Global Fixed Income Strategy

Invesco Fixed Income

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Outlook for Fed Policy: Near-Term, Longer-Term

In November 2018, the US Federal Reserve (Fed) announced that it would conduct a broad review of its monetary policy framework. The new framework will likely shape monetary policy in the coming years. What do we expect from this soon to be concluded policy review? The main change in the Fed's policy framework will likely be in the way that it manages inflation, namely a switch to more flexible "average inflation targeting". This approach would differ from the Fed's current approach, which targets inflation over the next couple of years at a two percent rate. Under the current regime, if the Fed fails to meet its target, bygones are bygones and there is no attempt to "correct" for the difference between actual inflation and the target. But the current strategy creates a downward bias in inflation relative to the target. During recessions and early in a recovery, inflation typically remains low and below the Fed's target. In the later stages of a recovery, the Fed aims to keep inflation at the target, meaning that inflation may tend to average below the target over a business cycle. That has been the experience in the US since the last recession. If that is the case going forward, the public and markets could expect inflation to average below two percent, causing wage and price-setting behavior to settle below the target rate.

In average inflation targeting, however, the Fed would aim to keep inflation on target over a longer time frame. If inflation runs below the target for a period of time, the Fed would compensate for the shortfall by encouraging above-target inflation for some time. In this approach, bygones are not bygones. The Fed believes this new strategy would remove the downward bias to inflation and better anchor it at the two percent level, which could help avoid the low inflation problem experienced in the eurozone and Japan.

How to achieve two percent inflation on average?

One question that comes to mind is whether the Fed can achieve two percent inflation on average, given that the Fed's policy rate is effectively at zero and that it is already undertaking quantitative easing (QE). Despite this proactive policy response, the bond market and the Fed's own expectations suggest that inflation will likely be below-target for many years to come. Would changing the target mean anything, if the tools to achieve it are not available? Could the Fed try to do more, by pushing its policy rate to negative, or by trying to control the yield curve by using yield curve control (YCC), a method currently undertaken in Japan?

We believe negative interest rate policy in the US is unlikely. First, the benefits of negative rates on the economy are still uncertain. The evidence of the positive effects of negative interest rates in other countries is mixed at best. And in the US, policy makers have almost no appetite for negative rates. When this issue was discussed in a Federal Open Market Committee (FOMC) meeting last year, "All participants judged that negative interest rates currently did not appear to be an attractive monetary policy tool in the United States".[1] With this level of consensus, we believe it is unlikely that negative rates will become a policy reality. Moreover, the FOMC judged that the impact of negative rates on the willingness of banks to lend and consumers and firms to borrow and support credit expansion was uncertain.

What is the Fed's view on YCC, which targets or caps interest rates across the yield curve up to some maturity? The Fed has been discussing this option for some time. In the minutes of the June FOMC meeting, there was a clear lack of consensus for that option, but it was not ruled out. According to the minutes, "...nearly all participants indicated that they had many questions regarding the costs and benefits of such an approach" and only a couple seemed to strongly advocate that it "...could serve as a powerful commitment device for the Committee".[2] This may be a discussion for another day.

[1] Minutes of the Federal Open Market Committee, Oct. 29-30, 2019.
[2] Minutes of the Federal Open Market Committee, June 9-10, 2020.

What tools are we left with?

Going forward, we expect the Fed to use a mix of forward guidance and QE to achieve its revised inflation objective. And there is reason for optimism that it will achieve its objective. It is true that inflation has averaged below the Fed target between the two recessions – the one following the global financial crisis and the current one. But the Fed did achieve its two percent target in the last cycle and began a hiking cycle, that, in retrospect, looks a bit premature. Most analysts would now agree that the US could have run somewhat looser policy without overheating the economy. Next time around, the Fed will probably be more patient. The revised policy framework would likely allow the Fed to briefly and modestly overshoot its two percent target. That flexibility and patience would likely allow the Fed to keep monetary policy simulative for longer.

While the timing is not certain, we expect the Fed to announce its new framework at the September meeting. That announcement will likely be coupled with strong forward guidance to support the recovery. Fed policy during the Covid-19 crisis has, so far, focused on the repair of market functioning and the flow of credit during an exceptionally uncertain and turbulent time. Going forward, the Fed will likely focus on economic recovery. We expect it to condition its policy rate on achieving the revised inflation target. That would mean not raising interest rates until inflation is expected to be around two percent on a sustainable basis. Given the depth of the recession, high level of unemployment and the disinflationary shock facing the economy, this would likely mean interest rates at the zero-bound for many years to come.

