# Global Fixed Income Strategy

Monthly report

**Invesco Fixed Income**

July 26, 2024

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**IN THIS ISSUE:**



Global macro strategy

## Europe's recovery on track as energy shock fades

We believe the energy shock that buffeted the eurozone after the pandemic is now in the rear-view mirror and a cyclical recovery is largely on track. As the energy shock abates, real incomes are once again turning positive — supporting a previously downtrodden consumer. The manufacturing sector is, however, struggling to emerge from a prolonged period of weakness, which is adversely impacting export-orientated economies such as Germany. But southern European countries such as Spain, Portugal and Greece, are powering ahead. Not only did these countries avoid the worst of the 2022 – 2023 energy shock, but their external accounts have been boosted by strong tourism flows.

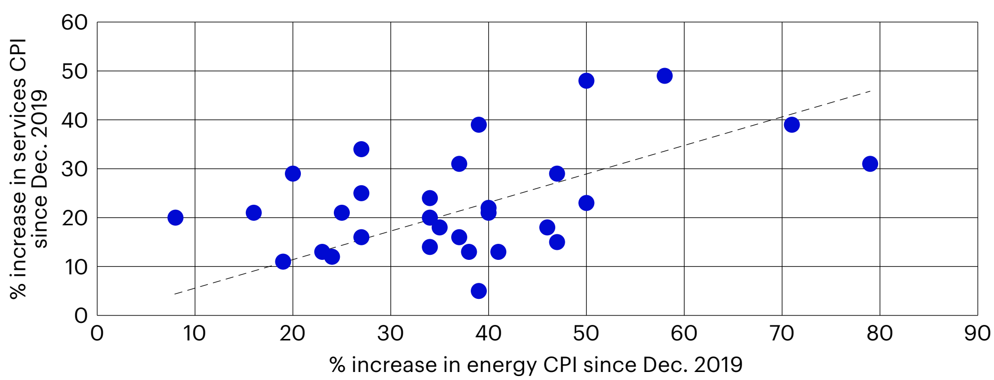
### A benign inflation environment but strong wage growth

European headline inflation appears on track to hit the European Central Bank's (ECB) inflation target. We think headline inflation could get very close to 2% in the late summer or early autumn before rising again toward the end of the year. Core inflation remains above target and above the ECB's latest projection; however, we see further disinflation in this category too. What's troubling the ECB is a combination of strong wage growth — currently running between 4% – 5%, depending on the measure used — alongside flat productivity growth. This combination is leading to higher services inflation and significant cost pressures. The ECB is, at least, comforted by the fact that some of this cost pressure is being absorbed by company margins.

### We believe higher wage growth is temporary

Hawkish members of the ECB worry that higher inflation expectations alongside a tight labor market could lead to higher structural wage growth. The doves argue that the situation is temporary. We lean toward the latter. We believe high wage growth reflects a "catch-up effect" as workers have sought to maintain their real purchasing power in the face of high

**Figure 1: Countries with higher energy inflation also experienced higher services inflation**
(% change in services CPI Dec. 2019 – May 2024 vs % change in energy CPI Dec. 2019 – May 2024)




Source: Eurostat and Office for National Statistics. Data from Dec. 31, 2019 to May 31, 2024.

headline inflation. Our own analysis finds that countries with high energy inflation have also experienced high services inflation. As such, we believe wages and services inflation will likely moderate in the second half of 2024, as cost-of-living pressures ease.

## We still see two more ECB rate cuts in 2024

Despite what the ECB have called “bumps in the road”, we still think it will ease in September and December. We detect more willingness at the ECB to look through some of the recent volatility in inflation. This could reflect greater confidence that peers — such as the US Federal Reserve (Fed) — are moving toward cuts. It could also reflect a perceived window of opportunity around late summer if headline inflation moves back toward its 2% target. Nevertheless, as shocks fade from the global economy, we believe it makes sense to, once again, set policy according to forward-looking forecasts — not only realized wage and inflation developments.

