Invesco Fixed Income

Global Fixed Income Strategy

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Global macro strategy

Global Investors' Summit – 2018 macro overview

Over 70 investors gathered in Atlanta in November to discuss and debate Invesco Fixed Income's (IFI) views on global macroeconomic trends. Below we highlight the meeting's major conclusions by region, including views on the three macro factors that figure into our global investment decisions: growth, inflation and financial conditions (policy). We also note the risks to our views.

US

The economic forecasts we presented at the previous Summit in June have largely been realized: US economic growth has remained solidly above-potential in 2017 and financial conditions have remained easy.[1] Our call for structural weakness in the US dollar has also played out and we expect the trend toward US dollar weakness to continue in 2018. The one discrepancy in our forecasts has been with regard to inflation, which has not picked up as much as we expected. Instead, it has stayed at the lower end of our forecast range and below the Fed's target of 2%. We expect inflation to remain below target in 2018, despite tight labor market conditions, but expect it to stabilize at around 1.8%. Above-trend growth should continue, although at a slightly lower 2.25% in 2018 compared to this year's forecast range of 2.3-2.5%, given that the US economy is now closer to full capacity. The US Federal Reserve (Fed) will likely be balancing this low inflation, strong growth environment by gradually normalizing policy with an interest rate hike in December and two to three rate hikes in 2018, depending on the path of inflation.

Risks

The biggest risk to our view of strong growth, low inflation and easy financial conditions would be an unanticipated shift in central bank policy that results in aggressive monetary tightening – i.e. a policy mistake. Another important risk would be an unexpected sharp rise in inflation that leads to sharply tighter Fed policy. In other words, we view the biggest risk to US economic performance as a reversal in current easy financial conditions.

Eurozone

Our expectations for 2017 eurozone growth have been above consensus and generally on target. Consumption has been a strong driver of growth this year and the recovery has become more broad based, with both France and Italy catching up with the rest of the region. In 2018, we expect the growth impulse to remain broad-based across sectors and countries, resulting in a growth rate of around 2.0%-2.4%, which is a very positive development given low potential growth in Europe of around 0.8%, according to our estimates. Nevertheless, we do not expect inflation to meet the ECB's 2% target next year due to still-muted overall demand and weak credit growth. We expect core inflation to measure around 1.0%-1.2% in 2018. Continued easy monetary policy should mean no interest rate increases during ECB President Mario Draghi's term and gradual bond purchase tapering between January-September 2018, as announced, unless there is a downturn in growth. With the end of quantitative easing (QE), private bond markets are going to be required to take up bond supply no longer purchased by the ECB. While we expect this to pressure bond yields higher, we believe many European government bond markets are prepared for higher yields, having lowered their cost of debt and extended debt maturities.

Risks

Eurozone political risks remain, as various elections and Brexit negotiations have yet to unfold. Political uncertainty combined with greater bond supply, post-QE, could pressure bond yields higher in 2018, especially in the European periphery. In the UK, Brexit-related negotiation delays and uncertainty are likely to negatively impact the economy via downward pressure on sterling, reduced confidence and a slowdown in investment and consumption.

China

China has displayed stronger growth momentum in the second half of 2017 than we expected at the June Summit, resulting in a 6.9% growth rate in the first three quarters.[2] We correctly foresaw slowing credit growth, but we did not anticipate the recent resilience in China's lower-tier property markets and underestimated consumption strength. We expect China's overall growth rate to average in the low 6% range in 2018, driven by our expectation of a softening property market, further tightened financial regulations and slowing credit growth in the year ahead, although consumption growth continues to provide a strong buffer. In October's 19th Party Congress, China's leadership conveyed a major policy objective to expand capabilities in heavy manufacturing. We also expect a continued focus on financial deleveraging and regulatory tightening that could slow shadow credit growth and allow the bankruptcy of some loss-making state-owned enterprises (SOE). While these policies may slow economic growth in the medium term, we believe the government has increased its tolerance for more moderate growth. Statements following the 19th Party Congress appeared to downplay numeric growth targets while favoring quality of growth over quantity.

Risks

Major risks revolve around the outlook for the property sector and smaller-sized financial institutions including non-bank financial institutions, as further tightening measures in these sectors could cause sharper than expected market reactions. We are also monitoring China's high level of debt, especially within the local SOE sector. Disorderly defaults or deleveraging could lead to market volatility.

Japan

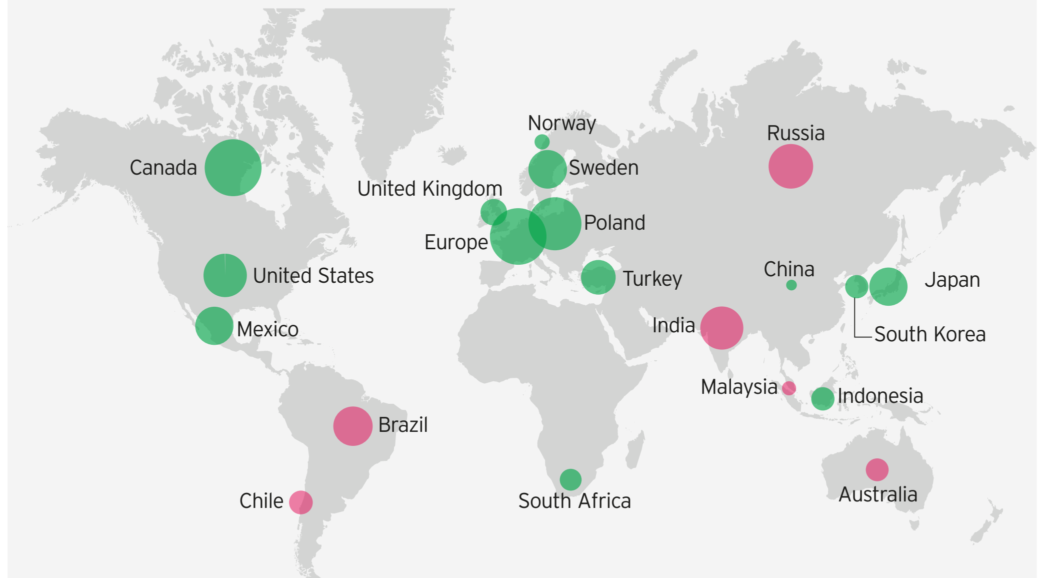
The Japanese economy performed better than expected in 2017, posting above-trend growth rates for the last several quarters. We expect above-trend growth to continue in 2018 at around 1%. While inflation remains well below the Bank of Japan's (BoJ) 2% target, it is likely to end 2017 at around 0.6%, solidly in positive territory after a period of worrying deflation. Higher oil prices, rising wages and a weaker yen have all contributed to an uptick in prices, although we expect these factors to be less supportive next year. With inflation expected to remain little changed in 2018, we expect the BoJ to maintain its inflation target, but extend the timeline for meeting it. Monetary policy is likely to remain unchanged in 2018.

