Global Fixed Income Strategy

Monthly report

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Macro conclusions from IFI's June Summit

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

US: Growth below trend, inflation above target, but recession likely averted

Our main call has been that the US economy will continue to grow below trend but avoid a recession in 2023. We believe that inflation has peaked, and after moving sideways in the first half of the year, will likely fall in the second half. However, we expect core CPI inflation to be around 3.5% at year-end, which is above the Federal Reserve's (Fed) target, meaning the Fed will likely keep monetary policy tight and not deliver any cuts this year.

Next year, we expect inflation to decline below 3% in the first half of the year. That would still be higher than the Fed's target but the Fed might be reluctant to tighten policy further and risk a significant downturn in economic activity. So, we expect some stickiness in inflation around 3%, which would mean that interest rates would likely be higher for longer.

Arguments for a soft US landing

Why has the US economy been more resilient than in past cycles? First, private sector leverage is relatively low. Most cycles in the US and around the world have involved private sector leveraging, which ultimately becomes excessive and unsustainable. The economic downturn tends to be severe after such cycles, with deleveraging amid higher interest rates. In the current cycle though, private sector leverage, especially household leverage, is not high and so risks are moderate.

Second, we have not seen the much feared wage-inflation spiral take hold this cycle. Measures of inflation expectations, whether implied by market instruments or household surveys, remain well anchored. Real wages actually declined during the inflation shock and recent measures of inflation expectations have been coming down.

Third, fiscal policy headwinds have abated. Fiscal policy was tight in 2022 after the removal of many pandemic support measures. But in 2023, fiscal policy is no longer a headwind to growth.

Finally, we believe economic resilience has been bolstered by firms' reluctance to lay off workers. The labor market continues to be very tight. After the pandemic-led recession, firms found it very difficult to hire workers. It has also been difficult and costly to rehire and train workers during the recovery. Given this recent experience, we believe firms may prefer to retain workers while adjusting work hours if necessary, if the economy slows.

1. Source: Bureau of Labor Statistics. Data as of May 10, 2023.
2. Source: Ward's Automotive Group. Data as of May 2, 2023.
3. Source: Ward's Automotive Group. Data as of May 2, 2023.
4. Source: Manheim Auctions. May preliminary data. Data as of May 17, 2023
5. Source: Bureau of Labor Statistics. Data as of May 10, 2023.

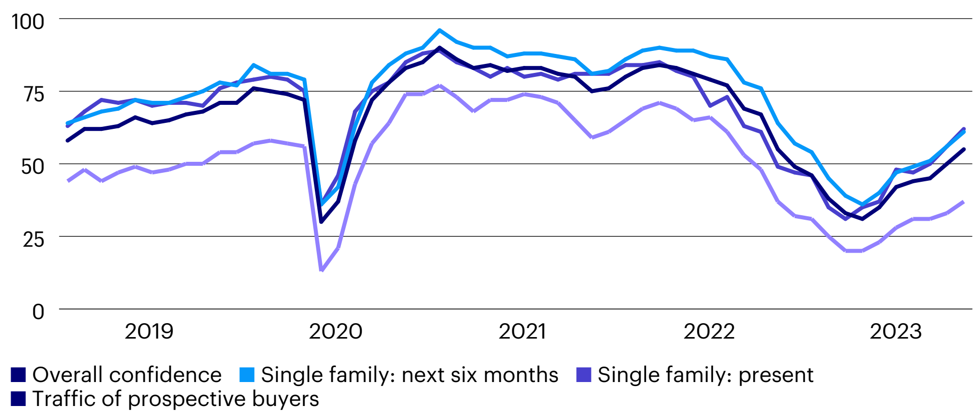
The impact of monetary policy is being felt

What about the widely held assumption of long and variable lags of monetary policy? While it is true that monetary policy lags can be variable, they are not always long. Lags can be both short and long and can hit the economy at different points in time after a tightening cycle.

The first stage of monetary transmission is from the federal funds rate to asset prices, including longer-term interest rates, credit spreads, the exchange rate and equity prices, sometimes summarized in financial condition indices (FCIs). The transmission from the policy rate to financial conditions was rapid in this tightening cycle and financial conditions are tight (FCIs elevated).

