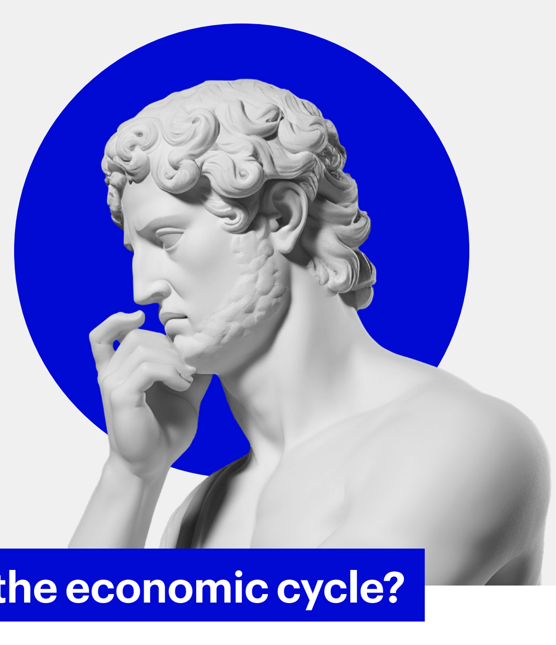
Invesco

Credit's credentials

Nine charts to guide
your fixed income decisions

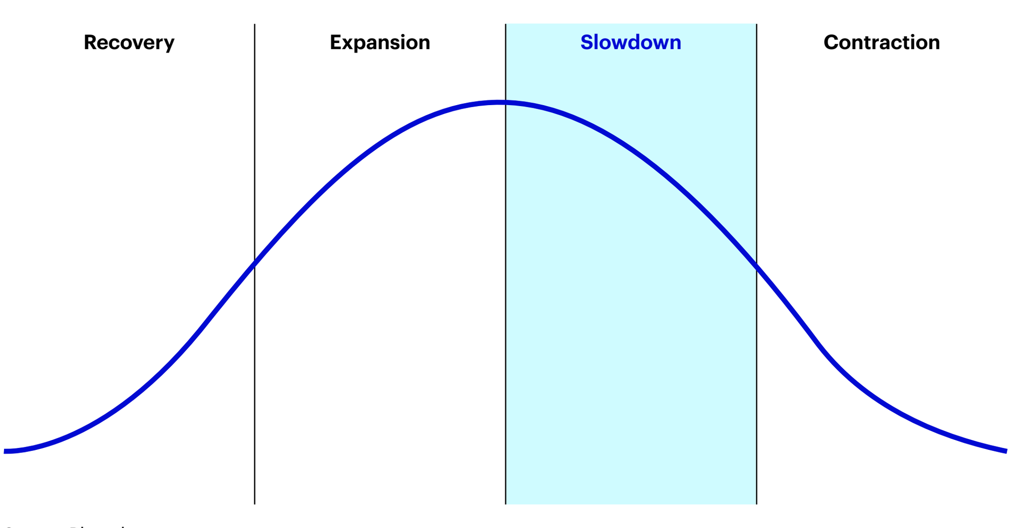
March 2024



Where are we in the economic cycle?

We're currently in the "slowdown" phase of the economic cycle.

"Contraction", also known as "recession", typically follows a period of economic slowdown. This means investors may want to improve the credit quality of their portfolio to avoid the risk of losses, defaults or impairments in the event businesses start to struggle.



Source: Bloomberg.

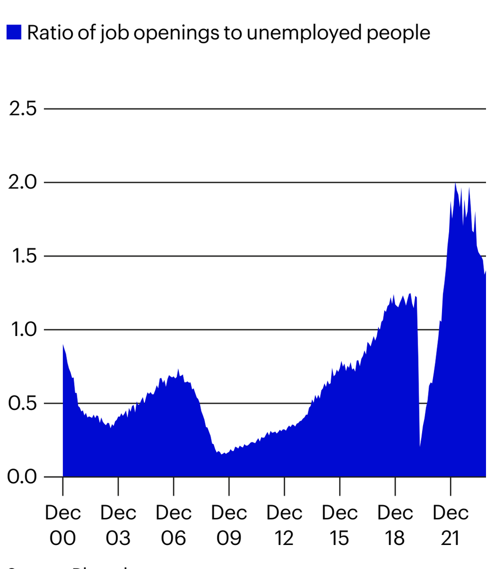
> **The corporate bond environment looks favourable for returns in 2024 as policy rates fall.**
>
> **Andy Byfield**
> Senior Client Portfolio Manager

Global growth has been solid, but there are signs this is starting to change.

