Invesco Fixed Income

Global Fixed Income Strategy

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Global macro strategy

What does market volatility mean for fixed income?

Two critical US data points disrupted world financial markets in February – January wage growth and consumer price inflation. Both measures were higher than expected, igniting inflation fears and upsetting the prevailing calm in global stock and bond markets. While another 0.25% interest rate hike is widely expected at the US Federal Reserve's (Fed) next scheduled policy meeting on March 20-21, the January numbers raise questions about how many more rate hikes are on the horizon. These concerns and concerns about whether the Fed is on top of inflation have pressured benchmark interest rates higher.

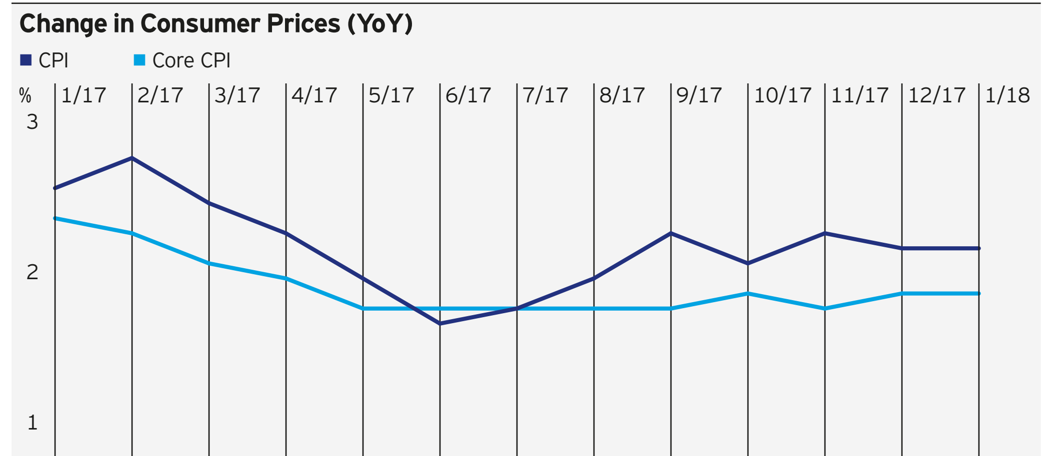
Source: Bloomberg L.P. Data from April 21, 2017 to Feb. 21, 2018.

We have noted for a while that investors may have been underpricing inflation and that signs of inflation pressure could disrupt markets. Inflation is a risk we are monitoring closely. This is because concerns over inflation could incentivize the Fed to hike interest rates faster and higher than previously expected. Tighter monetary policy could tighten overall financial conditions, which could be negative for financial markets.[2] There has been little realized inflation, but recent volatility suggests that bond investors are starting to worry that inflation will rise sharply on the back of strong growth, boosted by tax cuts in a late-cycle economy.[3] We believe that few investors have anticipated a sharp rise in inflation, so this would be a surprise to the market.

Deeper dive into inflation

Based on our bottom-up views on various sectors, we had expected to see softness in education and health care prices during 2018, coupled with less support from housing. So far, this has not played out in the housing sector: Rents rose 0.3% month-over-month in January, which accounted for most of the inflation gain, although price increases were broad-based.[1] The quarterly annualized rate of inflation is now running close to 2.9%, [1] which supports the possibility of four Fed rate hikes this year, in our view. However, our base case is three – revised up from two. We believe we would need to see persistent increases in inflation for four to play out, and we are monitoring this closely.

Going forward, we continue to think that housing prices will slow. However, the underlying strength in sticky core prices (including housing) could be a persistent trend. If the bond market believes the Fed needs to hike interest rates more aggressively, market volatility could pick up and risk assets could come under pressure.



Source: US Bureau of Labor Statistics. Data from Jan. 1, 2017, to Jan. 31, 2018.

Our macro factor framework guides investment decisions

Our macro factor framework provides guidance on asset allocation by helping us interpret market moves and economic fundamentals. Our framework is based on three key macro factors: growth, inflation and financial conditions.

Macro outlook

We do not believe that economic fundamentals justify the high level of market volatility we have just experienced. Invesco Fixed Income believes that global growth should continue to be strong, supported by easy monetary and fiscal policy, and that inflation should remain relatively stable in the coming months.[4] We expect US growth to be around 2.75% in 2018, driven by strong consumption and capital spending, with some drag from trade. We believe that US inflation will finish the year around 1.8% percent, still below the Fed's target. Base effects may raise year-over-year inflation in the next several months, but we believe slowing residental rent growth and low goods prices should keep overall inflation below the Fed's target this year.