Risks

High levels of public debt persist and official will to reduce the debt burden appears to have waned amid shorter-term objectives to stimulate the economy. A heavy debt burden could imply a slower shift to monetary policy normalization and potential fiscal stress. A downturn in the global economy would also likely be challenging for Japan whose current growth trend is partially dependent on exports.

Global growth is very strong

Actual growth versus potential growth by country



Source: Bloomberg L.P., Invesco, data as of Nov. 1, 2017. The chart shows the difference between Invesco Fixed Income's forecasts of actual growth and potential growth over the next quarter. A green circle shows a country growing above potential, while a red circle shows a country growing below potential. The size of the circle indicates the size of the differential between actual and potential growth. With few exceptions, growth is solid globally.

Rob Waldner, Chief Strategist, James Ong, Senior Macro Strategist, Gareth Isaac CIO EMEA, Yi Hu, Senior Analyst, Sean Connery, Portfolio Manager

1 Potential growth, or "trend" growth, is the annual rate of growth implied by population and productivity growth.
2 Source: National Bureau of Statistics, Oct. 19, 2017.

Interest rate outlook

US: Recent inflation data are likely to keep the Fed on track to hike interest rates in December. Stable inflation despite strong growth will likely continue to support slow monetary policy normalization going forward. As we expected, price pressures from recent hurricanes are beginning to feed through to inflation data. Uncertainty around the true inflation trend will likely cap US Treasury yields in the near term, despite upward pressure from policy normalization.

Europe: European growth continues to surprise to the upside while inflation remains muted. The ECB's commitment to maintain its asset purchase program and not increase interest rates until well past the end of the program has kept the short end of the yield curve anchored, continued with no rate hikes currently priced in by the market before 2019. 10-year bund yields have traded in the 35-40 basis points range, while peripheral government bond yields have traded tighter.[1]

China: Longer-term onshore government bond yields rose relative to short-term yields in the first half of November as higher than expected inflation and concerns over additional financial regulations shifted market sentiment. President Xi's speech at the 19th Party Congress pointed to a quality-focused growth strategy and probable further emphasis on strengthening financial regulation. In our view, this suggests slower credit growth and a lower rate of economic growth going forward, which should support the performance of Chinese onshore rates in 2018.

Japan: Japan is experiencing its longest growth streak in sixteen years, helped to a large degree, by a pickup in global demand.[2] We believe external demand will remain robust as we head into 2018. Domestic consumption should remain positive also, helped somewhat by a government tax initiative that incentivizes companies to pay higher wages to its staff. Headline inflation has moved higher over the past few months, however, oil prices have been elevated and the yen has traded at depressed levels (on a real effective exchange rate basis), therefore, additional upside from here appears limited. We expect the (BoJ) to keep policy unchanged over the coming months and for 10-year government bond yields to range between 0%-0.1% through year end.

UK: The Bank of England (BoE) hiked rates by 25 basis points in November, in line with market expectations.[3] The comments that accompanied the decision suggested that the pace of future increases would be relatively slow (two more hikes over the next three years). Given the uncertainty surrounding Brexit discussions, that would appear to be reasonable. It is difficult, however, not to see additional hikes being priced in as we make our way toward the end of Brexit discussions. These discussions are likely to prove fractious over the next six months, but as the end game becomes clearer (our base case is a soft Brexit or no Brexit), we believe the market will likely price in additional hikes. Our positioning remains neutral at this time, but we are looking for an opportunity to move underweight.

Canada: The Bank of Canada (BoC) has backed away from the rate hiking cycle that began in July as economic growth has slowed from the rapid pace seen earlier this year. Despite strong employment growth, the next rate hike is now not expected until March 2018. Inflation remains low and should allow long-term interest rates to consolidate at current or lower levels, in our view.

Australia: The Reserve Bank of Australia (RBA) remained neutral in November, leaving the interest rate at 1.50%.[4] The statement remained balanced with a positive business outlook offset by concern over weak household consumption. The unemployment rate has fallen, but wage inflation continues to be non-existent. High consumer debt and low wage growth should continue to constrain consumer spending. We expect low overall inflation and a strong housing market to keep the RBA on hold. We remain neutral on Australian rates.

India: Government bond yields have risen significantly since August after an upside inflation surprise. We believe that inflation will likely stabilize at around 4-4.25%, up from its current level of 3.6%, but remain within the Reserve Bank of India's (RBI) target range.[5] The combination of a hawkish central bank, high real interest rates by historical standards, and a benign growth environment has made yields potentially attractive, in our view. However, we would like to see inflation stabilize.

