

# Global Fixed Income Strategy

Invesco Fixed Income

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## Contributor

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Chief Strategist and  
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## Global macro strategy

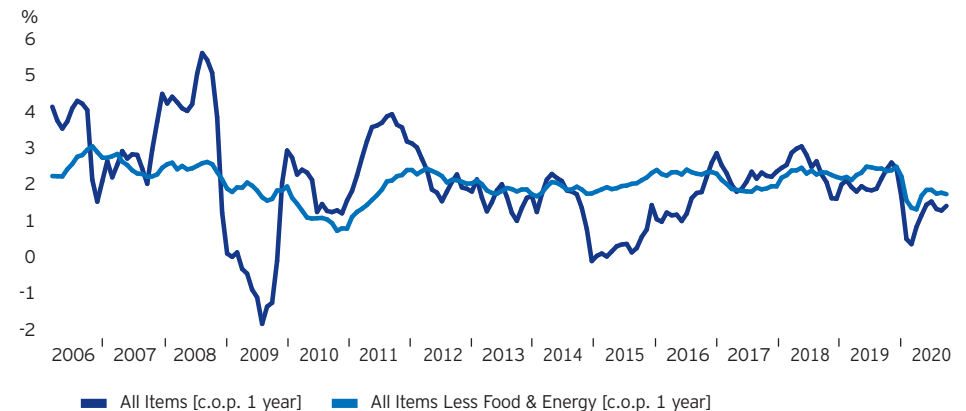
### Inflation dynamics in the post-COVID-19 economy

Aggressive macro and fiscal policies and a vaccine rollout that potentially paves the way for normalized economic activity have renewed the market's focus on inflation. Although base effects are likely to push up inflation in the first half of 2021, we expect inflation to remain well contained in the medium term due to excess capacity in the service sector and the residual impacts of COVID-19. We lay out our near and longer-term views on inflation below.

#### Near-term outlook for inflation

US inflation plummeted in response to the sharp demand contraction due to the COVID-19 shutdown. Inflation has begun to recover, but on a year-over-year basis, remains depressed versus before the COVID-19 shutdown. This is likely to change in 2021 as the period of the shutdown recedes, and the base effects lead to a year-over-year pickup in measured inflation in Q2 2021. Measured core inflation should equal or surpass the level before the shutdown by mid-year 2021. This just represents the impact of the shutdown washing through and the economy returning to an inflationary trend. Inflation breakevens, measured by the US Treasury Inflation-Protection Securities (TIPS) market, are indicating exactly this dynamic, having returned to the levels that prevailed before the shutdown.

Figure 1: US inflation



Source: Macrobond, data from Jan. 1, 2006, to Dec. 1, 2020.

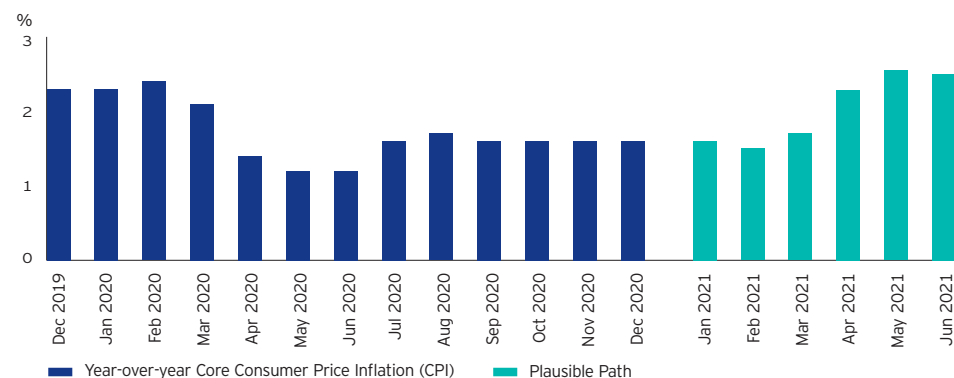
#### Medium-term outlook for inflation

US inflation in the medium term will likely be driven by the confluence of two different factors. The first factor is the extraordinary amount of monetary stimulus that has been put into the US economy. This has led to sharp growth in lending and monetary aggregates. The sharp growth in money supply should put upward pressure on prices in the coming two or three years. The exact amount of upward pressure is hard

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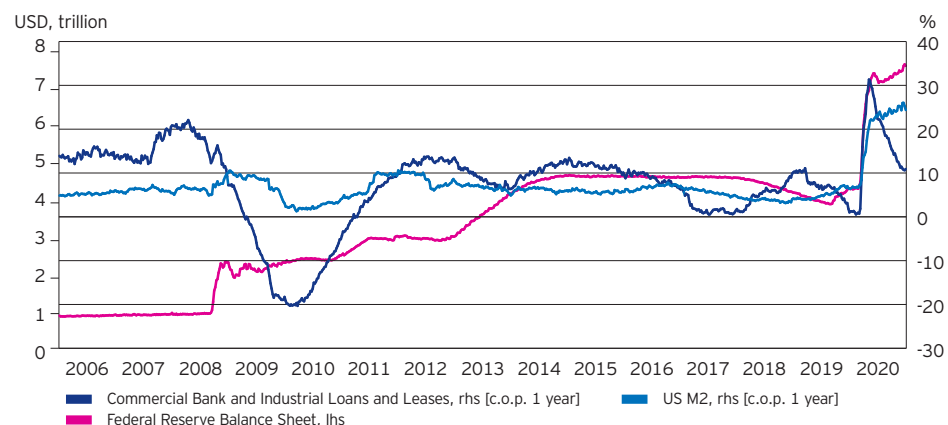
to calibrate, but we have not seen growth in monetary aggregates like the current situation in many years. This argues for inflation two to three years out breaking above the levels that have prevailed in recent years. This might allow US consumer price inflation to achieve levels above 2.5%. This is why Invesco Fixed Income favors yield curve steepeners and long inflation breakeven trades.