Economies held up well in 2023, despite aggressive monetary policy tightening. However, as we move into 2024, there are signs that this will change.

There are signs that the labour market is easing, e.g. the number of job openings is falling.

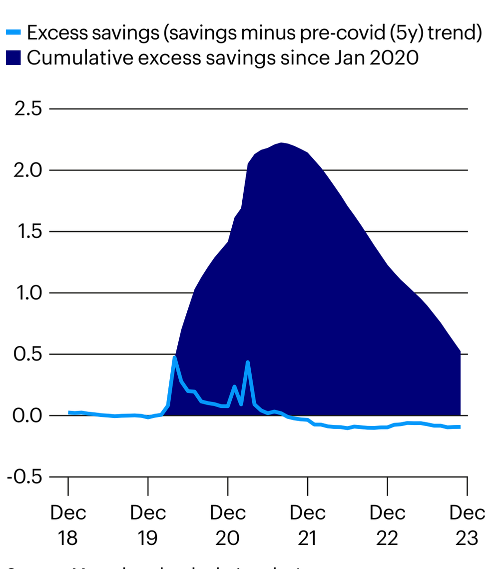
Job openings are normalising (ratio)



Source: Bloomberg.

Consumers are set to lose the protective savings shield they built up during the pandemic.

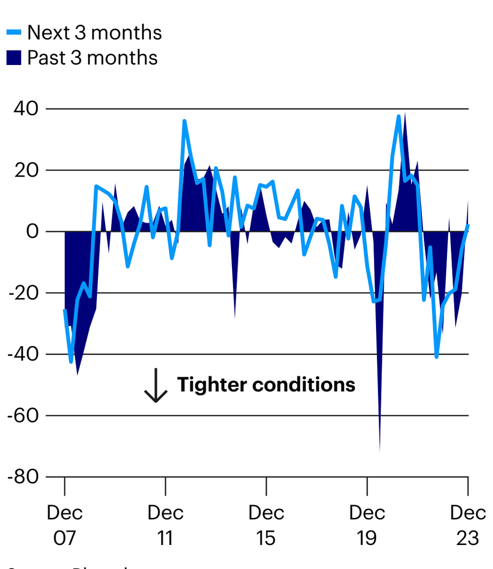
Cumulative US household savings (trillion)



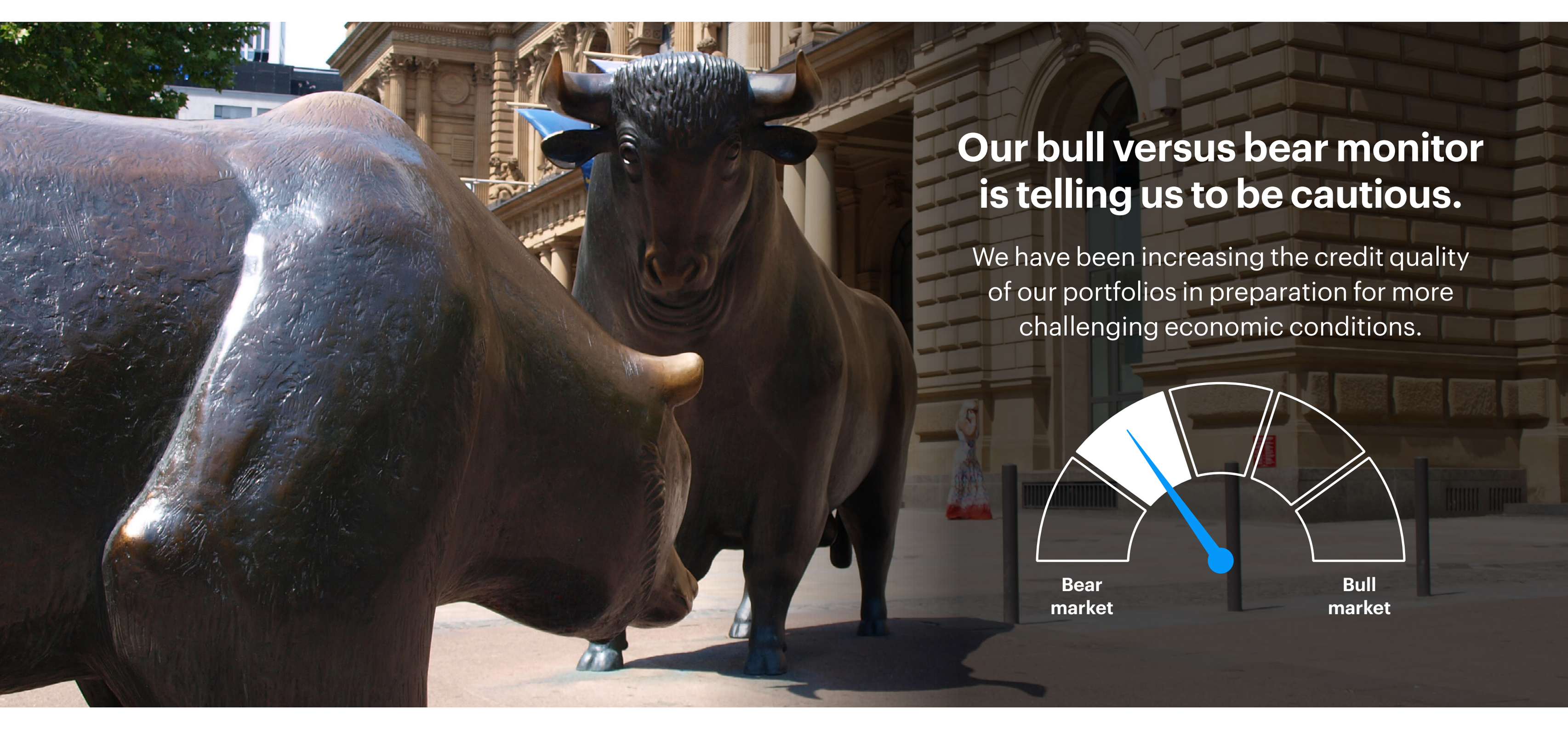
Source: Macrobond, calculations by Invesco.

