Global Fixed Income Strategy

Monthly report

Invesco Fixed Income

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IN THIS ISSUE:

1. **Macro: US macro outlook: Rate cuts and resilience in 2024**
   Page 01
2. **Interest rate outlook**
   Page 04
3. **Currency outlook**
   Page 06
4. **Credit: Global credit outlook: Positive dynamics support opportunities in 2024**
   Page 07
5. **The bottom line: Falling global inflation and rates favor EM local debt**
   Page 09

US macro outlook: Rate cuts and resilience in 2024

Each month, Invesco Fixed Income's Investment Strategy Team holds discussions to assess and debate its economic and market outlooks. The team reviews global developments and market drivers to determine prospects for global rates, currencies, economies and the performance of fixed income asset classes. This month, we share a summary of IFI Chief US Economist Turgut Kisinbay's outlook for the US economy and Senior Portfolio Manager James Ong's view on the rates market.

Our views summarized:

- A US soft landing is now the baseline outlook of the market and the Federal Reserve (Fed).
- The most aggressive monetary tightening of recent decades is over. 2024 is the year of rate cuts in the US and globally.
- The key adjustment to our growth projections is more resilience. We previously expected a modest slowdown in US growth, but the US economy is not slowing significantly. We expect GDP growth to be below potential in the first half of 2024, but barely.
- The labor market is cooling off – this part of the previous slowdown story remains intact.
- Financial conditions are easing, easing recession fears. Financial conditions will likely soften further as the odds of a soft landing increase. That will likely limit the number of Fed rate cuts, as the market will likely do the job for it.
- We expect the Fed to start cutting rates in May and cut three to four times in 2024.
- Markets have priced in a more aggressive Fed rate cut stance than implied by our baseline view. We are therefore neutral on US rates and would seek to increase exposure if markets align with our more patient Fed policy outlook.

2024 outlook: We have revised up our projections for US growth

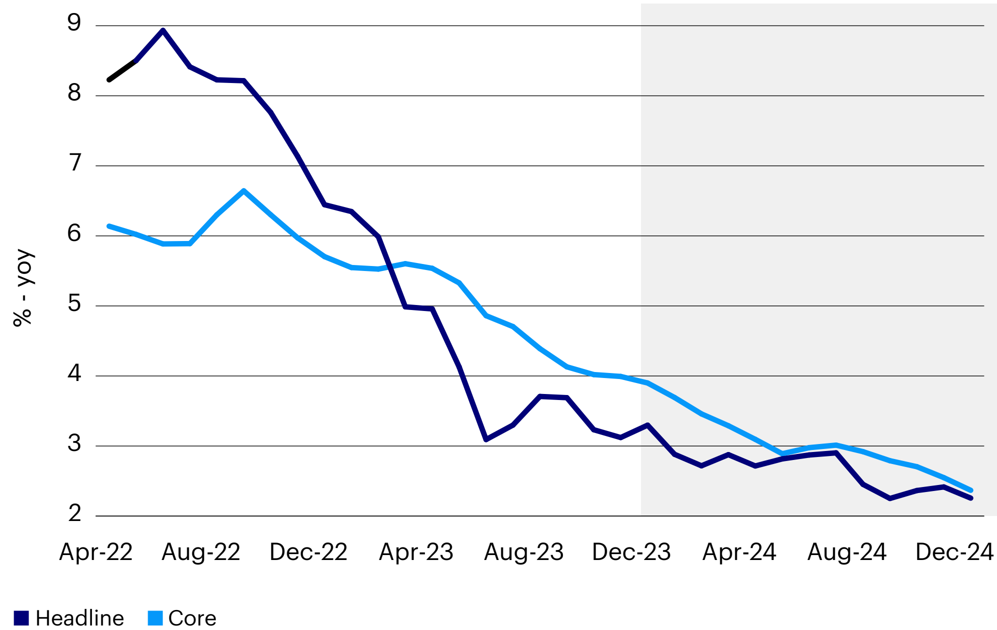
The US economy has proven to be resilient and does not seem to be slowing as much as we expected late last year. We expected a slowdown to around 1% growth over a few quarters, but Q4 growth was strong, and some of the factors that led to our softer outlook have changed. We expect average GDP growth to measure 2.4% in 2024 versus a market consensus of 1.3%.[1]

Inflation remains in line with our previous forecasts

Inflation has continued to decline, thanks to improvements in supply chains, labor markets and some moderation in goods demand. We expect core CPI inflation to end 2024 at 2.4%, compared to a market consensus of 2.6%.[2]

1. Source: Consensus figures from Bloomberg L.P. as of Jan. 25, 2024.
2. Source: Consensus figures from Bloomberg L.P. as of Jan. 25, 2024.

