Invesco Global Flexible Bond Strategy

Performance and Outlook

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Economic Outlook

The **US** economy has slowed over the last 6 months, from strong growth at the start of the year, to around trend currently. We expect the slowing trajectory to persist. Whilst chances of recession are low for now, the likelihood of a more meaningful deceleration ahead is higher than risk markets discount.

Rates have fallen in anticipation of Fed cuts, but this easing of rates will not be sufficient to offset the lagged impact of a prolonged period of high rates on the economy. Higher interest rates have curbed demand in rate-sensitive sectors and weighed on investment spending.

Fiscal policy has supported growth in recent years, but in 2025, regardless of the election outcome there is little scope for countercyclical fiscal policy should it be needed.

The labour market has softened from the strong pace of last year. Post pandemic distortions have further moved back into balance, due to labour force growth, and labour demand has waned. The unemployment rate has ticked further higher (to 4.2%), and the triggering of the Sahm Rule has garnered much attention . A wide range of surveys, including PMIs, regional Fed survey data, small business indicators, and Conference Board surveys, suggest a labour market that is softening. At this point, layoffs, as indicated by initial and ongoing jobless claims and JOLTS data, remain at very low levels. Past cycles suggest that labour market trends play out in a non-linear fashion and we think this cycle will be no different. If the softness persists, it is likely to eventually translate to job losses.

Consumption has been powered by wage gains and pent-up pandemic savings over several years. However, household savings balances have now been wound down, and from here it is doubtful that households will be able to increase spending out of current income, nor is it likely that they will increase their borrowing to fund consumption against the backdrop of a softening labour market.

Although household debt burdens are manageable, credit card and auto loan delinquency rates have still risen back to where they were in 2010. Banks have responded by tightening lending standards and lifting interest rates on credit card borrowing, with credit card debt growth slowing correspondingly. At this point, delinquency rates on housing related loans are still very low.

We believe the US remains on a disinflationary path. Inflation will continue to decline towards the Fed's target driven by declines in shelter inflation, further declines in goods inflation and declines in non-shelter core services inflation driven by a moderation in wage pressures. Inflation expectations are well anchored and the feared wage-price spiral has been avoided.

Declining inflation, and signs of labour market softening, caused the Fed to start with a bang, front-loading their cutting cycle. This was counter to our previous expectations that the first steps would be cautious.

We are still discovering the new reaction function of the Fed, and recent speak from hawkish FOMC members such as Waller, Bostic and Kashkari suggest that the bar for further 50bps is not high.

Ultimately, we expect more Fed cuts will be delivered than are discounted in the next 2 years (given we see the softening in the labour market as a downside risk to the economy). But at this juncture, the market already prices a meaningful cutting cycle and is arguably due a period of consolidation – certainly given the markets expectation for a “soft” or “no” landing for the economy.

In the **UK**, growth is a little better than last year, but remains very low. A post-election bounce has not really materialized, and the budget later this quarter threatens to dampen sentiment further. Although falling inflation is boosting real incomes, the consumer continues to flatline, under the weight of cost of living pressures of recent years. Inflation is normalizing, and should fall further as pay pressures diminish. The BoE cut rates in the summer, and market rates have started to fall, in anticipation of further cuts. But the policy setting remains highly restrictive and continues to weigh on the economy. We believe the BoE are responding too slowly to the sluggish pace of the economy and weakness in Europe. Their focus on lagging spot inflation (which is driving the slow pace of policy easing) will ultimately result in a need to cut deeper in the quarters ahead.

The **European outlook** has become increasingly gloomy with manufacturing woes deepening, and construction activity flat-lining, weighing on the large economies most weighted to those sectors. External demand for capital goods remains depressed. The sustained weakness in manufacturing raises questions about the sustainability of service sector growth. Our medium term outlook is for sluggish growth and possible stagnation as structural headwinds weigh on the economy for the foreseeable future, whilst the terms of trade shock due to the Russia/Ukraine war still reverberates. In the short term, the dynamics are increasingly recessionary.

From an absolute perspective, labour markets are tight, and consumers are supported by a rise in real incomes from lower inflation and high savings. However, job openings in the euro area continue to trend lower and it is questionable how companies can continue to horde labour with external demand so depressed. We see downside risks.

Political uncertainty in Europe could undermine long-term sentiment and investment. The European Union (EU) is demanding significant fiscal consolidation from many member states in the coming years. It is not clear whether domestic political dynamics, in France and Italy especially, will enable consolidation, setting up a potential collision between member states and the EU, which could weigh on business and consumer confidence. Far right parties are also making ground in Northern European countries, challenging the previous trend for “more Europe”.