Credit conditions are now tighter, making it harder for businesses to borrow.

BoE secured credit availability (%)



Source: Bloomberg.



Our bull versus bear monitor is telling us to be cautious.

We have been increasing the credit quality of our portfolios in preparation for more challenging economic conditions.

What's next for inflation and interest rates?

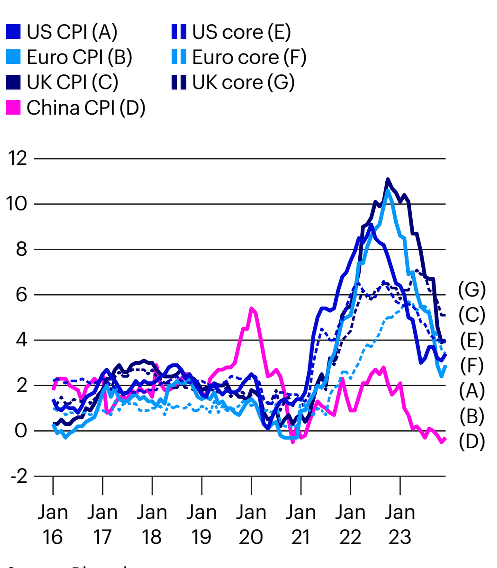
We're now firmly in disinflation mode.

The path of inflation is now much clearer.

We expect disinflation to continue across the UK, Europe and North America with central banks keeping rates where they are for now, before introducing cuts in the second half of the year.

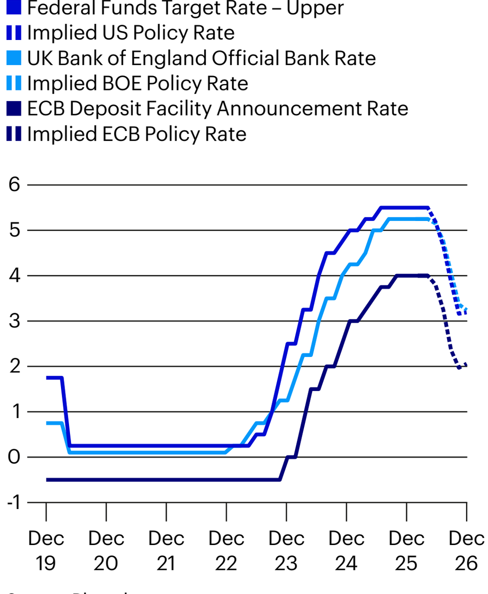
The rate of inflation is declining across all major regions...

(%)



Source: Bloomberg.

...and rate cuts are on the horizon for the second half of the year.



Source: Bloomberg.