## Fiscal tightening on the horizon

One factor that might prove more jarring than a “bump” in inflation is the relationship between politics and fiscal policy. In late 2024, the European Commission plans to reinstate the Stability and Growth Pact, a set of rules designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies. And while it’s true that the new rules are more lenient than the old ones, it’s also true that fiscal metrics are much worse. Already, the Commission has recommended putting five eurozone countries, including France, Italy and Belgium, into an excessive deficit procedure. This is particularly problematic when political parties at the more extreme ends of the political spectrum are making significant inroads. In France, for example, the political center has held for now, but the margin is increasingly tight. It would likely be an extremely fraught situation if the eurozone’s second largest economy rails against the Commission’s demand for fiscal tightening.

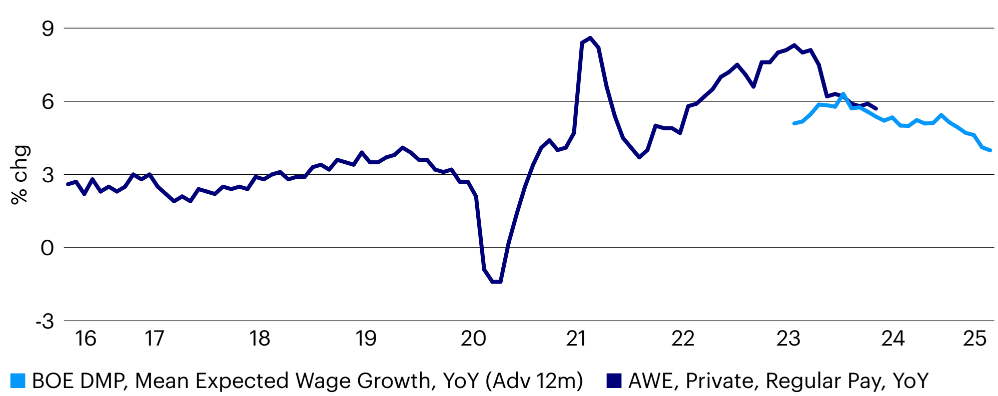
## UK political winds blowing in the opposite direction

While anti-establishment parties have made gains in continental Europe, the UK has bucked the trend, electing a seemingly market and bond-friendly, center-left government. The new government was also elected by a sizable majority, which raises the prospect that the incoming administration can push through important reforms and take difficult decisions around important issues, such as planning and infrastructure.

## We now think the first UK rate cut will be delayed until September

In the UK, a relatively stable political backdrop is offset by the prospect of delayed rate cuts. A rate cut was priced for August; however, that is now looking less likely due to a series of upside inflation surprises and stronger GDP growth. Like the eurozone, we don’t believe these upside surprises represent a structural shift in inflation dynamics. Instead, we believe UK services inflation is being artificially boosted as regulated prices and wages are indexed to last year’s inflation rate. Like in the eurozone, we believe UK services inflation will moderate in the second half of 2024. This means that, while we see the first cut now taking place in September, we still see the Bank of England cutting twice in 2024.

**Figure 2: UK firms are expecting pay growth to soften in the second half of 2024**




Source: Office for National Statistics and Bank of England (BoE). AWE is private sector average weekly earnings, ex-bonus. The Decision Maker Panel (DMP) is a survey of chief financial officers from small, medium and large UK businesses. The DMP series begins in June 2022 because data prior to that were distorted by the pandemic. Data from Jan. 1, 2016 to Apr. 1, 2024. Forecasts thereafter.

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# Interest rate outlook

**US: Overweight.** We favor long positions in US Treasuries. Slowing inflation and decreased momentum in employment suggest that monetary policy in the US is tight enough to slow growth. We expect economic data to be compatible with a September cut in the federal funds rate. We expect US Treasury yields to outperform in the medium and long term. Interest rate market volatility should decrease as the Fed begins its rate cutting cycle.