Figure 1: US CPI inflation projections



Source: US Bureau of Labor Statistics, Invesco. Data from April 1, 2022 to Dec. 31, 2024. CPI is consumer price inflation.

The Fed could start cutting in May

Given the resilience of the US economy, and a softening, but still tight, labor market, we believe the Fed will be cautious. It will likely continue to gather evidence on disinflation to raise confidence that inflation is on a sustainable path toward its price stability target. March looks early for the Fed to start its cutting cycle, in our view, but cuts could begin in May. Having said that, this is a close call, and data will likely dictate the timing.

Reasons for our upward growth revisions

Tightening financial conditions were a key factor behind our initial slowdown thesis late last year. However, improved inflation data and the Fed's dovish pivot in December have significantly eased financial conditions, prompting our reassessment of US growth prospects.

We expect even more easing of financial conditions in 2024. Potential Fed tightening was a sword of Damocles hanging over markets and the economy in 2023. With that fear behind us, we are contemplating rate cuts. Inflation has come down without an increase in unemployment and recession risks have declined. Peak rates and lower recession odds should lift animal spirits, and lead to more favorable lending and borrowing conditions.

Housing is a good example of the impact of looser financial conditions. High mortgage rates had dampened confidence in the housing sector, however, the decline in rates to below 7% has triggered a swift recovery, exceeding the expected timeline for a bounce-back in housing demand. Single-family starts, the best barometer of the housing market, continue to rise. We expect housing to contribute positively to growth in 2024.

Other interest rate sensitive sectors should also benefit from peak rates and declining risk premia in 2024. In addition, we expect other headwinds to fizzle out. Previous concerns, such as the resumption of student loan payments and a potential government shutdown, no longer appear to be significant risks.

What is left of the slow-down hypothesis?

While financial conditions are loosening, one can argue that they are still in mildly restrictive territory. Short-term interest rates, mortgage and other consumer rates are still on the high side. Bank lending conditions are tight. These conditions should improve, but it could take time.

A key area to watch is job growth, which is slowing. Sectors that failed to hire sufficiently during the rapid recovery phase, such as healthcare, are now catching up. But many sectors are closer to their employment targets and are hiring less. The decline in new jobs means less income growth. Lower inflation provides a buffer for purchasing power, but, on net, we expect to see slower real income growth in 2024.

The Fed

The US economy is already growing around its potential, if not above, financial conditions are finally easing, and the unemployment rate is near historical lows. Firms are still hiring and clearly not firing. We believe this is an environment in which the Fed needs to be patient. We argue against extrapolating too much from favorable inflation developments over the last six months.

We believe starting the cutting cycle in May is a good option for the Fed. This would allow it to proceed with greater confidence, mitigating the risk of “sticky” inflation. The 2024 election should not affect the Fed’s big picture decisions, but it might affect the timing of policy somewhat. We believe it would be better to start the easing cycle further ahead of the election, which would allow time to deliver some of the easing moves the Fed has planned. We believe three cuts - in May, June and July - would be appropriate.

Rates market outlook

In the short term, the US rates market has factored in a more aggressive Fed policy stance than is warranted by our economic base case of slow, positive growth. Market pricing is appropriate, in our view, since, in the event of an adverse economic outcome, the Fed could be compelled to implement more aggressive rate cuts than in a more favorable scenario, in which current interest rates would suffice.

Consequently, in the near term, our stance on US interest rates is neutral, with a preference for global yield curves that offer higher carry. Looking ahead, the long-term prospects for the fixed income market appear significantly brighter than they have in recent years. In line with this perspective, we are poised to increase our exposure to US interest rates at pricing levels that more closely reflect our base case expectations of Fed policy decisions, which include a patient start to the cutting cycle, as the Fed assesses progress on inflation.