**Figure 2: Core US inflation will likely rise due to base effects**



Source: US Bureau of Labor Statistics, Invesco estimates, data from Dec. 31, 2019, to Dec. 31, 2020. Forecasts thereafter.

**Figure 3: Fed balance sheet, money supply, and bank lending all expanding**



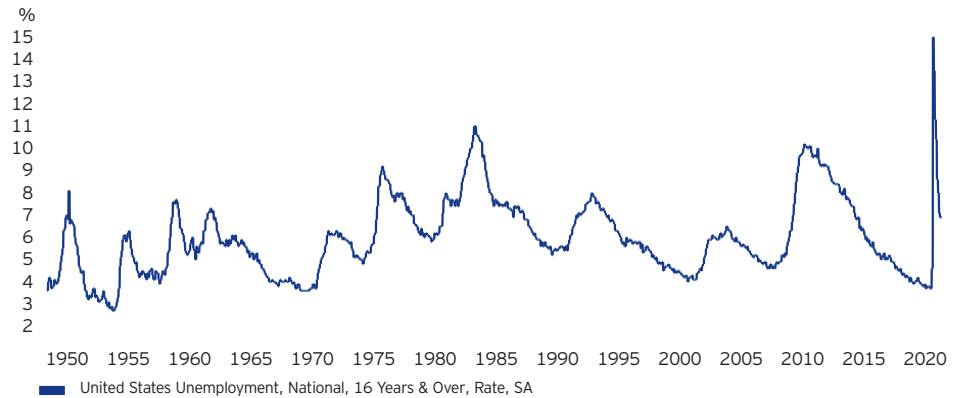
Source: Macrobond, data from Jan. 2, 2006, to Dec. 28, 2020.

**Figure 4: US 10-year inflation breakeven**



Source: Macrobond, data from Jan. 1, 2014, to Jan 15, 2021.

The second factor is the amount of spare capacity in the aggregate economy. US unemployment has dropped substantially since its peak during the shutdown but still remains at elevated levels. There is likely to be continued churn in the labor market as the economy changes and evolves in response to COVID-19. While some areas of the economy will recover back to the situation that prevailed before the crisis, other areas will likely be permanently changed (think retail, travel). Workers who are impacted by this change are likely to keep spare capacity in the labor market for a while. This spare capacity is likely to keep wage pressures down and prevent a wage spiral leading to inflationary pressure.

**Figure 5: US unemployment**

Source: Macrobond, data from Jan. 5, 1948, to Dec. 28, 2020.

Invesco Chief Economist John Greenwood has laid out more detail behind these two forces – what might be called Keynesian versus Monetarist. This will be an interesting time to see how these two offsetting forces interact.

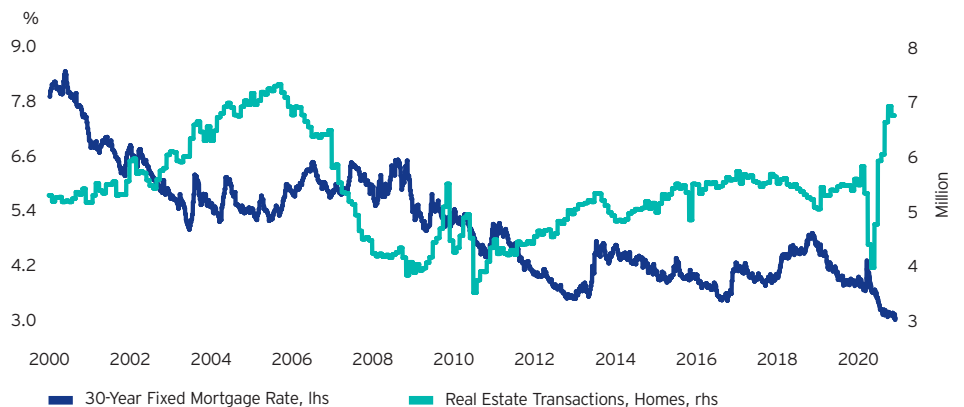
#### Important inflationary dynamics operating under the surface of the economy

A key feature of the current economy is that the service sector and the industrial sector are in very different cyclical positions. The service sector is in an early cycle, which should exhibit very little inflationary pressure; the industrial sector is in a mid-to-late cycle and is likely to exhibit upward price pressure due to high levels of demand and capacity constraints.

