Invesco

Global Fixed Income Strategy

Monthly report

Invesco Fundamental Fixed Income

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IN THIS ISSUE:

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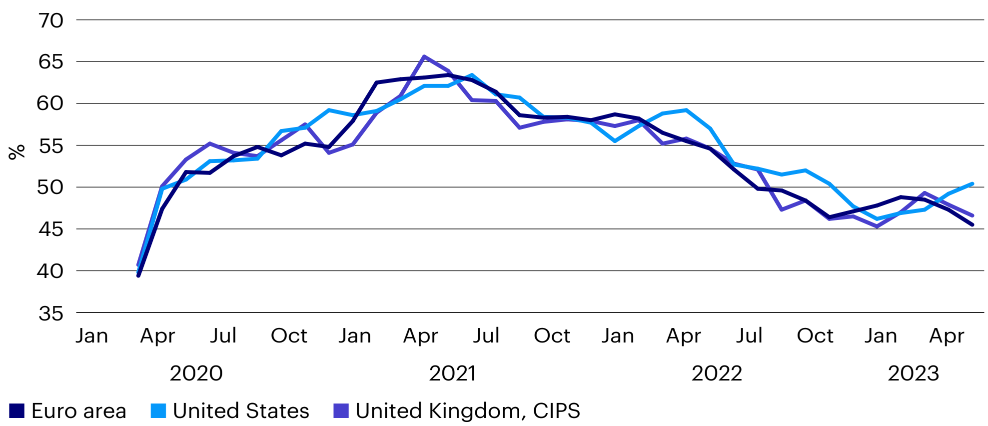
Is it the best of times, or worst of times?

The current environment seems very uncertain for investors. In our view, this is because, depending on how we interpret current economic data, or forecast future data, we can believe it is either the best of times or the worst of times, and these drive two very different asset allocations! We talk through our thoughts below.

Figure 1: S&P Global composite PMIs

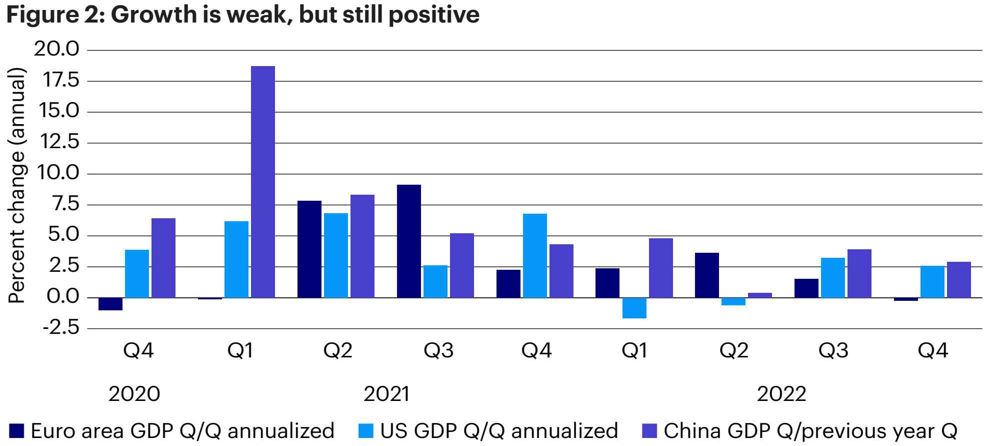


Source: Macrobond. Data from May 1, 2020 to April 1, 2023. The Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors.

The best of times

Recent growth has been stronger than many expected, and the US labor market has been more resilient to rising rates. Worries about energy availability have also eased, allowing better economic performance in Europe and across the global economy. While not booming, global economic momentum has remained solidly in positive territory, and, so far, the major economies have skirted a recession. There certainly have been pockets of weakness, housing in the US being a clear example, but the US economy has proven resilient and able to continue to generate solid, if unexciting, growth.

