Global Fixed Income Strategy

Monthly report

Invesco Fixed Income

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Evolving market narrative creates investment opportunities

The Invesco Fixed Income Team just concluded our semi-annual summit in May. We brought together our senior investors from around the world for debate and dialogue at our Atlanta headquarters. It was invigorating to be in person with so many of our colleagues, and it was incredibly valuable to work through our strategic views on economic and market direction and developments.

The basic tenets of our view remain unchanged. We believe the global economy will continue to grow at a steady pace with the US slowing somewhat from the strong pace of last year and European growth picking up. The underlying momentum of the economy and lack of clear imbalances means the risk of recession remains low.

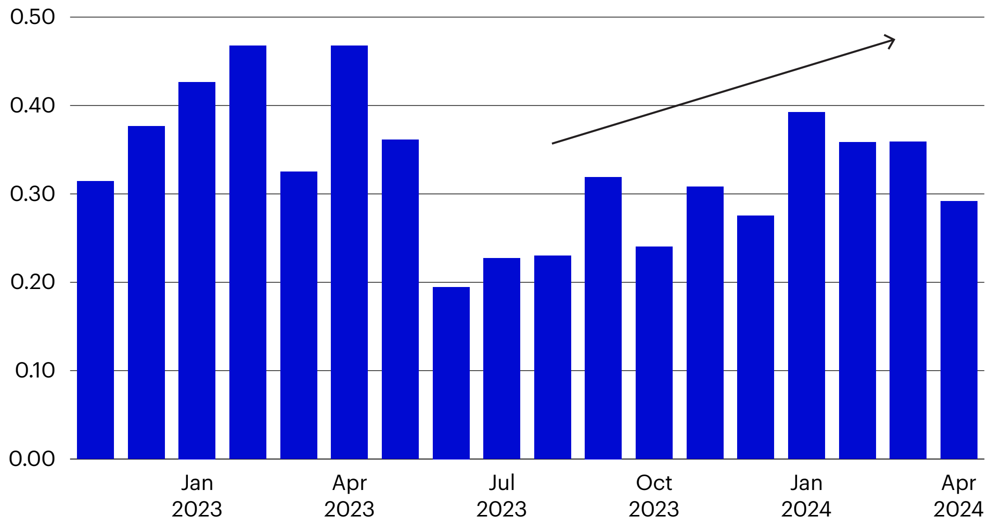
We firmly believe that we are in a disinflationary environment. Indeed, inflation has dropped steadily in the last year across most economies and is getting closer to central bank targets. The easing of supply chain pressures means goods inflation is out of the system, with goods prices in deflation in aggregate. Services inflation is slower to come down, but with easing labor market pressure, we believe services prices will continue to come toward central bank targets with time. Many of the data points on services inflation, in particular shelter prices, enter the official data with a significant lag, so cooling services prices will likely take a while to fully show up in the official data.

Most developed market central banks, including the US Federal Reserve (Fed), believe the current level of interest rates is restrictive and hence too high for an economy that is in balance. Central banks would like to cut rates this year in response to the declining inflation, and we believe they are likely to do so. The European Central Bank (ECB) and the Bank of England are likely to begin cutting as soon as June, and we believe the Fed will likely cut two times this year, starting after the European central banks.

The Fed's hands are tied by the higher than expected core consumer price index (CPI) prints at the beginning of this year. Core CPI surprised to the downside in the second half of 2023 but has come in stronger than expected in 2024. The market has worried that these stronger than expected data points may indicate a reacceleration of inflation, but we do not believe this is the case. We believe we are in a continued disinflationary trend, but progress will likely not be a straight line. The first few months of this year represent somewhat of a setback, but not a trend change. This view should allow the Fed to cut rates by September and will likely allow the Fed to cut twice this year in total.

Figure 1: US core inflation higher recently

US core CPI % change m/m



Source: Macrobond. Data from Nov. 1, 2023 to April 1, 2024.

While our view has been pretty consistent over recent quarters, the market narrative has shifted aggressively in response to incoming data. When there is so much uncertainty on how the economy will evolve, and the central banks have stated that they are data dependent, this makes sense, but also creates opportunities to take advantage of the market's overshooting. Over the last year, the market has priced more than six rate cuts by the end of 2024 in response to a recession/disinflation narrative, and only one rate cut when the higher-for-longer narrative has been in the ascendancy. Over the last year this has created range trading opportunities as the actual macro momentum has been significantly more stable than the market narrative. This is likely to remain the case in our view.

