Global macro strategy

Five things we think could go right in 2019

We often talk about the risks likely to upset markets. This month we highlight the five things we think could go right and support markets. First, the US Federal Reserve (Fed) has told markets it is willing to be “patient,” and there is the possibility this patience could last a while. Second, US-China trade tensions have calmed somewhat, as the two countries appear motivated to reach agreement on key issues. Third, China is stimulating its economy, which we believe will support growth. Fourth, Brexit is softening, with the tail risk of a hard or no-deal Brexit diminishing in recent weeks. Finally, we see no signs of an impending US recession, despite the fears that disrupted markets at the end of 2018. Each of these five possibilities would likely be supportive of risk assets.

Fed on hold

Recent Fed rhetoric and actions have caused markets to begin contemplating a potential policy regime change. The change involves a shift in the Fed’s focus from a forward-looking inflation constraint, effectively capping inflation at around 2%, to a framework that would allow symmetrical variation around a target of 2%. Under the new regime, the Fed would be willing to allow core personal consumption expenditure (PCE) inflation to increase to around 2.5%, for example, to compensate for inflation that has remained below-target for a decade. In theory, the Fed’s reaction function has always targeted symmetrical inflation, but, in practice, this has hardly been the case. Realized inflation has existed above-target in only seven of the last 20 years. This reality is also reflected in Treasury Inflation-Protected Securities, which are currently pricing below-target inflation in perpetuity.
In some ways, we believe the Fed has been building toward this type of policy shift for some time. In 2012, it changed the language describing its mandate to reflect a symmetrical inflation target, and recent speeches by some top Fed officials have emphasized such thinking. In trying to achieve a more symmetrical inflation target, the Fed would likely leave the federal funds rate stable for longer (or perhaps lower it if global growth slowed). This policy should promote stronger growth, higher inflation and easier financial conditions.

If this shift is viewed as credible and durable, it would likely be very positive for risk assets. While long-dated real yields would likely remained contained, we would expect the nominal yield curve to steepen as inflation risks rose. Inflation expectations could rise by as much as 75 basis points, in our estimation. The US dollar would likely depreciate versus emerging markets currencies, but the effect versus developed markets would likely vary, depending on relative economic performance.

It is not certain that the Fed has changed regimes. If it has not, and if financial conditions improve and wage pressures build, the Fed may shift back toward a forward-looking inflation framework. In this case, asset markets would likely resume the fluctuating risk-on/risk-off paradigm that has prevailed since 2014. However, whether or not there is a durable policy shift underway, a period of stability in interest rates will likely benefit markets over the medium-term.

**Trade tensions on the mend**

Trade friction has become a source of international tension, downside risk to global growth, upside risk to currency volatility and inflation and a threat to financial conditions. There are three major areas of trade tension that represent truly global threats, in our view - relations between the US and China, the US and European Union (EU) and the UK and EU, via Brexit. We believe the downside risks are significant, but also see potential upsides in each of these areas.

First, the Trump administration's rhetorical bark has often been far more aggressive than actual policies, given the risk of disrupting the US or global economies. The most important individual trade deal so far - the revision of the North American Free Trade Agreement (NAFTA) into the United States-Mexico-Canada Agreement (USMCA) - occurred with far more rumble than actual revisions warranted in the view of most trade experts. In our view, the changes were both symbolic and substantive: The Trump administration proved willing to avoid immediate and potentially severe disruption in key US states with close trade and investment relationships with NAFTA partners. The symbolism was important politically: the USMCA replaced NAFTA as a trade deal acronym - that is, the new name puts America first.

Second, Brexit is a major known unknown and would likely have asymmetric implications, but our view is that a hard Brexit will be avoided. If Brexit is soft (or there is no Brexit), the impact on global activity and trade would likely be modest, as the UK economy gradually recovers poise and trade with the eurozone and the rest of the world remains largely unchallenged. While the risks are high, we remain optimistic that the worst case of a no-deal Brexit will be avoided. Beyond the immediate economic downside, there would still be hope for free trade, however, given the desire of many hardline Brexiteers to be free of EU rules in order to liberalize trade with the rest of the world.

Third, and most important, in our view, are the challenges in US-China trade negotiations and other elements of the bilateral relationship. Here we expect no quick or easy resolution, but we do not expect the worst case. Foreign policy and national security concerns are clearly a major factor in US policy, but we believe shared interests argue against “decoupling” as per the full-blown Cold War geopolitical analogy. The extensions to the negotiation timeline reveal that the Trump administration would like to avoid full-scale escalation, just as China's continued negotiation suggests that it is prepared to meet the US halfway. This leads us to think that the better historical analogy is not the 20th century Cold War, which began when the US stood out as far larger and stronger than the other major economies and was essentially segregated from the Soviet Union, but rather the late 19th century, when the world was becoming economically and politically multipolar, thanks to the spread of industry. Notably, that was a time of continued globalization, innovation and economic advancement, despite political tensions.
Chinese growth stabilizing

Signs of Chinese economic deceleration have caused concern about the potential knock-on effects to global growth, but we are more optimistic than other market participants about China’s macroeconomic outlook and asset performance. Since mid-2018, supportive adjustments to Chinese macro policy and improved market sentiment have been in line with our expectations and suggest that Chinese growth will likely stabilize later this year.

We believe China’s recent series of easing measures has set the stage for a potential bottoming of growth as soon as the second quarter. In addition to policies already implemented (such as several rounds of required reserve ratio cuts), we expect further easing measures to be announced by China’s policy makers in the coming months. The People’s Bank of China (PBoC) recently indicated possible reforms, which, if implemented, could lead to effective cuts in lending rates and private sector funding costs. In addition, the PBoC has focused on improving the monetary policy transmission mechanism, including efforts to facilitate the recapitalization of banks and relax the investment scope of banks’ wealth management products. We expect such measures to boost broader credit growth.