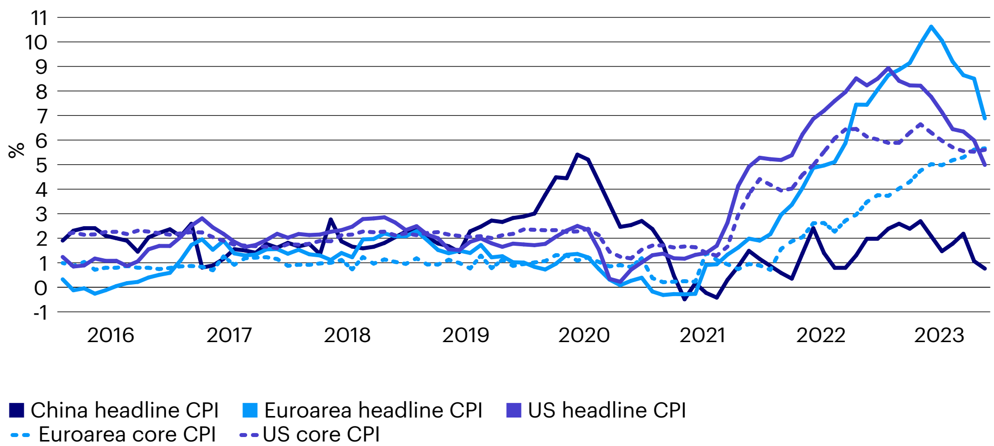
Figure 2: Growth is weak, but still positive



Source: Macrobond. Data from Oct. 1, 2020 to Jan. 1, 2023. GDP = gross domestic product.

Inflation in the US has, in the meantime, established a clear downward trajectory. We believe we have seen the peak in inflation in the US and expect it to continue to come down over the coming quarters. European inflation has been rising until recently but is likely to follow the path of US inflation with a lag. The outlook for US inflation is steadily improving as we see housing price weakness work its way into price indices and as wage pressure shows signs of easing. Market fears of a wage/price spiral are increasingly looking misplaced as a wide range of indicators point to contained wage pressures.

Figure 3: Inflation high, but declining



Source: Macrobond. Data from Jan. 1, 2016 to March 1, 2023.

Typically, a disinflationary, slow growth environment should be very good for asset markets. This type of growth backdrop should support revenue and earnings growth and easing inflation should take cost pressures out of the system. Currently countering all this good news for markets is the fact that central banks are still tightening financial conditions. Indeed, the US Federal Reserve (Fed) is expected to raise rates at least once more in an environment where the yield curve is already steeply inverted, and some banks are showing signs of stress. This tightening of financial conditions is keeping interest rates and spreads higher than where they would otherwise be. In the best of times, when the Fed pauses or cuts, it should be a good environment across all financial assets. A disinflationary growth environment should be rewarding for investors across the board.

The worst of times

Despite current rosy macro data, many forecasters see clouds on the horizon that could precipitate negative market outcomes. These two clouds are recession and inflation:

Recession: Historical patterns suggest that an inverted yield curve and large amounts of rate hikes translate into a recession. Recent recessions, particularly the global financial crisis and the pandemic recession, have come with major market dislocations across rates and credit markets. A drop in growth typically stresses credit across the economy and drives spreads wider and risky assets lower. Market observers can also point to current banking stress and declining deposits as signs of tightening credit growth – the early signs of recessionary activity. Whether we actually get a recession in the coming quarters remains a forecast for now. Current data show remarkable stability, and there are not obvious imbalances in the US economy, outside the labor market that appears to need the type of correction a recession facilitates. So, while a recession remains a possibility, it is far from a certainty, and less than a 50% probability, in our view.

Inflation: The surprising rise in inflation across Western economies in the post-pandemic recovery has left markets deeply concerned about the possibility of continued inflation pressure. The fact that inflation has begun to come down should ease some of this concern, but many market observers continue to be concerned that tight labor markets will exert renewed upward pressure on inflation going forward. If inflation renews an upward push in the coming months, while growth remains anemic, we may move to a stagflation environment, which is quite negative for financial assets across the board. While it is certainly possible that inflation could renew its upward push, every month that goes by with prices and wages looking contained makes this stagflation scenario look less likely. Inflation remains a risk for markets, but that risk is fading as benign data continue to come in.

A pragmatic approach

Recent data are supportive of the disinflationary growth view, and recent "Fed speak" indicates that the Fed is likely to hike once more and then pause. Any additional acknowledgement of disinflationary forces in the economy by central banks will likely clear the path for good asset market performance going forward. While negative scenarios of recession or higher inflation would likely be negative for markets, these remain forecasts that are not consistent with current data. Acknowledging the good news of the current data, while keeping an eye out for signs of our negative scenarios, would seem to be the way to go for now.

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Interest rate outlook

US: Underweight. We believe US bond yields are stuck in a range of approximately 3.5% to 4.0% on the 10-year Treasury in the near term. Bonds are caught between two forces and are unlikely to break out of this range unless a banking crisis becomes truly systemic or a near-term recession develops. We are in a disinflationary environment and expect inflation to continue to moderate over the balance of this year. We are also in a slow growth environment where we expect growth to be below potential. Disinflation and slow growth will likely keep a lid on the upside in bond yields, and we do not see 10-year Treasury yields exceeding 4.0%. On the other hand, global central banks, including the Fed, continue to raise rates with the yield curve already steeply inverted. These two factors will likely limit the downside for yields in the near term. We are toward the bottom of our expected range for Treasury yields, and, therefore, we have an underweight duration stance.