Figure 2: Market has significantly repriced the Fed

Number of Fed cuts by December 2024

Source: Macrobond. Data from July 31, 2023 to May 16, 2024.

We continue to anticipate a supportive macro backdrop for investing. A growing global economy that is also in a period of disinflation is a benign backdrop for most asset markets. The likelihood of rate cuts in coming quarters will likely also support markets and bolster flows into fixed income assets. The headwind for investors is valuations. An inverted yield curve and tight credit spreads limit the upside. We look to maintain a conservative risk posture but take advantage of the range environment as the market narrative continues to change and evolve.

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Interest rate outlook

US: Neutral. US Treasury yields are likely to offer favorable returns over cash in the long term. We favor a cautious approach to increasing long US interest rate exposure. Market volatility is expected to persist until inflation data become more stable. There is still uncertainty regarding the timing of the next rate-cutting cycle, and we have adjusted our forecast to expect the Fed to begin cuts in September or December rather than July.

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. The ECB has indicated that it will cut rates in June, but beyond this, will be data dependent. We expect the ECB 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 story 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", with continued measures to lower financing costs for the real economy. This has been evidenced by recently announced lower mortgage rates. Monetary policy is expected to continue to maintain sufficient liquidity to support large sovereign and quasi-sovereign bond issuance. The potential recovery in risk sentiment in China's onshore stock market may lead to short-term volatility in the performance of onshore rates bonds.

Japan: Underweight. The Bank of Japan's (BoJ) recent minutes were relatively hawkish, noting increased confidence in the rise in wages and concerns about the upside risk from the yen's depreciation. The BoJ has already reduced the size of its quantitative easing (QE) operations in the 5-10 year sector and seems likely to further cut QE operations in June, at least to a level where the balance sheet is no longer expanding. The signalling around interest rate policy also seems to point to the likelihood of a July hike if firms pass on recent wage gains. Weaker Q1 growth and Tokyo inflation data might limit the BoJ's hawkishness. However, the reaction function now seems more asymmetrically hawkish, with policy likely to be tightened in the event of upside inflation or wage surprises, but unlikely to be eased further.

UK: Overweight. The May Bank of England (BoE) meeting sent a dovish message overall, supporting expectations that policymakers could cut rates as soon as June, if data broadly follow their forecasts. Two members preferred to reduce the Bank Rate by 0.25 percentage points, to 5%. The forecasts now anticipate that inflation will decline below the 2% target, based on a market interest rate profile implying a cumulative 150 basis points of easing over the next two years.[1] More explicitly, Governor Bailey refused to rule out a cut at the June meeting. Although recent wage data have been a bit stronger than expected and growth surprised to the upside in Q1, overall domestic data are in line with the BoE's forecasts. We believe the April inflation data will be crucial for the BoE, with a sharp decline in domestically generated inflation a likely pre-condition for cuts in June.

Australia: Overweight. Higher than expected inflation in the first quarter has resulted in higher local government bond yields and underperformance relative to US Treasuries and UK gilts. The market even briefly priced a hike from the Reserve Bank of Australia (RBA) this year. However, the RBA's May Statement of Monetary Policy signalled that the hurdle to hiking remains high, even with stickier inflation. Domestic data remain relatively soft, making it more likely that policy will be eased in the future. Although the federal budget added to the already relatively large positive fiscal impulse, this is unlikely to derail the disinflationary trend significantly, with wages slowing and unemployment ticking up.

1. Source: BoE Monetary Policy Report, May 9, 2024.

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Currency outlook

USD: Neutral. We are broadly neutral on the US dollar in the short term. Given the recent outperformance of the US economy, and higher short-term rates than peers, the US dollar should remain well supported. Further ahead, the picture is less clear. On a valuation basis, the dollar screens expensive. Should the Fed press ahead with rate cuts later this year, the US dollar will likely lose some of its lustre. Our medium-term expectation is that the US economy will slow more than the market expects, leading to a more protracted rate cutting cycle by the Fed, which should be more negative for the US 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 recently, we maintain that falling inflation will drive the ECB toward reducing rates.

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. From a seasonal perspective, the April-May period typically sees higher demand for US dollars from local companies to pay dividends. Overall, we remain neutral on the renminbi considering its relative strength against other non-US dollar currencies, potential seasonal pressures, and expectations that the central bank will maintain a stable renminbi fixing level.