Fiscal policy is also expected to play a major role in arresting China’s growth slowdown. Tax cuts and fee reductions in 2019 are likely to exceed 1% of nominal GDP (RMB800 billion). Infrastructure investment is also expected to accelerate this year, with incremental investment to be funded by local government special project bonds and a higher fiscal deficit.

Some economic data have already started to stabilize and improve. Corporate funding costs, especially onshore bond yields, have posted significant declines and credit growth picked up strongly in January from a low level posted in late 2018. Considering the time lag from policy easing to positive economic response, we expect China’s series of easing measures to stabilize growth sometime in the second quarter of 2019 or early in the third quarter.

Brexit getting softer

We think a “no deal” Brexit, defined as the UK leaving the EU on March 29 without an agreed transition period (therefore reverting to WTO trading terms) is unlikely. We believe the UK government, a majority of members of parliament (MPs) and the EU appreciate the potential economic damage from such an outcome and will seek to avert it. We think the EU will be willing to extend the March 29 “Article 50” deadline under almost all circumstances. At the extreme, a recent European Court of Justice ruling has confirmed that the UK could unilaterally revoke its application to leave the EU under Article 50.

The most likely Brexit scenarios are:

1) Prime Minister May is able to extract minor concessions from the EU regarding the Irish Backstop (a clause in the withdrawal agreement guaranteeing an open land border on the island of Ireland regardless of the state of future UK-EU relations). Her tweaked deal passes the UK Parliament, largely with the support of the majority of her own Conservative Party MPs, the Northern Irish Democratic Unionist Party and a handful of Labour Party MPs.

2) Failing the first option, Prime Minister May is forced to pivot toward accepting a softer form of Brexit, probably including a permanent customs union, which could win the support of the majority of Labour MPs, offsetting the likely dissent from the Eurosceptic wing of her own party.

Although we believe these two scenarios are the most likely, it is unlikely that any extension to Article 50 will be confirmed before mid-March. This is because the EU will not want to concede on the Irish backstop until it knows if May can gain a parliamentary majority, which is itself dependent on MPs fearing “no deal” and their failure to coalesce around a soft Brexit option or a new referendum.
The lack of certainty as we approach the March 29 deadline is likely to cause increased financial market volatility. However, the passing of a tweaked version of Prime Minister May’s deal or a softer Brexit option could result in the appreciation of sterling, underperformance of UK gilts and outperformance of UK credit, particularly financials.

Another scenario not discussed above is another referendum, resulting in the UK remaining in the EU. Although this is probably more likely than “no deal,” the chances of another referendum are relatively slim, in our view. Beyond the practical issues, such as the requirement of at least a six-month extension to the Article 50 deadline and a lack of agreement on the format, there does not appear to be a parliamentary majority for a new public vote. Since all but a tiny fraction of Conservative MPs oppose a referendum, its chances would likely rely heavily on Labour Party support. Recent votes, however, suggest there is substantial opposition to overturning Brexit among Labour MPs and that the Labour leadership is prioritizing a soft Brexit ahead of a referendum. A referendum, which does not of course guarantee that the UK would remain in the EU, would only be likely if all other options have been exhausted, in our view, probably including another general election.

Recession not on the horizon

Late last year, many market commentators prognosticated the onset of recession as soon as the end of 2019, roiling markets. Increased market volatility only exacerbated worries about growth. However, first quarter economic data have not shown signs of recession. In addition, the Fed has begun to wind down its tightening cycle, helping to calm markets. These developments give us confidence that the US will avoid recession in 2019 and likely beyond.

Employment data, in particular, have shown strength. The moving average of monthly job growth, which is one of our favorite indicators of current growth, is near cycle highs at around 240,000 jobs. The Job Opening and Labor Turnover Survey has also rebounded to new highs, suggesting that labor demand is strong. Measures of industrial activity have been more volatile, likely due to increased trade tensions with China. Many manufacturing surveys dipped in the fourth quarter of 2018 but have since rebounded somewhat. The Institute for Supply Management survey of manufacturers dipped to a three-year low in Dec. 2018, but rebounded in January, meaning industrial activity may have bottomed. Overall, manufacturing surveys point to some softening in the economy compared to the very rapid pace of growth in mid-2018, but they still indicate a strong level of current activity.

Increased market volatility experienced at the end of 2018 will likely have some slowing effect on growth. However, in the past month, the Fed has paused its interest rate hiking cycle and shifted to a more dovish stance. This move should contribute to easier financial conditions and support interest rate-sensitive areas of the economy like housing, potentially reducing the drag caused by previous market volatility.

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1 Source: Bureau of Economic Analysis, 1994 to 2018.
Global macro strategy (continued)

Interest rate outlook

US: Underweight. Globally interest rates are close to their recent lows, despite the fact the growth risks are fading, in our view. In addition it appears likely that the Fed will extend its pause longer than the market anticipates, and there is a chance of a pivot to a new framework, as we discussed in our lead article. Both of these factors argue for higher bond yields and steeper curves going forward. The best expression of this trade is in inflation breakevens.

Europe: Neutral. The eurozone economy expanded by only 0.2% in the fourth quarter of 2018, about half its potential rate of growth. A large part of the unexpected deterioration likely came from domestic demand and weak business investment. We believe economic sentiment will benefit from the unwinding of adverse temporary factors soon, but we expect the European Central Bank (ECB) to maintain its dovish rhetoric, attempting to restrain spreads and reduce market volatility. With markets pricing a first interest rate hike well into 2020, the bar for more dovish repricing seems high.

China: Neutral. We are neutral on Chinese interest rates due to our expectations of supportive Chinese monetary and fiscal policies, potential investor shifts toward credit and US Treasury yield movements. We expect China’s monetary policy to remain accommodative and fiscal easing to play a more active role going forward. In the medium term, we expect liquidity to remain reasonably accommodative, but investors may cut interest rate positions and add risk via the credit market due to the recently announced series of credit-supportive measures. US Treasury and Chinese equity market performance could impact the performance of Chinese onshore interest rates.