Rob Waldner, Chief Strategist, James Ong, Senior Macro Strategist, Noelle Corum, Associate Portfolio Manager, Reine Bitar, Macro Analyst,Yi Hu, Senior Analyst, Sean Connery, Portfolio Manager, Brian Schneider, Head of North American Rates Portfolio Management, Alex Schwiersch, Portfolio Manager, Scott Case, Portfolio Manager, Amritpal Sidhu, Quantitative Analyst

1 Source: Bloomberg L.P., Nov. 15, 2017.
2 Source: Cabinet Office, Aug. 14, 2017.
3 Source: Bank of England, Nov. 15, 2017.
4 Source: Reserve Bank of Australia, Nov. 7, 2017.
5 Source: Bloomberg, Reserve Bank of India, Nov. 13, 2017.

Currency outlook

USD: The US dollar has strengthened in recent months on expectations of a December Fed rate hike. We do not expect strengthening to be the longer term trend for the US dollar, however. Strong global growth, resulting in less accommodative global central bank policy, against a backdrop of gradual Fed policy normalization, is likely to drive the US dollar weaker over the longer term.

EUR: We maintain our forecast for further euro appreciation. Global growth momentum remains positive while inflation is subdued, which will likely continue to support the weak US dollar trend and higher euro valuations. We continue to view pullbacks in the euro as consolidation within a secular trend higher.

RMB: We expect the USD/RMB exchange rate to trade in a range of 6.5-6.7 in a stable US dollar environment and a range of 6.80-6.99 if the US dollar strengthens sharply from here. Officials indicated in the 19th Party Congress that currency stability is a near-term policy priority. We, therefore, expect the spot level of the renminbi to move in tandem with the US dollar, but with lower volatility compared to other major currencies. Capital flows have become increasingly two-way, compared to previous periods of net outflows, and we expect this dynamic to continue in the near term.

JPY: We expect the yen to remain range-bound (¥110-115) against the US dollar over the next quarter. There appears to be a general market view that US and Japanese central bank monetary policy will continue to diverge and that this will likely push the USD/JPY exchange rate higher. While a weaker yen would likely push Japanese inflation closer to the BoJ's 2% target, it could negatively impact consumption in the process, which would not be welcome. The yen is also trading at depressed levels on a real effective exchange rate basis, so the potential for significant weakness from here appears limited. We, therefore, maintain our neutral stance on the yen but would view further weakness as limited if the exchange rate moved toward the higher end of the ¥110-115 range.

GBP: We continue to expect a positive outcome to Brexit discussions, but it could take some time for this to materialize. The coming weeks will be crucial for Prime Minister May, as she tries to persuade her European Union counterparts to start talks on a trade deal. If her efforts are unsuccessful, May is likely to face a challenge to her job. Such uncertainty would be detrimental for the currency, in our view, and would continue to negatively impact both consumer and business sentiment. We remain underweight sterling in the short term.

CAD: The Canadian dollar has been on a roller coaster this year, peaking in September just after the second interest rate hike by the BoC. We believe the recent slowdown in growth should allow the BoC to be patient in assessing the need to hike rates again, leaving the currency to trade in a fairly tight range through the end of the year.

AUD: The RBA remained on hold in November, keeping the interest rate at 1.50%.[1] It was optimistic about business investment but also remained concerned about weak household consumption. Labor data have improved, with the exception of wage inflation. Overall inflation remains stubbornly low as well. Low inflation along with the robust housing market should keep the RBA on hold. With the Australian dollar still relatively expensive, amid positive global growth, we remain neutral on the currency.

INR: We maintain our neutral stance on the Indian rupee. Favorable macro fundamentals such as moderate growth, benign inflation, a hawkish central bank and a manageable current account deficit have already caused the rupee to strengthen. Therefore, we believe upside potential remains limited. However, strong fundamentals and a substantial foreign reserve cushion should provide the rupee with some downside protection against external shocks, in our view.

Ray Uy, Head of Macro Research and Currency Portfolio Management, James Ong, Senior Macro Strategist, Yi Hu, Senior Analyst, Sean Connery, Portfolio Manager, Brian Schneider, Head of North American Rates Portfolio Management, Alex Schwiersch, Portfolio Manager, Scott Case, Portfolio Manager, Amritpal Sidhu, Quantitative Analyst

1 Source: Reserve Bank of Australia, Nov. 7, 2017.

This section highlights the key themes driving Invesco Fixed Income's global credit research process and views. Themes are updated based on evolving trends and expectations.

Global credit themes

Geographical themes

Investment grade (IG): Global central bank forces, global growth impulse, fiscal policy changes

Rationale

Despite the Fed's announcement that it will begin "quantitative tightening," the pace of tightening will likely be very slow and will be more than offset initially by continued easy monetary policy from the ECB and BOJ. As a result, IG credit should see strong global investor demand at least through the end of 2017, driven by continued strength in cross-border flows. Fundamentals are now broadly improving across most geographies and sectors, driven by a pickup in the global growth outlook. Leverage has stabilized near recent cycle highs in 2016, and with little pressure from shareholders to increase leverage, we expect balance sheet improvement from here. The outlook for US tax policy is uncertain, but any changes that may occur should lead to improving profitability and less bond issuance going forward. On the other hand, regulatory changes seem more likely and should reduce expenses and enable opportunities for revenue growth. European credit markets are generally earlier in the credit cycle and less levered, although Brexit and political uncertainties remain. Although credit spreads in many asset classes are near cycle tights, the fundamental backdrop should remain supportive and there is historical precedent for returns to remain positive despite tight index spreads.

IFI strategy

We remain modestly overweight IG credit, favoring US and Europe over the UK and Asia. Key drivers to monitor include: 1) changes in monetary policy from the Fed, ECB, BoJ and BoE, viewed on an aggregate basis for their impact on global credit flows 2) changes in shareholder sentiment that could pressure firms to start increasing leverage 3) development of fiscal and regulatory policy changes 4) "hard" economic data to confirm the increase in "soft," sentiment-based leading economic indicators.