JPY: Neutral. The Japanese authorities finally intervened in the currency market when the USD/JPY exchange rate breached 160. This briefly sent the exchange rate down to 153, however, it has subsequently rebounded to 156, largely due to positive global risk sentiment.[2] The price action demonstrates the difficultly the Japanese authorities will likely have in reversing the yen's depreciation without a meaningful narrowing of interest rates differentials, which in turn would likely require a downward shift in global growth and inflation expectations.

GBP: Neutral. The British pound has performed strongly year-to-date, helped by high short-term interest rates, positive terms of trade and buoyant risk sentiment. Although the better growth outlook is supportive, especially if it drives unhedged equity inflows, risks to the pound are skewed to the downside, in our view. In the likely event that the BoE follows the ECB and cuts rates this summer, interest rate differentials are unlikely to be as supportive going forward, particularly versus the US dollar. In addition, the risk environment is vulnerable to downside growth and geopolitical shocks from the Middle East, the US election and the Ukraine war.

AUD: Neutral. Recent commodity price buoyancy supports the Australian dollar. However, it is hard to explain this strength given the backdrop of still very weak Chinese demand. At the same time, interest rate differentials, while improved from one month ago, are still a headwind for the Australian dollar, particularly versus the US dollar. In addition, the Australian dollar is exposed to geopolitical shocks from US-China competition, as Australia is economically dependent on China but aligned with the US on security matters.

2. Source: Bloomberg L.P. Data as of May 20, 2024.

Tim Spitz
Head of Municipal Business Strategy and Development

Mark Paris
Chief Investment Officer, Municipals

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

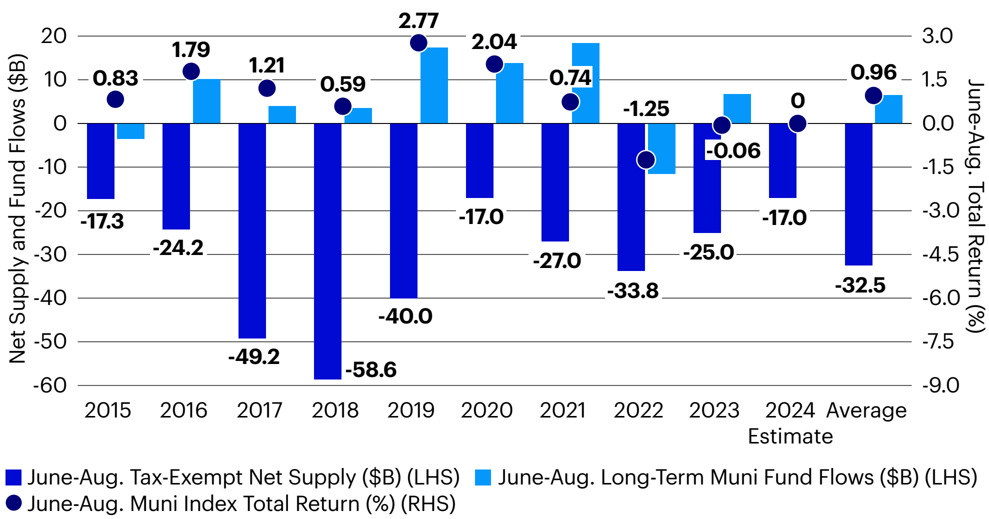
Global credit strategy

Is now a good entry point for municipal bond investors?

So far in 2024, the municipal bond market, and much of fixed income, has not performed as many had expected at the beginning of the year. The furious rally at the end of 2023 was likely too quick and too sharp, based largely on expectations of multiple Fed rate cuts in 2024. First quarter upside surprises in CPI data diminished those expectations and turned bond market performance negative by April.

Nevertheless, this pullback may have created an interesting entry point for municipal investors. We have also just entered an historically strong seasonal period for municipals, one that typically starts in May and lasts through August.

Figure 1: Negative net supply has historically supported municipal valuations in the summer months



Source: Lipper US Fund Flow, Bloomberg Finance L.P. as of Dec. 31, 2023, JP Morgan estimate as of Nov. 12, 2023. There is no guarantee that estimates will come to pass. The Bloomberg Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market. An investment cannot be made directly in an index. Past performance is no guarantee of future results.

Figure 1 shows that municipal market performance has tended to be positive over the summer months. The Bloomberg Municipal Bond Index has produced a positive total return every year since 2015, barring 2022 and 2023. Looking at returns by month, July returns have been positive every year since 2013, even in years with outflows, such as 2015 and 2022. Total returns in June and August have been more mixed.

