Invesco Fixed Income White Paper Series
Global Investors' Summit November 2018

December 2018

Over 90 investors gathered in Atlanta in November to discuss and debate Invesco Fixed Income's (IFI) views on global macroeconomic trends. Below, we discuss some of the major developments currently driving global macro performance, our outlook for key economies and how they influence our asset allocation decisions.

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Key macro conclusions

- In the US, we believe peak levels of growth are behind us and growth will likely moderate to around 2% by the end of 2019 as the effects of fiscal stimulus subside. Our below-consensus inflation estimates for 2018 have been largely realized. Going forward, we expect core inflation to remain benign, increasing to around 2.5% in 2019, including the impact of recent tariffs, but remaining in line with the historical trend of around 2.3% if the impact of tariffs is excluded. US monetary policy will likely continue to tighten as the US Federal Reserve (Fed) continues its gradual hiking cycle, although slowing growth may force the Fed to pause.
- European growth is slowing but is likely to remain above-potential in 2019 at around 1.6%, which should give rise to a gradual pickup in core inflation to around 1.3%. Monetary policy and political uncertainty are likely to be headwinds to growth as the European Central Bank (ECB) winds down its quantitative easing program and the euro area faces significant political risks in 2019: Italian budget concerns, Brexit and European Parliamentary elections in May.
- We expect growth to stabilize in China as the effects of fiscal and monetary easing measures take hold. Monetary policy will likely remain accommodative in 2019, but we expect fiscal easing to be the main policy lever going forward, with a focus on additional tax cuts and support of private sector companies. Inflation will likely remain below the central bank's "alert" level of 3%.
- In Japan, we expect continued stable above-potential growth and benign inflation. However, the Bank of Japan will likely make further changes to its quantitative and qualitative easing program to curb possible negative effects on the government bond market and banking sector.
- We believe there may be some recovery in emerging markets (EM) growth relative to expectations. Additionally, we expect stable-to-lower inflation and modest improvements in external accounts. EM will likely continue to be driven by changes in US macro conditions, especially the path of the US dollar, although we believe the market will be increasingly driven by idiosyncratic country and regional factors.

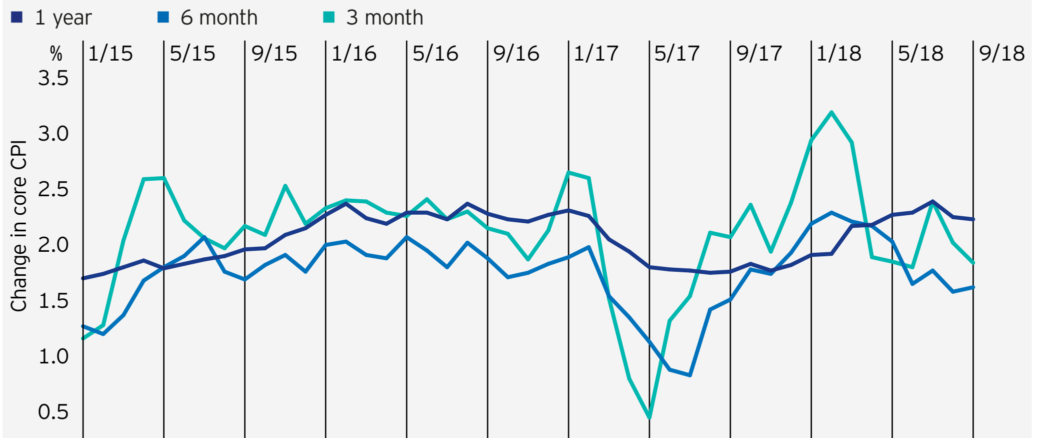
US

Peak growth behind us

At the May Summit, we upgraded our 2018 growth forecast to 2.8%, due mainly t o fiscal stimulus measures related to 2017 tax reform. We now believe peak levels of growth are behind us. We expect annual growth to be maintained at around 2.75% thr ough the first half of 2019, but slow in the second half of the year toward 2.0%. Fis cal stimulus is still boosting growth, but we expect that momentum to wane in the second half of 2019. Positive financial tailwinds that have driven the economy in 2018 turn more negative as monetary policy tightens. In particular, consumption has grown at an unsustainably high level over the last several quarters, in our view, driven by stronger consumer confidence and tax cuts. While consumer spending will likely be additive to growth through the first half of next year, we question how much consumers will continue to spend as the impact of tax cuts winds down. A meaningful consumption slowdown could have negative implications for broader growth. This means risks to economic growth will likely be higher in the second half of 2019 than they have been at previous points in the cycle.

