Global Fixed Income Strategy

Monthly report

Invesco Fixed Income

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US macro update

Key takeaways

- **US economic strength:** The US is growing at potential
- **Recession risk:** Receding
- **Fed cutting cycle:** Easing financial conditions could slow rate cuts

Overview

Our focus this month is on the strength of the US economy, receding recession risks and the start of the US Federal Reserve (Fed) rate cutting cycle. All of these factors could lead to easier financial conditions and potentially lift animal spirits. This backdrop would be stimulative for the US economy, which is already growing near its potential. If financial conditions ease too rapidly, the Fed may lean against them by cutting rates more slowly than expected. Earlier this year, the bond market was pricing in around five rate cuts for 2024, though that looked like too many. Currently, the market is pricing in between three and four cuts. Recent higher than expected inflation data suggest that disinflation can be bumpy. However, we believe it is too early to predict changes in Fed policy since price adjustments tend to be volatile early in the year.

US growth is resilient

The US economy did not slow in 2023 as expected and actually gained momentum in the second half of the year. While we have penciled in a modest deceleration in the first half of 2024, the latest data suggest a stronger path, with growth at, or above, potential. We may revise up our 2024 growth projections, but we prefer to see more data for the first quarter since turn-of-the-year data are often noisy, and the pandemic has altered seasonal patterns.

Nevertheless, we expect growth to remain strong this year, for two interrelated reasons. First, the risk outlook has improved relative to last year, and that could lead to stronger investment and spending decisions, or so-called animal spirits. Second, financial conditions should ease, as we have reached the peak in the Fed policy rate and now anticipate cuts. The interplay of these two factors should lead to robust growth in 2024:

1. **Lower recession risk should boost confidence, spending and investment decisions**

   At the beginning of last year, the market consensus called for a recession in 2023. Inflation was over six percent. The Fed was still hiking rates and banking sector stress erupted in March, embroiling Silicon Valley Bank and Signature Bank in the US, and systemically important Credit Suisse in Europe. This was not a one-and-done issue; First Republic Bank later failed and was sold to JP Morgan in May. How would a company manager react in such an environment? Keep hiring and investing, or be cautious? We think the latter was more likely.

   What do we expect this year? The consensus at the start of this year has not been a recession, but some version of a soft landing. Inflation, as measured by the Personal Consumption Expenditures Price Index (PCE), is below three percent. The Fed is expected to cut rates sometime in the middle of this year. Banking tensions are behind us for the most part (please see more about our views on banks in the Credit article on page 7). Corporate managers in such an environment should behave differently than last year. They will likely be less concerned and more inclined to hire and invest. For lenders, lower recession risk means lower risk premia and higher lending volumes. Recent data show significant improvement in the Conference Board's CEO Confidence and the University of Michigan Consumer Expectations indices.

2. **Fed cuts and declining recession risk should ease financial conditions**

   There is often significant focus on the policy rate-the number of cuts priced in, the level of the real policy rate and the rate implied by the so-called Taylor rule, which prescribes a value for the federal funds rate based on inflation and the output gap. These all matter of course. But there is more to financial conditions than the short-term risk-free rate. The key for the economy is the transmission to other asset prices and lending and borrowing activity. In an improving outlook, expectations and risk perceptions can enhance policy easing, and we believe this will happen this year. The pending Fed rate cuts will likely lower borrowing rates for the private sector, but risk premia will likely also fall. For example, the spread between the average mortgage rate and the 10-year US Treasury yield is elevated. The spread has fallen from its highs, but we believe there is more narrowing to go to. The current average mortgage rate is around 6.6% but further spread compression could reduce it to 6%.[1] The housing market struggled with mortgage rates over 7% but seems able to handle rates in the 6% range. We expect housing to contribute to growth this year.

   As for bank lending, the January Senior Loan Officer Opinion Survey on Bank Lending suggests that banks tightened lending conditions early this year but at a decreasing rate. This is a typical pattern: as risks decline, banks first stop tightening their lending standards and then begin to ease them. In this cycle, the economy has not faced a recession, and a severe default cycle has not occurred, so lending conditions could reverse more quickly than in the past. We expect banks to begin to ease lending conditions before summer. Credit growth could gain momentum even before that, and we see green shoots forming in bank lending data.

