waldner
Head of IFI Strategy and Macro Research

Gareth Isaac
Head of Multi-Sector Portfolio Management

Yi Hu
Head of Asia Credit Research

Michael Siviter
Senior Portfolio Manager

Interest rate outlook

US: Neutral. Recent inflation and growth figures have surpassed market expectations, leading to an upward adjustment in US Treasury yields. While we see these yields as offering favorable returns over cash over the long term, a cautious approach to increasing long US interest rate exposure could prove beneficial. The market will likely remain volatile with potentially asymmetric upside yield risk until more stable inflation data emerge. There is still uncertainty regarding the timing of the next rate-cutting cycle, and we have adjusted our forecast; we expect the Fed to begin cuts in July rather than May.

Europe: Overweight. We remain positive on European rates and see the current level of yields as an attractive investment opportunity, especially at the front end of the yield curve. Despite the reserved commentary of ECB members, we expect them to cut interest rates more sharply than the market anticipates as inflationary pressures recede further over the coming months. While the region's economy has begun to show tentative signs of recovery following a dismal 2023, we see this as a cyclical bounce rather than a structural move and expect it to have limited impact on the path to lower inflation.

China: Neutral. We have been expecting Chinese rates to be "lower-for longer", however, given the limited magnitude of moves by Chinese onshore bonds compared to government bond yields in other parts of the world, we maintain our neutral stance. Amid a series of interest rate cuts in various formats in recent months and market expectations of more issuance of ultra-long bonds by government and policy banks, we think monetary policy will continue to maintain sufficient liquidity to support large sovereign and quasi-sovereign bond issuance. Despite relatively crowded positioning in the China onshore rates market, Chinese banks are likely to continue investing in the bond market, which should provide support to market performance.

Japan: Underweight. Although recent Japanese inflation data have been softer than market and Bank of Japan (BoJ) expectations, growth appeared to pick up in Q1, wages are accelerating and yen weakness should boost imported inflation, limiting the downside for Japanese government bond (JGB) yields, in our view. The smooth exit from Yield Curve Control policy in March might incentivise the BoJ to consider further reducing the pace of JGB purchases in the sub 20-year sector, particularly as issuance will likely be reduced in future. The BoJ's guidance regarding the future pace of JGB purchases at its April meeting will be crucial to watch. The risk remains of a further reduction in the BoJ's purchases, which should support yields.

UK: Overweight. UK interest rates are up 20-25 basis points across the yield curve over the last month, leaving the market pricing just 40 basis points of rate cuts by the BoE in 2024 and a total of 160 basis points of cuts to a terminal rate of 3.6%.[5] Although part of this selloff can be explained by higher than expected core inflation and wage growth in March, and signs of a rebound in Q1 GDP, the overall macro outlook remains one of below-trend growth and decelerating inflation, with signs that employment is decelerating. The recent data therefore might delay rate cuts but it does not preclude them, in our view. BoE policymakers will likely be alert to signs that disinflation is stalling, however, base effects should almost guarantee a relatively meaningful decline in year-over-year inflation in April. Furthermore, it is worth noting that the BoE's forecasts in February were conditioned on a path of interest rates around 70 basis points below current pricing. Economic data have not diverged meaningfully from BoE forecasts, consequently it seems unlikely that policymakers will want to exacerbate the recent interest rate repricing. In fact, Ben Bernanke's recent review of BoE forecasts might suggest an avenue for guiding market expectations via the introduction of scenarios. It is likely these will probably plot a path below current market expectations for interest rates.

Australia: Overweight. Australian government bond yields are 20 basis points higher over the last month, outperforming US Treasuries but underperforming German bunds.[6] Current valuations appear moderately attractive, with 10-year yields only modestly below the Reserve Bank of Australia's (RBA) policy rate. Weak growth and decelerating inflation should result in interest rate cuts later this year, possibly as soon as August, which should lead to a decline in yields from current levels. However, the scope for US Treasuries to outperform on a cross market basis is perhaps limited, given the convergence of RBA and Fed pricing. A source of support in future, which contrasts dramatically with the US situation, is the potential for lower supply to support Australian government bonds.