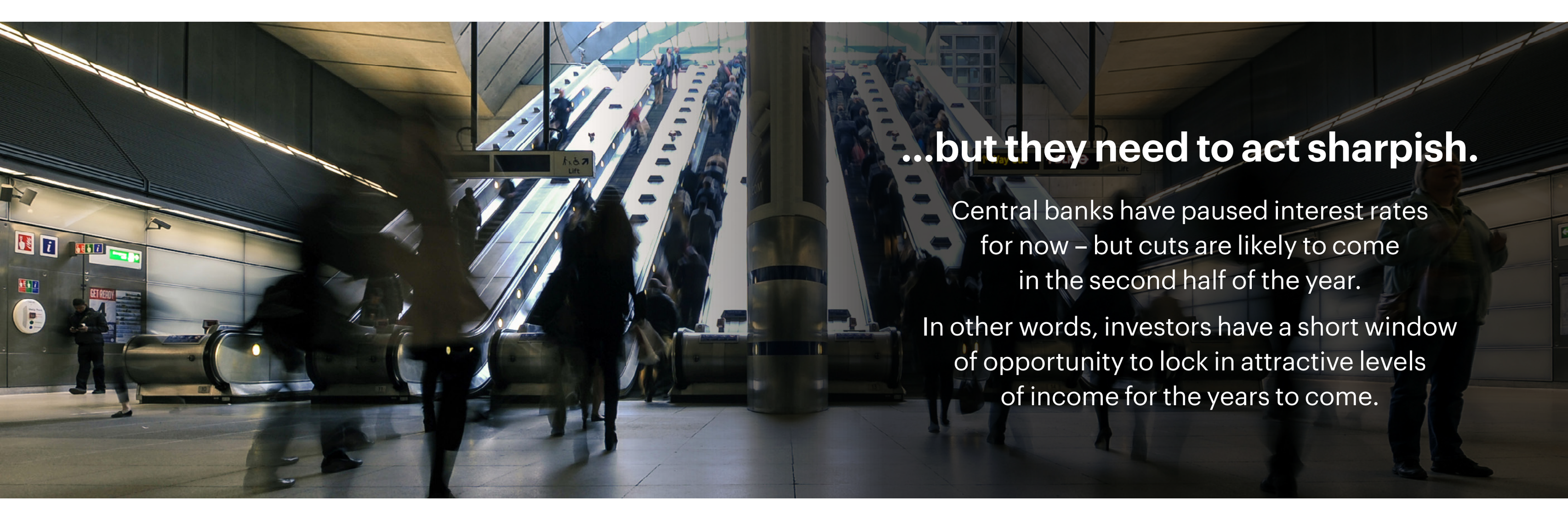
What does this mean for fixed income?

Investors have a "once in a generation" opportunity to lock income into their portfolios...

We've just lived through the most aggressive central bank policy in a generation – but the silver lining is that yields are now the highest they have been since the Global Financial Crisis.

Investment Grade Corporate Yields to Worst (%)

Source: Bloomberg.



...but they need to act sharpish.

Central banks have paused interest rates for now – but cuts are likely to come in the second half of the year.

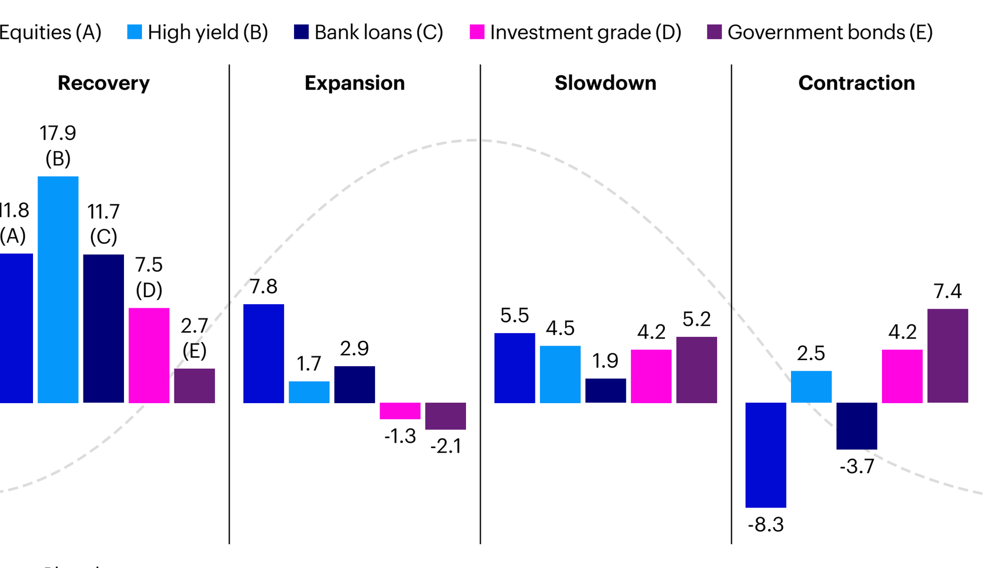
In other words, investors have a short window of opportunity to lock in attractive levels of income for the years to come.

