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## Macro conclusions from IFI's November Summit

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

### US: Persistent, but not permanent

This is a cycle like no other. Both the nature of the shock, the global health crisis and the policy response, which has been unprecedented compared to previous crises and recessions, have made this cycle special. Also, unlike past shocks, the recovery from the pandemic has been rapid. To be sure, significant output was lost, but thanks to policy and the nature of the shock, economic activity has largely returned to trend.

The behavior of disposable income has been particularly interesting. While disposable income does not typically rise in a recession, the COVID-19 pandemic coincided with a major spike in disposable income. This is because the policy response, including large - and rapid - income transfers to households, has been very different than in past cycles. In a typical credit cycle, the policy transmission mechanism would be slower and recession would be associated with declining goods consumption, especially on durables. In this crisis, we saw a very fast increase in goods consumption. On the other hand, services in past recessions did not decline significantly, but due to the nature of this crisis, services consumption collapsed.

The dynamics of the pandemic have led to an increase in goods demand so big that factories have not been able to match it. At the same time, worker shortages

have exacerbated goods supply. We call this the "pandemic economy" and it is still with us today due to the rise of the Delta variant, which has delayed economic reopening and normalization. With global supply chains snarled and the labor supply not fully back to work, the specter of wage inflation is rising. We expect core goods inflation to subside next year as supply chains are resolved and goods demand normalizes towards services consumption; we may even see goods price deflation. The key risk, in our view, is on the services side: Will currently unemployed, discouraged or even retired workers return to the service sector? And will this keep wages under control? We will be monitoring these developments closely as we formulate our inflation expectations.

In the short term, the ongoing pandemic and elevated personal savings will probably lead to higher-than-expected inflation. However, next year, normalizing demand and easing supply constraints will likely reduce inflation, although it is likely to remain above the US Federal Reserve's (Fed) 2% target.

What will this mean for Fed policy? Now, with inflation risks on the rise and growth and labor markets gaining momentum, we expect hikes in September and December next year, with the risk of an earlier and additional hike in the summer.

The Fed is also expected to accelerate tapering in December and end asset purchases in March, to demonstrate that it is on top of wage and inflation pressures and create an option for hiking even earlier, if inflation continues to surprise to the upside. But, even if reopening remains problematic and labor does not return to work, we expect the Fed to err on the side of inflation and pursue only modest tightening next year.

### Eurozone – Getting more interesting?

The European Central Bank's (ECB) job is going to become more difficult in 2022, as

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the inflation pick-up moves across some parts of Europe and not others. What's more, price pressures are rising against a backdrop of slowing economies. Since the summer, there has been a modest slowdown after the strong reopening rebound. Germany, for example, which was growing quickly through much of the pandemic due to its reliance on the manufacturing sector, has started to lose some momentum. Although inflation is elevated across Europe it's especially high across Germany and Central and Eastern Europe.

There is some divergence appearing in France and Italy, where inflation pressures are not quite as severe as in other parts of the European Union. A key component of Europe's inflation story, and where it diverges from the US, is that supply bottlenecks are not the only driver of price pressures. The European Union also faces acute energy inflation - gas prices, for example, have risen as much as 300% since the beginning of the year.<sup>1</sup> Going forward, gas prices are expected to remain elevated but not on the same trajectory. We expect the longer-term inflationary outlook to remain benign, with inflation likely to stay close the ECB's 2% target for the next 18 to 24 months.

The eurozone's direct fiscal policy response to the pandemic has not been as aggressive as in the US and policy has been more focused on job creation. As a result, consumer demand has not been as strong. This should allow the ECB to take a more relaxed approach to monetary policy as we emerge from the pandemic. Persistent elevated inflation would require a tight labor market, in our view, which is unlikely given the amount of slack and pockets of unemployment that currently exist across the European Union. In the short term, however, elevated inflation makes it more difficult for the ECB to maintain its current level of stimulus, or even to be prevented from winding it down significantly, as we progress through the end of this year. To quell market concerns, and to respond to fiscal pressures, especially in the periphery, we believe the ECB will need to maintain some level of support for the bond market. Several countries have already breached budget deficit and debt thresholds prescribed under the Growth and Stability Pact, which suggests that issuance will remain significant and will likely need to be absorbed by the ECB or the private sector. Given this backdrop of benign inflation and ECB support, we

believe that interest rate increases, even though they are priced in toward the end of the next year, are likely many years away.