The COVID-19 shutdown has largely been a service sector recession, not an industrial recession. This is an unusual dynamic, as recessions are normally driven more by the industrial side, which is typically more volatile than the service sector. In this case, the service sector parts of the economy were those that were directly impacted by the shutdown orders. There is significant excess capacity in the service sector, and a recovery in the service sector from the shutdown has only just begun.

The industrial side of the economy, on the other hand, had very little setback during the shutdown and is now facing a sharp increase in demand. The industrial side of the economy has little spare capacity just when it is facing a demand pickup. This is leading to mid-to-late cycle dynamics in the industrial side of the economy.

The US housing market is just one of several examples of a large pickup in demand in a sector directly tied to the industrial side of the economy. There was virtually no shutdown in the housing market, and housing market activity in the US is now running the strongest it has in a decade. There was little excess supply of houses to start with, and demand has picked up. This will likely lead to pricing pressures in this market as well as in the commodity markets that supply the raw materials for the housing market.

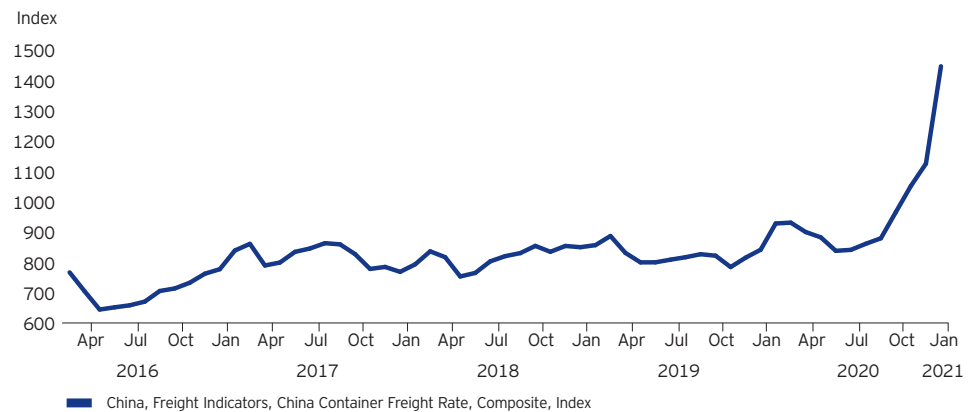
**Figure 6: US Home sales have rebounded sharply**

Source: Macrobond, data from Jan. 3, 2000, to Nov. 30, 2020.

This dynamic is visible across a range of industries, and we are starting to see the pricing pressure in spots. Iron ore and steel prices are rising sharply. Shipping costs are rising, and oil prices have started to rise again. These are all signs of pricing pressure on the industrial side of the global economy, and this trend is likely to continue, in our view, for the near future. This will likely lead to continued strength in commodity prices and support for goods prices.

**Figure 7: Iron ore and oil prices**

Source: Macrobond, data from June 1, 2018, to Jan. 14, 2021.

**Figure 8: Cost of shipping goods has increased sharply**

Source: Macrobond, data from Feb. 1, 2016, to Dec. 1, 2020.

This dynamic will likely mean that, although there will likely not be inflationary pressure across the US economy, there will probably be areas of strong inflationary pressure in pockets tied to the industrial side of the economy.

#### Bottom line

Near-term measured inflation will likely continue to rise to return to the levels that broadly prevailed before the pandemic. In the medium term, we expect the stimulus in the system to cause inflation to gently rise to levels close to the top of the range for the recent decade. The spare capacity still in the economy, particularly in the labor market, will likely restrain any increase in prices.

The important inflation dynamic in the near term will likely be the dichotomy between the service and industrial sector. Prices tied to the industrial side of the economy are likely to continue to experience upward pressure, while service prices will likely remain moribund.

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**Global macro strategy**


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**Interest rate outlook**

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

**Europe: Neutral.** The outlook for the European economy in the short term has deteriorated somewhat over the past month. The rollout of the COVID-19 vaccine has been much slower than anticipated across the region, as a combination of reliance on a small number of approved vaccines, logistical challenges of delivering the vaccine, and delays in supply have pushed back our expectations of a relaxation of lockdown measures and a return to some sort of normality. We now expect the vaccination of the most vulnerable across the region to take until the latter part of the second quarter, placing additional pressure on sovereign balance sheets. That said, the European Central Bank (ECB) stands ready to respond. The bond purchase program still has considerable firepower remaining to calm markets, and, as such, our analysis indicates that yields will likely stay low and within a narrow range for the time being. The political temperature in Italy has risen again as the unsteady government coalition has begun to fracture. While this dynamic has the potential to widen Italian sovereign spreads versus core Europe, our central view is that a new coalition in some form will be agreed to, and elections will be delayed until 2022 or 2023.

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

**Japan: Neutral.** Japanese government bond (JGB) yields followed US Treasury yields higher after the Democrats won control of the US Senate. However, the upside for Japanese yields is probably limited compared to other developed markets. JGB yields are already at pre-COVID-19 levels, as the Bank of Japan (BoJ) has only partially offset the increase in supply caused by fiscal stimulus, especially in the long end. Consequently, JGBs are less susceptible, in our view, to a "taper tantrum" due to fears about receding quantitative easing (QE) purchases. The JGB curve is also relatively steep compared to other low yield markets, particularly in Europe, and offers relatively attractive real yields. Although US Treasuries appear increasingly attractive to Japanese investors on a currency-hedged basis, European assets appear relatively unattractive, which might result in some European allocations being redirected back to the domestic market.

