Invesco

Invesco Fixed Income
Multi-sector asset allocation outlook

Q1 2021

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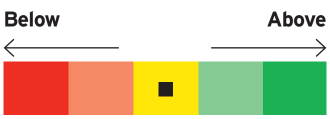
IFI multi-sector asset allocation overview

- **Macro factor summary:** We continue to expect growth to bounce back strongly in 2021 on the back of vaccine distribution and large amounts of stimulus. Our growth expectations continue to be above consensus. Although base effects should push up inflation in the first half of 2021, we expect inflation to remain well contained in the medium term due to excess capacity in the service sector and residual impacts of COVID. Global financial conditions remain easy and are supportive of markets, in our view.
- **Asset allocation summary:** Our macro factor framework suggests neutral positions in global duration and credit and an underweight position in the US dollar.
- **Risk position summary:** Underlying growth momentum is relatively supportive of risk taking, but valuations are tight, in our view. We prefer to stay neutral in risky assets, and use selloffs as an opportunity to buy risky markets that we believe will be supported by the fundamentals in the medium term. Growth with easy policy should be supportive of emerging markets generally.

Factors vs. market expectations

IFI macro factor outlook (3-month outlook)

Global growth: Above expectations
Global growth faces near term headwinds from renewed spread of the coronavirus and associated decline in mobility, but the longer-term expectations for growth are for a robust recovery next year. After a successful vaccine roll-out, economies will likely be able to fully reopen and put significant excess capacity in the service sector back to work. Very easy monetary and fiscal policy will likely bolster this return to activity, leading to a strong recovery. Regional differences in growth are likely, with Asia already returning to growth, the US next and Europe and emerging markets lagging due to a slower pace of vaccination. On the industrial side, where the growth correction associated with COVID was not as deep, some signs of late cycle capacity constraints may be visible during the year. Markets will likely look through near-term growth weakness and factor in the strong recovery expected next year. Better than expected growth developments should continue to be a key driver of market activity.



Global inflation: At expectations
US inflation plummeted in response to the sharp demand contraction as a result of the COVID shutdown. Inflation has begun to recover, but on a year-over-year basis remains depressed versus before the COVID shutdown. This is likely to change in 2021 as the period of the shutdown recedes and the base effects lead to a year-over-year pickup in measured inflation in Q2 2021. Measured core inflation should equal or surpass the level before the COVID shutdown by mid-year 2021. This just represents the impact of the shutdown washing through and the economy returning to an inflationary trend. In the medium term, we expect excess capacity in the labor market and ongoing sector headwinds from the COVID crisis to keep a lid on inflationary pressure and prevent a move above the recent trend.

Global policy and financial conditions: Easier than expectations
The combination of fiscal and monetary stimulus already in the system, along with commitments for both additional fiscal spending and continued monetary ease, is extraordinary from an historical perspective. The size of fiscal spending in the US, in particular, dwarfs the fiscal response to previous recessions. The speed of the recent recovery from the COVID recession has been bolstered by the strong policy response, and policy is likely to continue to bolster growth and financial markets in the coming year. In particular, the US Federal Reserve (Fed), which influences dollar liquidity, is committed to ongoing easy policy. This will likely provide liquidity to US dollar asset markets and ease financial conditions for other countries through a decline in the dollar.

IFI 2021 macro outlook

	Growth (%)		Inflation (%)		Policy	
	IFI forecast	Consensus	IFI forecast	Consensus	Next move	Consensus
US	6.2	4.1	2.0	1.8	We expect policy rates of all three major central banks to remain at the effective lower bound until at least end-2023. Continued quantitative easing likely.	Consensus is broadly in line with our forecast.
Europe	5.0	4.3	1.5	0.9		
China	8.0	8.2	2.0	1.6		
Japan	3.0	2.6	0.0	0.1		

Source: Invesco Fixed Income, Bloomberg L.P., data as of Jan. 15, 2021. IFI forecasts are a 6-month trend forecast.