Asset allocation

According to our factor framework, a strong global growth environment should drive positive returns for risky assets, keep volatility contained, put upward pressure on interest rates, weaken the US dollar and benefit emerging markets assets. An increase in inflation should also drive interest rates upward, weaken the US dollar and benefit emerging market assets, but cause an increase in volatility and negative returns on risky assets. Given our view that the positive growth outlook should outweigh the potential negatives from inflation, our factor framework suggests staying long risky assets, short interest rates and short the US dollar. This generally describes the latter half of the recent market moves, as risky assets stabilized while rates continued their upward move.

While it is not our base case, if the Fed were to allow inflation to continue rising, that would likely cause the inflation factor to dominate market conditions. In this environment, rates would be expected to continue to sell off, risky assets would be expected to perform poorly and volatility would be expected to increase. The Fed does not appear to be poised for this approach, but we are monitoring monetary policy closely.

Invesco Fixed Income's view of key asset classes:

Investment grade

Investment grade credit spreads are tighter compared to the start of year.[5] We believe the sharp drop in the supply of corporate bonds has been supportive, as companies have used repatriated cash rather than issue new bonds in the investment grade market. Recently, we have noted some selling pressure at the shorter end of the investment grade yield curve, which has pressured shorter-term yields higher.[6] Some selling may be related to the repatriation of overseas earnings and we are monitoring this dynamic closely. Despite this weakness in shorter-term bonds, investment grade spreads have generally held in well as market volatility has increased.[7] Liquidity appears lower than usual, but markets are operating normally.[8]

We are focused on analyzing the impacts of US tax reform on inflation – especially on wage pressures. While inflation itself is typically not bad for credit spreads, potential Fed rate hikes to combat this could be negative. We believe markets need to reassess inflation expectations and monetary policy before we see stability.

Taking a longer-term view, we believe greater volatility could generate attractive opportunities for certain high quality investment grade bonds. Such opportunities were previously difficult to find. We believe the positive trajectory of the economy continues to support credit, but we are aware of increased volatility risks and the need to be agile.

High yield

The high yield market has been pressured downward by the recent sell-off in risky assets but outperformed the S&P 500 Index in the first half of February, when much of the initial volatility took place.[9] In general, the spillover effect of recent market volatility on high yield has been limited. As we view the high yield market today, we see strong fundamentals and benign overall financial conditions. We do not believe these market underpinnings have changed in the last few weeks. While we acknowledge that overall high yield spreads are tight, we still see value in certain individual names.[10] In terms of performance, we believe strong underlying fundamentals will likely allow us to return to a healthy market in which spreads continue to narrow. History has shown that high yield has performed well in rising interest rate environments, having benefited from growing earnings and potentially lower default risk in a stronger economy.[11]

European fixed income

The yield on the benchmark 10-year German government bond has risen from 40 basis points at the start of the year to 76 basis points in the past few weeks.[12] This is a response to an upbeat European Central Bank (ECB) President, Mario Draghi, and the realization that quantitative easing (QE) in the euro area is coming to an end. Our analysis suggests that the ECB could taper its bond-buying program in September, after which other investors would be expected to take up the slack.

While it is possible the market could overshoot, we do not think the European bond sell-off will gather pace unless we begin to see signs that inflation is gathering pace. Our analysis indicates that global inflation pressures could remain subdued for the next six months or so, enabling the ECB to remain accommodative. A slow and gradual approach, coupled with a continued buoyant global economic environment, should be good for risk assets, in our view. The risk, however, is that, with labor markets tight in some regions, such as Germany, we may begin to see material wage increases and subsequently higher inflation. The probability of this scenario has increased in recent months.

As global central banks, including the ECB, bring their QE programs to an end in 2018 and begin to raise interest rates, the safety net is being removed and markets will have to survive without the ECB's constant (and reassuring) demand for bonds. This should undoubtedly create a more volatile environment. However, that may be a positive dynamic for active investors. As central bank policies diverge, we could see more dispersion of returns across markets and asset classes, meaning there may be more relative value opportunities and greater opportunities within currency and rates markets.

Emerging markets

In general, volatility has been muted in emerging markets relative to what we would expect based on history, given the significant sell-off in developed market equities. We believe this is due to still-easy overall financial conditions, even if they are tightening somewhat. In the past, the US dollar has often appreciated when US Treasury yields were rising, but this has not been the case recently – and as a result, financial conditions have remained easy.

The primary risk we see to emerging markets debt is a strengthening in the US dollar that markedly tightens financial conditions; this could lead to a widening in emerging markets credit spreads and depreciation in emerging markets currencies versus the dollar. Absent such a move, we expect the emerging market asset class to hold up relatively well.

We do not view the recent financial market sell-off as indicative of a slowdown in global growth, but rather a short-term, market-volatility event. Unless the sell-off deepens and materially impacts financial conditions, we do not expect to adjust our expectations for emerging markets growth, fundamentals or return expectations for emerging markets debt this year.