Europe: Neutral. Uncertainty over the European banking system has faded after the extremely volatile March period, and markets have resumed discounting further rate hikes. Publicly, the European Central Bank (ECB) remains resolute in its determination to bring inflation back to target and it will likely want to move rates further into restrictive territory in the coming months. However, we think we are approaching the peak in rates and believe longer-term value is emerging in 10-year German bunds at 2.5%.[1] Nevertheless, yields are likely to remain volatile with inflation continuing to run hot and labor markets tight, and further rate hikes still to come.

China: Neutral. Despite the international community's positive expectations regarding China's growth path and expectations for a high Q2 GDP number on the back of base effects, onshore investors have appeared relatively more conservative. This conservatism has been reflected in the government's relatively modest GDP growth target for 2023 and limited expectations for substantial easing efforts on both monetary and fiscal sides. Interbank liquidity continues to be carefully managed by the central bank and it has better flexibility compared to global peers if it needs to loosen liquidity, in our view, given China's benign inflation picture. Thus, we expect Chinese onshore government bonds to trade in a range for now, with room for downward yield moves in the medium term.

Japan: Underweight. The sharp fall in 10-year Japanese government bond (JGB) yields in the wake of the collapse of Silicon Valley Bank has now largely reversed, reflecting the fact that the move was due largely to short covering demand. Fundamentals still point toward higher risk going forward, with underlying inflation and wage data showing broadening upward price pressure. New Bank of Japan (BoJ) Governor Ueda has maintained that Yield Curve Control remains appropriate but has hinted that the market should not extrapolate the status quo. It remains likely that the BoJ will drop, or further tweak, the Yield Curve Control policy over the next six months, allowing 10-year JGB yields to push higher.

UK: Overweight. UK gilts have almost completely retraced the fall in yields seen after the collapse of Silicon Valley bank, underperforming both US Treasuries and German bunds. The retracement in yields is partly justified by better than expected UK growth, limited signs of a credit crunch and upside pressure on inflation from higher wage demands. However, the outlook has not changed so dramatically to justify a higher terminal rate relative to early March, in our view. Consequently, with the market now fully pricing a cumulative 50 basis points of further rate hikes to a 4.75% peak, the risk-reward is becoming more skewed to long positions on both an outright and relative basis versus US Treasuries, in our view.[2] Heavy supply is likely to result in curve steepening and an underperformance of gilts versus swaps, hence we believe long positions are best expressed in received front-end swap positions.

Australia: Neutral. The Reserve Bank of Australia (RBA) paused its hiking cycle at the April meeting, justifying the move as providing policy makers more time to assess the impact of past hikes, while not ruling out further tightening. The pausing of the hiking cycle is likely to lead to a more rangebound trading environment for Australian government bonds and interest rate markets relative to the last 18 months. Lower global yields and signs of slowing growth and inflation are likely to cap 10-year yields below 4%, but the high starting point for inflation will likely make near-term rate cuts unlikely, barring a substantial growth or financial conditions shock, likely limiting the downside for 10-year yields at around 3%. Current 10-year levels at 3.5% are therefore broadly in the middle of this range, justifying a neutral stance, in our view.[1] However, we believe a selloff above 3.75% could justify a shift to an overweight position.

1. Source: Bloomberg L.P. Data as of April 19, 2023.
2. Source: Bloomberg L.P. Data as of April 18, 2023.

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Currency outlook

USD: Neutral. Despite the significant volatility in markets in recent months, the US dollar has not benefited from safe-haven status in the same way as in previous "risk-off" episodes – with valuations little changed versus major currencies. With other central banks continuing to hike rates, it's clear the interest rate differential support is declining for the dollar, and with the US banking system being at the forefront of recent turmoil, it's not surprising that support for the dollar has been challenged. However, with the backdrop set to remain highly uncertain in the coming quarters, ranges are broadly likely to persist. We are wary of betting against the dollar here since safe-haven status could quickly return if banking uncertainties start to feed global recessionary fears, and additional downside in the dollar is unlikely before the Fed has finished hiking rates.