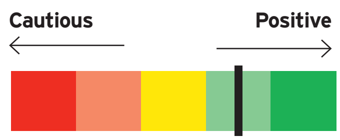
IFI broad asset allocation (3-month outlook)

Global duration: Neutral, with steepening bias
With a wide output gap remaining across developed economies and a commitment from major central banks to keep interest rates low for a long period of time, nominal interest rates should remain stable in the near-term. Real yields are expected to stay firmly in negative territory. As growth picks up, and inflation base effects push up measured inflation, the long end of yield curves may rise, generating steeper yield curves.

US dollar: Underweight
We continue to expect the US dollar to decline in the coming months as US monetary policy remains very easy. Capital flows have been slow to return to emerging market currencies, so their recovery has lagged somewhat.

Global credit: Neutral, we look for idiosyncratic opportunities
The fundamentals associated with growth and policy are positive for credit, in our view, but valuations are not compelling. We believe the current risk-reward balance favors a more cautious stance on credit. We are seeking to add value via security selection and buy into pullbacks.

IFI risk position (3-month outlook)



Growth momentum in 2021 should be a positive factor for risky assets. Monetary and fiscal policy will likely also be extremely easy, which also should be supportive of risky assets. The issue for risky asset markets is valuations, which are tight across most asset classes. Risky assets should continue to perform relatively well, but the upside is limited, in our view. Investors may want to look to assets such as emerging markets and foreign currency assets where valuations are less of a headwind.

Underweight ← → Overweight

IFI multi-sector asset allocation (3-month outlook)

Long-term government interest rates

US			■		
Fundamentals			■		
Valuations			■		
Technicals				■	

We expect Fed policy to remain accommodative for some time, given its average inflation targeting regime and commitment to a zero bound for interest rates. This suggests that, even as growth recovers, interest rates will likely remain low until inflation becomes apparent in the economy. Real yields have also remained low as inflation has increased in line with nominal interest rates. A committed Fed will likely keep the short end of the US Treasury curve uneventful, although we could see some steepening due to increased supply, especially in the 30-year part of the curve.

Europe			■		
Fundamentals				■	
Valuations		■			
Technicals				■	

The outlook for the European economy in the short term has deteriorated somewhat over the past month. The rollout of the COVID vaccine has been much slower than anticipated across the region, as a combination of reliance on a small number of approved vaccines, logistical challenges of delivering the vaccine and delays in supply have pushed back our expectations of a relaxation of lockdown measures and a return to some sort of normality. We now expect the vaccination of the most vulnerable across the region to take until the latter part of the second quarter, placing additional pressure on sovereign balance sheets. That said the European Central Bank (ECB) stands ready to respond, the bond purchase program still has considerable firepower remaining to calm markets and, as such, our analysis indicates that yields will likely stay low and within a narrow range for the time being. The political temperature in Italy has risen again, as the unsteady government coalition has begun to fracture. While this dynamic has the potential to widen Italian sovereign spreads versus core Europe, our central view is that a new coalition in some form will be agreed and elections will be delayed until 2022 or 2023.

China			■		
Fundamentals		■			
Valuations				■	
Technicals			■		

We maintain a neutral stance on Chinese onshore government bonds, as we expect relatively stable funding conditions and a potentially steeper yield curve. Policy makers have articulated that there will be no sharp turn in monetary policy in 2021. In our view, this indicates a monetary policy stance that is still evolving but in a gradual manner. We foresee potentially more interesting entry points in the longer-end of the bond yield curve after the first quarter, when China's economic and credit growth are likely to peak.

