Invesco

Global Fixed Income Strategy

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Invesco Fixed Income

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Macro conclusions from the November IFI Summit

Twice a year, investors from across Invesco Fixed Income's global platform gather at the IFI Global Investors' Summit to discuss and debate their views on global macroeconomic trends. Macro themes play an important role in IFI's investment process and our framework of macro factors - growth, inflation and policy - helps us project macro trends and interpret market movements. At our November 15-16 Summit, a panel of investors provided their views on global macro developments. We share their main conclusions below.

US

Soft landing likely - Fed could cut in May

The US economy outperformed expectations in 2023, especially in the surprisingly strong third quarter. We expect Q3's strength to be one-off, however, and not the start of a trend. As tight monetary policy continues, we expect economic growth to slow to below trend. Our baseline forecast is for 2.6% growth in the fourth quarter and slower growth of around 1.3% in 2024.

Inflation has been well-behaved this year despite strong growth. We expect continued disinflation next year, though inflation could prove sticky in the next few months. As the economy and inflation slow, we would expect the Fed to cautiously start cutting rates in the first half of next year. At that point, monetary policy would still be tight, with high interest rates and lower inflation. We expect a rate cut as soon as May.

Four factors point to a modest slowdown

We expect US growth to moderate to below its potential rate in the near term, before gradually returning to its potential rate of around 1.8%. This modest slowdown is attributable to several factors:

1. Tight financial conditions

Financial conditions have tightened since the summer. Interest rates are high and borrowing is costly, which will likely have a negative impact on spending going forward. The housing market, which had been recovering since the beginning of the year, is showing renewed signs of weakness and we expect car sales to remain sluggish. Car sales declined sharply during the pandemic due to chip shortages and other supply side bottlenecks and didn't fully recover. High car prices and costly auto loans are now further deterring demand.

2. Lagged effects of policy

We have argued that monetary policy lags are not necessarily long. The transmission of initial rate hikes to market prices, for example, was swift and housing rapidly fell into a contraction.

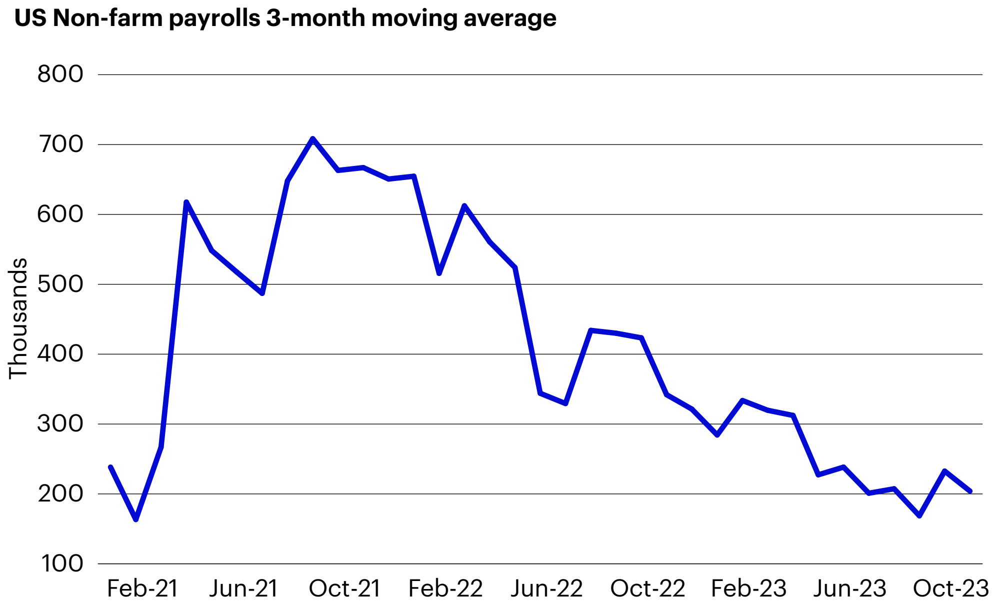
But it takes time for policy to impact other areas. It took some time for banks to tighten lending conditions and the latest Senior Loan Officer Survey shows that banks continue to do so. Loan delinquencies have risen recently amid high interest rates, posing a headwind for lending activity. Tightening arising from such channels has not yet peaked and should have some effect going forward.

3. Labor market slowdown

Job creation and wage growth are slowing, which means that total incomes and spending growth should fall. The labor market is still strong and tight, but monthly job creation has slowed from around 400,000 jobs during the summer of 2022 to around 300,000 at the turn of the year and 200,000 recently. [1]

In addition to the recent jobs numbers, broad labor market indicators also suggest a slowdown. Job openings have steadily declined, and the hiring rate has fallen and is now at pre-pandemic levels. Consumers say that jobs are not as plentiful as they used to be and small firm hiring intentions have declined. Labor supply has improved, as immigration has returned to pre-pandemic levels and the prime-age labor participation rate has now exceeded pre-pandemic levels. This should help keep wage growth in check.

Figure 1: Why a slowdown in growth? Labor market is cooling



Source: US Bureau of Labor Statistics. Data from Jan. 1, 2021 to Oct. 1, 2023.

4. Pent-up demand in certain sectors should wane

While the pandemic is no longer a major concern, its impact still lingers. We still see pent-up demand for some goods and services, but this demand is expected to gradually diminish.

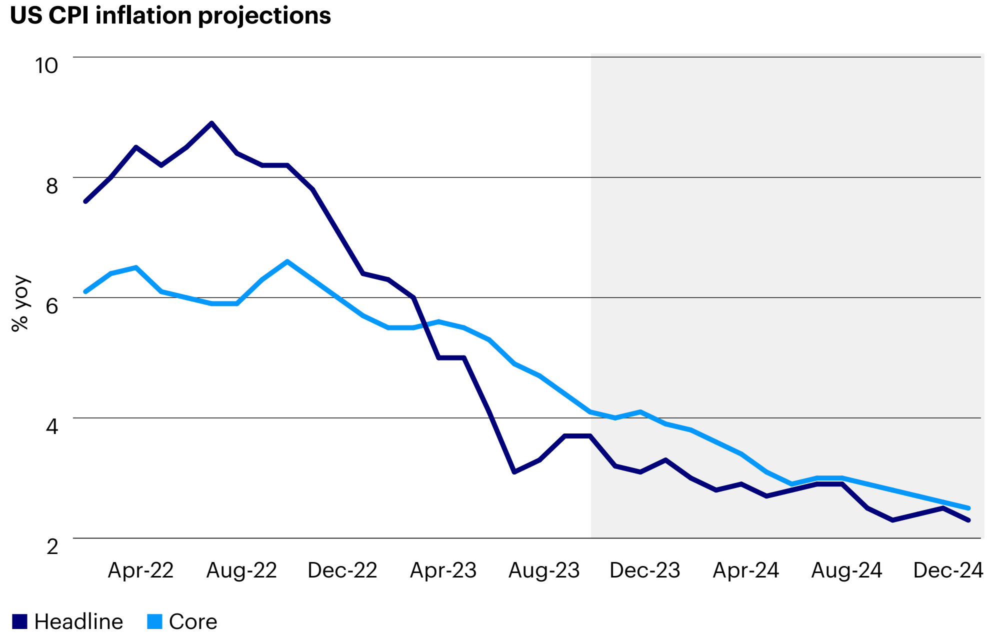
A prime example is international travel. After two years of limited mobility, consumers flocked to domestic and international travel destinations following the full reopening. 2022 and 2023 were banner years for travel, but much of the pent-up demand has likely been satisfied. Going forward, we expect demand growth in such sectors to normalize to pre-pandemic trends.

