Invesco

Invesco Fixed Income

Global Fixed Income Strategy

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Global macro strategy

Brexit, Brexident or Bremain?

Scenarios and shockwaves from the UK's EU referendum

Rather than a binary event, we believe the UK's European Union (EU) referendum is best thought of as a continuum of uncertain outcomes, potentially with significant financial and economic impacts well beyond the UK in the EU, extending to the eurozone (EZ) and potentially the wider world. Even so, we define three broad scenarios: the first with sub-scenarios, which we call "Brexit" – a decisive "Leave" vote, subdivided into a "Bravo Brexit" and a "Bad Brexit"; the second, "Brexident" – an ambivalent, split vote for "Leave" – almost by accident; and finally, "Bremain" – a vote to "Remain," in which the margin would have a smaller impact.

I. "Brexit": We define Brexit as a decisive referendum result in favor of "Leave" which requires major political and policy responses in the UK, EU and EZ. We subdivide the potential financial and economic consequences in two: First, a "Bravo Brexit" – a broadly positive outcome, in which a successful and constructive policy response by both the UK and EU results in a new modus vivendi that, beyond preventing downside risks, opens up upside possibilities for the EU, EZ and encourages global stability. Alternatively, there could well be a "Bad Brexit" – a generally negative outcome in line with many of the official expectations, largely due to an inadequate policy response as Europe is forced to turn inward because of similar fissile pressures within the EU and EZ; and in which the economic and financial pressures in the UK play out in line with many official scenario analyses.

I.a. "Bravo Brexit": A positive but decisive vote for "Leave": An upside scenario in the event of a decisive Brexit would involve the UK and EU engaging in positive negotiations about exit and about maintaining open borders in UK-EU trade negotiations, as well as UK trade relations with the rest of the world under WTO trading rules. Such a scenario could also entail the post-Brexit UK stepping up to the plate, to resurrect and sustain the Transatlantic Trade and Investment Partnership among the US, EU and the UK itself as an independent trading force and voice apart from the rest of the EU.

UK, EZ, EU and global economy: The recent growth slowdown would continue, but downside risks would be contained by constructive engagement among the UK, EU and global trading partners. The emerging financial shock reflected in sterling volatility and weakness, as well as falling risky asset prices in the UK, EZ, EU and indeed the wider world, would also be contained. There would be no particular reason to expect a rapid economic reflation or complete financial rebound, because it could take some time and there would be uncertainty around post-Brexit negotiations for more inclusive, wider opening for UK-EU-global economic relations. Even so, the prevention of financial risk aversion and gradual recovery in risky asset prices in response to renewed global engagement would allow for regional and indeed global economic stabilization. The avoidance of another feared financial shock, on top of US Federal Reserve (Fed) rate hikes, concerns about China's currency policy, debt burden and economic slowdown and EZ and Japanese deflationary pressures would help as far afield as global emerging markets.

I.b. "Bad Brexit": A negative-case scenario: A decisive vote for "Leave" could cause a difficult and expensive UK-EU divorce. It could also prompt pressure for copycat exit referenda in other EU and EZ member-states. National governments and the EU itself might have to respond to the threat of EZ fragmentation with policies aimed at faster EZ federalization. The overriding imperative to prevent potential financial crisis due to EZ exits could discourage the idea of a two-track Europe: one with a broader, less integrated EU and a deeper EZ. As a result, the EU and EZ could become more contiguous, with Euroskeptic/anti-federal members leaving the EU.

UK: Growth could slow, led by an investment slowdown and capital outflows, causing asset price volatility and weakness. Sterling could fall perhaps another 10-20%. The Bank of England (BoE) would probably elect to stay on hold because imported inflation would be transitory. The demand shock would probably result in lower inflation fears in the longer term and a flatter yield curve. The downside risks to growth and fiscal revenue might raise the risk of sovereign rating downgrades, which, in turn, could prompt central bank reserve manager diversification away from sterling and gilts.

EU/EZ: Lower EU-UK trade could cause a new deflationary demand shock in Europe. Plans for stronger measures to prevent EZ fragmentation would be required, in our view, to reverse this risk and restore financial stability. Central Europe, notably Poland and other new EU entrants, could be most affected through lower migration and remittances, as well as higher barriers to continued integration. Catch-up with the far richer Western Europe could be at stake.