5. Source: Bloomberg L.P. Data as of April 19, 2024.
6. Source: Bloomberg L.P. Data as of April 19, 2024.

Rob Waldner
Head of IFI Strategy and Macro Research

Gareth Isaac
Head of Multi-Sector Portfolio Management

Yi Hu
Head of Asia Credit Research

Michael Siviter
Senior Portfolio Manager

Currency outlook

USD: Neutral. The recent strength in the US dollar is understandable given the slew of positive US growth data in recent months. While inflation has fallen, it has lagged market expectations and the scale of rate cuts priced for 2024 has been scaled back, providing a further tailwind to the greenback. That said, we expected the path of disinflation to be "bumpy" and we view current market pricing as a potential investment opportunity. We expect growth to slow in the second half of the year and inflation to resume its downward path, allowing the Fed to lower rates and potentially halt the advance of the dollar.

EUR: Underweight. We remain underweight the euro in expectation that the ECB will begin to lower interest rates in the summer as inflation in the region falls toward the central bank's 2% target. Although economic data in the region have begun to show signs of improvement after a weak 2023, falling inflation will likely drive the ECB toward reducing rates. With the US economy gathering pace and the market scaling back expectations of Fed rate hikes, the euro is likely to struggle to make headway.

RMB: Neutral. We expect the continued interest rate differential between the US and China to keep some investors and exporters interested in the US dollar versus the renminbi and we recognize that the April-May period typically sees higher demand for US dollars from local companies to pay dividends. We remain neutral on the renminbi considering its relative strength against other non-US dollar currencies and potential upcoming pressures due to seasonality.

JPY: Neutral. The yen has depreciated versus the US dollar over the last month, hitting its weakest level since 1990. The pace of depreciation and level of the exchange rate is now leading to increased verbal intervention from Japanese government officials. The threat of currency intervention is increasingly real if the current trend continues. However, while currency intervention would likely result in a knee-jerk short squeeze, it would likely not result in sustained yen appreciation, in our view. For a more meaningful change in the yen's trend, nominal and real interest rate differentials would likely need to shrink faster than implied by forwards, which would likely require a faster deceleration in growth and inflation than expected, together with a resulting decline in risk appetite. Current macro data, particularly in the US, have pointed to a faster pace of growth and inflation than forecast, supporting interest rate differentials, and disincentivising long yen positions, due to the punitive negative carry. It is possible that the start of the ECB cutting cycle in the summer will lead to downside for the euro-yen exchange rate, but the somewhat better eurozone growth outlook might limit the downside for the cross. It is worth noting that, while the macro backdrop isn't particularly friendly for yen longs, valuations relative to interest rate differentials are cheap, in our view, suggesting limited downside for the yen, unless US and European interest rates rise substantially or capital outflows from Japan accelerate.

GBP: Underweight. The British pound has depreciated versus the US dollar over the past month but has remained little changed against the euro. Buoyant risk sentiment, high carry and a better UK growth outlook have contributed to the pound's resilience, particularly against the euro and yen. However, looking forward, it seems likely that the BoE will cut rates in the second half of the year, with the risk skewed toward a convergence of UK and eurozone rates, given the soft growth outlook, and a divergence from the US. This will likely undermine the pound's high yielder status, likely leading to further losses versus the US dollar and potentially some depreciation against the euro and yen, particularly if risk sentiment starts to sour.

AUD: Neutral. Australian dollar valuations relative to interest rate differentials, the terms of trade and external balances look relatively attractive, in our view. However, negative carry versus the US dollar and continued concern about the Chinese growth outlook are potential headwinds for Australian dollar appreciation. The weakness of the Australian dollar versus the euro and pound is harder to explain and could reverse once the ECB starts cutting and/or if commodity prices continue to rebound.

Wim Vandenhoeck
Senior Portfolio Manager

Claudia Castro
Portfolio Manager

Gerald Evelyn
Senior Client 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

A new green market grows: Climate adaptation bonds

Climate change impacts societies in many ways - it disrupts food security, damages infrastructure and destroys coastal zones. Sea level rise, widespread wildfires and supply chain disruptions induced by more frequent and severe weather events are only a few examples of climate-related risks. As a result, climate adaptation has become an important investment theme.