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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%. However, 10-year US Treasuries are likely to trade below this level while the economy remains in the current slow growth/low inflation regime caused by the virus. We expect the federal funds rate to stay near zero as well. US Treasury issuance in the long end may cause the yield curve to steepen in the 10 to 30-year portion of the curve. Undervalued inflation breakevens may benefit from Fed policy.

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. The People's Bank of China's (PBoC) recent speeches, monetary policy reports and commentaries have been more hawkish than earlier this year, with an exit to easing being mentioned. China's economic recovery path and capital market risk sentiment (as reflected by strong onshore stock market performance) may continue to drive bond market performance in the near term. The China-US 10-year government bond yield differential has reached a multi-year high. With currency stability likely in the near term, the yield pick-up versus developed market government bonds may present interesting opportunities for international investors.

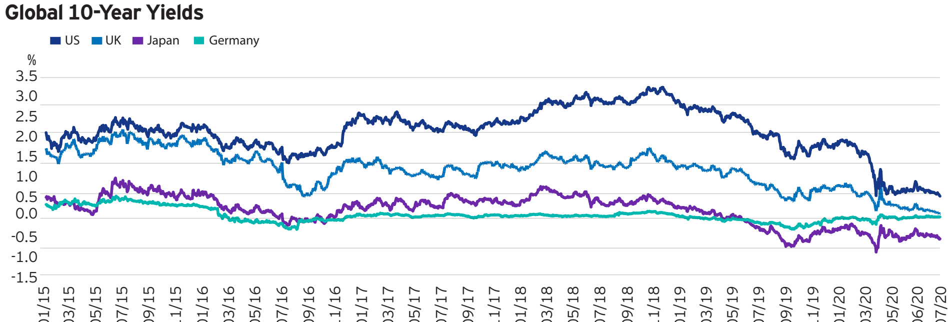
Japan: Neutral. Japanese government bond (JGB) yields jumped in the early part of July after the increase in BoJ QE operations was smaller than expected, resulting in a large increase in net JGB supply following the second supplementary budget. However, bond yields have recently reversed the move higher, largely due to the fall in offshore yields. Going forward, it is likely that JGB yields will largely track global yields with a low beta, as the BoJ appears unwilling to aggressively push yields lower, particularly 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 levels. We believe this limits the scope for JGB underperformance, especially taking into account Japan's relatively low level of inflation.

UK: Underweight. Although it is possible that the Bank of England (BoE) may eventually adopt negative interest rates, longer-term forward rates appear to offer insignificant risk premia in the context of a recovering economy and the tapering of BoE QE. Gilts look particularly poor value relative to other international markets, in our view, which offer higher real yields and more term premium.

Canada: Overweight. The Canadian economy has bounced back from the sharp economic contraction, but will likely take an extended period of time to recover to its previous size. The Bank of Canada has made it clear that the key lending rate will remain at the lower bound for at least the next two years. Monetary policies should continue to encourage strong demand for the longer end of the domestic yield curve and corporate credit risk. Weak economic fundamentals and strong market technicals continue to support our constructive stance.

Australia: Neutral. The recent resurgence of Covid-19 in Australia and the US has increased downside risks to the economic recovery, limiting the upside for yields in the short term. However, should the recovery survive this second wave of infections, yields will likely move higher over time, as the market increases the term premium. Australian rates have recently underperformed US Treasuries, gilts and Canadian government bonds due to the Reserve Bank of Australia's hands-off stance. However, high long-term forward rates and a steep yield curve are increasingly making Australian government bonds look attractive on cross market basis, in our view.

Global 10-Year Yields



Source: Bloomberg L.P., Jan 2, 2015 to July 31, 2020. **Past performance is not indicative of future results.**

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Currency Outlook

USD: Underweight. We expect the US dollar to broadly depreciate versus other currencies. The US monetary policy reaction to the Covid-19 crisis has reduced real yields to levels sharply below those of most other countries. We believe this will lead to meaningful dollar depreciation. In addition, the US public heath response to Covid-19 points to an earlier economic recovery than in many other countries. This indicates that policy in the US is likely to stay easy for a long time, further increasing the likelihood that the dollar depreciates.

Euro: 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. International portfolio flows have been positive for China onshore assets. China's balance of payments account has already shown "speculative inflows" versus outflows in Q1 2020. In the medium term, we see room for the renminbi/US dollar exchange rate to trade down to 6.7-6.8. However, in the near term, it may continue to trade in the range of 6.90-7.15, given concerns over the potential deterioration in the US-China relationship and related headlines.