Rob Waldner, Chief Strategist, Matt Brill, Senior Portfolio Manager, Steve Thompson, Senior Client Portfolio Manager, Scott Roberts, Head of High Yield, Dawn Silvia, Senior Client Portfolio Manager, Rashique Rahman, Head of Emerging Markets, Craig Altholz, Senior Product Manager, Gareth Isaac, CIO EMEA

Past performance is not a guarantee of future results.

1 Bloomberg L.P. From Jan. 31, 2018, to Feb. 6, 2018, the S&P 500 Index fell 4.6%, the Bloomberg Barclays US Aggregate Credit Index total return was -1.5%, and the Bloomberg Barclays US Corporate High Yield Total Return Index returned -0.95% over the period.
2 Financial conditions refer to how easy or difficult it is for businesses to borrow and for banks to lend at reasonable interest rates. Easy financial conditions represent periods when financing is relatively cheap, while tight financial conditions represent periods when financing is relatively expensive.
3 Board of Governors of the Federal Reserve System, FAQs, Feb. 7, 2018. Annual core personal consumption expenditures (PCE) inflation was 1.5%, as of Dec. 31, 2018 (Bureau of Economic Analysis). This is well below the Fed's target of 2% PCE inflation.
4 Easy monetary policy is central bank policy that increases the money supply, usually by lowering interest rates or keeping them low. Easy fiscal policy is government policy of taxation and spending intended to stimulate economic growth.
5 Bloomberg L.P. The spread on the Bloomberg Barclays US Aggregate Credit Index was 88 basis points on Feb. 15, 2018, compared to 89 basis points on Dec. 29, 2017.
6 Bloomberg L.P., TRACE Market Flow, Jan. 1, 2018 to Feb. 16, 2018.
7 Bloomberg L.P. The spread on the Bloomberg Barclays US Aggregate Credit Index was 88 basis points on Feb. 15, 2018, compared to 81 basis points on Feb. 1, 2018.
8 Bloomberg L.P., TRACE Market Flow, data from Jan. 6, 2018, to Feb. 15, 2018.
9 Bloomberg L.P. High yield defined by the Bloomberg Barclays US Corporate High Yield Total Return Index. From Jan. 31, 2018, to Feb. 15, 2018, the Bloomberg Barclays US Corporate High Yield Total Return Index returned -1.38% compared to the S&P 500 index, which returned -3.14% over the same period.
10 Merrill Lynch. The spread on the BofA Merrill Lynch US High Yield Master II Index was 368 basis points on Feb. 15, well below the 20-year average of 608 basis points.
11 JP Morgan. Based on the Bloomberg Barclays US Corporate High Yield Total Return Index; data from Feb. 1, 1994, to June 30, 2009.
12 Bloomberg, L.P.; data from Jan 1, 2018, to Feb. 15, 2018.

Interest rate outlook

US: Strengthening inflation data have driven US yields higher in recent weeks. We expect inflation to remain on the higher side in the coming months due to statistical comparisons to a low base, but we expect this effect to fade. Nevertheless, we have revised up our expectation for 2018 Fed hikes from two to three due to the price pick-up. Continued broad-based price pressures could lead the Fed to hike four times this year, but this is not our base case. At this point, we do not believe the market is worried that the Fed is letting inflation get away from it, which could cause markets to overreact, driving rates higher, creating a financial conditions shock. While uncertainty over inflation will likely keep rates volatile for now, low non-US government yields combined with subdued inflation should keep US Treasury yields contained.

Europe: The sell-off in German bunds accelerated after the January ECB meeting failed to deliver the dovish tone that the market was expecting based on the strong euro. However, we believe Europe's strong growth backdrop, muted inflation and an accommodative ECB have helped to support bond markets and compensate for the political fears surrounding the upcoming Italian elections. We expect the ECB to announce an end-date for QE by June and to cease its bond buying program in September.

China: China's short-term government bond yields fell relative to longer-term yields in February, thanks to easier liquidity conditions and improved sentiment. The central bank (PBoC) has been more generous in terms of liquidity injection, but onshore investors remain cautious, reflected in the steeper 10-year part of the government yield curve. Financial regulatory tightening has pressured non-bank financial institutions, thus, we see limited room for the PBoC to tighten liquidity further from here. We continue to see attractive opportunities in onshore government bonds. If tax implications are considered, government bond yields are appealing compared to lending rates, in our view. With new asset management rules and liquidity management guidance in place, we expect demand for Chinese government bonds to pick up.

