



# Invesco Fixed Income White Paper Series

## Global Investors' Summit November 2016

December, 2016

Invesco Fixed Income (IFI) held its semi-annual Global Investors' Summit in November, gathering around 80 of IFI's investment professionals from around the world to discuss key themes affecting global bond markets and determine our strategic views for the next 12-18 months. The following represents our current views and outlook.



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### Key macro conclusions

- We have upgraded our long-term US GDP growth forecast by 0.5% on the US election outcome to around 2-2.3%. We believe the US Federal Reserve (Fed) remains on track to hike interest rates by 25 basis points in December, in line with our own and current market expectations.
- Although it is early days in the US political transition, we expect potential restrictions on trade and immigration, greater fiscal stimulus and reform of the Affordable Care Act (ACA), also known as Obamacare, to take political precedence in the new Trump administration.
- While these policies may lead to higher cyclical economic growth in the shorter term, they may lead to potentially higher inflation and lower structural growth in the longer term.
- We believe the ACA explains much of the fluctuation in consumption over the last few years given higher consumer outlays for health care related expenses. As a result, we believe the recent consumption slowdown does not foretell economic weakness but rather more normalized health care spending following the initial surge post-ACA. Consumption growth excluding healthcare spending remains solid and we expect it to average around 2.5% in 2017.
- We continue to be cautious about the long-term inflation outlook in Europe and expect economic growth to remain low. We expect around 1% growth in the eurozone overall in 2017 and 0-0.5% inflation.
- The European Central Bank (ECB) is likely to keep monetary policy relatively loose ahead of the upcoming European electoral cycle to manage not only economic and financial contagion, but potentially political contagion.
- We believe European Union (EU) institutions and member-states will seek to lower incentives to turn inward and erect national barriers within the EU by taking a hard stance on Brexit. But when actual negotiations get underway, we expect economic rationality and practical politics to prevail, enabling nuanced negotiations on the specific issues raised by Brexit.
- We continue to foresee a structural growth slowdown in China with implications for global disinflationary pressures, but we also continue to believe that Chinese authorities will be able to avoid a hard landing. We expect 2017 growth to moderate to around 6%.
- Chinese household and corporate appetite to allocate assets overseas appears to remain strong, although capital outflows seem to have stabilized. We expect Chinese policy makers to continue to smooth currency volatility and curb leverage in the system.
- Overall, emerging markets (EM) external debt is at manageable levels and foreign exchange coverage ratios are generally good, thus limiting, in our view, the adverse impact of external shocks. However, some countries have experienced deteriorating fiscal balances and rising debt levels.
- More than ever, we see the need to discriminate based on a likely dispersion in outcomes among different EM countries. Longer term, potential pressure on capital flows and slow growth may lead to positive reforms that could aid domestic rebalancing in major countries such as India, Indonesia, and Mexico.

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## Regional macro views

**US:** Within a few months' time, both opinion polls and financial markets were surprisingly wrong about two far reaching events - the UK Brexit vote and the US election. Market reaction to these events was also unexpected. Post-Brexit, financial markets saw a sharp sell-off followed by an equally sharp risk rally. The surprise Trump election victory was similarly followed by a brisk sell-off and rapid bounce back in risk assets, despite uncertainty surrounding the new Trump administration's potential policy framework. We believe the US Federal Reserve will be interpreting such market reactions carefully as it decides its next policy action. As it relates to near-term policy decisions, since a financial conditions shock did not materialize post-the US election, we believe the Fed is not likely to be delayed in December and will hike interest rates as expected by the markets and us. Depending on the policies of the Trump administration and their possible inflationary impact, the Fed may be more aggressive in 2017. US consumer price inflation is already ticking up alongside wage inflation and the US economy has essentially reached full employment.

Although it is early days in the US political transition, the Trump campaign highlighted a number of initiatives that are likely to be viewed as priorities in the Trump presidency. Potential restrictions on trade and immigration, greater fiscal stimulus and reform of the ACA, also known as Obamacare, are likely to take political precedence. While these policies may lead to higher cyclical economic growth in the shorter term, they also point to potentially higher inflation and lower structural growth in the longer term, in our view. We have upgraded our long-term GDP forecast by 0.5% on the Trump win to around 2-2.3%. Over the longer term, we view structural growth largely as a function of labor force size, labor utilization and productivity. Our outlook is a function of potential Trump policies on these variables. So far, campaign rhetoric points to a reduced size of the US labor pool (via restricted immigration) and lower productivity (via restricted trade), suggesting lower potential growth. A more protectionist, restrictive trade environment would likely be inflationary. A major reversal of Obamacare, which has, up to now, had a depressing effect on consumer prices, could also fuel inflation. On the other hand, increased fossil fuel production, as was discussed during the Trump campaign, would likely imply lower energy prices - although recent OPEC production cuts have been supportive.