II. "Brexident": A low-margin, almost accidental vote to leave, marked by voter passivity or ambivalence. Downside risks might be mitigated by efforts to renegotiate by both the UK, to secure a better deal in reflection of voter ambivalence, and the EU, to prevent copycat exit referenda and the associated fissile tendencies in the region.

UK: Growth would also likely slow in this scenario, but we would expect any financial shock to be more contained than in a full-blown Brexit scenario. Sterling would likely be buffeted in this scenario too, but the potential ambiguity and hope for a renewed effort to keep the EU together might limit the hit to riskier UK asset classes, including sterling credit. The BoE might be even more likely to stand pat in this scenario, looking through the impact of the market turbulence.

EU: The collateral damage of fissile political pressures and the deflationary demand shock would likely also be less than in a Brexit. The policy response might not need to be as strong if the threat of copycat referenda could potentially be averted.

III. "Bremain": The benefits would be the lack of a financial shock as well as significantly reduced economic uncertainty, but equally there would likely be no new pressure for deeper EZ integration. The focus would probably return to the status quo, which is not all that positive – marked by an already weakening UK economy and EZ disinflation pressures, in the face of reasonable growth.

UK: A major relief rally. Sterling would probably bounce back and gilt yields would probably rise somewhat as pricing at the short end of the yield curve would likely bring forward the timing of economic recovery and policy rate hikes.

EU: The EU and EZ could benefit from a relief rally too, including periphery and Central and Eastern European spreads and currencies – after all, some risk of Brexit has to be priced in across the board. However, we believe the upside would be limited because of the absence of a political shock to rejuvenate and accelerate EZ reform and integration.

Arnab Das, Head of Emerging Markets Sovereign and Macro Research

Interest rate outlook

US: US Treasuries continue to trade on the expensive side, in our view, given rising global uncertainties. We expect the Fed to continue policy normalization as growth and core inflation continue to firm. We believe inflation dynamics are likely to benefit US Treasury inflation-protected securities (TIPS) relative to nominal US Treasury securities. Investors currently receive very low compensation for holding US Treasuries. We expect the 10-year US Treasury bond to trade around 1.50-1.90% over the next month.

Europe: June's European Central Bank (ECB) meeting delivered few surprises. The ECB said it will monitor the efficacy of its existing easing programs and do more if needed. With this meeting out of the way, investor focus turned to the rising risk of Brexit. This led investors to seek shelter in German bunds and other issuers deemed safe, driving yields lower and causing European government yield curves to flatten. We do not expect political risks in Europe to go away. After the UK referendum, we have the elections in Spain, where inconclusive results are likely. We expect the 10-year bund to trade in a range of 0-20 basis points over the next month.

China: Recent economic data out of China have been weaker than consensus expectations in several areas including industrial production, retail sales, fixed asset investments and exports. Consumer price inflation has also been softer than expected in recent months. We expect the Chinese government to expand its fiscal policy in terms of increased government spending and tax cuts. We currently see more value in offshore Chinese government bonds versus onshore government bonds as they provide more yield for the same maturity. The 10-year offshore Chinese government bond currently yields around 3.6% versus a yield of around 3% for the 10-year onshore Chinese government bond.[1]

UK: The outcome of the EU referendum on June 23 appears too close to call. A "Leave" outcome would likely throw financial markets into disarray, with gilts likely to be the core beneficiary. How would the government react to such an outcome? Would it refuse to implement the wishes of the voting public or seek to renegotiate a better deal to stay in? We see the latter scenario as being more likely. A "Remain" outcome would likely cause less stress, but it could be too simplistic to think that the UK economy would return to normal given such a result. House prices are showing signs of peaking while household savings are at their lowest level in decades. Not a good mix for growth going forward. The UK is likely to have a new Prime Minister within months of the referendum, regardless of the outcome. Uniting the government will likely be a huge challenge for Prime Minister Cameron's successor. With the main opposition also continuing to fight amongst itself, getting agreement on policy initiatives going forward could prove difficult. We expect gilt yields to trade in a 1.00-1.40% range over the next month.