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Interest rate outlook

US: Neutral. In the short term, the US rates market has factored in a more aggressive Fed policy stance than is warranted by our economic base case of slow, positive growth. Market pricing is appropriate, since in the event of an adverse economic outcome, the Fed could be compelled to implement more aggressive rate cuts than in a more favorable scenario, in which current interest rates would suffice. Consequently, in the near term, our stance on US interest rates is neutral, with a preference for global yield curves that offer higher carry. Looking ahead, the long-term prospects for the fixed income market appear significantly brighter than they have in recent years. In line with this perspective, we are poised to increase our exposure to US interest rates at pricing levels that more closely reflect our base case expectations of Fed policy decisions, which include a patient start to the cutting cycle, as the Fed assesses progress on inflation.

Europe: Overweight. While we remain positive on European duration over the medium term, we are cautiously positioned following the sharp rally in rates toward the end of last year. Over the coming year, we expect the European Central Bank (ECB) to reduce rates significantly as inflation falls toward their 2% target and the region's economy continues to struggle from tighter financial conditions and a weaker global growth environment. The ECB has maintained hawkish rhetoric but it will likely be tested from the second quarter onward, as inflation starts to move lower again.

China: Neutral. On January 24, China's central bank announced a 50 basis point cut in the reserve requirement ratio (RRR) for banks, which is set to release liquidity of RMB1 trillion. The bank also cut the relending rate on loans to small and medium-sized enterprises and the agricultural sector by 25 basis points. Central bank officials stated that they will use interest rates to promote consumption and investment, and to lower financing costs in the real economy. The 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 from international investors into onshore bonds 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, we maintain our neutral stance.

Japan: Underweight. The 10-year Japanese government bond (JGB) yield has fallen 30 basis points since its peak of 0.97% in early November, closely following the rally in global bonds.[3] There is little further downside for 10-year JGB yields from current levels, in our view. Although headline inflation has now peaked on a year-over-year basis, due to base effects from lower food and energy prices, underlying price pressures are still running between 2% and 3%, leaving the real yield on 10-year JGBs at historically low levels, and comfortably the lowest among major bond markets. The Bank of Japan's (BoJ) January statement suggests growing confidence among policymakers that inflation will sustainably reach its 2% target, justifying an end to negative interest rates and quantitative easing (QE) purchases later this year. Indeed, the BoJ has already reduced its QE purchases as yields have declined. Slowing BoJ demand has resulted in a large increase in bond supply to the private sector, which is showing increased price sensitivity amid uncertainty about when the BoJ might hike interest rates. This has been reflected in weak JGB auctions and large covers for BoJ purchase operations.

UK: Overweight. The 10-year UK gilt yield has jumped 50 basis points this year, almost completely reversing its decline in December.[4] Higher global yields, heavy supply and stickier than expected core inflation have all contributed to the selloff. However, yields are now approaching relatively attractive levels, in our view. The macro environment remains consistent with faster disinflation than the Bank of England (BoE) anticipated in November. Wage data have moderated faster than expected and the stickiness of core inflation can largely be attributed to volatile items. The market pricing of rate cuts remains a bit too front loaded, in our view, given that the BoE is likely to want to see more evidence that minimum wage hikes in April do not boost overall wages, and that new labor market data are consistent with policymaker expectations of a build-up of slack. Nevertheless, the BoE will likely start cutting in the middle of the year, and a later start might be compensated by a more rapid series of cuts once policy makers decide to ease. As a result, a terminal rate around 3.5%, looks relatively high relative to an inflation trajectory that is likely to converge toward

3. Source: Bloomberg L.P. Data from Nov. 1, 2024 to Jan. 23, 2024.
4. Source: Bloomberg L.P. Data from Jan. 1, 2024 to Jan. 23, 2024.

2%. An upside risk to yields comes from the potential for further fiscal stimulus to be announced at the March 6 Budget. However, fiscal stimulus is unlikely to dramatically change the macro outlook and will probably require offsetting austerity after the general election, which will probably occur in October or November.