Japan: The Japanese economy expanded again in late 2017, but is growing below potential. Inflationary pressures are unlikely to build against such a backdrop and will likely be further hindered by the recent appreciation in the Japanese yen. There is much speculation that the Bank of Japan (BoJ) will tighten monetary policy in the near future, however, lower than expected inflation could disappoint speculators. Our base case remains that the BoJ will remain on hold through 2018, but a more aggressive monetary policy stance by other global central banks could cause us to reassess that view. We expect 10-year Japanese government bond yields to remain range bound over the next month between 0-0.1%.

UK: UK economic growth continues to be negatively impacted by uncertainty surrounding Brexit, but not to the extent that some predicted. Nonetheless, the latest Purchasing Managers' Index (PMI) readings suggest that the economy will likely continue to underperform its European Union (EU) peers over the near term. The UK government is almost exclusively focused on resolving the Brexit issue at this time. With many issues yet to be resolved, we believe a clear solution will not be found before the UK's expected departure from the EU in March 2019. The Bank of England has turned slightly more hawkish in response to concerns that the global pick-up in capital expenditures could be an early sign of upward wage pressure. We agree with market expectations of 1.5 hikes in 2018[1], but the risk is that investors may become more aggressive. We remain neutral on UK interest rates.

Canada: The most recent employment number was a mixed bag with part-time employment falling off. The pace of economic growth overall has slowed somewhat, but this has largely been expected. We believe the Bank of Canada will be watching for a pick-up in wages and inflation to calibrate its speed of interest rate normalization. The 10-year Canadian government bond yield will likely consolidate around 2.3% before making its next move. We are currently short Canadian interest rates.

Australia: The Reserve Bank of Australia (RBA) held rates neutral as expected in February. In its statement it said it believes there will be gradual improvement in the economy, and it remains committed to being patient on interest rates. The RBA also continues to be concerned about sluggish wage growth and anemic consumption. Therefore, despite a strengthening economy, the RBA is likely to remain on hold for the foreseeable future. We remain neutral on Australian rates as there is no catalyst for change in either direction.

India: Government bond yields have risen significantly since August after several upside inflation surprises. January inflation came in at 5.1%, close to market expectations.[2] We believe the consumer price index (CPI) will stay in a range of 5-5.2% in the first half of 2018 before reverting to 4.5% in the second half, although risks are skewed to the upside. We expect the Reserve Bank of India (RBI) to maintain its hawkish stance but stay on hold through the first half of 2018. We believe its next move will be a rate hike rather versus a cut. We believe current interest rate levels are attractive, but we are waiting for more clarity on inflation before going long Indian rates.

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1 Bloomberg L.P., Feb. 2, 2018
2 Bloomberg L.P., Jan. 31, 2018

Currency outlook

USD: We expect the US dollar to continue to depreciate, driven by global growth and converging central bank policies. We have revised our US rate hike call from two to three, in line with US bond pricing. We do not expect the Fed to shift to an aggressive tightening stance in response to recent inflation strength, especially without significant wage pressures. Globally, the growth trend is expected to be stronger relative to the US, meaning non-US central banks should shift away from their accommodative stances, especially the BoJ and ECB. There may be a demand shift away from US investments as growth outperforms elsewhere – weighing on the US dollar.

EUR: We remain positive on further euro appreciation. We believe we are in the nascent stages of an inflation regime shift globally, transitioning from a world of disinflationary risk to one more balanced. We believe the resulting policy changes will support a weaker US dollar. We continue to view pullbacks in the euro as consolidation within a longer-term trend higher.

RMB: The USD/RMB exchange rate appreciated in February on the back of a weaker US dollar, the conversion of US dollars into local currency by Chinese companies, and macro funds' trading activities. The move has been in line with other currencies against the US dollar. Although the USD50,000 foreign exchange conversion quota for individuals was renewed in January, the renminbi has remained strong, suggesting that corporates and households have over-accumulated US dollars in recent years. China's policy makers have already started to loosen regulations to allow more capital outflows, and if the renminbi strengthens further, we expect more channels for outflows to be opened.

JPY: The yen has started out strong in 2018 due to increased expectations of tighter BoJ monetary policy, repatriation flows, and general US dollar weakness. A strong yen should have a dampening effect on Japanese inflation, which will likely not be welcomed by policy officials and could make achieving the BoJ's 2% [1] inflation target more difficult. We have already seen government officials verbally intervene to hamper further yen appreciation and we expect those efforts to intensify. However, we remain positive on the yen over the longer term given our bearish longer-term US dollar view.

GBP: We continue to look for opportunities to move overweight sterling. We expect the currency to be volatile in the coming months as talks get underway around the future of trade and a transition deal with the EU. We believe the UK will either agree on a soft Brexit or decide to remain in the EU. With the economy unlikely to collapse regardless of the outcome, we continue to look for attractive entry points for sterling. We expect these to come about if Brexit discussions become contentious.