EUR: Neutral. The euro has remained in a tight range for the last few months and is currently at the top of that range. While the ECB is arguably more hawkish than the Fed, we expect the range to broadly persist. The uncertainty that has gripped markets in recent months will likely limit the scale of US dollar weakness, thus limiting the scope for the euro to break meaningfully higher.

RMB: Overweight. Although the USD/RMB exchange rate may be led higher by US dollar strength on readjusted market expectations, we think the renminbi will likely continue to outperform on a basket basis. China's recent policy changes have increased market optimism regarding Chinese assets, including the renminbi, and have led the currency to outperform. We expect capital inflows to turn more positive, although this may be partly mitigated by weaker export growth and rising numbers of outbound tourists.

JPY: Overweight. Yen weakness over the last year has been driven by monetary policy divergence between the BoJ and other major central banks and Japan's deteriorating terms of trade, due to higher energy prices. Both these dynamics are shifting in the yen's favor in 2023. The Fed and ECB appear likely to conclude their hiking cycles in the next three months, as growth and inflation pressures subside. In contrast, broadening inflation pressures and accelerating wages in Japan are likely to lead the BoJ to drop its Yield Curve Control policy shortly, allowing JGB yields to move higher. Interest rate differentials are, therefore, likely to become less of a headwind for the yen. At the same time, lower energy prices will likely lead to an improvement in Japan's trade balance. Capital outflows are also probably going to subside, as companies become more cautious regarding foreign investment amid a slowing global economy and Japanese investors moderate their appetite for foreign equities and bonds.

GBP: Neutral. Better sentiment around UK and European growth, partly driven by lower energy prices, has led to a recovery in sterling versus the US dollar. However, sterling continues to trade on the relatively weak end of the range against the euro, which has reflected continued growth underperformance relative to the eurozone and a perception that the BoE is more dovish than the ECB. Going forward it is hard to see either growth differentials or interest rate differentials being a sustainable support for sterling. Consequently, the currency continues to remain rangebound on a trade-weighted basis.

AUD: Neutral. The terms of trade, balance of payments and relative growth dynamics in Australia, and Asia more broadly, support the Australian dollar's appreciation, in our view. However, this is offset by the negative interest rate differential relative to the US and Europe and the Australian dollar's sensitivity to risk sentiment, which makes it vulnerable to concerns about global recession. These conflicting factors are unlikely to change in the short term, leaving the Australian dollar relatively constrained around current levels, in our view.

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Julien Eberhardt
Fund Manager and Senior Analyst

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

The fall in AT1 prices was understandable, but their recovery better reflects underlying fundamentals

The European banking sector has come under scrutiny following the collapse of two US regional banks and the managed acquisition of Credit Suisse by UBS. European bank share prices and regulatory bank debt capital have been volatile.

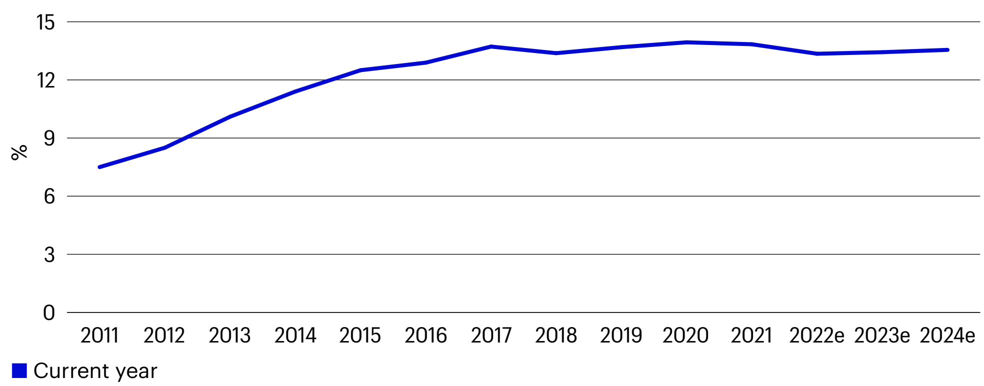
Was this volatility justified and will the sector fully recover?

European bank shares and AT1 prices fell sharply following the sudden collapse of Silicon Valley Bank (SVB) as investors feared that contagion could put European banks under pressure and potentially expose new losses.

This concern was understandable; after all a decade ago, European banks were under great strain, having been buffeted by the global financial crisis (GFC) and the eurozone crisis. The GFC revealed the perilous state of many European banks, which had pursued aggressive lending in often risky assets only supported by thin and poor-quality capital bases.