The labor market has cooled, but is not a leading indicator

Nonfarm payrolls have been strong in recent months but other indicators, such as those from the US Bureau of Labor Statistics Household Survey, suggest a weaker labor market. The December Job Openings and Labor Turnover Survey (JOLTS) reported in January showed that quits fell below pre-pandemic levels, suggesting that workers are not changing jobs as readily as before.

Our view is that the labor market has softened somewhat, but not significantly. Job creation has declined compared to last year, but jobs are still being generated at a rate above the demographic trend. Various labor market indicators, such as jobless claims, purchasing manager indices, regional surveys, small business surveys and others suggest a softer labor market but still a healthy one.

More importantly, the labor market does not lead the cycle. It is at best a coincident, or lagging, indicator. If economic growth remains around trend, as we expect, and the risk outlook improves, we would expect companies to continue hiring at a robust pace.

Inflation prints suggest the risk of stickiness is rising

We believe the overall disinflation story is intact; progress toward the Fed's target will likely continue, but it could be a bumpy road. The January consumer price inflation (CPI) report was a disappointing upward surprise. Owners' equivalent rent was a significant contributor, which should normalize in line with current market rents. But the problem was broader; many categories in core services surprised to the upside. Trimmed-mean and median CPI measures have shot up. This report represents only one month, and one-off adjustments to some prices will not be repeated. But, on balance, risks have risen. The Fed was already cautious and telegraphed that it wanted to wait to collect more evidence on the sustainability of disinflation before embarking on cuts. Higher than expected January producer price data have further validated the Fed's patient approach.

1. Source: Bloomberg L.P. Data as of Jan. 20, 2024.

The Fed cutting cycle

Rate cuts may be delayed after January's strong inflation readings, but it is unlikely that the Fed will keep the short-term risk-free rate higher than the economy's nominal growth rate for long. There are many additional data points to come between now and the May and June Federal Open Market Committee meetings, but for now, the current data suggest a delayed and cautious cutting cycle.

We have pushed out our expectation of the first rate cut to June from May. We maintain our expectation of four cuts for the year (June, July, September, and December). The market appears to be pricing in fewer cuts, at between three and four.

What does this mean for risk taking?

The US economic outlook creates a tailwind for markets. Resilient growth, disinflation and the start of a rate cutting cycle establish a very favorable environment for risk taking. This is supportive of fundamentals across most markets, including credit. Market liquidity and technicals are also generally positive in an environment of easing monetary policy. This positive tailwind is offset by valuations that are not compelling, in our view. Yield curves are inverted, so extending duration costs yield. Credit spreads are quite tight, and indeed investment grade credit spreads are approaching the tights not seen since before the global financial crisis of 2008. Positive fundamentals and technicals, but tight valuations, create a challenge for investors. In our view, the positive macro backdrop is likely to prevail, so we favor a positive exposure to credit and carry. That being said, we do not favor stretching for yield and prefer to keep risk contained. We favor utilizing any volatility that brings better valuations to add to portfolio risk.

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Interest rate outlook

US: Neutral. Recent inflation and growth data have pointed to higher inflation and stronger growth outcomes than the market expected. The US Treasury market has repriced higher in yield. We believe that at current levels, US yields offer positive expected excess returns versus cash. However, the growth and inflation data have likely reset the clock when it comes to the potential easing of the federal funds rate. We have revised our base case for the beginning of the Fed cutting cycle to June from May. The market will likely reward patience in adding to long US interest rate exposure.

Europe: Overweight. We are positive on European duration over the medium term. We believe the repricing so far this year presents a buying opportunity. Over the coming year, we expect the European Central Bank (ECB) to reduce rates significantly, as inflation falls toward its 2% target and the region's economy struggles from tighter financial conditions and a weaker global growth environment. The ECB rhetoric has become less hawkish as inflation has eased and the eurozone economy has recorded sub-par growth. We expect rate cuts to have started by the second half of this year.