Why investment grade over high yield?

As we move towards the contraction phase of the cycle, high quality assets are typically the top performers.

This includes investment grade corporate bonds and government bonds.

Average asset class returns, based on thirty years of historical data



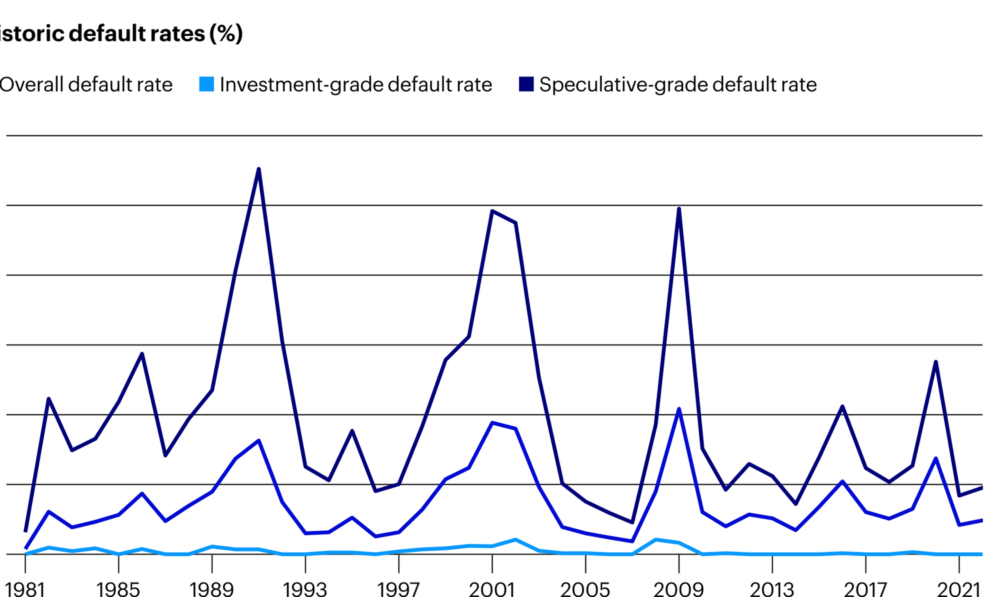
Source: Bloomberg.

Defaults are currently low, but they are expected to rise, impacting riskier issuers worst.

Investment grade issuers typically have the strength needed to weather challenging economic periods, while high yield issuers may run into more challenges.

Because weaker growth will likely be felt most in riskier credit, we favour reducing exposure across higher credit risk markets.

Historic default rates (%)



Source: Bloomberg.

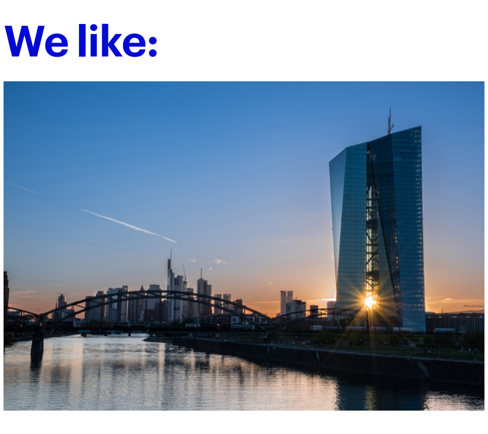
Investment grade defaults may be lower than you think...

History shows us that defaults are very rare for investment grade issuers. Even between 2008 and 2009, the default rate peaked at only 0.3-0.4% of the universe.

The threat of credit downgrades is more common but can be mitigated with thorough credit analysis.

Spotlight on sectors

We like:



European financials

Our strategy has held a long-term preference for financials over non-financials as capital buffers remain at all-time highs, whilst they largely continue to trade with an additional spread premium over non-financials. A dynamic that has remained since the Global Financial Crisis. Recently, banks returned to profitability, driven by rising interest rates improving loan book margins, whilst loan loss provisioning has remained contained.

Specifically, we like core European national champion banks and where we do have exposure to US issuers, this is solely in the "Big 6".

We're less keen on:

Industrials

With growth weakening and spread valuations at the tights of historical ranges we are cautious on cyclically exposed areas of the market here, particularly in those that don't have globally diversified revenue streams.

However, the strength of economic data out of the US continues to surprise many, hence any weakness in spreads could present opportunities to add high quality issuers in our most favoured names.

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