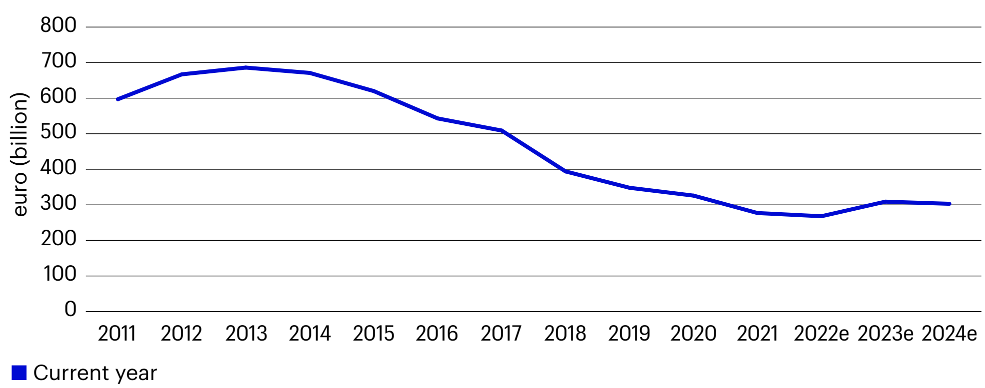
However, unlike a decade ago, the banking sector in Europe today enjoys a much more secure footing, having shed risky assets and rebuilt capital bases. In fact, today, the fundamentals of the European banking system are arguably stronger than they have been in years.

Figure 1: Average CET1 capital ratio - European banks



Source: Autonomous, Invesco. Data from Dec. 31, 2011 to Dec. 31, 2021, forecasts thereafter. CET1 is Common Equity Tier One.

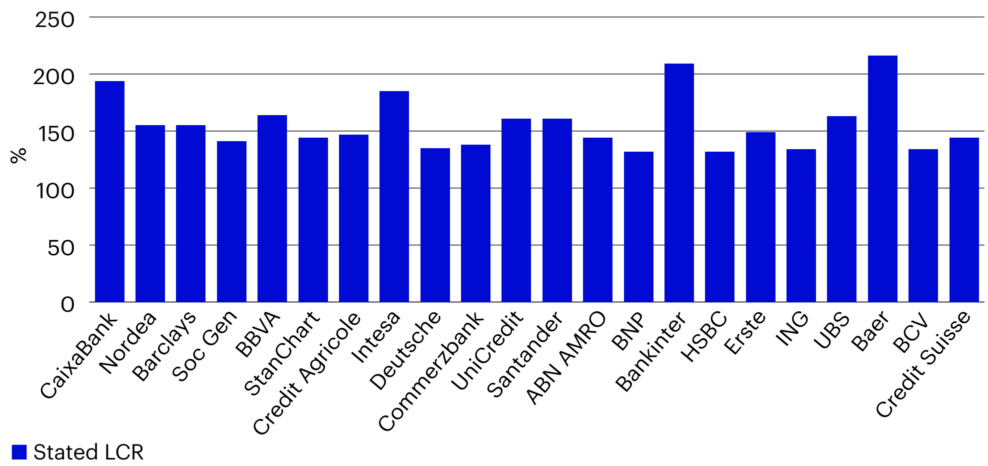
Figure 2: Asset quality - European banks average non-performing loans (euros bn)



Source: Autonomous, Invesco. Data from Dec. 31, 2011 to Dec. 31, 2021, forecasts thereafter.

Figure 3: Liquidity (LCR)

Liquidity Coverage Ratio (the stock of high quality liquid assets as a proportion of total estimated cash outflows over a 30 day stress period). The regulatory minimum is 100%.



Source: Autonomous, Invesco. Data from Dec. 31, 2011 to Dec. 31, 2021, forecasts thereafter.

A closer look at Credit Suisse

Many European banks underwent a fundamental restructuring of their businesses in the last decade. In many ways, Credit Suisse was the last remaining large European bank that was undergoing surgery of this kind.

Each restructuring example has its unique characteristics. In the case of Credit Suisse, it exhibited strength in a number of important metrics such as capital ratios and asset quality. However, the bank was also grappling with reputational damage and large losses resulting from its involvement in several financial scandals related to its investment bank.

This undermining of confidence in Credit Suisse had led to deposit outflows and left the bank vulnerable to the increase in risk aversion that resulted from the collapse of SVB. Deposit flight increased markedly, despite liquidity commitments from the Swiss National Bank, and the Swiss authorities were ultimately forced to intervene.

The collapse of Credit Suisse was a shock, but equal damage to sentiment was caused by the unexpected writing down of the AT1s, despite no losses resulting from its managed acquisition by UBS, and when there was still value in the equity. This unusual treatment of the capital hierarchy required new legislation that was only enacted during the weekend negotiations about UBS's acquisition of Credit Suisse.