Australia: Overweight. Recent data have reinforced the likelihood that the Reserve Bank of Australia's (RBA) next move will be to cut rates. Employment growth was weak in December, business and consumer confidence remain lacklustre and November's monthly inflation data have moderated in line with RBA expectations. Unlike the US dollar or euro curves, the Australian dollar forwards do not price in a substantial rate cutting cycle. Furthermore, the Australian curve prices a retracement higher in rates, with long forwards, such as five-year, five-year forwards, trading at over 4.8% and 10-year bond yields only slightly below the RBA's official cash rate. Although, this can be partly justified by the relatively low level of ex-ante real rates in Australia compared to the US, we believe a likely faster moderation of inflation than the RBA's November forecasts creates some potential downside for yields on an absolute and cross market basis.

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Currency outlook

USD: Neutral. We are broadly neutral on the US dollar in the short term, given the current market pricing of US interest rates. With around 150 basis points of rate cuts priced into the yield curve, there could be some disappointment in the rates markets if the US economy continues to perform well.[5] In that scenario the US dollar could be well supported. Our medium-term expectation, however, 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 on the euro over the medium term, based on our expectations 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. If the announced RMB2 trillion stabilization fund is put to work, the impact on capital flows would 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, though we look for the pair to dip lower before it rises slightly due to seasonality.

JPY: Neutral. The yen has been the weakest major currency this year, depreciating by 5% against the US dollar and 3% against the euro.[6] Higher global bond yields due to resilient economic data and buoyant risk sentiment have widened the interest rate differential with Japan, leading to a weaker yen. However, we believe the current level of the yen is cheap compared to interest rate differentials, with the currency close to its lows, despite the narrowing of the yield gap since November.
Flow dynamics might account for this discrepancy. Commodity trading advisors are re-entering yen shorts that were stopped out in December and Japanese investors are increasing their allocations to international assets via the expanded Nippon Individual Savings Account tax-free investment account program. Looking forward, the prospect of Fed and ECB cuts, combined with possible BoJ hikes, should support the yen, but signs of weaker data leading to a front-loading of cuts relative to pricing is probably necessary to drive a substantial yen appreciation. Yen longs are attractive against the Swiss franc, in our view, as they are less negative carry compared to US dollar-yen and euro-yen shorts, and also benefit from the Swiss National Bank's reluctance to accommodate Swiss franc strength, which contrasts with the Japanese authorities' discomfort with further rapid yen weakening.

GBP: Neutral. Disinflation has been moderately supportive of the British pound. It has raised growth expectations, due to the improved real income outlook, while the BoE has positioned itself behind the Fed and the ECB in the cutting cycle, allowing the pound to benefit from its relatively high yield. However, the pound remains vulnerable to any weakening in growth and risk sentiment that could lead to a faster decline in interest rates in the future.

AUD: Neutral. The Australian dollar looks cheap compared to the US dollar and euro, given current interest rates and the level of commodity prices. However, negative sentiment around China's growth prospects and the risk that rate cuts beyond current Fed and ECB expectations would require a meaningful downside growth surprise, which would likely be negative for the Australian dollar, are acting as a headwind to valuations. We believe the Australian dollar will benefit from what currently looks like an unlikely combination of better growth sentiment outside the US, particularly in China, and a rapid series of Fed rate cuts.

5. Source: Bloomberg L.P. Data as of Jan. 24, 2024.

6. Source: Bloomberg L.P. Data from Jan. 1, 2024 to Jan. 24, 2024.

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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: Positive dynamics support opportunities in 2024

Each month Invesco Fixed Income's Investment Strategy Team discusses and debates its views on global credit trends. The team evaluates key fundamental, technical and market drivers likely to impact the performance of a broad range of credit asset classes. This month we share the IFI credit team's outlook for the global credit sectors listed below, with an introduction by our Head of Global Credit Research, David Todd.

Introduction

The spectre of inflation did not result in the global economy tumbling into recession last year and the robustness of the consumer shone through. As we started the fourth quarter, the environment became increasingly difficult for market participants, as asset owners were reluctant to put money to work due to fears about the stability of US Treasury yields. The tension finally dissipated and the magnitude of the rally, once the "pivot" proponents got the upper hand, has meant that a lot of the prevailing opportunity has gone. One of the main takeaways from our recent investment strategy meetings is that corporates broadly look somewhat rich compared to other asset classes right now.

Focusing on credit quality is always important and, hopefully this year, less government bond volatility will allow the market themes and drivers we identify more room to breathe. Of course, with some key elections on the horizon, there is a risk that further uncertainty could cause volatility again. However, we thought that yields a year ago gave us a relatively attractive entry point, so one year on, we believe there may be another 50 basis points of cushion across the credit yield curve. Below is a summary of our views on key global credit sectors.