CAD: We are currently neutral on the Canadian dollar. The Canadian dollar rallied sharply at the beginning of the year, but has since lost all of its gains, and then some. Economic data at the end of January disappointed as the Canada Consumer Price Index (CPI) remained low. That, combined with the increase in Canada's trade deficit, probably weakened the currency. In addition, oil prices have fallen from their peak in January.

AUD: We remain neutral on the Australian dollar. The Reserve Bank of Australia (RBA) held rates constant as expected at its February meeting. The RBA continues to forecast a gradual improvement in the economy, with inflation reaching its target range of 2-3% [2] sometime in 2019. However, it remains concerned about the lack of wage inflation and weak consumer spending. The RBA reiterated its commitment to remain patient with interest rates.

INR: We maintain our neutral stance on the Indian rupee. Going forward, we see downside risks to the currency from higher than expected inflation, higher oil prices and an increasing current account deficit. On the other hand, strong foreign direct investment inflows, sizable foreign exchange reserves and an improving growth outlook will likely continue to support the rupee at current levels.

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1 Source: Bank of Japan, Feb. 21, 2017
2 Source: Reserve Bank of Australia, Feb. 21, 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 global investor demand, at least through the end of 2018, driven by continued strength in cross-border flows. Fundamentals are now broadly improving across most geographies and sectors, driven by a pick-up in the global growth outlook. Leverage has come down from cycle highs in 2016, and with little pressure from shareholders to increase leverage, we expect balance sheet improvement to continue. Tax policy is likely to support fundamentals through improved profitability and credit market technicals via less debt issuance. On the other hand, regulatory changes seem more likely and should improve cost structures (financials specifically) 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 at or near cycle tights, the fundamental and technical 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) unexpected pace of change in monetary policy from the Fed, ECB, BoJ and BoE, viewed on an aggregate basis for their impact on global credit flows 2) development of fiscal and regulatory policy changes 3) "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 decline from cycle highs, and we expect this trend to continue at a measured pace. Global inflation pressures remain conspicuously absent, but would likely become a favorable credit influence.

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, Oman, quasi sovereigns. 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 2017 despite slightly tighter credit standards. US property price growth continues, but will be monitored given higher interest rates.

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, while the home price outlook is expected to normalize as affordability declines after strong price gains. Limited housing supply and long-term negative net issuance remain dominant factors in US RMBS. Valuations appeared stretched relative to other asset classes following outperformance during 2017 in legacy US RMBS and below-IG CRT. The slight widening in spreads during 3Q 2017, driven by an active hurricane season, has reversed and brought valuations back to full valuations, in our view, relative to other similarly rated credit asset classes.

IFI strategy

We favor higher quality legacy prime, alt-A, and seasoned BBB-rated CRT. We are avoiding sub-prime, coastal concentrations, and option adjustable-rate mortgages.

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

Rationale

Normalization of credit underwriting and our forecast for a healthier economy should support consumer credit performance in 2018. As the overall market continues to weigh the longer-term impact of Trump administration policies and additional rate hikes going forward, uncertainty should be supportive of a more stable, shorter-duration US ABS market.

IFI strategy

We favor adding exposure to floaters where collateral performance remains stable. We believe senior prime auto US ABS and esoteric issuers can provide opportunities. We are avoiding deep subprime auto US ABS.

Sector themes

Commodities: Global supply concerns creating energy volatility, prefer pipelines

Rationale

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

IFI strategy

We favor gaining exposure to pipeline credits with favorable idiosyncratic credit catalysts that 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 are more value and delivery conscious, while international retail demand remains uneven. We are watching the European consumer for any post-Brexit behavior shifts.

IFI strategy

We favor selected US consumer sectors including leisure and housing-related sectors. We are negative on “big box” and mall-based retailers that lack differentiated products. We favor EM consumer sectors on a selective basis. We are more cautious on the 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, repatriation potential post-tax law changes, low all-in financing costs, still modest organic revenue growth, and the need to reposition business portfolios.

IFI strategy

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

Global technology – big data

Rationale

We expect global use of data to grow and a transition to cloud-based platforms.

IFI strategy

We prefer to gain exposure to software and services, cell towers and select wireless issuers. We have avoided hardware original equipment manufacturers.

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 the 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. Repatriation may result in underperformance of the front end.

IFI strategy

We favor 7-10 and select 30-year points on the US IG and EM credit yield curve. New issuance has declined slightly year-to-date but is expected to remain susceptible to the uncertain pace of mergers.

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

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

Impact of repatriation on US investment grade

December's sweeping US tax reform could spark the return of billions of overseas corporate cash to the US. A sharp reduction in the US tax rate on foreign earnings (from 35% to 15.5% on liquid assets and 8% on illiquid assets) could bring as much as USD1.5 trillion back onshore, according to Invesco Fixed Income estimates. We think this could impact corporate bonds in a couple of important ways.