Japan: The Bank of Japan (BoJ) kept policy unchanged in June, but it may need to ease at one of it's upcoming meetings. Negative Interest Rate Policy (NIRP), introduced at the January meeting, has had some positive impact but not as much as anticipated. Some of the disappointment can be attributed to the impact on the Japanese yen of concerns over China, declining confidence in Fed hikes and concerns over the UK referendum. Either way, the outlook for inflation is not good. Nor is it good for growth, despite the fact that Prime Minister Abe recently decided to defer the consumption tax hike (originally planned for April 2017) for two years. Co-ordinated action between the BoJ and Japanese government (fiscal stimulus) seems the most likely course of action from here as Abe seeks to put the Abenomics project (program to boost growth) back on firmer ground.

Global macro strategy continued

Canada: The Canadian economic outlook remains weak. Residential investment remains the only engine of growth, supporting job growth and moderate household spending. Net trade continues to disappoint, although the rebound in energy prices has helped somewhat. Currency weakness is needed, in our view, to help rebalance the economy, in addition to macro prudential measures to curb the ongoing rise of house prices in Canada's largest cities. The longer this unsustainable price trajectory continues, the worse the eventual decline could be for households and the banking sector alike, in our view. We expect 10-year Canadian government bond yields to trade in a range of 0.9%-1.55% for the remainder of 2016.

Australia: As expected, the Reserve Bank of Australia (RBA) held rates steady at its June 7 meeting. However, the June statement was very light on forward guidance. Nevertheless, the market appears to be expecting one more rate cut in August. We agree with that expectation since it appears that Australia is entering a period of extended lower than desired inflation, partly due to pressure on the consumer. The second quarter inflation report on July 27 will be important, in our view, to judge whether the RBA is likely to ease further. With Australian government bonds still among the highest yielding in the developed markets and the RBA expected to continue easing policy, we expect Australian government bonds to remain well supported. We expect them to trade in the 2.00-2.20% range over the next month.

Rob Waldner, Chief Strategist, James Ong, Senior Macro Strategist, Noelle Corum, Analyst, Sean Connery, Portfolio Manager, Avi Hooper, Senior Portfolio Manager, Josef Portelli, Portfolio Manager, Ken Hu, CIO Asia Pacific, Alex Schwiersch, Portfolio Manager

1 Source: Bloomberg L.P., as of June 14, 2016.

Currency outlook

USD: US growth indicators are pointing to a rebound in the second quarter while labor market data has been mixed. Consumption data continues to hold in which is largely underpinning our above-potential growth outlook. If the US economic picture clears and the Fed assumes a more hawkish stance, we would expect a stronger dollar overall.

EUR: We remain on the sidelines. The global macro risk environment remains challenging and the euro range bound. The tension between firming US economic performance and global growth concerns may limit how much the Fed tightens, which should limit the extent of euro weakness, in our view.

JPY: The yen has again come in for support during the month of June as uncertainty regarding the outcome of the UK's EU referendum has increased. As that event edges closer, it is possible that the yen continues to strengthen over the shorter term, particularly if it becomes more likely that the UK will vote to leave. A stronger yen will likely not be welcomed by Japanese policy officials, so we expect any strengthening to be met with the threat of unilateral intervention (even though we do not think this tool will be utilized). The BoJ continues to miss its inflation target, so the chances of an adjustment to policy are likely to increase in an environment of a stronger yen and oil prices tapering off. The July policy committee meeting would be the most likely timing for such action given that this meeting would coincide with the release of updated inflation and growth forecasts.

GBP: We continue to hold an overweight in sterling ahead of the June 23 EU referendum in the expectation that the UK will vote to remain. We are closely monitoring this position, however, as recent opinion polls suggest that the outcome is likely to be much closer than we previously envisaged. Sterling is likely to appreciate on the back of a "Remain" outcome, in our view. However, post the vote, that could reverse somewhat, as market participants return their focus to the state of the UK economy (we expect weak growth in the second half of the year and a change of Prime Minister). A "Leave" outcome would likely see sterling trade down to around the USD1.30/GBP level. But as initial panic calms, we would expect it to move back toward the USD1.40/GBP level.

