Global Fixed Income Strategy

Invesco Fixed Income

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Contents

Contributors

John Greenwood
Chief Economist

Adam Burton
Assistant Economist

Assessing Policy: Why This Time Is Different

What will be the immediate and longer-term impact of the monetary and fiscal support provided by the US Federal Reserve (Fed) and government on the US economy during the coronavirus pandemic? And, more generally, what will be the impact of similar monetary and fiscal policies implemented in other leading economies?

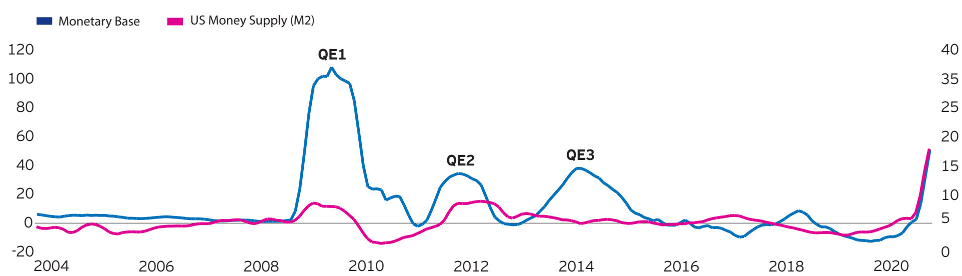
Currently, the official view from governments, central banks and official institutions, such as the International Monetary Fund, appears to be that the world will be so depressed, activity so much lower, and unemployment so much higher than pre-COVID-19 that governments and central banks will need to roll out unprecedented measures for years to come.

The judgment of the authorities, in short, is that the current downturn is far worse than that caused by the global financial crisis (GFC) of 2008-09. Moreover, since that crisis took many years to overcome and there will be widespread "scarring" of the labor force on this occasion, even more stimulus will be required to deal with the pandemic-induced recession, and it will be needed for much longer.

However, a very different assessment of the post-GFC situation is possible. Despite three episodes of quantitative easing (QE), which hugely increased "money on the books of the central bank," broad money (M2) or "money in the hands of the public" grew only at a very modest rate between 2009 and 2018 (Exhibit 1).

Exhibit 1. After the GFC, the Fed's QE did not generate rapid M2 growth; this time it is different

US: Growth of monetary base and M2 (3-mo. mov. avg., year-over-year % chg)



Source: Refinitiv as of July 27, data from Jan. 1, 2004 to June 1, 2020.

The evidence suggests that the slow recovery and sub-target inflation rates in the US, the eurozone and Japan between 2009 and 2019 were all the result of an excessive emphasis on interest rates, rather than money growth as the main policy tool of central banks, resulting in money growth that was too low. It is only by truly understanding what happened in the wake of the GFC that appropriate policies can be designed for the post-pandemic environment.

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Post-GFC policies not as expansionary as they seemed

In the wake of the GFC, central banks and governments turned to monetary and fiscal policies to restore economic growth, reduce unemployment and stave off disinflation or deflation. Interest rates were reduced almost to the "zero lower bound" in many economies. In addition, partly to lower long-term rates, the Fed and Bank of England (BoE) increased the size of their balance sheets by buying government securities. Fiscal deficits also expanded, comparable with wartime interventions in the economy.

However, despite all this stimulus, the recovery turned out to be anemic and inflation, for the most part, well below expectations. Why was it that these unprecedented policies that were talked up so much delivered so little?

On the monetary side, the main reason was that balance sheets had been so badly damaged in the housing and stock market crash of 2008-09 that an extended period of balance sheet repair was needed. No matter how low interest rates fell, borrowers were not enticed to re-leverage. As a result, more drastic measures were needed. This led directly to the policies of QE in the US and the UK. By purchasing securities from non-bank holders, both central banks boosted the deposit component of the money supply. What mattered was that "money in the hands of the public" was increased, enabling some firms and individuals to deleverage and others to realign their portfolios toward riskier assets, promoting a portfolio re-balancing process among institutional investors and a wealth effect across the economy.

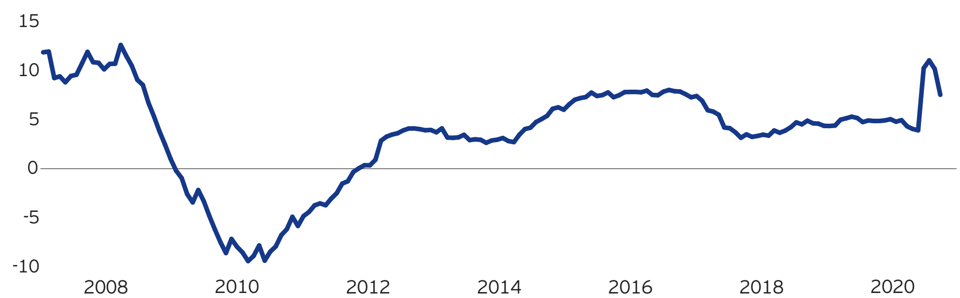
On the fiscal side, government deficits increased rapidly in 2009-10 due to large declines in tax revenue and simultaneous increases in the payment of unemployment and other safety-net benefits. Even though governments were able to borrow large amounts at very low interest rates for most of the decade, there was little or no upward pressure on bond yields, primarily because significant parts of the private sector, preoccupied with balance sheet repair, were not competing for funds.

Why broad money did not grow rapidly after the GFC

There are two main reasons why broad money did not grow rapidly in the aftermath of the GFC. First, a wide range of US entities was over-leveraged, causing a sharp drop in US bank lending over the period 2009-11. Therefore, when the Fed implemented its first round of QE (QE1) from November 2008 until March 2010, the main effect was merely to offset the decline in lending on banks' balance sheets (Exhibit 2).