Japan: Neutral. Japanese government bond (JGB) yields fell in February, with 10-year JGB yields hitting a year-to-date low of -0.04%. We believe the catalyst was a combination of weaker domestic and international economic data and more dovish Bank of Japan (BoJ) and other central bank rhetoric. The yield curve has become increasingly directional, as short-term yields have approached the -0.2% floor, resulting in a sharp flattening move.

UK: Neutral. Ongoing Brexit uncertainty and weaker global growth, especially in the eurozone, have resulted in sharp downward revisions to the Bank of England’s (BoE) growth forecasts. The urgency to hike interest rates has lessened, even in a relatively constructive Brexit scenario, reducing the upside for yields, in our view. In the short term, UK gilts will likely be impacted by quantitative easing reinvestment flows in March, which may further constrain the upside for yields. However, a more positive Brexit outcome could lead to a modest bounce in yields, especially if European growth shows more signs of recovering.

Canada: Neutral. Economic growth softened in the fourth quarter of 2018, prompting the Bank of Canada (BoC) to deviate, at least temporarily, from its path of normalizing rates. Employment remains strong, offsetting some softness in the housing market and retail sales, but market expectations for the next BoC rate hike have been pushed into 2020. Given that other major central banks have shifted to a more dovish stance, we believe the BoC will likely be cautious before hiking rates again. At 1.92%, the 10-year Canadian government bond yield remains near its lowest levels of the last year and does not appear attractive, in our view. We do not see any immediate catalysts to push yields higher.

Australia: Neutral. Reserve Bank of Australia (RBA) Governor Lowe confirmed that the central bank’s policy bias is now symmetric and not toward higher rates as a next move. Although the RBA cut its growth and inflation forecasts in February, the forecasts remain above consensus expectations. This raises the risk that the RBA could cut rates even in response to a relatively small downside data surprise, especially if it stems from labor market deterioration. This outlook somewhat validates current market pricing of a 25-basis point interest rate cut by the end of 2019.
**India: Overweight.** Lower than expected January inflation and a surprise interest rate cut by the Reserve Bank of India (RBI) in February have further extended the interest rate rally that began in October 2018. We still find current yields attractive from a valuation perspective and see room for long-term interest rates to decline further in the near term, especially on 10-year government bonds. We expect several supportive factors to remain in place through the first half of 2019, including low inflation, RBI liquidity improvement measures and another possible interest rate cut at the RBI’s April policy meeting.

**Figure 1: Global 10-year yields**

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Global macro strategy (continued)

Currency outlook

**USD: Underweight.** We expect the US dollar to weaken against a backdrop of renewed global growth convergence. This will likely be driven by the unwind of the US exceptionalism theme of 2018 and the pivot toward a more dovish Fed policy going forward. Additionally, US budget and current account deficit concerns will likely persist, potentially weighing on the US dollar.

**EUR: Overweight.** We are constructive on the prospects for euro appreciation given our bearish US dollar outlook. Valuations and investor positioning remain supportive for a modest recovery in the euro, in our view. Brexit developments and Italian headlines remain a headwind.

**RMB: Neutral.** The renminbi traded in a range of 6.70-6.80 in February.¹ We expect US dollar performance against other major currencies and US-China trade relations to continue to drive the renminbi’s performance versus the US dollar in the near term. Capital market performance and China’s inclusion in certain indexes may encourage more capital inflows into China. Our base case is that the exchange rate is likely to be range-bound between 6.60-6.80 in the near term, unless unexpected developments emerge from trade talks or the US dollar strengthens.

**JPY: Overweight.** The yen depreciated in February. Better risk sentiment and lower asset volatility has reduced demand for safe haven assets, despite generally weak economic data and lower global yields. Nevertheless, the yen remains an attractive hedge for risk assets, in our view, given attractive long-term valuations and still favorable positioning.

**GBP: Overweight.** Although the March 29 Brexit date is approaching, a “no deal” Brexit remains a remote possibility, in our view. We believe it is more likely that Prime Minister May will get an adjusted version of her deal through the UK Parliament, probably entailing a short delay to Brexit. Failing that, a longer-term extension to UK membership in the European Union (EU) will likely be proposed by the EU. This could lead to a wider range of possible outcomes, from a “softer Brexit,” including a permanent customs union with the EU, to a possible general election and/or referendum. In the near term, the removal of the “no deal” tail risk could present some modest upside for UK assets.

**CAD: Neutral.** We expect the Canadian dollar to continue to trade in a tight range in the near term. It has rallied from its lows in December 2018 but has remained range-bound in 2019. It has likely benefited from recovering oil prices and strong employment, a combination that has offset headwinds from the country’s housing slowdown and higher consumer interest rates. Following a somewhat dovish shift from the BoC, market expectations for the next interest rate hike have been pushed out into 2020.

**AUD: Neutral.** The Australian dollar depreciated in early February in response to the RBA’s increasingly dovish stance. However, it has recouped much of its losses, supported by buoyant commodity prices and improved sentiment regarding Chinese growth. Sentiment has also been boosted by reduced US-China trade tensions. The range-bound price action reflects the mixed drivers of the Australian dollar: Domestic factors point to a weaker currency, while global factors, especially trade-related, suggest undervaluation at current levels.