The fact that Credit Suisse's AT1s had been trading in the high 70s (compared to an average of 87 for the wider AT1 market) only a week before the write-down demonstrates the extent to which AT1 investors were caught off guard.[3]

The treatment of the Credit Suisse AT1s left some investors questioning the future of the instrument. The fact that a bank's capital hierarchy could be disregarded could force the cost of debt capital to rise in compensation, with consequences for bank lending and profitability. AT1s may become too expensive to issue for the region's smaller banks. At the extreme, if the cost of AT1 capital eventually exceeded that of equity, then it would have implications for the whole future of the AT1 security.

For now, however, the AT1 market is an established USD200 billion asset class, which forms an important element of banks' regulatory capital requirements.[2] Seeing the threat to the stability of the European banking sector in this episode, the European Banking Authority and Bank of England swiftly reiterated their commitment to respecting the capital hierarchy in the event of a bank resolution.

In our view, the fall in AT1 and share prices was an understandable reaction to an unexpected event. However, the declines were not reflective of the underlying fundamentals of the sector. AT1 prices opened sharply lower following the Credit Suisse rescue but have been steadily recovering. The initial

3. Source: Bloomberg L.P., ICE Indices. Data as of March 2023.

sell-off left the AT1 market largely priced to perpetuity, suggesting that banks would no longer call these bonds, but rather leave them outstanding. Since then, however, the market has recovered somewhat and increasing numbers of bonds are now once again priced to call. If banks do resume calling and refinancing their AT1 capital, which we think is likely, then the market could recover further.

A note about AT1s: AT1 securities have capital-like elements and bond-like elements. One feature is that the bonds are perpetual and only called when it's in the bank's interest to do so. For example, if it would cost the bank significantly more to issue new capital, then the bank is under no obligation to retire the existing. In most cases, banks call their AT1s on the first call date. Currently, many AT1s are priced at a significant discount to par, implying high yields. This raises the question of why banks would call the bonds if the current cost of capital is so high. However, banks may choose to call the bonds to demonstrate their strength to the market. If so, AT1 prices could rise further in expectation that more banks will resume calling their AT1 bonds as normal.

Panelists

Niklas Nordenfelt
Head of High Yield

Rahim Shad
Portfolio Manager

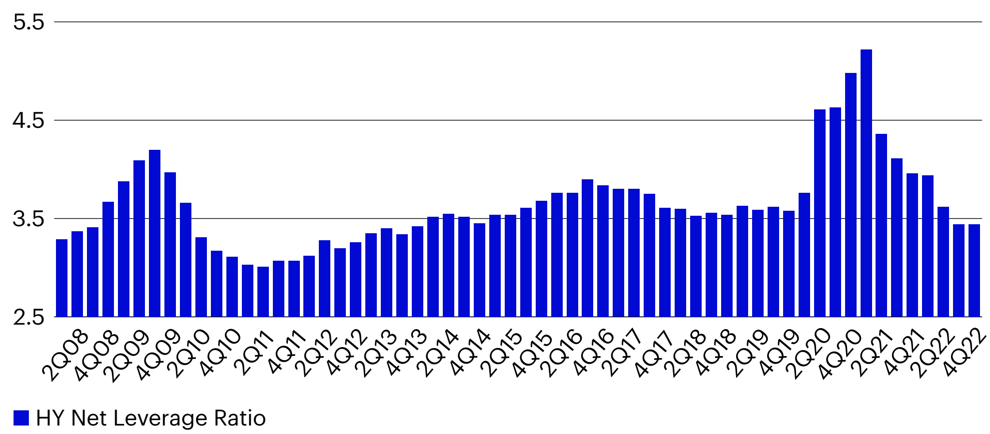
The bottom line: Why high yield now?

Our investment team believes high yield currently presents an opportunity that investors seldom see. Yields are elevated and credit fundamentals are solid, a positive combination when it comes to potential investment outcomes. We speak with Niklas Nordenfelt, Head of High Yield, and Portfolio Manager, Rahim Shad, about the historically unique situation facing high yield today, and what it means for their investment strategy.

Q: Why invest in high yield when we are potentially going into a slowdown?