Exhibit 2. The first task of QE in 2009-11 was to offset loan and deposit contraction

US: Commercial bank loans and leases, adjusted (year-over-year % chg)



Source: Refinitiv as of July 27, 2020, data from Jan. 1, 2007 to July 1, 2020.

Second, in the aftermath of the GFC, new regulations were introduced, such as Dodd-Frank and Basel III, which required US commercial banks to hold more capital, particularly loss-absorbing, or equity-like capital, than pre-crisis. The higher the capital requirements, the less the ability to extend credit and create money. The immediate consequence of the straitjacketing of commercial banks' balance sheets has been, therefore, lower broad money growth than in a normal business cycle expansion.

To sum up, the fall in bank lending between 2009 and 2011, combined with the increased commercial bank capital requirements imposed after the GFC, slowed bank lending growth and hence deposit creation and M2 growth for most of the decade 2009-18. These factors were responsible for the sub-par growth rates of economic activity, sub-target inflation, and - along with these results - persistently low interest rates and low bond yields.

Application of the analysis to the eurozone, Japan and China

The eurozone and Japan were less successful in generating faster broad money growth via QE compared to the US or the UK. The reasons were twofold. First, both central banks were much later in adopting QE (March 2013 in the case of Japan and March 2015 in the case of the European Central Bank (ECB)). Second, in each case, the central banks purchased securities under their QE programs from banks instead of non-banks – a crucial difference. Only by purchasing securities from non-banks can central banks "create money" in the sense of adding new deposits to the banking system. This happens because central banks pay for the securities purchased with new money. If, however, central banks buy securities from commercial banks, as the Bank of Japan (BoJ) and ECB did, the result is that these transactions amount to little more than asset swaps and do not create new deposits in the banking system or faster money growth. In order to generate new money growth, the commercial banks would still need to create new loans, which, in turn, would be matched by new deposits or money. However, for the most part, banks in Japan and the euro area remained risk-averse, reluctant to lend, and subject to regulatory pressures to increase capital ratios.

In China, the central government did very little incremental spending,and its budget balance did not record large deficits. Instead, the provincial and municipal authorities were instructed to borrow from the banking system, particularly the state-owned banks, with the result that China's M2 growth rate surged in 2009-10, averaging 24% per annum over two years, 10 percentage points above its previous average, creating a massive increase in domestic spending power.[1] In other words, this was a stimulus that was as much monetary as fiscal. China therefore experienced a surge in stock and commodity prices in 2009-10, a housing boom, a strong economic recovery, and, ultimately, a dramatic shift from consumer price deflation to inflation by the second half of 2011.

Implications for asset markets, the economy and inflation

Returning to the US, bank lending plunged in 2009-11, so initially, QE merely offset what otherwise would have been a decline in broad money. In effect, it prevented a repeat of the Great Depression, which had resulted from a sustained contraction of money. This time (in 2020), not only has QE pushed up the monetary base in the US, but broad money is soaring (Exhibit 1). In contrast to 2008, banks have ample capital, regulators have been easing capital requirements, and there is plentiful liquidity.

It is always important to focus on the key issues. Some commentators, for example, make a big issue of the Fed buying or offering to buy lower-grade securities, but this is nothing new. In the first few decades after its founding in 1913, the Fed operated mainly in commercial bills. What matters is how much broad money is created, and the purchase of government securities or lower-grade bills or bonds is simply one step in the process. Generally, under normal conditions, money is mostly created by commercial banks when they make loans, not by the central bank.

Another mistake people make is to think that more government debt inevitably means that there will be inflation. The fallacy of this view can be shown with reference to Japan. Japan has seen its government debt grow to around 230% of GDP over the past 20 years, yet there has been negligible inflation.[2] The reason Japan has not suffered inflation is that money growth (M2) has been too low for too long. It is money that creates inflation, not debt.

This means that, despite the huge increase in US government debt, this will not turn out to be inflationary unless accompanied by a rapid growth in the quantity of money ("money in the hands of the public"). So far, markets have absorbed the deluge of government securities relatively easily, and without any upward pressure on yields (this could change if risk aversion re-emerges).

Another issue is that today, the consensus of US economists holds the view that money has nothing to do with inflation. Neo-Keynesian economists argue that large output gaps and/or high unemployment will keep inflation low, hence the need for continuing stimulus. However, as argued above, inflation was low over the past decade only because broad money growth was low, whereas, in the current environment, money growth is much more rapid.

The consensus view also holds that since massive QE did not create inflation in 2009-18, the central banks can do it all over again without any consequences for inflation. The problem with this view is that, with few exceptions, inflation is not created by "money on the books of the central bank;" it is created by "money in the hands of the public." The current circumstances will, therefore, likely provide an important test of monetary analysis versus the neo-Keynesian consensus.

The monetary view of the recent surge in money growth is not that central banks have directly monetized the increase in government debt, but that central banks have expanded their balance sheets in a bid to accommodate the "dash for cash" as witnessed at the time of the scramble for liquidity in March and April. This classical "lender of last resort" response of the Fed to the crisis has created a tidal wave of new money that is already evident in the strong recovery in equity prices and most likely will later show up in the form of large increases in spendable balances ("money in the hands of the public").

One way to illustrate the current conjuncture and to conclude this survey is to sketch out the implications of the monetary transmission process in three phases.

In the current first phase, most of the new "excess" money remains in the hands of investing institutions, money market funds and others in the financial sector. Although many non-financial companies raised funds by drawing on bank credit lines in the early stages of the pandemic, these funds are still being held as precautionary balances (e.g., in government money market funds) and have not yet migrated to those businesses and consumers who might be more inclined to spend the funds. The strong revival in stock prices - reported by many commentators as being out of line with developments in the economy - is evidence of an excess of purchasing power in the hands of non-bank institutions and others. At this first stage in the transmission process, these excess funds are tending to keep interest rates very low.