Inflation: Down from its peak

While some temporary stickiness in inflation is a risk for the rest of the year, we expect disinflation to resume in early 2024. Several factors have contributed to lower price pressures, including the cooling labor market, a moderation of shelter prices, deflation in new and used car prices and the normalization of supply chains.

1. Source: US Bureau of Labor Statistics. Data from June 1, 2022 to Oct. 31, 2023.

Figure 2: Disinflation but with bumps along the way



Source: US Bureau of Labor Statistics, Invesco. Data from Jan. 31, 2022 to Oct. 31, 2023. Invesco estimates thereafter.

A tight labor market and high wage growth contributed to high inflation over the past two years, but the labor market is cooling. Non-shelter services prices are correlated with wage growth and Federal Reserve Chair Jerome Powell has highlighted services prices as a source of risk for price stability. However, labor market indicators overall suggest a cooling of the labor market, and importantly, cooling wage growth. This should help keep services inflation in check.

Housing inflation has been a significant contributor to overall high inflation, but current market rents and models based on well-established research suggest that rent inflation is normalizing. By design, shelter inflation measures in inflation indices lag market rents by approximately one year. Market rents declined to pre-pandemic levels in the fall of 2022, so we would expect a moderation in shelter inflation in the coming months. Going forward, we expect monthly and year-over-year shelter inflation to converge to pre-pandemic levels.

Car inflation has been another major contributor to overall inflation but declined noticeably in 2023. We expect car sales to be subdued in the coming quarters and expect further deflation in 2024. On the demand side, affordability is a challenge. Median car prices are high relative to incomes, and the cost of borrowing has increased substantially due to tight monetary policy. Insurance and maintenance costs have also risen. On the supply side, improvements in global supply chains are easing constraints and should continue to do so in the foreseeable future. Given our expectations of muted demand and improving supply, we expect car prices to decline.

Overall, we expect continued progress toward price stability in 2024, but core inflation measures will likely remain above the Fed's target.

The Fed

Our baseline view is a soft-landing scenario with no recession, but below-trend growth and a softening labor market. This outcome should allow the US Federal Reserve (Fed) to start cutting rates in May, plus or minus one meeting. Inflation at that point would likely still be above the Fed's target, but lower inflation and growth would likely mean that financial conditions are too tight for an economy that is slowing in nominal and real terms.

That being said, an aggressive cutting cycle would likely not be consistent with a soft landing and still-high inflation. Moreover, if our baseline of a soft landing plays out, risk markets would likely do well, household and corporate borrowing rates would likely be lower than their peak levels, and lending conditions would likely begin to improve. Easier financial conditions should mean that the Fed could cut rates gradually. For now, we think three or four rate cuts next year look reasonable.

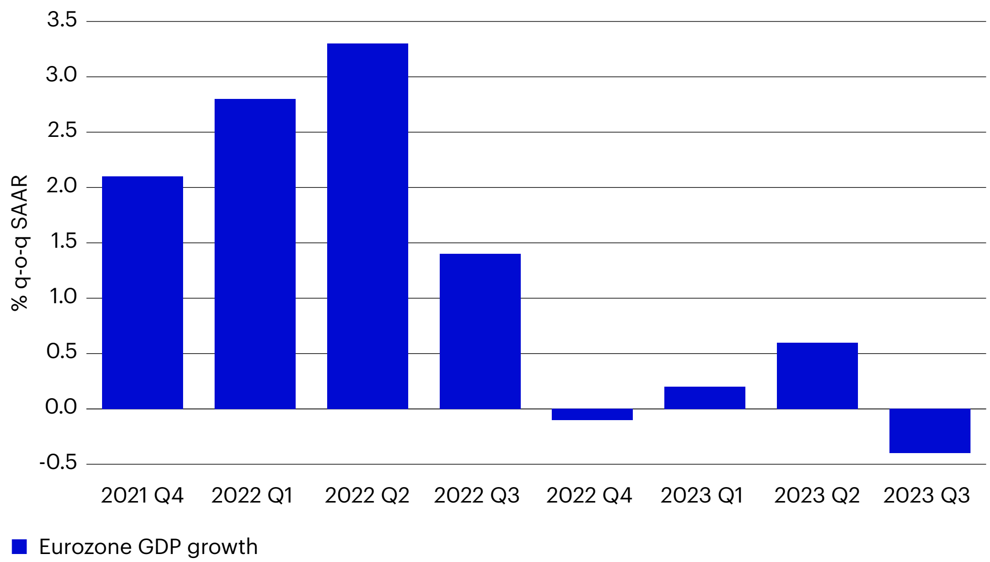
Europe

Europe faces stagnating growth but should avoid recession

Last year, the Russian invasion of Ukraine and massive increase in commodity prices created understandable nervousness among European companies and households that a recession was all but assured. But, even with a war next door, Europe has avoided a recession, and its economy has shown remarkable resilience.

Excluding volatile Ireland, Europe would not have even posted a contraction in the fourth quarter of last year. This year, however, several quarters after the initial shock of Russia's invasion, a large contraction occurred in the third quarter and Europe's economy looks weak. Why?

Figure 1: Eurozone: stagnation or recession?



Source: Eurostat. Data from Dec. 31, 2021 to Sept. 30, 2023.

Three headwinds to European growth

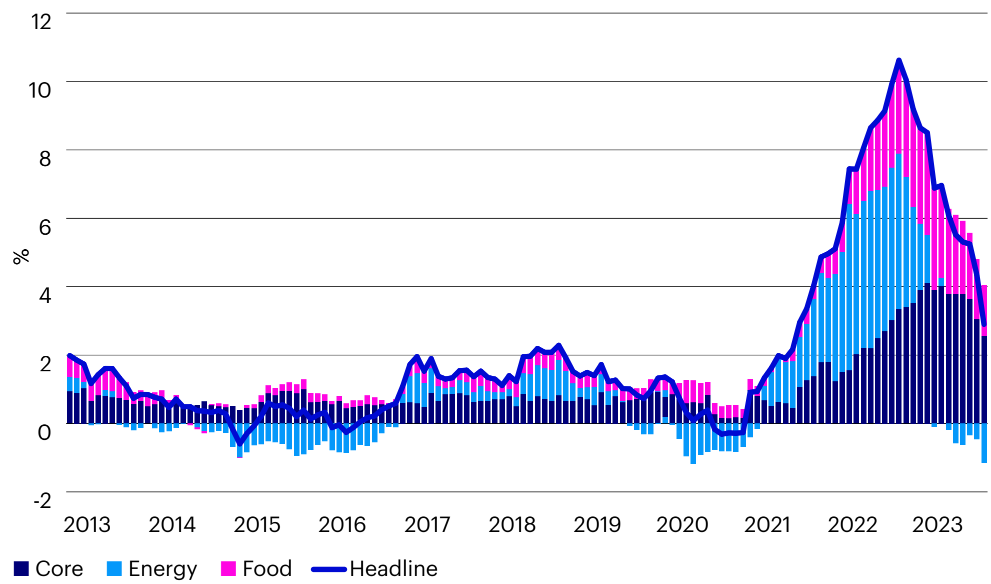
Three main factors have contributed to weak growth in Europe, in our view: an income shock due to high inflation, monetary tightening, and soft manufacturing.