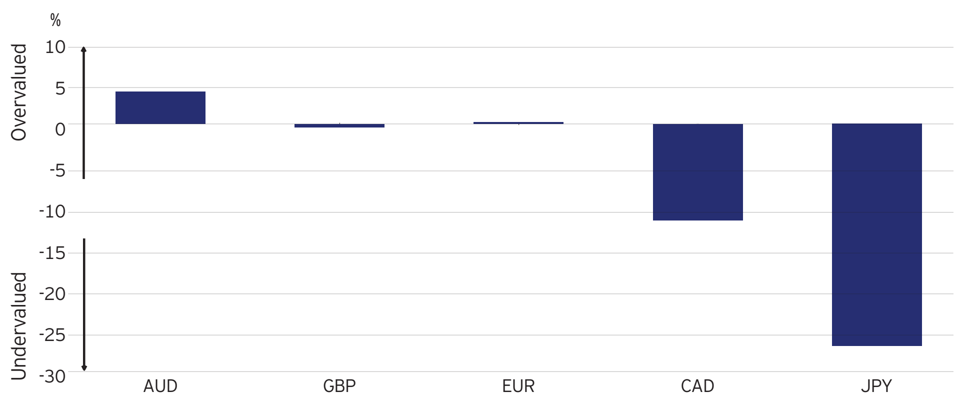
JPY: Overweight. Although, the yen has underperformed the euro over the last month, it has appreciated versus the US dollar and most major emerging market currencies, such as the Chinese renminbi. The prospects for further yen appreciation look positive going forward, as headwinds from mergers and acquisitions 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) will likely provide positive tailwinds going forward.

GBP: Underweight. Brexit negotiations have not broken down completely but neither are they showing decisive progress, increasing the chance of rising stress as we head toward the Dec. 31 cliff edge, when the transition period ends. Indeed, as the Head of the Task Force for Relations with the UK, Michel Barnier, has pointed out, the practical deadline to reach an agreement is actually Oct. 31, as two months will be required to ratify it. It is possible that out of frustration, the EU will wish to demonstrate the cost of a No Deal to prevent any misconception that this is a relatively low-cost exercise. However, given that any deal will likely be relatively limited in scope, the actual gap between No Deal and a deal is relatively limited in macroeconomic terms, making the opportunity cost of breaking off talks relatively limited, especially if the domestic political costs appear greater.

CAD: Neutral. Canada's strong export ties with the US should continue to anchor its direction going forward. Relative underperformance against other currencies is expected, as the US economic recovery is uneven as the virus remains uncontained. Higher global commodity prices and weak domestic demand could provide some positive support to the Canadian dollar, but it is more likely to remain rangebound in a weak US dollar environment.

AUD: Neutral. The Australian dollar trade-weighted index has continued to appreciate over the last month, however, the upside catalysts of improving commodity prices and global risk sentiment have largely played out, likely limiting the upside from here. Iron ore prices should moderate going forward as Brazil supply resumes and the normalization of travel should increase tourism imports into 2021. Australia's own lockdown might also limit the performance of domestic data.

Valuations of Major Currencies Compared to Purchasing Power Parity (PPP)



Source: Bloomberg L.P., July 31, 2020.

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Global Investment Themes

Asset class themes

Investment grade (IG): Selectively and opportunistically adding risk where we stand to benefit from (i) Fed bond purchasing programs driving (ii) continued strong technical demand from global investors, in spite of (iii) record levels of new issue supply and (iv) material uncertainty of the degree of fundamental weakness stemming from the Covid-related macro slowdown.

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 (ii) continues to delay and somewhat obfuscate the fundamental deterioration in corporate operating performance and balance sheets. The Fed's bond purchasing programs announced on March 23 thawed an otherwise frozen new issue market in US corporates, paving the way for historic levels of issuance in April, May and June. While this issuance has alleviated pressure on both (i) corporate liquidity and (ii) the broader financial system, corporate leverage will undoubtedly rise, and fundamentals will likely remain materially weaker as companies work through Covid-related impacts over the ensuing several quarters.

Offsetting record levels of new issuance and fundamental uncertainty, technical demand remains strong. The Fed announced an aggregate USD750 billion of targeted bond purchases spread across its primary and secondary market programs. These programs are a clear message that the Fed has both the willingness and ability 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 expect the cadence of new bond issuance in the second half of 2020 to revert to a more normalized level. However, with the Fed continuing purchases in the secondary market and fund flows remaining a tailwind, the technical environment should remain supportive of overall corporate spreads and remains the core pillar of our constructive near-term outlook for US IG spreads.