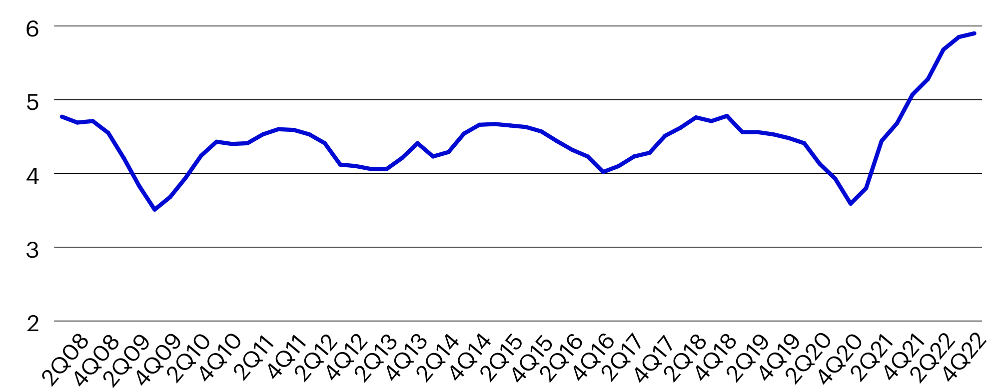
Niklas: We believe we are facing a rare opportunity in high yield today, one seldom seen by investors. Currently, we can invest in 8.5% yielding bonds (the average for the high yield index) issued by companies paying less than 6% on those bonds.[4] This probably won't last forever, and most of these issuers will likely have to refinance their bonds eventually at higher rates. But, for now, we get the benefit of high income paid by fundamentally healthy issuers enjoying low interest expenses. We do believe issuers will face a more difficult backdrop if there is a recession, but their ability to absorb a shallow recession has never been better, in our view. Currently, high yield net leverage and interest coverage metrics are at, or near, all-time best levels (Figures 1 and 2). The asset class has fewer lower-rated and more highly rated bonds than usual, near-term maturities are manageable, and we do not expect the default rate to reach previous peaks.

Figure 1: Net leverage ratio (net debt/last 12 mos. EBITDA)



Source: JP Morgan, Capital IQ. Data as of Dec. 31, 2022.

Figure 2: Coverage ratio (last 12 mos. EBITDA/last 12 mos. interest expense)



Source: JP Morgan, Capital IQ. Data as of Dec. 31, 2022.

4. Source: Bloomberg US High Yield 2% Issuer Cap Index. Data as of April 24, 2023.

Q: Given recent market volatility, is the new issue market functioning well?

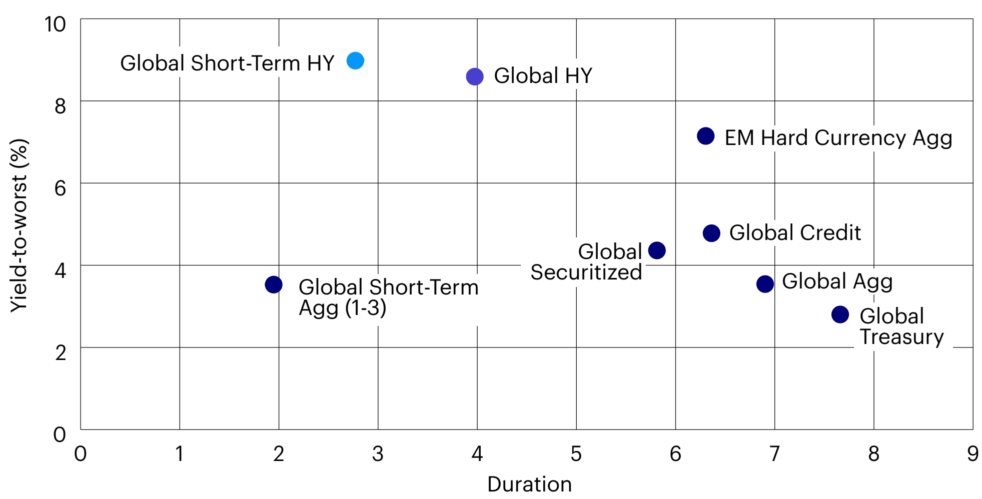
Niklas: Yes, it came to a screeching halt in March, but as rate volatility has subsided, the market has re-opened and is functioning very well. We don't believe a lack of demand for bonds, or a non-functional new issue market will be a meaningful source of bankruptcy risk in the near future. But the nature of issuance has changed in recent years and that change has accelerated this year. The high yield market is typically populated by new issues with maturities of seven to eight years with a non-call period of three to four years, and these issues are mostly structured as unsecured bonds. This year, we've seen a large increase in secured issuance with shorter tenors. Issuers have been reluctant to "lock-in" long-term debt at current levels and, instead, have focused on five-year tenors on the premise that they will be able to refinance at lower rates in the future. Meanwhile, to induce investor interest, issuers have been issuing secured bonds. Over 60% of this year's new issues have been secured.[5] As a result, nearly 30% of the high yield market is currently secured.[6] Secured bonds tend to have higher recoveries in the event of defaults. In short, the quality of the index, which was already historically high, has improved with the increase in secured and shorter tenor bonds. This bodes well for high yield's longer-term risk-reward characteristics, in our view.

