Invesco Fixed Income

Global Fixed Income Strategy

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Global macro strategy

Don't fear the Fed: diversified credit portfolios can defend against rising interest rates

Invesco Fixed Income (IFI) portfolio managers discuss a multi-sector approach to dealing with a rising interest rate environment. We speak with Rob Waldner, IFI Chief Strategist, Joseph Portera, CIO, High Yield and Multi-Sector Credit and Mike Hyman, CIO Global Investment Grade and Emerging Markets Debt about strategies for navigating a rising interest rate environment.

Q: Rob, How do you think about rising interest rates as you determine your asset allocation decisions?

Rob Waldner: We think one of the best ways of handling a rising interest rate environment is to have a portfolio diversified across different credit-related asset classes. Traditionally, we think about government bonds as being the risk-free asset class. But clearly in a world where government bond yields are very low and we expect yields to rise, there is little in the way of coupon income to offset downward price movement.

Rob Waldner
Chief Strategist

Joseph Portera
CIO, High Yield and
Multi-Sector Credit

Michael Hyman
CIO, Global Investment
Grade and Emerging
Markets Debt

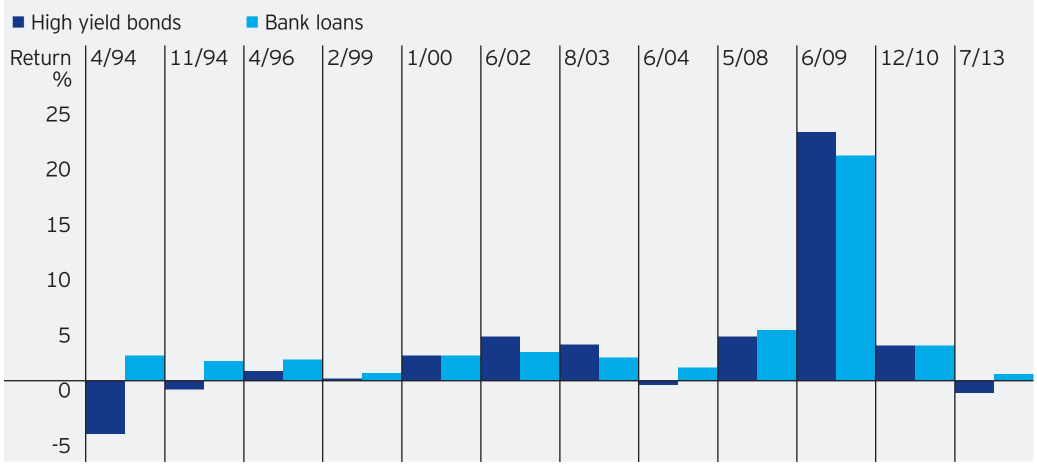
So for us, the idea is to use credit asset classes that benefit from a positive growth environment and are less correlated to government bonds. These can include investment grade, high yield, bank loans, emerging markets sovereign bonds and corporates, as well as structured securities and even municipal bonds.

Generally, we favor credit exposures because they should be tied to the economy, which we believe will perform relatively well. Within emerging markets we would look for specific opportunities which stand to benefit broadly from modest global growth and more stable commodity prices. The thing that we need to be concerned about is the status of global financial conditions, and whether tightening financial conditions could cause volatility in credit markets in 2017. Concerns over financial conditions could arise if we see a more aggressive than expected US Federal Reserve (Fed), a sharp rise in bond yields or the US dollar.

A more active Fed should drive the US dollar higher, so we are focused on US dollar debt and are cautious about taking currency exposures outside of the dollar. If we are taking exposure to non-dollar debt, we would look to hedge a lot of the currency back into US dollars because we expect the US dollar to continue to rise.

Q: Joe, as a multi-sector portfolio manager, can you describe your approach to navigating a rising interest rate environment?
Joe Portera: In diversified credit strategies, we take advantage of different credit sectors – each one of which brings something a little different to the table. In the current environment of rising interest rates underpinned by growth and moderate inflation, we favor leveraged credit, such as high yield bonds and bank loans. High yield and bank loans have performed well in most rising interest rate environments when the economy was expanding (Figure 1). The floating rate nature of bank loans can be especially defensive since interest rates on bank loans adjust on a regular basis to keep pace with rising short-term rates. Given these characteristics, we have increased exposures to loans in the last couple of months.

Figure 1: High yield bonds and bank loans performed well in several rising rates periods



Source: JPMorgan High Yield and Leveraged Loan Outlook June 2015. Data shown are most recent data available. High yield is represented by JPMorgan Domestic High Yield Index. Bank loans are represented by the S&P/LSTA Leveraged Loan Index from 1994-2006 and the JPMorgan Leveraged Loan Index from 2007 to 2013. Dates shown are end of three-month period when interest rates rose by at least 70 basis points.