Moving to the second phase of the transmission process, however, it seems likely that the current disinflationary episode will last only until year-end or early next year. By that time, the excess funds will have started to generate an upswing in spending and stronger economic activity. While this will not necessarily achieve full employment any time in the next year or two, the recovery in spending will likely boost the demand for credit, causing market interest rates and bond yields to start to rise in this second phase.

In the third phase, starting in late 2021 or 2022, continued rapid money growth will likely mean that economic activity will remain strong, and inflation will start to increase. The gold and silver markets are already indicating nervousness about inflation, and the US dollar has started to weaken. Unless steps are taken to withdraw some of the excess funds provided to deal with the crisis, the risks of inflation emerging in 18-24 months will likely be on a rising trajectory.

[1] Source: People's Bank of China. Chinese M2 money growth exceeded 24% y-o-y between March 2009 and February 2010.
[2] Source: Bank of Japan, Japanese Cabinet Office. Latest government debt-to-GDP figure is 230% of GDP, as of Q1 2020.

Contributors

Rob Waldner
Chief Strategist and
Head of Macro Research

James Ong
Director Derivative
Portfolio Management

Noelle Corum
Associate Portfolio Manager

Gareth Isaac
Head of Multi-Sector
Portfolio Management

Yi Hu
Head of Asia Credit Research

Michael Siviter
Senior Fixed Income
Portfolio Manager

Avi Hooper
Portfolio Manager

Scott Case
Portfolio Manager

Interest Rate Outlook

US: Neutral. US Treasury yields are likely to stay low for a significant length of time. In our view, the deflationary growth shock unleashed by the coronavirus has decreased the fair value of the 10-year US Treasury yield to around 1%. 10-year US Treasuries are likely to trade below this level while the economy remains in the slow growth/low inflation regime caused by the virus. We expect the federal funds rate to stay near zero as well. The Fed has initiated a major policy shift by moving towards an average inflation targeting regime. This suggests that while overall rates will remain low, real US interest rates may continue to rally. The Treasury curve may steepen, especially in the 30-year part of the curve as supply increases.

Europe: Neutral. The outlook for the European Union (EU) sovereign bond markets is a positive one, despite continued headwinds to growth and inflation. The decisive actions taken by the European Central Bank (ECB) and EU to support growth in the region should ensure that rates stay low and support for peripheral economies and bond markets remains strong. We expect the ECB to increase its bond-buying program further in the coming months, as Europe struggles to emerge from lockdown successfully and growth across the region stalls, placing additional burdens on sovereign balance sheets.

China: Neutral. Moves in onshore government bond yields have been led by local equity market performance, supply pressure, interbank liquidity conditions and international investor demand. 10-year yields around 3% have sparked foreign buying demand. Recent speeches by the People's Bank of China (PBoC), monetary policy reports and commentaries have been relatively hawkish, with mention of exits to easing policy. While stock market performance and US-China news headlines may drive near-term bond market performance, the upside to rates/bond yields may be limited by strong buying interest from international investors when rates/bond yields reach certain attractive levels.

Japan: Neutral. We expect Japanese government bond (JGB) yields to largely track global yields with low beta, as the BoJ appears unwilling to aggressively push yields lower, especially at the long end of the yield curve. It is worth noting, however, that JGB yields are now high relative to other G10 markets, with long-end forward rates above pre-COVID-19 levels. We believe this limits the scope for JGB underperformance, especially taking into account Japan's relatively low level of inflation.

UK: Underweight. Gilts offer poor value on an outright and cross-market basis, in either nominal or real terms, in our view. The market continues to price a high probability of Bank of England cuts, which appear increasingly unlikely while reflecting little risk premia for the tapering of QE later this year. Increased supply in September (net of QE) will likely increase the upward pressure on yields.

Canada: Neutral. The ongoing containment of the coronavirus is allowing increased re-opening of the domestic economy. Savings rates are high, while tourism activity is trapped within the country's borders. Rising commodity prices are adding some support to the bounce back. The shorter end of the yield curve is expected to remain anchored by Bank of Canada rate policy and very strong demand for coupon income. Rich valuations have led us to neutralize our long-held positive view.

Australia: Neutral. The lack of limited policy action by the Reserve Bank of Australia (RBA) means that Australian rates markets will probably remain largely range-bound, with external drivers dominating price action. However, on a cross-market basis, Australian government and semi-government bonds look attractive, in our view, due to the relatively steep yield curve, which results in the highest long-term forward rates in the developed market universe.

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Rob Waldner
Chief Strategist and
Head of Macro Research

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Director Derivative
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Noelle Corum
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Gareth Isaac
Head of Multi-Sector
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Head of Asia Credit Research

Michael Siviter
Senior Fixed Income
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Avi Hooper
Portfolio Manager

Scott Case
Portfolio Manager

Currency Outlook

USD: Underweight. We expect the US dollar to broadly depreciate versus other currencies. The Fed has initiated a major policy shift by moving toward an average inflation targeting regime. US monetary policy is likely to sharply reduce real yields in the US below the levels experienced in other countries. We believe this will lead to meaningful dollar depreciation.

EUR: Neutral. We continue to expect the euro to be rangebound on a broad basis over the coming months, but expect it to perform versus the US dollar in a wider US dollar declining environment.