Impact on short-term bonds

Our estimates suggest that US companies currently hold around USD3 trillion in unremitted foreign earnings. Of this total, we believe around half is held in illiquid "operating assets," such as plants, equipment and intellectual property. The other some USD1.5 trillion, appears to be held in high quality, short-term assets such as US Treasuries, corporate bonds and asset backed securities, although estimates of the dollar amount vary widely.[1] These assets provide companies with some return with low volatility until they decide when to return their funds to the US.

According to JP Morgan, corporate earnings invested overseas are highly concentrated among a small number of firms and in short-term investments.[2] Based on our estimates, the top five holders of cash hold some USD573 billion overseas.[3] Figures 1 and 2 show the breakdown of those holdings by investment type and maturity.

Allocation of Cash Balances (%)
Top five holders of cash

Cash equivalents	8
US govt & agency	38
Non-US	3
Corporate bonds	41
Munis	1
MBS	7
Other	1

Source: 10Qs, data as of Sept. 30, 2017, Oct. 28, 2017 and Nov. 30, 2017.

Maturity Profile of Cash Balances (%)
Top five holders of cash

0-5 yrs	91
5-10 yrs	4
> 10 yrs	4
Other	1

Source: 10Qs, data as of Sept. 30, 2017, Oct. 28, 2017, and Nov. 30, 2017.

Under the new US tax law, we expect these funds to be repatriated to the US where they will likely be spent in a variety of ways. Some may be used to honor tax obligations. Another portion may be put toward reducing debt, rewarding shareholders, increasing capital expenditures, pursuing M&A and benefiting employees. After these expenditures, we anticipate less demand for short-term investment grade bonds. We have already seen some evidence of weaker demand for recent new issues.[4]

The mitigating factor to this potential reduction in investment grade demand is the law's provision allowing companies to pay tax liabilities over eight years (8% in each of the first five years, 15% in year six, 20% in year seven and 25% in year eight). Therefore, although companies may have less cash to invest in shorter-term bonds going forward, they will probably not be forced to sell their holdings up front to honor tax obligations. Instead, they may allow some of their short-term holdings to mature, freeing up cash to pay their tax bills and other expenses. That being said, we have noted some selling pressure at the shorter end of the investment grade yield curve.[5] Some selling may be related to the repatriation of overseas earnings and we are monitoring this dynamic closely.

Impact on longer-term bonds

The other possible impact we see from corporate cash repatriation is a reduction in the supply of longer-term investment grade bonds. As companies bring cash onshore, there should be less need to issue debt. The result should be a lower supply of intermediate and longer-term bonds, which could cause those credit spreads to tighten, all else equal. The net result of less demand for shorter-term bonds and less supply of longer-term bonds may be a flatter investment grade yield curve.

Outlook

Over the longer term, we would expect these effects to fade, as shorter-term investment grade yields appear relatively more attractive over time, attracting investor demand.
In the near term, we are cautious on shorter-term corporate bonds and biased toward overweighting intermediate to longer-term corporate credit. However, we are keeping in mind that future market volatility could provide attractive tactical opportunities on the shorter end of the investment grade yield curve.

Matt Brill, Senior Portfolio Manager, Mike Hyman, CIO Global Investment Grade and Emerging Markets, Steve Thompson, Senior Client Portfolio Manager

1 The Joint Committee on Taxation, letter from Barthold to Brady/Neal, Aug. 31, 2016, Moody's "Corporate cash to rise 5% in 2017; top five cash holders remain tech companies", Richard J. Lane, Lenny J. Ajzenman, Invesco Ltd., CNBC.com, "Companies are holding a USD2.6 trillion pile of cash overseas that's still growing," April 28, 2017.
2 JP Morgan, "Implications of corporate repatriation on FX and USD fixed income markets," Jan. 17, 2018.
3 Source: 10Qs, data as of Sept. 30, 2017, Oct. 28, 2017, and Nov. 30, 2017.
4 Bloomberg L.P., "Apple Cuts back on Bond Buying in Advance of Bringing Cash Home," Feb. 6, 2018.
5 Bloomberg L.P., TRACE Market Flow, Jan. 1, 2018 to Feb. 16, 2018.

The bottom line

How will repatriation impact money markets?

Matt Bubriski
Analyst

Joe Madrid
Head of Credit Portfolio Management

Robert Corner
Senior Client Portfolio Manager

For further discussion on this topic, please see Invesco Fixed Income's upcoming Investment Insights by Analyst Matt Bubriski, "The impact of repatriation on money markets.

As discussed in this issue's Global Credit Strategy article, the repatriation of foreign earnings could materially impact the US investment grade yield curve. However, Invesco Global Liquidity believes it will likely have a limited impact on money markets. Below, we speak with three members of the Global Liquidity team about why repatriation is unlikely to disrupt US and offshore money markets and money market interest rates.