China: Neutral. China cut its five-year loan prime rate by 25 basis points on Feb. 20 to 3.95%, a larger cut than the market expected, while keeping the one-year loan prime rate unchanged. This came after a 50 basis point cut in the reserve requirement ratio (RRR) for banks and a 25 basis point cut in the relending rate on loans to small and medium-sized enterprises and the agricultural sector in January. Central bank officials said they will use interest rates to promote consumption and investment and to lower financing costs in the real economy. The central bank also noted the gap between the current level of inflation and its target level. We expect monetary policy to maintain sufficient liquidity and support large government bond issuance. The end of 2023 saw large inflows into onshore bonds from international investors after a relatively long period of outflows. We have been expecting Chinese rates to be "lower-for longer", however, given the limited magnitude of moves by Chinese onshore bonds compared to US Treasury bonds.

Japan: Underweight. Japanese government bond (JGB) yields have traded in a tight range over the last month, despite the shift higher in US Treasury and German bund yields. Softer January Tokyo CPI data and a contraction in Q4 GDP have reduced expectations of an imminent rate hike from the Bank of Japan. In addition, life insurance companies have increased their demand for long-end JGBs, as 30-year yields have reached 1.8%, leading to a flattening of the yield curve between 10-years and 30-years.[2] Looking forward, we still believe the BoJ will normalize policy gradually later this year. Although inflation has peaked, the underlying trend appears to be around 2%. The BoJ's January statement noted growing confidence among policymakers that the 2% inflation target can now be reached. Anecdotal evidence about the crucial spring wage round also points to further acceleration in wage growth, which will likely be an important determinant of the timing and extent of BoJ policy normalization.

UK: Overweight. 10-year gilt yields are 22 basis points higher over the last month, matching the jump in US Treasury yields and underperforming German bunds.[3] Outright and cross market valuations now look relatively attractive. The market is pricing under 70 basis points of cuts in 2024 and a trough for rates at 3.7%, which points to relatively high implied real rates, if market expectations of a moderation of inflation toward 2% is realized.[4] Recent data have been mixed. Q4 GDP data were weak and core inflation has fallen faster than forecast. However, leading indicators have picked up, wage growth remains too high and the labor market has not loosened significantly. The Bank of England (BoE) remains focused on services inflation and wage growth. Therefore, the April minimum wage hike and release of revised employment data in Q2 will likely be important guideposts for the start of the cutting cycle. Nevertheless, the direction of travel toward cuts is clear. The BoE's February forecasts implicitly endorse cuts, as inflation under constant rates was substantially below target, albeit the forecast also slightly pushed back against market pricing in early January, as the 2-year and 3-year inflation forecasts were above 2% based on market pricing.[5] However since the February forecasts were compiled, market pricing has shifted higher by approximately 50 basis points, making the path of rates look more consistent with what policymakers are targeting. Fiscal stimulus at the March budget remains a risk for the gilt market, but the Chancellor has recently played down expectations for a substantial

2. Source: Bloomberg L.P. Data as of Feb. 22, 2024.
3. Source: Bloomberg L.P. Data as of Feb. 22, 2024.
4. Source: Bloomberg L.P. Data as of Feb. 22, 2024.
5. Source: Bloomberg L.P. Data as of Feb. 22, 2024.

easing. It is also possible that in Q2 the BoE could start to discuss moderating active gilt sales, as its forecast for the necessary level of reserves seems to have shifted higher lately.

Australia: Overweight. Australian government bond yields are little changed compared to last month, outperforming most major developed global bond markets. Weaker domestic CPI and employment data have helped anchor Australian yields, with the market now confident that the Reserve Bank of Australia's (RBA) next move will be to cut rates. Outright valuations look moderately attractive with only 55 basis points of easing priced in over the next two years and long forwards trading over 4.5%, which is well above estimates of Australia's neutral rate. However, Australia no longer looks cheap from a cross market basis, in our view, with limited scope for the front end to continue to outperform since the RBA will likely lag the Fed and ECB in cutting rates, due to the higher starting level of underlying inflation. Combining these views, we favor curve flattening exposures in Australia against curve steepening exposures in the US, eurozone and New Zealand. This takes advantage of Australia's higher term premium and lower bond supply, while potentially insulating against the likelihood that the RBA lags other central banks in cutting rates.

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Currency outlook

USD: Neutral. We are broadly neutral on the US dollar in the short term. Given the outperformance of the US economy, and higher short-term rates than peers, the US dollar should remain supported in the near term. However, with the Fed still intent on rate cuts later this year, and valuations stretched, the case for overweight dollars is challenged. Our medium-term expectation is that the US economy will slow more than the market consensus, leading to a more protracted rate cutting cycle by the Fed, which should be more negative for the US dollar.