Climate adaptation refers to actions taken by governments, non-governmental organizations and companies to adapt to the current and future impact of climate risks. The goal of climate adaptation is to render communities and ecosystems more resilient to the detrimental effects of climate impacts. Climate transition is a related concept that refers to the steps that organizations and governments take to reduce emissions and move toward a low-carbon economy. By investing in resilience today, governments and companies can mitigate future climate-related liabilities and costs, including direct ones like physical damage to assets, and indirect ones, like higher insurance costs.

Financing needs are large

According to advisory organization, Climate Policy Initiative (CPI), USD4.3 trillion in annual investment is needed by 2030 to avoid the worst impacts of climate change.[7] The International Monetary Fund estimates that developing economies alone will require up to USD300 billion a year by 2030 to adapt their agricultural sectors, infrastructure, water supplies and other parts of their economies to offset the physical effects of climate impacts.[8] But developing countries often lack the financial resources and institutional capacity to put adaptation programs in place.

Making an impact through climate adaptation

Recent funding for developing countries' climate adaptation efforts has largely been through the issuance of green, social and sustainability (GSS) bonds. Climate adaptation efforts are as diverse as climate's effects on societies. They include constructing sea walls to safeguard assets from flooding, developing early warning systems for weather events and developing drought-resistant crops. Although the market for GSS bonds is still in its early stages, we believe there is room for growth.

Proceeds from these bonds are used to implement environmental or social projects and help sovereign, corporate and financial institutions achieve their sustainable development goals.

Recent developments in the climate adaptation market

Several recent developments underscore the evolution of the climate adaptation market and its prospects for further expansion.

- Seychelles, Belize and Barbados are among issuers that have used innovative GSS bond approaches in "debt-for-nature" swaps. In a debt-for-nature swap, a portion of a country's foreign debt is cancelled in exchange for investing in, in this instance, marine conservation.
- In 2020, Egypt became the first country in the Middle East and North Africa region to issue a sovereign green bond. Egypt sold USD750 million in green bonds to invest in areas like clean transportation, sustainable water and renewable energy.
- In the Maldives, a USD250 million "green adaptation bond" is being used to help cities adapt to climate risks, with some projects employing innovative new approaches. Examples include funding small-scale water and sanitation solutions specifically developed for populations disproportionately impacted by climate risks, such as women and the poor.
- In 2022, the IMF established the Resilience and Sustainability Trust, its first ever long-term affordable financing facility, to support vulnerable countries tackling the challenges of climate disasters.
- In May 2023, the Asian Infrastructure Development Bank launched its first Climate Adaptation Bond. Investment sectors will include water, urban development, transportation and energy.[9]

The investment industry can mobilize climate adaptation finance

So far, the public sector has played the lead role in financing climate adaptation projects, mainly through multilateral development banks and development finance institutions. However, the Global

7. Source: Global Landscape of Climate Finance: A Decade of Data - CPI (climatepolicyinitiative.org).
8. Source: How to Scale Up Private Climate Finance in Emerging Economies (imf.org).
9. Source: AIIB Issues First Climate Adaptation Bond Targeting Resilient Infrastructure, May 11, 2023.

Center on Adaptation (GCA), which supports government and private sector financing of climate adaptation efforts, argued that "public spending alone cannot meet the adaptation finance gap, so private sector investment must scale alongside public investment to supplement limited public resources."[10]

We believe the investment industry can offer institutional investors the opportunity to scale up climate adaptation investments in developing countries.

Monitoring market developments

We believe several advances are needed to enable the climate adaptation market to grow and develop to meet institutional standards and unlock private capital at scale. One challenge is that GSS bond issuance is dominated by developed market issuers and skewed toward climate mitigation in the energy and transport sectors, which means that these areas are heavily funded compared to other adaptation projects. In addition, more issuer disclosure of information and the standardization of information is critical to the market's growth, in our view. Issuers in developing countries also require technical assistance to explain the issuance and management of GSS debt instruments in practice, including guidance on how eligible adaptation projects are selected and evaluated, impact reporting and the role of external reviewers.

We believe asset managers can assist in these developments through active engagement with issuers and global institutions.

Invesco has widespread experience in thematic investing, including climate investing and nature and social-based investing. We created the first clean energy strategy in 2006 and currently manage eight climate mitigation-focused fixed income strategies. We work in partnership with key players like the Global Center on Adaptation to identify high impact investment opportunities. In this way, we seek to galvanize private investors to help close the financing gap in the global efforts to achieve climate adaptation goals.