RMB: Overweight. The strong performance of the renminbi has been on the back of a relatively weak US dollar, despite headlines related to Chinese tech companies and sanctions. Flows have continued to be positive for Chinese assets and China's balance of payments account has shown "speculative inflows" versus outflows in Q1 2020. As China has contained the coronavirus with a significantly reduced number of new cases, we see room for China's assets, including the renminbi, to outperform. In the medium term, we see room for it to trade down to 6.7-6.8.

JPY: Overweight. Although the yen has underperformed the euro over the last month, it has appreciated versus the US dollar and most major EM currencies, such as the Chinese renminbi. The prospects for further yen appreciation look positive going forward, as headwinds from mergers and acquisitions and public pension fund outflows are fading and stronger exports (as global growth recovers) and the likely increase in foreign exchange hedging (especially of US dollar assets) should provide positive tailwinds going forward.

GBP: Underweight. As the only possible Brexit deal available ahead of the end of the transition period on 31 Dec. is a basic goods-only, zero-tariffs and zero-quotas free trade agreement, the upside for sterling appears fairly limited, even if a Brexit deal is agreed, which is not certain. Services trade will likely not be covered and goods trade will likely see increased friction due to customs red tape. The likely Brexit deal is inferior to former Prime Minister May's Chequers plan, but somewhat better, particularly for agriculture, than a No Deal outcome.

Beyond Brexit, it appears unlikely that the UK will outperform economically in the post-COVID-19 world, due to the relative lack of policy space for further easing and low levels of household and corporate savings. Sterling is a currency that tends to be correlated to risk assets that offers no carry and relatively high volatility. In our view, there are few compelling arguments to be long sterling, beyond perhaps the market's pessimism.

CAD: Neutral. Canada's terms of trade have bounced back to their average level over the past decade. In our view, valuations of the Canadian dollar look fair overall versus major currencies. Domestic activity is recovering in Canada, but an uneven recovery in the US will likely limit an economic rebound. An expected weaker US dollar environment typically leads to Canadian dollar underperformance. We expect a range-trading environment for the Canadian dollar in the coming months.

AUD: Neutral. The Australian dollar's appreciation has been driven by better global risk sentiment, the rally in iron ore prices, the improving trade balance, the RBA's relatively hawkish stance and Australia's strong performance in containing COVID-19. Unfortunately, most of these tailwinds now appear to have largely played out. The rally in iron is probably going to abate as Chinese fiscal stimulus wanes and Latin American supply returns; the trade balance should normalize as import demand picks up; the RBA has recently restarted QE, and Victoria has re-entered lockdown due to a renewed COVID-19 outbreak.

Contributors

Michael Hyman
CIO Global Investment Grade and Emerging Markets

Joe Portera
CIO High Yield and Multi-Sector Credit

Mario Clemente
Head of Structured Investments

Global Investment Themes

Asset class themes

Investment grade (IG): We are shifting to neutral positioning as duration-adjusted credit valuation screens less cheap, and market technicals soften on greater-than-expected refinancing and tender-driven supply. The market continues to remain supported by the Fed's bond purchasing program and continued strong demand from global investors. However, uncertainty remains about (i) fundamental weakness stemming from the COVID-19-related macro slowdown and (ii) the US November election outcome.

Rationale
Global economic activity has rebounded from historically depressed levels following broad-based economic restrictions aimed at curbing the spread of COVID-19. This rebound seemingly paused in July as COVID-19 cases increased to worrisome levels in several large states, calling into question the pace of economic re-opening. Though the fundamental outlook remains a major uncertainty, investor focus has shifted to corporate liquidity positioning to weather the current downturn. In response to broad-based macro weakness, governments and central banks are providing unprecedented levels of monetary and fiscal stimulus that has both (i) absorbed the initial impact to risk assets yet and (ii) continued to delay and somewhat obfuscate the fundamental deterioration in both (a) corporate operating performance and (b) corporate balance sheets. The Fed's bond purchasing programs announced on March 23 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 both corporate liquidity and the broader financial system, corporate leverage will undoubtedly rise, and fundamentals will likely remain materially weaker as companies work through COVID-19-related impacts over the ensuing several quarters.

Offsetting record levels of new issuance and fundamental uncertainty is technical demand, which remains quite strong. The Fed's targeted bond purchases - spread across primary and secondary market programs - send a clear message that it is both willing and able to support the orderly functioning of corporate bond markets, as it pertains to the importance of a stable financial system. The Fed's announcement of bond market activities has resulted in massive inflows of capital into the corporate bond market and supported spread tightening from levels not seen since the global financial crisis.

Having already eclipsed full-year 2019 levels, we have expected the cadence of new bond issuance in the second half of 2020 to revert to a more normalized level. However, a favorable interest rate environment continues to support new issuance activity aimed at (i) refinancing and (ii) opportunistic tendering, driving elevated supply expectations through September. When coupled with the recently slower pace of Fed purchases in the secondary market, we now have a somewhat less constructive assessment of the technical environment, given shifting issuance expectations.

The outlook for corporate fundamentals continues to evolve, especially in sectors more exposed to COVID-19-related economic restrictions. With the Fed's support, 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 ratings-sensitive investors. Accordingly, spread dispersion within the index and among names most at risk of downgrade continues to persist, underscoring the necessity to remain vigilant in both sector allocation and security selection.

In Europe, we continue to expect market technicals to remain the prevailing driver of European IG credit spreads in the near term. As such, our outlook is positive, given the significant backstop that the ECB is providing to the market through its QE program. The ECB has upsized its bond-buying program to €1.35 trillion and IFI estimates the ECB is buying around €10 billion of corporate bonds per month (or around 1% of the outstanding eligible index).[1] While new supply should pick up after the seasonally quiet summer months, we do not expect a return to the H1-2020 levels, as corporates have created significant liquidity reserves already. Additionally, the tender and refinancing activity we are seeing in the US is not being repeated in Europe, given that negative European risk-free rates and lower "all in" financing costs for issuers have been a feature of this market for some time.