Q: What is the size and allocation of unremitted foreign earnings?
Matt Bubriski: We estimate that US companies currently hold USD3 trillion[1] in unremitted foreign earnings, but only half is held in liquid cash and investments. The remainder appears to be held in less liquid "operating assets" and is unlikely to be liquidated.[2] The five largest holders of cash and investments, all technology firms, hold a large portion of these assets, and by using their holdings as a proxy, we estimate that money market instruments account for a relatively small portion of total cash, at about 8%. [3]

Q: How much will likely be repatriated? Will all earnings be returned in 2018?
Matt Bubriski: While headlines have suggested we'll see trillions of dollars return to US markets in a relatively short period, we believe this is being overestimated. Based on our estimates, the amount of cash available to be repatriated is around USD 1.5 trillion. Because companies can elect to pay the repatriation tax in installments over an eight-year period, we anticipate funds to flow back over several years. Also, because the majority of holdings are in 1-5 year securities, we expect repatriation flows to be distributed over time as companies allow them to gradually roll off to meet tax liabilities or be put toward other uses.

Q: How do you expect companies to use their repatriated funds?
Matt Bubriski: Many companies have highlighted their plans to increase employee compensation and capital expenditures in the US, but we expect a significant portion of repatriated cash to be used for stock buybacks and M&A. The repatriation tax will likely incentivize companies to use their own overseas cash in place of debt issuance to fund these endeavors.

Q: What effect will repatriation likely have on US money market funds?
Robert Corner: The overall amount of cash and investments that is ultimately repatriated could be meaningful and most likely will find its way into bank deposits, US money market funds, and other short-term investments. As Matt mentions, the amount of cash and investments repatriated could reach USD1.5 trillion. However, since there is no actual deadline, or requirement to immediately bring cash back onshore, except to pay the tax, we don't necessarily expect a flood of cash to come back to the US all at once. We think asset flows back to the US should be orderly and resulting onshore investments to be relatively short-lived as companies eventually redeploy their cash to reward shareholders, pursue M&A, or capital expenditures, among other things. Regardless of the ultimate uses, US money market funds should be an important parking spot for newly repatriated cash.

Q: What are the implications for offshore money market funds?
Robert Corner: Similar to US money market funds, offshore money market funds could be a valuable parking spot for corporations prior to repatriating cash. These balances were remarkably stable over the four-year period ending in 2016 and likely reflect companies' actual working capital needs. Balances increased in 2017, but we think companies may be adding liquidity to help cover tax bills. We expect companies to draw down these balances as they prepare for initial tax payments, but we expect balances to be rebuilt to previous levels to meet working capital needs. There could be some large, one-off transactions that cause companies to tap their cash balances, but we would similarly expect them to be rebuilt as securities mature.

Q: What will be the likely impact of repatriation on money market interest rates?
Joe Madrid: We do not foresee a significant impact on money market interest rates due to repatriation. This is due to the small allocation to money market instruments relative to the total size of liquid offshore holdings, and based on our expectation that fund flows will likely be distributed over several years. As a guide, we look to 2016 US money market reform, which led to massive flows out of prime money market funds into government money market funds. In the year leading up to the compliance deadline, an estimated USD1 trillion[4] flowed out of prime money market funds, with the bulk switching to government funds. This flow represents more than eight times our estimate of offshore cash in non-government money market instruments that could potentially be liquidated and repatriated to US markets.[5]

If we scale for the relative difference in the size of potential repatriation flows, this would imply a widening in the 3-month Libor OIS spread well below the 25-basis point move we saw in 2016. Given this potentially limited impact of repatriation, we would anticipate other factors, such as Fed interest rate hikes, to have a much greater influence on money market interest rates in the near-to-medium term.

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

1 Source: The Joint Committee on Taxation, letter from Barthold to Brady/Neal, Aug. 31, 2016, Moody's "Corporate cash to rise 5% in 2017; top five cash holders remain tech companies", Richard J. Lane, Lenny J. Ajzenman, Invesco Ltd.
2 Source: CNBC.com, "Companies are holding a USD2.6 trillion pile of cash overseas that's still growing," Nick Wells, April 28, 2017.
3 Source: 10Qs, data as of Sept. 30, 2017, Oct. 28, 2017, and Nov. 30, 2017.
4 Source: FT.com, "US money market fund reform: an explainer," Joe Rennison, Oct. 14, 2016.
5 Source: Invesco estimates, 10Qs, data as of Sept. 30, 2017, Oct. 28, 2017, and Nov. 30, 2017.

