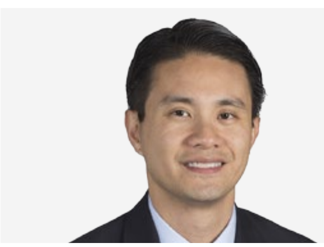
Invesco Fixed Income White Paper Series
Global Investors' Summit November 2017

Dec. 12, 2017

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

Rob Waldner, CFA
Chief Strategist, Head of Multi-Sector



Tony Wong,
Global Head of Credit Research, Liquidity and Municipals

Key macro conclusions

- Global growth is very strong. In the US, Europe and Japan, actual growth exceeds potential growth. In China, growth is roughly in line with potential. We expect continued solid global growth in 2018.
- Inflation remains benign worldwide. We do not expect inflation to meet central bank targets over the next year in the US, Europe or Japan. Emerging market (EM) inflationary trends, broadly, are also on the decline.
- Global financial policy is easy and likely to stay accommodative in 2018. Despite a pivot away from quantitative easing (QE) in the US and Europe, globally, central bank balance sheets continue to grow in aggregate. QE tapering is likely to be well-telegraphed and measured. Central bank policy in Japan is likely to remain stimulative.
- The major risk to our view of strong global growth, low inflation and easy financial conditions centers on an unanticipated sharp rise in inflation or shift in central bank policy that results in aggressive monetary tightening and sharply tighter financial conditions.
- Other risks include political uncertainty. In Europe, various elections and Brexit negotiations have yet to unfold. Policy shifts or disappointments in the US could impact growth and inflation outlooks. In EM, several major elections next year could shape policy and impact perceptions of credit quality.

US

The economic forecasts we presented at the previous Summit in June have largely materialized: 2017 US economic growth has remained solidly above-potential and financial conditions have remained easy, despite the beginning of US Federal Reserve (Fed) tapering in October.[1] Our call for structural weakness in the US dollar has also played out and we expect the trend toward US dollar weakness to continue in 2018. One area of discrepancy in our forecasts has centered on inflation, which has not picked up as much as we expected. Instead, core inflation has stayed at the lower end of our forecast range and below the Fed's target of 2%.

Looking ahead, we expect continued above-trend growth in 2018, with contributions across sectors. However, we expect a slightly lower growth rate of around 2.25%, compared to 2017's forecast range of 2.3% to 2.5%, given that the US economy is now closer to full capacity. Not included in our 2018 growth forecast is some potential upside due to fiscal stimulus. Passage of tax reform by year-end, for example, could add 0.4% to our 2018 growth forecast, according to our estimates.

Despite tight labor market conditions, we do not expect inflation to reach the Fed's 2% target in 2018 and expect it to stabilize at around 1.8%. Shelter has been a major support for inflation in recent years, while other core prices have weakened, dragging down overall inflation. Recently, shelter prices have also faltered amid weakening supply fundamentals, which bodes poorly for higher inflation in the near-to-medium term.

The Fed will likely balance the current low inflation, strong growth environment by maintaining a gradual pace of monetary policy normalization. We expect an interest rate hike in December of this year and two to three hikes in 2018, depending on the path of inflation.

Risks

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

Eurozone

Our 2017 eurozone growth forecasts were above consensus and generally on target as the eurozone has recovered smartly this year. in 2018, we expect the growth impulse to remain broad-based across sectors and countries at a rate of around 2.0% to 2.4%, which is a very positive development given low potential growth in Europe of around 0.8%, based on our estimates. Consumption has been a strong driver of growth this year. House prices, services activity, employment and wages have also shown strength. The recovery has become more widespread, with both France and Italy catching up with the rest of the region. Nevertheless, we do not expect inflation to meet the European Central Bank's (ECB) 2% target next year due to still-muted overall demand and weak credit growth. We expect core inflation to measure around 1.0% to 1.2% in 2018.

Since 2012, a major driver of eurozone economic performance and markets has been the ECB's policy, led by President Mario Draghi. The ECB's stimulus policies in recent years have stabilized growth and inflation and bolstered the euro after crumbling confidence in the euro project threatened the currency's stability. With two years remaining in his term, we expect President Draghi to maintain his dovish stance to safeguard this progress and further narrow the output gap.

Continued easy monetary policy means we do not expect interest rate increases during President Draghi's term and we expect gradual bond purchase tapering to go ahead, as announced, from January-September 2018, unless there is a downturn in growth. With the end of quantitative easing (QE), private bond markets will be required to take up bond supply no longer purchased by the ECB. While we expect diminished demand to pressure bond yields higher, many European government bond markets are prepared for higher yields. European governments have lowered their cost of debt in recent years, thanks to ultra-low yields, and in many cases have extended the average maturities of their debt, making them less vulnerable to market disruption, in our view.