Inflation is likely to increase somewhat in 2019, bolstered by tariffs on goods prices. But, aside from tariff-driven inflation, price pressures are likely to be generally subdued. While we expect wages to slowly rise as labor markets tighten, we do not expect wage inflation to be passed through to consumer prices in a meaningful way in 2019.

Figure 1: Core inflation has already slowed



Source: Bloomberg L.P., data from Jan. 1, 2015 to Sep. 30, 2018. Core CPI is the US Consumer Price Index, Urban Consumers Less Food & Energy, Seasonally Adjusted.

The combination of strong labor markets and strong growth make it likely that the Fed will continue its (gradual) hiking cycle though the first half of 2019. We expect two rate hikes in the first half. However, if the US Treasury yield curve continues to flatten and financial conditions tighten, the Fed may find it difficult to hike in 2019. The US Treasury market has undergone a significant correction this year and valuations are now inexpensive relative to long-term fundamentals, in our view. However, large fiscal deficits will continue to cause the US Treasury to issue large amounts of debt. Increased supply, combined with declining Fed purchases, could create US Treasury market volatility in the coming year.

The US dollar is likely to find support in the near term as US growth attracts capital flows. However, if global growth paths begin to converge, other markets would become potentially more attractive. If there is a significant US slowdown next year, we think it is unlikely to be driven by internal forces and more likely to be imported from China, if China is unable to ease itself out of the slowdown it is currently experiencing.

Risks
We believe it is too early to call for a US recession. However, if US growth does slow significantly, for example on the back of a deeper than expected slowdown in China, US policy makers may struggle with limited policy options, given the already low level of the federal funds rate and the high fiscal deficit.

Europe

Growth has tapered but remains above-potential
European growth has underperformed our expectations at the May Summit, but remains above potential. Private consumption is healthy, unemployment is falling and wages are rising. Fiscal policy is marginally expansive. Credit conditions remain accommodative, with interest rates still in negative territory across many European markets.

However, growth is slowing. An uncertain trade outlook, a slowdown in China and emerging markets, and risks related to Italian politics and Brexit have all presented headwinds to European growth, after strong performance in Q4 2017. We expect the euro area to continue to post above-potential growth in Q4 2018, but at a rate of around 1.5% c ompared to 2.8% in the f ourth quarter of last year. While lower, we believe this growth rate will be sustainable in 2019 based on stabilizing trends in manufacturing (especially in Germany) and consumer confidence.

As the euro area continues to grow above potential, we expect inflation to continue to pick up, although very slowly. Banks remain reluctant to lend and loan demand is anemic, which should lead to relatively benign core inflation of around 1%-1.4% in 2019.

Policy is a further headwind. The ECB winds down its quantitative easing program at the end of December and we believe the bar to restarting the program is high. Moreover, after the term of current President Mario Draghi ends in October 2019, the future policy stance of the ECB will become less clear. We would expect the next ECB governor to be considerably less accommodative than President Draghi, in terms of policy stance.

Risks

Italy's political situation remains one of the biggest unknowns in Europe's outlook, in our view. As we head into 2019, we expect friction over Italy's budget deficit to weigh on investor sentiment and create bouts of market volatility. We also remain concerned about the country's political situation and its long-term debt sustainability, especially in light of its low growth prospects and the removal of ECB monetary stimulus. If uncertainty and negative sentiment cause Italy to lose financial market access, we believe the situation could develop into a deeper crisis, potentially spilling over into other European financial markets and economies.