**Europe: Overweight.** We are positive on European rates, despite the ECB's cautious stance on inflation. While inflation is above the ECB's comfort zone, it is converging to its 2% target and will likely, in our view, fall below that level in 2025. While the economic climate has improved in Europe this year, interest rates of 3.75% are not consistent with a meaningful recovery and, as such, we expect growth to remain anaemic. Although the ECB is likely to be slow to loosen policy meaningfully in the near term, due to above-target spot inflation and a focus on lagged indicators, such as elevated wages, it will likely need to cut more aggressively than the market currently prices for 2025, as inflation cools and growth remains subpar.

**China: Neutral.** We expect Chinese onshore interest rates to remain low in the near and medium term and we should see curve steepening, as we expect short-term rates to outperform long-term rates. We expect more proactive guidance from the central bank through its open market operations rate setting, as the 7-day reverse repurchase rate is likely to become the main policy rate in China. Further room for downward yield moves is likely to be influenced by the US rate cutting cycle, US presidential election and trade and financial policies under the new administration, given their potential ramifications for the US dollar/renminbi exchange rate.

**Japan: Underweight.** Recent wage and inflation data will likely reinforce the Bank of Japan's (BoJ) confidence that inflation has shifted sustainably to a 2% run rate. It is therefore likely that the BoJ will hike at its July meeting and announce a reduction in quantitative easing purchases — initially down to a five trillion yen annual pace from six trillion yen currently, but potentially down to three trillion over the longer term. This should push yields up in the belly of the Japanese government bond curve. However, longer-term forwards are already very elevated and are approaching eurozone levels, limiting their scope to rise, in our view, resulting in a likely flattening of the curve beyond 10-year maturities.

**UK: Overweight.** The June Bank of England (BoE) minutes signalled that several Monetary Policy Committee members saw the decision to maintain current policy as "finely balanced". Since the June meeting, GDP data have been stronger than expected and services inflation stickier than forecast. However, employment, wages and survey data have been largely consistent with policymakers' expectations of gradual disinflation. In the words of BoE chief economist, Pill, it is a question of "when not if" the BoE eases policy. Even if a cutting cycle is delayed past August, the BoE will likely cut twice in 2024, underpinning current gilt valuations. Recent signs that inflation pressures are easing in the US and eurozone should also give policymakers more confidence in adjusting policy. As spot inflation moves closer to target, policy will likely become more forward-looking and more sensitive to the deteriorating trend in the labor market. It is therefore likely that terminal rate pricing will shift closer to a more neutral setting, at around 3% in the future.

**Australia: Overweight.** The Reserve Bank of Australia's (RBA) relatively hawkish tone after a series of upside inflation surprises has led to the underperformance of Australian interest rate markets relative to US and European peers. Australian yields have been rangebound, lagging US Treasuries by over 20 basis points.[1] However, current yields now look attractive on an outright and relative basis. The domestic economy remains weak and, although inflation is proving sticky, this is largely due to administrative prices and housing, and there is little obvious passthrough to higher wages. Indeed, forward-looking indicators point to a loosening of the labor market going forward. As a consequence, it seems more likely that the RBA's next move will be to cut rather than hike, allowing Australian interest rate markets to recouple with other developed markets.

1. Source: Bloomberg L.P. Data as of July 15, 2024.

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# Currency outlook

**USD: Neutral.** We are neutral on the US dollar in the near term but expect the tailwinds that have driven the dollar in recent times to dissipate. We have a somewhat less optimistic view on the US economy than the market consensus and, as such, expect the Fed to lower interest rates more than the market currently anticipates. This stance should place downward pressure on the US dollar, especially against undervalued currencies such as the Japanese yen and other Asian currencies that have recently been trading at multi-decade lows.