While European IG valuations have recovered significantly from the COVID-19 sell-off, we see a good level of dispersion within this; specifically, we continue to favor subordinated parts of the IG capital structure in issuers and sectors that we feel will be relatively protected from the fundamental headwinds of the virus. In a global negative real yield environment, we expect these parts of the market to continue to compress, as investors hunt for "high quality" returns.

IFI strategy
We have shifted to a neutral position in US and Asia IG, while remaining selective and opportunistic in European IG credit. Global central bank support remains in place to combat further challenging scenarios for corporate fundamentals, suggesting a healthy degree of near-term downside protection for global IG credit, in our view. Valuations, especially when adjusted for a near all-time high duration in the US, have tightened following the announcement of fiscal and monetary policy support measures and provide a growing headwind when evaluating risk-adjusted credit valuation. Key market drivers we are monitoring include (i) the potential for a moderation in the new issue cadence (i.e., a slowing of supply) during the second half of the year, (ii) recovering corporate fundamentals as global economies experience normalizing levels of economic activity, (iii) continued market support from policymakers and (iv) global management of the coronavirus, which has direct impacts on consumer demand and confidence. 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, supporting our preference for subordinated financial paper issued by fundamentally strong "core" European banks and selective corporate hybrid issuers.

[1] Source: ECB, June 4, 2020, Invesco, August 28, 2020.

US residential mortgage-backed securities (US RMBS): Housing has been resilient though risks remain; we favor higher quality RMBS

Rationale

Housing market fundamentals continue to excel relative to other sectors of the economy despite the pandemic-driven landscape. We expect this strength to continue in the near term as inventory levels remain extremely low, and affordability has risen to multi-year highs on declining mortgage rates. However, the challenging macroeconomic environment and eventual dissipation of pent up demand represent longer-term headwinds, especially in geographic markets with disproportionate exposures to COVID-19-related job losses. Meanwhile, RMBS market technicals remain firm, as investors seek yield amid a modest decline in issuance activity and limited secondary supply.

IFI strategy

The relative value offered by the sector has improved modestly following recent underperformance. We currently favor higher-quality credits due to greater liquidity and structural buffers against pandemic-driven economic uncertainty. Senior classes collateralized by Non-Qualified Mortgage loans remain compelling relative to comparable profiles in the corporate and consumer ABS sectors, in our view. While there are pockets of value in tranches further down the capital structure, cash flow profiles are idiosyncratic and detailed underwriting remains critical.

US commercial mortgage-backed securities (US CMBS): Market sell-off and Fed intervention create potential opportunity in senior CMBS

Rationale

We believe risk premiums have overshot in the recent COVID-19-related market sell-off, creating opportunities to capitalize on attractive risk-adjusted returns in senior non-agency CMBS.

The COVID-19 pandemic and related decline in economic activity have negatively impacted commercial real estate. Lodging and retail property markets have been the most impacted due to travel restrictions and a slowdown in retail activity. Looking ahead, we expect many tenants to continue to forego rent payments or seek relief.

Despite our expectations for notable fundamental weakness, we believe bonds at the top or near the top of the capital structure offer attractive value as they've been impacted by a lack of liquidity just as much as by heightened concerns regarding COVID-19. We believe the Fed's Term Asset-Backed Securities Loan Facility (TALF), along with limited new issuance volumes, provides support for senior bonds. In contrast, subordinate bonds must be carefully selected as government support is lacking and idiosyncratic risk has spiked.

IFI strategy

We believe attractive valuations, combined with Fed support and the substantial subordination available in CMBS, have helped to create attractive opportunities in senior CMBS.

US asset-backed securities (US ABS): Fundamentals temporarily supported, cautious outlook, but potential opportunities remain in senior ABS

Rationale

The short-term positive impact of payment deferrals offered by lenders, recent stimulus packages and federal unemployment benefits are set to expire or be reduced in the coming weeks and months. Despite our expectations of near-term fundamental weakness, there are several opportunities to add benchmark and non-benchmark ABS, given robust structures and credit enhancement. In addition, technical trends remain supportive in both the primary and secondary markets. The recent demand/supply imbalance has contributed to the strong rally in ABS spreads.

IFI strategy

We continue to focus on the capital structure, given our weaker views on fundamentals. There are opportunities to add non-benchmark assets, which have trailed the spread rally in benchmark ABS to date. While esoteric ABS new issue supply has increased on positive technical momentum, we have mostly avoided adding. In the secondary market, we continue to find it difficult to pick up decent-sized positions in the names we like. Despite the strong rally in spreads, most ABS remain attractive to generic corporates, in our view, except bank credit card and prime auto loan ABS. Select esoteric ABS, such as aircraft, remain under considerable pressure.

High Yield (HY): Continued economic improvement into the second half of the year is likely to be supportive of risk assets, including high yield

Rationale

The global economy is recovering from COVID-19, but the pace of recovery varies by country. We have seen better than expected earnings profiles from many industries in Q2, with management commentary suggesting growing revenues for Q3 as well. This improvement in credit quality bodes well for spread levels and enterprise values, in our view. Many companies have accessed the new issue market to refinance and extend near-term maturities. These new issues have been met with robust demand as investors continue to allocate capital to the asset class. While we acknowledge the strong rally since March, we still see attractive investment opportunities in the new issue and secondary markets. We continue to monitor default activity but are not overly concerned, given the backward-looking nature of defaults.

IFI strategy

With the fundamental picture incrementally improving, we are focused on sectors and companies that still offer attractive value. Our fundamental credit research suggests that industries like autos, housing and construction seem better positioned than airlines, restaurants and certain leisure businesses. While the rally in the high yield market has been significant, we continue to find alpha opportunities at the sector and individual security level.