The outlook for corporate fundamentals continues to evolve, especially in sectors more exposed to Covid-related economic restrictions. With the Fed's support, the new issuance market has allowed even the most challenged sectors to raise liquidity, 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 selective in sector and security allocation.

Similarly, in Europe, we feel market technicals will remain the prevailing driver of European IG credit spreads in the near-term. As such, our outlook is positive as (i) the ECB has increased its Pandemic Emergency Purchasing Programme ('PEPP') by a further EUR600 billion to a total of EUR1.35 trillion; the ECB has so far targeted sovereign bonds and commercial paper, but we expect corporate bond purchases to pick up, (ii) inflows into the asset class continue as investors "follow the central banks" and (iii) we expect supply in the second half of 2020 to slow sequentially as the recent wave of liquidity-driven issuance tapers off.[1]

Q2 earnings season has shown weakening corporate fundamentals for European issuers as a result of Covid-related impacts, with the greatest pressure on industrial and cyclical firms alongside the leisure and travel industries. However, companies are moving back toward "early credit cycle" dynamics. This should be positive for bondholders as/when the macroeconomic backdrop improves and free cash flow generation is diverted to debt paydown at the expense of dividends and share buybacks. Bank balance sheets are much stronger versus 2008/2009, although loan loss provisioning will likely increase as small and medium sized enterprises feel the greatest pressure on funding lines.

IFI strategy
We selectively and opportunistically maintain overweight positions in US and European IG credit as global central bank support remains in place to combat a challenged near-term outlook for corporate fundamentals. While valuations have tightened following the announcement of fiscal and monetary policy support, an improving fundamental outlook could be buoyed by a supportive technical market backdrop. Key market drivers we are monitoring include 1) the potential for a moderation in the new issue cadence (aka a slowing of supply) during the second half of the year, 2) recovering corporate fundamentals as global economies re-open, 3) continued market support from policy makers and 4) global management of the coronavirus, which has direct impact on consumer demand and behavior. In Europe, dispersion within the asset class remains key and we would expect the next leg of any rally to be driven by further beta compression, continuing to favor subordinated financial paper issued by fundamentally strong "core" European banks and selective corporate hybrid issuers.

[1] Source: ECB, Invesco, June 26, 2020.

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, we believe 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 supply/demand imbalance has contributed to the strong rally in ABS spreads.

IFI Strategy
We continue to focus up the capital structure, given our weaker views on fundamentals. We see opportunities to add non-benchmark assets, which have trailed the spread rally in benchmark ABS to date. Most of the recent new issue supply has been in benchmark ABS and in the secondary market it is difficult to pick up decent sized positions in the names we like. Despite the strong rally in spreads, most ABS remain attractive relative 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.

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

Rationale
The housing market remains resilient in the face of the ongoing Covid-19 pandemic. Forbearance and delinquency rates appear to have peaked absent another widespread economic shutdown. Tight housing supply and robust demand driven by low mortgage rates should limit the downside in home prices, though high unemployment will likely slow household formation in the coming months and reductions in borrower relief programs may impact performance. Meanwhile, RMBS market technicals remain firm despite an active new issue calendar.

IFI Strategy
With spreads remaining well wide of pre-Covid tights, we believe the sector offers compelling opportunities relative to similar profiles across other fixed income sectors. We believe the gap is likely to close more quickly in senior classes as risk premiums on lower rated securities with greater credit exposure should remain elevated until the pandemic is better contained. We prefer investment grade-rated Fannie Mae and Freddie Mac credit risk transfer securities over higher yielding classes. Finally, senior classes collateralized by Non-Qualified Mortgage loans remain compelling relative to comparable profiles in the corporate and consumer ABS sectors, in our view.

High yield: While uncertainty remains, we expect continued economic improvement in the second half of the year to support high yield

Rationale
While we acknowledge the uncertainty regarding the immediate path of the global economy, our base case calls for an improvement in growth in the second half of the year. Despite the strong performance of the high yield market since the March lows, we believe valuations in the asset class remain attractive. Strong investor demand for new issuance continues to be helpful in the balance sheet repair process. Additionally, while default activity tends to garner media attention, we view recent defaults, and those likely to occur in the coming months, as a lagging indicator and not predictive of future total returns. Despite our estimated default rate of 9% this year, the majority of the price erosion for the bonds of those companies has already occurred.
IFI Strategy: With the fundamental picture poised to improve incrementally, we are focused on sectors and companies that still offer attractive value, as well as those positioned to benefit from "getting back to work" within virus constraints. Our fundamental credit research suggests industries like autos, housing and construction seem better positioned than airlines, restaurants and certain leisure businesses. Idiosyncratic opportunities exist across industrial and consumer cyclical end markets. In sum, despite recent strong performance, our team of analysts continues to find attractive relative value investment ideas that offer compelling total return opportunities.