## China – Searching for the bottom line

The events of this year have caused many market participants to wonder where China's policies and economic outcomes will end up. We have forecast a quarterly deceleration in growth for some time, driven mainly by the impact of tightening policy and the resurgence of local COVID-19 cases. We expect continued economic slowdown on a year-over-year basis, despite gradual sequential improvement, to lead to 5.5% growth in 2022. However, after a weaker first half, we expect growth to recover in the second half of next year on the back of looser macro policies and an improved COVID-19 situation.

Credit growth is likely to be a driver of overall economic growth in the coming year. Credit growth has posted a notable decline this year compared to 2020 and the credit impulse has dropped to a multi-year low. We expect the credit impulse to improve next year as policy becomes less tight. However, we do not expect full-blown stimulus and expect restrictions to remain on certain sectors, such as the property sector, and, therefore, do not expect a sharp rebound in economic growth. Pressure on the property sector has likely peaked, but the "good old days" are likely gone and we expect to see consolidation in the sector. As credit conditions improve, we expect corporate bond issuance to pick up but market access may remain restricted for private high yield companies.

In the rates market, we continue to favor government bonds. This is driven by our expectation that the central bank's easy monetary stance will continue alongside weak growth momentum. Our positive view on the renminbi has played out, but we are becoming concerned about its potentially stretched valuation. In the near term, we expect the renminbi to continue to perform well, and believe the fundamental drivers remain strong.

## Asia – The delayed recovery is on

Asia's re-opening, which was delayed by the Delta variant, is now firmly on. Some countries, however, have yet to exceed pre-pandemic levels of activity. This means there is room for upside surprises to growth from the recent re-opening, especially in the Southeast Asian countries. On the other hand, North

1. Source: Bloomberg L.P., January 1, 2021 to November 15, 2021.

Asia's and India's recoveries are expected to taper in 2022, following above-trend growth rates this year and already normal levels of activity.

Exports have been a key driver of growth so far in Asia, but looking forward, the export surge has likely peaked, as goods demand is starting to normalize in the US and Europe and China's growth decelerates. However, Asia's exports could benefit from a post-pandemic global investment cycle. Global capital expenditures, which have grown faster than global GDP lately may continue, perhaps driven by some of the business and consumer behavioral shifts brought on by the pandemic and the potential diversification of supply chains within the region.

We expect a gradual fiscal consolidation across the region in 2022 as growth normalizes. However, compared to other emerging markets (EMs), Asia's fiscal policy response during the pandemic has been more prudent and Asia generally has low government debt levels, with the exception of India. This leaves Asia with more fiscal room if the need arises to provide additional support in 2022.

Weak domestic demand and low inflation in Asia have allowed central banks to keep monetary policy accommodative so far, with the exception of South Korea where recovery has been more advanced. With domestic demand recovery expected to firm in 2022, and inflation on the rise, albeit from low levels, we expect other central banks in the region to commence a gradual policy normalization cycle in 2022.

The biggest risk to our outlook stems from China's growth trajectory and still evolving pandemic. Although not our base case, the tightening in China's property sector, which indirectly accounts for almost one quarter of China's GDP, could lead to a sharper than expected slowdown in China, which would likely affect external demand for Asian EMs. The region has very low tolerance for COVID-19 (except India) and has been slow to loosen travel and other mobility restrictions. Although we expect these policies to be relaxed in 2022 as vaccination levels reach more comfortable levels, any new resurgence in cases could delay re-opening and slow the recovery in domestic demand.

