Global Fixed Income Strategy

Invesco Fixed Income

September 30, 2020

Contents

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We have upgraded our growth outlook for the US and Europe

The global economy has experienced an unusual recession - one induced by public policy following a health crisis, rather than an economically driven one. The recession took hold rapidly as people were asked to stay home to limit the spread of the coronavirus and allow time for the medical sector to deal with a pandemic that caught the world unprepared. As outbreaks have been brought under control, the exit from recession has also been rapid. Compared to our expectations at the peak of the crisis, the economic contraction has proved to be shallower than we expected and the recovery faster. As such, we have upgraded our growth forecasts for the US and eurozone.

Better than expected growth

Recent growth outcomes in the US and Europe have beat expectations for a number of reasons. First, the opening of the US and eurozone economies has been more rapid than anticipated. Most countries were able to resume much of their economic activity without major second waves of the virus. In regions that experienced renewed outbreaks, such as the US South and West, the spread of the virus was limited without full lockdowns. Instead, targeted business closures, mask wearing and social distancing have been effective.

Second, some sectors are less exposed to the virus, such as construction and manufacturing, where production and sales are recovering sharply. Other sectors where face-to-face interaction is essential still face challenges and will likely not fully normalize until a vaccine becomes available. But a partial recovery in such sectors is underway - think of restaurants serving food outside, hairdressers serving clients with masks and personal protection equipment and sports events returning to TV. Clearly, there has been a loss of jobs and incomes in these sectors, but policy support has helped.

Third, policy support has been quick, very large, and effective. During the global financial crisis, new monetary policies, such as quantitative easing (QE) and forward guidance, had not been tried or tested and were consequently deployed gradually and timidly. In Europe, QE was not launched until 2015. This time, however, central banks announced monetary stimulus in the form of forward guidance and QE programs immediately after the coronavirus shock. On the fiscal side, governments have offered an unprecedented amount of income support and loan guarantees, providing a cushion for business and consumer spending.

These policies have been arguably effective. In a typical recession, debt levels tend to be high, creating a need for deleveraging in the early stages of a recovery that tends to hamper the effectiveness of monetary policy. This recession, however, has not been triggered by economic reasons and the private sector still has the ability to borrow. Therefore, we believe monetary policy can be more effective in the current environment. In the US, high levels of activity in the housing sector and mortgage applications is one sign of this. In the eurozone, European Central Bank (ECB) lending surveys have suggested that, despite some signs of tighter conditions, the credit channel has remained open in the region.

We expect economic recovery to stay on track

Going forward, we expect the economic expansion to continue for the reasons outlined above. Traditional economic data, as well as high-frequency alternative indicators, such as mobility and credit data, confirm the strong rebound in activity in the third quarter in the US and eurozone. We expect growth to remain strong in the fourth quarter, but to slow somewhat, since most of the economic opening in the two regions is now behind us. Given that uncertainty remains high, we continue to provide alternative scenarios for our economic outlook. Our bull, bear and base cases are provided below.

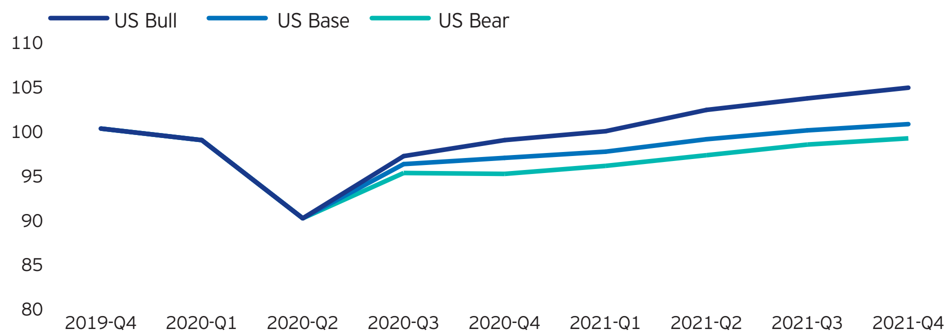
US

Recently available data suggest that the US economy is bouncing back sharply in the third quarter. The main driver of growth in the third quarter came from recovery in consumption. As the economy opened up, spending on goods increased sharply, thanks to pent-up demand. Despite being at low levels due to social distancing, services sector spending recovered considerably as well. Fiscal support under the Coronavirus Aid, Relief, and Economic Security (CARES) Act helped boost incomes in the third quarter, and led to savings that should provide some cushion in the coming months as fiscal support lapses.

Housing has recovered quickly and we expect it to remain strong during the recovery. Historically low mortgage rates, low housing inventory and healthy household finances should support activity in the sector. Indicators suggest that equipment investment bounced back strongly in the third quarter, though structures investment will likely recover slowly. Finally, inventories should add strongly to third quarter growth as companies rebuild inventories after a collapse in the second quarter.

We now expect the US economy to contract 4.0% in 2020 (compared to our June forecast of -6.2%) on a calendar year basis, and grow 5.3% in 2021 (compared to our June forecast of 5%). On the health side, we assume that potential new outbreaks this fall will likely be local and contained with targeted measures and without widespread lockdowns. Despite a lapse in fiscal support after July, we assume that high saving rates and better than expected job creation will support the recovery in the fourth quarter. We would expect a new fiscal package to be agreed in 2021 to avoid a fiscal cliff. We expect monetary policy to continue to be very supportive, and expect the US Federal Reserve (Fed) to announce revamped forward guidance and details of its asset purchase program in December. In the bearish scenario, we assume outbreaks in the fall to be widespread, requiring more stringent social distancing, causing further disruption to the services sector. In the bullish scenario, we assume a vaccine is approved by the US Food and Drug Administration in 2020.