10. Source: GCA, Financial Innovation for Climate Adaptation in Africa, Oct. 2021.

Panelists

Manuel Terre
Sovereign Strategist

Daniel Phillips
Senior Emerging Market Strategist

Claudia Castro
Portfolio Manager

The bottom line: What's new in EM debt restructuring?

We speak with Sovereign Strategist, Manuel Terre, Senior Emerging Market Strategist, Daniel Phillips and Portfolio Manager, Claudia Castro, about recent developments in emerging market (EM) debt restructuring. The recent sovereign restructurings in Zambia and ongoing negotiations in Sri Lanka, Ghana and Ethiopia, the rescue of Egypt from severe financing pressures, and the growing market acceptance of President Milei's approach in Argentina, offer encouraging improvements in the debt work-out landscape, including possible improved outcomes for bondholders.

Q: What has led to recent EM debt restructurings?

Manuel: Several factors have culminated in the recent debt distress of certain sovereigns. Debt levels had been building over the past 15 years, fostered by loose developed economy monetary policies that created easy credit conditions. A simple average across high yield-rated sovereigns shows an increase in the level of gross government debt stocks from 45% of GDP in the early 2010s to a peak of 83% in 2020.[11] Debt service ratios increased to levels above 15% of exports, versus the historical average of 10%.[12] Additionally, unlike other periods when EM debt stocks rose significantly (such as the 1980s and 1990s), certain factors exacerbated this problem: a higher percentage of non-concessional debt, an increase in the importance of bilateral (e.g., Chinese) debt, and a rising number of commercial creditors at the expense of multilaterals.

On top of these trends, other forces exacerbated indebtedness: less public policy flexibility after COVID, the effects of the Russia-Ukraine war and the start of the Fed hiking cycle, making countries less able to manage debt payments. Current account balances deteriorated via terms of trade shocks and external financing needs and financial account balances were pressured amid less international market access. These drivers combined to ultimately trigger recent EM debt restructurings.

Q: What new developments improve the outlook for EM debt restructurings and outcomes for bondholders?

China has played an increasing role as a bilateral creditor in recent years and recent changes in this role have positively impacted the debt restructuring process. China grew from an almost non-existent lender to EM sovereigns in 2000, to one of the largest by 2020. As noted above, the EM debt stock swelled during this period and a rolling wave of defaults followed the COVID shock – including Zambia in late 2020. Prior to China's lending spree, most bilateral creditors (sovereign governments lending to other sovereigns) were grouped into the Paris Club (wealthier European and North American countries and Japan). The Paris Club had a well-oiled process for dealing with a country that could no longer pay. It typically allowed the International Monetary Fund (IMF) to take the lead in assessing the problem and determining a debt reduction and reform plan. This would include a new amount and schedule of debt payment capacity that would be available to repay creditors, which the Paris Club and private creditors (banks, bondholders, companies) would then divide amongst themselves roughly equally.

Once a crisis struck, China, who is not a member of the Paris Club, but not a bondholder or a bank, participated in this established process in an ad hoc way. For several years between 2019 and 2023, there was significant confusion about which Chinese entities were owed money (the government, state-owned companies, private companies, banks, etc.) and how each would be treated. The inability to restructure Chinese debt meant bonds could not be restructured and the presence of China in a country's lender group made restructuring considerably more difficult. After much negotiation between the Paris Club, borrower nations, different Chinese entities, and bondholders, a new, but tentative, process emerged in the case of Zambia. In 2023, Zambia announced an agreement with China on its debt restructuring that was acceptable to the IMF and Paris Club and, in early 2024, Zambia's restructured Eurobonds received the blessing of the other creditors. This development provided a template for navigating a new world of restructuring sovereign debt and provided some certainty to the market.

Q: Though debt relief can be required in some circumstances, how do value recovery instruments (VRIs) enhance EM debt's investment value?

Daniel: At the behest of creditors, the return of VRI's as an element of sovereign debt restructurings will likely provide some potential upside for creditors faced with haircuts on their initial loans. In addition

11. Source: IMF, Invesco. Data from Dec. 31, 2010 to Dec. 31, 2022.

12. Source: IMF, Invesco. Data for calendar year 2022. Average since 2010.

to a traditional bond issued to replace old bonds after a restructuring, VRIs are being added that will increase coupons paid to creditors if a country recovers faster and more strongly than expected. Zambia and Suriname each added VRI instruments to their sovereign debt restructurings - Zambia's were linked to export growth and Surinam's were linked to oil production. Creditors are seeking similar instruments in the ongoing Ghanian and Sri Lankan restructurings.