Q: What's the most compelling trade in high yield today, in your view?

Rahim: High quality, short duration high yield is our "pound the table" call. While this strategy has historically provided strong risk-adjusted returns, there are two factors worth highlighting: First, today's starting yield levels are some of the highest we have seen combined with prices well below par.[7] This can provide an opportunity to capture significant capital gains in the event of an early tender or special call due to merger activity. Second, yield curve inversion has created a unique situation in which one to five-year maturity bonds are yielding more than longer dated bonds.[8] The value proposition gets stronger as we move into the higher quality segment of short duration, where a defensively positioned portfolio can be constructed without a significant give-up in yield.[9] We believe current fundamentals will allow companies to potentially weather economic turbulence with minimal defaults, even during periods of stress.

Figure 3: Global bond yields per unit of duration

High yield stands out on yield per unit of duration



	Global Short-Term HY	Global HY	Global Credit	Global Agg	EM Hard Currency Agg	Global Securitized	Global TSY's	Global ST Agg (1-3)
Yield per Duration	**3.24**	**2.17**	**0.75**	**0.51**	**1.13**	**0.75**	**0.37**	**1.81**

Source: Bloomberg L.P., Global Short-Term HY is represented by the BBG Global HY Corporate 1-5 Year Index, Global HY is represented by the BBG Global High Yield Corporate Index, Global Credit is represented by the BBG Global Aggregate Credit Index, Global Agg is represented by the BBG Global Aggregate Index, EM Hard Currency Agg is represented by the BBG Emerging Market Hard Currency Agg Index, Global Securitized is represented by the BBG Global Aggregate Securitized Index, Global Treasury is represented by the BBG Global Aggregate Treasury Index, Global ST Agg (1-3) is represented by the BBG Global Aggregate 1-3 Years Index. As of March 31, 2023.

5. Source: JP Morgan. Data as of March 31, 2023.
6. Source: ICE BofA Global Research. Data as of March 31, 2023.
7. Source: Bloomberg L.P. Bloomberg Global Corporate 1-5 Year High Yield Index YTW 9.02%. Data as of April 21, 2023.
8. Source: Bloomberg L.P. Bloomberg Global Corporate 1-5 Year High Yield Index YTW 9.02%. Bloomberg Global Corporate High Yield Index YTW 8.65%. Data as of April 21, 2023.
9. Source: Bloomberg L.P. Bloomberg Global Corporate 1-5 Year Ba/B High Yield Index YTW 7.91%. Data as of April 21, 2023.

Q: How did the recent banking crisis impact the high yield market?

Niklas: Normally, when there are market stresses, high yield finds itself in the middle. Currently, the areas of most obvious stress have been in the banking sector (especially, smaller regional US banks), commercial real estate and start-up technology firms. None of these have much direct linkage to the high yield market. Nonetheless, risk aversion in other areas of the market can drive spreads wider in high yield. We saw this in March, but high yield has since retraced those losses. As investors, we find dislocations and forced selling to be interesting opportunities. In the case of the banking crisis, we identified a number of attractive investments. In general, we seek to take advantage of high yielding opportunities where we feel the risk is well managed, at both the portfolio and issuer level.

Q: Which sectors do you favor in today's environment?

Rahim: We like energy at the moment. In our view, spread levels reflect improvement in the credit quality of the sector and its trajectory, as companies exhibit capital discipline. Our focus has been on oil field services, which should continue to benefit from increased activity in on-shore and off-shore drilling amid supply side challenges. We expect several upside catalysts as we head into summer. First, aggregate demand should pick up with the driving season and as China reopens from its COVID lockdowns. Second, the US Strategic Petroleum Reserve will need to be refilled eventually. On the supply side, the US remains rangebound with no expansion activity so far. Within consumer cyclicals, we see value in a couple of segments that could benefit from a resurgence in travel. Cruise lines, for example, are set up well in this environment as there is pent-up demand for vacations but travel has gotten expensive over the last few years and cruises tend to offer good value for the money. The other area is casinos, especially in Macau, where operational results should improve significantly as China reopens.

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