Macro Factor Framework Helps Assess New Market Conditions

Invesco Fixed Income shares its asset class views based on expected changes to three key factors

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Robert B. Waldner
Chief Strategist and Head of Multi-Sector

Invesco Fixed Income utilizes a framework based on the idea that changes in growth, inflation and financial conditions drive much of market beta performance, and that understanding these "macro factors" can help us understand market conditions and price action. We believe this macro factor framework is particularly useful today, as we believe these three factors are undergoing changes, and hence market behavior may be different that it has been in the recent past.

Furthermore, changes in these three factors will likely have different impacts on markets. We believe understanding the changes and impact of each factor and how they relate to each other will promote understanding of market moves.

Growth and inflation

Our historical view has been that global growth would remain slow due to deleveraging, demographics and increasing regulation (which can lead to a lack of productivity). We have also believed that inflation would remain low for similar reasons. Indeed, since the global financial crisis of 2008, it has been mostly financial conditions and changes in financial conditions that have been driving markets. This has meant that central banks, quantitative easing (QE), and changes in the dollar have been the drivers of markets.

Since the Trump election victory, however, a change toward more active fiscal policy and deregulation appears to be in the cards, in our view. This will likely be primarily in the US, although policymakers globally have been calling for more active fiscal policy. We believe the US economy will be boosted by tax cuts to individuals and corporations, deregulation of the financial system and energy sector, and a pickup in infrastructure spending. While the exact magnitude of these changes is not yet clear, the direction is–we expect growth to move up. This is enough to allow us to explore what this could mean for financial markets.

The US economy is also mid-to-late cycle with a low unemployment rate and underlying inflation that is in an uptrend. Boosting growth in such an economy will likely boost inflation, in our view, and we would expect to see additional upward pressure on inflation in the US economy.

This upward boost to growth and inflation expectations is what is driving much of the market action in the current environment, in our view. We would reiterate the significance of the fact that we believe we have moved to a new regime. A new regime will likely entail new correlations and significant changes in market pricing.

Trade

We have also downgraded our concerns on trade issues. Aggressive anti-trade moves would be a negative for growth, in our view, but recent statements from the newly nominated Treasury and Commerce secretaries have eased our concern on this front. It appears to us

that a Trump administration may likely have a much more constructive approach to trade than the Trump campaign indicated. In particular, it appears that tariffs may likely be a last resort, and that the emphasis could be on negotiating bilateral trade deals that are more favorable to the US. Given this view, the new administration's policies should not be as negative for global trade as we originally feared.

Financial conditions

In our view, growth and inflation could be the key drivers of markets in the near term. That said, financial conditions could return as a driver at any time if they tighten significantly, which would have a significant impact on markets.

We believe financial conditions will remain easy for the following reasons:

- QE continues in Europe and Japan at a significant pace.
- Negative interest rates in Europe and Japan have enhanced the impact of QE and forced liquidity into global markets.
- Deregulation of the financial system may create easier financial conditions and support market liquidity.

At the same time, we must watch for a tightening of financial conditions. A tightening of financial conditions is possible through one or more of the following channels:

- An aggressive Federal Reserve (Fed) (suggesting more 2017 rate hikes)
- A sharp rise in the dollar (5% or more from current levels)
- A sharp rise in term premium and real yields in bond market (so far, the rate rise has been orderly and accompanied by an increase in inflation expectations)
- A sudden increase in Chinese capital outflows
- A sharp increase in euro break-up risk (due to political events)

All of the above factors are conceivable in the intermediate term, but are not present currently. We will watch these carefully, but do not think they will drive market pricing in the near term.

Bottom line

We reiterate our view expressed immediately after the US election that growth and inflation are likely to be the drivers of markets (**What will drive markets after Trump's victory?**). We believe that financial conditions will remain easy for now, and we are more positive on trade.

Views on markets

Duration. We favor short duration, best expressed in the US, and via inflation-linked bonds. This is a direct result of the growth and inflation driver. We believe that fair value on the 10-year US Treasury is currently around 2.6%, although rates could overshoot fair value.

Dollar. We believe growth is good for the dollar. We expect the dollar to rally generally, but we have less conviction compared to our views on duration because US inflation is not a positive for the dollar.

Commodities. We believe current conditions are reasonably good for commodities due to the growth and inflation drivers. With the growth driver being the most important factor, we believe the dollar can rally while commodities could also do reasonably well.

Credit and risky assets. We are positive on credit and risky assets. Growth and inflation are reasonably supportive for risky assets as long as financial conditions are easy. Our belief that financial conditions will likely remain easy for now and that trade is not going to be a negative is a low-conviction positive for credit. We expect to earn interest, but not receive too much in the way of capital gain.

Emerging markets. We are less negative on emerging markets (EM). Growth and inflation is good for EM, in our view. We had been concerned about a negative trade shock to EM from the US election, but recent commentary from the incoming administration points to less risk of immediate trade shocks. Stable financial conditions currently also support EM. There are opportunities in EM given its recent underperformance versus other asset classes – we believe Mexican local duration is an obvious one.

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