CAD: Continued strength in oil prices has benefited the Canadian dollar recently. However, concerns over Canada's external balance will likely remain a headwind as the ongoing weakness in the trade account is expected to reemerge if commodity price strength subsides. Bond yields in Canada remain exceptionally low, limiting the attractiveness of portfolio inflows on a sustainable basis. The Bank of Canada appears unwilling to entertain lowering interest rates further, although weak activity is expected to increase this possibility. The Canadian dollar is vulnerable, in our view, to changes in global investor sentiment towards energy and equities. We remain negatively positioned in the Canadian dollar.

AUD: As expected, the RBA held rates steady at its June meeting. However, its June statement was light on any forward guidance, prompting modest strength in the currency. Since inflation remains very low and the RBA is likely to cut rates one more time, the currency strength should be somewhat temporary.Australia remains in a period of lower than desired inflation with consumers under pressure. The second quarter inflation report on July 27 will help determine if the RBA cuts rates again in the near future. With the RBA expected to take a more relaxed approach to policy rates, it should keep downward pressure on the Australian dollar.

Ray Uy, Head of Macro Research and Global Multi-Sector Portfolio Management,
James Ong, Senior Macro Strategist, Noelle Corum, Analyst, Avi Hooper, Senior Portfolio Manager,
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Global investment themes

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 macro themes

Global convergence: Market risks decreasing

Rationale

Volatility likely to increase with Fed data dependence and uncertainty around recent weakness in US economic data, in our view.

IFI strategy

We favor playing the current risk-on rally tactically as concerns remain over China and EM growth dynamics. We believe reducing credit risk into the rally is appropriate.

Asian deflation

Rationale

Asia is the epicenter of global deflation pressures, regardless of developed market central bank actions. Asia still faces a significant growth and inflation deficit. Slowdown in China continues to pressure Asian economies.

IFI strategy

Allocations to currency and interest rate risk remain at the low end of the range. Seek to add JPY exposure on weakness as a strategy hedge.

Global credit themes

Geographical themes

Investment grade (IG): Global cycle differences remain

Rationale: Preference for US and Europe over Asia. Europe at earlier stage of credit cycle, ECB provides tailwind. US fundamentals challenging with leverage at cycle highs, although recent corporate actions have been credit supportive, particularly in energy.

IFI strategy: Favor gaining exposure to select higher quality issuers in energy and metals where shorter-term maturities are well covered by liquid assets. Favor industrials, consumer cyclicals. Neutral financials.

Emerging markets (EM): Growth impulses following Fed stabilization

Rationale: Fundamentals have improved at margin with Fed on hold. Retreat of US dollar has profound implications for EM domestic financial conditions, should it be sustained. Oil price stability is noteworthy – a reflection of supply/demand fundamentals and we are seeing early signs of convergence for industrial metals as well. If so, this would be a further positive for EM risk in the context of slowing but still growing US – and Chinese – economies. We favor risk-neutral posture but aware of risk factors. Moreover event risks loom, with the 'Brexit' vote end-month posing a significant tail risk. And, there remains uncertainty with the data-dependent Fed.

IFI strategy: Prefer gradually building long-side exposure. Keeping China beta low. High-yield and commodity-related exposure likely well-supported for June.

US commercial mortgage backed securities (US CMBS): Macroeconomic volatility headwind

Rationale: Experiencing nationally slowing transaction volume and property price appreciation. Early signs of tighter financial conditions have become apparent.

IFI strategy: Remain negative on recent vintage subordinate tranches. Prefer seasoned US CMBS as cycle progresses. Credit-differentiation is accelerating, placing a premium on selection.

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

Rationale: Legacy non-agency US RMBS offering opportunity where fundamentals are favorable. Credit risk transfer (CRT) deals show solid fundamentals, however, valuations are stretched in the below-investment grade segment. Liquidity remains inconsistent. Market remains sensitive to supply.

IFI strategy: Prefer higher quality legacy prime, alt-A, seasoned CRT, 2014-early 2015 vintages. Avoiding sub-prime, option adjustable rate mortgages. Neutral BBB-rated CRT and below-investment grade.

Global investment themes continued

US asset backed securities (US ABS): Value in subordination

Rationale: US ABS has been less volatile versus US IG. Fundamentals are strong but modestly weaker as collateral performance has moved off of historical low delinquency and loss levels. Technicals are supportive.