Emerging Markets (EM): Inflows likely to pick up on reasonable valuations and the hunt for yield

Rationale
We expect EM to broadly follow the recovery in developed markets as the return of global demand remains key for small open EM economies. However, differentiation will likely become more important with fundamentals tied to pre-COVID-19 initial conditions, the COVID-19 policy mix followed by individual countries and the reality on the ground in terms of the easing of lockdowns and "second-wave" risks. Several big countries look vulnerable regarding macro and COVID-19-related weaknesses, including Turkey, Brazil and South Africa, in particular. Mexico and Russia look strong among bigger countries, and Latin America as a region appears to be lagging the recovery. We think the smaller manufacturing-based economies in Europe are well-positioned for the developed market recovery, as well as a number of Asian economies, such as South Korea.

We also seek to single out economies that can benefit from the secular trend toward the regionalization of supply chains, in the face of potential weakening in global trade. US elections add a new element of uncertainty in this respect.

IFI strategy
We are turning more cautious amid a mix of US election uncertainty and the likely resumption of heavy issuance across EM, as budget funding needs rise. We favor hard currency assets in EM. We prefer a mix of higher-quality names in the EM IG space but are looking to rotate into higher-grade HY and selected low dollar price names. We think falling volatility and the hunt for yield will continue to drive inflows into the EM asset class, eventually including EM local debt more broadly, despite diminishing carry and uncertainty around growth. We think growth-sensitive, low yielding EM currencies may start to appreciate against the US dollar, the first being Central and Eastern European and high-grade Asia currencies. In the meantime, we like to take advantage of carry and roll in some pockets where local yield curves are steep, and credit risks are well understood. We believe Russia, Mexico and Indonesia offer value in the long end.

Sector themes

The US consumer: Monitoring the impact of COVID-19 and fiscal policy

Rationale
The consumer has transitioned from tailwind to headwind in the past few months as many services have shut down or reduced capacity to slow the spread of COVID-19. Travel, dining, personal care, entertainment, auto, and discretionary retail have all fallen significantly, resulting in millions of layoffs and economic hardship. While we believe a recovery is inevitable, it will likely be slow, tenuous, and incomplete until a vaccine is approved or effective treatments are discovered.

IFI strategy
We are focused on companies that are either positioned to continue generating profits through the pandemic or have a balance sheet strong enough to ensure survival until demand recovers sufficiently to restore profitability. We still see value in home building and home improvement, auto part retailers and travel focused on leisure.

Contributors

Robert Simnick
Senior Fixed Income Trader

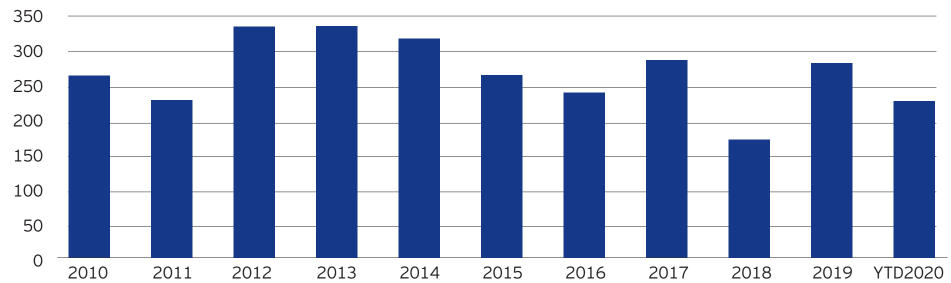
Dierdre Strickland
Senior High Yield Trader

New Corporate Debt Issuance and its Impact on Markets

In this article, we highlight new issue market dynamics with insights from our high yield and investment-grade trading desks. Their in-depth assessment of market technicals and expectations for future trends is a critical part of our credit strategy work across the Invesco Fixed Income platform.

Record-breaking corporate bond issuance in 2020
As of mid-August, new issuance in the US high yield market had already reached the second-highest monthly figure on record. High yield issuance topped USD49 billion mid-way through August, sending the year-to-date total to over USD285 billion, a 56% increase over the same period last year. Breaking it down by credit quality, 41% of this year's new supply has been rated BB, 23% has been rated B and 6% has been rated CCC. Consumer cyclicals have led the pack with 23% of total issuance, while the energy and technology sectors have priced just 11% and 9% of deals, respectively. Proceeds from most of the deals (67%) have been used for refinancing existing debt, while proceeds from 21% of deals have been raised opportunistically for general corporate purposes. Just under 8% have been used for mergers and acquisitions (M&A).

Exhibit 1. US High Yield Bond Issuance (USD bn)

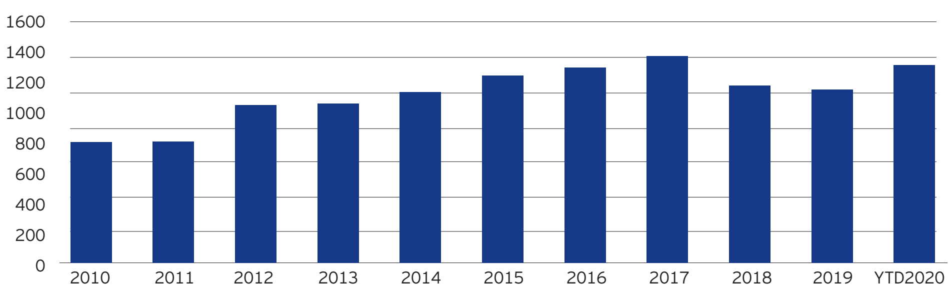


Source: SIFMA, data from Dec. 31, 2010 to July 31, 2020. YTD 2020 is through July 31, 2020.