We would expect a combination of loose fiscal policy and increased inflation to pressure interest rates higher. Increased US Treasury issuance needed to fund a higher fiscal deficit would likely reinforce that trend. As mentioned above, we believe a December rate hike is still likely and the risk is now greater for more rate hikes in 2017 than our previously expected two. But the pace of Fed hikes will likely depend on how fiscal policy shapes up in 2017. If the Fed hikes rate faster than market expectations, currency hedging costs could rise, causing foreign demand for US Treasuries to drop faster than expected. Declining global trade could also reduce current account surpluses abroad, potentially reducing demand for US dollar assets such as US Treasuries.

At the June Summit, we were looking for marginally above-potential US growth, although we had revised it down recently. We had forecast inflation at around the Fed's 2% target and had expected global forces to keep interest rates below fair value.<sup>1</sup> We have now revised our near-term growth forecast slightly higher on the election outcome, and look



for the US to continue to lead the rest of the world with above-trend growth. We expect core consumer price inflation (CPI) to stabilize at around 2.3% and growth in the Personal Consumption Expenditures Index (PCE) to stabilize at around 1.9%. We continue to expect downward pressure on US Treasury yields from global deflationary forces but at higher levels overall. We anticipate a strong US dollar over our 12-18 month forecast horizon.

**Europe:** Overall economic conditions in Europe have not changed materially since our June Summit. Economic growth in the summer was stable, but faced downside risks due to Brexit. Inflation was low but benign. Not much has changed in our overall outlook since then. Growth remains sticky, fragile and to a large degree unbalanced across the eurozone. Pockets of success have emerged (e.g. Spain and Germany) but some laggards remain (e.g. Italy and France). We expect around 1% growth for the eurozone overall in 2017 and only marginal inflation of around 0-0.5%.

A number of factors could pose downside risks to our view. Trump's election win could pose downside risks, especially to Germany, depending on how US trade policy evolves. The US is Germany's largest trading partner, accounting for almost 10% of all German exports.<sup>2</sup> A protectionist US path could have significant repercussions for German exporters and their large labor force. European growth could also be hurt by uncertainty over the full docket of upcoming European elections where the possible advance of euroskeptic parties will be watched, European Central Bank (ECB) policy and the ongoing complexities of Brexit. The ECB's target is to hit 2% inflation, but the eurozone is nowhere near that level and there appears to be no strong inflationary impulse.<sup>3</sup> Although unemployment has declined, the eurozone has not seen a pick-up in wage growth. Most of the increase in employment has been in lower productivity, lower wage sectors. Therefore, we believe ECB inflation projections are ambitious (1.2% in 2017 and 1.6% in 2018).<sup>3</sup> Core inflation has averaged only about 0.8% since 2013.<sup>4</sup> We could see a spike in prices in the first quarter of 2017 due to the waning impact of falling energy prices, but we would expect it to be transitory. We continue to be cautious about the long-term inflation outlook in Europe and expect economic growth to remain low.

With structural reform and fiscal stimulus on hold ahead of the election cycle, the ECB will likely be obliged to keep monetary policy relatively loose to manage not only economic and financial contagion, but potentially political contagion. We believe the ECB will extend its bond purchase program by six months at a minimum in December, maintaining purchase levels at the existing EUR80 billion per month. However, given the challenge of bond scarcity, we believe the ECB will tweak its guidelines to increase the universe of bonds it may buy. Bank lending appears to be tightening, possibly in response to low bank profitability, and political risk in Europe will likely require the ECB to manage through the next several months by maintaining a dovish stance. We are, therefore, bullish on European duration based on strong technicals largely driven by ECB bond buying. The outlook for the euro is less clear. Negative political surprises could mean capital flight, which would be potentially very negative for the euro, in our view.