Market monitors

Fixed income market monitor

	Coupon (%)	Yield to worst (%)	1 month change in YTW	Option-adjusted spread: Current	1 month change in spread	10 year range min	10 year range max	Returns: 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
Global Aggregate (USD hedged)	2.66	1.80	0.14	33	-3	23	156	-0.71	-0.34	-0.71	2.67
U.S. Aggregate	3.07	2.97	0.26	34	-2	32	258	-1.15	-0.83	-1.15	2.15
U.S. Mortgage-backed	3.53	3.20	0.29	25	0	-16	181	-1.17	-0.99	-1.17	1.31
Global Inv Grade Corporate (USD hedged)	3.47	2.69	0.14	85	-9	55	515	-0.67	-0.12	-0.67	4.87
U.S. Investment Grade Corporate	3.94	3.45	0.20	86	-7	76	618	-0.96	-0.20	-0.96	5.08
Emerging Market USD Sovereign	n/a	5.35	0.08	264	-21	157	906	-0.04	0.74	-0.04	8.64
Emerging Market Corporate	n/a	4.63	0.10	204	-20	120	1,032	0.07	0.41	0.07	6.71
Global High Yield Corporate (USD hedged)	5.97	5.11	0.00	308	-26	231	1,845	0.59	0.66	0.59	7.12
U.S. High Yield Corporate	6.37	5.78	0.06	319	-24	233	1,971	0.60	0.65	0.60	6.60
Bank Loans	5.13	5.22	0.07	n/a	n/a	n/a	n/a	1.08	1.59	1.08	4.81
Municipal Bond	4.70	2.57	0.21	n/a	n/a	n/a	n/a	-1.18	-0.68	-1.18	3.52
High Yield Municipal Bond	5.11	5.25	0.11	n/a	n/a	n/a	n/a	-0.94	0.60	-0.94	7.16

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	2.14	2.47	0.28	-1.36	-1.19	-1.36	0.69
Canada	2.19	2.05	0.16	-0.83	-1.03	-0.83	-0.48
United Kingdom	3.47	1.42	0.23	-2.21	-0.36	-2.21	1.63
Germany	1.90	0.23	0.18	-1.06	-1.63	-1.06	-1.15
Italy	3.35	1.26	-0.01	0.42	-0.64	0.42	3.81
Japan	1.02	0.15	0.02	-0.17	0.18	-0.17	0.59
China	3.49	3.89	-0.05	0.33	0.87	0.33	-1.13
EM Local Currency Governments	n/a	n/a	n/a	0.91	2.38	0.91	8.70

FX market monitor[1]

	Current	10 year range min	10 year range max	Returns: 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
EURUSD	1.25	1.05	1.60	4.15	7.67	4.15	16.17
USDJPY	109.40	75.82	124.77	2.97	4.36	2.97	3.51
GBPUSD	1.43	1.22	2.11	5.64	7.69	5.64	12.68
USDCNY	6.30	6.04	8.28	3.23	4.85	3.23	8.96
USDCHF	0.93	0.75	1.39	5.24	8.30	5.24	7.18
AUDUSD	0.80	0.60	1.10	3.00	4.73	3.00	5.97
CADUSD	0.82	0.72	1.09	2.28	4.88	2.28	6.38
EURJPY[2]	136.85	94.31	169.49	-1.12	-3.03	-1.12	-10.87
EURGBP[2]	0.88	0.70	0.89	1.46	0.04	1.46	-2.98

Sources: Bloomberg Barclays, J.P. Morgan, as of Dec. 31, 2017. Credit Suisse Leveraged Loan data as of Jan. 31, 2018. 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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4. **November 2017 Summit Outlook,** November 2017, Rob Waldner, Chief Strategist, Head of Multi Sector, Tony Wong, Global Head of Credit Research, Liquidity and Municipals
5. **Global Liquidity: A long-term approach to short-term investing,** October 2017, Invesco Global Liquidity
6. **Q&A: Strategies for investing in a low yield world,** October 2017, Rob Waldner, Chief Strategist, Head of Multi-Sector
7. **The US debt ceiling saga resumes,** August 2017, Justin Mandeville, Portfolio Manager

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 312.1 billion in assets under management

Experienced team

- 170 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	21
Global research	95	9	17
Total investment professionals	170	10	19
Business professionals	54	12	19
Total fixed income employees	224	11	19

Source: Invesco.

As of Dec. 31, 2017. Subject to change without notice.
Investment specific experience for investment professionals.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Past performance is not a guide to future returns.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

Mortgage- and asset-backed securities, which are subject to call (prepayment) risk, reinvestment risk and extension risk. These securities are also susceptible to an unexpectedly high rate of defaults on the mortgages held by a mortgage pool, which may adversely affect their value. The risk of such defaults depends on the quality of the mortgages underlying such security, the credit quality of its issuer or guarantor, and the nature and structure of its credit support.

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Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

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