Figure 1: US growth - Three scenarios (2019-Q4=100)



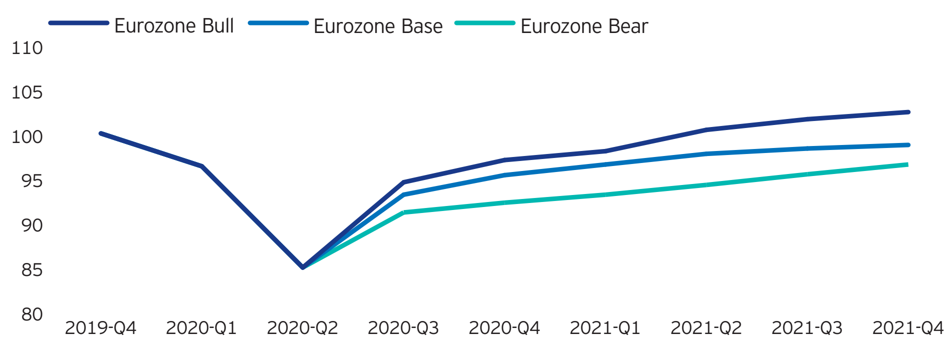
Source: Invesco, data as of Sept. 30, 2020.

Eurozone

Eurozone growth has also been better than expected but the contraction in Europe was deeper than in the US. The eurozone was hit earlier by the virus, undertook more widespread lockdowns and was more exposed to global growth than the US. The eurozone policy response was also quick and sizeable. The ECB's Pandemic Emergency Purchase Program (PEPP) calmed initial market volatility and led to easier financial conditions. All countries announced and implemented fiscal support programs. The European Union (EU) agreed to launch a recovery fund that would issue EUR750 billion of debt to support the recovery by distributing grants and loans to members that were hit hardest by the pandemic.

The eurozone economy also bounced back strongly in the third quarter. The reopening of the economy and income support through job protection programs led to strong recovery in consumption. We now expect the eurozone economy to contract 7.4% on a calendar year basis in 2020 (compared to our June forecast of -9.4%), and grow 6.1% in 2021 (compared to our June forecast of 5.2%). The assumed risk scenarios related to the pandemic are similar to the assumptions for the US. Regarding policy, we assume that fiscal support and job protection programs remain in place, supporting growth in the fourth quarter and through 2021. We expect the ECB to increase the amount of its bond purchases under the PEPP program by early 2021 and extend the duration of purchases to the end of 2021.

Figure 2: Eurozone growth - Three scenarios (2019-Q4=100)



Source: Invesco, data as of Sept. 30, 2020.

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Interest rate outlook

US: Neutral. US Treasury yields are likely to stay low for a significant length of time. The deflationary growth shock unleashed by the coronavirus has decreased the fair value of the 10-year US Treasury yield to around 1%, in our view. 10-year US Treasuries are likely to trade below this level while the economy remains in the slow growth/low inflation regime caused by the virus. The Fed has initiated a major policy shift by moving toward an average inflation targeting regime. In addition, it has committed to leaving rates at the zero bound until inflation is forecast to be moderately above its 2% target. This suggests that, while overall rates will likely remain low, real US interest rates may continue to rally. The US Treasury curve may steepen, especially in the 30-year part of the curve, as supply increases.

Europe: Neutral. Despite the continued rise in COVID-19 cases and the recent deterioration of the economy following the post lockdown bounce, the region's bond market has remained in a tight range. Stressed sovereign balance sheets and an avalanche of new issuance has had little impact, as the EU has stepped and mopped up the excess issuance. The plethora of ECB bond purchase programs has ensured that yields have remained low and spreads between countries tight. The ECB has shown its determination to keep the market functioning in an orderly manner and we expect it to announce an extension to its bond buying programs before the end of the year.

China: Neutral. Onshore government bond moves have continued to be led by onshore equity market performance, supply pressure, interbank liquidity conditions and international investor demand. Monetary operations have shown some flexibility, but the year-end effect may still pressure front-end funding levels. Stock market performance and US-China news headlines may continue to drive near-term bond market performance. However, the upside to yields on rates bonds may be limited by strong buying interest from international investors when yields reach certain levels.

Japan: Neutral. Japanese government bond (JGB) yields declined in September, reflecting global risk aversion and the market's ability to absorb significant supply. At current yields, there appears to be solid demand for JGBs, perhaps reflecting their relative cheapness to US and European bonds. However, there is equally little impetus for lower yields, as the Bank of Japan appears happy to keep QE operations unchanged and there is scope for additional fiscal stimulus, which should keep the yield curve relatively steep.

UK: Neutral. The September Bank of England (BoE) minutes signaled that policymakers continue to consider cutting interest rates below zero, making the distribution for UK short rates less skewed to the upside. In addition, rising COVID-19 cases and the increased risk of a No Deal Brexit raise the likelihood that downside risks to growth will be realized and the BoE might respond with additional QE, which would likely significantly improve the supply/demand balance for gilts. At current yields, 10-years are not very attractive on an outright basis, in our view, but they do look interesting versus German bunds, as the BoE has greater room to cut rates than the ECB and appears more likely to increase QE in the near term.

Canada: Neutral. The economy is showing signs of stabilization, supported by ongoing fiscal measures to support income and defer debt re-payments. Elevated household debt levels have not curtailed demand for residential housing. Growing savings are leading to some positive improvement in household debt reduction. The economic recovery is expected to remain uneven, supported by both fiscal and monetary policies. Valuations continue to remain expensive, in our view, while fundamentals support a rangebound outlook for government bond yields.