**UK: Neutral.** Gilt yields have been range-bound over the last month, reflecting the conflict between near-term downside risks of the renewed national lockdown and the improving medium-term outlook given the rollout of the COVID-19 vaccine. If the vaccine alleviates the severity of the virus outbreak, the market is likely to push yields higher in anticipation of a surge in growth in Q2 and increased potential for the withdrawal of monetary policy support as the economy normalizes. From a strategy point of view, this probably supports selling gilts on rallies toward the low end of the recent yield range. However, we expect a relatively limited upside for yields given only a moderate supply net of QE and the Bank of England's (BoE) determination to maintain stimulus until the recovery is well entrenched. This is particularly relevant in the front end of the yield curve, which should remain well anchored, particularly if the BoE maintains the option of taking interest rates into negative territory in the future.

**Canada: Neutral.** Economic output is expected to remain volatile this year as major city centers have now entered renewed lockdowns due to the ongoing pandemic. Supply chain disruptions continue, leading to some inflationary pressures, but our expectation is that they will be transitory as production returns and inventory levels are rebuilt. Currency strength will likely continue to be a concern for the Bank of Canada, with some speculation that it may cut the overnight rate further. This action would likely continue to support a steeper yield curve. We have moved back to a neutral stance as the year-end technical demand played out as anticipated.

**Australia: Neutral.** Our outlook for Australian interest rate markets remains mixed. The domestic economy is recovering faster than expected and is likely to continue to grow above trend as the COVID-19 vaccine is rolled out in 2021, potentially putting some upward pressure on term premia. However, price pressures remain very subdued; the global economy is still facing an upsurge in COVID-19 cases. The surge in the Australian dollar is adding to deflationary pressures. In addition, technical factors are supportive – the Reserve Bank of Australia's QE is offsetting almost all bond supply in Q1 2021. Regulation will likely boost demand for high-quality Australian dollar fixed income from banks, and Australian government bonds should look relatively attractive to foreign buyers, compared to other international markets of comparable credit quality.

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**Global macro strategy**


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**Currency outlook**

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

**EUR: Neutral.** The outlook for the euro is especially challenging as we look forward to 2021. The divergence in the COVID-19 vaccine response between the US and Europe has the potential to keep the euro area in the economic growth slow lane for months to come while the US powers ahead. While our main expectation is for the US dollar to continue to drift lower, a sharp move lower in the euro and other currencies cannot be ruled out, especially if yields continue to rise in the US.

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

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

**GBP: Neutral.** The tail risk of a "No-Deal Brexit" has been removed. As a result, sterling will likely now be driven by more orthodox concerns, such as relative growth, monetary policy, and portfolio flow dynamics. In the short term, the rapid rollout of the COVID-19 vaccine in the UK, particularly relative to Europe, could lead to some growth outperformance in Q2 in the UK. In addition, equity inflows could be supportive, as the UK market has lagged other markets post-COVID-19 but includes many of the cyclical companies that could potentially outperform in a reopening recovery. Over the longer term, however, we believe the upside for sterling appears more limited. Brexit will likely be an ongoing drag on economic growth, and the BoE's dovish bias will likely limit the scope for interest rate differentials to support the currency.

**CAD: Overweight.** The Canadian dollar continues to be supported by rising commodity prices as Canada's terms of trade improve. Immigration is expected to return this year, adding a positive fundamental driver for the capital account as portfolio inflows remain strong. The external balance will likely continue to improve. Relative valuations, especially against the euro, look particularly compelling, in our view, given Canada's current interest rate advantage and expectation of a quicker economic recovery in the post-vaccine world.

**AUD: Neutral.** Australia's strong terms of trade and buoyant global risk sentiment should continue to support the Australian dollar. However, valuations are no longer as attractive, in our view, and market positioning appears to be already long.

This section highlights the key themes driving Invesco Fixed Income's global credit research process and views. Themes are updated based on evolving trends and expectations.

## Global credit strategy

### Global investment themes

#### Asset class themes

**Investment grade (IG): We recently moved to neutral on United States investment-grade (USIG) credit as tighter credit valuation leaves excess return potential increasingly two-sided.**

#### Rationale

Market technicals remain very firm as we move from the large wave of tender-driven issuance seen in the latter half of 2020 to notably lower supply expectations in the new year. Traditionally, the first two months of the year tend to be seasonally positive for excess returns, and the combination of a positive technical and improving fundamental backdrop is supportive in the near term. The market continues to be supported by healthy demand from global investors and progress on global vaccinations. However, uncertainty remains about (i) fundamental weakness stemming from recent COVID-19-related macroeconomic impacts and (ii) the legislative success of politically sensitive fiscal stimulus efforts.