**China:** We continue to foresee a structural growth slowdown in China with implications for global disinflationary pressures, but we also continue to believe that the Chinese authorities will be able to avoid a hard landing. Fiscal expansion has been aggressive in





2016 and is expected to be more aggressive in 2017. Currently, fiscal spending is running at around 10% of GDP - roughly double its 2013 level.<sup>5</sup> Lending has also picked up, especially among government-owned policy banks. However, much of the lending has been directed toward local governments who have yet to put the funds to work. We expect investment to pick up next year ahead of the 19th Party Congress in the fall, where party leadership and platforms will be decided. Nevertheless, there may not be a significant growth pay-off since productivity is slowing and debt service is rising. We expect 2017 growth to moderate to around 6%.

There has been considerable market concern over a potential property market bubble in China. However, recent housing data show that the sharp rise in housing sales has been mainly concentrated in Tier 1 cities and is due to largely to sales of existing stock, while property investment growth has remained quite low. While housing has clearly become less affordable in Tier 1 cities, this has been less of a problem in Tier 2 and Tier 3 cities. And while mortgage costs have risen across all tiers, we still expect mortgage default rates to remain low since mortgage liabilities are often shared by extended families in addition to homeowners. That said, higher mortgage costs could eat into homeowners' overall consumption power.

Although we believe the risk of a property market crash is low, the Chinese central bank (PBoC) has pursued monetary tightening through various channels to control asset bubbles and leverage levels in the economy. Overnight lending rates have already increased sharply. Further efforts to reduce leverage may reduce liquidity in the financial system leading to reduced appetite for wealth management products, which invest in bonds, among other assets. A slowdown of flows into the credit market would likely be negative for bonds and, therefore, we are cautious on onshore Chinese corporate bonds. Household and corporate appetite to allocate assets overseas appears to remain strong, although capital outflows appear to have stabilized. We anticipate a large capital outflow early next year when the individual foreign exchange purchase/sale annual quota of USD50,000 is renewed. If the US dollar strengthens, we would expect the Chinese renminbi (RMB)/US dollar (USD) exchange rate to reach around RMB7/USD. We expect Chinese policy makers to continue to smooth currency volatility.

Over the next 12-18 months, we believe Chinese economic policy will be a key determinant of market performance. However, future policy remains uncertain ahead of next year's Party Congress which could entail major leadership changes. We believe next year is likely to be characterized by official attempts to manage the economy "down the middle," with efforts to grow the economy while avoiding downside risk.

**Emerging markets:** Emerging markets (EM) continue to grapple with a sequence of rolling external shocks and, in many cases, domestically-induced challenges. While they have demonstrated a large degree of resilience, the ability to maintain recent positive momentum will likely vary greatly from country to country. Generally, we find that external adjustment has largely been achieved via currency depreciation and resulting improvement in external accounts (both trade and financial). Overall, EM external debt is at manageable levels and foreign exchange coverage ratios are generally good, thus limiting, in our view, the adverse impact of external shocks. Domestic adjustments have



been more uneven. Some countries have rebalanced fiscal accounts to accommodate lower commodity prices, wages have fallen in line with slower growth, and currency adjustments have not led to excessive inflation, given the slowdown in domestic demand. Others have not fared as well, and overall we have witnessed deteriorating fiscal balances and domestic debt levels have been on the rise - both for governments and the private sector. Key to the outlook for these countries will be whether policymakers keep fiscal deficits in check in order to contain the rise in debt levels.

Going forward, we expect moderation in EM private sector credit growth as credit conditions are beginning to tighten. External demand also remains relatively subdued. As such, EM growth will likely remain modest in 2017, and even as there is scope for some recovery from 2016, we believe the risks to growth are nonetheless tilted to the downside. The outcome of the US election may pose further challenges to EM, though it is still too early to gauge with confidence. Growth may slow if restrictive trade policies are pursued and financial conditions could tighten if the US dollar strengthens further from here. On the other hand, improvement in US growth has typically supported risk assets, including emerging markets. Moreover, US trade policies may not end up being as restrictive as presumed immediately after the election.

More than ever, we see the need to discriminate based on a likely dispersion in outcomes among different EM countries. We expect that pressure on capital flows and slow growth will lead to additional reforms that will aid domestic rebalancing in countries such as India, Indonesia, and Mexico. We also remain optimistic that recent political transitions in both Brazil and Argentina will continue to support better economic and, particularly in the case of Brazil, fiscal outcomes over time. Russia too may stand to benefit from stable oil prices and prospective rapprochement with the incoming US administration. Political risks are most worrisome in South Africa and Turkey, where we remain cautious. Growth is improving after a difficult period of adjustment to lower oil prices and debt burdens are modest, but geopolitical risks remain. Regionally, we favor Asia for growth prospects and relatively sound fundamentals, though we remain watchful for further depreciation pressures led by the Chinese currency. Latin America's outlook is still generally tied to commodities. We have a favorable outlook for metals given prospects for China and US infrastructure development, but are less certain regarding the path of oil even if recent stability/improvement continues. Eastern Europe's fate remains tied to political outcomes in the EU, where we remain somewhat cautious given the heavy electoral calendar.