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

Rationale
EM broadly will likely follow the recovery in the developed markets (DM) as the return of global demand remains critical for small open EM economies. However, differentiation will likely become more important as fundamentals are tied to pre-Covid-19 initial conditions, the policy mix followed by individual countries post-Covid-19 and the reality on the ground in terms of easing of lockdowns and second wave risks. We note that several big countries look vulnerable to macro and Covid-19 related weaknesses, including Turkey, Brazil and South Africa, in particular. Mexico and Russia look particularly strong among the bigger countries. We see Latin America lagging the recovery and think that smaller manufacturing-based economies in Europe are well positioned for the DM 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 to regionalize supply chains in the face of likely continued weakness in global trade.

IFI Strategy
Hard currency remains the asset class of choice in EM, we continue to prefer a mix of higher quality names in EM IG space but are looking to rotate into higher grade HY and selected low dollar price names. We think falling volatility and hunt for yield will continue pushing inflows into EM asset class and eventually this will include EM local debt more broadly, despite diminishing carry and uncertainty around growth. We think growth sensitive low yielding EMFX may start appreciating against the USD first such as CEE and high-grade Asia. In the meantime, we like to take advantage of carry and roll in some pockets where local curves are steep and credit risks are well understood. Russia, Mexico and Indonesia offer potential value in the long end.

Sector themes

The US consumer: Monitoring the impact of Covid-19, 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 resulting in 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, in our view, 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 homebuilding/home improvement, auto part retailers and travel focused on leisure.

Commodities: The pandemic caused significant demand disruption, however, a rebound in economic activity and supportive government policies provide near-term support.

Rationale
Demand for commodities has weakened due to the global Covid-19 pandemic, driven by declining manufacturing activity and oil inventory build-up following the rapid and unanticipated contraction in global demand. However, after significant price declines in March and April, investor sentiment regarding commodities seems to have partially stabilized as prices have strengthened in recent weeks, reflecting (i) a strong rebound in China's industrial activities, (ii) the global implementation of supportive fiscal and monetary stimulus measures, and (iii) Covid-19 related supply disruptions and curtailments.

Issuers' shareholder-friendly capital allocation policies, including large dividend pay-outs and share repurchase programs, have rapidly shifted amid the pandemic toward balance sheet protection measures to protect credit profiles and credit ratings. However, lingering uncertainty about the supply and demand for major commodities remains significant, given the unprecedented level of (i) demand disruption during the pandemic and (ii) consequent level of monetary and fiscal support to economies around the globe. Political tension between China and the US, Iran's growing influence in the Middle East, and OPEC+'s energy policy will likely continue to influence commodity markets.

IFI strategy
We favor iron ore miners in the short term, as Brazilian supply disruption supports price increases. We are underweight the relatively expensive Russian commodity complex, favor integrated Indian energy companies, some high-beta emerging exploration and production companies, which are free cash flow breakeven above USD40 per barrel, and some South American metal miners.

We also remain constructive on hybrid issuances of European energy majors, certain US exploration and production companies with low-cost shale assets and US midstream companies focused on cost of capital optimization and active deleveraging to stabilize or maintain investment grade ratings. Finally, we favor South African gold miners that will likely quickly de-lever their balance sheets on near-record gold prices and weaker local currencies.

Technology, media and telecommunications (TMT): Analyzing Covid-19 benefactors, picking up on 5G where we left off, and looking for the return of sports

Rationale
Covid-19 has accelerated the growth in connectivity and streaming, as people spend more time at home. With a wireless merger behind us and the creation of a new fourth carrier, the market focus will likely turn toward the 5G rollout. In addition, the long-awaited return of sports leagues is pivotal for both teams and media companies, as it continues to remain a significant revenue source for both.

IFI strategy
We remain constructive on assets that benefit from the acceleration in connectivity and streaming demand. 5G build-out activity is likely to gain momentum into next year as we move past the pandemic. We expect infrastructure assets to do well in that scenario. While defensive positions have performed better this year, we are finding value in more cyclical media assets with sensitivity to advertising and the return of sports.