The second stage is from financial conditions to spending. In the standard theory that most central banks adhere to, policy transmission works through interest rate-sensitive components of demand. This includes durables consumption, but mainly housing and cars. Transmission to the housing market has been rapid, and the lag has been far from long and variable. Residential investment contracted for eight quarters in a row, and was a major headwind to growth last year. Lately, the housing market has bottomed and appears to be stabilizing. Home builder confidence has improved and prospective buyers are coming back to the market. Housing permits have been up in recent months, along with housing starts.

Figure 1: Homebuilder survey components show upturn



Source: National Association of Homebuilders. Data from Jan. 1, 2019 to June 1, 2023.

Another area affected by interest rates is car sales. Car sales had been in recession for different reasons, largely supply-side bottlenecks experienced after the pandemic. In a typical recession, spending on cars falls by around 20% (Figure 2). During the pandemic, car sales declined by around 25% dragged down by supply-side bottlenecks (Figure 2). As supplies and inventory have improved, car sales have been trending up, but still remain below normal, suggesting there is still pent up demand that needs to be filled.

Figure 2: US car sales recovering though still below normal

Source: Bureau of Transportation Statistics. Data from Feb. 1, 2007 to May 1, 2023.

But tighter monetary policy has not been fully transmitted to the economy

We expect higher borrowing costs to be a headwind for spending in the housing and auto sectors going forward. But both sectors are recovering from their respective recessions and are unlikely to go into another recession at the prevailing level of interest rates.

There are also long lags that are currently hitting or have yet to hit the economy. Tighter credit is showing up in loan officer surveys and tighter financial conditions will probably lead to weaker investment in the coming quarters. Survey evidence confirms weaker investment intentions, especially among small and medium-sized firms. These headwinds are behind our outlook for below potential growth rates in the coming quarters.

What about inflation?

The rise in US inflation can be understood in different stages. The initial rise was due to imbalances in the composition of demand and production created by the pandemic and fueled by fiscal and monetary policy. The pandemic led to an unprecedented increase in the consumption of goods, while services consumption declined and recovered very slowly. The massive increase in consumption demand would have been difficult to meet even in normal times, but during the pandemic, the supply-side was also disrupted - think of factory closures. Policy was also very stimulative; households received stimulus checks in 2021 and immediately spent them on goods. This demand boost on top of supply disruption led to an acceleration of inflation in 2021.

The second stage of the inflationary process arose with the Russian invasion of Ukraine, which led to increases in global commodity prices, including food and energy. This fed global inflation and contributed to upside surprises in inflation in the US in 2022.

However, as we outlined in last month's issue, **Inflation high enough to keep Fed on guard**, we expect core CPI inflation to decline to around 3.5% by the end of the year and fall below 3% in the first half of next year. This would be progress toward the Fed's price stability objective but inflation would remain high enough for the Fed to keep interest rates elevated and monetary policy tight.

The Federal Open Market Committee's latest "dot plot" of interest rate projections suggested that two more hikes are possible this year, but it remains to be seen if they will be justified by the data. While there is uncertainty about the peak in policy rates, we do not expect any cuts for the rest of this year, and we expect the Fed to keep its policy rate tight.

Europe: Growth resilient but no acceleration

Despite a large negative shock arising from the Russia-Ukraine war, the eurozone economy has proved to be resilient and has avoided a deep recession. We nevertheless do not expect the economy to accelerate over the next year and we expect growth to remain below potential. But our growth outlook is still above consensus for the second and third quarters of this year, as we expect another year of strong summer travel - travel reservations in southern Europe are strong again this year. More generally, though, the domestic eurozone recovery since the pandemic has been subdued. Real consumption is still around pre-pandemic (2019) levels and real investment spending is below the 2019 level. There is catching up to do, which should support some modest growth for the time being. Fiscal policy is also modestly supportive, putting a floor under growth rates. However, tight monetary policy will likely be a headwind to growth going forward.

Headline inflation has peaked and is declining. Underlying inflation was high until recently, but most measures show that underlying inflation has also peaked or is coming down. With the stabilization of global energy, goods and other commodity prices, tighter policy and strong base effects, inflation in Europe should continue to come down noticeably in the coming months. But we expect it to remain above the European Central Bank's (ECB) target for some time. While inflation dynamics have improved, progress on core inflation has started only recently; there has not yet been a series of disinflationary numbers, which the ECB would like to see. And the level of inflation is still very high. The ECB will likely remain hawkish and maintain its hiking cycle until there is more consistent evidence of disinflation.