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### **Update on the US consumer**

Given consumption's importance in the US economy (personal consumption expenditures represent around 70% of gross domestic product), we provide an analysis of both consumer spending and income trends over the last few years and use that as the foundation to make a more informed projection for 2017.<sup>6</sup>

Personal consumption growth has followed a volatile path in recent years: It accelerated sharply in 2014, peaked in May 2015 and has been on a decelerating path since.<sup>7</sup> But after looking at the components of both consumer spending and income, we conclude that the majority of the fluctuation has been due to government policy rather than



a material shift in the economic cycle. In particular, we believe the ACA is largely responsible for the recent up and down consumption pattern, although volatility in interest rates and the curbing of several entitlements such as food stamps, social security, and unemployment benefits also played a role. As a result, we believe the recent consumption slowdown does not foretell economic weakness but rather more normalized health care spending following the initial surge post-ACA. Consumption growth excluding healthcare spending remains solid and we expect it to average around 2.5% in 2017.

When the ACA was first implemented in 2014, healthcare spending jumped to well above historical levels. But after an initial surge in 2014/5 driven by millions of newly insured individuals, growth has recently leveled off to roughly historical levels. We do not believe this retrenchment in consumer spending signals recession. When the impact of healthcare is excluded, year-over-year real consumer spending growth only decelerated by about 0.5% to 2.4% through August of this year, after a period of nearly stagnant growth in 2012/3 of around 1.5%.<sup>7</sup> A similar pattern can be seen on the income side of the ledger. Total year-over-year income growth peaked in late 2014 at around 6% but decelerated to around 3% over the last several months.<sup>7</sup> However, when other forms of income aside from employee compensation (which are less impacted by the economic cycle) are excluded, the story is less ominous, and the deceleration was been more benign, falling from 4.7% to 3.9%.<sup>7</sup> Much of this decline can be linked to a decline in hours worked which can be shown to have occurred primarily in the retail sector as retailers attempted to reduce employee hours to under 30 to avoid healthcare penalties under the ACA. Job growth has also decelerated as the economy has reached full employment. However, we expect wage growth to more than offset this as labor shortages in particular industries become more widespread.

With this knowledge, we are more optimistic that consumer spending is unlikely to materially fall from its current trend and consequently expect consumer spending growth to average around 2.5% for the next four quarters. However, while we expect total spending to continue to grow at a solid pace, which is key for the economy, we also project that discretionary consumer spending will continue to give way to increased spending in non-discretionary sectors such as healthcare, energy and housing, in line with the recent trend, meaning that consumers may continue to feel a little poorer.

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### **Brexit - a rough guide**

Despite uncertainty around Brexit, the UK economy has outperformed consensus expectations of a post-referendum slowdown. It appears that the economy slowed ahead of the referendum but quickly rebounded, as the political shock of the outcome resulted in only a brief tightening in financial conditions. Indeed, both UK and global financial conditions were loosened by the Bank of England's (BoE) so-called "sledgehammer" monetary easing in August.

That said, business investment and hiring appear to be affected by uncertainty about the free flow of goods, services and people between the UK and European Union (EU). Furthermore, the sharp fall of sterling to its weakest levels in three decades has started to generate inflation and will likely eventually crimp domestic purchasing power, even though



it is currently boosting tourism and the attractiveness of UK assets. The UK once again faces a risk of stagflation, just as the eurozone faces the risk of a drag on export growth as the UK economy slows.

Going forward, the lack of investment inflows to finance the large UK current account deficit could imply still greater pressure on sterling and rising inflation, at least for tradable goods. Under such circumstances, the BoE is likely to stay on hold, caught between two issues: on one hand, the downside risks of tightening to combat inflation, given profound Brexit uncertainties; and on the other hand, the reputational costs of easing in the face of rising inflation, even amid declining potential growth.