#### **EM – Walking the talk**

EM countries face the same inflationary and supply-side pressures as developed market (DM) countries but EM central banks have been more active in adjusting their policies in response - in some instances sharply hiking rates. EM inflation has accelerated amid a strong cyclical

recovery fueled by strong demand and supply-side bottlenecks. This dynamic had led markets to price in sharp increases in inflation risk premiums earlier in the year and drew swift actions from central banks. Some central banks have already moved into restrictive territory, believing that a degree of demand destruction is needed to control prices. In other cases, markets have priced in terminal rates at historic levels. We expect rate hikes, tighter fiscal policy and tightening credit markets to calm price pressures, though we expect current "transitory" inflation to persist for the next six to nine months. Higher policy rates combined with softer inflation down the line will likely cause real monetary policy rates to turn positive from negative in most EMs. Real rates in low-yielding countries may remain negative, but less so. This should lead to more attractive valuations going forward, in our view, and improved buffers for EM currencies.

On the growth side, GDP in most EM countries is likely to remain below pre-COVID-19 levels this year and next year, and potentially beyond. It is important to note that EMs face far greater challenges related to the pandemic compared to DMs, especially when it comes to vaccines, health systems and not least, the capacity for policy responses. While DM growth will likely remain above potential next year, most major EMs will likely barely reach potential. This poor growth backdrop and a more benign inflation outlook support our more positive view on EM rates going forward, but could also raise credit issues for some of the more leveraged EM issuers.

It will be important to monitor the impact of growth uncertainty on EM fiscal policy, especially for the most vulnerable countries that need to adopt credible plans for both fiscal consolidation and debt sustainability. We believe this will be a market differentiator and expect to see some issuers adjust fiscal policy to maintain market access. Countries will likely also differentiate themselves by their abilities to navigate key macro challenges, such as uncertain Chinese economic growth, oil price volatility and US monetary policy.

We also note a new challenge that has been undertaken by many EM central banks, which is the incorporation of climate change into their analyses. Understanding the impact of environmental outcomes is not only important for managing financial stability, but also for price stability. Several central banks have already conducted climate scenario exercises and more will likely

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incorporate them into their economic forecasting and policy formulations in the coming years. Invesco Fixed Income

is adopting a similar approach by incorporating climate scenario analysis into our sovereign research.

## Interest rate outlook

**US: Underweight.** Economic growth forecasts have begun to reaccelerate over the past several months and the Fed has announced it is tapering quantitative easing. We reiterate the Fed's view that tapering does not signal significant tightening. We believe the Fed will be slow to hike rates as it waits for unemployment data to improve and inflation data to stabilize, giving it more confidence in the sustainability of prices. As a result, we expect to see upward pressure on US Treasury yields over the longer term. In the near term, however, we are watching risks closely – such as supply chain constraints, fiscal policy developments, the Omicron variant and a possible miscommunication around tapering that could cause market participants to believe the Fed is tightening significantly. Such concerns could generate a safe-haven bid for US Treasuries.

**Europe: Underweight.** The ECB will likely have some difficult decisions to make when it meets for the final time this year in December. Despite the insistence of many board members earlier in the year that inflation would prove to be a transitory phenomenon, it continues to reach new highs and is now not expected to peak until well into 2022. At the meeting, the new ECB staff forecasts for growth and inflation will be released with inflation projected to be close to the 2% target in 2023, up from 1.5% in September's report. Against this backdrop of higher prices, momentum in the economy continues to slow with supply bottlenecks and spiralling energy costs hampering the manufacturing sector, while rising COVID cases and a reticent service sector have proved headwinds to the recovery. The ECB is faced with a dilemma: act to anchor inflation expectations or wait for inflation to peak. With the emergency pandemic asset purchase program (PEPP) due to end in March and the market starting to price in rate hikes next year, it may prove to be a challenging meeting for ECB president, Christine Lagarde. As such, we remain underweight core rates in Europe and expect the yield curve to steepen in 2022.