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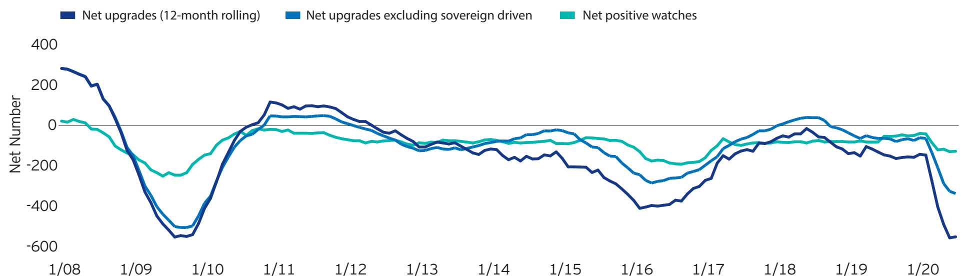
Emerging Market Debt: Compelling Value in a Lower Yield World

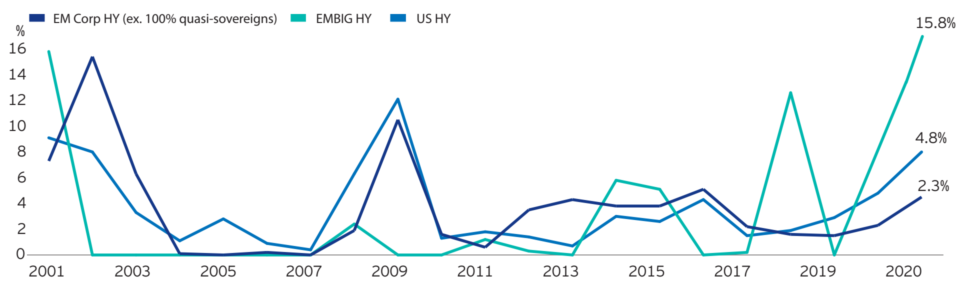
Since the start of the Covid-19 crisis, we have published two pieces highlighting the value in emerging market hard currency debt (IFI Weekly Update April 3, "Sector Focus", and IFI Weekly Update May 4, "Credit Bounceback Supported by Past Fed Action"). While we acknowledged that the global economy, and emerging markets, in particular, face a challenging environment to put it mildly, we also highlighted our belief that valuations of emerging market sovereign and corporate debt provided attractive compensation for the risk. Since our first publication in early April, the emerging markets hard currency sovereign and corporate indices have returned 16.6% and 13.5%, respectively.[1] Notably, these returns were achieved despite elevated numbers of ratings downgrades and defaults (Exhibits 1 and 2).

Exhibit 1: Credit Rating net Upgrades/Net Positive Credit Watches



Source: JP Morgan, data from Jan. 1, 2008 to July 31, 2020.

Exhibit 2: Emerging Market High Yield vs US High Yield Default Rates



Source: JP Morgan, EM Corporate HY is JPM CEMBI Broad Diversified High Yield Index, EMBIG HY is JPM EMBI Global Diversified High Yield Index, US HY is JPM Corporate Credit US High Yield Index. Data from Jan. 1, 2001 to June 30, 2020. **Past performance is not a guarantee of future results.**

The fact that the asset class rallied despite these headwinds underscores the importance of a proper assessment of valuations in analyzing investments. We believe it is as important to understand what is priced in as it is to have a good assessment of future outcomes. As we noted in early April, high yield spreads on the JP Morgan Emerging Markets Bond Index (EMBI) and JP Morgan Corporate Emerging Markets Bond Index (CEMBI) were pricing in cumulative five-year default rates of more than 45%.[2] As it would take an extraordinarily adverse set of circumstances to reach such levels of default, we felt comfortable that the asset class risk-reward was weighted in our favor, even considering the challenging macro backdrop.

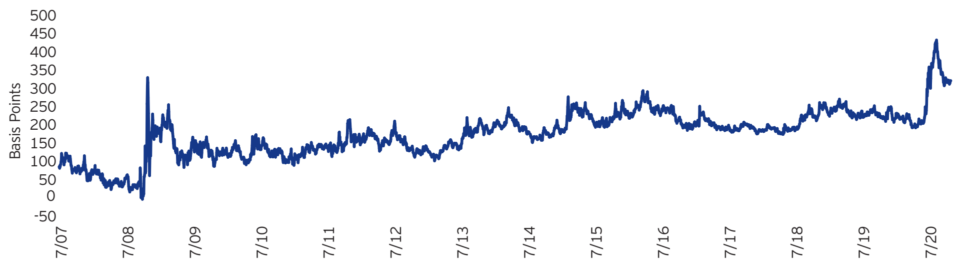
Relative Value Remains Robust

The question now is whether the asset class still offers value after its strong run. Emerging market credit does continue to offer value, in our view, especially when compared to developed market credit. Exhibit 3 shows that, while high yield emerging market sovereigns have rebounded sharply, spreads remain at crisis levels. Exhibit 4 shows that the relative value of emerging markets versus developed markets remains robust.