The future of Brexit is another significant unknown facing markets with the potential to impact economic fundamentals. We believe the outcome will ultimately be toward a softer, rather than harder, Brexit. Following the recent Brexit agreement between the UK and European Union (EU), ratification by the UK Parliament is the next major hurdle. While the vote is currently too close to call, even if Parliament rejects the deal, we do not believe this would guarantee a "no deal" Brexit. A parliamentary coalition around a form of Brexit that has cross-party support, such as European Economic Area membership, or a national unity government and/or an eventual referendum are other possible outcomes. Any of these scenarios could delay ratification and result in an application to the EU to extend the exit deadline beyond March 2019. We believe the EU would accommodate this request, especially if the UK is planning to hold an election or referendum. The Irish Backstop will probably ensure the UK remains closely aligned with the EU on trade post-Brexit. In addition, in the long-run, we believe that demographics and a potential future change of government could ultimately yield a softer Brexit. Because voting in the 2016 EU referendum was largely split by age – with older voters tending to vote "Leave" and younger voters tending to vote "Remain" - as more younger voters are enfranchised, support for Remain could increase. A change of government following a future election could also result in a softer version of Brexit, given the Labour party's bias toward a softer outcome.

Next May's European Parliament elections will also be pivotal to Europe's future, in our view. Will voters favor populist and EU-critical political movements over traditional centrist parties? Will Italy's defiant attitude toward the EU's influence reinforce other nationalist movements heading into the elections? These questions and others, such as the potential for a trend toward more spending-orientated governments across the region, will be important to monitor, in our view, for their impact on the continued success of the European project.

China

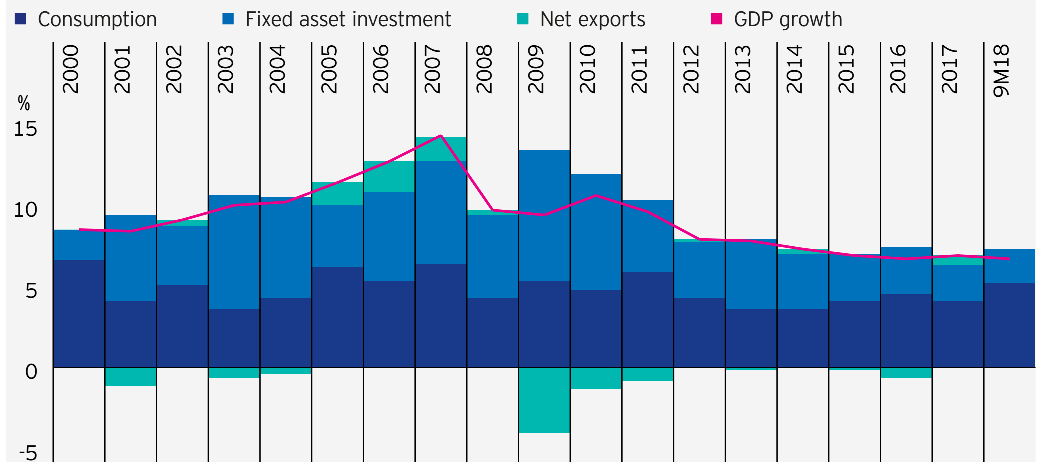
Since the November 2017 Summit, we have maintained our non-consensus view that Chinese growth would slow in 2018, despite strong growth in 2017. This was driven by our expectations of tighter regulations, slowing credit expansion and an increasingly complex external environment. Since then, data reports and market consensus have converged to our view. Markets appear to expect slowing growth as well in 2019, but, once again – our view at the November 2018 Summit breaks with consensus. We believe economic growth will stabilize at the end of 2018 and into the first quarter of 2019, helped by the monetary and fiscal easing measures adopted since mid-2018. With easier policies in place, credit growth trends have started to recover. We also expect to see further stimulus from more proactive fiscal policies in 2019, with a focus on additional tax cuts and support for private sector companies. While these measures should curb the slowdown in economic growth, a reacceleration is less likely in the near term, in our view. We expect inflation to reach around 2.0%-2.5% in 2019, below the central bank's 3% alert level. This would give the central bank the flexibility to maneuver while using macro-prudential measures, if necessary, to keep the renminbi exchange rate at a reasonably stable level. We continue to see 6.80-6.90 as the likely trading level for the US dollar/renminbi exchange rate in the medium term.

Policy outlook – fiscal policies will likely dominate

Rounds of required reserve ratio (RRR) cuts and central bank (PBoC) open market operations in 2018 have injected a large amount of liquidity into the banking system, helping to lower onshore short-term rates by over 100 basis points during the year.[1] However, the credit transmission mechanism has not fully directed this liquidity toward credit extension to the real economy. Therefore, we believe monetary policy has run its course, and fiscal policy will likely play a more proactive role going forward. PBoC advisor Ma Jun estimates that tax and fee cuts in 2019 could amount to the equivalent of 1% of GDP.[2] The cuts could come in the form of a value added tax cut and/or reductions in pension contributions by corporates. This is in addition to the personal income tax cut announced in October 2018, which is expected to significantly reduce monthly tax payments, especially for those in lower-to-middle income brackets.