**INR: Neutral.** The rupee has remained volatile in recent months, largely following movements in oil prices. Going forward, we believe risks are tilted to the downside, given policy uncertainty and a somewhat rich valuation level. Despite our relatively downbeat view of the rupee, we remain neutral as external factors, such as oil prices or the US dollar, could influence its performance.
Figure 1: Valuations of major currencies compared to purchasing power parity (PPP)

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<tr>
<th>Currency</th>
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<tr>
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</tbody>
</table>


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Asset class themes

**Investment grade (IG): Fundamentals diverge, uncertain earnings outlooks influenced by trade policy and government shutdown, Fed on hold, technicals improving into 2019**

**Rationale**

Despite recent volatility surrounding idiosyncratic credit concerns, we continue to believe broad US corporate credit fundamentals will improve across most sectors heading into 2019. First quarter operating fundamentals will likely be negatively impacted by the government shutdown and trade policy uncertainty, but we expect them to remain supportive as issuers increasingly focus on deleveraging. In the past several years, many factors encouraged issuers to increase their debt burdens, including low interest rates, tight credit spreads, low organic growth rates and tax policy that restricted the use of overseas retained earnings. Going forward, we believe these factors will reverse, resulting in a declining use of debt as organic growth rates normalize, interest rates and spreads increase and companies repatriate overseas cash. We are also noting pressure from shareholders to decrease leverage in response to rising funding costs and tax reform. Additionally, the Fed's increased flexibility is a favorable development for market stability in the first half of the year.

Our sector credit outlooks have diverged due to global growth and trade concerns and higher interest rates. We expect certain cyclical sectors, including those sensitive to US housing, to exhibit increased revenue and earnings volatility. While the recent Fed pivot is seen as a clear credit positive, we are closely watching the Trump administration for clarity surrounding future trade policies, which could have an increasingly negative impact on global demand and issuer cost structures. We remain skeptical of rating agencies' allowance of elevated leverage in recent mergers and have become very selective. We also note deteriorating economic and credit conditions in China as a risk to global issuers that could lead to increased volatility in financial conditions.

Technicals are mixed but have improved following a notable decline in January issuance, and there are signs that foreign investor demand is returning, despite still-elevated currency hedging costs. Repatriation of overseas cash by US corporations, much of which has been invested in short-maturity IG corporates, is putting downward pressure on demand for shorter-term bonds, and is also reducing the supply of new debt. Increasing debate over the social impact of share repurchases could also accelerate existing repurchase authorizations and result in further liquidation of short-term assets held by corporations. We expect the uptick in US Treasury issuance to shift from US Treasury bills to longer maturities, posing another potential drag on technicals as the Fed moves toward reversing quantitative easing over time. Fortunately, institutional and overseas demand for long-term corporate bonds remains robust.

European credit markets are generally earlier in the credit cycle compared to the US and are less levered, though risks from Brexit and political uncertainties in Italy and other countries remain elevated. We view recent PBoC actions to support domestic financial institutions in China as a positive development for Asian credit.

**IFI strategy**

We favor US, Europe and Asia over the UK. Key market drivers we are monitoring include 1) the pace of monetary policy changes from the ECB, BoJ, BoE and PBoC, viewed on an aggregate basis for their impact on the US dollar and global credit flows 2) the development of US fiscal and regulatory policy changes and 3) the impact on costs, margins, demand and investment of announced tariffs and the potential for a more destabilizing global trade war.
High yield (HY): Technicals supportive; geopolitical concerns may present headwind

**Rationale**
High yield credit fundamentals continue to be resilient in both the US and Europe as the macro environment remains largely supportive. However, we continue to watch for signs of slowing earnings growth. Regarding technicals, new issuance activity has started to resurface in 2019. In contrast to 2018, we are seeing new issuance of high yield senior secured bonds that previously would have been issued in the bank loan market. However, overall issuance levels for 2019 remain below those for the same period last year. The positive backdrop created by this lack of supply has been reinforced by continued inflows into the asset class year-to-date. While still early in the year, we view these trends as positive for the asset class. However, concerns from 2018 remain, including the ongoing overhang of geopolitical uncertainty related to US-China trade policy, Brexit and Italian budget concerns.

**IFI strategy**
We believe the largely positive macro backdrop, solid fundamentals, and positive technicals are supportive for the high yield credit market through the first half of 2019. However, this could be offset by market volatility if geopolitical concerns resurface. We believe the high yield market offers some price appreciation potential with attractive coupon carry over the medium term.

Emerging markets (EM): Valuations remain favorable as funding pressures ease

**Rationale**
Returns in EM sovereign credit have retraced almost all of the 2018 losses on the back of a more dovish Fed, easing policy measures in China and softer global economic data. Flows into the asset class have also resumed, almost reversing 2018 redemptions, and supply has so far fallen short of projections. This leaves us more balanced on the macro picture, but upbeat on technicals. We believe valuations in EM sovereign credit remain favorable in both the investment grade and high yield segments of the market. Upcoming trade talks between the US and China will likely be significant in determining future risk appetite. Aside from concerns over the US dollar and tighter financial conditions, US foreign policy developments necessitate a higher risk premium in EM assets, in our view. However, we believe current spreads reflect this. Recent stability in the US dollar and steepening of the US yield curve have provided scope for EM credit spreads and currencies to recover, in our view.

**IFI strategy**
We continue to believe the market has overpriced risks to EM from rising US interest rates, a stronger US dollar and geopolitical concerns. While some EM countries face significant challenges, we do not foresee a broader EM crisis, and we believe fundamentals remain broadly supportive. As such, we continue to favor adding risk in a selective manner, focusing on those countries that are less externally vulnerable or that have solid policy anchors, especially at the lower end of the credit quality spectrum. Easier US funding conditions would likely provide context for adding outright exposure to EM, given improved valuation.

US commercial mortgage backed securities (US CMBS): Positioning is key as the commercial real estate cycle progresses

**Rationale**
We expect commercial real estate rent growth and property price appreciation to continue. However, we believe the pace of appreciation will slow as new supply dampens space absorption. Further, we expect growth in e-commerce to remain a headwind for the retail property sector. On the bright side, lending conditions remain accommodative across property markets despite slightly tighter credit standards. Additionally, we expect modest new issuance volumes to be absorbed by investors.