This year, principal redemptions and coupon payments are estimated to total around USD230 billion from May through August, while issuance is forecast to reach only about USD160 billion.[3] This large supply-demand imbalance should be a positive tailwind at the backs of municipal investors. We expect these strong technical conditions to allow municipal credit spreads to squeeze tighter.

In addition, the market is currently pricing a higher probability of a September Fed rate cut, which seems to have started a rally in Treasury rates. This should be welcome news for municipal investors, as we enter the summer period.

Municipal credit fundamentals remain strong

Municipal credits continue to be in good fundamental shape overall. Funds from federal pandemic aid and healthy tax collections continue to strengthen balance sheets, while fiscal restraint should help keep most credits in a resilient position. In 2023, Moody's Investors Service (Moody's) and S&P Global Ratings (S&P) upgraded more than 1,400 credit ratings and downgraded fewer than 350 — a combined upgrade/downgrade ratio of 4 to 1. We continue to believe that collectively, municipal credit is the strongest it's ever been.

3. Source: Bloomberg L.P. Data as of April 30, 2024.

While this remarkable pace of upgrades versus downgrades will likely not be sustainable, we still expect relatively stable credit quality in 2024 and no significant increase in defaults. This view played out in the first quarter of 2024 as S&P upgraded 93 credits and downgraded 38. Moody's was not quite as positive, upgrading 153 credits versus downgrading 79. Combined, that is slightly better than a 2 to 1 upgrade/ downgrade ratio, which is not quite as strong as 2023, but still a positive signal to the municipal market and its investors.

According to the rating agencies, the driving force behind the strong pace of upgrades is the strength of the US economy and solid finances of municipal issuers. Revenue sources for municipalities, such as sales taxes and property and personal income taxes, are doing well and most municipalities prudently managed the influx of federal stimulus dollars related to the pandemic. At Invesco, our experienced, dedicated municipal team of 23 professionals has seen a similar trend in terms of internal rating upgrades. Our team puts an internal rating on every position we hold and provides forward-looking guidance to help our portfolio team determine the risk-reward benefit, or lack thereof, of each holding.

We are getting paid to wait

The yield to worst (YTW) on the Bloomberg Municipal Bond Index ended April 2024 at 3.78%. Prior to the current Fed hiking cycle, April 2011 was the last time we saw the index YTW reach those levels. Even at the height of the pandemic in March 2020, the YTW on the index peaked at 3.52%. It is important to note that municipal bond interest is exempt from federal income taxes, so the tax-equivalent yield for a municipal bond yielding 3.78% for investors in the highest tax bracket is 6.39%.[4]

For those willing to take on additional risk, the YTW on the Bloomberg Municipal High Yield Bond Index could be even more compelling, at 5.66% as of the end of April. While yields did top current levels briefly during the pandemic, we would have to go back to July 2017 to see yields where they currently are.

The bottom line is, we don't know when the Fed is going to start cutting rates. We have opinions based on current data, but our opinions and the Fed are data-dependent, and the data change constantly. Fortunately, while we wait for the data to drive the Fed to lower rates, which should help the municipal market perform well, we believe we are getting paid handsome amounts of income for waiting, the likes of which we haven't seen in years.

4. Source: Bloomberg L.P., US Internal Revenue Service, Invesco. Data as of April 30, 2024

Panelists

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The bottom line: Credit ideas from our expert panel

We concluded our semi-annual investor summit in May with a panel of asset class experts to discuss their latest thoughts on credit markets. Setting the scene were polling results from our investment team that indicated an expectation for investment grade credit to be the most favored asset class in 2024 from a flow perspective, with emerging markets (EM) and US high yield least favored. The sensitivity of credit to rate volatility was noted to have declined significantly over the last nine months, with the view that investors appear to be embracing higher yields on offer. Despite this, tight spreads mean that returns are more likely to be driven by carry. Below, we highlight some key insights from our panelists.

Q: Jason, what are your thoughts on the demand outlook for EM?

Jason Trujillo: It's surprising to see limited flows into EM since, typically, a period of very strong returns over 12 months, which we have just seen, would trigger inflows — both retail and institutional. However, retail flows have been persistently negative for EM. Institutional flows are picking up, but they are still quite muted, though there is some interest from investment grade portfolios able to take some off-benchmark positions. High yield hedge funds are also looking at special situations, such as distressed sovereigns, so there is some interest, just not from traditional, dedicated EM funds.

Q: Do you think recent sovereign restructurings have been putting off traditional investors?