**China: Overweight.** We are overweight Chinese onshore government bonds and see room for rates bonds to outperform

in Q1 2022. Although economic growth is likely to gradually recover on a sequential basis in 2022, the first half is expected to be weak on a year-over-year basis and the central bank may need to step up its monetary easing efforts in the first half. Chinese onshore rates bonds are expected to perform well in such a macro and market environment. Downside risks include a spillover effect from US Treasury yield volatility related to Fed operations and US rate moves.

**Japan: Underweight.** Japanese government bond (JGB) yields have fallen recently, almost completely reversing their rise in September and October, as concerns about the Omicron variant has led to a flight to quality. Looking forward, provided the Omicron variant doesn't lead to a significant reduction in the efficacy of vaccines, the impact of the latest COVID wave will likely be smaller than that following the outbreak of the Delta variant earlier this year. Japan is in a far better position to face the latest variant compared to earlier this year, as it has now vaccinated 78% of its population, compared to just 5% last May when the Delta variant hit.<sup>1</sup> Indeed, Japanese growth is currently accelerating, helped by reopening after last summer's lockdowns, faster industrial production as chip shortages abate and fiscal stimulus. These factors together with higher global bond yields, as the Fed and ECB taper bond purchases and move toward hiking rates, should push JGB yields higher.

**UK: Underweight.** Long end gilt yields have now retraced almost their entire sell-off seen during September and October, despite relatively strong data and an increasingly hawkish Bank of England (BoE). Although part of the move can be explained by cuts to issuance and the continuation of the BoE's quantitative easing program, this factor is now probably priced in. Looking ahead, the economy would likely have to deteriorate significantly to justify a further fall in longer-term rates, in the context of the imminent start to a rate hiking cycle.

**Canada: Overweight.** A strong rebound in domestic consumption is being supported by stronger than anticipated employment growth. Wages are firming, increasing the risk of demand-led

1. Source: Reuter's COVID-19 Tracker, Data as of December 7, 2021.

inflation. This is happening as capacity constraints are growing amid supply-side pressures. We now expect the Bank of Canada to begin a rate hiking cycle in Q1 2022. The yield curve has been impacted by global forces, but we anticipate domestic drivers to take the lead next year. We favor being underweight the 10-year part of the Canadian bond curve.

**Australia: Neutral.** The recent COVID-19 outbreak has increased the downside risks to growth, raising the probability that the Reserve Bank of Australia (RBA) will

delay its scheduled QE tapering and push back the likely start of its hiking cycle. Although yields have priced this reality to some extent (having already retraced the entire Q1 selloff), there is still scope for Australian government bonds (ACGBs) to outperform other core markets, in our view; we believe the RBA is more likely to lag the Fed and other central banks in normalizing policy, given the downside risk to growth posed by COVID-19, when the population remains largely unvaccinated.

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## Currency outlook

**USD: Neutral.** The US dollar has found strength recently, though it has remained in a tight range since July. We believe this will be the story in the near term as the market focuses on dollar-supportive factors (a tapering Fed, Omicron-variant concerns) rather than the longer-term view that the Fed will remain on the sidelines post-tapering. We believe the Fed will remain one of the more accommodative global central banks over the longer term, largely underpinned by its commitment to an average inflation target and its patience regarding inflationary data. This will likely force investors to look elsewhere for better yielding opportunities, ultimately putting downward pressure on the dollar.

**EUR: Underweight.** The path of the euro will likely be driven largely by US rate expectations and the divergence in monetary policy between the US and euro area. There is little chance, in our view, that the ECB will raise interest rates in 2022 and it will likely remain dovish compared to the Fed, which should keep downward pressure on the euro. We are mildly underweight the euro, but with low conviction, given current market conditions.

**RMB: Overweight.** We are positive on the renminbi's performance against the US dollar in the near term. At the same time, we are aware of the increasingly stretched valuation of the renminbi, which may leave room for adjustment in the medium term. Our near-term positive view is based on favorable fundamental and policy factors that could support the renminbi's appreciation. In addition to continued strong export data, the softening of US-China trade tensions in the past few years could provide a catalyst for the renminbi's performance.