In the past, boosting infrastructure investment was the main form of fiscal stimulus. However, currently, the focus has been on reducing the tax burden on corporates and boosting household consumption. Consumption accounted for 78% of China's GDP growth in the first nine months of 2018.[3] Of the 6.7% real GDP growth rate recorded in the first nine months of 2018, 5.2% was due to consumption, 2.1% from capital formation and -0.7% from net exports (Figure 2). Prior to the G20 meeting held in early December 2018, the International Monetary Fund (IMF) estimated that trade tensions between the US and China could negatively impact China's GDP growth by 0.6%-1.0%.[4] However, as the two parties make progress toward reaching a deal, easing tensions, we expect to see less impact from trade friction than the market previously feared.

Figure 2: Consumption is the main contributor to GDP growth



Source: CEIC, Invesco, data as of Sep. 30, 2018. 9M18 refers to the first 9 months in 2018.

Growth outlook – expecting stabilization
We expect a low 6% GDP gr owth rate for China in 2019. Additionally, China is likely to lower its GDP growth target from 6.5% t o a low 6% le vel, which is expected to be sufficient to meet China's unemployment rate target. China's policy makers have articulated a willingness to accept a moderating GDP growth level in exchange for higher-quality growth.

Currency outlook – central bank stands by
We see 6.80-6.90 as the likely trading range for the US dollar/renminbi exchange rate in the medium term. The renminbi will likely face pressure from China's shrinking current account surplus and a declining yield differential versus the US. And downside risks could rise if the US dollar strengthens sharply or US-China trade tensions escalate. However, we expect the PBoC to intervene if the renminbi approaches 7.0. Recent changes to the language in PBoC statements have indicated that the central bank is ready to use macro-prudential measures, if necessary, to keep the renminbi exchange rate at a reasonably stable level.

Overall, we believe the current deceleration in economic momentum will stabilize in 2019 as the effects of monetary and fiscal policy easing measures start to kick in. Monetary policy will likely remain accommodative, but the main policy lever going forward will likely be fiscal easing, with a focus on additional tax cuts and the support of private sector corporates to boost consumption growth. We believe the PBoC will seek to manage foreign exchange expectations if the renminbi faces pressure in 2019.

Japan

Stable growth

We believe growth is likely to remain above-potential in 2019. High corporate earnings growth in 2018 – about 7% year-over-year[5] – has led to a pickup in capital expenditures, which is projected to accelerate further in 2019 to around 8%-9%.[6] The labor market has also been strong. Unemployment is currently at multi-decade lows, and we expect continued labor market strength to support consumption and investment.

However, ongoing trade disputes and an upcoming consumption tax increase are potential risks to Japan's growth outlook. Auto tariffs are likely to have a greater impact on Japanese gross domestic product (GDP) than a spillover from US-China trade disputes. It is expected that a 25% tariff on Japanese autos could decrease Japanese GDP growth by 0.6%, while tariffs on all Chinese exports to the US would likely decrease growth by 0.1%.[7] However, US threats of auto tariffs have diminished recently, and the US and Japan have opened bilateral negotiations on a trade agreement that should conclude in 2019. We believe this will likely be resolved with Japan accepting some limits on its exports to the US in exchange for continued US access to its market.

Additionally, Japan is planning an increase in the value-added tax (VAT) from 8% to 10% for October 2019.[8] Historically, VAT hikes have led to sharp slowdowns in GDP growth. We do not expect a similar slowdown in 2019 for two reasons: first, the 2019 increase is smaller than previous hikes, and second, the government has pre-emptively implemented some offsetting measures and exemptions. However, the increase is still expected to negatively impact GDP by 0.4% and increase the headline Consumer Price Index (CPI) by about 1%.[9] We expect to see some increase in demand ahead of the tax increase in October.

Still benign inflation

We expect headline consumer price inflation to revert below 1% in 2019 due to lower energy prices and mobile phone charges. However, this may be offset somewhat by a pickup in wages and tighter corporate capacity, which could constrain supply. While underlying measures of inflation remain low, survey outputs from companies are beginning to show signs of tighter supply and demand conditions and increases in output prices. Wages in Japan have been largely stagnant due partly to the increased entrance of women and workers between the ages of 65 to 69 to the workforce, as these workers tend to earn lower wages. However, we have also seen some recent signs of increased wage growth, particularly in bonuses.