The economic rebound that persisted through a difficult summer spike in COVID-19 cases has turned over since November, with growing concerns of further economic shutdowns in Europe and rapidly growing global cases counts. In response to the broad-based macro weakness seen in 2020, governments and central banks continue to provide unprecedented levels of monetary and fiscal stimulus that have absorbed the initial impact to risk assets and delayed – and somewhat hidden – fundamental deterioration in corporate operating performance and balance sheets. The Fed's bond purchasing programs announced last March thawed an otherwise frozen US IG new issue market, paving the way for historic levels of issuance since April. While this issuance has alleviated pressure on corporate liquidity and the broader financial system, corporate leverage has risen to cycle highs. While fundamentals have been weaker in recent quarters, the near-term trajectory of corporate earnings is improving, though disparate. Further progress will likely depend on the continued normalization of global economic activity levels as global vaccinations progress.

Offsetting fundamental uncertainty is a highly favorable technical demand backdrop, which remains quite strong. In the second half of 2020, foreign flows into US credit markets were supported by declining hedging costs, while hedged credit yields increased. In addition, while the Fed's targeted bond purchases ceased as of Dec. 31, the program sent a clear message that the Fed is willing and able to support the orderly functioning of corporate bond markets as it pertains to the importance of the credit market in a stable financial system. Since the Fed's bond market activities began, massive capital inflows into the corporate bond market supported spread tightening from levels not seen since the global financial crisis.

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

In Europe, we maintain our neutral near-term outlook for European IG credit. We believe that spreads, which are now back at pre-COVID-19 levels, are likely to remain range bound (with excess return generation driven predominantly by carry). Despite our expectation of a successful vaccine rollout and an eventual macroeconomic recovery, our optimism is tempered by ongoing lockdowns across Europe that are likely to weigh on corporate operational performance in Q4 2020 and Q1 2021. Fortunately, the ratings agencies appear to be adopting a relatively lenient approach, focusing on the medium-term outlook, which has allowed the pace of rating migration to slow. Issuance levels in 2021 are likely to moderate versus 2020 and ECB buying through the Corporate Sector Purchase Program (CSPP) remaining a supportive technical. The Pandemic Emergency Purchase Program's (PEPP) presence in the background in case of any meaningful market weakness should also serve to dampen volatility.

Although we maintain a neutral stance on European IG credit overall, we still see several attractive areas within the asset class. We believe that subordinated parts of the IG capital structure in both financials and corporates can continue to compress in the global, negative real yield environment. We also believe that the financial, insurance, consumer cyclical, and transportation sectors offer pockets of value if the macroeconomic recovery plays out as we expect.

#### IFI strategy

We are neutrally positioned across Asian IG, European IG, and US IG credit markets. We remain highly selective and opportunistic in global credit, as spreads have recently tightened following positive vaccine developments. Corporate fundamentals, while currently stressed following an unprecedented economic collapse in early 2020, continue normalizing, a trend that we anticipate should benefit corporate credit over the coming quarters. Further, global central bank policies remain supportive to counter further challenging scenarios for corporate fundamentals, and we expect a favorable near-term market technical to benefit global IG credit as well.

Credit valuations, particularly when adjusted for a near all-time high duration in the US, have tightened significantly following fiscal and monetary policy support measures, providing a notable headwind when evaluating risk-adjusted valuation. While valuation is certainly a near-term concern, we believe the



combination of a favorable market technical dynamic and improving corporate fundamentals could remain supportive near-term market drivers. In Europe, dispersion within the asset class remains key, and we would expect the next stage of any potential rally to be driven by further beta compression across certain parts of the capital structure, supporting our preference for subordinated financial paper issued by fundamentally strong “core” European banks and selected corporate hybrid issuers.

**High yield (HY): Fundamental improvement balances tight valuations as we enter 2021.**

**Rationale:** The supportive risk sentiment from Q4 has carried into January. While the unfortunate realities of COVID-19 remain in the headlines, the market focus has turned toward recovery in a post-vaccine world. In the interim, both Fed policies and capital markets have provided a much-needed liquidity bridge. More recently, refinancing activity has been very strong for what were severely stressed components of the index last year, CCC-rated and energy sector issuers. The ability to extend debt maturities and build liquidity buffers is a leading indicator for a more benign default forecast for the year. While earnings recovery will likely remain uneven and sector-driven, we expect overall trends to improve substantially over the course of this year.

**IFI strategy:** Given the strong technical for the asset class, valuations continue to drift toward historical tightness. While we recognize that valuations may get even tighter due to the improvement in fundamentals, the opportunity cost of lowering our beta is much lower today. As a result, we continue to move back towards a neutral risk position into market strength. We like the rotation into higher quality situations, especially rising stars and up in capital structure trades in select names. From a sector standpoint, the economic tailwinds and yield curve trends keep us constructive on energy, materials, and financials.

**US residential mortgage-backed securities (US RMBS): Robust housing recovery and strong RMBS technicals support valuations.**

**Rationale**

Housing market trends remain very supportive of residential credit investments. The rate of home price appreciation continues to accelerate as supply remains very tight, despite a rapid recovery in single-family housing starts. While the improvement in forbearance rates has slowed in recent months, we expect ultimate defaults and loss severities to remain contained, given substantial borrower equity. Investor demand for RMBS remains firm, while high prepayment rates and issuer refinance activity have outpaced securitization of recent originations, driving negative net supply in the sector. We expect issuance to increase in 2021 as low mortgage rates drive non-agency origination activity and sponsors take advantage of attractive long-term funding costs, but we anticipate that demand will continue to exceed supply.