Australia: Neutral. The prospect of increased QE from the Reserve Bank of Australia (RBA) and a potential cut to the 3-year yield target are supportive for the Australian yield curve, which remains relatively steep compared to many international peers. As a consequence, we would expect foreign demand for Australian bonds to remain strong, limiting possible underperformance.

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Currency outlook

USD: Underweight. We expect the US dollar to broadly depreciate versus other currencies. The Fed has initiated a major policy shift by moving toward an average inflation targeting regime. In addition, it has committed to leaving rates at the zero bound until inflation is forecast to be moderately above its 2% target. US monetary policy is likely to sharply reduce real yields in the US below the levels experienced in other countries. We believe this will lead to meaningful dollar depreciation.

EUR: Neutral. The euro's appreciation in recent months has begun to wane as the second wave of COVID-19 takes hold and the market begins to discount additional measures by the ECB. Another driver has been comments from senior members of the ECB that they are watching the euro's recent appreciation and are concerned that a stronger currency may weigh on inflation in the region. We expect the euro to remain range bound, but its path will likely be determined much by the performance of the US dollar.

RMB: Neutral. We have turned neutral on the renminbi after several months of being overweight. We think the USD/RMB exchange rate may consolidate at the current level for a period of time before new catalysts emerge. Both current account and portfolio flows have been supportive of renminbi performance. As China has swiftly contained the outbreak with a significantly reduced number of new cases, we see room for Chinese assets, including the renminbi, to continue to outperform in the medium term.

JPY: Overweight. The Japanese yen outperformed the US dollar and euro in September. Its stronger performance may reflect reduced capital outflows and the rebound in exports. Regarding the first issue, it is worth noting that the Government Pension Investment Fund's (GPIF) weight to foreign assets has now reached 50%, limiting further scope for diversification into other currencies. Other public pension funds could still buy more foreign assets to match GPIF's asset allocation, but these flows will likely be relatively small and could be offset by exports and hedging demand from life insurers.

GBP: Underweight. The UK government has recently antagonized the EU by putting forward legislation that contravenes the Northern Ireland Protocol of the Withdrawal Agreement. Although the EU's response has been measured and negotiations are continuing, this provocative act has reduced trust and created an additional obstacle to reaching a free trade agreement by December 31. Alongside fishing and state aid, the UK and EU will now also need to compromise on their various views on the implementation of the Withdrawal Agreement.

While it is in the interest of both parties to reach a deal, and, arguably, the worsening UK domestic situation will likely increase pressure on it to compromise, the window of time available for a compromise is now very tight. A breakthrough at the October 15 EU Council, or shortly after, appears paramount to avoid a No Deal Brexit.

However, even if a deal is reached, it is worth noting that at best it will likely be just a zero quotas/zero tariffs free trade agreement covering goods alone; it will likely be a much harder Brexit than was proposed by Prime Minister May 18 months ago. Even if this "upside" scenario is realized, the UK will likely face greater trade friction with the EU.

CAD: Neutral. We expect the Canadian dollar to remain rangebound against the US dollar in the near term. Valuations remain fair, in our view, but the ongoing uncertainty around further COVID-19 led economic disruption and trade disputes creates a negative headwind versus other G10 currencies. The closed border to non-essential services is providing much needed improvement to the country's external balance.

AUD: Neutral. Since March, the Australian dollar's appreciation has been driven by strong balance of payments dynamics, relative success in containing COVID-19, a relatively hawkish RBA and improving global risk sentiment. Although the balance of payments remains supportive, we believe these factors are likely to fade going forward, limiting the upside potential for the Australian dollar.

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Global investment themes

Asset class themes

Investment grade (IG): We have shifted to neutral positioning as duration-adjusted credit valuation screens less cheap and market technicals soften on greater-than-expected refinancing and tender-driven supply.

Rationale
The market remains supported by the Fed's bond purchasing program and healthy demand from global investors, but uncertainty remains about (i) fundamental weakness due to the COVID-19-related economic slowdown, (ii) the US November election outcome and (iii) the potential need for further politically sensitive fiscal stimulus. Global economic activity has rebounded from historically depressed levels, but growing concerns of further economic shutdowns in Europe and growing cases in younger populations call into question the ongoing pace of global economic re-opening. In response to broad-based macro weakness seen during 2020, governments and central banks continue providing unprecedented levels of monetary and fiscal stimulus that have both (i) absorbed the initial impact to risk assets and (ii) delayed and somewhat obscured the fundamental deterioration in (a) corporate operating performance and (b) corporate balance sheets. The Fed's bond purchasing programs announced on March 23 thawed an otherwise frozen US IG new issue market, paving the way for historic levels of issuance since April. While this issuance has alleviated pressure on both corporate liquidity and the broader financial system, corporate leverage will undoubtedly rise and fundamentals will likely remain weaker as companies navigate COVID-19-related impacts over the next several quarters.

Offsetting record levels of new issuance and fundamental uncertainty has been technical demand, which remains quite strong. The Fed's targeted bond purchases, spread across primary and secondary market programs, sent a clear message that it is both willing and able to support the orderly functioning of corporate bond markets and that it believes stable credit markets are important for a stable financial system overall. The Fed's announcement of bond market activities has resulted in massive capital inflows into the corporate bond market and supported spread tightening from levels not seen since the global financial crisis.

Having already eclipsed full-year 2019 levels, we have expected the cadence of new bond issuance to revert to a more normalized level in the second half of 2020. However, a favorable interest rate environment continues to incentivize new issuance aimed at refinancing and opportunistic tendering, driving elevated supply expectations through October. When coupled with the recently slower pace of secondary market Fed purchases, we now have a somewhat less constructive assessment of the technical environment.