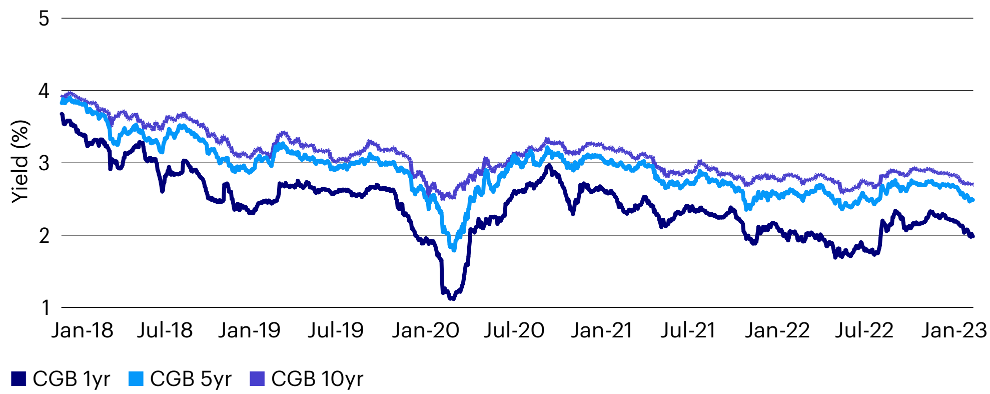
We expect the ECB policy rate to rise to 3.75%, but an additional hike to 4.00% cannot be ruled out, given the ECB's hawkish rhetoric.

China: Focus on quality of growth

We expect China's economy to grow by around 5.3% in 2023, with disinflation throughout the year. We have been less bullish than the market consensus on both growth and inflation, as we have factored in households' lower risk appetite and more moderate easing measures from a policy perspective. De-leveraging and de-risking behavior by Chinese households has led to rising deposits and lower retail loan growth this year. We believe this leaves room for further rate cuts in various forms in the near future.

Fiscal easing measures to support the private sector and the relaxation of property purchase restrictions could be put in place if policy makers view the growth trajectory as less than optimal. However, we think China's new leadership may focus more on a sustained improvement in the quality of growth over the long term. Therefore, we foresee lower yields in the onshore bond market in the medium term.

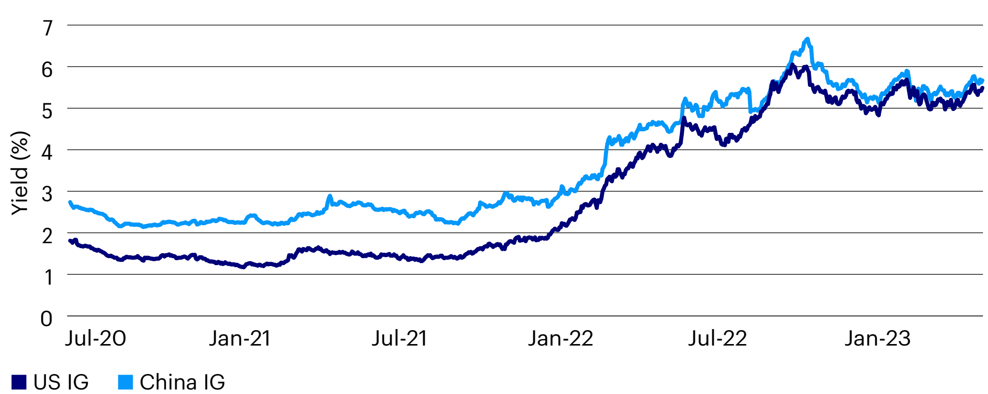
Figure 3: We see room for further Chinese government yield declines



Source: Wind, Invesco. Data from Jan. 2, 2018 to Jan. 2, 2023.

The substantial yield gap between Chinese renminbi and US dollar-denominated bonds could continue to support strong Chinese investor demand for higher yielding foreign currency denominated bonds overseas, while the supply of US dollar bonds of mainland Chinese issuers has been shrinking. This has provided positive technical support to the US dollar-denominated investment grade bonds of Chinese issuers, which have outperformed the broader market in the past two years.

Figure 4: Chinese investment grade US dollar bonds offer attractive yields vs onshore, despite narrowing spread vs US investment grade



Source: ICE indices, Invesco. Data from June 8, 2020 to June 7, 2023.

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Interest rate outlook

US: Neutral. Slowing inflation and low growth argue for lower yields across the yield curve. But a very hawkish Fed is keeping short-term rates high, and limiting the downside for yields, given the very inverted yield curve. We continue to look for US 10-year Treasuries to be in a 3.0% to 4.0% range. At current levels, we are in the middle of this range and favor a neutral stance on duration.