**EUR: Underweight.** We are underweight the euro in anticipation that the ECB will cut rates sharply over the coming 12 months in response to falling inflation and a weak growth outlook. Political uncertainty in the region, which is likely to hinder further fiscal integration, has the potential to increase volatility in the currency, as investors' fears of a disorderly euro breakup are rekindled.

**RMB: Neutral.** We expect the Chinese central bank to continue to maintain a relatively stable renminbi and US dollar/renminbi exchange rate. The potential start to the US rate cutting cycle may bring room for further interest rate adjustments in China, which may limit the renminbi's performance against the basket. The upcoming US presidential election and trade and financial policies under the new administration will likely be the key catalysts for renminbi performance in the medium term.

**JPY: Neutral.** The yen is little changed over the last month, but stronger than its weakest level versus the US dollar. The yen has rebounded thanks to tightening interest rate differentials, driven by slower US inflation and weaker employment data, and some evidence of Japanese currency intervention. However, with the market now pricing close to three Fed rate cuts in 2024, recent US data may have allayed fears of a bigger US slowdown, which might limit the yen's further appreciation. A more hawkish BoJ than expected at the July meeting could lead to a further squeeze of yen short positions. Weaker risk sentiment in August has in the past proven yen-supportive, particularly against high beta currencies, such as the New Zealand dollar.

**GBP: Underweight.** The British pound has benefited recently from political instability in the eurozone and the US, high UK rates and relatively positive UK growth surprises. However, at current valuations, the pound reflects much of the good news in terms of growth and policy stability, in our view, while the start of the BoE rate cutting cycle is likely to undermine its attractiveness as a relative high yielding currency. A bigger global slowdown would likely see the pound exhibit its cyclical characteristics, as markets price a convergence of UK rates with the eurozone, weighing on the currency. Positioning is now long the British pound, although foreign direct investment and merger and acquisition-related inflows might increase following the election.

**AUD: Neutral.** The divergence in policy stance between a more dovish Fed, ECB and Reserve Bank of New Zealand, and a more hawkish RBA, has been a supportive factor for the Australian dollar over the last month, with the trade-weighted currency index up 2%.[2] However, this dynamic has largely played out, with the market now pricing US and New Zealand rates below Australian rates in 18 months' time. Furthermore, Chinese data remain very weak, raising questions about the resilience of commodity prices. Risk sentiment might also be vulnerable ahead of the US election, especially if a second Trump presidency is associated with greater geopolitical and trade tensions in the Indo-Pacific region.

2. Source: Bloomberg L.P. Data as of July 15, 2024.

**Panelists**

**Matt Brill**
Head of North America Investment Grade

**Todd Schomberg**
Senior 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

## How to navigate investment grade in the second half? IFI PMs share their strategy

Key drivers of US financial markets in the first half of this year centered on inflation and Fed policy. There have been some ups and downs with inflation, but recent data suggest that it is declining toward the Fed's 2% target and that rate cuts are on the horizon. There is now a growing focus on US growth dynamics. We talk with Invesco portfolio managers Matt Brill and Todd Schomberg about the implications of this shift for investment grade and their strategy for navigating the second half of the year.

**Q: What do you expect for inflation and interest rates going forward?**

**Matt:** The first half of the year was interesting — for several months all eyes were on the Fed and other central banks as markets gauged the possibility of rate cuts. But by April, everyone threw in the towel and decided cuts were probably not going to happen this year. Then the second they threw in the towel, we started getting better inflation data in the US and globally. This allowed the ECB to cut rates, along with the Bank of Canada. So, US friends and neighbors are cutting interest rates, but the US has not yet, though we believe cuts are certainly on the way.

We think the market's focus has now shifted from inflation to growth. Growth is clearly slowing, though not sharply, and we are seeing it with the consumer and other spots in the economy. This makes us more comfortable that inflation is on a downward path. We think inflation prints will continue to moderate, driven by a slowdown in goods inflation — and perhaps deflation. Services and shelter prices may continue to be a challenge, but we believe they will also moderate, and that we will see two rate cuts before the end of the year.