Risks

Significant eurozone political risks exist, with various elections and Brexit negotiations yet to unfold. Political uncertainty combined with greater bond supply, as QE winds down, could pressure bond yields higher in 2018, especially in the European periphery. In Spain, new regional elections are set to be held in December, following a bid for independence by Catalonia's separatist leadership. Youth unemployment also remains high in Spain, despite a drop in overall unemployment, which could fuel social and political discord. In Italy, parliamentary elections, expected to be held in March, could result in a hung parliament, given an evenly split electorate among the three broad political groups: the center-right coalition, the governing center-left Democratic Party and the 5 Star Movement.[2] In the UK, we expect Brexit-related negotiation delays and uncertainty to negatively impact the economy via downward pressure on sterling, reduced confidence and a slowdown in investment and consumption.

China

China has displayed stronger growth momentum in the second half of 2017 than we expected at the June Summit, resulting in a 6.9% growth rate in the first three quarters.[3] We correctly foresaw slowing credit growth, but we did not anticipate the resilience seen in lower-tier property markets and underestimated consumption strength. We expect China's overall growth rate to average in the low 6% range in 2018, driven by our expectations of a softening property market, further tightened financial regulations and slowing credit growth, although consumption growth continues to provide a strong buffer.

In October's 19th Party Congress, China's leadership cited the expansion of China's heavy manufacturing capabilities as a major policy objective. China's electronics sector has already led global markets and the blueprint for growing the manufacturing sector could significantly impact both developed and emerging markets in the medium term.

But as China endeavors to shift the drivers of its economy, we expect continued focus on financial deleveraging and regulatory tightening. Further such measures in 2018 will likely slow shadow credit growth and lead to the bankruptcy of some loss-making state-owned enterprises (SOE). While these policies may slow economic growth in the medium term, the government appears to have increased its tolerance for more moderate growth going forward. Statements following the 19th Party Congress appeared to downplay numeric growth targets while favoring quality of growth over quantity.

Risks

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

Japan

2017 has been a year of improvement in Japan's growth and inflation. Growth, especially, has been better than expected, with above-trend rates posted in the last several quarters. We expect above-trend growth to continue in 2018, driven partly by productivity gains.

While inflation remains well below the Bank of Japan's (BoJ) 2% target, it is likely to end 2017 at around 0.6%, solidly in positive territory after a multi-year period of worrying deflation. Higher oil prices, rising wages and a weaker yen have all contributed to an uptick in prices, although we expect these factors to be less supportive going forward. With inflation expected to remain little changed in 2018, we expect the BoJ to maintain its inflation target but extend the timeline for meeting it. We expect monetary policy to remain unchanged in 2018.

Japan's labor market trends have been especially encouraging. Abenomics has appeared to pay off by raising productivity and drawing people into the labor force, especially older workers and women. Increased corporate profitability has boosted employment and consumer confidence, while tightening labor markets have caused some wage growth, even among part-time workers. We expect these positive employment trends to continue in 2018, supporting growth and inflation.

Exports have also been a key source of growth in 2017, following the pick-up in the economies of Japan's trading partners. We expect continued robust export performance in 2018, as global growth remains on track.

Risks

High levels of public debt persist and the official will to reduce the government's debt burden appears to have waned amid shorter-term objectives to stimulate the economy. A heavy debt burden could imply a slower shift toward monetary policy normalization and potential fiscal stress. A downturn in the global economy would also likely challenge Japan's growth outlook since it is partially dependent on exports.

Emerging markets (EM)
Growth conditions have improved in EM broadly. We believe there is upside growth potential in the first half of 2018, led by Latin America, as it plays catch-up, and growth in Emerging Europe remains strong. In EM Asia, growth has likely peaked and we expect it to moderate in 2018, settling in at a comfortable level. Inflation is also generally benign across EM and, in many countries, is on the decline.

The strongest, and often-overlooked, aspect of the EM story, in our view, is the marked improvement in EMs' external positions. Current account deficits have narrowed in Latin America and Emerging Europe and, in Asia, current account surpluses have narrowed, but balances remain positive. Excluding China, EMs overall have experienced balance of payments improvement in the past few years, helped by capital inflows and leading to a significant re-accumulation of foreign reserves. External debt and funding requirements have also risen, but we do not believe they pose a systemic threat to EMs due to the build-up of external buffers.