Exhibit 3: Emerging Market Sovereign High Yield Spread

Source: JP Morgan EMBI, data from Dec. 31, 2007 to June 30, 2020. **Past performance is not a guarantee of future results.**

Exhibit 4: EMBI vs Barclays US Aggregate Corporate Index OAS Differential



Source: JP Morgan EMBI, Barclays US Aggregate Corporate Bond Index, OAS is option-adjusted spread. Data from July 13, 2007 to July 13, 2020. **Past performance is not a guarantee of future results.**

Nevertheless, we believe it is important to be more selective as we have moved past the acute stage of the crisis and valuations are not broadly as attractive as they were in April. Although valuations are still historically attractive (Exhibits 3 and 4), drilling more deeply into the data suggests that most of the value is driven the by the high yield segment of the market, while emerging market investment grade debt has returned to more normalized levels. Exhibit 5 shows that the spread differential between investment grade and high yield remains at its highest level in five years. Given the likelihood of greater pressure on high yield issuers, we think elevated spread premiums are justified. However, we believe current premiums that are well wide of the last decade's periods of market weakness are excessive. While pressure will likely remain on emerging market economies in the medium term, emerging market high yield spreads should return to more normalized levels as the world recovers from this crisis. We believe spread normalization, coupled with the current low interest rate environment and the relatively high carry of the asset class, has the potential to drive strong returns over the next 12 months.

Exhibit 5: High Yield vs Investment Grade Differential (OAS)

Source: JP Morgan EMBI Investment Grade and High Yield, data from July 14, 2010, to July 13, 2020. OAS is option-adjusted spread. **Past performance is not a guarantee of future results.**

Positive Return Outlook

Although the global economy still faces risks related to the pandemic and geo-political tensions and uncertainties, we believe elevated spreads in the high yield segment of emerging markets provide adequate compensation. In many cases, issuers that are most negatively affected by the pandemic, such as Argentina, are trading at highly distressed levels. Other lower rated countries and cyclical credits in the emerging market universe trade similarly where bearish scenarios are priced in. As such, even if the growth rebound takes longer to materialize than anticipated, or is tepid, we believe the asset class should deliver potentially solid returns. In a scenario where the recovery is sharper, returns should be potentially robust. For instance, if EMBI spreads recover from current levels of 442 basis points to the longer-term average of 338 basis points, the index should return above 14%.[3]

Emerging market credit and other higher beta asset classes could experience pressure in the near-to-medium term as the Covid-19 pandemic continues to weigh on the global economy and geopolitical risks remain elevated. Most periods of significant market weakness (such as 2008/2009 and 2001) have been characterized by at least one additional sharp drawdown in asset prices after their initial recovery. It would be a unique situation to see markets continue to grind higher or hold in place from here without any meaningful pullback. However, our own experience and empirical evidence suggest that it is difficult to predict short-term market moves, especially in a highly uncertain environment such as the current one. Rather, we think better investment outcomes may be achieved by taking a longer-term view underpinned by robust analysis of valuations, fundamentals and macroeconomics. On that basis, we think emerging market hard currency debt makes for a compelling investment.

[1] Bloomberg L.P., JP Morgan Emerging Markets Bond Index (EMBI) and JP Morgan Corporate Emerging Markets Bond Index (CEMBI), data from April 3, 2020 – July 29, 2020.
[2] JP Morgan, data as of April 1, 2020.
[3] Invesco, 442 basis points: as of July 27, 2020, 338 basis points average over the past decade: July 27, 2010 to July 27, 2020.

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CIO and Head of Municipals

Stephanie Larosiliere
Head of Municipal Business Strategies and Development

The Bottom Line

Opportunities in US Municipals: Short-Term, High Yield and ESG

Invesco Fixed Income's (IFI) municipal team sees opportunities in various sectors of the US municipal market. We speak with CIO and Head of Municipals, Mark Paris, and Head of Municipal Business Strategies and Development, Stephanie Larosiliere, about where they see value, the impact of government support and the incorporation of ESG.