**IFI strategy**

Credit spreads have largely recovered from the widening that occurred at the onset of the pandemic. While scope for further spread tightening appears limited, in our view, we believe available carry is attractive relative to comparable credits in other fixed income sectors. In our view, any incremental tightening will most likely materialize in lower-rated classes of non-qualified mortgage and single-family rental securitizations, as strong demand potentially drives further credit curve compression. Prime jumbo mortgage spread premium over similar coupon agency mortgage-backed securities (MBS) remains on the low end of the historical range. We are cautious on unrated government-sponsored entity credit risk transfer (GSE CRT) securities, given sensitivity to modest fundamental deterioration and limited spread compensation.

**US asset-backed securities (US ABS): Consumer collateral performance has been resilient; positive technical trends continue to support the market.**

**Rationale**

Consumer collateral continues to perform better than expected, especially given the current level of unemployment. A second stimulus package at year-end and the likelihood of additional stimulus and other program extensions should continue to support the consumer over the near term. Upward revisions to economic growth forecasts should also be positive for selected commercial – and esoteric – ABS performance. Strong investor demand, below average new issue supply, and historically low dealer inventories continue to drive spreads tighter with several benchmark ABS at multi-year tightness and many other ABS now inside of pre-pandemic levels. We believe there are still opportunities to outperform in some non-benchmark ABS and selected esoteric assets where fundamental improvements are expected to continue.

**IFI strategy**

We are focused on higher-rated bonds within the capital structure across benchmark and non-benchmark assets and top-tier names in certain esoteric US ABS sectors. We are also selective as tiering among sponsors and sectors has compressed. We expect positive technical momentum across certain non-benchmark and higher yielding esoteric US ABS to continue, as current spread differentials versus corporates are still attractive, in our view.

**Sector themes**

**The US consumer: spending patterns adjust to the new normal.**

**Rationale**

Consumer spending on services (about two-thirds of total spending) transitioned from a tailwind to economic growth to a headwind, when social distancing became the predominant method to slow the



spread of COVID-19. The use of masks and technology has enabled some service categories to recover, but recovery has regressed over the winter as most activities must occur inside. With vaccine distribution underway, the recovery in service spending this spring should prove to be more durable, providing more incentive for companies to fight through temporary financial hardship. Spending on durable goods spiked over the summer as consumers acquired vehicles, computers, and furniture to allow them to adjust to the new realities of a COVID-19 world, including work from home, school from home, and avoiding public transportation. This bonus of durable spending has offset much of the weakness in services, but we expect this anomaly to recede, although we still expect goods sales to outperform while services remain weak. This mixture should slowly reverse during this spring, returning to the pre-pandemic mix by this fall.

**IFI strategy**

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

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

#### Contributor

**Christopher Maurice**  
Credit Analyst

## Global credit strategy

### The rise of the conscious consumer

Invesco Fixed Income believes the analysis of ESG-related factors in the credit research process helps identify emerging themes that can decide tomorrow's fundamental winners and losers. As such, we believe asset managers that view ESG analysis as a source of alpha stand to benefit. Currently, the rise of a more conscious consumer is merging ESG and fundamental analysis more than ever in our evaluation of consumer-oriented companies.

#### The emergence of the "conscious consumer"

The "conscious consumer" is an umbrella term that refers to a consumer who engages in the economy with an awareness of how his or her consumption impacts society at large. The conscious consumer is not only making economic decisions in the checkout line but is willing to pay higher prices in exchange for more ethical business practices.

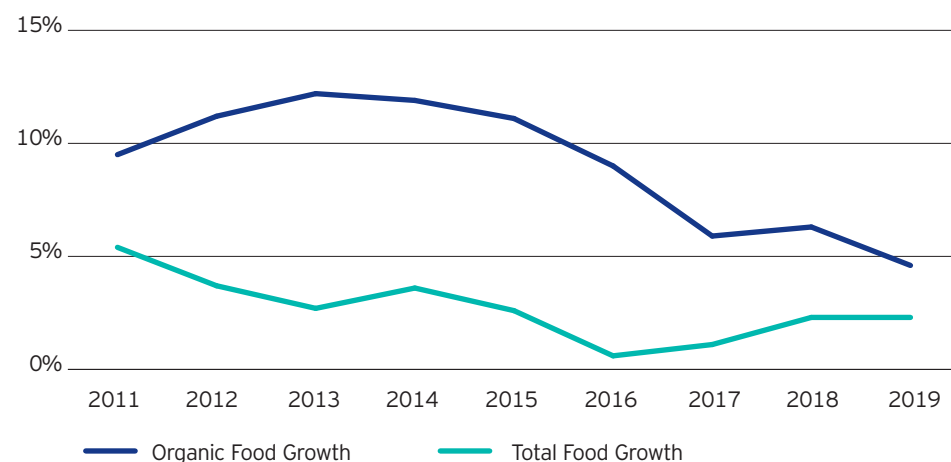
At Invesco Fixed Income, we see several megatrends that are likely to support a shift in consumer behavior toward such ESG considerations over the longer term:

- + **Increased environmental awareness:** Globally, people are growing more concerned about the environment. In the UK, concern for the environment is at its highest level on record.<sup>1</sup> In the US, the percentage of Americans who say global warming is important to them is at an all-time high of 72%.<sup>2</sup>
- + **Access to consumer education:** There are more research tools at consumers' disposal than ever before, and more consumers demand transparency and authenticity in the products they purchase. Recent surveys have found that transparency is important, or extremely important, to 81% of shoppers.<sup>3</sup>
- + **The power of collective action:** The rise of social media has allowed consumers to label companies they view as bad actors, with almost immediate impact.

#### The conscious consumer in the marketplace

We have already seen examples in which the conscious consumer has driven consumer sector performance. Consider the organic food market, which has more than doubled in size in the US since 2010, delivering a compound annual growth rate (CAGR) of 8.1% , compared to a 2.42% CAGR for the overall food market.<sup>4</sup> The organic consumer was galvanized by the prospect of buying a pesticide-free product with better nutritional value. Plus, there was the added benefit of shunning industrial farming, a practice that many consumers consider unethical.

#### US organic food vs total food growth



Source: Organic Trade Association, data from Jan. 1, 2011, to Dec. 31, 2019.

The conscious consumer's increased demand for organic products demonstrates a trend we have seen play out across many consumer subsectors. In beverages, a similar theme has emerged as health-conscious consumers have reduced their demand for sugary drinks. In the so-called "fast-moving consumer goods" (FMCG) sector, sustainably marketed products made up 54.7% of market growth in the US from 2015-2019, despite having only a 16.1% market share.<sup>5</sup>

Going forward, we believe companies that understand and resonate with the conscious consumer stand to benefit, and this understanding is likely to separate the fundamental winners and losers.

#### Monitoring companies that benefit from the conscious consumer

We believe companies that can generate a higher level of trust with consumers through sustainable

business practices will be fundamental outperformers in the long term. These companies will probably also exhibit lower regulatory risks, as the rise of the conscious consumer has also led to more aggressive regulation of certain business practices globally.

While measuring company authenticity and consumer trust is a difficult endeavor, we believe monitoring key ESG risk factors can put us on the right track:

#### Environmental

- + **Packaging material and waste:** With more than 40% of the world's plastic packaging waste mismanaged<sup>6</sup> (meaning that disposal is not formally managed in a dump or recycling center), consumers and regulators globally are lining up against plastic packaging. We believe it is important for companies to tackle this risk head-on. Companies that are aggressive about managing plastics packaging risks are likely to see better demand for their products over the long term and are less likely to come under scrutiny from non-governmental organizations (NGOs) or risk regulatory fines. We look for companies that outline a sustainable packaging policy and disclose their plastics packaging volume.
- + **Raw material sourcing:** Many companies in the consumer sector rely on commodities that can have adverse impacts on their local environments. A failure to commit to sustainable raw material sourcing can result in negative brand sentiment on social media or increased scrutiny from environmental groups or NGOs. We look for companies that disclose the percentage of raw materials drawn from sustainable sources and are signed up to the Membership of the Roundtable on Sustainable Palm Oil (RSPO).

#### Social

- + **Opportunities in health and nutrition:** With global consumers increasingly conscious of the health implications of the products they consume, we believe companies that offer healthier products stand to benefit. In order to track this, we take a holistic look at a company's research and development program and the scope of reformulation programs of companies that are slanted toward unhealthy products.

#### Governance

- + **Business ethics:** The conscious consumer cares deeply about business ethics. To monitor this, we seek to understand a company's value system and how it drives its actions as an organization. We look for whistleblower hotline programs and usage, as well as dedicated ESG teams and consistent monitoring and disclosure of ESG risk factors and progress on ESG goals.

#### Conclusion

We believe the rise of the conscious consumer will lead to the fundamental outperformance of consumer sector companies that embody better ESG characteristics. This trend has already played out in various consumer subsectors, such as the organic food subcategory, and stands to repeat itself as regulators and consumers place increased importance on sustainable business practices globally.

At Invesco, we believe ESG research is an integral part of the bottom-up, fundamental research process. With ESG and fundamentals becoming more intertwined every day, asset managers who view ESG as a source of investment performance stand to benefit, in our view. Those who view ESG as merely a formality in the investment process and only "check the box" might be left behind.

1. Source: YouGov Survey Most Important Issues Facing Country, June 2019.

2. Source: Anthony Leiserowitz, Director of Yale's Program on Climate Change Communication, Jan 2019.

3. Source: FMI and Label Insight, June 2020.

4. Source: Organic Trade Association, June 2020. CAGR is growth rate of sales in US dollars.

5. Source: Stern Center for Sustainable Business, July 2020.

6. Source SYSTEMIQ, July 2020.

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**The bottom line**

## Life beyond zero: Opportunities in the European money market

With negative interest rates deeply entrenched in the eurozone, there has been much discussion about how to achieve a zero yield. We talk with three members of the Invesco Global Liquidity team about not only getting to zero, but how to potentially go beyond zero in the short-term European fixed income market.