We also include emerging markets sovereign and corporate debt as well as investment grade corporates. While we have de-emphasized investment grade relative to other sectors recently, given our favorable growth outlook, our analyst team can still find opportunities among these corporate bonds. The investment grade space brings quality to the mix in portfolios, and despite conventional wisdom, may present select opportunities despite the rising rate environment.

Active investment managers can also take advantage of bond futures to hedge portfolios and interest rate swaps to convert fixed rate holdings into floating rate holdings. If the price of the swap is attractive, managers can take advantage of rising interest rates even when holding an underlying portfolio of fixed rate securities.

Q: Mike, as an investment grade and emerging markets portfolio manager, what are some of your strategies for dealing with rising US interest rates, especially when investment grade valuations are so stretched?

Mike Hyman: When the bond market begins to anticipate a Fed tightening cycle, investors often react by gravitating toward the short end of the yield curve – i.e. toward shorter maturity bonds. The general thinking is that longer duration bonds should be avoided to avoid price declines when interest rates rise. However, the short end of the yield curve has typically been the most vulnerable segment of the yield curve when the Fed raises rates. In past Fed hiking cycles, the yield curve has typically bear flattened (short-term rates have risen more than long-term rates) and investments have underperformed in the shorter end of the curve. Instead, in a rising rate environment, we look for opportunities in longer-term maturities in the investment grade sector to take advantage of attractive yields and to help defend against the greater interest rate increases that may occur at the shorter end. Many institutional investors such as insurance companies maintain ongoing exposure to longer-dated corporates, so they are often a source of demand when yields rise.

In many of our investment grade portfolios, we are also permitted to take exposure to diversifying credit sectors such as high yield and emerging markets debt. We believe high yield can be a good diversifier for investment grade credit in a solid growth environment. Due to the higher spread of these bonds, they typically have the ability to absorb increasing Treasury rate movements with little change in price.

Rising US interest rates are generally a headwind for emerging markets fixed income performance, however, there are three factors we believe should be considered when investing in emerging markets during periods of rising rates.

First, rising global interest rates in the context of stronger global growth and supportive financial conditions are generally favorable for emerging markets. In such a scenario, compression in emerging markets credit spreads can compensate for rising US rates. As long as the growth backdrop is supportive of improving credit trends, emerging markets credit spreads can narrow and help provide a total return cushion against rising US rates.

Second, emerging markets is a very diverse asset class. Below-investment grade debt exhibits much less sensitivity to US interest rates given the large credit component relative to the interest rate component of its total yield. Also, emerging markets consists of both US dollar and non-US dollar denominated assets. The net exposure of emerging markets countries to US dollar funding has declined as they have built up healthy cushions of foreign exchange reserves. Although US dollar-denominated debt, particularly corporate debt, has grown significantly in recent years, foreign exchange reserves have grown even faster. We believe this provides a crucial buffer for most emerging markets countries when navigating through a period of potentially higher US interest rates, particularly if funding conditions deteriorate.

Third, the non-dollar denominated debt of emerging markets countries tends to respond more to domestic interest rate trends and currency movements, which bear watching as US interest rates rise. As a diverse asset class, we believe emerging markets offers enough different levers to pull to help successfully navigate the increasingly complex global financial landscape in the period ahead.

Q: Rob, what is IFI's overall outlook for 2017?
Rob Waldner: We believe we are entering a new regime where growth and inflation drive markets rather than just central banks. We believe that US President Trump's policies will be on balance supportive for US growth, although much uncertainty remains around policy specifics. We expect steady, although moderate, growth in Europe and China. While we are mindful of political risk globally, especially in Europe where the election calendar is heavy, we think that stronger global growth and a little higher inflation will likely determine much of market performance in 2017.

Rob Waldner, Chief Strategist, Joe Portera, CIO High Yield and Multi-Sector Credit, Michael Hyman, CIO Global Investment Grade and Emerging Markets Debt

Global macro strategy

Interest rate outlook

US: We expect US government interest rates to remain range bound in the near term. The agenda for US tax reform and infrastructure spending under the Trump administration, which has been the major driver of yields, is unlikely to become clearer in the next several weeks. Economic data is likely to point to a US economy near full employment. The Fed is unlikely to hike rates at its March meeting, however, it may begin to signal a potential hike at its May meeting.