1. Income shock

The income shock caused by high levels of inflation is still impactful today. Despite some moderation, energy and food prices are still elevated after the Ukraine-Russia war (Figure 2). Persistently high energy prices have disrupted the European growth model, especially German production, which was based on cheap and reliable gas from Russia, which is now gone. Alternative energy sources like liquid natural gas have helped but are not viable for heavy manufacturing. This energy dependence has dampened growth prospects across Europe, and we have already seen evidence of stagnating consumption and investment (Figure 3).

Figure 2: Eurozone inflation was mostly an external supply shock – not demand driven

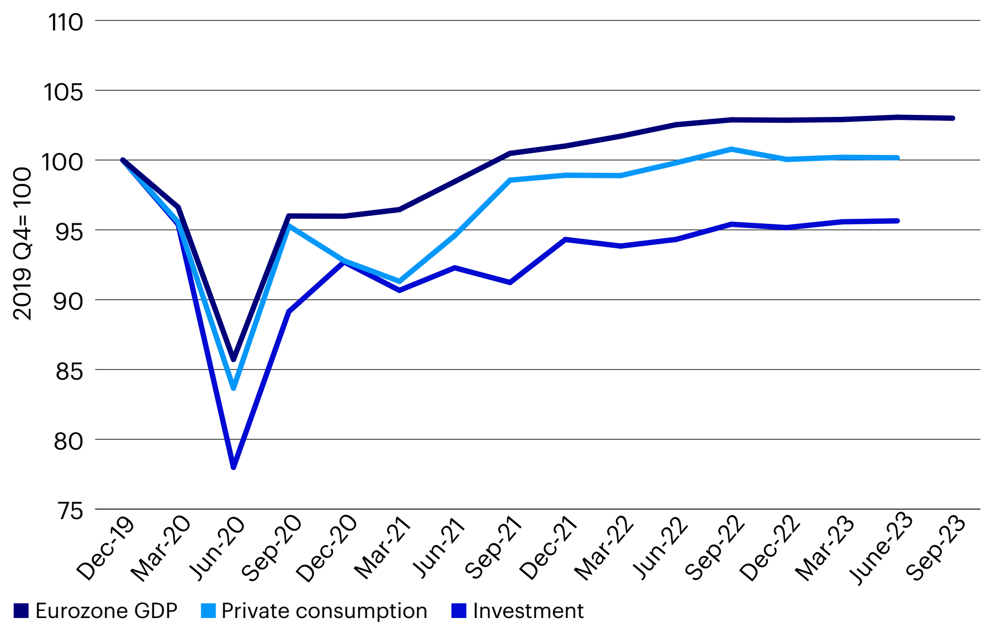
ECB: Headline inflation and component contributions



Source: Eurostat. Data from Jan. 1, 2013 to Oct. 1, 2023.

Figure 3: Consumption still at pre-pandemic level, investment significantly below

Eurozone GDP, private consumption, and fixed investment



Source: Eurostat. Data from Dec. 1, 2019 to Sept. 1, 2023.

2. Monetary tightening

Monetary tightening is another important factor in Europe's weak growth story. Europe's inflation shock was primarily supply-side driven, but it has tightened monetary policy as much as any other developed economy, raising rates from negative territory to 4%. Monetary policy is considered more effective in Europe given its bank-centric system, which allows for a faster and stronger transmission of rate increases to lending costs.

3. Soft manufacturing

Manufacturing has been in recession in 2023, driven by a shift in consumer preference toward services post-pandemic. Rising commodity prices and interest rates, and China's slowdown have also been factors, given Europe's status as a manufacturing and export powerhouse.

Economic recovery likely in 2024

The negative effects of the income shock on consumption and investment, monetary tightening and soft manufacturing will probably remain headwinds to European growth for the time being. But we expect these conditions to improve, allowing for economic recovery in 2024. We believe we are near the bottom of the global manufacturing dip and expect China to pick up next year. We also expect banks to gradually ease their tight lending stance by the middle of next year. And importantly, we believe the European Central Bank (ECB) has completed its hiking cycle. We expect greater clarity about where interest rates will be next year and expect the ECB to start cutting rates in the second quarter.

As inflation declines and nominal wage growth partially makes up for the past deterioration in purchasing power, we should see real wages grow, which we would expect to be a tailwind for growth. It is not surprising that higher real wages have allowed consumer confidence to improve, which should help drive consumption going forward.

Inflation on the mend

We expect inflation to converge to the ECB's target by the end of 2024. The main contributors to eurozone inflation have been food and energy prices, which have pressured other core prices. Unlike in the US, demand driven inflation in Europe was limited. As energy and other commodity prices have stabilized this year, we expect rapid disinflation in the eurozone to continue. Growth and wage growth also matters and sluggish growth should contribute to disinflation.

The ECB

We believe the ECB is done with its hiking cycle. The ECB's current guidance suggests that it expects to maintain its policy rate at the current level until the second half of next year. After a series of inflationary surprises, the ECB wants to ensure continued disinflation and avoid a premature easing cycle. The ECB will likely watch the spring round of wage negotiations closely to make sure they do not lead to stubborn high wage inflation. We believe the ECB would like to see wage growth moderate to below the current 4%-5% range.

The ECB's policy response has been aggressive for an economy that has been stagnating and hit by supply and confidence shocks. Not surprisingly, inflation has come down sharply in recent months. Given the weakness in the economy and the moderation in inflation, we believe the ECB's policy guidance is shaky, and rate cuts could start in the spring of next year, if not earlier.

China

Embracing the new reality

At the November Summit, we focused on understanding what is top of mind among Chinese policymakers and the likely drivers of the economy in the year ahead. We explored policymakers' priorities as China faces a growth model transition. We believe policy will hold the key to projecting China's economic performance in the years ahead.

Recent policymaker speeches have provided insights into China's likely policy direction. Several key messages have been repeated in the past few years, though not all market participants have taken them to heart, in our view. As such, we entitled this Summit's presentation, "Embracing the new reality."

High quality sustainable growth

Economic growth is central to China's policy agenda. While many market participants believe the government needs to add further stimulus to the economy, policymakers appear more focused on generating high quality growth and sustainable development – in short, quality of growth over quantity.