Japan			■		
Fundamentals			■		
Valuations				■	
Technicals			■		

Japanese government bond (JGB) yields followed US Treasury yields higher after the Democrats won control of the US Senate. However, the upside for Japanese yields is probably limited compared to other developed markets. JGB yields are already at pre-COVID levels, as the Bank of Japan (BoJ) has only partially offset the increase in supply caused by fiscal stimulus, especially in the long end. Consequently, JGBs are less susceptible, in our view, to a "taper tantrum" due to fears about receding quantitative easing purchases. The JGB curve is also relatively steep compared to other low yield markets, particularly in Europe, and offers relatively attractive real yields. Although US Treasuries appear increasingly attractive to Japanese investors on a currency-hedged basis, European assets appear relatively unattractive, which might result in some European allocations being redirected back to the domestic market.

Currencies

USD		■			
Fundamentals			■		
Valuations		■			
Technicals		■			

We expect the US dollar to weaken over the longer term, as the Fed keeps yields low relative to other countries. Even with a recovery in growth next year, we believe the Fed's inflation regime will support lower yields for some time. Furthermore, certain US asset classes have rich valuations, driven by increased demand. Lower US yields and rich valuations will likely encourage investors to look elsewhere for better investment opportunities, ultimately causing the US dollar to depreciate due to reduced demand.

EUR			■		
Fundamentals		■			
Valuations				■	
Technicals			■		

The outlook for the euro is especially challenging as we look forward to 2021. The divergence in the COVID vaccine response between the US and Europe has the potential to keep the euro area in the economic growth slow lane for months to come, while the US powers ahead. While our main expectation is for the US dollar to continue to drift lower, a sharp move lower in the euro and other currencies cannot be ruled out, especially if yields continue to rise in the US.

RMB			■		
Fundamentals				■	
Valuations				■	
Technicals		■			

We have turned neutral on the renminbi's performance against the US dollar in the near term, as the US dollar consolidates at its current level. Recent policy moves have pointed toward easing appreciation pressure on the Chinese currency. For example, more channels have been opened for capital outflows and currency fund-raising by financial institutions has been tightened. We continue to see a favorable fundamental backdrop for the renminbi, although we believe its near-term performance will be more dependent on US dollar moves against major currencies.

JPY			■		
Fundamentals			■		
Valuations			■		
Technicals		■			

Yen flow dynamics have moved in a more positive direction since the large public pension fund diversification into international assets has largely past and yen investors have less incentive to take currency risk with their international bond holdings now that short rates in the US and Europe are at or below Japanese levels. However, cyclical dynamics could start to work against the yen in 2021. The slowdown in mergers and acquisition (M&A) activity that took place among Japanese corporates in 2020 might reverse as confidence about the global recovery builds. Furthermore, an acceleration in growth due to a vaccine-led reopening of the US and European economies could cause the market to anticipate less monetary accommodation, resulting in a selloff in US Treasuries that could widen the yield differential with Japan, which could push the USD/JPY exchange rate higher.

Credit

Investment grade (IG)

US				■	
Fundamentals			■		
Valuations		■			
Technicals					■

Corporate credit sentiment remains positive partly due to the Fed's willingness to support functioning debt markets. Credit spreads declined in the second half of 2020, despite record issuance of IG corporate bonds. Foreign demand remains strong as the global search for yield leads investors toward the US IG market. We expect fundamentals to continue to improve amid a recovery that is supported by liquidity combined with fiscal stimulus, and as economies open up. We anticipate that firms with excess cash will begin reducing leverage in 2021 as clarity improves around the economy, further tightening the supply of high-quality debt. We remain constructive on the IG asset class as the Fed maintains interest rates near zero, although valuations may limit further significant appreciation.

Canada			■		
Fundamentals			■		
Valuations			■		
Technicals				■	

Canadian economic indicators have continued to surprise to the upside, as activity held up into year end. However, renewed restrictions on movements across major economic centers create an uncertain fundamental outlook. Supply disruptions could lead to inflationary pressures, though they are expected to be transitory due to weak demand. Canadian companies took the opportunity to raise capital in 2020 to strengthen their balance sheets, but supply this year is not expected to be anywhere near as abundant. With government bond yields likely to remain low for a long time, demand for corporate bonds is likely to remain robust. Valuations are increasingly less compelling, but we believe there remain specific issuer opportunities.