EUR: Underweight. We have a negative view of the euro over the medium term, based on our expectation of a more active ECB rate cutting cycle. That said, over a shorter time horizon, much depends on the path of the US dollar and the continued economic resilience of the US economy. If the US continues to grow at or around trend growth, while the ECB is reducing rates, we would expect the euro to struggle to make headway, despite the dovish pivot by the Fed.

RMB: Neutral. We believe recent policy measures announced to support local financial markets are marginally positive for the renminbi against the US dollar. However, the interest rate differential between the US and China is likely to keep some investors and exporters interested in the US dollar versus the renminbi. If the announced RMB2 trillion stabilization fund is put to work, the impact on capital flows will likely be beneficial for the renminbi's performance. However, we recognize that the April-May period typically sees higher demand for US dollars from local companies to pay dividends. We remain neutral on the renminbi against the US dollar considering its overall stability but could see slight pressure due to seasonality.

JPY: Neutral. The yen has weakened in recent weeks against the US dollar and euro, driven by widening interest rate differentials, as the US and European rates markets have repriced expectations of interest rate cuts in the face of buoyant risk sentiment and resilient economic data. In addition, weaker Japanese data have tempered expectations for an imminent rate hike from the BoJ. Current yen valuations look relatively cheap when compared to the level of interest rate spreads, as the USD/JPY and EUR/JPY exchange rates are close to their highs, but interest rate spreads are still near the October wides. Nevertheless, until economic data deteriorate substantially, leading to a rapid cutting cycle from the Fed and ECB, it is hard for us to expect substantial yen outperformance.

GBP: Neutral. The British pound has been one of the best performing developed market currencies year-to-date, helped by better risk sentiment, improved domestic economic data and the repricing of rate cut expectations, reinforcing the pound's status as a relative high yielder. However, the upside for the pound going forward looks more limited. There are less than 70 basis points of cuts now priced into the UK yield curve for this year, limiting the scope for interest rate differentials to shift in the pound's favor. Growth expectations have picked up already and further upside might be more limited. In addition, the level of UK growth remains lacklustre on a relative basis. If global growth picks up substantially it is hard to see the pound outperforming more cyclical currencies like the Australian dollar or Norwegian krone. Alternatively, lower growth would likely see the pound suffer versus the US dollar and Japanese yen.

AUD: Neutral. Australian dollar valuations look attractive relative to interest rate differentials and the terms of trade. However, the path for Australian dollar outperformance remains a relatively narrow one. The Australian dollar probably requires a combination of a dovish Fed, a stable-to-hawkish RBA and a recovery in growth outside the US, particularly in China, to meaningfully rally against the US dollar. There are tentative signs that global growth is picking up and signs that Chinese stimulus efforts are building, but as yet, these trends are nascent and continue to be overshadowed by strong US growth, which keeps pushing back expectations of Fed easing.

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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.

Global credit outlook: Is trouble at New York Community Bancorp déjà vu all over again? No.

Key takeaways

- We believe the situation at New York Community Bancorp (NYCB) is unique.
- We have not seen a run on NYCB similar to last year's run at Silicon Valley Bank.
- Concerns about commercial real estate are growing when it comes to US regional and global banks. But we believe the systemic risk from CRE is manageable.

What happened at NYCB?

Recent troubles at New York Community Bancorp (NYCB) have reminded investors of last spring's banking sector turmoil, when Silicon Valley Bank suddenly collapsed and ensuing contagion led to the failure of Signature Bank. At the time, the government quickly stepped in to protect depositors and stabilize the US financial system. Fears of a broader regional banking sector crisis subsequently subsided.

But events at NYCB have reignited fears surrounding pressures at US regional banks. NYCB's share price plummeted by almost 40% on January 31 after it announced a fourth quarter loss and cut its dividend. The bank said it was taking measures to bolster its balance sheet and meet stricter regulatory requirements. Such measures are credit supportive and were triggered when NYCB became a "large" bank following its acquisition of the assets and liabilities of failed Signature Bank last year and Flagstar Bank in 2022. But NYCB's negative earnings results rekindled investor fears over the stability of the banking system and dragged down the shares of other regional banks.