US investment grade

US investment grade corporates are at historically rich spread levels, but they still offer attractive yields, in our view. We are focused on sector selection and financials, in particular, continue to screen cheap versus other corporate sectors. We are also focused on yield curve positioning and believe that shorter-dated bonds offer value.

Investment grade fundamentals are strong but moderating - interest coverage has broadly eroded, and margins are weaker due to higher input costs. We expect this trend to continue. We think market technicals are very positive with supply forecasts manageable.

European investment grade

Even after a strong year-end rally, we believe spread levels adequately compensate investors for what we expect to remain negligible default risk and modest rating migration risk in the year ahead. Single-name risk persists, but credit selection can help mitigate this. We expect net supply to remain at relatively low levels and the "new normal" yield levels should drive asset class inflows. We favor overweights in the utility and financial sectors and increasingly favor selective subordinated opportunities, such as AT1s and corporate hybrids. Our base case envisions the European investment grade corporate index as not much tighter at the end of 2024 than it was at the end of 2023.

US high yield

US high yield starts the year on solid fundamental footing, but we expect the effects of higher interest rates to weigh on the consumer and corporate borrowers as the year progresses. Though economic slowdown will likely push default rates higher, we expect them to remain at manageable levels. The year-end 2023 bond market rally pushed spreads considerably tighter, leaving our views on valuation at fair-to-rich for most sectors. The handful of sectors that rank cheap do so because of their high distressed composition. Returns for the year will likely be driven by carry more than spread compression, potentially resulting in modest excess returns. Full valuations and concerns over a slowing economy leave our sector ratings leaning toward neutral to underweight, reflecting the weight of cyclicals on the high yield investment universe. Despite this skew, we continue to focus on finding value across sectors through bottom-up credit selection.

Emerging market credit

The broad emerging market (EM) sovereign-corporate risk rally at the end of 2023 lost steam in the new year, bringing valuations closer to fair territory, in our view. We are currently neutral on EM credit but expect to turn more optimistic, awaiting improved valuations. We still expect total returns for both the sovereign and corporate EM indices to be driven by carry and US Treasury performance, as spreads remain on the expensive side, in our view. Our outlook faces significant downside risk if US inflation increases again. But we still believe that all-in EM yields remain attractive for investors with strategic investment horizons and believe that certain higher yielding names continue to offer compelling value, with either upcoming catalysts or deep discounts stemming from the EM sovereign technical environment.

EM fundamentals have proven to be resilient. Questions around China remain central to the broader EM outlook, as a US soft landing becomes a higher conviction base case with associated rate cuts priced in for 2024. Rate cutting cycles in major EM's continue apace.

We believe EM valuations are fair. Relative to developed markets, every EM rating bucket looks close to historically fair levels, in our view, apart from BBBs, which appear cheap but are skewed by a few issuers. Index-level yields are still historically compelling, in our view, even with distressed names stripped out of the index. The high yield-investment grade compression trade played out well after the rate sell-off in 2022 through the end of 2023, which resulted in significant spread compression. But the next move tighter, toward pre-COVID levels, will likely be more difficult and require more policy reforms among remaining high yield names. We believe some true alpha stories exist in the single B and CCC buckets, with catalysts related to resolving debt restructurings or signing IMF programs.

In terms of market technicals, we expect 2024 net issuance to be in line with 2023, while flows into the asset class remain challenging. According to Bank of America Merrill Lynch, a 1% of EM AUM inflow this year would be enough to absorb the net issuance on tap, which is largely from the investment grade space.[7] We like this technical backdrop, though it might take time to materialize and could depend on stability in the broader macro environment.

Asia credit

We expect Asian corporate fundamentals to improve overall in 2024, supported by decent economic growth prospects, ample access to local funding and a normalized default trend. In terms of risk, sustained pressure on financing costs from elevated yields could lead to an erosion in corporate earnings, especially if growth prospects weaken. The Chinese property sector will likely continue to be a drag on corporate credit performance, and we expect credit risks in the Hong Kong property sector to rise. Nevertheless, we expect the default rate to normalize after a few years of being elevated and expect less of a market impact from any further property defaults.