**IFI strategy**
Despite continued fundamental strength in the US commercial property sector, we are exercising careful security selection as the real estate cycle continues to extend and central bank tailwinds have diminished. We prefer slightly seasoned Non-Agency CMBS that benefits from embedded property price appreciation and decreasing spread duration, along with Agency CMBS.
US residential mortgage backed securities (US RMBS): Fundamentals remain favorable despite downshift in housing activity; compelling value in senior classes

Rationale
Fundamental conditions remain supportive despite moderating home prices, as a strong labor market and positive demographic trends have boosted housing demand. The market has successfully navigated a period of elevated supply thanks to a positive environment for risk assets, and we expect technicals to remain relatively stable as issuance normalizes in the coming weeks. Valuations currently appear modestly attractive, in our view, given outsized spread tightening in other fixed income credit markets.

IFI strategy
We see value in AAA-rated prime jumbo classes as the yield premium over agency MBS is at the highest level in over a year. Meanwhile, senior classes collateralized by non-qualified and reperforming loans offer substantial carry following recent credit spread widening and given limited exposure to further market volatility due to low spread duration. In Government Sponsored Enterprise Credit Risk Transfer securities, we see better value in high yield classes relative to investment grade based on spreads versus corporates and the steepness of the credit curve.

US asset backed securities (US ABS): Fundamentals, good relative value support positive technical trends

Rationale
Fundamentals remain supportive in most consumer and commercial ABS sectors on continued rational underwriting, current favorable-to-stable collateral performance trends and our positive near-term economic outlook. Investor sentiment has improved as broader market volatility has subsided and technical trends in both the primary and secondary ABS market are positive. With the flattened to slightly inverted yield curve, short-duration benchmark ABS will likely remain in high demand.

IFI strategy
Relative attractiveness to corporate bonds has improved for certain lower-rated esoteric and subordinate class ABS. As the new issue pipeline continues to build over the near-term, we will see some opportunities to selectively invest at current wider spreads. Our focus will continue to be on larger, seasoned sponsors, especially at this point in the economic cycle. We also see value at the top of the capital structure on liquid, amortizing benchmark, and certain non-benchmark, sectors, which tend to benefit from additional spread on the steeper, short end of the yield curve.
Sector themes

**Commodities: Supply backdrop may drive near-term pricing; monitoring trade, global growth and Chinese manufacturing for potential downside risks**

**Rationale**
Commodities have generally benefitted from broad global growth, which has increased global commodity demand. However, tariff-related uncertainties pose near-term risks to the commodity space, coupled with broader concerns about slowing global growth. With that said, financial conditions have loosened, and policy rhetoric has softened materially over the last month, which has helped stabilize and even strengthen commodity prices. Nonetheless, the effectiveness of Chinese stimulus as it relates to the deceleration of manufacturing activity will need to be closely monitored. We still expect corporate and credit fundamentals to remain supportive, given anticipated organic deleveraging driven by earnings growth. While we are actively monitoring commodity demand risks, we believe that shifts in the commodity supply backdrop will continue to be key near-term price drivers.

**IFI strategy**
We favor aluminum and copper producers, which tend to benefit from better supply/demand dynamics and given more attractive bond valuations. We like selective exploration and production oil companies located in Latin America as well as certain Russian oil and gas producers. We also remain constructive on selective US midstream companies that are focused on cost of capital optimization and active deleveraging to stabilize or maintain investment grade ratings.

**Consumer story more nuanced globally, watching US fiscal policy influences**

**Rationale**
The solid US labor market and consumer confidence are supportive of the consumer sector, but US consumers are more value and delivery conscious, while international retail demand remains uneven. We are watching the European consumer for post-Brexit behavior shifts.

**IFI strategy**
We favor certain US consumer sectors, including leisure, but are negative on department stores and mall-based retailers that lack differentiated products. In EM, we favor consumer sectors on a selective basis. We expect US automotive original equipment manufacturers (OEM) sector fundamentals to weaken, given an adverse trade environment, but we favor the sector on the margin, given our confidence that OEMs will be able to maintain an IG profile. European auto demand is proving resilient, which creates some potential in the European crossover segment (the border between investment grade and high yield). We are cautious on large European consumer goods companies, based on tight valuations and financial policies that favor equity.

**Post-merger and acquisitions (M&A) deleveraging plays**

**Rationale**
M&A activity remains a moderate risk, driven by large cash balances and the need to reposition business portfolios. Certain recent transactions have elevated leverage profiles and seem inconsistent with historical rating agency methodologies. Therefore, we have become very selective in deal participation.

**IFI strategy**
We prefer to play post-transaction bond issuance which is typically characterized by size, liquidity, concessions and credible plans for deleveraging. We believe an increasingly discriminatory approach to this strategy is warranted due to seemingly more relaxed credit agency ratings during what is potentially the later stages of the credit cycle.
Technology, media and telecommunications (TMT): Data and connectivity

**Rationale**
The US administration continues to focus on 5G and believes that a leading position versus the rest of the world is necessary. We believe this bias will likely lead to further consolidation in the sector.

**IFI strategy**
We prefer exposure to issuers that build on connectivity, such as spectrum owners, equipment manufacturers, mobile carriers, and tower owners.

Yield curve themes

**Short end may continue to benefit from recent volatility; long end steepening could make long-term bonds more attractive**

**Rationale**
Credit curves have flattened in the 30-year versus 10-year space since mid-November 2018, as higher all-in yields have attracted institutional buyers that traditionally buy longer-term bonds. This long-end demand is primarily coming from pension funds. The ultra-short part of the curve continues to receive demand as most retail investors are flocking to cash-like products given recent volatility and fairly attractive short-term interest rates. Cash is now receiving the bulk of retail flows as investors believe it has returned as a viable asset class.