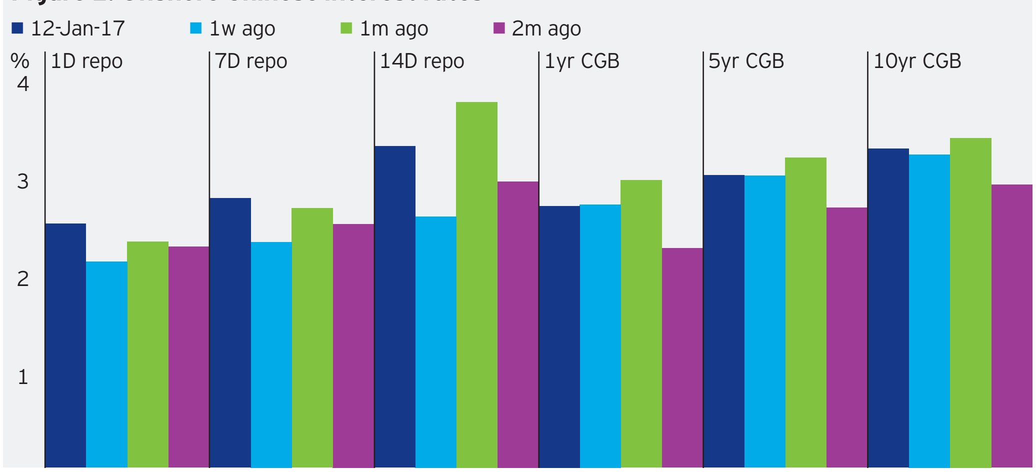
Europe: In its latest meeting, European Central Bank (ECB) President Draghi indicated that the ECB is not confident that higher Q1 eurozone inflation will be sustained. Having said that, imported inflation measures have crept up and manufacturing surveys remain strong. This could undermine support for never ending quantitative easing from some members of the governing council, which could, in turn, undermine investor confidence in bunds. We also believe that political risks are overstated and that the impact on markets may be more localized. We would underweight bunds relative to US Treasuries, given valuations and cyclical dynamics.

China: Onshore government bond yields, especially short-term yields, have retreated sharply from high levels reached in mid-December 2016. Lower short-term yields have been attributable to looser liquidity after a period of seasonal year-end tightness. Longer-term yields have been stickier, however, and remain at elevated levels, as onshore investors have been expecting higher inflation pressures in the first half of 2017.

Money market rates, on the other hand, have been much more volatile. The recent spike in money market rates was driven by (1) Chinese New Year-related seasonal demand for cash (2) corporate tax payments and (3) tightening by the central bank via bank regulatory measures. Capital outflows, albeit slowing, have also contributed to tighter liquidity conditions in money markets.

Looking ahead, although money market rates and short-term bond yields are expected to decline post-Chinese New Year (Jan. 28th), tax payments and the central bank's tightening stance remain. Therefore, we expect short-term interest rates to remain pressured upward in the month ahead and long-term yields to be well supported at current elevated levels.

Figure 1: Onshore Chinese interest rates



Source: Bloomberg L.P., Invesco. Data from Nov. 12, 2016 to Jan. 12, 2017. CGB represents Chinese government bonds.

Japan: 10-year Japanese government bond yields continue to trade in a tight range "around zero," suggesting that the Bank of Japan continues to have control over the yield curve. We do not expect any near-term change in policy from the central bank as a result. However, a significant strengthening in the value of the yen could bring about a change in mindset, in our view.

UK: Brexit discussions will likely continue to drive market sentiment through 2017, with European Union (EU) negotiators facing a particularly challenging time. They will likely be seeking to ensure that the terms of any deal with the UK are punitive, so as to dissuade other EU countries from considering an exit from the union. The UK government is not in a weak negotiating position, however. It has control over its own currency, growth indicators remain solid and it has the capacity to (and has warned it could) lower its corporate tax rate to maintain its competitiveness. EU breakup concerns could increase as the year progresses.

Canada: Canadian government yields have remained under the same upward pressure felt globally in the aftermath of the US presidential election which boosted expectations of higher growth and inflation fueled by US fiscal stimulus and tax cuts. The Bank of Canada meeting in January recognized that Canada's economy has shown some improvement, but emphasized there was more work needed to reduce excess capacity as inflation remains very low.

Australia: The Reserve Bank of Australia (RBA) did not meet in January thus the policy rate remains at 1.50%.[1] The next meeting is scheduled for February 7th. While strong growth and improving inflation should give the RBA no reason to move the policy rate anytime in the near future, the December unemployment rate at 5.8% is a point of concern to the RBA.[2] We expect Australian rates to be range bound in the near future and we maintain a neutral stance versus US rates.

Rob Waldner, Chief Strategist, James Ong, Senior Macro Strategist,
Sean Connery, Portfolio Manager, Brian Schneider, Head of North American Rates,
Scott Case, Portfolio Manager, Josef Portelli, Portfolio Manager, Ken Hu, CIO Asia Pacific,
Yi Hu, Senior Credit Analyst, Alex Schwiersch, Portfolio Manager

1 Source: Reserve Bank of Australia, Dec. 16, 2016.
2 Source: Australian Bureau of Statistics, Jan. 19, 2017.

Global macro strategy

Currency outlook

USD: A resumption of the Fed's hiking cycle is bullish for the US dollar, in our view. Global yield differentials currently favor US asset markets and should drive capital flows into the US, benefiting the US dollar. The pace of US dollar appreciation is likely to be slower than in 2015 and 2016, unless foreign central banks begin easing again. The Trump administration's tax and trade agenda is likely to cause significant currency volatility.