Credit fundamentals outside of the China/Hong Kong space appear robust, having benefited from an improved operating environment and good access to local funding. Relatively high commodity prices have been beneficial. Local industrial policies have been mostly supportive and we expect to see fewer credit events this year. Due to the accommodative domestic funding environment, refinancing risk, aside from some single-B or idiosyncratic cases, appears manageable, despite high US dollar funding costs. In terms of valuation, we believe spreads are tight, but all-in yields remain attractive, in our view. Market technicals will likely continue to be supported by the scarcity of corporate US dollar bond supply in Asia, which will likely persist in 2024. Asian corporate issuers have alternative access to bank loans and local currency bond markets that can be tapped if US dollar bonds are deemed too expensive. This supply shortage, although less pronounced than last year, exists despite resilient demand. Notably, we have observed that Asian corporate bonds with a proportionately larger Asian investor base have tended to exhibit greater resilience, so this could prove to be a positive market dynamic.

7. Source: Bank of America Merrill Lynch. Data as of Jan. 4, 2024.

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The bottom line: Falling inflation and global rates favor EM local debt

What is your outlook for EM local debt performance in 2024? How do you currently see fundamentals, valuations and market technicals?

We are constructive on EM local debt performance in 2024. We think monetary policy volatility will be lower this year, as the Fed's December pivot has lessened the probability of an outsized policy response in either direction. EM central banks will likely continue to follow orthodox policies, taking advantage of the easing path pursued by the Fed to allow them to adjust their policy rates downward as well. Fundamentally, we believe that relative growth differentials between EM and developed markets, high nominal and real yields, a clear disinflationary trend and supportive technical backdrop, given the under-owned nature of the asset class, make EM local debt attractive.

What do you think the key market drivers will be this year? What are you watching for in terms of positive developments?

Given attractive nominal yields in EM, an easing bias by most EM central banks and a benign macroeconomic backdrop support income generation from both interest rates and currency carry. The normalization of the term structures of rates will likely also be meaningful market drivers this year. We think EM rates could deliver beta returns higher than their current yield levels, with shorter-dated bonds delivering significantly higher returns relative to their yield levels. Our macroeconomic base case is still a soft-landing scenario, but we continue to monitor developments on the inflation and growth fronts, especially in the US, as they will likely set the tone for global risk assets.

What are the key risks?

The primary risks are a reacceleration of global inflation, geopolitical instability and US politics. Inflation is a greater nemesis of developing countries than developed ones due to its outsized impact on external financing costs, which lowers overall credit quality, and resultant tighter financial conditions, which are a drag on growth. Additionally, the impact on the shape of the yield curve, namely a shift from flatter to inverted, is disruptive. Geopolitical instability in regions like the Middle East, Asia and Europe, and US politics, with 2024 elections coming up, are beta drivers that could increase market volatility and uncertainty around EM performance.

What is the role of the US dollar in your outlook and how do you see the dollar playing out this year?

Our view on the US dollar has not changed over the past 15 months. We believe the dollar remains on a weakening trend and expect better performance from higher carry currencies. Carry has been the primary driver of currency movements and is likely to remain so as the monetary easing cycle broadens globally. There are three reasons behind this dollar view:

1. The dollar is only 10% off its 50-year high in real terms and is significantly above its long-term median valuation.[8]
2. Twin deficits in the US will likely require a weaker dollar to fund them by making US assets more attractive to investors.
3. When the Fed embarks on its easing cycle, the interest rate support that the dollar has enjoyed will likely diminish over time.

Is there a particular region or regions where opportunities stand out this year?

There is a large dispersion in yields among developing countries at the moment. Rates in some countries remain far above long-term neutral rates, particularly in Latin America, and we believe this region will provide attractive investment opportunities for active managers to extract alpha this year.

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

Three key differentiators that have led to our team's success in the asset class include our macroeconomic risk framework, our focus on downside risk mitigation and our fully integrated approach to environmental, social and government (ESG) factors in the investment process. We seek to manage downside risk by maintaining portfolio volatility at, or below, that of the benchmark and only taking tracking error to reduce risk. We believe this asymmetric risk approach allows us to deliver improved downside risk mitigation relative to our peers. By integrating ESG factors into our investment approach, we assess EM economies in a holistic manner that we believe should deliver improved returns over the long-term.

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

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