Europe			■		
Fundamentals			■		
Valuations			■		
Technicals				■	

Central bank intervention has enabled European IG markets to retrace the COVID-19 spread widening, meaning that excess return generation in 2021 will likely be driven primarily from carry. Although we are at the start of the macroeconomic recovery, we believe that recovery is largely priced into current spread levels. However, we see attractive pockets of value given the level of dispersion within the European IG market, especially in the subordinated bond space. We expect market technicals to continue to be a powerful driver of spreads in European credit markets in 2021. Although the ECB's bond purchasing program (PEPP) has not yet been fully directed at the corporate space, the ECB is still buying up to €10 billion of corporate bonds per month across all its programs (equating to just over 1% of the eligible index).[1] Inflows into the asset class remain positive as investors "follow the central banks," and supply should moderate in 2021, underpinning current levels.

UK			■		
Fundamentals			■		
Valuations			■		
Technicals			■		

The Bank of England's (BoE) decision to pause its own bond-buying scheme has diminished some of the technical support in the sterling market. However, we are still seeing strong demand for sterling credit from pension schemes, which is currently the main driver of technicals in the sterling market. Credit spreads are now at the relative tights of the past five years, which reduces their attractiveness, in our view, even in the current low yield environment. We believe that BoE buying would quickly resume if market conditions were to deteriorate, which is helping underpin a market facing the fundamental challenges of COVID-19. The removal of the "no deal" Brexit has alleviated near-term headline risk, but the ramifications of life outside the European Union could still weigh on the UK fundamental outlook in 2021.

Asia			■		
Fundamentals			■		
Valuations			■		
Technicals			■		

US sanctions on Chinese state-owned enterprises (SOE) could weigh on investor sentiment toward the Chinese IG space, but we see limited impact on credit fundamentals. We believe recent Chinese onshore default events are idiosyncratic and will not result in systemic financial risk. However, we expect continued credit differentiation in the SOE and local government financing vehicles space and we believe credit selection remains critical. Uncertainty regarding long-term US Treasury yields could impact demand for long-term Asian IG bonds.

High yield (HY)

US			■		
Fundamentals			■		
Valuations			■		
Technicals				■	

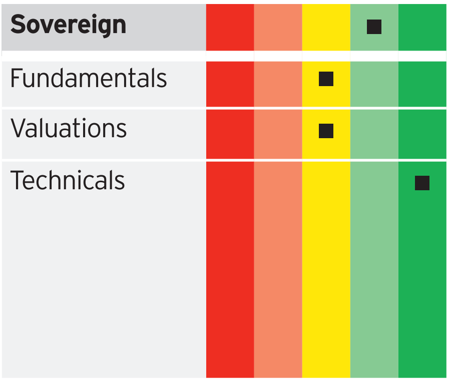
We are positive on HY, though we believe upside is limited following the strong rally in credit spreads after the lows of mid-March. We expect an uneven but solid economic recovery as the vaccine is rolled out. The speed and breadth of vaccinations will likely determine how quickly and well the global economy can recover to pre-pandemic levels. As recovery unfolds, we expect investors to rotate attention from technology and consumer non-cyclicals to sectors impacted by COVID-19. Support is also likely to come from a weaker US dollar, still-low interest rates and an upward sloping yield curve, which has historically tended to support credit markets. With inflationary pressures mounting (most evident in commodity prices) and fiscal stimulus in the outlook, if interest rates rise in response, we expect rate-sensitive segments of fixed income to feel greater pressure than HY. The default outlook for HY also appears more favorable with 2021 defaults expected to be potentially half of what was experienced in 2020. We expect issuance to remain strong, although below the record-breaking level of 2020, providing a solid technical backdrop. These factors contribute to our constructive view on portfolio risk positioning, though our view is tempered by tighter spreads and smaller compensation for taking on risk. We believe careful security selection will drive relative performance and total returns will be more muted compared to the past couple of quarters.