The outlook for corporate fundamentals continues to evolve, especially in sectors more exposed to COVID-19-related economic restrictions. With the Fed's support, the new issuance market has allowed even the most challenged sectors to raise liquidity and address near-term maturities, reducing pressure on the banking system and providing a degree of patience from ratings agencies. However, downgrades to high yield continue to be a major concern for ratings-sensitive investors. Accordingly, spread dispersion within the index and among names most at risk of downgrade persists, underscoring the necessity of remaining vigilant in both sector allocation and security selection.

In Europe, we continue to expect market technicals to remain the prevailing driver of European IG credit spreads in the near term. As such, our outlook is positive, given the significant backstop that the ECB is providing to the market through its QE program. The ECB has upsized its bond-buying program to €1.35 trillion and IFI estimates the ECB is buying around €10 billion of corporate bonds per month (or around 1% of the outstanding eligible index).[1] While new supply should pick up after the seasonally quiet summer months, we do not expect a return to the 1H-2020 levels, as corporates have already created significant liquidity reserves. Additionally, the tender and refinancing activity seen in the US is not being repeated in Europe, given that negative European risk-free rates and lower "all in" financing costs for issuers have been a feature of this market for some time.

While European IG valuations have recovered significantly from the COVID-19 sell-off, there is dispersion within this; we continue to favor subordinated parts of the IG capital structure in issuers and sectors that we feel will be relatively protected from the fundamental headwinds of the virus. In a global negative real yield environment, we expect these parts of the market to continue to compress, as investors hunt for "high quality" returns.

IFI strategy
We have shifted to a neutral position in US and Asia IG, while remaining selective and opportunistic in European IG credit. Global central bank support remains in place to combat further challenging scenarios for corporate fundamentals, suggesting a healthy degree of near-term downside protection for global IG credit, in our view.

Credit valuations, especially when adjusted for a near all-time high duration in the US, have tightened following the announcement of fiscal and monetary policy support measures and provide a growing headwind when evaluating risk-adjusted valuations. Key market drivers we are monitoring include (i) the potential for a moderation in the new issue cadence during the fourth quarter (i.e. a slowing of supply), (ii) recovering corporate fundamentals as global economies experience normalized levels of economic activity, (iii) continued market support from policymakers and (iv) global management of the coronavirus, which has direct impacts on consumer demand and confidence. In Europe, dispersion within the asset class remains a key factor, and we would expect the next stage of any potential rally to be driven by further beta compression, supporting our preference for subordinated financial paper issued by fundamentally strong "core" European banks and selected corporate hybrid issuers.

High yield (HY): Improving Q4 GDP likely to support company-level credit improvement

Rationale
We expect growing revenues to help improve earnings profiles for many companies. In our view, growing earnings could lead to tighter credit spreads as default risks diminish from the elevated levels seen earlier this year. Importantly, many companies continue to access the primary markets to push out near term maturities with new 8 or 10-year bonds. This type of refinancing behavior is credit-friendly and improves near-term balance sheet liquidity. While we expect to see more distressed companies restructure their balance sheets, many of these are already priced into the markets. Additionally, despite the impressive total return gains since late March, we continue to find attractive investment ideas, both in the new issue and secondary market. Given the large spread compression over the last six months, we expect near-term market gains to be more muted, but still attractive given the overall risk backdrop.

IFI strategy
We have adopted a more cautious view on risk markets given the strong excess returns posted in Q3. Record new issuance has allowed companies, especially those exposed to COVID-19 headwinds, to fortify their liquidity positions. This is a positive development combined with expected improvement in earnings over the next couple of quarters. However, we expect increased volatility in the near term due to the uncertain US fiscal policy backdrop and upcoming elections. We are looking to add to selected BBs in Europe while maintaining our procyclical allocation to retail in the auto and specialty retailers. Low US mortgage rates have met with willing buyers and have been positive for HY homebuilders.

US residential mortgage backed securities (US RMBS): Housing has been resilient though risks remain; we favor higher quality RMBS

Rationale
Positive technicals, housing market strength and improved visibility into emerging borrower performance trends have driven recent outperformance in the residential credit sector. We expect long-term tailwinds to provide support to the housing market, even as the benefits of short-term catalysts begin to fade. At the same time, a failure to extend meaningful fiscal stimulus and supplemental unemployment benefits could drive delinquency rates higher, especially in geographic markets with disproportionate exposures to COVID-19-related job losses. Market technicals remain firm as investors scour fixed income markets for return opportunities in a low yield environment.

IFI strategy
Though the sector has richened relative to other fixed income credit markets, we still see value in the middle-to-top of the capital structure. We believe there is incremental room for further spread tightening in higher quality bonds, which are likely to be supported by declining issuance volumes into the end of the year. In contrast, we are cautious on certain deep credit classes as the strong market bid implies aggressive extrapolation of recent borrower performance improvement, in our view.
US asset-backed securities (US ABS): Collateral performance risk has increased, positive technical trends support the market

US asset-backed securities (US ABS): Collateral performance risk has increased, positive technical trends support the market

Rationale
Collateral performance trends since the pandemic began have been better than expected as federal employment benefits and lender payment deferrals have been supportive to-date. Credit performance risk has increased, however, as many of these programs have lapsed and it remains to be seen when, or if, a new stimulus package will be passed by Congress. Despite our expectations of near-term fundamental weakness, we believe there are several opportunities to add benchmark and non-benchmark ABS, given robust structures and credit enhancement. In addition, technical trends remain favorable in both the primary and secondary markets, given positive market sentiment for higher quality ABS.