Europe: Overweight. As the ECB looks forward to the second half of the year, it is faced with a dilemma. Inflation in the region remains stubbornly high, and, while falling, it is falling more slowly than anticipated at the beginning of the year. At the same time, the economic environment in recent months has begun to deteriorate. Currently, the ECB is talking tough, pushing up market expectations of the terminal rate close to 4%, while emphasizing that rates will remain high for some time. That resolve will likely be tested over the coming quarters. While the service sector has remained relatively robust, despite malaise in the manufacturing sector, our analysis indicates that the service sector will likely begin to falter as the full impact of the recent rate hiking cycle begins to take effect. We are broadly positive on European fixed income and believe current yields offer value on a medium-term basis. But we are cognizant that the ECB's hawkish rhetoric may keep yields higher than we anticipated in the near term.

China: Overweight. We see room for Chinese government bond yields to decline, based on relatively moderate policy easing measures and the low risk appetite of the household sector. Yield spikes on the back of unexpected policy easing measures may be seen as potential buying opportunities, in our view. As investors have gradually built their positions in the onshore market, further yield moves through key levels may face resistance.

Japan: Underweight. Japanese government bond (JGB) yields are roughly unchanged over the last month, reflecting the Bank of Japan's (BoJ) decision to keep policy unchanged at its June meeting and ongoing life Insurance demand for long-end bonds. However, rising inflation and wages continue to point toward a change in BoJ policy in the near future.

UK: Overweight. The UK interest rate market has undergone a dramatic repricing over the last month. Market expectations for the peak in the Bank of England's base rate have risen from just over 4.75% in May to over 6%, as a series of upward surprises to inflation and wage data pressured popular long duration positions.[1] This has culminated in the BoE's surprise decision to hike by 50 basis points at its June meeting. Current pricing implies a substantially tighter policy path than envisaged by the BoE when it made its forecasts in May. Consequently, the market has to some extent already reflected the upward surprises to inflation, creating scope for a decline in yields, if inflation moderates going forward and/or evidence emerges of a slowdown in growth due to higher rates. The BoE's decision to accelerate the hiking cycle is more of an attempt to shore up its credibility than an attempt to induce a further upward repricing of the terminal rate. The BoE's forward guidance makes future hikes conditional on signs of inflation persistence, limiting the scope to extrapolate 50 basis point hikes in the absence of further upside inflation surprises. Given that the market is now pricing over 100 basis points of hikes over the BoE's next three meetings, it will likely require a substantial worsening of the inflation outlook to exceed this pricing, offering opportunities to position long duration, in our view.[3]

Australia: Overweight. The Reserve Bank of Australia's (RBA) surprise decision to hike at both its May and June meetings, taking the cash rate to 4.10%, has driven a substantial repricing of Australian interest rate markets over the last month.[2] The market is now at a peak cash rate of 4.56%, up from 3.9% one month ago.[3] Over the same period, 10-year Australian government bond yields have risen by over 30 basis points to their highest level since January, underperforming US Treasuries by 30 basis points.[4] Although recent inflation and wage data have been disappointing, the market has now priced a meaningfully tighter path for policy in the context of a relatively weak growth outlook. As a consequence, the distribution for yields is becoming more skewed to the downside going forward, in our view, even if the RBA hikes again at its August meeting.

1. Source: Bloomberg L.P. Data as of June 23, 2023.
2. Source: Reserve Bank of Australia. Data as of June 6, 2023.
3. Source: Bloomberg L.P. Data as of June 23, 2023.
4. Source: Bloomberg L.P. Data as of June 23, 2023.

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Currency outlook

USD: Neutral. The recent weakness in the US dollar can be attributed to a more benign US Fed and expectations that the June skip in the rate hiking cycle may signal that the terminal rate has been reached. If the Fed holds steady while other developed market central banks continue to hike, then the recent weaker trend may persist. However, if inflation data in the US remain higher than anticipated, the Fed may opt for additional tightening, providing some short-term support for the greenback.

EUR: Neutral. The euro has benefited recently from hawkish ECB rhetoric and supportive service sector data. We are sceptical that policymakers will remain as enthusiastic to tighten monetary policy further once the region's economy begins to falter and inflation falls. The euro may also face headwinds in the coming months if the Fed continues to move US rates higher.