Europe			■		
Fundamentals		■			
Valuations		■			
Technicals				■	

Asia				■	
Fundamentals			■		
Valuations			■		
Technicals				■	

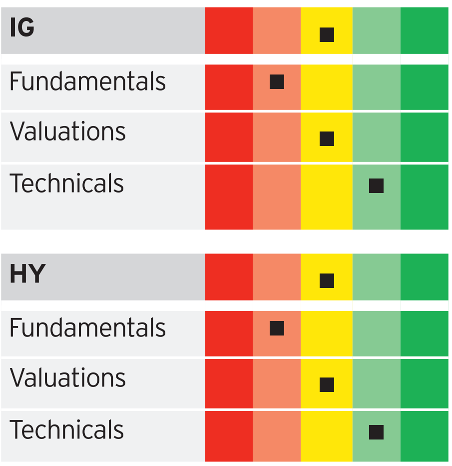
Chinese property sales have remained steady, although moves by the government to tighten borrowing criteria for property developers to help reduce debt levels in the real estate sector (the "three red line" restriction) will likely push developers to deleverage in the medium term. Major central banks remain supportive, refinancing conditions are generally easy and the emerging market hard currency bond market is still attracting inflows on US dollar weakness. Progress in vaccine development could change the fundamental outlook and benefit certain sectors, such as Macau gaming. We expect strong technical support for Asian HY given what we believe are attractive valuations.

Emerging markets (USD)



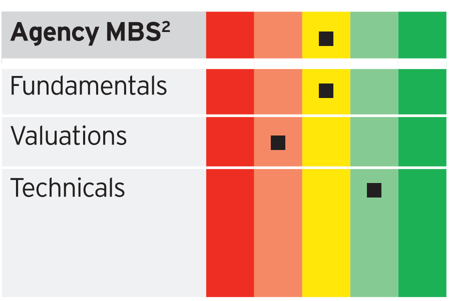
We enter 2021 with a moderately positive outlook on emerging market sovereign debt. Ratings momentum overall remains negative but the list of "fallen angels" is diminishing and we expect sovereign restructurings to slow. A cyclical recovery is setting in with an improving developed market outlook on better COVID-19 management. Pent-up domestic demand should support emerging market growth further, offsetting some key structural weakness, such as rising leverage. Credit spreads are "neutral", in our view, on an historical basis, but bifurcated with IG marginally "rich" while HY retains some value. Portfolio inflows have picked up sharply over the last quarter. Aggressive developed market easing and the continued global hunt for yield is helping emerging markets absorb the supply of new issues. Hard currency issuance finished 2020 at a record pace and while issuance is typically front loaded in the new year, we expect full-year issuance to moderate somewhat. Premia for new bond placements have been quite low. With valuations not yet stretched, we expect inflows to stay healthy.

Municipals

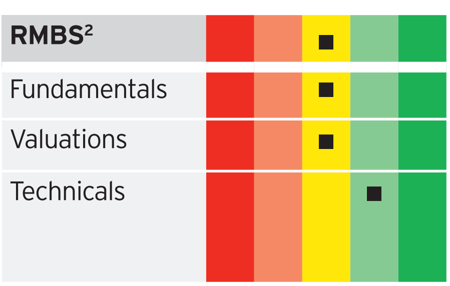


We expect the recovery in the municipal market seen in the second half of 2020 to continue into 2021. The result of the US election has been supportive of the municipal market, with the probability now increased for higher corporate taxes, more stimulus for state and local governments and potential infrastructure spending. The technical picture remains supportive as well, as the asset class enjoys consistent demand, which we believe would easily digest an uptick in issuance in 2021. Fundamentally, the picture is less consistent, as several sectors within the municipal market struggle with the impact of COVID-19 and the materializing migration away from large cities like New York and San Francisco.