Disinflation is firmly underway in Europe. Whilst services sector prices with infrequent resets continue to drive some headline stickiness, faster moving indicators are firmly in disinflationary territory and inflation is on a downward trajectory.

A cutting cycle is underway from the European Central Bank (ECB), and faced with further evidence of slowing, they appear to be increasingly concerned – but any notion of getting "ahead of the curve" at this stage is wide of the mark. Our view is that policy rates are meaningfully above neutral and, with the economy likely to stutter for the foreseeable future, the market still underestimates the pace and depth of rate cuts that will have to be delivered in the next 12-24 months.

The **Japanese outlook** remains favourable. Earnings are robust, supporting business sentiment and capex plans. Inflation expectations are above 2% for the medium term. The labour market remains tight, supporting consumption and ongoing cost-push inflation might increase wage hikes in the spring labour negotiations next year.
Yen appreciation, the shift in the global rates outlook, and a new LDP leader have dampened BoJ hawkishness, in favour of a more cautious stance. We expect further policy normalisation, but the urgency has diminished, and the next leg of policy adjustment are likely to be in 2025.

The **outlook for China** has become increasingly challenging with macro data showing broad-based deterioration. The imbalance between domestic demand, and domestic production is well documented. The trade surplus has swelled as the country tries to export its excess production to the rest of the world. Coupled with a high domestic savings rate, and continued housing sector woes, fears of domestic deflation taking hold have prompted a more aggressive policy response from the PBOC and Politburo. Whilst these measures will improve confidence in the near term, they are unlikely to fundamentally unleash higher growth. We remain cautious in the medium term, and expect the labour market to remain under pressure.

In **Emerging Markets** growth has been slowing across much of EM, with those countries dependent on China or Europe feeling the chill. Those countries where the domestic policy setting remains too tight face further headwinds. We expect cyclical slowing to continue – further weighed down by geopolitical risks and DM election uncertainty.
Whilst in recent quarters the progress on disinflation has stalled, broadly, inflation, has moderated across most EM economies towards central bank targets. This opens up room for interest rates to normalize closer to neutral levels, particularly in the wake of the dovish pivot from developed market central banks.

Market Outlook

In terms of **markets**, we are structurally positive on duration, given our expectation of slowing growth and conviction about continued disinflation. Rate cutting cycles have started in many developed market countries and we expect further rate cuts on the horizon. In the shorter term we have become less positive, on valuation grounds, given yields have rallied so far in a short period of time and now discount aggressive rate cutting cycles. Any correction higher presents a buying opportunity.

We continue to expect yield curves to steepen, as central bank cuts support short-term rates, and continued heavy issuance weighs on longer-term rates.

Differentiation between economies and easing timetables is creating relative value opportunities in rates, curves and currencies, in our view. We favour being long duration in Eurozone and UK markets, where central banks are currently proceeding timidly with their rate cutting cycles – and could accelerate the pace of cuts. We are more cautious on the US and Sweden where valuations are less compelling.

In **EM**, we are modestly overweight. More aggressive rate cuts in DM open up the possibility for more EM cuts ahead. Terminal rates are still well above pre pandemic norms in many EM countries and we are compensated with favorable carry to extend duration. But selectivity is key – geopolitical concerns abound, and election risks will also have a profound impact on winners and losers within EM. We have overweight positions in Mexico, Brazil, Indonesia and Poland.

Yield buyers have driven **credit spreads** to extremely tight levels - we think credit spreads should widen as slowdown risks increase. If we are wrong, and there is no slowdown, spreads are currently so tight that we give up such little carry and spread tightening potential we can be patient.
Favored plays of recent years, such as the senior - sub ratios are now uncompelling and we have reduced exposure further.

Preemptive fed cuts should undermine the **US Dollar** in the medium term as the yield advantage is eroded. However, with growth so poor in China and Europe, and together with US election tail risks, the short-term outlook is less clear cut. We expect narrow ranges in EUR vs USD.

We find the **Japanese Yen** fundamentally undervalued vs fair value. However, the recent adjustment has reduced the valuations discrepancy, while near term US growth resilience together with a lack of imminent BoJ action are likely to limit JPY gains. The next leg of the undervaluation unwinding may be a 2025 story, and carry is punitive to wait.

EM carry can be attractive if the Fed are cutting rates, but the ingredients for a broad-based EM rally are not place at this point. The geopolitical backdrop presents a headwind.

Risk Warnings

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.

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