Question: Where do you currently see opportunities in the municipal market?

Mark: We see an opportunity for investors in the short end of the municipal market. Short-term municipal rates appear attractive right now versus similarly rated taxable bonds. And for those investors still concerned about volatility, they offer a better yield than money market funds, while not adding much potential price volatility.

We also see value in high yield municipal bonds. While investment grade municipals have rebounded, high yield continues to lag due to concerns over future economic growth and the level of economic stress that lower-rated municipal bonds may be able to handle. We believe high yield credit spreads should continue to tighten as the economy re-opens in various parts of the US. Credit research is critical in these times of uncertainty. Because the municipal market represents a large number of issuers with esoteric characteristics, it is important to focus on each individual credit's metrics along with its sector. We believe IFI's exceptional municipal credit team of 22 experienced credit analysts, with an average of nearly 20 years of municipal bond investing experience, provides our active portfolio management team with an edge when it comes to finding hidden gems that may have been cast aside simply due to their sector.

Question: Are there specific sectors or credits that offer potential opportunities?

Stephanie: One example would be healthcare. Although hospitals are under increased stress as the Covid-19 crisis continues, certain hospitals have strong financials and are supported by favorable demographics and geographies. We believe IFI's ability to pick through a sector and identify attractive risk-reward opportunities can potentially add value for our clients. When the market perceives stress, causing prices to decline across a sector, we look to fundamentals to judge whether a particular credit is being priced fairly based on its own merits or is just being lumped in with other credits. This "bond picking" strategy allows us to examine credit worthiness and market sentiment and make thoughtful decisions about what we want to own and not own.

Question: Have any steps been taken to repair liquidity in the municipal market?

Mark: After a hiccup in the late first quarter and early second quarter, primary issuance in the municipal market is functioning normally again. In March, the federal government stepped in to support liquidity in the municipal market, lowering rates on 7-day paper from over 5% to current levels of under 0.5%.[1] The federal government also created the Municipal Liquidity Facility (MLF) which allows the Fed to provide credit to states and local governments through the purchase of short-term municipal notes with maturities of up to 36 months. Both programs have helped relieve stress on secondary municipal market prices and created liquidity for issuers.

Although the municipal market has not benefited from some of the additional programs that have helped the corporate and taxable markets, there have been some positive developments and we believe there may be more to come. IFI has been asked to consult with various government agencies and we continue to provide our thoughts on ways the government could help the municipal market in this time of crisis.

Question: How has the municipal marketplace benefited from various stimulus packages coming out of Washington DC?

Stephanie: The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) provided financial assistance to many issuers in the municipal market when it was signed into law in March. Over USD400 billion directly or indirectly benefits municipal issuers, with USD150 billion going to state and local governments and USD100 billion to healthcare providers, such as hospitals.[2] At the time of publication, discussions in Washington were ongoing regarding additional economic stimulus, with both sides of the aisle agreeing that dollars should flow to state and local governments - the question is, how much? One answer we are fairly certain about is that someone will have to pay for these stimulus packages. This likely means tax increases down the road and a higher value placed on the tax-exemption that municipals provide.

Question: Given the growing importance of socially responsible investing (SRI), how is Invesco incorporating SRI into its municipal strategies?

Mark: Invesco Fixed Income and the Municipal Bond investment team recognize the importance of considering environmental, social and corporate governance (ESG) factors. As a result, ESG analysis has been incorporated into the credit process, including quantitative and qualitative reviews of ESG-related risks and their potential impact on an issuer's credit profile. Specifically, issuer scorecards track data on ESG-related factors, compare them to peers and measure historical progress. Analysts also raise ESG awareness with management teams through active engagement and dialogue.

In making investment decisions, the Municipal team utilizes a proprietary screening tool based on ESG principles. The output is a universe of sectors that we believe provide sustainable value, in addition to labeled

[1] Securities Industry and Financial Markets Association, (5.20%) March 23, 2020, (0.11%) July 10, 2020.
[2] US Department of the Treasury, March 27, 2020.

green bonds. The general overlay is a broad-spectrum approach to impact investing where assets are allocated to available investment opportunities with impact potential. These include opportunities related to the environment, education, housing, healthcare, social improvement, energy efficiency and infrastructure improvements, among other focus areas. We expect to further expand our impact capabilities in September when we convert an existing mutual fund to an environmental focus fund implementing our proprietary methodology to serve investors looking for socially responsible investing options.

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

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