Structured



Nominal and option-adjusted spreads, after tightening significantly in Q4 2020, look rich, in our view, yet consistent with prior periods of quantitative easing. Additional Fed purchases and strong bank demand continue to help absorb a high level of mortgage production spurred by low interest rates. Dollar roll markets weakened somewhat in November/December but are still additive to the mortgage valuation picture, for those who can roll "TBA", or forward-settling MBS. We expect prepayment rates to remain high, even if interest rates increase somewhat, due to a wide primary/secondary mortgage spread, which will likely compress over time as the retail mortgage community clears the backlog of demand for refinancing single-family homes. Simply put, higher Treasury rates may not translate into higher rates to homeowners desiring to refinance their mortgages.



The housing sector has staged an impressive recovery since the onset of the pandemic, as lower interest rates and demographic trends have driven strong demand and accelerating home price appreciation. While levels of mortgage forbearance and delinquency remain elevated, we expect future fiscal policy to be supportive as we get closer to a return to normal helped by wider vaccine distribution. Additionally, for those homeowners who cannot recover lost income, high levels of borrower equity and robust housing demand should limit losses in foreclosure events. Housing market supply remains historically low, which continues to support the strong housing market.

CMBS[2]			■		
Fundamentals		■			
Valuations				■	
Technicals			■		

COVID-19 has caused an abrupt decline in property revenue and an anticipated decline in property valuations. Loan delinquencies are beginning to decline as loans cure, but remain elevated. The near-term impact of COVID-19 is most severe in the lodging and retail sectors, but offices face long-term challenges. Investor interest in CMBS has accelerated as vaccinations have begun. CMBS AA and A rated securities are slightly cheap to corporate bonds, in our view, but we believe most AAA securities are less compelling after their strong performance in the past few quarters.

ABS[2]			■		
Fundamentals		■			
Valuations			■		
Technicals				■	

While many sectors in ABS are facing fundamental challenges, robust credit enhancement and structures can potentially withstand deep recessionary experience. AAA-rated generic ABS (credit cards and prime autos), have tightened back to, or in some cases through, pre-COVID levels. Investor interest has migrated to lower rated bonds where spreads are still wider than pre-pandemic levels. We are extremely selective in esoteric ABS with opportunities to outperform contingent on continued improvement in fundamentals. Supply and investor demand have been very strong and low dealer inventory rounds out a strong technical picture for most ABS transactions.

Bank loans

US				■	
Fundamentals			■		
Valuations				■	
Technicals				■	

Credit fundamentals continue to improve, despite the recent virus surge. Lockdown measures in the US remain broadly conducive to consumption, fiscal stimulus has been renewed, and vaccinations are underway, all contributing to an ongoing rally in loan prices. Rising vaccination rates will likely pave the road back to normal, particularly for cyclical and COVID-sensitive sectors, which are likely to outperform. Default rates have also declined in recent months, never having reached the extreme peaks that investors feared. We expect defaults of 3.0-3.5% in 2021. Market technicals are supportive of loan prices, in our view, as strong demand from collateralized loan obligations (CLO) and a better outlook for retail and institutional flows keep the market well bid. We expect loan issuance to accelerate with the decline in election and COVID uncertainty, which has created a better environment for M&A and leveraged buyouts (LBO).

Europe				■	
Fundamentals			■		
Valuations				■	
Technicals				■	

We believe accelerating macroeconomic momentum and positive sentiment around vaccines will drive bank loans higher (spread compression) into the summer of 2021, with outperformance across consumer cyclicals and COVID-exposed sectors. Positive technical drivers, such LBO and CLO activity, could provide significant momentum, offsetting an uptick in refinancing activity and maintaining the current coupon rate. We believe defaults will be in the 3-4% range and manageable, and that idiosyncratic pockets of distress will have little systemic impact on the wider market.

1 Sources: ECB, Invesco, data as of Jan. 15, 2020.

2 MBS is mortgage-backed securities. RMBS is residential mortgage-backed securities. CMBS is commercial mortgage-backed securities. ABS is asset-backed securities.

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