Jason Trujillo: Maybe somewhat, but it's more about the fact that the pandemic pushed a number of EM issuers into distressed situations and then the Russian invasion of Ukraine created an additional swathe of default/sanctioned situations, followed closely by the deterioration of the Chinese real estate sector. The good thing is we're through these crises and seeing a nice recovery on the distressed side, where countries like Ghana and Zambia are working with creditors to resolve their debt situations and move forward. Even Argentina and Ecuador are looking much better as well.

Q: Is it a similar demand story in HY?

Niklas Nordenfelt: In the last two weeks, demand for high yield has been off the charts, but it's been concentrated in demand for exchange traded funds (ETFs). We have recently seen flows into and out of ETFs whipping around in very large numbers. In terms of dedicated money, I'd agree there has been a lack of demand, but I think that's because high yield is being squeezed as many investors have been opting for safer investment grade paper at these higher yields, rather than for any fundamental credit reasons. In the leveraged finance space, illiquid yields are available that are 150 to 200 basis points higher than yields on public bonds.[5] So, we're seeing more demand for private credit and especially bank loans. We have also favored bank loans for that yield advantage. I would expect this dynamic to turn once the Fed starts cutting rates and the yield advantage of floating rate debt narrows.

Q: Our polls showed that people are aware of the sensitivity of commercial mortgage-backed securities (CMBS) to interest rates. What are your latest thoughts?

Kevin Collins: Yes, CMBS is very sensitive to rates. Across much of the securitized space, we are at 52-week spread tights with investors expecting that the Fed will pivot soon and recession risk is off the table. That ties into the moderating disinflation backdrop that is beginning to play out, although there have certainly been some bumps in the road. Commercial real estate properties are typically a levered investment and they're often significantly levered so, arguably, nothing matters more than the cost of financing. As a result, with real rates now above 2%, compared to 1.5% at the start of 2023, the longer that rate cuts are pushed out, the more it will likely weigh on property valuations.

Q: Given the impact of shelter costs on US inflation, can you provide some color on the US property supply/demand picture?

Kevin Collins: We have to think about the market in two parts: single and multi-family properties. In multi-family, which accounts for roughly one third of the US property market, there has been significant supply. We expect this trend to continue with peaks of new deliveries each quarter, stretching into 2025. While occupancies are still around 94%, this is now at a 12-year low.[6] Rent growth is flatlining and we expect it to soften further into 2025.

5. Source: Invesco, Bloomberg L.P. Data as of May 14, 2024.
6. Source: RealPage. Data as of March 31, 2024.

Single family is interesting since we haven't seen a lot of new supply. Consequently, single family rental rates have risen approximately 5% year-over-year, so this sector has been more inflationary and represents two-thirds of the market.[7] However, it's much cheaper to rent right now than to buy a home in almost every market. As a result, disinflation across multi-family rents, along with an increase in newly constructed build-to-rent properties, has the potential to eventually place downward pressure on shelter costs and reconcile the economy to the disinflationary targets we are expecting overall.

Q: In investment grade, are we looking to take some chips off the table?

Todd Schomberg: Yes, valuations are very tight, volatility is low and there is a record level of new paper being issued, so while we like current yield levels, we want to protect our portfolios from potential spread widening. To do that, we have moved a little closer to the front of the yield curve where we still access high-quality income. Spreads have actually widened somewhat in the three to seven-year part of the curve. The 10-to-30 year range is very close to all-time tights, driven by tremendous demand from pension buyers.

Q: Are you seeing competition between public high yield and private markets?

Thomas Moore: The private high yield market has grown substantially to around USD4-5 trillion and this is positive for borrowers.[8] The access to capital is immense, so a going concern can find refinancing avenues in one market or the other. This lowers default rates overall. We're seeing specific instances in which there is credit available in private markets that public markets would not be willing to provide, although we are still seeing a normal amount of borrowers shifting from one zone to another. But there are certain areas like stressed retail where there are private lenders that are willing to provide revolving credit facilities at a price that banks would not be. Another way of thinking about it is competition for flows, and public high yield is facing some competition at the moment, given the interest in private markets.

In summary, our session highlighted the continued need for active managers to selectively and intentionally position client portfolios to benefit from the higher yields currently on offer, while protecting from downside risks to maximize risk-adjusted returns.

7. Source: Zillow Observed Rent Index (ZORI). Data as of April 30, 2024.
8. Source: Invesco. Data as of May 14, 2024.

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The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

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