IFI strategy
We continue to focus on higher rated bonds within the capital structure, given our weaker views on near-term fundamentals. There are opportunities to add non-benchmark assets, which have trailed the spread rally in benchmark ABS to-date. While esoteric ABS new issue supply has increased on positive technical momentum, we have been very selective when adding. In the secondary market, given historically low dealer inventories, we also find it difficult to add sizable positions in the names we like. Despite the strong rally in spreads, many ABS remain attractive to generic corporates, in our view, except bank credit card and prime auto loan ABS. Select esoteric ABS, such as aircraft, remain under pressure.

Sector themes

The US consumer: spending patterns adjust to the new normal

Rationale
Consumer spending on services (about 2/3 of total spending) transitioned from a tailwind to economic growth to a headwind when social distancing became the predominant method to slow the spread of COVID-19. The use of masks and technology has enabled some spending categories to recover but a vaccine or more effective treatments are needed to attain a more complete recovery. Spending on durable goods actually spiked over the summer as consumers acquired vehicles, computers, and furniture to enable them to adjust to the new realities of a COVID-19 world, including work from home, school from home and avoiding public transportation. This bonus of durable spending has offset much of the weakness in services, but we expect this anomaly to recede, resulting in slower total spending growth going forward. (Read more about out views on retail in the Credit Strategy article below).

IFI strategy
We are focused on companies that are either positioned to continue generating profits through the pandemic or have balance sheets strong enough to endure until demand recovers sufficiently to restore profitability. We still see value in building materials and travel providers focused on leisure.

Commodities: The pandemic has caused significant demand disruption but a gradual rebound in economic activity and supportive government policies provide near-term support.

Rationale
Demand for commodities has materially weakened following the onset of the global COVID-19 pandemic, driven by declining manufacturing activity and oil inventory build-ups, given the rapid and unanticipated contraction in global demand. However, following significant price declines in March and April, investor sentiment around commodities seems to have partially stabilized, as prices have strengthened in recent months, reflecting (i) a strong rebound in China's industrial activity, (ii) the global implementation of supportive fiscal and monetary stimulus measures, and (iii) COVID-19-related supply disruptions and curtailments.

Shareholder-friendly capital allocation policies, including large dividend pay-outs and share repurchase programs, have rapidly shifted toward balance sheet protection measures to protect issuer credit profiles and credit ratings. However, lingering uncertainty around supply and demand outlooks for major commodities remain significant, given the unprecedented level of (i) demand disruption during the pandemic and (ii) consequent level of both monetary and fiscal support to economies around the globe.

Geopolitical risk seems to have temporarily subsided somewhat, as the global pandemic remains a key focus of political leaders and policymakers across the globe. However, political tensions between China and the US, Iran's growing influence in the Middle East, and OPEC+'s energy policy will likely continue to influence commodity markets.

IFI strategy
We favor iron ore miners in the short term, as Brazilian supply disruption supports price increases. We are underweight the Russian commodity complex, which we believe is relatively rich, while favoring integrated Indonesian coal miners, some selective high beta EMEA and Latin American exploration and production companies that are free cash flow breakeven above USD40/barrel, and some South American steelmakers.

We also remain constructive on hybrid issuances of European energy majors, certain US exploration and production companies with low-cost shale assets and US midstream companies focused on cost of capital optimization and active deleveraging to stabilize or maintain their investment grade ratings. Finally, we favor South African gold miners, which we expect to quickly de-lever their balance sheets on near-record gold prices and weaker local currencies.

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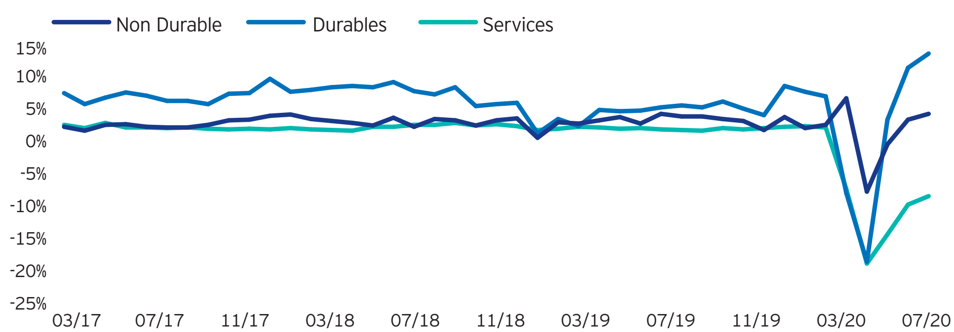
Consumers and COVID: Spending patterns adjust to the new normal

Since the start of 2020, we have witnessed the most volatile period of consumer spending in US history. The primary catalyst has been the COVID-19 pandemic, which has taken almost 1 million lives globally.[1] It has been the worst pandemic since the Asian flu in 1957, which resulted in 1.1 million lives lost, including 100,000 in the US.[2] To minimize the chance of contracting the virus, millions of consumers have disrupted their lives to avoid contact with others. Businesses and local governments have also restricted commerce to enforce social distancing guidelines. These changes have caused consumer spending to plunge, driven by sharp declines in spending on services and consumer durables. While some obvious consumer trends have emerged from the COVID-19 crisis – such as the boon to online retailers and the devastating damage to the cruise industry – we analyze recent consumer data to uncover less obvious COVID-19-related trends and changes in consumer behavior.