A greater concern is the deterioration in the fiscal position of many EMs and the steady rise in domestic debt levels – especially in Latin America – which bears close monitoring going forward. Moreover, the slowdown in EM domestic credit – a reflection of the advanced age of the prevailing economic cycle – may dampen growth prospects beyond the first half of 2018 and challenge fiscal outcomes.

Risks
As such, we are monitoring rising domestic debt burdens across EMs. Private sector debt has accumulated quickly over the last few years. Rising domestic debt in part reflects financial deepening, which is positive, but has also been fueled by easy financial conditions. Though not our base case, if financial conditions tighten significantly, refinancing as well as debt servicing could be strained and pose a risk to growth and domestic financial stability outcomes.

Political developments will also be important to watch. Elections in 2018 in Colombia, Brazil, Mexico and Russia, for example, could shape reform efforts and economic programs, influencing perceptions of creditworthiness.

Arguably, EM credit and local markets broadly reflect recent fundamental improvements. On balance, in an environment of benign financial conditions, we believe the EM macro-fundamental backdrop remains a source of support for EM asset prices as we head in to 2018.

1 Potential growth, or "trend growth," is the level of annual growth implied by population and productivity growth.
2 Source: Wall Street Journal, Italy's Parliament Approves New Electoral Law, Oct. 26, 2017.
3 Source: National Bureau of Statistics, Oct. 19, 2017.

IFI macro views and 2018 outlook

	US	Eurozone	Japan	China
GDP trend growth	Expect 2.25% growth in 2018. Growth should be broadly supported by consumption, capital expenditure and easy financial conditions.	Expect 2.0-2.4% growth. Domestic demand remains the key driver, helped by synchronized global growth momentum and the reduction in euro-area political risks.	Expect 1% growth in 2018. Exports should be the primary driver, however, consumption should also make a meaningful contribution.	Expect annual growth to be in the low 6% range, driven by softening property markets, further tightening of financial regulations and slowing credit growth.
Inflation	Core inflation expected to stabilize at around 1.8%.	Expect core inflation of 1.0-1.2% and headline inflation to remain under pressure from fading energy base effects.	Inflation to remain positive in 2018 at around 0.6%. Tighter labor market and upward pressure on wages will likely be primary driver.	Expect 1.5-2.0% inflation, below the central bank's 3% alert level. Unexpected changes in oil prices and food supply dynamics could pose upside risk.
Monetary policy	Fed likely to hike rates in December and two or three times in 2018.	A degree of monetary policy normalization looks warranted at this stage. We expect a "lower for longer" taper of EUR30 billion for nine months beginning Jan. 2018.	Yield curve control has been a success and lessens need for further easing anytime soon, in our view.	Monetary policy is expected to be neutral including regulatory tightening measures coupled with potential reserve ratio cuts.
Fiscal policy	Fiscal policy may become expansionary in 2018.	Fiscal policy could be loosened in Germany as Chancellor Merkel seeks to form a broad coalition.	Expansionary.	Neutral fiscal policy with stable budget deficit expected.
Government yields	In short term, 10-year US Treasury yields are likely to remain in the 2.2-2.4% range.	Expect 10-year bond yields of 0.8-1% at year-end 2018.	Expect BoJ to keep Japanese 10-year government bond yields contained "around zero."	Expect 10-year Chinese government bond yields to range between 3.5-4.0%.
Currency	Converging global nominal growth rates are likely to drive weakness in the US dollar	We remain broadly positive on the euro as the economy improves and the ECB begins to pull back on QE.	Expect yen to trade between Y105-115 per US dollar for the remainder of this year. Yen moves most likely to be driven by developments external to Japan.	Expect the renminbi to remain in range of 6.50-6.70 in a stable US dollar environment or 6.80-6.99 in a very strong US dollar environment.

Important information

The opinions expressed are that of Invesco Fixed Income and may differ from the opinions of other Invesco investment professionals. Opinions are based upon current market conditions, and are subject to change without notice. Past performance is no guarantee of future results.

As with all investments, there are associated inherent risks. Please obtain and review all financial material carefully before investing. Asset management services are provided by Invesco in accordance with appropriate local legislation and regulations.

This document has been prepared only for those persons to whom Invesco has provided it for informational purposes only. This document is not an offering of a financial product and is not intended for and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any person without the consent of Invesco is prohibited.

This document may contain statements that are not purely historical in nature but are "forward-looking statements", which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

- may contain references to amounts which are not in local currencies;
- may contain financial information which is not prepared in accordance with the laws or practices of your country of residence;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address local tax issues.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.