After a brief period of popularity in the early 2000's, EM sovereign debt restructurings had largely eschewed these instruments. Design flaws in the Greek, Ukrainian, and Argentine GDP warrants gave creditors the impression that these instruments were more trouble than they were worth. However, new versions of VRI's are capped to prevent excessive payouts and have enhanced language to clarify definitions and triggers in the hope that past mistakes can be corrected. Time will tell whether this wave of instruments will work more effectively, but they represent an attempt to capture potential upside in a dynamic economic situation rather than locking in fixed bond cash flows at a moment that tends to be a country's most extreme period of uncertainty.

Q: How has Egypt avoided a debt restructuring and opened the door to attractive market opportunities?

Claudia: In recent months, the tide has turned for the Egyptian economy, making investors take note. The trigger was unprecedented funding which alleviated financing pressures and took the United Arab Emirates' longstanding support of Egypt to a new level. It comes with large, front-loaded transfers, which were followed by other international financial commitments. Credit markets reacted positively to the end of Egypt's short-term liquidity crisis, opening the door to local debt market opportunities that we hope will last, as long-term debt sustainability looks more achievable.

This is not the first time we have seen such course correction, only for imbalances to rebuild, driving an exodus from Egyptian assets. During these times, the Egyptian authorities have taken steps to address economic imbalances. However, ambitious structural reforms, including sizable currency devaluations, a solid primary surplus, a strong asset sales program, unwavering regional support and IMF programs, were unable to provide a credible anchor to the country's credibility gap and long-term sustainability. The economy also suffered major shocks from the Arab Spring in 2011 and the Russia-Ukraine conflict in 2022.

But the current USD50 billion support package is unprecedented, representing over 10 percent of Egypt's USD400 billion economy.[13] Other major developments include a large exchange rate adjustment, a surprise 600 basis point interest rate hike and an IMF deal augmentation. These developments have significantly eased Egypt's balance of payments pressures, enabling a newly enhanced IMF program and a tighter fiscal stance.

High nominal yields and the stabilization of the currency post-devaluation, coupled with the robust external funding pipeline and up-sized IMF program, make Egyptian local debt attractive, in our view. Over time, Egypt has an opportunity to rebuild its local debt curve, accompanied by foreign direct investment and asset sales that enhance private investment. We think converting gains into more sustainable, long-term economic policy is challenging. But, in our view, a new window has opened for a credible currency regime, tighter monetary and fiscal policy, and foreign private investment - all keys to reversing the trajectory of Egypt's credit rating.

Q: Are other potential candidates on a similar path?

Claudia: Argentina is worth mentioning. As often happens when emerging markets require significant and painful changes to their economic models, economic rebuilding comes on the heels of a political transition. Unlike Egypt, which faced short-term liquidity needs, Argentina required a comprehensive macro stabilization program to alter its monetary and fiscal policies and support wide-ranging economic reforms. Strong cyclical and structural adjustments currently underway give the country an opportunity to tap into its economic potential and infrastructure in industry, agriculture, and services to deliver a path to macro stabilization and long-term sustainability. The work is arduous, requiring changes in relative prices and incomes, bringing inflation down from three-digit annual rates, regaining investor credibility and obtaining widespread social and political support.

Argentina's macro stabilization is progressing swiftly, and we expect that, as policies are implemented and credibility is rebuilt, Argentina may be able to turn the corner. The path to stability will likely be challenging as conditions worsen before they get better, though the government's initial actions

13.Source: Egyptian Ministry of Finance, IMF, World Bank, Invesco. Data as of March-April 2024.

have avoided an intensification of the crisis. It is in the stage of correcting the currency's misalignment and removing legacy price controls, which will likely have an inflationary effect and deepen the ongoing contraction in economic activity. The plan also envisages the scaling-up of social assistance to protect the most vulnerable population. Stronger macroeconomic balances should ensue, characterized by disinflation, a solid external position, and a recovery in output and real wages. We believe Argentina's ambitious stabilization plan is consistent with a stronger market-oriented economy for the years ahead.