What is our view of the NYCB situation?

We believe the market reaction to events at NYCB were overdone and that the fundamentals of NYCB are dissimilar to other regional banks. Over the past 18 months, NYCB grew above the USD100 billion regulatory threshold to become classified as a "Category IV" bank and, in the fourth quarter, it rightfully decided to bolster its capital and liquidity metrics. To be sure, we consider management's communications surrounding the regulatory transition weak. But in our view, the situation at NYCB is idiosyncratic and not representative of the broader regional banking sector. NYCB has a more monoline business structure than the average regional bank, with a heavy concentration in multi-family and office commercial real estate loans. Also, we have not seen a run on its deposits; NYCB has seen its deposits grow so far this year and only around 30% of its deposits are uninsured.

NYCB highlights the risks of CRE exposure

We believe the broader message from NYCB's recent troubles is that last year's banking sector concerns and the continued risks surrounding commercial real estate (CRE) are still present. Commercial real estate occupancy and property valuations have declined across most property sectors as rent growth has slowed and, in many instances, turned negative. Price discovery remains limited with fewer transactions taking place than in prior years. Multi-family property valuations have experienced downward pressure due to increasing supply and decelerating rent growth. While vacancy rates remain near or below pre-COVID levels in several property types, the effect of the pandemic on other types of commercial real estate is significant and may be lasting. Most notably, office properties have experienced significantly weaker tenant demand due to increased hybrid work arrangements. Lodging properties remain hurt by lower business travel and uneven demand from leisure travelers. Despite signals from the Fed that lower interest rates are on the cards for 2024, we expect many borrowers to find it difficult to refinance amid significantly higher rates than their current mortgage loan coupons.

Both large systemically important global banks and regional banks have CRE exposure. But the important factors to consider are the different sizes and types of CRE exposure relative to banks' balance sheets and their levels of reserves. We highlight some important metrics to consider below.

What makes NYBC idiosyncratic?

First, it is important to point out that NYCB's New York City multi-family loan portfolio is unique, with features unlike its peers. Namely, its portfolio of New York City loans are rent-controlled properties. In 2019, New York State passed a housing act which curbed landlords' ability to raise rents, hurting the underlying value of multifamily buildings. The valuations of rent controlled properties have experienced downward pressure due to oversupply and decelerating rent growth. From a market perspective, both bond and equity investors see a material risk in the name. The NYCB 2028 subordinated debt bonds, are currently trading at 74 cents on the dollar, and NYCB's equity price is down more than 50% since year-end.[6]

NYCB has highlighted that it will continue to build its capital base and review its loan portfolio, including the possibility of reducing its CRE concentration, which may entail asset sales. Nevertheless, Fitch placed NYCB on negative credit watch, and Moody's cut it to junk status, which will likely make it difficult for the bank to issue senior debt to meet new requirements for regional banks with assets over USD100 billion. Moody's action was largely driven by NYCB's unanticipated CRE loss, which is a significant concentration for the bank, as well as governance challenges facing the bank amid concerns over its risk and audit functions. Fitch's action reflects NYCB's net fourth quarter loss, as well the higher levels of on-balance sheet liquidity and higher wholesale funding requirements, which will likely negatively affect the bank's profitability in 2024.

Why NYCB does not represent most banks

Pressures in the CRE sector will likely continue to pose challenges for banks. Commercial office space is challenged by higher interest rates, a drop in property valuations and pressure on occupancy rates as tenants re-size their real estate footprints amid the trend toward remote work. During the fourth quarter, banks experienced increased credit losses on commercial mortgages, as they charged off some office exposures.

However, while office loan credit quality will likely deteriorate further, we think exposure to CRE is a manageable risk for the US banking system overall. Compared to NYCB, other US banks are better positioned - with more diversified loan portfolios, lower concentration risk, higher allowances for credit losses, higher reserves and higher capital levels.

Figure 1 shows that, for Category IV banks, defined as banks with total assets of USD100 billion to USD250 billion, (excluding NYCB from the average):

- The average CRE to total assets was 10.48% versus 43.54% for NYCB.
- The average common equity tier 1 capital (CET1) was 10.8% versus 9.1% for NYCB.
- The average allowance for credit losses (ACL) was 1.58% versus 1.16% for NYCB.
- The average liquidity was 23.60% versus 20.06% for NYCB.