EUR: While we continue to expect further euro weakness as the chances of tighter Fed policy increase, we are cautious given crowded investment positioning and prospects for additional political uncertainty to weigh on risk sentiment across asset markets. We have reduced our risk positions accordingly as we evaluate fresh catalysts.

RMB: Chinese capital outflows slowed more than expected in January 2017 due largely to stronger capital controls, especially those related to households' foreign exchange conversion. In addition, state-owned enterprises and exporters have reportedly been asked to convert foreign exchange proceeds to renminbi (RMB) in case they are needed to stabilize the currency. Banks and corporates are also being encouraged to issue more foreign currency bonds in the offshore market with some proceeds to be remitted onshore, a shift from past practices. In our view, these measures could be very powerful, since from 2014, corporates have been the major source of foreign exchange outflows. In the offshore currency (CNH) market, reduced liquidity and spikes in funding costs have made short selling of CNH positions vulnerable, especially amid rising market volatility. The above factors have helped the RMB trade between 6.7-6.99, mainly on the stronger side of this range.[1]
We expect this trend to continue in the near term, unless new Trump administration policies lead to a much stronger US dollar move.

JPY: The value of the yen is likely to be driven more by external than domestic developments in the near term, with a particular focus on the actions of US President Donald Trump as his administration gets underway. The yen should act as a good hedge for short US duration/long US dollar positions if Trump's policies do not meet market expectations – US yields would likely decline in that case. A long yen position could help offset losses in the short duration position.

GBP: Sterling continues to be undervalued, in our view, however, we do not see any obvious catalyst for a meaningful correction in the near term. The UK government will likely want to ensure that its economy remains strong as it enters negotiations over its EU exit, and a weaker sterling could also enhance its bargaining position; if the UK rejects an EU trade agreement meaning higher World Trade Organization (WTO) tariffs would apply by default, higher WTO tariffs could be offset by a weaker sterling.

CAD: The Canadian dollar has bounced around since the US presidential election as economic growth has shown positive signs but inflation continues to disappoint the Bank of Canada (BoC). It sold off initially after the Fed raised rates in December, but rallied back strongly after year end. The BoC stated at its January meeting that rate cuts are still a possibility, but it will likley wait until more clarity is available on US fiscal and trade policy before taking action. The Canadian dollar remains overvalued, in our view, but will likely trade within a range in the near term.

AUD: Increased commodities prices plus recent signs of higher than expected inflation have put upward pressure on the Australian dollar recently. With the Australian policy rate remaining at all-time lows, and the economy appearing to be in good shape, we do not expect the RBA to lower rates further in the near future. With the RBA on hold, we expect the Australian dollar to be relatively stable at current levels.

Ray Uy, Head of Macro Research and Currency Portfolio Management,
James Ong, Senior Macro Strategist, Brian Schneider, Head of North American Rates,
Sean Connery, Portfolio Manager, Scott Case, Portfolio Manager,
Alex Schwiersch, Portfolio Manager

1 Source: Bloomberg L.P., Jan. 18, 2017.

This section highlights the key themes driving Invesco Fixed Income's global macro and credit research process and views. Themes are updated based on evolving trends and expectations.

Global credit

Geographical themes

Investment grade (IG): Global central bank forces, US fiscal policy changes

Rationale

Strong investor demand for US, Europe and Asia IG due to easy global monetary policy. US fundamentals remain challenging with leverage at cycle highs, but fiscal policy changes could lead to growth impulse and less issuance going forward. Europe generally earlier in cycle, less levered, however Brexit poses uncertainty.

IFI strategy

Favor gaining exposure to selected higher quality issuers in energy and pipelines, financials, industrials, consumer cyclical, and technology, media and telecommunications. Recognize certain tight valuations.

Emerging markets (EM): Macro fundamental momentum steadies

Rationale

Signs of pickup in global and EM growth momentum supportive but China concerns and impact of higher inflation to keep raging bulls in check.

IFI strategy

We move long EM sovereign credit, and maintain neutral EM currency, corporate credit and EM rates. We will be quick to moderate this stance should valuations deteriorate or signs of upward pressure on core rates and the US dollar resurface.

US commercial mortgage backed securities (US CMBS): Notable decline in primary market issuance

Rationale

Transaction volume and property price appreciation are slowing. Early signs of tighter financial conditions. Rent growth has stabilized.

IFI strategy

Prefer seasoned US CMBS as cycle progresses. Credit-differentiation is accelerating, placing a premium on selection. Positive short-term technicals offset rich valuations and poor hedge-adjusted carry.

US residential mortgage backed securities (US RMBS): Favorable fundamentals, valuations fair, liquidity inconsistent

Rationale

Expect notable decline in primary market issuance and continued Fed support to benefit the sector. However, credit selection has become increasingly more important due to: (i) early signs of tightening financial conditions and (ii) belief that the trend of rapid property price appreciation will likely end.

IFI strategy

Prefer higher quality legacy prime, alt-A, seasoned CRT. Avoiding sub-prime, option adjustable rate mortgages. BBB rated CRT and below-investment grade benefit from good fundamentals and valuations.