Q: Why are these events important, and what do they mean for bondholders?

Manuel: If a restructuring agreement credibly guarantees a sustainable macro and sovereign debt trajectory, credit outcomes can improve significantly. External balances should benefit from previously withheld foreign direct investment inflows and from a broader availability of external funding, either from the official sector and/or private creditors, once the country is able to regain market access. Both factors should impact positively on growth and balance of payments dynamics. In other words, restructuring paves the way to a structural improvement in the sovereign's credit health, and creates potential re-rating routes toward single B status. Historical evidence indicates that ratings decline sharply before a default and improve slowly afterward – typically taking three years to reach single B, on average. Going forward, these new developments may make this path more likely and faster.

Q: Are there any idiosyncratic issues on the horizon?

One unexpected development in the last few months is the emergence of a set of laws in the New York State Legislature that seeks to alter the process of sovereign debt restructurings. This is relevant as half of the world's sovereign bond contracts are governed by New York law, to provide added safeguards for investors.[14] Though this initiative has been pushed by civil society for years, it only became potential legislation last year and is now close to a vote. The main provisions of the law attempt to establish (1) a formal legal process for resolving a sovereign debt restructuring and (2) a cap on recovery values in certain instances. The passage of this law is not certain, and there is a lobbying effort underway to clarify the language. In addition, if passed, challenges to the law are likely, and the New York legislature could change it. In any event, the implications of the law could be quite large. Its broad language could create significant uncertainty surrounding distressed or potentially distressed names. This is an issue we are monitoring closely.

Q: What do recent developments in debt restructuring mean for the EM asset class?

The above developments show that sovereigns can move past the recent pressures on their balance sheets and they could help smooth current debt restructurings. The market seems to have recognized this potential impact - the distressed complex has been the highest performing EM cohort so far in 2024, with C rated EM sovereign bonds posting a total return of 25.6%, followed by B rated sovereigns at 4.8%, BB rated sovereigns at 2.7% and investment grade rated sovereigns at -1.3%.[15]

14. Source: International Monetary Fund, The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors – Recent Developments, Challenges, and Reform Options 22 n.27 (Sept. 23, 2020), https://www.imf.org/en/Publications/Policy-Papers/Issues/2020/09/30/The-International-Architecture-for-Resolving-Sovereign-Debt-Involving-Private-Sector-49796.

15. Source: JPMorgan Emerging Market Bond Index Global. Data from Jan. 1, 2024 to April 10, 2024. EMBI Global measures total returns for traded foreign debt instruments in emerging market countries.

Team contributors

Senior Editor — Ann Ginsburg

Atlanta

Robert Waldner
Head of IFI Strategy and Macro Research
+1 404 439 4844
robert.waldner@invesco.com

Daniel Phillips
Senior Emerging Market Strategist
+1 404 439 3107
daniel.phillips@invesco.com

James Ong
Senior Portfolio Manager
+1 404 439 4762
james.ong@invesco.com

Ann Ginsburg
Head of Thought Leadership Fixed Income
+1 404 439 4860
ann.ginsburg@invesco.com

New York

Turgut Kisinbay
Chief US Economist
+1 212 323 0460
turgut.kisinbay@invesco.com

Claudia Castro
Portfolio Manager
+1 212 323 5269
claudia.castro@invesco.com

Wim Vandenhoeck
Senior Portfolio Manager
+1 212 323 4636
wim.vandenhoeck@invesco.com

Gerald Evelyn
Senior Client Portfolio Manager
+1 212 652 4313
gerald.evelyn@invesco.com

London

Gareth Isaac
Head of Multi-Sector Portfolio Management
+44 20 7959 1699
gareth.isaac@invesco.com

Michael Siviter
Senior Portfolio Manager
+44 20 7959 1698
michael.siviter@invesco.com

Henley-on-Thames

Manuel Terre
Sovereign Analyst and Strategist
+44 14 9141 6591
manuel.terre@invesco.com

Mark McDonnell
Macro Analyst
+44 14 9141 6489
mark.mcdonnell1@invesco.com

Hong Kong

Yi Hu
Head of Asia Credit Research
+852 3128 6815
yi.hu@invesco.com

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