On the demand side, net flows into high yield stand at USD51 billion year-to-date, on top of USD214 billion in inflows from coupon payments, called bonds and tender offers, which have allowed investors to easily keep up with the supply.

In the investment-grade market, USD1.4 trillion of new debt supply this year already eclipses the prior full-year record set in 2017. The bulk of deals has been in the five, seven and 10-year tenors, representing 63% of the deal volume year-to-date. Just over half of the volume (52%) has been in the BBB rating category. While the financial sector typically represents a large percent of the volume, with this year at 33%, the communications, cyclical and non-cyclical sectors together have made up another third of the volume. Despite over USD500 billion in net issuance year-to-date for the Bloomberg Barclays US Corporate Total Return Index, the energy and basic materials sectors have been effectively unchanged. Issuance has been aggressive in the technology sector, posting strong increases in both nominal and percentage terms despite reasonably strong balance sheets, as companies take advantage of historically low funding costs.

Exhibit 2. US Investment Grade Bond Issuance (USD bn)



Source: SIFMA, data from Dec. 31, 2010 to July 31, 2020. YTD 2020 is through July 31, 2020.

Record low yield in high yield and limited new issue premiums in over-subscribed deals
In the high yield market, many recent new issues have been announced with initial yield guidance that is about 50 basis points cheap to existing bonds. Order books have been consistently over-subscribed, and yields on most deals have tightened to levels that are 0 to 25 basis points cheap to existing bonds. In terms of performance on the break, those deals that have priced at least 25 basis points cheap have tended to trade up by about a point in dollar price, whereas those that have priced closer to fair value have stayed around their new issue pricing, if not a bit lower. While many BB issuers priced deals with yields in the low-to-mid 3% area in August, Ball Corporation priced a 10-year deal at 2.875% on August 10, a historic low level in the high yield market. The bond has subsequently traded close to par.

Investment-grade debt issuers are still finding very favorable borrowing conditions with an average order oversubscription of 4.1 times so far this year and an average coupon compression of 31 basis points from a deal's announcement to its final pricing. This level of compression is nearly twice that seen in 2019. In many cases, the issuer concession (yield premium over existing debt) has been zero or even negative this year. We had been expecting a slowdown in the new issue calendar in recent weeks, but instead, issuers have been racing to price deals with borrowing costs setting new all-time lows. Many blue-chip issuers have recently set new all-time low borrowing cost records (coupons) in their respective deals.

What to expect for the rest of 2020
With rates as low as they are, we expect high yield issuers that need to refinance near-term maturities to continue to take advantage of available funding while they can. We expect September issuance to reach around USD40 billion, USD32 billion of which we expect to be absorbed by near-term inflows from coupon payments, called bonds and tender offers. We expect fourth-quarter issuance to slow with the election cycle to around USD15-USD20 billion per month.

With four full months left in 2020, the investment-grade new issue total is already running 76% ahead of 2019's level. Some estimates indicate that we could see another USD500-600 billion in new issuance by the end of the year and, in our view, this is not out of the question. We expect low costs of borrowing to persist as inflows into credit products remain strong and the Fed maintains its support of primary and secondary credit markets. This year we have witnessed a shift in the use of proceeds of new debt toward refinancing and consolidation versus prior years' focus on M&A and stock buyback programs. We believe this shift is positive for the credit markets overall. We believe it would take a large rotation out of "safe haven" assets for the market to experience increased borrowing costs. Perhaps a viable, widespread vaccine against the coronavirus could cause such a positive change in risk sentiment before the end of the year. But with the Fed now a potentially permanent market feature, after extending its corporate bond-buying program through year-end, we are bracing for lower yields and the potential for increased market fragility.

All data is from Bloomberg L.P., as of Aug. 17, 2020.

Contributors

Mike Kelley
Head of Global High Yield Research

Paul English
Head of US Investment Grade Research

Fabrice Pellous
Senior Credit Analyst

Sam Morton
Head of European Investment Grade Research

Yi Hu
Head of Asia Credit Research

The Bottom Line

Thoughts on Earnings Season 1H 2020: Not Good, but Not as Bad as Feared!

Invesco Fixed Income's (IFI) corporate research team has never been busier as the pandemic pushes to varying degrees on company business models and balance sheets. We speak with the team about what they see as the highlights of the recent earnings season and which areas they are focusing on right now: From High Yield, Mike Kelley; US Investment Grade, Paul English; Europe, Sam Morton; Asia, Yi Hu, and Emerging Markets, Fabrice Pellous.

We came through Q2 with record downgrades and retractions of company forward guidance, as uncertainty reigned. What has drawn your attention from this latest set of company results?

Mike: The sectors most significantly impacted by COVID-19 included entertainment (movies), real estate (hotels and resorts), autos, and restaurants, but management teams have been resourceful. For example, in auto retailers, as the percentage of sales online has increased, we have seen better productivity with lower staffing needs. Food and beverage companies' customer base has shifted. "Pantry loading" has been a major positive sales driver, and the sector posted year-over-year sales and earnings growth.

Paul: The rebound in expectations has been remarkable, and this could be a record high for favorable earnings surprises, at over 20%.[1] Of course, with actual revenue figures down about 10%, this is still not great, and would be the largest year-over-year revenue decline in over 10 years.[2] The energy sector is still recovering from historic commodity price weakness that coincided with the market peak in pandemic-related fear, with associated production shutdowns and planned capital expenditure pullbacks. This impacted the exploration and production sector more than midstream operators. We saw more resilience in the chemicals space, as strong cash generation provided more capital flexibility to offset operating weakness.