**JPY: Neutral.** The yen has been stable against the US dollar, but has significantly outperformed most other G10 and

emerging market currencies over the last month, as risk aversion, falling global bond yields, resulting lower interest rate differentials and a squeeze on widely held shorts have all supported the currency. Although valuations look relatively attractive historically, in our view, the yen will probably struggle to outperform in 2022 if the Fed and other major central banks hike interest rates.

**GBP: Underweight.** UK growth momentum will likely slow in 2022 on an outright and relative basis due to the terms of trade shock from higher natural gas prices and fiscal tightening. The BoE is likely to hike rates, but this isn't supporting the pound because it reflects a worsening inflation-growth trade-off and no longer looks out of step with other central banks, especially the Fed. The Fed is now projected to hike by almost the same amount as the BoE, and given the relative economic context, it seems likely that US rates will exceed UK rates over the cycle, putting downward pressure on the GBPUSD exchange rate. While the EUR/GBP exchange rate might be pushed lower by higher UK rates, this appears largely priced in, with the cross already close to post Brexit referendum lows. Indeed, the pound might be vulnerable to the Omicron variant since the BoE is the only major central bank from which the market is pricing a significant probability of a rate hike in December.

**CAD: Overweight.** Recent underperformance, driven by the sharp decline in oil prices, has improved the competitiveness of the Canadian dollar. Our expectations for the commencement of rate hikes by the Bank of Canada should be supportive in 2022. The recent border re-opening has not translated into a meaningful shift in the external accounts. Export volumes remain very strong as the trade surplus with the US is reaching all-time highs. Portfolio outflows

have been an additional source of pressure, but expensive global valuations may limit further outflows. We remain constructive on the Canadian dollar outlook for next year.

**AUD: Neutral:** The Australian dollar appears relatively cheap, in our view, versus its terms of trade, but is suffering from weaker global risk sentiment and a narrowing of interest rate differentials with the US as the Fed moves in a more hawkish direction.

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Head of North American Investment Grade

### Jason Trujillo

Senior Portfolio Manager

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Head of High Yield

### Kevin Collins

Head of Commercial Mortgage Credit

## Credit conclusions from IFI's November Summit

At the November Summit's credit session, four investors from across the IFI platform discussed their thinking on current credit topics, from potential risks on the horizon to likely drivers of asset valuations in the coming months. We highlight their discussion below. IFI's Head of Global Corporate Credit Research, David Todd, moderated.

**David Todd: In your view, what are the short to medium-term risks for risky assets right now? Are they spiking inflation expectations, the removal of unprecedented central bank support that could increase the risk of default in weaker corporate sectors, ongoing COVID waves, or supply chain pressures and growth, to name a few?**

**Matt Brill:** From the perspective of US investment grade credit, the greatest concern to me is rate hike expectations. From a fundamental standpoint, inflation matters for corporate profit margins, but the largest corporations could likely weather a decrease in margins from 33% to 31%, for example, and this probably wouldn't move the needle in terms of perceived credit quality. What does matter greatly to the investment grade market is technicals. Technicals are currently largely being driven by foreign inflows and hedging costs, which are directly tied to overnight rates. So, if the Fed becomes more aggressive and markets expect more than two rate hikes next year, that could pressure short-term rates and hurt foreign demand for investment grade. So, we believe rate hikes and rate hike expectations are the biggest risks to watch for.

**Jason Trujillo:** In emerging markets, we think the removal of central bank support is a key risk. There appears to be a fairly large consensus, for example, that inflation will be more permanent, and many investors have adjusted accordingly. However, I don't think the market is expecting central banks to pull back anytime soon. The probability of this happening may be low, but if it were to take place, we believe it would be very disruptive to the marketplace.