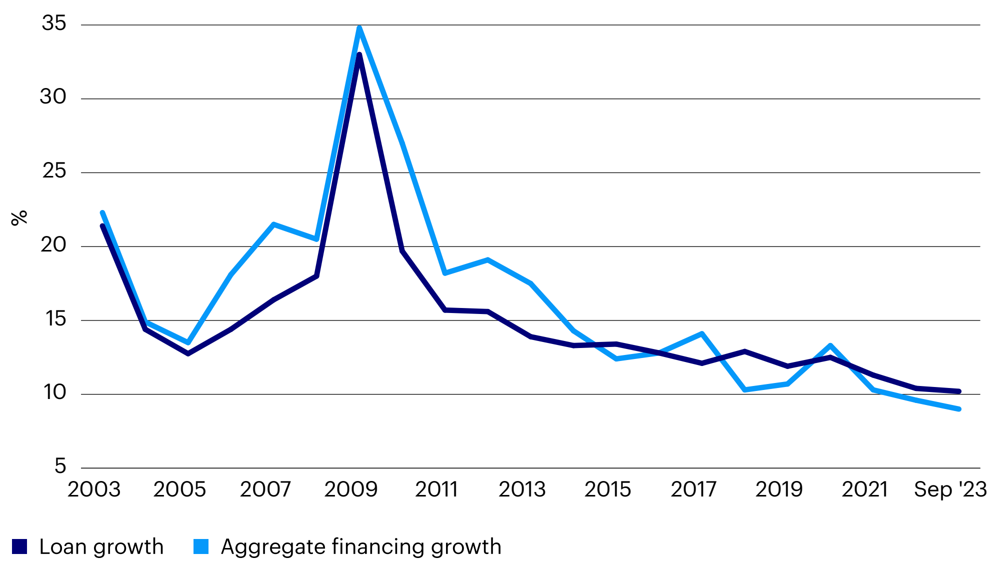
In a recent speech, new Central Bank Governor Pan Gongsheng stated that 5% annual economic growth "is not slow", which suggests to us a tolerance for growth moderation as China's growth model undergoes a process of transition. This transition includes efforts to boost productivity by devoting financial resources to technology, advanced manufacturing, green financing and small and medium-sized enterprises.

Credit trends have softened

Recent official statements have lowered our expectations of more aggressive monetary easing. We no longer expect aggressive interest rate cuts, and we expect slower credit growth and resulting economic growth.

Authorities have highlighted the importance of maintaining monetary policy stability, which, in our view, means maintaining sufficient interbank liquidity but not creating stimulus. In terms of the availability of credit, policymakers have also emphasized the "efficient use of existing loans." In our view, this indicates policymakers' understanding and acceptance of potentially slower credit growth, with implications for slower economic growth in the year ahead.

Figure 1: Chinese credit growth has been trending lower



Source: People's Bank of China, Bloomberg L.P., Invesco. Data from Dec. 31, 2003 to Sept. 30, 2023.

China's Central Financial Work Conference recently convened to deal with the themes of financial supervision and risk prevention. We were not surprised to see guidance on stabilizing lending and bond issuance for private companies, though the final decisions on this front are made by financial institutions themselves.

The highlight of the speech, in our view, was the surprising announcement that the Central Bank will provide emergency liquidity support to local governments facing heavy debt burdens. At the same time, there was an emphasis on plans to strictly control incremental debt in areas already facing heavy debt loads.

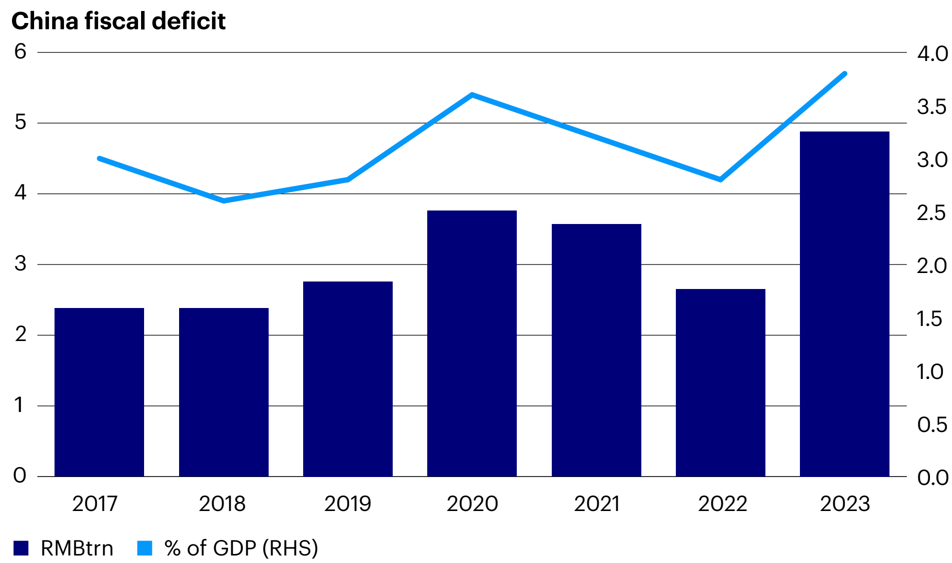
We believe this means that local government financing vehicles (LGFVs) are less likely to be a tail risk, a main concern among overseas investors. The proposed strict control of incremental debt, however, means that local governments will likely see their financial flexibility further constrained in the year ahead which will likely be a drag on credit and investment growth going forward.

We also noted the solidification of Hong Kong's status as an international financial center. This helped answered question's regarding the Hong Kong dollar peg, which, in our view, will remain in place for the foreseeable future.

Fiscal policy supportive but not stimulative

Could fiscal policy be a growth driver in 2024? Figure 2 shows that China's fiscal deficit has reached a multi-year high of 3.8% of GDP. However, we believe central government spending currently only provides a buffer to growth and not stimulus. Local governments could also tighten fiscal policy from here, especially given their recent lackluster land sales, which constrain their revenue.

Figure 2: China fiscal spending: buffer, not stimulus

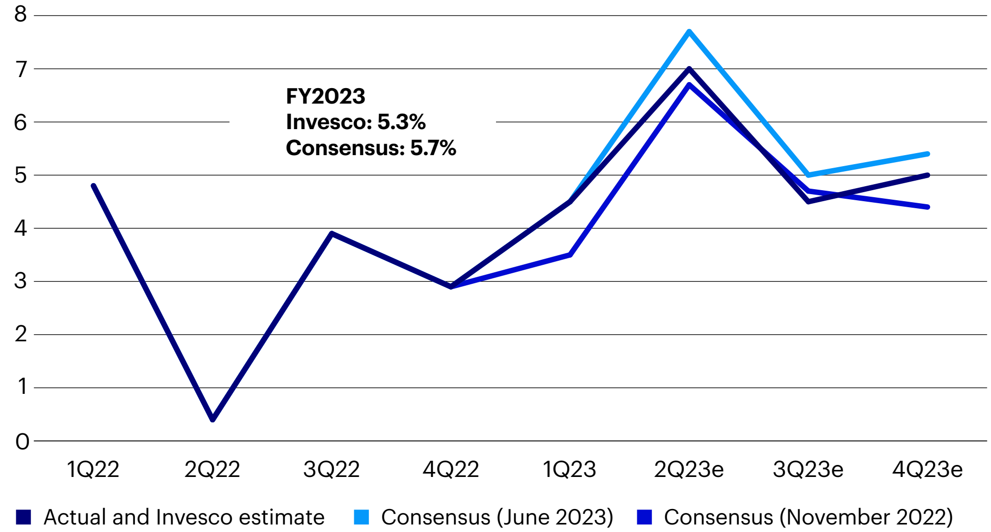


Source: Government report, Citic Securities. Data from Dec. 31, 2017 to Oct. 31, 2023.