**IFI strategy**
We continue to like the 2 to 4-year part of the curve as we can wait for these bonds to roll down the curve and benefit from retail demand for money market/cash securities. We are closely watching the 10 to 30-year portion of the US Treasury curve, and should it steepen we will look to add more 30-year credit with the expectation that strong long-end demand from pension funds will increase further if long end rates move higher. We are less enthusiastic around the 10-year part of the curve because it does not have a natural retail or institutional buyer currently. We are treating it more tactically as it is the most liquid part of the curve.

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
Global credit strategy
What is the potential impact of BBBs on high yield?

Last month, our investment grade colleagues discussed the potential implications of the growing BBB segment of the US investment grade market. In high yield, we have also received questions regarding the growth of BBB’s. We address some important questions here: Are we likely to see significant downgrades among BBBs? Would the high yield market be able to absorb these “fallen angels” and what would be the overall impact on high yield?

Could the growth in BBBs lead to significant downgrades?
We agree with our investment grade colleagues that most BBB companies will likely be able to de-leverage in the coming years. Increased leverage has not been driven by deteriorating operating results (which would concern us more) but by incentives created by central bank policies. Stimulative policies have made the cost of debt historically cheap, allowing companies to optimize their capital structures and reward equity holders with share buybacks, dividends and growth via mergers and acquisitions. Will there be some downgrades? Of course, but we do not believe this behavior will lead to a massive wave of downgrades.

Moody’s average one-year rating migration rates for the past 35 years show the upper tiers of US BBBs (BBB and BBB+) experienced a 2.5% migration to high yield, on average, compared to around 9.5% for BBB- companies.1 Given this history, we focus on the “lowest tier” BBBs (BBB-) for potential downgrades. The Bloomberg Barclays Aggregate Baa Index currently contains just under USD800 billion in market value of BBB- exposure.2 During each credit cycle, there are always idiosyncratic issues that cause certain companies to be downgraded to below investment grade, but the market is currently concerned with the possibility of widespread downgrades due to slower economic growth. We believe the portion of BBB- companies likely to be most affected by slower growth are the highly cyclical sectors. We estimate the highly cyclical portion BBB- credits at approximately USD460 billion in market value.3 Applying the average historical migration rate of 9.5% suggests about USD44 billion of potential high yield downgrades. Using the 2009 BBB- migration rate of approximately 14% (the highest during the global financial crisis) as a downside case, implies USD65 billion in potential rating downgrades. We think the high yield market could absorb these amounts, as discussed below.

Could the US high yield market absorb BBB downgrades?
Much has been written about the shrinking US high yield market. The lack of new issuance and loss of share to the leveraged loan market are cited as factors potentially hindering the market’s ability to absorb fallen angels in the next downturn. We believe this concern is somewhat overblown. Figure 1 shows that the high yield bond market has not massively shrunk, but rather, the leveraged loan market has grown sharply. At the end of 2018, the US high yield market was only around USD31 billion smaller than at its peak of USD1.16 trillion in 2014, equivalent to the outstanding debt of one large, high yield issuer.4 Partly feeding this view was the fact that primary debt issuance was down in 2018 – totaling USD187 billion compared to the trailing three-year average of USD302 billion.5 Issuers have been opportunistic, choosing to tap the loan market due to strong investor demand for floating rate products and looser underwriting standards that have led to better economics for issuers. However, we view this as a cyclical phenomenon which is already reversing. Early 2019 has already seen multiple, large secured bond deals that likely would have been financed in the leveraged loan market a year ago.

We believe the entire leveraged finance market, including loans, must be considered when gauging the potential impact of fallen angels. The US leveraged finance market, including loans, totals over USD2.2 trillion in size, which we believe is sufficient to absorb a potential uptick in fallen angels.6

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1. This section highlights the views of Invesco Fixed Income's credit analysts across a broad range of fixed income assets managed by Invesco.
Expected impact on US high yield

The overall impact of fallen angels on high yield during a cycle downturn would be manageable for a few reasons, in our view. Historically, fallen angels have tended to experience the most spread widening prior to a downgrade, as investment grade investors rotate out of a name ahead of an announcement. In addition, a large portion of selling is due to forced sellers, often insurance companies facing higher risk-based capital charges for holding below-investment grade bonds. However, under new proposals which may be implemented in 2019, capital charges may be reduced on bonds downgraded one-to-two notches below investment grade, which may lead to less forced selling in a downturn.

Looking at historical experience, the last meaningful fallen angel cycle in the US occurred in 2016, with USD142 billion in fallen angels, one of the largest years on record. Most of these downgrades were in the energy and materials sectors, driven by pressure on commodity prices. We do not expect such concentrated downgrades in the next cycle, even though the midstream sector is the largest within the lower tier BBB market. We believe the market is more prepared for commodity volatility today than in 2016 and many BBB midstream companies would likely be able to maintain their investment grade ratings due to modest commodity exposure and strong cash flows. Moreover, even though the US high yield market experienced a heavy volume of fallen angels in 2016, it also posted the highest total return since the global financial crisis that year, with a total return in excess of 18%. So, while we may see elevated fallen angel volumes in the next cycle downturn, we do not think it necessarily implies poor returns for the US high yield market.