Emerging markets (EM): Reversal of reflation trade, favorable financial conditions, growth outlook supportive

Rationale

The positive view on global growth, aggregate global monetary policy and benign inflation pressures support our constructive view on EM credit, despite tight valuations. These forces have helped leverage come down from cycle highs, and we expect this trend to continue at a measured pace. Global inflation pressures remain conspicuously absent.

IFI strategy

We prefer high yield bonds due to our positive view on global growth, benign inflation outlook and continued easy financial conditions. We prefer to take credit over interest rate risk. We favor Latin America over Europe and Asia and are underweight Central and Eastern Europe. We are focused on sovereigns that have underperformed without a meaningful catalyst: Lebanon, Kazakhstan, quasi sovereigns, Oman. We actively use the new issue market as a source of alpha and to build exposure in favored names and regions.

US commercial mortgage backed securities (US CMBS): Notable decline in primary market issuance, watching retail industry fundamentals

Rationale

Negative retail news has dominated headlines. However, we are generally not advocates of selling stronger US CMBS credits since they are often hard to replace. Issuance is increasing after a slow first half 2017. US property price growth continues, but there are signs of tighter financial conditions from the Fed's senior loan officer survey. Fortunately, this survey has not always been a good predictor of commercial real estate loan losses and the non-bank sector has proven willing and able to provide credit while banks have taken a step back.

IFI strategy

Given the significant move in spread tightening we prefer seasoned US CMBS as the cycle progresses. We think AAA-rated US CMBS look less attractive. Credit-differentiation is accelerating, placing a premium on selection, so we must navigate large regional mall concentrations. Rich valuations and poor hedge-adjusted carry weigh on shorter-term high quality paper.

US residential mortgage backed securities (US RMBS): Favorable fundamentals, valuations fair, Credit Risk Transfer (CRT) securities market depth improving

Rationale

Mortgage underwriting quality remains high, the home price outlook remains supported by limited housing supply, and long-term negative net issuance remains the dominant factor in US RMBS. Valuations appeared stretched relative to other asset classes following outperformance during first half 2017 in legacy US RMBS and below-IG CRT, but a slight widening in spreads during the third quarter of 2017, driven by an active hurricane season, has brought valuations back to fair value, in our view, relative to other similarly rated credit asset classes.

IFI strategy

Favor higher quality legacy prime, alt-A, and seasoned BBB-rated CRT. Avoiding sub-prime, coastal concentrations, and option adjustable rate mortgages.

US asset backed securities (US ABS): Value in floaters, fundamentals normalizing, favorable technicals

Rationale

Normalization of credit underwriting and forecast for a healthier economy should support consumer credit performance in 2017. Recent widening in swap spreads and LIBOR rates provide a potential opportunity to add at fairly attractive levels. As the overall market continues to weigh the longer-term impact of a Trump administration and additional rate hikes going forward, such uncertainty should be supportive of a relatively stable, shorter-duration US ABS market.

IFI strategy

Favor adding exposure to floaters where collateral performance remains stable. Believe senior prime auto US ABS and esoteric issuers can provide opportunities. Avoiding deep subprime auto US ABS.

Sector themes

Commodities: Global supply concerns creating energy volatility, prefer pipelines

Rationale

Expect global IG credit risk premia to remain volatile as energy and metals credits reflect supply imbalances, offset by credit friendly financial engineering. Credit quality in focus due to still-modest economic growth and risk of volatility due to OPEC, US crude supply, fiscal policy implementation and Fed uncertainty.

IFI strategy

Favor gaining exposure to selected higher quality energy issuers where shorter-term maturities are well covered by liquid assets and positive corporate actions have the potential to support financial profiles. Also favor pipeline credits with favorable parental relationships that have the potential to provide downside protection at attractive yields.

Consumer story more nuanced globally, watching US fiscal policy influences

Rationale

Solid US labor market and consumer confidence are supportive, but consumers more value and delivery conscious, while international retail demand remains uneven. Watching European consumer for post-Brexit behavior shift.

IFI strategy

Favor selected US consumer sectors including leisure and housing-related sectors. Negative on "big box" and mall-based retailers that lack differentiated products. Favor EM consumer sectors on a selective basis. Incrementally more cautious on automotive original equipment manufacturer (OEM) sector, given excess inventory.

Post-merger and acquisitions (M&A) deleveraging plays

Rationale

M&A activity has moderated but remains a risk, driven by large overseas cash balances, low all-in financing cost, still soft organic revenue growth, and need to reposition business portfolios.

IFI strategy

Preference to play post-transaction bond issuance typically characterized by size, liquidity, concessions and plans to deleverage. Believe a discriminating approach to this strategy is warranted due to lower, but still large, M&A-related pipeline.

Global technology – big data

Rationale

Expect global use of data to grow and transition to cloud-based platforms.

IFI strategy

Prefer to gain exposure to software and services, cell towers and select wireless issuers. Have avoided hardware OEMs.

Yield curve themes

Credit curve positioning, long end valuations getting full

Rationale

Global interest rate policy has forced cash investors and sovereign wealth funds into 3-5 year part of the credit yield curve, creating a steep 5-7 year part of the curve. Lately, sovereign wealth funds have targeted the 10-year part of the curve. We expect demand for 5-10 year paper to be resilient.

IFI strategy

Favor 7-10 and select 30-year points on US IG and EM credit yield curves. New issuance has remained strong year-to-date, but is expected to decline as the pace of mergers returns to normal.

Tony Wong, Head of Global Research, Joe Portera, CIO High Yield and Multi-Sector Credit, Michael Hyman, CIO Global Investment Grade and Emerging Markets

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

Global credit strategy

Global fixed income markets – 2018 outlook

Global investment grade

The positive economic conditions in 2017 that reduced corporate credit spreads to multi-year lows is expected to continue in 2018. We believe economic growth is moving in a positive and coordinated manner globally for the first time in many years, resulting in strengthening trends in corporate fundamentals. Expectations of a global recession remain low and inflationary trends are positive, yet appear to be contained across most developed markets. Monetary tightening may pose a slight headwind in the US, while liquidity remains high in Europe as the European Central Bank (ECB) is only starting to consider the discontinuation of asset purchases and the BoJ will likely remain easy in Japan. As a result, we expect credit to outperform sovereign counterparts in 2018 as the additional spread generates incrementally higher income and provides a level of protection from slightly higher interest rates. Appreciation in corporate credit will likely be more challenged as the rally that started in the first quarter of 2016 becomes more sector and security-specific.