Sector themes

Commodities: Global rebound in energy, metals but volatility remains

Rationale

Expect global IG credit risk premia to improve as energy and metals credits stabilize. Fundamental credit quality concerns remain due to modest economic growth and risk of volatility due to OPEC, US fiscal policy and Fed uncertainty.

IFI strategy

Favor gaining exposure to select higher quality energy, pipeline and metals issuers where shorter-term maturities are well covered by liquid assets and positive corporate actions support financial profiles.

Consumer story more nuanced globally

Rationale

Solid US labor market and consumer confidence, but consumers more value-conscious and international retail demand uneven, due partly to strong US dollar and volatile capital markets. Watching European consumer post-Brexit.

IFI strategy

Favor select US consumer sectors including autos, leisure and housing-related sectors. Negative on "big box" retailers that lack differentiated products. Favor EM consumer sectors on a selective basis.

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

Rationale

M&A activity has moderated but remains a risk, driven by large cash balances, low all-in financing cost, lack of organic growth, and need to reposition business portfolios.

IFI strategy

Preference to play post-transaction bond issuance typically characterized by size, liquidity, concessions and plans to deleverage. Due to lower but still large M&A-related pipeline, favor a discriminating approach.

Global technology – big data

Rationale

Expect global data use to grow and transition to cloud-based platforms.

IFI strategy

Prefer to gain exposure to software and services, cell towers and select wireless issuers. Have avoided hardware original equipment manufacturers.

Yield curve themes

Credit curve positioning, value in long end diminishing

Rationale

Global zero interest rate policy has forced cash investors and sovereign wealth funds into 3-5 year part of the credit yield curve, creating steep 5-7 year part of the curve. Lately, sovereign wealth funds have targeted the 10-year part of the curve. We expect demand for 5-10 year paper to be resilient.

IFI strategy

Prefer 7-10 and select 30-year points on US IG credit yield curve. New issuance at longer maturities has tended to come at healthy concessions.

Rob Waldner, Chief Strategist, Ray Uy, Head of Macro Research and Currency Portfolio Management, Tony Wong, Head of Global Research and Liquidity, Joe Portera, CIO High Yield and Multi-Sector Credit, Michael Hyman, CIO Global Investment Grade and Emerging Markets Debt

Selectively constructive on US investment grade energy

OPEC cooperation near-term positive for oil but idiosyncratic company catalysts important in 2017

OPEC's recent agreement to curtail output (along with other non-OPEC producers) has improved the prospect of global oil supply/demand rebalancing and leaves us constructive on the near-term price of oil. Global oil inventories rose in 2016 as some OPEC countries expanded production and US shale producers proved resilient despite weak and volatile commodity prices. However, in November 2016, OPEC member nations agreed to a monumental coordinated oil supply reduction that should, in the near term, accelerate the process of aligning global oil supply and demand - a welcomed short-term agreement that we believe helps clarify the near-term outlook for global oil supply.

Outlook for US investment grade (IG) energy sector

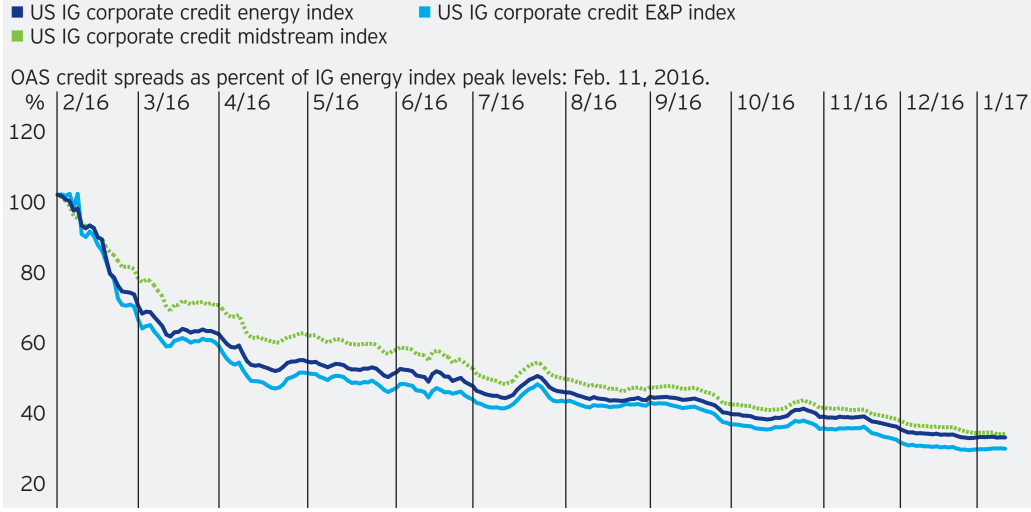
2016 was a positive year for US IG energy bonds and we remain selectively constructive on US IG energy credit as we anticipate balance sheet strengthening to remain an attractive theme in 2017. However, we recognize that higher oil prices may encourage certain companies to re-focus capital allocation toward growth-oriented projects (which can generally favor equity holders) at the expense of de-leveraging (which can generally favor bondholders). For this reason, we strongly believe that (i) idiosyncratic credit catalysts and (ii) company-specific balance sheet nuances will become increasingly important for IG energy bond performance in 2017. Notably, with the price of oil having stabilized for now, we believe 2016's commodity price tailwind may be less important for IG energy returns this year.