RMB: Neutral. The USD/RMB exchange rate moved higher in June. We expect China's solid external sector fundamentals to support the renminbi's performance over the medium term. However, corporate dividend payments in the middle of the year could create corporate demand for dollars. On the other hand, exporters' dollar supply could be a mitigating effect.

JPY: Neutral. The BoJ's reluctance to change the Yield Curve Control policy at its June meeting, in contrast to the more hawkish Fed and ECB, has led to a sharp depreciation of the yen against the US dollar and the euro. On a trade-weighted basis, the yen is now at its weakest level since October 2022, prior to the currency intervention by the Ministry of Finance and the BoJ's decision to change the Yield Curve Control yield cap from 25 basis points to 50 basis points. This is despite a marked improvement in Japan's balance of payments due to lower energy prices. The yen is fundamentally undervalued at current levels, in our view. However, until the BoJ becomes more hawkish and/or the Fed and ECB stop or reverse their recent hikes, it is unlikely that the yen will outperform, given the very negative carry of yen long positions.

GBP: Neutral. Sterling has been supported this year by a gradual improvement in the UK's growth outlook. However, signs of persistent inflation and the consequent rise in interest rates will likely weigh on growth going forward, limiting the scope for sterling upside. Wider interest rate differentials are unlikely to support the currency, as they are in response to a worsening inflation outlook, not a better growth outlook, which might attract capital inflows. If UK growth cracks ahead of a moderation in inflation, which seems likely, sterling might face increased downside pressure, even if interest rates remain relatively high compared to peers. Stagflation has rarely been supportive of currencies.

AUD: Neutral. The RBA's hawkishness has shifted yield differentials in a more favorable direction for the Australian dollar, even if the starting point is still one of lower rates versus the US. However, higher domestic yields have been offset by a souring of sentiment toward the Chinese growth outlook and related commodities. Until Chinese growth improves, it is hard to see sustainable upside for the Australian dollar, in our view, even if current valuations are viewed as cheap based on the favorable balance of payments dynamics.

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

Credit conclusions from IFI's June Summit

At our June Summit, our global corporate credit teams gathered from across the platform to share their latest thoughts. Among our major conclusions, we are conscious of the following key macroeconomic risk factors: higher interest rates and tighter financial conditions that could extend for some time, the risk that the US consumer could roll over amid slowing economic activity and global recession fears.

Our base case assumes a soft landing in the US

Our base case is currently coalesced around a soft-landing in the US, and we believe it is appropriate to look through the recent periods of historically high interest rate volatility. Yields of US investment grade companies are at levels not seen for over a decade. We are seeing investor demand even from those with a more pessimistic view on the macro outlook. In the US high yield market, the recent decline in rate volatility has been technically supportive with the new issue market opening up. Lower equity volatility has also been supportive for lower rated issuers, though we note that this has the potential to be less favorable in the scenario where issuer fundamentals weaken (from their current strong position). In emerging markets (EM), we are starting to see a pick-up in risk appetite as well. Earlier in the year, the outperforming sectors were Chinese state-owned entities and other higher rated sovereign and quasi sovereign securities, which has been reversing.

Looking through recent interest rate volatility

A great example of correlation to rate volatility is in the sterling investment grade market where credit spreads reached highs of 250 basis points last October on the back of the confusion caused by the mini-budget announced by then Chancellor, Kwasi Kwarteng.[5] Spreads are now back to an index average of 170 basis points over gilts, and the range of opportunities is notable.[6] European financials are still very attractive versus corporates, in our view. The failure of Credit Suisse created a buying opportunity, and we see the potential for further convergence. Corporate hybrids also offer a way to get exposure to bonds with higher yields but issued by stronger companies, where we think the spread pick-up more than compensates for potential extension risk. More broadly, in European investment grade, we also note the current spread pick-up in BBBs over single A credits – 50 basis points in euros and 70 basis points in sterling.[7] The recent compression between BB and BBBs is also making BBBs look relatively more attractive.

Dispersion in high yield rating segments

The dispersion in European high yield is getting more and more interesting as we come out of a long period of easy money. While the CCC segment is relatively small, we are starting to see more examples of companies struggling to agree to refinancing terms that are favorable, and when results come in even just a little below expectations, the market pricing reaction is significant where the sustainability of capital structures is being questioned. In contrast, the performance of the US CCC segment has been remarkably strong over the last year. This seems to be a rebound without any particular driver other than recovery from previous underperformance. With a weak growth outlook and no expectation that financing rates will fall significantly, we are not looking to chase this rally.