Shifts in US consumer spending patterns

US consumer spending totaled some USD13 trillion in 2019.[3] Most spending was on services (USD8.5 trillion) followed by non-durable goods like groceries (USD3 trillion), and durable goods like appliances (USD1.8 trillion).[4] After the onset of the pandemic in March, US spending on non-durables spiked by around 7% year-over-year, as consumers stocked pantries to prepare for an extended home stay (Figure 1). Spending on durable goods and services, on the other hand, fell by around 8% (Figure 1). As fears over the coronavirus peaked in April, total spending fell an astounding 16% year-over-year, but consumption in certain services sectors, such as hotels and airlines, cratered by more than 80% versus the previous year.[5]

Figure 1: Real US consumer spending (year-over-year % change)



Source: Bureau of Economic Analysis, data from Jan. 31, 2019, to July 31, 2020.

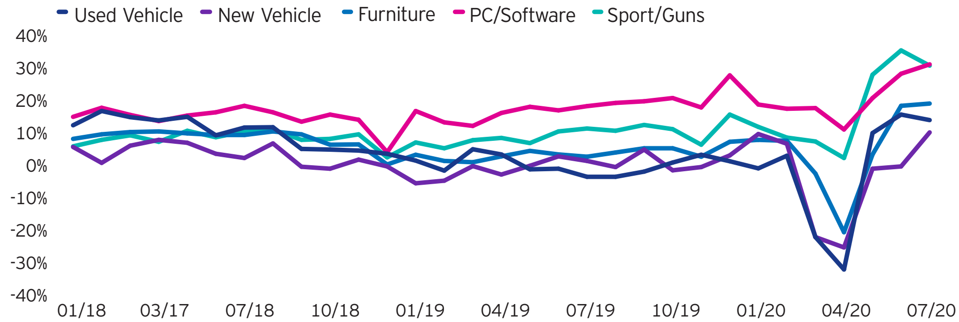
May marked the beginning of the recovery - durables spending exploded after April's 19% year-over-year decline and rose 3% in May (Figure 1). Durables spending remained strong through the summer, with double-digit gains in June and July. This surge was surprising initially, as high unemployment and a weaker economy are typically major headwinds to durables spending, but a closer look at the details explains this anomaly.

Durables spending led by cars, work from home, firearms

Within durables spending, there was a notable spike in used vehicle sales, which climbed 15% year-over-year in the summer, as consumers who might have previously used public transportation sought safer options (Figure 2). A shortage of used vehicles and higher prices are now driving demand for new vehicles as well. A second trend has been driven by one of the newest realities of American life: work and school from home. Summer sales of furniture (up 18% year-over-year) and personal computers and software (up 30% year-over-year) jumped as a result (Figure 2). We expect these trends to be short lived for the same reason that sales of snow shovels temporarily peak after the season's first snowfall. A separate trend – and one that we expect to remain intact – has been a rising demand for firearms. Spending on firearms and ammunition has risen an average of 30% year-over-year for the past three months (Figure 2).

[1] Worldometer, as of Sept. 18, 2020.
[2] Centers for Disease Control and Prevention, as of Sept. 18, 2020.
[3] US Bureau of Economic Analysis, as of Dec. 31, 2019.
[4] US Bureau of Economic Analysis, as of Dec. 31, 2019.
[5] US Bureau of Economic Analysis, as of April 30, 2020.

Figure 2: Durable goods leaders (year-over-year % change)



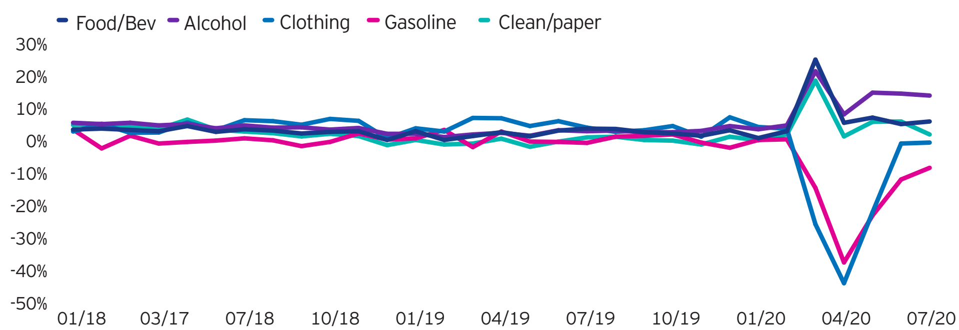
Source: Bureau of Economic Analysis, data from Jan. 31, 2019, to July 31, 2020.

Non-durables spending led by pantry goods, clothing, alcohol

While spending on non-durable goods has recovered to historical levels in aggregate, trends within the sector continue to be impacted by COVID-19. Groceries, cleaning supplies and paper products spiked at the onset of the virus as consumers built up supplies, unsure of how long they would be asked to shelter in place. As confidence grew that stores would remain open and necessities would remain available, consumable sales quickly returned to more normal levels. Grocery sales, however, have remained elevated (up 6% year-over-year) as consumers are still unable to eat out as often as they did pre-COVID (Figure 3).

Clothing and gasoline sales suffered dramatically during the shelter-in-place orders but began to recover when local governments allowed a gradual reopening of their economies. Children's clothing has been the most resilient since children grow out of wardrobes. Men's clothing has been the weakest, as work-from-home has reduced the need to replace old office apparel. Normally, gasoline sales can be used as a proxy for economic activity, but work and school-from-home have resulted in a semi-permanent drop in gasoline use that may last until a vaccine allows people to congregate without fear. Finally, spending on alcohol (up 13% year-over-year) has remained robust for the last six months, as consumers have been unable to patronize bars and restaurants and may be seeking a distraction from the elevated stress of today's new normal (Figure 3).