Figure 1: Comparing NYCB to large and small banks

Asset Category	Average of CRE LOANS/ ASSETS	Average of CET1	Average of ACL
US Big 6**	2.94%	13.53%	1.46%
Trust Banks***	1.90%	11.53%	0.41%
$250-$750bn - CAT III	6.77%	10.70%	2.44%
$100-$250bn - CAT IV	10.48%	10.81%	1.58%
New York Community Bancorp Inc	43.54%	9.10%	1.16%
$30-$100bn	24.37%	11.26%	1.18%

** Bank of America Corp, Citigroup Inc, Goldman Sachs Group Inc, JPMorgan Chase & Co, Morgan Stanley, Wells Fargo & Co
*** Bank of New York Mellon Corp, Northern Trust Corp, State Street Corp

Source: Company reports. Latest available data as of Dec. 31, 2023.

6. Source: Bloomberg L.P. Data as of Feb. 16, 2024.

Most banks are well positioned to weather CRE challenges

Most US regional banks and banks classified as global systemically important banks have diversified commercial real estate portfolios, including retail, industrial, office and multi-family properties. During 2023, many banks pro-actively built reserves against their CRE exposure. The smaller regional and community banks (USD30 billion assets and below) are of most concern since they have higher concentrations of CRE on their balance sheets. It is a concern when exposures are concentrated because any stress in the concentrated asset class, and possible deterioration in asset quality, could negatively impact a bank's income statement and capital ratios. In a recent television interview, Fed Chair Jerome Powell said, "We looked at the larger banks' balance sheets, and it appears to be a manageable problem. There are some smaller and regional banks that have concentrated exposures in these areas that are challenged." And "there will be some banks that have to be closed or merged out of existence because of this."

Non-US banks also face CRE risks

Concerns about CRE are not isolated to US banks. In the wake of NYCB's earnings, the equities and bonds of several international banks with large CRE exposure came under pressure. But major European banks' US CRE exposures look manageable, in our opinion. Deutsche Bank appears to be the most exposed of the major European banks. While Deutsche Bank has material exposure to US CRE, at €17 billion, it represents a modest 3.5% of the bank's total loan book, which we view as manageable.[7] While we don't see exposure to CRE as a destabilizing factor for the European banking sector, there will likely be issues at some smaller lenders with outsized exposures. In response to potential risk, the European Central Bank has warned European banks about managing their commercial real estate exposures.

Nordic lenders have been widely reported as heavily concentrated in CRE. While CRE exposure at some Nordic lenders is material, the exposure is domestically focused. Asset quality metrics and capitalization at the large Swedish banks are extremely strong and profitability is high, which should provide the capacity to absorb pressures arising from their CRE portfolios.

In Canada, bank regulators have said that commercial real estate loan losses remain on the radar but are a manageable risk for Canada's biggest banks.

Conclusion

The focus of concern when it comes to bank stability is on the smaller US regional banks. The larger banks' credit fundamentals are sound, characterized by diverse balance sheets, stable asset quality and strong capital and liquidity levels. Looking ahead, amid pressures in the CRE space, we expect smaller banks to continue to build their capital and liquidity profiles, which are credit supportive measures. However, these actions could result in further equity price volatility. While CRE credit losses should materialize gradually, we expect them to be manageable for the larger, highly rated banks. Smaller banks with higher CRE concentrations may see higher credit losses. The risk of deposit flight seems to be well managed currently. We have already seen an increase in NYCB's deposits and a large percentage of insured deposits. While the smaller regional and community banks have higher asset concentrations on their balance sheets, risks are mitigated by the ability of the regulators to either wind down those institutions and/or for larger banks to acquire their assets, with a low probability of contagion to the broader banking system.

7. Source: Deutsche Bank earnings report. Data as of Dec. 31, 2023.

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The bottom line: High yield is positioned to deliver in 2024

We speak with Invesco Fixed Income's High Yield Team about drivers and risk factors for high yield performance in 2024.

Q: What is your outlook for high yield performance in 2024? How do you see high yield fundamentals, valuations and market technicals?