**Niklas Nordenfelt:** What would matter most for high yield, in my view, is something that spooks the equity market. Of the potential risks mentioned, a rapid COVID-19 spread and fears of potential lockdowns, as seen recently in some European countries, would be a top candidate. Otherwise, I think the Fed has telegraphed its message well, that it is reducing support relatively soon. But the Fed coming to the conclusion that inflation is likely to be higher and more persistent than it modeled or communicated, would also likely be very impactful to the market.

**Kevin Collins:** it is not my base case, but I think the potential for a more hawkish Fed than what is already priced into the market is a key risk. The Fed is likely going to try to be as measured as possible in its guidance and communication. That said, if oil prices march higher and inflation expectations accelerate further, it could force the Fed's hand. I think this would be particularly problematic if it is coupled with lower growth expectations - in other words if the Fed pumps the brakes and markets start to worry about growth beyond 2022, potentially leading to yield curve flattening. This type of scenario would be a concern.

**David Todd: What do you think could have the most impact on valuations in your asset classes over the next few months?**

**Kevin Collins:** I think the biggest driver will be market technicals. As most economies continue to reopen and the Fed steps back, we are starting to appear more mid-cycle, in our view. These dynamics suggest that fundamentals are going to become increasingly important, but I don't think we're at that point yet. I believe technicals will be more influential in the near term, especially in the securitized space. Spreads on commercial mortgage-backed securities have softened recently, for example, and that's been due to increased supply. Looking ahead over the next few months, CMBS supply looks like it will remain elevated, making it difficult to envision

near-term spread tightening. Asset-backed securities have also seen a record pace of issuance. That is unlikely to slow down, given the growth in consumer spending. We have also seen spread widening in the residential mortgage space largely due to more supply, and we think elevated issuance will make it difficult to see meaningful spread tightening in the short term.

**Niklas Nordenfelt:** In my view, high yield is in as good shape as I've seen it. The high yield cohort is as high quality by rating as we have ever seen, with double Bs at all-time highs as a proportion of the market. Issuers had very strong earnings in the last quarter, and rising input costs have generally not impacted profit margins. The default outlook is basically around zero. Not surprisingly, this fundamental strength has been largely priced in, so the primary risk is that there is less room to absorb a surprise. As I mentioned before, we believe high yield will be most impacted by events that raise equity volatility, since it is the factor that tends to impact high yield the most. Historically, oil volatility has been impactful to high yield, but we believe the oil market is fundamentally supported by growing demand and OPEC discipline on the supply side. To me, the top three things that would raise equity volatility are inflation higher than Fed expectations, leading it to be more aggressive than what is currently priced in. The second would be tapering, since quantitative easing has been highly correlated with equity gains, so scaling it back could lead to losses or volatility. And the third is the spillover effect of turmoil in China's property sector. Each of these are likely medium-probability events with potentially limited impact. We do not want to be complacent about them, but given how strong the fundamentals are, high yield appears to be in a Goldilocks situation.

**Matt Brill:** Valuations are clearly tight, but there may be ways to go even tighter. One way would be to see continued foreign inflows. However, if the Fed hikes too aggressively, foreign flows might be discouraged. Another factor that could drive valuations is a wave of credit upgrades out of the high yield market. This would be an interesting opportunity, in our view, because it could bring credits trading at wider spreads into the investment grade market. Certainly, many of them are already pricing in potential upgrades, but, to me, this migration could be one of the most important drivers of overall valuations. If there is a flood of upgrades into investment grade, it could make investment grade appear cheaper. We believe these names are improving

credits with positive stories, so we will be watching this potentially attractive segment of the market.

**Jason Trujillo:** EM credit hasn't had the strongest year so far. But this has led to potentially attractive valuations, in our view. So, if we can avoid, as Niklas pointed out, an equity selloff, and growth remains decent, especially for EM countries, you could see EM credit performing well. I consider that to be a fairly decent base case over the next 12 months. It is based on the idea that not much changes over the next couple of quarters as economies re-open and recover. Inflation concerns could rise somewhat, but the base case would remain intact as long as they do not become disruptive or disorderly. I agree with Niklas that the equity market is probably the biggest potential catalyst to move EM credit spreads wider. We may not even need to see an actual Fed-driven or major macro event to derail the stock market, given the currently frothy nature of equity valuations. But my concern would be that risk-off sentiment toward developed market equities could spill over to riskier assets like EM.