Opportunities in the US energy space

In the US, one sector that we still think is out of fashion is energy. However, companies have completely changed their asset allocations and capital structure focus to pay down debt, following the difficult rating downgrade period a couple of years ago. We prefer the Master Limited Partnership (MLP) structures, some of which offer nearly 6% yield.[8] The independent energy space provides a little more volatility, but we see some potential for large integrated names to aggregate and scale further, while keeping their balance sheet focus.

Opportunities across EM credit

In EM, the key opportunity we see at present is in high yielding sovereigns. We've seen the average dollar price fall to levels that compensate for recovery expectations in a default scenario, which is more negative than we believe

5. Source: Bloomberg Sterling Aggregate Corporate Average OAS Index, Oct. 13, 2022.
6. Source: Bloomberg Sterling Aggregate Corporate Average OAS Index, June 8, 2023.
7. Source: Bloomberg Euro Aggregate Corporate BBB and A-rated Indices, June 2023.
8. Source: Bloomberg US Aggregate Corporate Yield Index, June 2023.
9. Source: JP Morgan EMBI Global High Yield Sovereign Yield Index, June 2023.

appropriate, and looks compelling in the 12% yield range.[9] We think the right way to play this is through a diversified basket of issuers to protect against idiosyncratic risk. We also like subordinated bank debt in the EM space from national champions that have underperformed as a result of banking sector pressures in the US and Europe. There are corporates in the BB/BBB space operating in countries that have been struggling, such as Columbia and Mexico, that have lagged recently, and we are looking more closely there compared to the Middle East and Asia. Our focus is on the high yield space in part because we note how the composition of the EM investment grade index has shifted as it has grown, with now over half of it rated A or better (up from around 25% five years ago).[10] As a result, it is important to remember that, overall, the index should trade at tighter levels than in the past.

Moderately positive technicals in US and European high yield

US high yield technicals have been interesting, with some outflows from the asset class, which have been more than offset by USD140 billion of rising stars.[11] This represents a move up of nearly 9% of the market into investment grade space.[11] New issuance has been driven primarily (around 70%) by the refinancing of existing deals and it has been in the leveraged loan market where it has been harder for companies to access funds.[11] Borrowers are relatively agnostic to syndicated loans versus private debt and so we've seen over 10% of the USD80 billion of issuance this year originate from bond-for-loan take outs.[11]

Technicals in European high yield have been firm. While fund flows have been relatively muted, there has been strong support from the reinvestment of coupons, tenders and redemptions. Anecdotally, investor cash balances were fairly high coming into the year and portfolios were largely defensively positioned.

Positive technicals in US and European investment grade

In the European investment grade market, there was EUR122 billion of new issuance by the end of May this year, which is broadly in line with expectations, and about EUR14 billion of inflows, slightly positive overall.[11] However, in the UK, the real surprise has been that the Bank of England has successfully sold the vast majority of its holdings of corporate bonds, in a disposal program that started last September (having bought £20 billion), on top of £14 billion of issuance this year, and that has all been absorbed by the market.[12]

Issuance in the US market has been very strong with over USD650 billion issued this year.[11] Critically, in the last month, regional banks were able to start issuing again, which demonstrates that confidence has somewhat returned to that segment. Also, the Federal Trade Commission appears to be in merger and acquisition prevention mode, blocking a number of large deals that would otherwise have led to significant supply. It is also interesting to see some normalization in issuance along the maturity curve. As interest rates rose earlier this year, companies were printing three or five-year paper, resisting locking in rates for longer, but there does now appear to be some acceptance of the current interest rate environment and 30, and even 40-year, maturities are being marketed. This is being soaked up by an increase in demand, with nearly ten straight weeks of retail inflows. Institutional demand appears strong as well. There is money to put to work from the CARES act distributions, but also foreign investors who were concerned about the rise in hedging costs are still investing, as the numbers still work at these higher yield levels.

EM technicals less positive

Finally, EM technical dynamics have been less positive, with lower supply driven by a lack of demand and issuers trying to wait for more positive sentiment or looking to local markets rather than US dollar bonds. This is one of the reasons that we see value in the asset class with spreads at relatively wider levels as a result.

10. Source: JP Morgan Corporate Broad EMBI Diversified High Grade Index, June 2018.
11. Source: Invesco calculations, June 2023.
12. Source: Bank of England website, June 6, 2023.

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