We think there is room for the central government to take on additional leverage, but with local government and household balance sheets constrained, we believe a credit-induced recovery has a low probability of occurring. This leads to our below-consensus forecast for China's 2024 GDP in the low 4% range, versus a market consensus in the high 4% range.[2] Our inflation forecast of around 1% for 2024 is also below the consensus estimate of 1.7%.[3]

2. Source: Broker reports, Invesco. Data as of Nov. 11, 2023.
3. Source: Bloomberg L.P., Invesco. Data as of Nov. 11, 2023.

Figure 3: Chinese GDP growth and our estimates



Source: Bloomberg L.P., Invesco. Data from March 31, 2022 to Nov. 12, 2023.

The differences between our estimates and the consensus can be explained by three factors: We see a lower growth impact of the central government's higher deficit, we see slower credit growth due to banks' margin pressure and stricter control of local governments' incremental debt, and we are less constructive than the consensus on global demand in the year ahead and therefore foresee a slower recovery in export growth.

The implications for interest rates are continued low rates, but we are no longer expecting a sharp decline from current levels. Given the large gap with US rates and favorable onshore funding conditions, we have not been surprised to see 3% corporate funding costs in China's onshore market, versus double-digit yields on US dollar bonds of the same issuer. This helps explain why we have seen China's US dollar bond market shrink. US dollar bond supply in the Asia credit market is sharply lower than in previous years. Given the current yield difference, we do not expect a reversal in the near or medium term.

The government's currency management philosophy has also been tweaked, in our view, and we could see some differences in currency management compared to the past. The central bank has emphasized that the market will play a decisive role in deciding the renminbi exchange rate but that measures will be taken to correct speculative behavior. We have seen a stronger hand in the renminbi fixing in the second half of 2023 and in efforts to anchor the renminbi/US dollar exchange rate at 7.3. The concept of comparing the renminbi to a currency basket appears less dominant now than it was in the past, and there appears to be more focus on the direct comparison to the US dollar. We expect continued control over the capital account and less emphasis on capital account liberalization.

Conclusion

Policymakers have highlighted their views in recent conferences and speeches and have affirmed a commitment to the quality over the quantity of economic growth, with a focus on strengthened supervision and risk aversion. Overall, we believe tail risks are lower than many international investors have feared. However, we also believe that easing measures are not on the cards to the extent that we previously anticipated. Rather, any growth-supportive measures will likely provide a buffer to growth versus outright stimulus, similar to what we saw after the global financial crisis in 2008 and in 2015. Due to reduced flexibility in local government spending and margin pressure among banks, we think credit growth will slow from here. Therefore, we maintain a below-consensus forecast for Chinese GDP growth and inflation in 2024 and believe that interest rates will remain low. We expect this to lead to a continued difference between onshore and offshore market yields and cause the US dollar bond space to shrink further. We think the renminbi is currently being closely monitored and carefully managed and we expect the currency basket to play a less important role than in the past. We expect more focus on the movement of the renminbi/US dollar exchange rate.

Emerging markets

EM resilience

Emerging markets (EM) have proven resilient this year. The projections we outlined at the June Summit have mostly materialized: a global slowdown with no recession and driven by the developed markets (DM).

We expected interest rates to remain elevated and inflation to gradually slow. We expected China's recovery to stabilize in the second half of the year, aided by policy support and base effects. These scenarios have largely played out, but DM and EM countries have posted higher levels of growth than we expected. The exception to the growth story has been China, which is stabilizing, but whose recovery is fragile and uneven. Risks on our radar included a possible US recession, which has not materialized, recurrent geopolitical tensions, which have, and uncertain US-China relations, which have stabilized, leading to guardrails and de-risking but, so far, not decoupling.

2024 outlook

We expect global growth to flatline in 2024,driven by weakness in DMs. We also expect EM growth to be tepid, driven by weaker global demand, including from China, and tight EM domestic monetary policies. China's overall impact on EMs and commodity markets has been smaller than in the past as its property sector remains troubled and we have yet to see an improvement in sentiment that would lead to sustainable Chinese consumption growth. That translates into our view that EMs will likely not see much incremental demand from China and, therefore, we expect this EM economic cycle to be driven largely by domestic and policy-related factors.

In terms of risks, this decade is starting out being defined by geopolitical tensions. We view Middle East tensions as contained, so far, and the Ukraine-Russia conflict as a potential stalemate, but the situations are obviously uncertain. Next year's elections in Taiwan represent another risk factor. While we do not see the risk of military escalation, the outcome could cause a flare-up in China-Taiwan tensions.

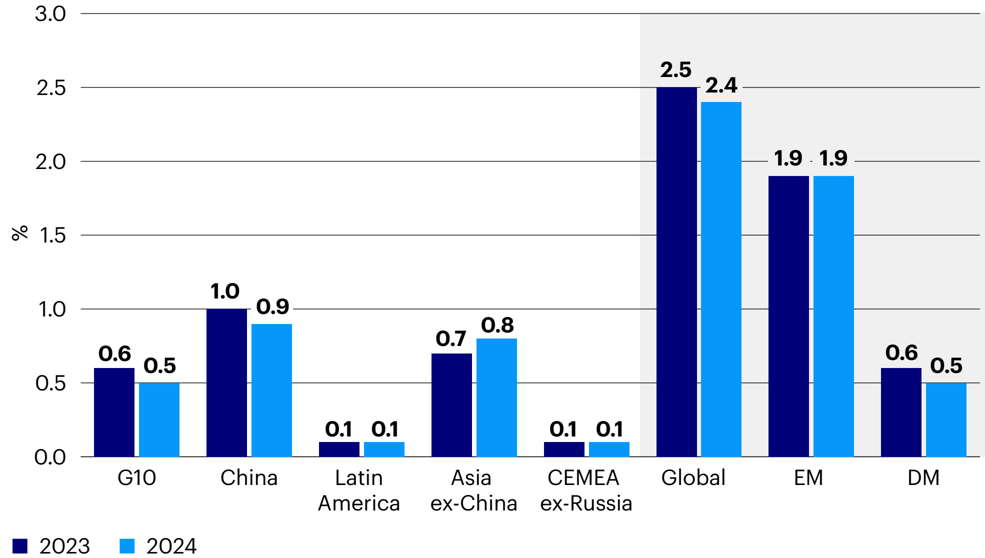
Global inflation could be sticky

The global inflation fight has been largely successful, with global headline inflation almost halved. But core inflation remains sticky, driven mostly by stubborn inflation on the services side, keeping global central banks hawkish. As a result, markets have adjusted to "higher-for-longer" interest rates and have pushed previously expected EM rate cuts further into the future, although some early hikers were able to deliver cuts this year. Lately several central banks in Latin America, Eastern and Central Europe and Asia have highlighted risks around when the Fed's rate hiking cycle will end and volatile long-term US rates. The adjustment to "higher-for-longer" interest rates among some EMs may therefore still take time. But we see room for further cuts in 2024 coming from the early hikers.