**David Todd:** Finally, ESG is a quickly developing topic and net zero, in particular, is being talked about more and more. What are your broader thoughts on the topic?

**Niklas Nordenfelt:** When thinking about ESG and net zero on the credit side, I think we have to acknowledge that they have implications for how businesses are run, how companies will transition their business models to affect change and the competition they face. There is a lot of investment going on in new technologies and companies must adapt to compete and survive. From a credit perspective, I believe we have to take this transition into account as part of our overall risk analysis. Analyzing a company's ability to manage transition is different from analyzing its ability to manage and grow an existing operation. I think that being mindful of the liabilities and expenses that will be necessary to decarbonize a business must be an overlay in our overall credit analysis. It will be important to assess the capacity for companies to make those investments and whether they can be profitable in a net zero world. Overall, I believe building out sustainable approaches to credit investing can allow us to be a more relevant partner to our clients, and I view net zero, in particular, as the next frontier and an opportunity to forge deep relationships with our clients.

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## The bottom line: What's going on in the US labor market?

The health of the US labor market has important implications for growth, inflation and Fed policy. Fed Chair Jerome Powell has said he will not entertain interest rate increases until the labor market reaches full employment, even if that means tolerating inflation on the higher side. At the November Summit, we gathered a panel to better understand the current state of the US labor market and answer the following questions: Is the US labor market tight? Why has the labor force participation rate not bounced back? Will the shortage of workers last? We spoke with IFI Senior Analyst, Ray Janssen, IFI Director of Fixed Income Research, Turgut Kisinbay, and guest, Ben Gitis, Associate Director of Economic Policy at the Bipartisan Policy Center. IFI's Chief Strategist, Rob Waldner, moderated the discussion.

**Rob Waldner:** Given the importance of attaining full employment in the Fed's policy decision making, we'd like to pin down the state of the US labor market. In your view, is the US labor market loose or tight?

**Ray Janssen:** There has been much attention paid in the press to the "great resignation". Labor market data show that quit rates and open jobs are at record highs, which indicates a tight labor market. Even before the pandemic, the labor force participation rate has seen a structural decline as baby boomers retired and fewer younger workers were available to replace them. But the pandemic has led to new behaviors and we have seen different age groups react differently to the challenges brought on by COVID-19. Data suggest that workers in the over 64-year-old age group have likely chosen to finally retire and will probably not return to the workforce. However, if you look at the 55 to 64-year-old cohort, their participation rates are back to pre-pandemic levels. In fact, the 55 to 59-year-old cohort labor participation rate is actually higher today than it was pre-pandemic and the 60 to 64-year-old cohort is in line with pre-pandemic rates. This data disputes the notion that wide swaths of the labor force have retired early. Most other cohorts have also shown a tendency to return to work and therefore do not explain why we have seen a persistent drop in the labor force participation rate. There are however, two age cohorts - 35 to 39 years old and 40 to 44 years old - in which we saw a

drop in the participation rate and only anemic recovery. Those cohorts are also the most likely to have school age children, so it makes sense that this group withdrew from the labor force when schools were not in-person. However, even though schools are returning to in-person learning, we have not yet seen the rebound in workforce participation that we would have expected.