Downside risks to inflation in 2019 include a potential cut to mobile phone tariffs, which could offset the inflationary impact of the VAT hike. However, we believe the possible decrease in tariffs has been overestimated. Additionally, risk-off investor sentiment, which typically leads to yen appreciation, could result in a dip in core goods inflation.

Monetary policy – changes likely ahead
Recently, the Bank of Japan (BoJ) has shown increased concern over the potential negative impact of its ultra-easy, quantitative and qualitative easing (QQE) program and negative interest rates on the functioning of the Japanese government bond (JGB) market and the banking sector. We have already seen policy tweaks from the central bank this year. In July it widened its target band for the 10-year JGB yield to plus or minus 20 basis points, from plus or minus 10 basis points. It also reduced its buyback operations for long-term and short-term government bonds. Going forward, we expect the BoJ to continue making changes to its QQE program, possibly further reducing the size and frequency of buyback operations. Additionally, the BoJ may further widen its target band for 10-year JGB yields, although we do not believe it will make this move before the VAT hike takes effect in October.

Currency
We believe the yen is trapped between the competing forces of historically cheap long-term valuations and the likely widening of interest rate differentials between Japan and the US and Europe, incentivising continued Japanese demand for unhedged foreign assets. This means the currency will likely be driven largely by external developments. Because the BoJ is unlikely to alter its own policy stance significantly in the near term, the yen will likely be largely driven by rising or falling expectations about US and European growth and the likely impact on Fed and ECB interest rate policy.

Emerging markets

Emerging markets have been challenged by several factors in 2018. Tighter funding conditions via a rising US dollar have led to concerns over the general ability of EMs to pay their external liabilities coming due. This has led to selloffs in assets of countries that were perceived to be particularly externally vulnerable, namely Argentina and Turkey. Additionally, political uncertainties in EM have led to increased volatility – EMs had a total of 26 elections in 2018, with more to come next year. Overall, the EM macro environment in 2018 has been characterized by moderating growth, rising inflation and stagnant creditworthiness. In 2019 we expect to see some upside risks to a recovery in EM growth relative to expectations, stable to lower inflation and modest improvement in external accounts. The fiscal outturn will depend on policy orientation in several countries – and this, in our view, will be the swing factor for overall creditworthiness where we are cautiously optimistic. Moreover, while EM will continue to be driven by changes in US growth, interest rates and the US dollar, we believe EM will increasingly be driven by idiosyncratic factors and fiscal debt dynamics.

Growth and interest rate differentials to continue driving EM capital flows

Capital flows are a major influence on both EM asset prices and macro conditions. We believe two main factors drive capital flows into or out of EM: growth and interest rate differentials between EM and developed market (DM) countries, with higher EM growth and interest rates versus DMs benefitting EM assets.

Going forward, we expect a modest recovery in EM GDP growth. Consensus expectations for overall EM GDP growth in 2019 now sit at below 5%, which w e believe to be a fair estimate, though we see modest upside risks from that outcome.[10]