Global 2024 growth forecast weighed down by DMs

Our baseline view is a global slowdown story, with most of the softening coming from the DMs, especially the US. For China, we have penciled in a mid-4% growth rate in 2024 and can see potential upside to 5%, if there is more policy support than we currently expect. The volatility in Chinese growth rates is a new concept for EMs and markets and is likely to persist, as the Chinese leadership focuses on a multi-year transition of its growth drivers from the property sector to domestically driven high-end manufacturing. For these reasons, we believe it is very difficult to think about a "global beta" lifting all EM boats in 2024. Rather, we favor focusing on individual countries when it comes to growth, inflation and policy dynamics. While we expect ex-China EMs to post weaker growth, the variation across EM economic cycles means that, at the aggregate level, a growth slowdown will likely be only marginal. After some stronger-than-expected growth, especially in Latin America and Central and Eastern Europe, the impact of tight monetary policies, and weaker global external demand, including from China, is expected to normalize growth in the EM world. For Asian EMs, the post-COVID cycle has been different, with lower inflation in general, later rate hikes, and more stable growth. However, despite lower external demand, the gradual healing of post-COVID wounds in domestic economies will likely support growth in 2024 (Figure 1).

Figure 1: EM growth expected to flatline while DM growth softens in 2024



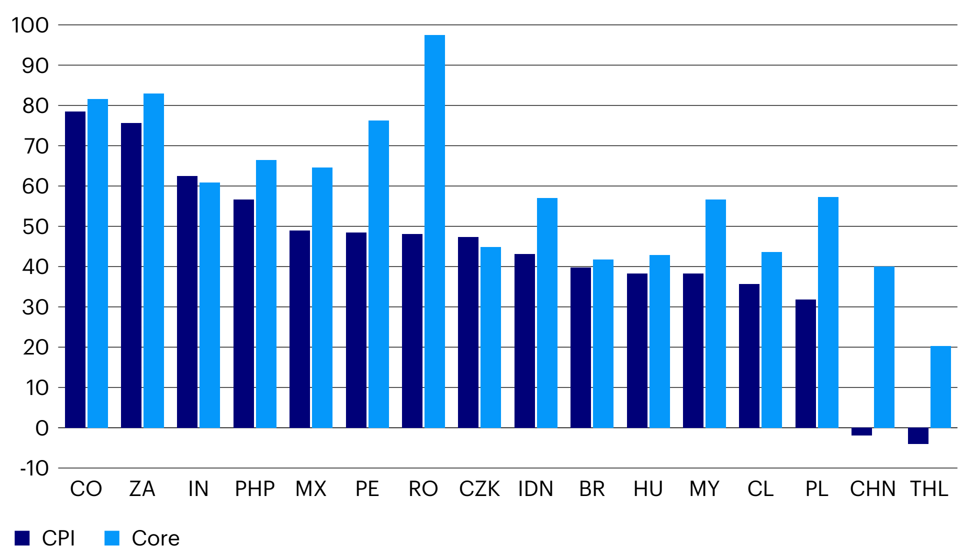
Source: Macrobond and Invesco projections. Data as of Nov. 8, 2023.

Idiosyncratic factors will be key in EM performance

We and the markets expect EM inflation to retreat further. However, core inflation remains elevated in many EMs and we believe it will be harder to make progress on the inflation front going forward, given the fading base effects of the energy price shock (Figure 2).

In addition, EMs face the challenge of widespread indexation, higher foreign exchange rate passthrough to domestic inflation and less central bank credibility than DMs. The potential effects of El Nino on food prices could also pose upside risks to headline inflation in some countries, especially in Asia.

Figure 2: Gains in headline inflation, but further progress could take longer to achieve inflation as % of rolling four-year highs



Source: Macrobond. Data as of Nov. 29, 2023.

Annual headline inflation as percent of its rolling four-year high. Core inflation as percent of its rolling four-year high. Colombia, Zambia, India, Philippines, Mexico, Peru, Romania, Czech Republic, Indonesia, Brazil, Hungary, Malaysia, Chile. Poland, China, Thailand.

On the external front, we have seen a dramatic decline in EM export volumes and prices, which does not bode well for EM terms of trade and currencies. Soft export performance also keeps countries' external balances vulnerable to other potential shocks, such as another oil price shock or further geopolitical risks.

On the fiscal side, public sector interest payments have grown as interest rates have risen. EM governments are now spending more as a percent of their reserves and income to finance interest payments on debt. Higher financing costs on the fiscal side could be a binding constraint for EM growth. We expect this dynamic to differentiate EMs from a credit perspective, reinforcing the concept that individual and idiosyncratic EM stories will likely be critical to investment performance over the next several months.

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Interest rate outlook

US: Neutral. In November, US interest rates reversed their previous bearish momentum. The long end of the curve generally benefited from declining yields and yield curves flattened. The rally in interest rates reflects the correction of several factors which we believe drove the selloff. Most importantly, recent inflation data have boosted confidence that inflation is moderating (our base case). Second, growth data have slowed from the third quarter's too-hot pace toward a more modest but not recessionary level. Third, US Treasury auctions generally performed more strongly than in the previous month, giving the market comfort that higher levels of interest rates will attract enough demand. The market is now pricing more than four interest rate cuts in 2024. This is somewhat more rapid than warranted by our economic base case. Given the magnitude of the recent rally and the aggressive pricing of the Fed, we have turned neutral on tactical interest rate positioning, while continuing to believe the market offers long-term value.

Europe: Overweight. We are positive on European duration. There are clear signs that inflation is falling faster than the ECB had anticipated, as the economy struggles with high interest rates, tight financial conditions and a collapse in credit growth. Our analysis indicates that the ECB will deliver on our expectations of significant rate cuts in 2024. The steadfastly hawkish rhetoric of ECB members has been replaced with concern that the growth outlook is poor and we expect them to start reducing rates as early as the first quarter of next year. That said, we expect a significant pipeline of new issuance in the region at the beginning of the year, so, while we expect shorter maturities to perform well, longer dated bonds may struggle. We expect to see a steeper yield curve in European rates in 2024.

China: Neutral. We expect Chinese government bonds to be rangebound, as we see limited room for either upside or downside moves in bond yields in the months ahead. Recent statements by the Chinese central bank governor suggest a commitment to keeping liquidity reasonably sufficient and funding costs at a lower level. At the same time, comments about "maintaining monetary policy stability" and paying closer attention to the "procyclical behavior" of the renminbi exchange rate indicate less room for aggressive rate cuts, in our view. This is in addition to potentially bottoming headline inflation, which is likely to remain at a low level in the coming year.

Japan: Underweight. 10-year Japanese government bond (JGB) yields declined sharply after peaking in early November. The rally largely mirrored that seen in other developed market sovereign bonds. However, some domestic factors have contributed. Japanese Q3 GDP was weaker than expected and the Bank of Japan (BoJ) has not reduced its purchases of JGBs as much as expected following the effective scrapping of the Yield Curve Control policy at the October meeting. The scope for a further decline in JGB yields is relatively limited going forward, in our view. Underlying inflation pressures in Japan continue to increase, in contrast to elsewhere. Real JGB yields have therefore not risen through this cycle and look increasingly at odds with the state of the economy and relative to other markets, increasing downward pressure on the yen, which is in turn forcing up imported inflation.