Perspectives on European BBBs

As in the US, European BBBs have grown significantly post-global financial crisis. According to Barclays, BBBs have grown from EUR472 billion in 2013 to EUR907 billion in 2018. BBB corporates now represent about 50% of the Barclays Euro Aggregate Corporate Index. We also believe it is important to focus on the lowest tier (BBB-) category, as this rating cohort is most likely to transition to high yield. According to Barclays, since the end of 2012, the BBB- category has grown from EUR117 billion to EUR228 billion. Within the BBB-category, subordinated debt has exhibited the highest rate of growth. Subordinated debt is typically owned by investors with more flexible mandates than traditional investment grade investors, meaning they tend to be less affected by downgrades than traditional investors.
Global credit strategy (continued)

In Europe, the historical downgrade rate for BBB- corporate debt peaked at 13.7% during 2010-2015 according to Barclays. Applying this rate to EUR228 billion of outstanding BBB- debt implies potential downgrades totalling EUR31 billion, about 10% of the market value of the Barclays Pan-European High Yield Index. Notably, we use a peak historical downgrade rate in our calculation, which is higher than the often-cited, longer-term downgrade rate published by Moody’s. Furthermore, the BBB- category includes subordinated-debt issued by higher rated issuers that tend to have lower downgrade risk than BBB- issuers. Overall, we think the European high yield market would be able to absorb fallen angels over time without much long-term impact to spread levels. In terms of concentration risk, we note that there is a large single financial issuer in the BBB- segment. If this paper entered high yield, it could be a challenge for the market to absorb, given its relative size and because there are fewer natural buyers of bank debt within the European high yield market.

Michael Kelley, Head of Global High Yield Research, Samira Sattarzadeh, Senior Analyst

1 Source: Moody’s, Annual Default Study, February 2019, Invesco.
2 Source: Bloomberg Barclays Aggregate Baa Index, February 2019, Invesco.
3 Source: Bloomberg Barclays Aggregate Baa Index, February 2019, Invesco.
4 Source: BofA Merrill Lynch Global Research, ICE Data Indices LC, S&P LCD, Invesco.
9 Source: Barclays Euro Aggregate Corporate Index, Feb. 25, 2019.
We speak with David Todd, Head of Global Corporate Credit Research, Yifei Ding, Portfolio Manager, and Haidan Zhong, Senior Client Portfolio Manager, about China’s Belt and Road Initiative, the country’s program to expand connectivity and economic integration across Asia, Europe, the Middle East and Africa. David, Yifei and Haidan discuss investment themes and potential opportunities for fixed income investors generated by this wide-ranging initiative.

Q: What is the Belt and Road Initiative (BRI)?
David: The BRI is a systematic development strategy launched by the Chinese government to promote land and sea connectivity with Asia, Europe, the Middle East and Africa and adjacent seas (the “B&R region”). The program is intended to establish and strengthen regional economic partnerships and cooperation. We expect it to generate increased levels of infrastructure spending, improve regional integration and promote economic growth.

Q: Why has China undertaken the BRI?
Yifei: China’s export-driven economic growth model has resulted in certain economic imbalances, for example, wealth and income inequality between its western, south-western, north-eastern and coastal provinces. Second, there are many sub-standard factories that create pollution and over-capacity in industries such as steel and metals, which has led to trade tensions abroad. Third, China’s reliance on sea routes for shipment of raw material imports and goods exports has subjected it to sea-route security risks. And fourth, China’s ageing population has made its labor-intensive, manufacturing-driven economy less sustainable. Through the BRI, China aims to transform its export-oriented economic model into one that focuses more heavily on services, consumption, innovation, high-tech and higher value-added manufacturing.

Q: How might the BRI influence other global investment flows?
Haidan: In response to the BRI, other major economies have already announced direct investment programs in the B&R region, including the United States, the EU, the UK and Japan. The US Congress recently passed a bill to create a new USD60 billion agency focused on US government lending to developing countries for infrastructure projects with the aim of incentivizing private-sector investment in emerging economies.1 The US has also committed to investing USD113 million in new technology, energy and infrastructure initiatives in emerging Asian countries and has signed a USD350 million investment deal with Mongolia to develop new sources of water.2 In September 2018, the European Commission proposed funding EUR 60 billion for the European Union’s External Investment Plan, part of which is to enhance connectivity between Europe and Asia. The UK has indicated its vision of making the UK the biggest G7 country to invest in Africa by 2022. Japan has been competing with China in Southeast Asia for infrastructure projects.3

We believe increased competition for influence will likely be positive for countries in the B&R region due to increased availability of capital and funding sources. The transparency and effectiveness of infrastructure projects and overall governance of countries in the B&R region may also improve, as voters, politicians and government officials choose sources of development capital, joint-venture partners, business investors and contractors among China and its competitors.

Q: What potential investment opportunities may arise out of the BRI?
Yifei: We have identified five investment themes that we find especially interesting related to the BRI, but additional themes are likely to emerge given the scope of the initiative.

- Improving financial strength: We expect potential capital inflows to improve job markets, government revenues and budget balances in the B&R region. Increased inter-regional connectivity among countries may also help boost trade volumes, boosting exports and trade surpluses. These dynamics may allow various countries in the region to see improved solvency and liquidity measures in the coming years, possibly leading to sovereign credit rating upgrades. Upgrades may extend to quasi-sovereign agencies, policy banks, state-owned or state-controlled enterprises and large corporations. As such, funding costs and credit spreads may improve, potentially supporting bond prices.
Expansion of infrastructure: Continued expansion of transportation networks (such as railways, highways, ports and airports) is potentially positive for selected transportation companies, exporters, manufacturers, real estate developers and governments in the B&R region. Companies in related industries, such as local banks and insurance companies that engage in trade finance and accident insurance, may also benefit indirectly. Underdeveloped digital infrastructure in the B&R region also provides fertile ground for telecommunications companies focused on mobile communications equipment, fixed-line broadband upgrades, internet data centers and other related areas to expand business and implement advanced technology.

Support for energy, commodities and agricultural products: The BRI facilitates the production and export of energy, commodities and agricultural products, which may contribute to increased economic growth and employment in the B&R region.

Boost to local consumption: Capital inflows into the BRI region may mean more job opportunities, meaning increased demand for consumption goods and services. We expect to see benefits in the food, leisure, banking, insurance and real estate sectors in both the developing and developed countries in Europe and Asia.