### **Q: How were money market funds affected by the COVID-19 crisis?**

**Natalie:** Money market fund assets experienced a sharp drop after the crisis, although, in the US, this dynamic was mainly a flow out of prime funds and into government funds, so not a drop in US money market funds overall. In Europe, banks found it very costly to maintain client deposits at zero or slightly negative interest rates. As depositors looked elsewhere to invest cash, many money market funds were the beneficiaries. As such, money market flows have recovered strongly since the March/April decline, especially in Europe.<sup>1</sup>

### **Q: What does the European money market landscape look like?**

**Paul:** The European money market is composed of “standard” and “short-term” money market funds. Standard funds can take on more risk, which makes them potentially attractive in Europe, given the prevailing negative interest rate environment. Standard money market funds are not regulated, while short-term money market funds are. Ratings agencies also place further limits on short-term funds beyond government regulations for their high-quality ratings.

Average standard money market funds tend to use the ability afforded to them under current regulations to take greater spread and duration risk than short-term funds. Standard money market funds also typically buy lower-rated issuers than short-term money market funds and may invest in longer-term securities.

But here, we point out how we think about the difference in risk between the two types of funds: We base our investment decisions on the potential for the “return of principal,” not the “return on principal.” We think this concept is paramount when thinking about the risk differentials between the different types of money market funds and cash management alternatives. In other words, while standard money market funds also have the aim of capital preservation and liquidity, they might generate more volatility if market conditions worsen, compared to a short-term money market fund.

Europe’s other cash management alternatives comprise “ultrashort” or “cash-plus” funds that are less regulated than money market funds and often take on more risk than money market funds. Given these additional risks and our focus on “return of principal,” we believe it is important to do one’s homework when it comes to these funds’ investment strategies and not to mistake them for money market funds.

### **Q: Where are money market yields currently, and where are they going?**

**Paul:** Money market yield curves are very flat in Europe, making it difficult for money market funds to generate yield. Recently, there has been an uptick in market expectations for US policy rates, given the recent outcome of the US election (a Democrat-controlled government), improving macro data, and the ramping up of the COVID-19 vaccine rollout. So, it is not surprising that futures markets are starting to price in Fed rate hikes in the second half of 2023. Things are very different in Europe, where no one expects rate increases for a long time, inflation is stubborn, the vaccine is rolling out slowly, and the macro outlook is subdued. Globally, we expect to stay in this low yield environment for at least 18-24 months, with perhaps hope on the horizon that we will get higher yields in the US in the middle of 2023.

### **Q: Can investors go beyond zero in European money market funds and achieve positive yields?**

**Paul:** This is a simplification, but to achieve a positive yield at the moment in the European money market fund universe, we would need to consider a five-year maturity and the lower-rated end of investment-grade securities. Alternatively, we could tap the high yield market and avoid having to take on as much duration.

### **Q: Are there other ways to generate positive yield?**

**Luke:** Yes, achieving a yield above zero in euros is still possible. However, choosing longer maturities and taking considerably higher duration risk might not be appealing to some investors – so we step back and look at the broader market. We believe opportunities exist outside of the money market fund universe – particularly if you can go down the capital structure. By doing this, we find we are able to potentially pick up attractive yield versus Euribor in the European investment grade market.

In the European investment grade market, we would expect certain sectors to offer more spread versus others due to the differential impacts of COVID-19 on different sectors (think of the severe impact of COVID-19 on retail and travel versus its more limited impact on manufacturing). Surprisingly this is not the case. Aggressive monetary policy and optimism over the vaccine have effectively dampened sector spread dispersion.

Our strategy to deal with this dynamic is to look a little deeper and consider things like subordinated corporate debt. We also consider subordinated financials, for example, Tier 2 financials versus senior financials. The spread dispersion here is still quite substantial. And moving further out to additional Tier 1 bonds offers further pick-up in the spread versus senior financials.

So, there are opportunities in investment grade, but we must look away from simple sector dispersions and instead consider dispersion within sub-sectors. While money market funds cannot invest in these securities, ultrashort and cash-plus funds can, so they may be an interesting option for some investors. There are trade-offs, of course, in terms of credit quality and liquidity, but we believe Invesco Fixed Income's deep and broad research capability allows us to understand these nuances. These strategies may also add diversification while allowing investors to reach beyond zero.

**Q: What are the main considerations when choosing between different types of cash management strategies?**

**Luke:** When jumping from money market funds to shorter-duration strategies, we believe a key consideration must be liquidity. Shorter-duration funds will tend to face greater volatility in returns and lower liquidity versus money market funds. But they still invest in high-quality securities and focus on risk-adjusted returns with a similar risk profile to money market funds.

**Paul:** The type of investor and the uses of cash also help determine whether a money market fund or ultrashort strategy is appropriate. For example, can the investor take mark-to-market risk? If the cash is needed for operational purposes, for example, to pay dividends or salaries, it may not be suitable for strategies outside of money market funds.

## Invesco Fixed Income

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