For these reasons, we remain highly constructive on the pipeline (midstream) sub-sector. Many US midstream companies currently exhibit leverage profiles that are either (i) approaching or (ii) uncomfortably close to credit rating agency downgrade thresholds. Further, many of these companies still suffer from exorbitant costs of capital that can be restrictive for project funding. However, we believe that many of these companies remain highly incentivized to maintain investment grade ratings for both (i) regulatory and (ii) fundamental operating and cost of capital reasons. Thus, it generally remains in the economic interests of certain pipeline companies to avoid costly rating agency downgrades by strengthening their balance sheets through creditor-friendly corporate actions (e.g. equity issuance, parent company financial support, equity funded de-levering mergers and/or acquisitions, etc.); a unique energy sub-sector feature that supports our constructive midstream view.

In terms of valuation, the recovery in midstream credit spreads has lagged that of the broader IG energy index along with IG exploration and production companies. This is a consideration which suggests that investors could benefit from a modest degree of downside protection relative to other sub-sectors while awaiting further balance sheet-supportive actions to materialize. We believe that ratings motivated bondholder-friendly corporate activity is an interesting and developing investment theme in the midstream space, and think this theme should generally be supportive for midstream credit spreads (all else being equal) as firms actively seek to avoid rating agency downgrades.

Seeking value in IG energy while searching for attractive risk-adjusted returns
As value-oriented active investors, we actively search the US investment grade energy landscape for unique and interesting investment opportunities where we identify both downside protection and near-term positive catalysts. We believe this selective, value-oriented approach can uncover opportunities with attractive risk-adjusted return profiles that may actively drive alpha generation and relative portfolio outperformance.

Figure 1: Midstream credit spreads have lagged recovery in energy and exploration and production (E&P) spreads



Source: Barclays Live.
Index detail reflects the Barclays US IG Credit Index. Data from Feb. 11, 2016 to Jan 20, 2017.

Bixby Stewart, Analyst

The bottom line

Emerging markets in the current macro and political environment

Rashique Rahman
Head of Emerging Markets

Michael Hyman
CIO, Global Investment Grade and Emerging Markets Debt

For the full interview, please see the upcoming Q1 2017 edition of Risk&Reward.

We speak with Mike Hyman, CIO Global Investment Grade and Emerging Markets Debt and Rashique Rahman, Head of Emerging Markets, about how they are thinking about investing in emerging markets in the current macro and political environment.

Q: What are the top three issues likely to affect emerging markets (EM) assets in 2017?

Mike: Global growth will be one of the key things to watch in 2017. Right now, most expectations are being revised upward, predominantly related to the US and China. Our team believes these upward revisions may have gone too far, and are thus subject to disappointment in the near term, but overall agrees that the world is on firmer footing after years of monetary life-support. Healthier growth and inflation trends would likely be supportive of risk assets, including emerging markets. The second key issue to watch is the path of US monetary policy, which may be an important driver of fixed income broadly in 2017. Lastly, the new US administration's proposed changes to both fiscal and trade policy will likely be important drivers for EM assets in 2017. To the extent that fiscal expansion plans impact expectations for monetary policy, they may also influence the direction of US Treasury yields and the US dollar. With respect to trade policy, the potential for the implementation of selective tariffs or a so-called "border tax" may adversely impact exports and therefore growth for a number of EM countries, particularly Mexico and goods exporters in Asia.

Q: How do you manage against the potential risk of a stronger US dollar?

Rashique: Generally, EM countries have become more insulated from US dollar moves as many countries have accumulated a larger stock of liquid US dollar assets against what has been a rising stock of external (primarily private-sector) liabilities. That said, in an environment of a sharply stronger US dollar we will tend to reduce overall market exposure. A stronger dollar can be associated with portfolio outflows from EM, downward pressure on EM currencies and upward pressure on EM credit spreads. When we expect US dollar strength, we tend to buy dollars against higher-beta EM currencies, particularly those with high external funding needs. We also tend to favor export-oriented corporate issuers over those that rely more on domestic revenues. We see a stronger dollar coupled with stronger commodities for the first half of 2017, which is a more benign environment for EM, and one that favours commodity-producing countries, currencies and credits. In such a scenario we would also selectively reduce our duration exposure in local government bonds as stronger commodities and a stronger US dollar may cause domestic inflation pressures to increase.

Q: What are the main political risks for EM in 2017?