IFI strategy: Prefer adding exposure to subordinate tranches where collateral performance remains stable. Lower volatility AAA attractive, in our view. Believe senior auto US ABS and esoteric issuers can provide opportunities. Favor avoiding deep subprime auto US ABS.

Sector themes

Commodities: Global rebound in energy, metals, volatility remains

Rationale: Expect global IG credit risk premia to improve as market digests transition of energy and metals credits to high yield. Expect large issuance volume to pressure valuations. Fundamental credit quality concerns remain due to modest economic growth. Risk of volatility due to OPEC and Fed uncertainty.

IFI strategy: Favor gaining exposure to select higher quality energy and metals issuers where shorter-term maturities are well covered by liquid assets.

Consumer story more nuanced globally

Rationale: Solid US labor market and lower gas prices are supportive, but consumers more value-conscious and international retail demand remains uneven, due partly to volatile capital markets.

IFI Strategy: Favor select US consumer sectors including autos, restaurants, 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 at post-recession high, 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 rise in M&A-related issuance, believe more discriminating approach to this strategy is warranted.

Global technology – big data

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

IFI strategy: Prefer to gain exposure to software and services (SAAS), cell towers and select wireless issuers. Have avoided hardware original equipment manufacturer (OEM) issuers.

Yield curve themes

Credit curve positioning, expecting demand shift outward

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. Longer duration spreads remain wide and offer favorable carry, in our view. As the Fed normalizes policy and money market rates become more attractive, we expect some outflows from 1-3 year part of the curve into money market funds, but 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 Global Multi-Sector Portfolio Management, Tony Wong, Head of Global Research, Joe Portera, Head of Global High Income, Michael Hyman, Head of Investment Grade

Global sector strategy

Please read more about China's bond market opening in Invesco's upcoming Invesco Global Insights, The Opening of China's Bond Markets: Opportunities for Global Investors, by Ken Hu, CIO Asia Pacific, Chris Lau, Senior Portfolio Manager, Yi Hu, Senior Analyst, Yifei Ding, Analyst.

China opens its bond markets:

Opportunities for global investors

China has the second largest economy and the third largest bond market in the world.[1] The offshore renminbi (RMB) bond market alone has more than quadrupled in size since 2010.[2] It is therefore not surprising that events in China are among the most important factors affecting global risk assets. Due to various structural restrictions, however, foreign investment in Chinese fixed income markets to date has been quite limited, even when compared with much smaller emerging market countries.

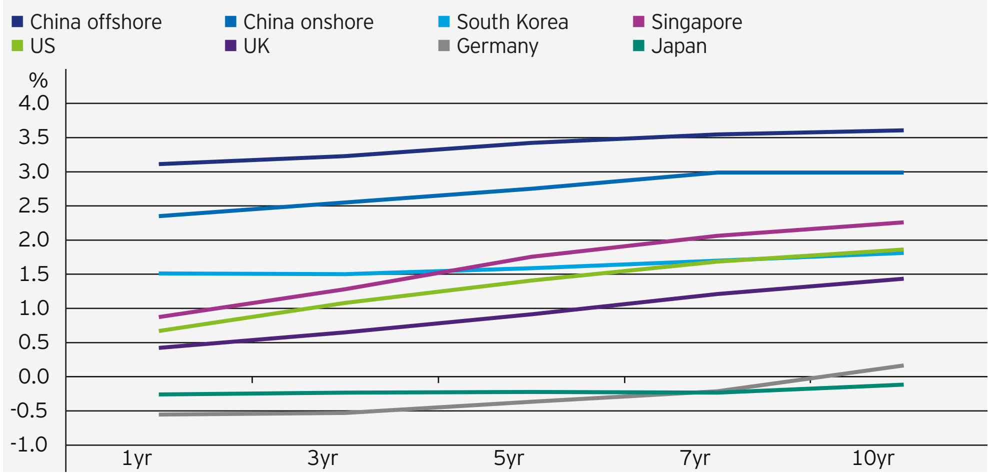
Recent steps by the People's Bank of China (PBOC) appear likely to change this. These steps are part of a broad, concerted effort by Chinese regulators and policymakers to open China's capital accounts and encourage internationalization of the RMB.[3] Given the significant implications of events in China for the global economy, we believe it is critical for investors, especially asset managers, to understand and react to the changes underway with respect to Chinese fixed income markets.