**Q: Do you expect increased flows into investment grade once the Fed starts cutting rates?**

**Todd:** There is still a tremendous amount of money sitting in cash in the US — around USD6 trillion in money market accounts.[3] There is a lot of cash in Canada on the sidelines as well, and these two yield curves are still inverted. So as the Bank of Canada and the Fed cut rates, we think people will start looking at their bank statements and realize that they aren't getting that 5% on their cash that they were getting before. They will probably start extending some of their maturities to lock in some of that higher rate. In the US, fund flow data suggest this is already happening.[4] Japanese investors may also be attracted to the US investment grade market if currency hedging costs improve, as the Fed cuts rates while the Bank of Japan hikes rates. Traditional fixed income demand from insurance companies and pension funds also remains strong.

**Q: Market technicals refer to supply and demand for investment grade. You just described the demand side — what do you expect for supply?**

**Todd:** We have definitely seen a tremendous amount of supply in our marketplace this year, at over USD800 billion.[5] Depending on the exact numbers, that represents a 30% to 40% year-over-year increase in bond issuance. But it's important to note that yields have been much lower this year than last fall when corporate treasurers and chief financial officers were weighing the market. The financing environment has been ripe, and companies likely wanted to lock in financing and avoid the potential volatility that might pick up later this year with the US elections. The new issues were very well absorbed and have performed well, with credit spreads tighter on the year. We expect supply to slow in the second half of the year because it started out very front-loaded. Also, we do not expect a heavy new issue calendar going forward as large merger and acquisition deals do not appear on the horizon and the leveraged buyout market has been quiet. We also expect supply to slow in several sectors, such as financial firms that were large issuers in the first half of the year. This should all promote supply and demand balance, favoring us as investors.

**Q: Turning to investment strategy, how do you plan to navigate the rest of the year?**

**Matt:** Looking back at the start of the year, we didn't buy the argument that there would be a massive slowdown in the US economy. We also didn't buy into the fears that US banks would be in serious trouble. We had a more favorable outlook that led us to favor overweight positions in corporate credit and higher-spread assets, which tend to do well when the economy does well. And while the economy is slowing, it is still doing well.

3. Source: Bloomberg L.P. Data as of June 30, 2024.
4. Source: Morningstar Direct. Data as of June 30, 2024.
5. Source: Bloomberg L.P. Data as of June 30, 2024.

Nevertheless, as the market shifts its focus from concerns about inflation to concerns about growth, we now favor dialing back risk somewhat, especially since credit spreads have narrowed and valuations may not look as attractive as they did earlier in the year.

**Todd:** That being said, we view the market as more fairly priced now, after previously being mispriced for a recession. And the yield on the investment grade index of over 5% is still compelling, in our view, on an historical basis.[6] The way we think about it, most of an investor's total return is likely to come from the coupon this year. We do think we could see some volatility, but we are looking forward to taking advantage of any softness this summer, and anticipate potential opportunities in the fall, especially as the new issue calendar resumes. In the meantime, we see some attractive yield opportunities in short-dated asset-backed securities, certain non-agency mortgage-backed securities and AAA rated collateralized loan obligations, as we wait for future opportunities to re-risk.

6. Source: Bloomberg L.P. Data as of July 13, 2024.

**Panelists**

**Niklas Nordenfelt**
Head of High Yield

# The bottom line: Jump in, the water's lukewarm; The case for high yield in a moderating world

We speak with Head of High Yield, Niklas Nordenfelt, about why he believes high yield is positioned to perform well in the current macro environment.

**Q: What economic conditions are ideal for credit?**

Credit in general, but especially high yield, benefits from conditions that aren't too hot or too cold. Moderate, moderating, moderation…these are all ideal words for credit in describing a macro backdrop. When conditions are too hot, or too strong, we typically see aggressive issuance; an increase in leveraged buyouts, mergers and acquisitions and even dividend deals that either lever balance sheets or transfer value from debtholders to equity holders. When conditions are weak, then top lines are pressured, which is a challenge for leveraged borrowers, such as those in the high yield market.