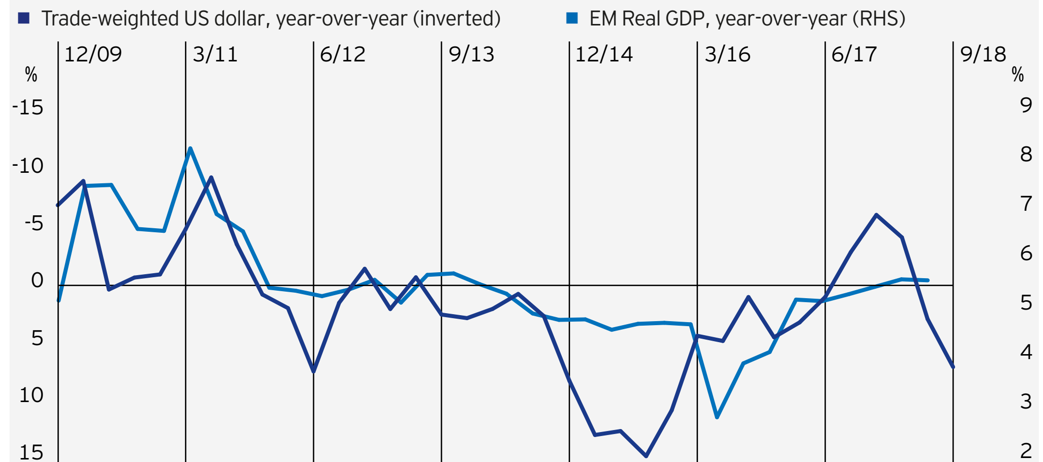
Projections for policy rates in EM and the US suggest that interest rate differentials are likely to decline in 2019 as the US likely remains on its hiking path. However, we believe risks are tilted to the upside for EM rates in 2019. On a country-by-country basis, most EMs are projected to have stable or increasing interest rates over the next 12 months, with a few outliers projected to experience declining rates. As US funding conditions remain tight, on the back of US Fed hikes, we expect EMs to be pressured into increasing interest rates. Therefore, we believe we may see some increases in interest rate differentials for EM countries.

Outlook for EM influenced by US dollar

Overall solid growth, benign inflation and interest rates point to stable creditworthiness for EMs in 2019. However, the main macro drivers of EM performance will likely be changes in US growth, interest rates and the US dollar. This dependence stems from the fact that most EM countries are small, open economies that are increasingly reliant on external funding, mainly via the US dollar. As seen in Figure 3, we find that a 1% ris e in the trade-weighted US dollar (on a year-over-year basis) has tended to lead to a moderation in aggregate EM real GDP growth (year-over-year) by 0.3% with a thr ee-month lag. Similarly, the US dollar has significant impacts on EM credit, foreign exchange and interest rates. Therefore, we believe a moderation in US growth and interest rates would likely lead to increased capital flows to EM, supporting EM asset prices.

1 Source: Bloomberg L.P., Jan. 1, 2018 to Dec. 5, 2018.
2 Source: Bloomberg L.P., Oct. 22, 2018.
3 Source: CEIC, Invesco, Sep. 30, 2018.
4 Source: International Monetary Fund, October 2018.
5 Source: Japan Ministry of Finance, Statistics Bureau.
6 Source: Bank of Japan, Research and Statistics Department, Tankan Summary, Oct. 1, 2018.
7 Source: JP Morgan, September 2018.
8 Source: Japan Times, Oct. 15, 2018.
9 Source: JP Morgan, September 2018
10 Source: Bloomberg L.P., Dec. 5, 2018.

Figure 3: Past US dollar weakness has supported EM growth impulse via financial conditions



Source: BIS, Macrobond, Invesco, Dec. 31, 2009 to Sept. 29, 2018.

However, we believe it is important not to over emphasize the impact of external factors on EM. While it is a necessary initial guidepost for understanding capital flows and EM asset prices, we believe EM has been increasingly driven by idiosyncratic developments. Therefore, we believe idiosyncratic fiscal policy developments are likely to be the main driver of opportunities in EM in 2019.

Major EM country outlooks

Argentina: Since accepting funding from the International Monetary Fund (IMF) in July 2018, we believe the country has finally appointed credible policy officials to achieve the IMF's priorities. The benefits of this can be seen in the country's expanding government revenues. Government expenditures have also expanded, though at a slower pace than the rate of inflation. However, this is still against a backdrop of negative GDP growth in the last two years, and still growing debt to GDP. Nevertheless, we believe Argentina currently offers attractive credit valuations.

Turkey: Recently, Turkey has been able to rapidly rebalance its external accounts in response to tighter US financial conditions. However, future improvements are uncertain as policy signals have been mixed, suggesting the authorities may be less inclined to allow a continuation of the macroeconomic adjustment required to more fully rebalance the economy. Though the government has the fiscal space to provide support for the banking system, policy signals also suggest the fiscal position of the country may deteriorate. Further, Turkey remains highly sensitive to external funding conditions. The recent recovery in Turkish assets indicates there is limited margin of safety should there be additional policy missteps.

Brazil: Brazil has the potential for some structural change under its newly elected President. Tailwinds for the country include supportive growth and relatively low inflation. 2019 expectations for consumer price inflation have moderated to levels below 2018 inflation. However, government debt-to-GDP is still high and running at unsustainable levels, in our view.