The high yield bond market faces a dynamic landscape in 2024, shaped by the interplay of interest rates, yield curve dynamics and broader economic trends. Corporate fundamentals have remained robust, with companies maintaining margins by passing through inflation to resilient consumers. While defaults may inch higher, we expect them to remain within reasonable bounds. Issuance has rebounded, primarily through opportunistic refinancings in a robust market. Capital discipline and high yields have contributed to less aggressive issuance, setting the stage for potentially another year of net negative issuance in 2024. In addition, steady demand, marked by consecutive months of inflows into the asset class, underscores the attractiveness of high yield. We anticipate a continuation of this trend through 2024, supported by high yields and a disciplined issuance environment.

Q: What do you expect the key market drivers to be this year? What are you watching for in terms of positive developments?

Interest rates are likely to play an outsized role in 2024, with the market focused on the timing and size of Fed rate cuts. Asset pricing has been highly reactive to those expectations. A soft, or no, landing would certainly be viewed as a positive development. High yield tends to be economically sensitive and the avoidance of a recession, which is looking increasingly possible, would likely be a strong positive for the asset class and reduce default risk. If the Fed is able to cut rates in response to falling inflation, that would likely provide additional support for high yield in 2024.

Q: What are the key risks?

The constitution of the high yield market, the maturity schedule and strong corporate fundamentals means that, while we are cautious in our security selection, the primary risks are macro oriented. Furthermore, high prices don't cause selloffs, so we are less concerned by current valuations, which we believe are generally rich across most asset classes. However, the market has priced in a very benign outlook and may struggle with a meaningful downturn in the economy. A surprise uptick in inflation leading to another increase in the federal funds rate would likely also be a negative to risk assets. Of course, heightened equity volatility from any escalation in global conflicts could result in a widening of credit spreads.

Q: How could Fed policy and Treasury rates impact high yield this year? Are you concerned about US growth and inflation?

High front-end rates and an inverted yield curve typically pose challenges for risk assets, including high-yield bonds. The higher borrowing costs are impacting companies with elevated leverage and floating rate debt. That said, the prospect of peak rates followed by anticipated rate cuts presents a bullish scenario for fixed income. Rate cuts can lower yields, supporting bond prices, and creating favorable conditions for bond investors. The current negative yield curve may be a headwind for high yield bonds in the short term, but the positive medium-term trend, driven by the expectation of multiple rate cuts in 2024, offers a favorable outlook. In addition, the starting yield level for high yield can be a strong mitigant for US Treasury volatility. If Treasury yields move higher from here, for example, we calculate that the high yield market could absorb 2.49% of higher yields (called the "breakeven yield") and still generate a positive return, not including the impact of changes to spreads and defaults. That is a relatively large cushion and gives us comfort that volatility in Treasury yields could have less impact on high yield than in the past.

Q: Is there a particular sector or rating segment where you see opportunities this year?

Shorter duration high yield bonds stand out as a compelling opportunity, offering an attractive yield per unit of duration on a credit risk-adjusted basis. Our expectation of a (bull) steepening US Treasury curve further enhances the appeal of shorter-dated bonds. However, we believe in the importance of careful security selection and proactive risk management. Our focus is on issuers and securities with clear paths to refinancing. In addition to

8. Source: Bloomberg L.P. Data as of Jan. 25, 2024.

short duration opportunities, we've taken a cautious stance toward idiosyncratic risk among lower-quality issuers heavily reliant on cheap financing to survive. As such, we're shifting toward better quality issuers within the high yield spectrum, recognizing the heightened importance of creditworthiness in a higher-cost-of-capital environment. Our selection criteria prioritize issuers with stronger fundamentals, with the aim of reducing their vulnerability to economic headwinds and higher financing costs.

Q: How does your team and investment process differentiate Invesco in this asset class?

Our framework uses multiple levers to add value. Our security selection is built on diligent, bottom-up credit analysis with a focus on mitigating downside risk. We combine that with a top-down approach that allows us to modulate risk based on valuations and economic projections. We actively seek catalysts that we expect to drive single-name performance, and themes or dislocations that we can take advantage of. We believe that investors in the high yield market can exhibit "group think", which often leads to the overvaluation of areas with significant investment, and the undervaluation of other areas of the market. We believe evaluating issuers with an independent mindset allows us to identify non-consensus views and generate alpha over full cycles.

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