**Q: What gives you comfort that we are in this "moderating" environment?**

Economic growth appears to be moderating but a recession seems unlikely in the foreseeable future. Inflation remains stubborn, yet on a persistent path of moderation. Disinflation provides an opening for a moderation in monetary policy, including the potential for at least one rate cut before the end of the year.

**Q: Corporate default rates had been rising. Where do you see them going from here?**

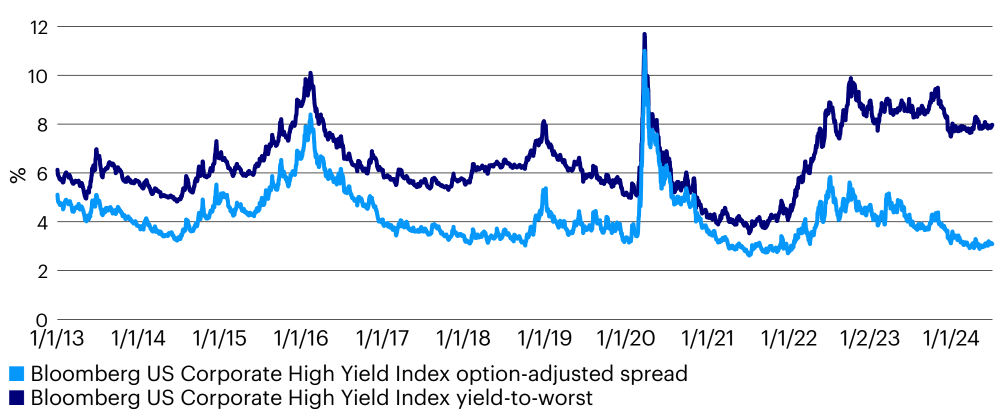
Until recently, default rates were on an upward trajectory. While we expect a continued rise in default rates across leveraged borrowers, the unique conditions underlying high yield borrowers have led to a declining default trajectory in the high yield bond market. First, distressed issues have declined within the high yield market. Second, rating agencies have been upgrading ratings more frequently than downgrading them — at least that is the case for most of the high yield market. BB rated bonds have seen 1.4 upgrades for each downgrade, while B rated bonds have seen 1.2 upgrades for each downgrade.[7] The picture is less rosy among CCC rated issuers, where idiosyncratic concerns and the higher cost of capital is weighing on a growing cohort of companies. In the context of the broader high yield market, however, these weakening credits make up a relatively small percentage.

Beyond ratings trends, balance sheets remain strong, with stable leverage levels and stabilizing interest coverage ratios. The coverage ratios remain well above historical averages, providing a healthy cushion to withstand softer economic conditions.

**Q: What about spreads? Are they too tight or do you see value?**

In our view, ideal investments combine attractive pricing with the tailwind of improving fundamentals. It's rare that you get both. Today, high yield enjoys solid, and arguably improving, corporate fundamentals but pricing that is less attractive. We would prefer higher spreads, but if I had to choose between cheap prices and good fundamentals, I'd take the latter. The fundamentals are more enduring and create a better view into near-term downside risks. The good news is that, in the more recent past, tight spreads meant exceptionally low yields. In today's market, however, all-in yields are quite attractive, in our view. These yields provide a nice cushion, which, combined with the positive fundamental outlook, significantly lowers downside risk. The probability of negative returns with this set-up is quite low, in our opinion, whereas we believe the probability of solid returns on the back of high current income is quite high.

**Figure 3: High-yield all-in yields look attractive despite tight spreads**




Source: Bloomberg L.P. Data from Jan. 1 to July 2, 2024.

7. Source: JP Morgan, June 14, 2024. Upgrade/downgrade ratios are year-to-date, ending May 2024.

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