As for the ultimate Brexit process itself, we expect political posturing to continue in both the UK and EU. The UK prime minister and cabinet must hold together a country and governing party each divided by strong, opposing views on Brexit, while respecting the referendum outcome. Equally, the EU and eurozone face internal divisions of their own, being no strangers to the wave of anti-globalization/anti-establishment politics resulting from weak growth, low inflation and economic uncertainty. To fend off the risk of disintegration across the EU and encourage deeper integration in the eurozone, EU institutions and member states feel they must lower the incentives to turn inward and erect national barriers within the EU by taking a hard stance on Brexit. But when actual negotiations get underway, we expect economic rationality and practical politics to prevail, enabling nuanced negotiations on the specific issues raised by Brexit.

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### Risks to our views

**US economy stalls:** In the US, solid consumption helped by strong labor market performance has supported our above-trend growth outlook. Deterioration in the US labor market could pose risks to consumer spending, feeding through to weaker growth. Financial market volatility due to increased global growth uncertainty or uncertainty over the incoming Trump administration's policies could also dampen US consumer confidence and spending.

**European political risk:** If risks of political fragmentation rise, the eurozone is likely to underperform our baseline scenario of subdued growth and inflation. Anti-EU and/or anti-eurozone political forces could exacerbate headwinds, causing declines in consumer confidence and animal spirits in both the corporate and financial sectors. Additional risks would be an abrupt ending of QE or indeed any tapering of QE announced by the ECB in the near term.

**Financial and economic instability in China:** As China focuses more on supply side reform and controlling private sector leverage, we could see greater than expected financial market volatility and/or downside pressure on Chinese economic growth. Shifts in policy direction due to possible personnel changes among key policy makers could also affect economic outcomes. Renewed volatility in China would likely have an impact on global financial markets.





**Geopolitical shocks causing generalized global risk-off sentiment:** Destabilizing geopolitical events could have systemic implications for developed market and EM countries. After the surprising “leave” result in the UK referendum and unexpected US election outcome, a push for additional referenda across Europe could pose significant risks to financial markets and sentiment.

<b>IFI macro views and 2017 outlook</b>				
	US	Eurozone	Japan	China
GDP trend growth	Expect 2.0-2.3% growth in coming year. Labor market improvement on track. Fiscal policy should ease.	Expect 0.8-1.2% growth in coming year with risks skewed to downside.	Expect 0.5% growth in coming year. Investment and consumption to pick up slightly. Contribution from exports to remain minimal.	Expect annual growth to moderate to around 6%. Growth appears to be stabilizing, but risk of further slowdown.
Inflation	Core inflation should run near 2.3% through 2017.	Expect annual core inflation of 0.0-0.5% over the next year with risks skewed to downside.	Expect inflation to move higher in 2017 on weaker currency and higher oil prices but remain well short of 2% target.	Expect 1.5-2.0% inflation, below central bank's 3% alert level.
Monetary policy	25 basis point rate increase in Dec. 2016. Data dependent in 2017.	Continued QE likely.	Yield curve control has been a success and lessens need for further easing anytime soon. BoJ has moved into incremental mode.	Monetary policy is expected to have a tightening bias in 2017. Tightening is more likely to be reflected via short-term rates and central bank's liquidity operations.
Fiscal policy	Fiscal policy likely to be expansionary.	Currently neutral, but somewhat likely to shift to expansionary.	Expansionary	Proactive fiscal policy with higher budget deficit expected.
Currency	Expect US dollar to continue to appreciate.	Expect depreciation based on political risks and US dollar strength.	Expect yen to trade between ¥105-115 per US dollar this year. Increased yield differential will make foreign securities more attractive to domestic investors.	Expect the Chinese currency (RMB) to move generally in line with target basket of currencies. Strong USD likely leads RMB/USD to trade around 7.0.

1 Source: Board of Governors of the Federal Reserve System, Dec. 1, 2016.

2 Source: German state statistical office, Nov. 27, 2016.

3 Source: European Central Bank, Dec. 1, 2016.

4 Source: Bloomberg L.P., Invesco, Jan. 1, 2013 to Oct. 31, 2016.

5 Source: China International Capital Corporation Limited, Oct. 31, 2016.

6 Source: Bureau of Economic Analysis, Sept. 30, 2016.

7 Source: Bloomberg L.P., Jan. 1, 2012 to Aug. 31, 2016.



## Important Information

All information is sourced from Invesco, unless otherwise stated. All data as of September 30, 2016 unless otherwise stated. All data is USD, unless otherwise stated.

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