Rashique: There are few scheduled political events in EM countries this year, with many more in play for 2018. For 2017, political events in developed markets, especially Europe, are much more likely to impact EM. Most importantly, diplomatic relations between the US and rest of the world will likely dominate headlines. We are most focused on how markets will calibrate political risk related to President Trump's policies and rhetoric toward China and to a slightly lesser extent Mexico.

In EM, elections in Argentina, Chile and Ecuador all bear watching. In Argentina, the elections can be seen as a referendum on President Macri's policies and whether there is scope to rein in recent fiscal expansion. Chile will swear in a new President after its November election, and, in Ecuador, the February election casts uncertainty over who will govern the country for the next five years.

We will also be closely monitoring political developments in Brazil, South Africa and Turkey. Though the so-called 'Lava Jato' investigation and related plea-bargaining in Brazil is winding down, other corruption investigations are continuing. In South Africa, the African National Congress (ANC) Conference in December 2017 may provide clarity on the party's future leadership. In Turkey, the country is gearing up for a constitutional reform and referendum to transform itself from a parliamentary to presidential republic, this after the failed coup attempt in summer 2016.

Q: Where do you see the biggest opportunity and risk right now in EM?
Mike: Stability in global growth and broadly more favourable supply/demand dynamics have supported commodity prices and we see this persisting in the first half of 2017. EM's relatively high correlation with equities, with growth being the common factor, suggests that EM assets can perform well under these circumstances. We therefore currently favor exposure to commodity-producing countries, currencies and credits. At the same time, we expect capital outflows from China to continue, which is likely to lead to steady depreciation of the renminbi. This depreciation pressure is likely to lead to weakness in many other Asian currencies particularly versus the US dollar. Given lingering headwinds for China, we believe a less certain outlook for Chinese growth, or global growth more broadly, would pose a downside risk for EM in the year ahead. Though we don't expect this, our research suggests that an unanticipated and aggressive Fed rate-hiking cycle may negatively impact EM if capital flows suddenly reverse.

Q: Despite the sour ending to 2016, EM posted strong returns. What might investors expect in 2017?
Rashique: EM is unlikely to repeat its stellar 2016 performance, as US interest rates are biased to rise over the course of 2017. We expect a year of mid-single digit returns for EM credit, supported predominantly by positive carry. Sovereign credit is likely to outperform corporate credit, in our view, as valuations are much more attractive for sovereigns as we begin 2017. Relatively stable, if subdued, global growth, firming commodity prices and moderate inflation provides a still-favourable backdrop for EM credit, in our view. Unlike in 2016, the prospect for steady US dollar gains during 2017 may put downward pressure on EM local assets, via EM currency depreciation and the pass-through to higher inflation. That said, fundamental EM currency valuations have improved and in most cases external deficits have moderated from just a few years ago. On balance, as with EM credit, we forecast mid-single digit returns for EM local currency investments in 2017. Importantly, the ongoing search for yield and the under-allocation to EM that prevails on the part of institutional investors suggest that the momentum of flows into EM assets will likely continue, and support the asset class.

Fixed income market monitor

	Coupon (%)	Yield to worst (%)	1 month change in YTW	Option-adjusted spread: current	1 month change in spread	10 year range: min	10 year range: max	Returns: 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
Global Aggregate (USD hedged)	2.76	1.60	0.01	44	-1	23	156	0.27	-2.34	3.95	3.95
U.S. Aggregate	3.08	2.61	0.04	43	-2	32	258	0.14	-2.98	2.65	2.65
U.S. Mortgage-backed	3.55	2.85	0.05	15	-1	-16	181	0.00	-1.97	1.67	1.67
Global Inv Grade Corporate (USD hedged)	3.69	2.70	-0.03	125	-5	55	515	0.73	-2.11	6.22	6.22
U.S. Investment Grade Corporate	4.08	3.37	0.00	123	-6	76	618	0.67	-2.83	6.11	6.11
Emerging Market USD Sovereign	n/a	5.79	-0.12	341	-20	157	906	1.33	-4.02	10.15	10.15
Emerging Market Corporate	n/a	5.05	-0.09	292	-17	120	1,032	0.78	-1.32	9.65	9.65
Global High Yield Corporate (USD hedged)	6.27	5.64	-0.46	409	-44	231	1,845	1.84	1.86	15.55	15.55
U.S. High Yield Corporate	6.50	6.12	-0.45	409	-46	233	1,971	1.85	1.75	17.13	17.13
Bank Loans	4.90	5.06	-0.03	n/a	n/a	n/a	n/a	1.15	2.28	9.88	9.88
Municipal Bond	4.77	2.65	-0.11	n/a	n/a	n/a	n/a	1.17	-3.62	0.25	0.25
High Yield Municipal Bond	5.24	6.42	-0.08	n/a	n/a	n/a	n/a	1.38	-5.84	2.99	2.99