South Africa: We expect South Africa's poor growth and debt dynamics to remain an enduring theme. However, there is scope for improvement, owing to the shifting political landscape under President Ramaphosa. Though potential growth is still limited due to structural concerns, a strong victory in the 2019 elections for the African National Congress may open the door for much needed structural reforms. Valuations in South African assets, particularly in credit and local currency bonds are compelling, in our view, but capturing this value will likely require favorable policy signals.

IFI macro views and 2019 outlook

	US	Eurozone	Japan	China
GDP growth	Growth has peaked, expect 2.3% gr owth in 2019. Consumption growth should slow to a more sustainable level, around 2%. In terest rate sensitive portions of the economy, such as housing, are slowing. The growth trajectory in 2019 is uncertain due to the roll-off of tax cut stimulus and tightening monetary policy.	Expect growth to moderate to 1.6%. De spite a relatively solid domestic backdrop, the worsening export outlook will likely continue to weigh on growth.	Growth is likely to remain above potential at 0.75%-1.25%, helped by buoyant capital expenditure and resilient consumption. The major risks to growth include the effects of protectionism, and a potentially larger than expected drag from an expected consumption tax hike.	Expect annual growth to be in the low 6% r ange. Fiscal easing measures are expected to take effect, mainly via tax cuts and recovery in investment spending.
Inflation	We expect core inflation of 2.5% at the end of 2019. However, ex-tariffs, inflation is likely to be more trend-like at 2.3%.	Expect core inflation to rise to around 1.3% and he adline inflation to decline to 1.5% on the back of lower oil prices.	Headline CPI is likely to revert below 1% due t o lower energy and mobile phone charges, but this should be somewhat offset by a pickup in inflation driven by rising wages and tighter corporate capacity.	Expect 2.0%-2.5% in flation, below the central bank's 3% alert level. Changes in oil prices and stabilization in food supply could pose downside risks.
Monetary policy	The Fed is likely to slow or pause rate hikes in 2019 due to slowing growth and market volatility. Additional hikes beyond mid-2019 could elevate recession risk.	ECB is likely to hike the deposit rate by 15 basis points in the fourth quarter, 2019. Reinvestments are likely to continue after the ECB stops QE at the end of 2018, and new liquidity facilities for banks will likely be announced.	The BoJ is unlikely to abandon its 10-year yield target or change its negative interest rate policy ahead of the October consumption tax hike. However, further tweaks to its QQE program, such as reducing the size and frequency of buyback operations, are likely.	The PBoC is likely to keep its benchmark rates unchanged, make RRR cuts when needed and maintain relatively stable short-term rates via open market operations and window guidance.
Fiscal policy	Expect US fiscal policy to become a drag in the second half of 2019.	Expect a slightly more expansionary fiscal policy, with the possibility of structural reforms to reinforce fiscal integration.	The consumption tax hike will likely weigh on growth by around 0.4%. Ho wever, we are likely to see more off-setting government measures if growth disappoints heading into October.	Expect easing fiscal policy in the form of tax cuts, potential cuts to corporate pension contributions, and recovery in infrastructure investment.
Government yields	Expect US 10-year yields to end 2019 close to 3%. S upply and demand conditions will likely remain poor, while fundamentals will grow more supportive.	Expect 10-year bund yields of 0.8%-1.0% at y ear-end 2019.	Expect 10-year JGB yields to trade between 0.05%-0.25% in 2019. The BoJ will likely be unwilling to push JGB yields lower, and any JGB selloff would likely be capped by increased repatriation demand, as domestic bonds start to look more attractive.	Expect 10-year Chinese government bond yields to trade between 3.1%-3.6%.
Currency	The US dollar will likely remain range-bound in 2019. US growth and monetary policy is likely to continue advancing more quickly than the rest of the world. We expect the trend in the US dollar to weaken as we approach hikes by other major central banks like the ECB.	Expect the euro to retrace recent weakness and trade around 1.20 versus the US dollar by year-end.	Expect yen to trade between 108-115 versus the US dollar in 2019, trapped between the competing forces of historically cheap long-term valuations and the likely widening of interest rate differentials between Japan and the US and Europe.	Expect the renminbi to trade in range of 6.80-6.90 versus the US dollar. Downside risks could rise if the US dollar strengthens sharply or if US-China trade friction escalates.

Investment risk

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