UK: Neutral. A longer-term stance could argue for an overweight duration position in the UK. However, the speed and extent of the recent decline in yields pushes us toward a more neutral stance at current valuations, with a bias to add duration on a meaningful up move in yields. Signs of moderating inflation and wage data have reinforced our conviction that the Bank of England's (BoE) hiking cycle has now peaked at 5.25%. The data have driven a decline in 10-year gilt yields to 4.15% over the last month and moved the market to price 75 basis points of cuts in 2024.[4] These valuations look about fair relative to our expectations for growth and inflation. Our near-term caution is based on the heavy supply calendar in Q1 for gilts and signs that domestic data are starting to pick up as the recent decline in yields feeds through to easier financial conditions. A resilient growth picture will probably keep the BoE focused on achieving its inflation mandate, delaying the start of any cutting cycle, particularly when labor market data are particularly opaque at present due to issues around the collection of unemployment statistics.

Australia: Overweight. The Reserve Bank of Australia (RBA) chose to hike 25 basis points in November to 4.35% in response to the higher than expected Q3 inflation report, despite mixed domestic growth data. New RBA Governor Bullock has emphasised that policymakers will not tolerate further upside surprises to inflation and will continue to aim to return

4. Source: Bloomberg L.P. Data as of Nov. 30, 2023.

inflation to the mid-point of the 2% to 3% target range. The RBA's November forecasts do not anticipate underlying inflation falling below 3% until after December 2025, signalling a period of interest rates at close to current levels for the foreseeable future. The impact of the RBA's hawkishness has been evident in the underperformance of Australian government bonds versus US Treasuries and New Zealand government bonds over the last month and the sharp flattening of the domestic yield curve. However, the October inflation data did point to some moderation in pricing pressures and domestic growth remains lacklustre. The scope for further underperformance of Australian government bonds now looks limited, given that the market is pricing close to unchanged rates for the next 12 months. It remains unlikely that the RBA will hike when the Fed and other major central banks are cutting. In addition, Australia is one of the few government bond markets that will likely benefit from lower supply next year. In this context, there appears to be limited upside for Australian long end yields from current levels, given that long forward rates are already trading over 5%.

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Currency outlook

USD: Neutral. The outlook for the US dollar is finely balanced as we look to 2024. Signs that inflation may be falling faster than anticipated coupled with a less hawkish stance by some Federal Open Market Committee members, has helped the greenback deflate recently against other major currencies. That said, growth is expected to be better in the US than in other regions next year, so we expect the dollar to perform relatively well during the early months of the year. Much rests on the ability of the US consumer to weather higher rates like they have in 2023.

EUR: Neutral. The outlook for the euro next year is challenging, given growth and inflation dynamics in the region. The recent sharp fall in inflation may provide the ECB with the cover to begin lowering rates, despite the hawkish rhetoric of recent months. Weak growth, falling inflation and a more accommodative central bank would not likely be a favorable mix for the currency.

RMB: Neutral. We think the main driver of the US dollar/renminbi exchange rate's performance is the US dollar's strength against the major currencies. The Chinese central bank has emphasized the market's role in deciding the renminbi exchange rate but also that measures will be taken to correct speculative behavior. We have seen a stronger hand in the renminbi fixing in the second half of 2023 and in efforts to anchor the renminbi/US dollar exchange rate below a certain level. With limited room for aggressive rate cuts in the year ahead, in our view, we see a cap on the US dollar/renminbi exchange rate in the near to medium term.

JPY: Neutral. The yen has appreciated against the US dollar over the last month, but has underperformed most other major currencies, despite a substantial narrowing of interest rate differentials. The yen's laggard status is largely due to buoyant risk sentiment, which has benefited higher beta currencies. This has partly reflected the fact that the recent repricing of interest rates is possibly more about softer than expected inflation than downward revisions to growth expectations. Real interest rate differentials have not narrowed to the same extent as nominal interest rate differentials. The yen will likely require lower growth expectations leading to weaker risk sentiment and tighter real interest rate differentials, driven by Fed and ECB cuts, to outperform. Looking forward to 2024, this environment could develop. Growth, particularly in Europe, is close to recessionary levels and cuts from the ECB, potentially coinciding with Bank of Japan (BoJ) hikes, could lead to substantially narrower rate differentials, which should weigh on the euro/yen exchange rate. A similar dynamic might well develop for the US dollar/yen exchange rate, but at present, US growth is more resilient, limiting the pressure on the Fed to ease.

GBP: Neutral. The British pound has been one of the best performing major currencies over the last month. Part of this rebound reflects the pound's weakness in Q3 and short positioning. Interest rate differentials are not an obvious driver of the pound's outperformance, as the BoE has shifted to a more dovish direction lately. UK growth has shown some signs of improving in Q4 but remains a laggard overall. As a result, the pound probably has limited upside once short covering has been completed.

AUD: Overweight. The Australian dollar has rebounded over the last month versus the US dollar, helped by short covering and a more hawkish RBA. Interest rate differentials have moved decisively in the Australian dollar's favor in the last month against the US dollar and the euro. Although this has been reflected in the Australian dollar/US dollar exchange rate, the Australian dollar remains relatively cheap compared to the euro and British pound, in our view, which have far weaker growth outlooks in 2024 and more dovish central banks. As a result, the biggest opportunity for Australian longs may not be against the US dollar going forward, but against the euro and the pound. This dynamic will likely gain further impetus if Chinese growth expectations rebound due to stimulus, supporting Australian commodity exports.

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

Credit conclusions from the November IFI Summit

At the November 15-16 IFI Summit, investors from across Invesco Fixed Income's platform shared their views on the dynamics driving their markets. They discussed their take on fundamental and technical drivers, valuations, and where they see opportunities across sectors. We share highlights of their conversation here.

Investment grade

Investment grade has rallied in recent weeks. The catalyst has likely been the market's view that Fed hikes are probably finished and interest rate cuts are coming at some point. This macro backdrop bodes well for the banking sector, in our view, which has been pressured this year by higher rates. Given the wide gap between spreads on large US and regional banks and US industrials, we see opportunity in financials.

Overall, third quarter earnings have stacked up well and companies have largely beat expectations. Companies went into this year in a very strong position with record amounts of cash, capital, and liquidity. During the pandemic, these companies built a war chest of cash and capital, preparing them to weather the storm. As then they got to the other side of it, they started to pay down debt, setting them up well for this year. The recent earnings cycle shows that high quality companies have been able to weather a minor slowdown well.

Market outlook

We expect supply and demand to be the driving factor for investment grade in 2024. We expect high quality companies to dial back their appetite for debt in 2024, given today's higher funding costs of around 6% to 7%, and because their high credit quality affords them the option to choose whether to take on more debt. So, we expect new issue supply to drop off a cliff going into 2024, if rates stay where they are. We think we could see industrial new issue supply down by 25% next year. At the same time, we think we will be in an environment with some of the strongest demand for fixed income in recent history, given the level of yields. So, while there will likely be less supply available, we also expect a large portion of the some USD6 trillion invested in money markets to find its way to investment grade, as investors potentially extend duration as the Fed winds down its hiking cycle.

High yield

The current high yield environment is one of the most opportune we have seen in a while. There is enormous dispersion within the European credit space, for example, creating a favorable "stock-picking" environment. Recent market dynamics have been strong in both the US and Europe, driven by a sense that central banks will pause soon or even reverse themselves in terms of rate hikes. The market narrative has now largely shifted from a somewhat hard landing to a somewhat soft landing.