**Ben Gitis:** I think we are witnessing symptoms of a very tight labor market with low unemployment, high quits and high job openings. People are quitting their jobs because they have the leverage to do so. The reason for this is that many workers have not returned post-pandemic and our labor force participation rate is still below where it was. Ray is right that retirements are a big factor. We are also still missing almost two million of what are referred to as "prime age" workers - people 24 to 55 years old. There have been many theories about why, and some of the leading ones are that the pandemic is still playing a major role, especially with the emergence of the Delta variant. A recent US Census Poll suggests that many people in this age group are afraid of getting COVID and spreading it. Also, as Ray suggested, this age group tends to include caregivers, especially to school age children, creating a significant barrier to resuming work for many workers over the last 18 to 20 months. Going forward, this caregiving effect should diminish, but there are still problems balancing caregiving needs. We could also be witnessing a behavioral shift as people take a step back and consider what they want to do with their lives - for example, how much do they want to work from home versus in the workplace? This questioning has likely been supported by the fiscal stimulus provided over the last year and a half. People have a bigger cushion than they did going into the pandemic, particularly in the bottom quartile of households. At some point, that fiscal support will wear off.

**Turgut Kisinbay:** In my view, yes, the labor market is tight. Both labor market data and surveys of CEOs and small businesses and others show that workers are very scarce. But we believe the labor market will not remain tight forever. Assuming the pandemic will end, which is the scientific consensus, I am not concerned in the long run about issues of early retirement, changing attitudes



toward work-life balance leading to a higher unemployment rate, higher wages and shortages of workers. In the short run though, the pandemic is still with us and, as Ray and Ben argued, these are the problems it has created. But I think we should remember that schools just recently opened in September and it will take time for workers and employers find job matches. We haven't seen the impact of back-to-school yet in the data. With COVID still with us, the winter months could be challenging, so the back-to-work trend may be disrupted again. But as the economy rebalances, I think labor supply will eventually come back. Labor shortages may just last longer than we expected. This has implications for wages, prices, and Fed policy.

**Rob Waldner:** You've laid out the proposition that workers will likely remain out of the labor force until they sort out caregiving and then they'll come back. But do you think there has been a permanent change in mindset that could cause workers to take much longer to come back?

**Ben Gitis:** I think most of these people will eventually come back. There will likely be a certain group who will remain careful and fearful, and many people have different medical and family issues to contend with. But I think, by and large, as life returns to normal, workers will return. We may go through a difficult winter, but the more we get back to normal, the more child care centers will likely reopen and the more we may be able to live with COVID, as its spread and deadliness are reduced.

**Ray Janssen:** This outlook suggests that the structural labor participation rate will improve as the economy lifts off, and we will likely see a lot of opportunities across the country for improvement. I would especially expect to see improvement in the states and cities that have been shut down the most. In other words, we will likely see the most job growth in the places where we had the most fear and COVID-related restrictions. I think this means that a material portion of the drop in the labor force participation rate is not structural but cyclical. The cyclicity in this case is being affected by the government's COVID response.

**Turgut Kisinbay:** I believe we can return to a 63% labor force participation rate, or can do even better. There are a number of ways to increase labor force participation when the labor market becomes tight. In the US, wages are already rising to attract workers and employers are offering more flexible work arrangements, which could attract a larger pool of applicants. There is also anecdotal evidence that some companies are reducing requirements for applications, for example, no longer requiring college degrees. In some cases, the interview process is faster and interviews are taking place online. All of these changes potentially facilitate hiring. Finally, immigration, which has historically been a ready source of labor in the US, has been very low in recent years. Japan was able to increase its labor force by expanding immigration, and it is conceivable the US could do the same.

**Rob Waldner:** The Fed has essentially promised not to change policy until the labor market is at full employment, though that has not been fully defined. How do you think the Fed will navigate the labor market issues discussed here?

**Turgut Kisinbay:** I believe the Fed subscribes to the positive story that, in the long run, the labor supply will return. But in the near term, the Fed must manage expectations and address broad-based concerns that inflation is rising. Politicians are beginning to treat inflation as a political issue and public perception is growing more negative. In this environment, the Fed has recently adopted a more hawkish tone, which is its first line of defense. If by December and January inflation numbers are becoming worse, the Fed could accelerate tapering, which is its second line of defense. If inflation concerns do not abate, the Fed may ultimately signal more rate hikes than are currently anticipated.

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

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