The risks to our views include a significant change in monetary policy or an unexpected deceleration in global growth, which could result in deteriorating credit fundamentals. While we view a potential monetary policy mistake as a low probability, such an event could disrupt the current market cycle and alter our fundamental outlook. Disruption is also occurring at unprecedented levels across certain sectors — retail, for example — and trends will need to be monitored closely to minimize downside risks. We expect risk oscillation and sound credit selection processes will be necessary in 2018 to capitalize on opportunities and avoid problem sectors and issuers.

Global high yield

Our outlook for high yield is cautious. We acknowledge the favorable fundamental trends for high yield issuers but note that valuations fully reflect strong fundamentals. We are also cognizant of the market's ability to maintain current spread levels for a period of time, and flows continue to come into the asset class. Themes for 2018 across all credit sectors include a preference for financial issuers over non-financials, due to improving bank fundamentals and regulatory changes. Strong idiosyncratic credit selection across a range of industry sectors will likely benefit portfolios. Overall market fundamentals remain solid, but we do note weakness in the retail sector as structural disruption has caused investors to question many retail business models. The energy sector, specifically oilfield services and integrated energy, continues to improve as oil prices firm. We think defaults will likely be muted in 2018 as favorable capital market conditions allow many companies to extend their maturity profiles. Most corporate revenue in the US high yield market is tied to the health of the US consumer, which, we believe, will likely remain stable in 2018.

Global liquidity

Continued economic strength in the US and abroad should keep the likelihood of higher interest rates and the US Federal Reserve (Fed) in play in 2018. However, recent years have witnessed some uncertainly around market expectations regarding the pace of monetary policy normalization, and 2018 will likely be no different. Money market rates should closely follow the direction of Fed policy. Inflation and inflation expectations, which were surprisingly subdued in in 2017, could also influence the direction of rates in 2018.

Prospects under newly nominated Fed Chair Jerome Powell are for continued transparency and predictability, which should provide a smooth transition and foster relative stability in the bond markets. As in recent years, we expect the Fed to utilize forward guidance and a gradual approach to monetary policy implementation with minimal disruption to the markets.

The unwinding of the Fed's balance sheet, begun in October 2017, should continue at the Fed's planned gradual pace. This would add to market supply and potentially place some upward pressure on yields. Ample supply of US government securities should satisfy the money market's appetite for short-term government securities. As in 2017, we will be watching for potential developments around the US debt ceiling in early 2018 and the impact on US Treasury issuance and Treasury bill yields.

In Europe, money market fund reform was signed into law in 2017 and should start to take shape in 2018, with final implementation slated for Jan. 21, 2019.

US municipal bonds

As we look into 2018, the major theme for the municipal market is likely to be the outcome of the proposed Tax Cuts and Jobs Act of 2017, specifically the language that curtails the ability of governments and other entities to issue advance refundings, private activity bonds, tax credit bonds, and tax-exempt bonds for professional sport stadiums. Under the private activity umbrella are issuers such as private universities, Continuing Care Retirement Communities (CCRCs) and not-for profit hospitals. As it stands, we estimate that 25-30% of municipal supply could be affected by the provisions of the House of Representatives tax bill. While these limitations could be problematic for both municipal issuers and investors going forward, current holders of these types of bonds could be compensated for the expected scarcity in terms of price appreciation.

Due to the threat that many issuers may no longer be eligible to access the lower borrowing rates that they currently enjoy in the municipal market, we expect a short-term spike in issuance through year end. While we believe that there is ample cash to absorb such an increase, it would likely result in a reduction of 2018 supply. Aside from these issuance limitations, the tax proposal is largely viewed as benign to the overall municipal market given that tax-exemption is preserved and individual tax rates remain largely unchanged for the top income tax bracket. This could improve the valuations of existing municipals and tighten municipal supply going forward – resulting in a positive technical environment for municipals in 2018.

Meanwhile, lower corporate taxes, and the cap on some net interest deductions, could drive significant deleveraging across the non-financial corporate universe. Decreased credit issuance could increase demand for municipals among crossover investors, which would likely be positive for the asset class.

Structured securities

We expect the primary focus of the agency mortgage-backed securities (MBS) market in 2018 to be the Fed's initiative to reduce the size of its bond portfolio. While the program is expected to be gradual, we expect agency MBS spread volatility to increase from historically low levels, as private investors must absorb greater supply, which could result in some spread widening.

Agency MBS valuations remain historically rich, with spreads at multi-year tights. While agency MBS have been supported by strong commercial bank and mortgage REIT demand, and we expect this to continue in 2018, the pace of home purchase activity will also likely be a driver of 2018 performance. If the housing market slows due to affordability or inventory issues, the market could face less origination volume to absorb. Foreign demand will also likely play a pivotal role. Given strong underlying fundamentals, exogenous macro developments and risk appetite will likely influence residential credit spread trends.

In commercial real estate, values have risen considerably in recent years, but we believe the risk of an asset bubble in 2018 is more an equity concern than an investment grade debt risk, as collateral quality, credit enhancement and underwriting have improved materially since the global financial crisis. We continue to believe that underlying commercial real estate fundamentals in the US, in terms of vacancy rates and delinquencies, will be a positive factor for the commercial mortgage-backed securities (CMBS) asset class in 2018, although we expect a slower pace of property price appreciation and further weakness in the retail sector.