Fabrice: With a 10% net beat ("beat" minus "miss") of earnings per share expectations across emerging market corporates, some sectors, including utilities, communications and consumer non-cyclicals, stood out, while energy and financials underperformed. This has been enough to cause Q4 corporate earnings to be revised up further from 3% to 5% over just the last month, which demonstrates the better sentiment we are seeing.[3]

Sam: European companies also significantly beat street estimates, with quite a range of outcomes. It's important to note the resilience of the banking sector as we make the obvious comparisons to the global financial crisis. Capital ratios have improved due to a combination of lower risk-weighted assets, regulatory relief and dividend restrictions. More broadly, we had been concerned about the potential for "kitchen-sinking" by management teams, using COVID-19 as an excuse to make further balance sheet adjustments; however, this has not appeared as a trend.

Yi: As in the US and Europe, Asian companies have benefited from policy-driven relief measures and have seen evidence of early signs of activity returning in China that we noted in April. This is particularly obvious in the property sector where we have revised up our annual sales forecast to a 5% increase from flat at the start of the year, as demand has become more apparent.

Looking ahead, where do you see the key opportunities and/or risks?

Mike: The improvement in advertising revenues from a 50% decline in April to a 25% decline in July is a promising trend for second-half recovery and, while packaging companies remain somewhat cautious, we see solid footing in end markets, which should be supportive.[4] Gaming is also a notable sector where, despite the challenges, over 85% of casinos have successfully reopened with profits on a par with previous peaks, year-over-year, demonstrating great resilience in bridge financing and managing down cash burn/costs.[5]

Paul: The Fed's unprecedented buying of corporate bonds has had a massive impact on the market. We continue to evaluate the key COVID-19-impacted sectors such as travel and "bricks and mortar" retail, but we see improvements in the energy sector, as the price of crude recovers further. Corporate fundamentals remain stressed and it is difficult to see a "V"-shaped recovery, making our investment decisions at current technically supported levels critical.

Sam: We continue to see value in the subordinated securities of corporates and banks that we like from a fundamental perspective. Our bank analysts are very clear on the continued conservative nature of bank lending. We have not seen a particular uptick in loan demand and expect that banks' credit standards are more likely to tighten.

Fabrice: Looking at relative value from the perspective of spread, versus rating category average, and mapping that against our latest earnings per share growth expectations, we see interesting opportunities in real estate, industrials, pulp and paper and metals and mining. The technology, media and telecom sector is projecting strong growth, but there is not much value on offer, in our view. From a regional perspective, some Middle Eastern companies look attractive, but we are conscious of geopolitical risks.

Yi: We would highlight some divergent trends at the country level. For example, well provisioned banks in Korea and Thailand have more runway to support credit growth, which has already started to taper elsewhere. However, the ability to generate incremental profits may fall from here, as central bank interest rate cuts start to compress asset yields and net interest margins.

1 Source: Factset, data as of August 20, 2020.
2 Source: Factset, data as of August 20, 2020.
3 Sources: Company reports and Bloomberg, L.P. August 20, 2020.
4 Source: Invesco estimate, as of August 20, 2020.
5 Source: Invesco estimate, as of August 20, 2020.

Conclusion

This has been one of the most eagerly anticipated and fascinating earnings seasons in recent memory. Our teams have pored over the data and messaging from companies around the world. The ability of companies to find incremental ways to improve productivity and find cost savings continues to surprise to the upside, as we see these trends accelerated by the acuteness of the pandemic.

Please read the Investment risk section at the end of this publication.

Invesco Fixed Income

Team Contributors

Senior Editor – Ann Ginsburg

Atlanta

Rob Waldner
Chief Strategist and Head of Macro Research
+1 404 439 4844
robert.waldner@invesco.com

James Ong
Director-Derivative Portfolio Management
+1 404 439 4762
james.ong@invesco.com

Noelle Corum
Associate Portfolio Manager
+1 404 439 4836
noelle.corum@invesco.com

Avi Hooper
Portfolio Manager
+1 404 439 4877
avi.hooper@invesco.com

Scott Case
Portfolio Manager
+1 404 439 4775
scott_case@invesco.com

Michael Hyman
CIO, Global Investment Grade and Emerging Markets
+1 404 439 4827
michael.hyman@invesco.com

Joseph Portera
CIO, High Yield and Multi-Sector Credit
+1 404 439 4814
joseph.portera@invesco.com

Mario Clemente
Head of Structured Investments
+1 404 439 4614
mario.clemente@invesco.com

Paul English
Head of US IG Research
+1 404 439 4819
paul.english@invesco.com

Dierdre Strickland
Senior High Yield Trader
+1 404 439 4769
dierdre.strickland@invesco.com

Mike Kelley
Head of Global High Yield Research
+1 404 439 4862
michael.kelley@invesco.com

Ann Ginsburg
Head of Thought Leadership, Fixed Income
+1 404 439 4860
ann.ginsburg@invesco.com

Chicago

Robert Simnick
Senior Fixed Income Trader
+1 630 684 6715
robert.simnick@invesco.com

London

John Greenwood
Chief Economist
+44 20 3753 0500
john.greenwood@invesco.com

Adam Burton
Assistant Economist
adam.burton@invesco.com

Gareth Isaac
Head of Multi-Sector Portfolio Management
+44 20 7959 1699
gareth.isaac@invesco.com

Michael Siviter
Senior Fixed Income Portfolio Manager
+44 20 7034 3893
michael.siviter@invesco.com

Sam Morton
Head of European Investment Grade Research
sam.morton@invesco.com

Fabrice Pellous
Senior Credit Analyst
+44 20 3219 2731
fabrice.pellous@invesco.com

Hong Kong

Yi Hu
Head of Asia Credit Research
+852 3128 6815
yi.hu@invesco.com

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