Modernization of economic corridors: The BRI includes plans to build six international economic cooperation corridors connecting China with Asia, Europe and Africa. Improved land-route transportation, for example, should help China’s inland areas, potentially addressing economic imbalances between coastal and inland regions. Additionally, western and north-eastern parts of China may become energy hubs as China imports more gas and oil via pipelines connecting these areas to Central Asia and Russia.

Q: What positive developments related to these themes have already played out in the B&R region?
Haidan: Mongolia and Ghana have received sovereign credit rating upgrades from at least one major rating agency in the last year. These countries have enjoyed strong capital inflows - not only from China, but from other major countries, including the US. We focus on countries that receive more capital inflows, and at the same time use the capital in productive ways.

Q: How does fixed income compare to other investment opportunities in the B&R region?
Yifei: While equity and private investment opportunities are available in the B&R region, we believe fixed income markets offer unique opportunities. On a top-down basis, we view country selection as one of the most important considerations for investing in developing countries. Initial benefits from BRI-related capital inflows will likely be realized in sovereign credit profiles, then trickle down via quasi-sovereign entities, policy banks, commercial banks and state-owned enterprises, before reaching private enterprises. While sovereign governments, quasi-sovereign entities and policy banks are bond issuers, they do not issue equities. Also, only some state-owned and private-owned enterprises have listed equity shares, while most have issued bonds.

Q: How you are managing risk as you invest in BRI-related themes?
David: We take a fundamentals first approach in all of our investment analysis. Traditional quantitative and qualitative factors underpin portfolio holdings. Importantly, we believe systematic consideration of environmental, social and governance (ESG) factors for country selection and corporate credit research will help further mitigate risk in Belt and Road-related fixed income investments. By filtering out the worst-in-class sovereign and corporate bond issuers, we aim to avoid countries and companies that may run into ‘debt traps,’ face corruption concerns or are otherwise negatively impacted by social and environmental issues in ways that could have a negative impact on their financial viability and hence the performance of their bonds.

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

## Market monitors

### Fixed income market monitor

<table>
<thead>
<tr>
<th></th>
<th>Coupon (%)</th>
<th>Yield to worst (%)</th>
<th>1 month change in YTW</th>
<th>Option-adjusted spread</th>
<th>Returns</th>
</tr>
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<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>10 year range</td>
<td></td>
</tr>
<tr>
<td></td>
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<td></td>
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<td>1 mth (%)</td>
<td>3 mth (%)</td>
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<td>Global Aggregate (USD hedged)</td>
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<td>-0.10</td>
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<td>-3</td>
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<td>Global Inv Grade Corporate (USD hedged)</td>
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<td>-19</td>
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<td>U.S. Investment Grade Corporate</td>
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<td>Emerging Market USD Sovereign</td>
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<td>Global High Yield Corporate (USD hedged)</td>
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### Treasury market monitor

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<tr>
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<th>Coupon (%)</th>
<th>Yield to worst (%)</th>
<th>1 month change in YTW</th>
<th>Returns in local currency</th>
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<td></td>
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<td></td>
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<td></td>
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<td></td>
<td></td>
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<tr>
<td>Japan</td>
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<td>0.05</td>
<td>-0.03</td>
<td>0.47</td>
</tr>
<tr>
<td>China</td>
<td>3.53</td>
<td>3.00</td>
<td>-0.15</td>
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<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

### FX market monitor¹

|                                | Current   | 10 year range | Returns |
|                                |           | min | max | 1 mth (%) | 3 mth (%) | YTD (%) | 12 mth (%) |
| EURUSD                         | 1.14      | 1.04 | 1.51 | -0.17     | 1.20      | -4.64   | -7.78      |
| USD/JPY                        | 108.89    | 75.82 | 125.63 | 0.69     | 3.76      | 3.52    | 0.29       |
| GBP/USD                        | 1.31      | 1.20 | 1.85 | 2.78      | 2.69      | -2.99   | -7.62      |
| USDCNY                         | 6.70      | 6.04 | 6.96 | 2.66      | 4.11      | -2.81   | -6.15      |
| USDCHF                         | 0.99      | 0.72 | 1.23 | -1.28     | 1.41      | -1.99   | -6.34      |
| AUD/USD                        | 0.73      | 0.60 | 1.10 | 3.18      | 2.83      | -6.86   | -9.71      |
| CAD/USD                        | 0.76      | 0.69 | 1.06 | 3.91      | 0.25      | -4.22   | -6.18      |
| EUR/JPY²                       | 124.65    | 94.31 | 157.95 | 0.91     | 2.48      | 8.52    | 8.73       |
| EURGBP²                        | 0.87      | 0.69 | 0.98 | 2.97      | 1.48      | 1.71    | 0.17       |

Sources: Bloomberg Barclays, J.P. Morgan, as of Jan. 31, 2019. Credit Suisse Leveraged Loan data as of Jan. 31, 2019. 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 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 (USD 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 (USD hedged) Index; U.S. Investment Grade Corporate is represented by Bloomberg Barclays Global 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 (USD 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.
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Recent IFI publications

1. China's Belt and Road Initiative – from increased commodity demand to shifting supply routes, February 2019, Fabrice Pellous, Senior Credit Analyst
2. Emerging markets debt outlook, February 2019, Rashique Rahman, Head of Emerging Market Debt
3. IFI Global Investors' Summit November 2018 Macro Overview, December 2018, Rob Waldner, Chief Strategist and Global Head of Multi-Sector Portfolio Management, Tony Wong, Head of Global Research and Credit Strategy
4. IFI Global Investors' Summit May 2018 Macro Overview, June 2018, Rob Waldner, Chief Strategist and Global Head of Multi-Sector Portfolio Management, Tony Wong, Head of Global Research and Credit Strategy
**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.

Asset-backed securities are subject to prepayment or call risk, which is the risk that the borrower’s payments may be received earlier or later than expected.

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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**Important information**

All data as of Feb. 28, 2019 unless otherwise stated. All data is USD, unless otherwise stated.

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