Fixed Income

Global fixed income markets look well-supported by macro factors

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Key takeaways

- Invesco Fixed Income's macro factor framework examines growth, inflation and financial conditions.
- Until and unless we see a change in momentum in one of these three macro factors, fixed income markets should remain well-supported.
- The "newsworthiness" of an event is not as important for markets as its impact on these three factors, in our view.

Macro

The current investing environment seems daunting. Markets have had a strong couple of years and valuations are tight. At the same time, risks abound. Geopolitical risks including North Korea, terrorism, Brexit and unpredictable politics in Europe and the US make for an uncomfortable investing environment. In such uncertain times, it is important to use an investing framework to help manage through the many risks in the markets, to remind us of the markets' key driving forces and to help measure the impact of events or potential risks.

Invesco Fixed Income's macro factor framework provides an understanding of how developments in growth, inflation and financial conditions globally are likely to impact markets. Currently, global growth is solid. US growth is now being supplemented by solid European and Japanese growth. Global inflation is low and benign. In 2018, we anticipate that central banks will begin to tighten financial conditions, but they will likely be cautious and the pace should be slow enough that overall financial conditions should remain easy. This view on global growth, inflation and financial conditions should be supportive of all risky assets in 2018, including credit and equities. Until and unless we see a change in momentum in one of these three macro factors, fixed income markets should remain well-supported. Our factor framework argues to maintain credit and risky asset exposures, but concentrate on closely managing risk in portfolios, given tight valuations.

We also use this framework to look at potential risks and actual political events. The "newsworthiness" of an event is not as important for markets as its impact on these three factors, in our view. We undoubtedly will continue to get some market volatility around political events in 2018, but we believe this volatility should mostly be short-lived, so long as it does not affect growth, inflation or financial conditions.

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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. 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.

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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 – r etail, 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. Following their September 2017 meeting, Federal Open Market Committee members indicated a median expectation of three rate hikes in 2018. 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.

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 market 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 European Central Bank (ECB) 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 quantitative easing (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.

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 in the US, specifically the language that curtails the ability of state and local governments and other entities to issue advance refundings, private activity bonds, tax credit bonds, and tax-exempt bonds for professional sport stadiums in the US. Under the private activity umbrella are US issuers such as private universities, Continuing Care Retirement Communities (CCRCs) and not-for-

profit hospitals. As it stands, we estimate that 25% to 30% of municipal supply could be affected by the provisions of the US House of Representatives tax bill. While these limitations could be problematic for both municipal issuers and US 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 2017. 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.

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.

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