But significant risks remain, which argue for a more cautious investment approach, in our view. "Higher-for-longer" interest rates can put stresses on certain parts of the market, so, we are carefully examining our holdings and identifying where we have the most conviction. We think it will be critical to avoid problematic situations in order to capitalize on the strong return potential that high yield currently offers.

Companies and their earnings are being scrutinized, especially those with challenging business trends in an elevated interest rate environment. We think the longer end of the yield curve will remain elevated compared to levels that issuers are used to operating under, which will likely put pressure on coverage ratios. High yield began the year with coverage ratios of about six times, but they have fallen to about 5.2 times and are widely expected to be on the path to the historical average of around four times.

In this environment, we believe the distressed part of the high yield market will be the most challenging. The good news for the triple C market is that we do not expect much issuance or maturities coming due in the next year, though they pick up in 2025 and 2026. To put triple Cs in the context of a recession, the average triple C issuer currently pays around a 7.5% coupon. If companies are forced to refinance at 12% or 14%, their coverage ratios would quickly fall below one and cross over into restructuring territory. Consequently, we are very cautious about going down in quality in this environment due to the potential economic challenges ahead and higher interest rate backdrop.

Market outlook

In the US and Europe, higher yields and modestly wider spreads present a more attractive entry point from a valuation perspective, in our view. We expect forward-looking total returns to be driven primarily by today's yield. The current "carry" is attractive by historical measures and the idea of compounding high incomes is mathematically powerful. We expect the loss rate (defaults less recovery) to be modest, which implies that most of the yield should get translated into returns (ignoring the impact of changes in US Treasury rates and spreads). We favor shorter-duration high yield, where the yield per unit of duration is historically high and credit risk can be managed through careful selection. On the other hand, we see little reason to extend the risk profile to stretch for yield when higher quality high yield issuers offer an attractive starting point.

In Asia, income will likely be the main contributor to total returns in the coming months, with credit differentiation via security selection and sector allocation critical. There are bright spots within the Asian high yield markets, such as Indian renewables, Macau gaming and oil and gas issuers with resilient fundamentals. We also see improved prospects for Asian frontier high yield sovereigns, given IMF support and debt restructuring progress. We expect limited new issuance in Asian high yield but expect a trend of buyback/ tender offers from selected Asian high yield issuers.

Structured debt

The structured market is a story of several different markets. The residential space has been relatively healthy, with little stress to speak of. Homeowners are sitting on a fair amount of equity and most people have very low mortgage rates. So, there is not a huge incentive for homeowners to refinance or move unless they are forced to. The high degree of equity within the mortgage market, from a homeowner's perspective, continues to be supportive of residential credit.

On the other hand, the commercial mortgage market is a much different story and various stories are playing out within that market. Many office markets are experiencing stress. A lack of demand for office space and challenging financing conditions due to tighter financial conditions, including higher interest rates and the reduced loan capacity of regional banks who have experienced stress since March, are weighing on office markets. The hotel segment is also facing challenges in some parts of the market. While we have seen an uptick in leisure travel, for example, business travel has not recovered to pre-pandemic levels, especially as businesses see the advantages of virtual interaction. So, we are seeing dispersion in terms of opportunities in different parts of the market, such as residential versus office and leisure versus business travel-related real estate. Also, differences exist on a property-by-property basis and there are parts of the market that are experiencing significant stress. On the other hand, trophy properties and properties with good locations have fared well and can present interesting opportunities.

Market outlook

Agency MBS

As we near the end of the Fed cycle, we expect interest rate volatility to recede, which should be positive for Agency mortgage-backed security (MBS) performance, particularly for higher coupon MBS. The prepayment outlook for Agency MBS continues to be driven by the large amount of deep discount bonds in the market. The amount of MBS with coupons that are 300-400 basis points below the prevailing mortgage refinance rate is keeping negative convexity near an all-time low.

RMBS

The lack of housing supply has driven home prices higher, despite record low affordability. We expect housing price appreciation to moderate in the coming months due to seasonal factors and persistent high mortgage rates. Delinquencies are creeping higher in lower quality loans but remain near historically low levels. The lower supply of non-agency RMBS has provided beneficial technical support to the market this year.

CMBS

Property vacancy rates are increasing and rent growth is slowing. Office properties face unique challenges given stalled return to office trends and increased sublease activity. Increased borrowing costs and tighter mortgage lending standards are creating refinancing challenges for loans maturing this year.

Commercial mortgage-backed securities (CMBS) transferred to special servicers are increasing. Furthermore, loan extension risk is elevated as servicers receive borrower requests for relief from high coupons that await them upon loan maturity. New issue supply has been lower this year, helping technical conditions. We favor selected triple-A rated multi-borrower conduit and senior single-asset single-borrower (SASB) exposure collateralized by property types that are positioned to outperform in the post-pandemic environment.

ABS

Asset-backed security (ABS) markets have been resilient through recent broader market bouts of volatility. Attractive valuations, supportive technical trends and manageable near-term fundamentals lend support to the assets class. While ABS have generally performed well in 2023, spreads are still attractive on a historical basis, in our view, and relative to corporate bonds. The continued inverted yield curve is supportive of demand for shorter average life ABS classes. We expect fundamentals to weaken slightly in the coming months and are watching consumer health at the lower end of the income spectrum for further declines. We expect market technicals be supportive through the end of this year, which should support spreads across much of the ABS sector.

Emerging markets

One of the key events impacting emerging markets (EM) in the past two years has been the war in Ukraine. Today, it appears that that focus has diminished in the absence of a major advance or significant change in the situation on either side. Also, the catalyst for the end of this conflict is highly uncertain. Russian assets that are not sanctioned being held by international asset managers are currently somewhat frozen and difficult to trade, so the Russia and Ukraine-related part of the EM market is at a standstill. One of the key implications of the war for the EM market has been to make investors wary of the impact that sanctions can have on countries that run afoul of the West, which could have implications for China and Taiwan. But the EM market currently appears to view a dangerous escalation of China-Taiwan tensions as a tail risk, versus a concern on the front burner.

Events like the Russia-Ukraine war, the Chinese property market collapse, and now the Israel-Hamas conflict appear to be viewed by the EM market as somewhat isolated events. But, as more such events occur, they highlight the pockets of risk that exist in EM, which concerns investors, especially institutional investors. As these events are taken in aggregate, they suggest that a higher EM risk premium may be required going forward, even for EM investment grade, which, in our view, is not yet priced in.

An important positive development worth highlighting is the recent breakthrough in the distressed part of the EM market. Until recently, there had been little progress in restructuring frontier sovereign debt owed to multilateral and bilateral lenders, including China. After a long impasse, China recently agreed to a coordinated debt restructuring plan with Zambia, potentially paving the way for similar agreements with other distressed debtors. Distressed sovereign debt reacted by rallying sharply. We believe this positive step is a turning point that could encourage further flows to the frontier asset class and high yield EM, due to the improved clarity around the terms and timing of current and future debt workouts.

Market outlook

We expect US rates to drive total EM returns in the near term. Despite significant moves in US rates recently, EM spreads are unchanged or tighter on the year. While EM spreads look fair to slightly rich in aggregate, in our view, outflows from the asset class have driven market dislocations. This has resulted in pockets of attractive opportunities in corporate, quasi-sovereign and high yield sovereign credits outside of core EM. Historically, high yields have supported attractive total returns in a stable macro environment.

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