Emerging markets (EM)

We are constructive on EM debt in 2018 as investors are expected to re-establish their allocations to the asset class. EM hard-currency credit and local-currency bonds should continue to benefit from broadly favorable global financial conditions and steady — if uneven — improvement in EM macro fundamentals. This outcome is predicated on a gradual removal of extraordinary monetary policy accommodation by developed market central banks, on the back of stable, synchronized global and EM growth and a manageable slowdown in China.

The longer-term outlook is also broadly supportive of EM, in our view. We expect relatively modest nominal growth among developed economies due to low inflation and modest real growth, which is limited by weak demographics and productivity growth. This means that any rise in global interest rates should remain relatively contained, preserving the attractiveness of higher-yielding asset classes such as EM.

We believe EM hard-currency bonds offer a compelling yield advantage to comparable asset classes when adjusted for credit quality, given that EM country fundamentals have improved and external vulnerability has declined since the so-called "taper tantrum" in 2013. At the same time, we expect EM local-currency bond yields to continue to compress, particularly relative to developed government bond markets. In addition, given the amount of currency depreciation between 2012 and 2015, EM currencies remain attractive on a valuation basis, particularly relative to the US dollar. In 2018, we expect EM local currency investments to outpace EM credit in terms of total return, in our baseline scenario, but recognize that EM currencies are a more volatile asset class. In 2018, therefore, we believe that EM local currency is likely favorable in terms of outright returns, while EM credit is likely favorable on a risk-adjusted basis.

Currencies

Our macro factor framework continues to support our view for continued cyclical US dollar weakness. Global convergence is expected to continue to play out and, absent systemic shocks, this regime is expected to lead to a weaker US dollar. We expect the other major currencies to continue to appreciate against the US dollar, save for the Swiss franc, which we expect to revert to its historical, pre-global financial crisis average. We do not expect inflation to force the Fed into a more aggressive stance. Emerging markets currencies will likely be dominated by idiosyncratic factors rather than global ones, so we prefer to focus on relative value opportunities in this space instead of directional trends.

European fixed income

European growth has been a great success story in 2017, and we remain constructive on further broad economic recovery in 2018. The euro-area continues to benefit from benign global growth momentum, and political risks have failed to drag down economic sentiment so far. Although underlying inflation pressures remain weak, they are expected to increase slowly on the back of steady growth and a firming labor market. The ECB's decision to extend its asset purchase program for nine months from January 2018, while stating that interest rates will remain at current levels, well past the end of QE, should keep expectations about short-term rates low until well into 2019. This should provide time for governments to work on structural reforms and potentially plan around closer eurozone integration.
We are less constructive on the European periphery as the ECB unwinds QE in the face of government bond supply. Politics will likely remain on the forefront, with Italian elections slated for no later than May 2018, for example, which is bound to generate headline noise.

Indian fixed income

The Indian fixed income markets are expected to reap the benefits of macro stability in 2018. The benefits of benign inflation, a lower fiscal deficit, lower levels of cash transactions, post-demonetization, a more efficient tax collection framework that unifies goods and services taxes, higher foreign exchange reserves due to higher foreign business and portfolio inflows and a low current account deficit are all expected to support Indian financial assets in 2018.

We expect Indian bond yields to decline in 2018 due to high real interest rates, easy liquidity and tepid credit growth. The demand for bonds remains high while supply has become constrained by a split between domestic issuance and offshore issuance in the new "masala" bond market. The rupee is also expected to remain largely range-bound, with a bias toward appreciation, due to contracting inflation differentials and improvement in India's current account deficit.

We expect Indian credit spreads to contract for higher rated credits due to the ample availability of liquidity and the pass-through of lower interest rates to borrowers. However, geopolitical tensions, trade protectionism and potential slippage on government fiscal targets, fuelled by the pressures of needed job creation, remain risks to this outlook.

Steve Thompson, Senior Client Portfolio Manager, Dawn Silvia, Senior Client Portfolio Manager, Robert Corner, Senior Client Portfolio Manager, Stephanie Larosiliere, Senior Client Portfolio Manager, Tony Semak, Senior Client Portfolio Manager, Craig Altholz, Senior Product Manager, Ray Uy, Head of Macro Research and Currency Portfolio Management, Peter Wendt, Senior Client Portfolio Manager, Rajnish Girdhar, Client Portfolio Manager.

The bottom line

"Quantitative tightening" – the bull and bear case IFI November Summit debate session

Brian Schneider,
Head of North American Rates Portfolio Management

Gareth Isaac
CIO, EMEA

James Ong
Senior Macro Strategist

Arnab Das
Head of EMEA and EM Macro Research

After massive amounts of central bank bond buying, QE is finally coming to an end. QE forced global investors away from government and government-guaranteed bonds, like Treasuries and mortgage-backed securities, toward investments further out the risk spectrum, like corporate bonds and equities – perhaps further out the spectrum than some may have otherwise gone. Now with the end of QE in sight, how will investors react? At our November Summit, four of IFI's analysts and portfolio managers had the opportunity to meet and debate what "quantitative tightening" (QT) might mean for fixed income asset prices and volatilities. Gareth Isaac and Brian Schneider argued the bear case, while James Ong and Arnab Das took on the bull case. Below are highlights of the discussion.

Will a tightening of monetary policy, particularly tapering of QE, cause a large move up in government yields? What are the implications for credit markets?

The bear case

Brian Schneider: Bond purchases under QE have influenced the prices of both equities and bonds. We have seen a direct relationship between the rise in equity prices and shrinking of bond spreads following the implementation of various QE programs in the US and Europe. The larger the QE purchases, the more asset prices climbed and both equity and bond market volatilities fell. Volatility has been ultra-low for so long it seems that central banks have lulled investors into ignoring risk. We believe the end of QE could shock market sentiment, triggering longer-term bond yields to move higher. The catalyst could be a more hawkish Fed or a pickup in inflation or growth in general. Any one of the three could cause a spike in volatility given the historically low levels we are now experiencing and coincidentally disrupt the rates markets.