Figure 3: Non-durable goods growth drivers (year-over-year % change)



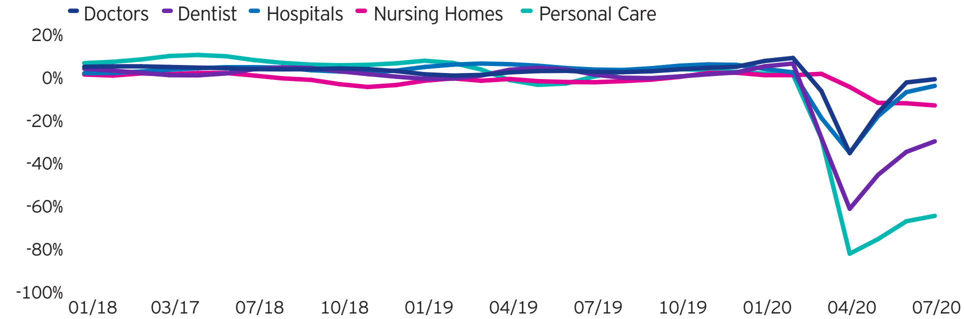
Source: Bureau of Economic Analysis, data from Jan. 31, 2019, to July 31, 2020.

Services spending led by leisure, especially gaming, dining

Services has been, and remains, the most challenging sector within consumer spending. While the impact of the pandemic on the housing and education sectors has been limited, there has been significant disruption to the consumer care and leisure categories.

Most observers might have expected COVID-19-related care to generate more spending on medical services, but the data show that hospital and doctor visits initially dropped around 40% before recovering, once consumers felt comfortable that COVID-19 cases were adequately isolated and "tele-doc" technology became more widespread (Figure 4). Dental care, which tends to be more preventative in nature and precludes patients from wearing masks, posted a steeper fall and continues to post a slower recovery. Personal care (such as hair and nail salons) has seen an even bigger fall, and the recovery has been anemic so far. Nursing home spending, which is usually relatively stable, since most clients are residents through the end of their lives, has seen a slow but steady decline with no recovery yet. Given the recent negative headlines and poor outcomes for nursing home patients during the pandemic, many families are reluctant to allow their relatives to move in under current conditions. Home care agencies and direct help from family appear to be filling the need in the interim.

Figure 4: Services: Growth in care spending remains anemic (year-over-year % change)

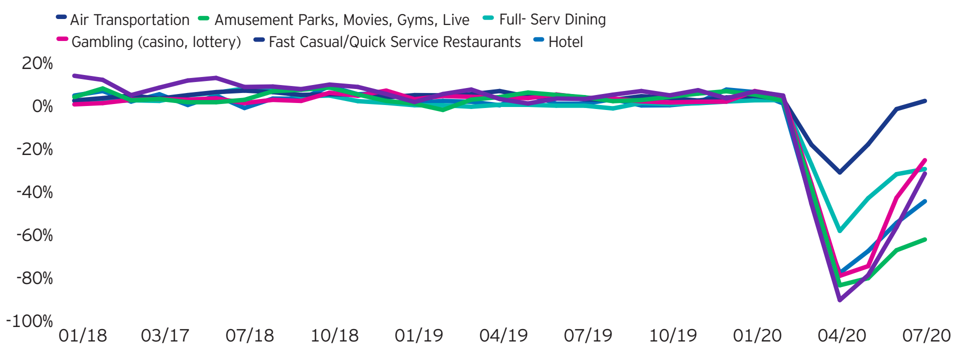


Source: Bureau of Economic Analysis, data from Jan. 31, 2019, to July 31, 2020.

Within the leisure sector, the recovery has varied by category. Fast casual and "quick-service restaurants" have fully recovered, as drive-through restaurants with limited indoor seating are adequate for consumers looking for a casual meal away from home. The decline in full-service dining was much deeper, as consumers in this sector are often seeking more than just a meal but also an experience, which cannot be replicated via take-out.

Among travel-related sectors, leisure demand for airlines and hotels, for example, has shown significant recovery from April's anemic levels. But we expect a slow recovery in travel spending overall, since business travel is likely to recover slowly as online communication increasingly substitutes for face-to-face business meetings. Gaming in local markets has fully recovered, but destination markets, such as Las Vegas, are still struggling as the return of conventions and international tourism may still be months away. We believe that live events, movie theaters and amusement parks will likely require a vaccine to fully recover, as occupying a room with dozens, or hundreds, of strangers is probably not sufficiently appealing to justify the current risk.

Figure 5: Services: Return of leisure spending (year-over-year % change)



Source: Bureau of Economic Analysis, data from Jan. 31, 2019, to July 31, 2020.

Conclusion

While a temporary boost in durables spending has supported consumer spending overall, services spending – which represents the bulk of consumer spending – continues to suffer. If a vaccine is developed and distributed effectively, we would expect spending on services to accelerate. But extended delays in the availability of a vaccine would likely cause the recovery to be slow. Durables spending has benefited from the transition to life with COVID-19, but we expect it to return to more modest levels as furniture and personal computing sales slow from the elevated levels posted initially following the crisis, potentially dragging down overall consumer spending.

Invesco Fixed Income's corporate research team will continue to dig deeper into the consumer data in the coming months to uncover underlying trends and opportunities as we seek to select the best investments for our clients.

The bottom line

Potential opportunities in taxable municipals

We speak with Mark Paris, CIO and Head of Municipals, Stephanie Larosiliere, Head of Municipals Business Strategy and Development, and Tim O'Reilly, Head of Institutional Municipals, about recent developments in the municipal market and the growing interest in taxable municipal bonds.