Treasury market monitor

	Coupon (%)	Yield to worst (%)	1 month change in YTW	Returns in local currency: 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
United States	2.05	1.89	0.05	-0.11	-3.84	1.04	1.04
Canada	2.36	1.35	0.09	-0.80	-3.95	-0.34	-0.34
United Kingdom	3.66	1.12	-0.14	2.00	-3.49	10.73	10.73
Germany	2.16	-0.19	-0.04	0.28	-2.46	3.97	3.97
Italy	3.57	1.12	-0.23	1.33	-3.27	0.76	0.76
Japan	1.10	0.10	0.03	-0.64	-1.69	3.21	3.21
China	3.50	3.08	0.30	-1.85	-2.09	1.97	1.97
EM Local Currency Governments	n/a	n/a	n/a	0.48	-0.95	9.14	9.14

FX market monitor[1]

	Current	10 year range: min	10 year range: max	Returns: 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
EURUSD	1.05	1.05	1.60	-1.27	-6.94	-3.75	-3.75
USDJPY	117.55	75.82	124.77	-2.63	-13.80	2.28	2.28
GBPUSD	1.23	1.22	2.11	-1.82	-5.35	-16.68	-16.68
USDCNY	6.96	6.04	8.28	-0.84	-4.20	-6.65	-6.65
USDCHF	1.02	0.75	1.39	-0.62	-5.12	-2.09	-2.09
AUDUSD	0.72	0.60	1.10	-2.72	-6.26	-1.40	-1.40
CADUSD	0.74	0.72	1.09	-0.04	-2.35	2.93	2.93
EURJPY[2]	122.90	94.31	169.49	-1.39	-7.31	6.30	6.30
EURGBP[2]	0.85	0.70	0.85	-0.58	1.69	-13.46	-13.46

Sources: Bloomberg Barclays, J.P. Morgan, as of Dec. 31, 2016. Credit Suisse Leveraged Loan data as of Dec. 31, 2016. Within the Treasury monitor, United States is represented by Bloomberg Barclays US Treasury Index; Canada is represented by Bloomberg Barclays Global Treasury Canada Index; United Kingdom is represented by Bloomberg Barclays Sterling Gilts Index; Germany is represented by Bloomberg Barclays Global Treasury Germany Index; Italy is represented by Bloomberg Barclays Global Treasury Italy Index; Japan is represented by Bloomberg Barclays Global Treasury Japan Index; China is represented by Bloomberg Barclays China Aggregate Treasuries Index; EM Local Currency Governments is represented by J.P. Morgan GBI_EM Broad Diversified Index. In the Fixed Income Monitor, Global Aggregate is represented by Bloomberg Barclays Global Aggregate (US$ Hedged) Index; US Aggregate is represented by Bloomberg Barclays US Aggregate Index; US Mortgage-backed is represented by Bloomberg Barclays US Mortgaged-backed Index; Global Investment Grade Corporate is represented by Bloomberg Barclays Global Aggregate Corporate (US$ hedged) Index; U.S. Investment Grade Corporate is represented by Bloomberg Barclays Aggregate Corporate Index; Emerging Market USD Sovereign is represented by the J.P. Morgan EMBI Global Diversified Index; Emerging Market Corporate is represented by J.P. Morgan CEMBI Broad Diversified Index; Global High Yield Corporate is represented by the Bloomberg Barclays Global High Yield Corporate (US$ hedged) Index; U.S. High yield Corporate is represented by Bloomberg Barclays U.S. Corporate High Yield Index; Bank Loans is represented by the Credit Suisse Leveraged Loan Index; Municipal Bond is represented by Bloomberg Barclays Municipal Bond Index; High Yield Municipal Bond is represented by Bloomberg Barclays Municipal Bond High Yield Index. Yield to Worst (YTW) is the lowest expected yield calculation given maturity and call features. Option Adjusted Spread (OAS) is the yield difference relative to similar maturity Treasuries that incorporates call, put, sinking fund or paydown features of a bond. Past performance cannot guarantee future results. An investment cannot be made directly in an index. Returns less than one year are cumulative.

1 Positive number represents the currency appreciated against USD, negative number represents currency depreciated against USD.
2 Positive number represents the currency appreciated against EUR, negative number represents currency depreciated against EUR.

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Invesco Fixed Income

Global perspective and deep local market knowledge

Global presence

- Regional hubs in Atlanta, London and Hong Kong
- IFI is in ten locations with additional Invesco colleagues in two
- USD 272.4 billion in assets under management

Experienced team

- 165 investment professionals
- Averaging 18 years of industry experience
- Deep macro and credit research
- Focused and accountable portfolio management

Global locations

Source: Invesco. For illustrative purposes only.

Invesco Fixed Income teams

	Team members	Average years with Invesco	Average years in industry
Portfolio management and trading	75	12	21
Global research	90	9	16
Total investment professionals	165	10	18
Business professionals	62	14	19
Total fixed income employees	227	11	18

Source: Invesco.

As of Dec. 31, 2016. Subject to change without notice.
Investment specific experience for investment professionals.

Important information