Gareth Isaac: The impact of QE on yields has been global. In other words, QE in the US, Europe and Japan has not only driven investors out of government bonds and into riskier asset classes, but it has also driven investment flows across countries and regions, ultimately driving down global yields. The massive stock of bonds held by central banks will likely keep global yields low in general, but the direction of rates is already turning around. Since QE peaked in 2016, global government bond yields have begun to rise. As central banks further reduce bond purchases in 2018, we think private investors will demand higher yields as they absorb increasing supply.

Positive global growth will likely lead the Fed to raise interest rates two to three times next year, but the market has only priced in one hike. The market will need to adjust. If government bond yields consequently become more attractive in yield terms, we question whether investors will take on the liquidity risk, interest rate risk and credit risk of corporate bonds at current spreads? If government bond yields can suddenly compete with corporate bond yields, the credit market will likely experience some dislocation as it struggles to deal with investor outflows amid continued corporate issuance. As QE ends, we don't anticipate a bear market in bonds, but we expect a period of volatility as the market finds a new steady state. Under this scenario, we would favor reducing risk and waiting for a better opportunity to invest further into the future.

The bull case

James Ong: We agree that asset valuations are high and that market vulnerabilities exist globally, but we do not believe that the end of QE is going to be a trigger that bursts asset bubbles. First, we think timing is critical. We believe a potential risk sell-off associated with the end of QE will likely not be an issue for at least a year. Global central banks are still buying massive amounts of bonds and their balance sheets are not projected to begin shrinking until the end of 2018. This means that any QT-related bond market downturn would be well into the future – in early 2019 at the earliest, in our view.

In the event of a term premium shock, in which long-term yields are pressured higher, we do not believe that increasing financing costs would derail growth because financial conditions remain so easy. Global central banks have communicated that they intend to maintain accommodative and that they only seek to normalize policy, not to tighten with the intention of aggressively slowing growth. This should support risk markets, in our view.

The main reason central banks can maintain their dovish stance is that the world is experiencing extremely low inflation. Low inflation has allowed global central banks to maintain very low interest rates and loose financial conditions. If there is a revival of inflation, we believe it would likely be at the heart of a potential risk sell-off, as central banks step in with tighter monetary policy. That being said, timing is again critical. A sharply higher inflation scenario is not around the corner - we do not foresee global inflation picking up significantly for at least another year.

Arnab Das: We rest our bull case with the importance of the macro backdrop. Almost a decade after the global financial crisis, far from deleveraging, the world has instead become more indebted. The bulk of rising debt burdens has occurred among governments and corporates, while households and financials in crisis-hit countries have delevered. This suggests that global growth should not be knocked off course by higher rates – to which households and banks are generally more exposed than credible governments and high-grade corporates.

Ours is also a world in which global central banks have not been able to meet their inflation targets. Today's policy challenge is to boost inflation up to target in many key economies, not to bring inflation down to target, as in the past. Thus, central banks could be faced with a policy dilemma. Since the global financial crisis, central banks have combatted deflationary pressures, while relying on "macro-prudential policy" – essentially financial-sector re-regulation – to prevent excessive leverage and financial bubbles.

What if a major central bank has to choose between price stability and financial stability? Given the hard battle already won, we believe it would be very unlikely to choose deflation to defeat financial bubbles. We would expect central banks to reason that deflation would likely increase the risks of financial instability, especially given high levels of indebtedness.

This is not to say that there won't be increased volatility and adjustments in bond, currency, credit, equity or commodity markets. But it is to say that central banks intend to normalize monetary policy now that the world economy is firing on almost every cylinder and the need for extraordinary monetary policy is past. But they will likely continue to be cautious, carefully telegraphing their intentions and staying mindful of market dynamics as they normalize policy.

Market monitors

Fixed income market monitor

	Coupon (%)	Yield to worst (%)	1 month change in YTW	Option-adjusted spread: Current	Option-adjusted spread: 1 month change in spread	Option-adjusted spread: 10 year range min	Option-adjusted spread: 10 year range max	Returns: 1 mth (%)	Returns: 3 mth (%)	Returns: YTD (%)	Returns: 12 mth (%)
Global Aggregate (USD hedged)	2.68	1.61	0.11	36	-5	23	156	0.42	0.87	2.65	1.23
U.S. Aggregate	3.06	2.60	0.18	35	-7	32	258	0.06	0.47	3.20	0.90
U.S. Mortgage-backed	3.53	2.86	0.16	21	-9	-16	181	-0.03	0.47	2.29	0.53
Global Inv Grade Corporate (USD hedged)	3.53	2.46	0.05	95	-14	55	515	0.64	1.18	5.13	3.72
U.S. Investment Grade Corporate	3.97	3.15	0.08	95	-15	76	618	0.40	1.01	5.61	3.46
Emerging Market USD Sovereign	n/a	5.23	0.03	284	-3	157	906	0.37	2.16	9.40	6.32
Emerging Market Corporate	n/a	4.44	0.01	226	-6	120	1,032	0.34	1.66	7.59	6.18
Global High Yield Corporate (USD hedged)	6.09	4.75	-0.20	320	-39	231	1,845	0.64	1.61	7.89	9.30
U.S. High Yield Corporate	6.42	5.43	-0.18	338	-40	233	1,971	0.42	1.28	7.45	8.92
Bank Loans	4.94	5.06	-0.02	n/a	n/a	n/a	n/a	0.66	0.93	3.72	5.25
Municipal Bond	4.73	2.25	0.17	n/a	n/a	n/a	n/a	0.24	0.49	4.92	2.19
High Yield Municipal Bond	5.23	5.31	0.04	n/a	n/a	n/a	n/a	0.27	1.11	8.01	2.99