Q: Can you give us a quick overview of recent developments in the municipal market?

Stephanie Larosiliere: Early in the year, equity market selloffs triggered a flight to quality that drove a strong rally in municipals. But by March, the outbreak of the COVID-19 pandemic had caused a flight to cash, causing extreme volatility and price declines across the municipal market.

Municipal funds suffered heavy outflows in March, averaging around USD10 billion per week.[1] Total fund outflows reached USD21 billion in the first quarter, with most coming out of the high-yield segment.[2] Because high-yield municipal funds typically hold 30% to 60% of their portfolios in investment grade securities, they sold both high yield and investment grade securities into a distressed market to meet shareholder redemptions.[3] This dynamic reinforced price declines across the municipal universe.

Investors continued to sell municipal bonds in April amid disruption caused by the pandemic. Performance improved in May and June, despite ongoing market turmoil as supportive government policy helped restore calm to the municipal markets. So far, federal assistance to the municipal market in the form of the Municipal Liquidity Facility (MLF) has included the Fed's plan to purchase up to USD500 billion in short-term municipal bonds to relieve pressure on short-term paper.[4] Additionally, the MLF enables certain large borrowers (two issuers per state, city or county) to use proceeds from the sale of notes to service their debt payments. Specific sectors such as airlines, transportation and hospitals have also received federal funding. These stimulus packages and those in other market segments could put upward pressure on taxes (we know taxes probably won't go down). Because municipal bonds are one of the few income sources not subject to federal taxes, we believe their tax-exempt income will continue to be attractive.

Municipal credits have a long history of low default rates since many provide essential services. Most municipal issuers were in strong financial shape heading into the COVID-19 pandemic. Despite market concern, a flurry of downgrades has not occurred, mainly because most issuers have rainy-day funds or cash on hand for difficult times. Though there may be isolated pockets of default in the future, we believe the vast majority of municipal bonds will remain current on principal and interest, in keeping with historical experience.

What is driving increased issuance of taxable municipals?

Mark Paris: Taxable municipals have accounted for more than 25% of this year's municipal issuance – the highest level since 2010.[5] Behind this surge is the 2017 Tax Cuts and Jobs Act, which eliminated so called "tax-exempt advance refundings." Under the new law, interest on advance refunding bonds–refunding bonds issued more than 90 days before the redemption or call date of the refunded bonds–will now be taxable. Interest on "current refunding bonds"–refunding bonds issued within 90 days or less of the redemption or call date of the refunded bonds–will remain tax-exempt.

Historically the bulk of refundings have been advance refundings. The current low interest rate environment has made refunding compelling, increasing the rate of taxable municipal issuance. Taxable issuance also offers greater flexibility in the use of proceeds than tax-exempt issuance, making it an attractive option for many issuers. Taxable municipals have also garnered interest from non-US investors, many of whom are grappling with negative yields in their own markets.

Indeed, there were a few taxable refunding transactions in 2018 and 2019, but taxable advance refundings really took off after interest rates dropped significantly last summer and the rising supply trend has continued this year. If rates remain relatively low, we would expect advance refunding issuance to remain strong in the coming months and possibly years.

What are the characteristics of taxable municipals and how do they compare to corporate bonds?

Tim O'Reilly: Issuers in the taxable municipal market are identical to those in the tax-exempt municipal market. The primary reason that municipal issuers choose to issue taxable bonds is that they allow for more flexibility in the use of loan proceeds.

Compared to corporate bonds, taxable municipal bonds have much longer maturities. About 73% of the market value of the taxable municipal index corresponds to bonds with a maturity longer than 10 years.[6] That share is just 35% for the high grade corporate bond index.[7]

Municipal bonds, including those that are taxable, are also generally of higher credit quality than corporate bonds. Even comparing bonds at the same rating level, municipal bonds historically have had far fewer defaults than corporates. This is true for taxable or tax-exempt debt.

How do you think about taxable municipals relative to corporate bonds?

Tim O'Reilly: The pace of taxable municipal issuance is running far above last year's – issuance through September is three times the amount issued in the same period of 2019.[8] This supply surge – coupled with the

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[1] Lipper US Fund Flows, March 31, 2020.
[2] Lipper US Fund Flows, March 31, 2020.
[3] Morningstar, Aug. 31, 2020.
[4] Board of Governors of the Federal Reserve System, April 27, 2020.
[5] The Bond Buyer, Aug. 31, 2020.
[6] : Bloomberg Barclays Taxable Municipal Index, Aug. 31, 2020.
[7] Bloomberg Barclays US Corporate Bond Index, Aug. 31, 2020.
[8] Refinitiv Thompson Reuters; BofA Global Research, June 30, 2020.

Fed's intervention in other domestic bond markets in response to the COVID-19 crisis – has made taxable municipals cheap relative to other taxable asset classes, in our view. During the first half of this year, taxable municipals reached their cheapest level to high grade corporate bonds since 2014.[9]

Have you seen investor interest in taxable municipals?

Mark Paris: Yes, we continue to see interest in taxable municipals, primarily from overseas investors, as they continue to search for investment opportunities amid negative sovereign yields. This is particularly true for foreign insurers who require high quality, long duration investments. Further enhancing the current investment opportunity for non-US investors has been the dramatic drop in currency hedging costs. We are also seeing increased interest from "crossover" buyers who would normally invest in corporate bonds, like pension funds and insurance companies. Invesco Fixed Income has also been able to use taxable municipals to add performance to a range of multi-sector strategies managed across our platform.

Please read the Investment risk section at the end of this publication.

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[9] Bloomberg Barclays, June 30, 2020.

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