Treasury market monitor

	Coupon (%)	Yield to worst (%)	1 month change in YTW	Returns in local currency: 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
United States	2.12	2.03	0.26	-0.12	0.09	2.14	-0.69
Canada	2.20	1.70	0.08	1.19	1.19	0.31	-2.67
United Kingdom	3.50	1.31	0.26	0.32	-0.41	0.06	0.67
Germany	1.98	-0.05	0.02	0.60	1.16	-0.80	-1.21
Italy	3.36	1.09	-0.19	1.97	2.16	1.82	1.26
Japan	1.04	0.14	0.04	0.02	0.17	-0.18	-1.51
China	3.47	3.89	0.18	-0.85	-0.83	-2.09	-4.94
EM Local Currency Governments	n/a	n/a	n/a	-0.62	1.06	7.35	6.17

FX market monitor[1]

	Current	10 year range: min	10 year range: max	Returns: 1 mth (%)	Returns: 3 mth (%)	Returns: YTD (%)	Returns: 12 mth (%)
EURUSD	1.16	1.05	1.60	-0.97	-1.55	11.13	5.10
USDJPY	114.18	75.82	124.77	-1.24	-3.33	2.96	-8.78
GBPUSD	1.32	1.22	2.11	-0.23	0.32	7.88	8.18
USDCNY	6.61	6.04	8.28	0.82	1.70	5.25	2.28
USDCHF	1.00	0.75	1.39	-2.85	-3.75	2.04	-2.78
AUDUSD	0.77	0.60	1.10	-1.93	-3.68	6.85	0.31
CADUSD	0.78	0.72	1.09	-2.76	-2.53	4.49	4.07
EURJPY[2]	132.68	94.31	169.49	-0.29	-1.82	-7.36	-13.21
EURGBP[2]	0.88	0.70	0.89	0.74	1.89	-2.94	2.93

Sources: Bloomberg Barclays, J.P. Morgan, as of Oct. 30, 2017. Credit Suisse Leveraged Loan data as of Oct. 31, 2017. Within the Treasury monitor, United States is represented by Bloomberg Barclays US Treasury Index; Canada is represented by Bloomberg Barclays Global Treasury Canada Index; United Kingdom is represented by Bloomberg Barclays Sterling Gilts Index; Germany is represented by Bloomberg Barclays Global Treasury Germany Index; Italy is represented by Bloomberg Barclays Global Treasury Italy Index; Japan is represented by Bloomberg Barclays Global Treasury Japan Index; China is represented by Bloomberg Barclays China Aggregate Treasuries Index; EM Local Currency Governments is represented by J.P. Morgan GBI_EM Broad Diversified Index. In the Fixed Income Monitor, Global Aggregate is represented by Bloomberg Barclays Global Aggregate (US$ Hedged) Index; US Aggregate is represented by Bloomberg Barclays US Aggregate Index; US Mortgage-backed is represented by Bloomberg Barclays US Mortgaged-backed Index; Global Investment Grade Corporate is represented by Bloomberg Barclays Global Aggregate Corporate (US$ hedged) Index; U.S. Investment Grade Corporate is represented by Bloomberg Barclays Aggregate Corporate Index; Emerging Market USD Sovereign is represented by the J.P. Morgan EMBI Global Diversified Index; Emerging Market Corporate is represented by J.P. Morgan CEMBI Broad Diversified Index; Global High Yield Corporate is represented by the Bloomberg Barclays Global High Yield Corporate (US$ hedged) Index; U.S. High yield Corporate is represented by Bloomberg Barclays U.S. Corporate High Yield Index; Bank Loans is represented by the Credit Suisse Leveraged Loan Index; Municipal Bond is represented by Bloomberg Barclays Municipal Bond Index; High Yield Municipal Bond is represented by Bloomberg Barclays Municipal Bond High Yield Index. Yield to Worst (YTW) is the lowest expected yield calculation given maturity and call features. Option Adjusted Spread (OAS) is the yield difference relative to similar maturity Treasuries that incorporates call, put, sinking fund or paydown features of a bond. Past performance cannot guarantee future results. An investment cannot be made directly in an index. Returns less than one year are cumulative..

1 Positive number represents the currency appreciated against USD, negative number represents currency depreciated against USD.
2 Positive number represents the currency appreciated against EUR, negative number represents currency depreciated against EUR.

Invesco Fixed Income

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Recent IFI publications

1. **Global Liquidity: A long-term approach to short-term investing,** October 2017, Invesco Global Liquidity
2. **Q&A: Strategies for investing in a low yield world,** October 2017, Rob Waldner, Chief Strategist, Head of Multi-Sector
3. **The US debt ceiling saga resumes,** August 2017, Justin Mandeville, Portfolio Manager
4. **IFI Global Investors' Summit,** June 2017, Rob Waldner, Chief Strategist, Head of Multi-Sector, Tony Wong, Global Head of Credit Research, Liquidity and Municipals
5. **Quality currencies can potentially diversify against growth risk,** June 2017, Ray Uy, Head of Macro Research and Currency Portfolio Management, James Ong, Senior Macro Strategist
6. **When US rates rise, it may be time to consider adding emerging market bonds,** May 2017, Julie Salsbery, Senior Client Portfolio Manager
7. **Asian US dollar bond market: China's new "local" market,** May 2017, Ken Hu, CIO, Asia Pacific

Invesco Fixed Income

Global perspective and deep local market knowledge

Global presence

- Regional hubs in Atlanta, London and Hong Kong
- IFI is in ten locations with additional Invesco colleagues in two
- USD 311.3 billion in assets under management

Experienced team

- 171 investment professionals
- Averaging 18 years of industry experience
- Deep macro and credit research
- Focused and accountable portfolio management

Global locations

Source: Invesco. For illustrative purposes only.

Invesco Fixed Income teams

	Team members	Average years with Invesco	Average years in industry
Portfolio management and trading	75	12	20
Global research	96	9	17
Total investment professionals	171	10	18
Business professionals	56	12	19
Total fixed income employees	227	11	19

Source: Invesco.

As of Sept. 30, 2017. Subject to change without notice.
Investment specific experience for investment professionals.

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