Perhaps the most significant change has been the recent announcement that most types of institutional investors are now eligible to invest in the onshore Chinese interbank bond market (CIBM). While observers had been anticipating an expansion of foreign investor access to Chinese markets for some time, the scope of the PBOC's announcement took many by surprise.

Chinese bond market snapshot

We believe that exposure to Chinese bonds, which currently offer relatively attractive yields and, historically, have had a very low correlation to other global fixed income assets, can add an important diversifying element to global bond portfolios.[4] Although China's onshore bond yields tightened by 60-80 basis points during 2015, as of the end of the first quarter 2016, Chinese government bond yields still offered a 100-basis point spread over Asian countries with significantly higher foreign exchange volatility, such as South Korea and Singapore (Figure 1). Onshore Chinese government bond yields traded 100-200 basis points over US and UK government bonds and around 300 basis points over Japan and Germany's, which have been trending deeper into negative territory (Figure 1).

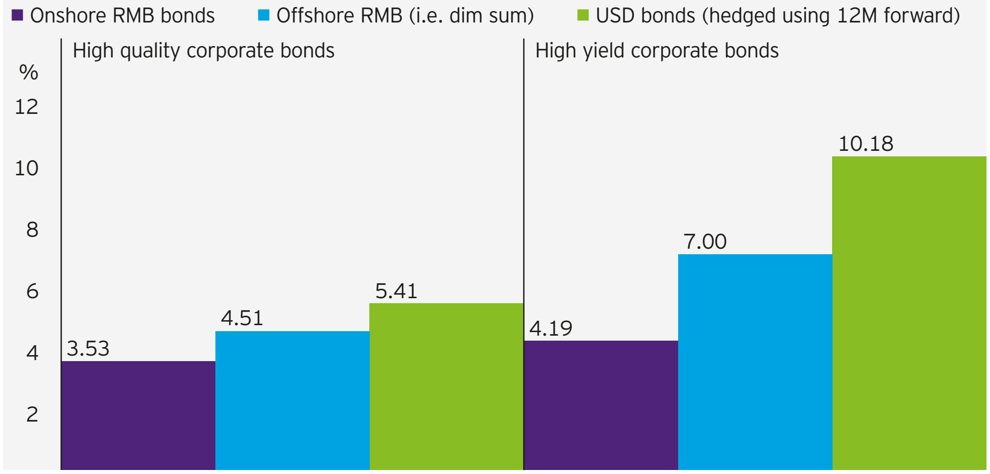
Figure 1: Comparison of various government bond yields



Source: As of March 31, 2016. Sources: Bloomberg L.P., Invesco.

Although Chinese government bonds introduce currency risk when compared with developed market bonds, as discussed below, we anticipate that this risk should remain relatively limited, given that RMB volatility has been significantly lower than major DM and EM currencies. While volatility may increase if and to the extent that China moves toward a more freely floating currency, either as part of wider economic and financial system reforms or otherwise, we anticipate that policymakers will continue to place a high value on controlling RMB volatility. In this context, it is worth noting that China has benefited from significant currency reserves of around USD3.2 trillion that could be used to support the RMB, if necessary.[5]

Figure 2: Yield comparison among the three Chinese bond markets



Sources: Bloomberg L.P., Invesco, CFETS, HSBC, Bank of America Merrill Lynch. Data as of end April 2016.

Notes:
1 The onshore high quality corporate bond yield is represented by the 3-year MTN AAA (locally rated) bond yield.
2 The offshore high quality corporate bond yield is represented by HSBC Offshore RMB Investment Grade Corporate Credit Index whose duration was 2.61 as of 31 December 2015.
3 The onshore high yield corporate bond yield is represented by the 2-year MTN AA (locally rated) bond yield.
4 Offshore high yield corporate bond yield is represented by HSBC Offshore RMB High Yield & Non-rated Corporate Credit Index whose duration was 1.71 as of 31 December 2015.
5 USD high quality corporate bond yield is represented by The BofA Merrill Lynch Asian Dollar Investment Grade Corporate China Issuers Index whose duration was 4.98 as of 31 December 2015. The 12 month CNH forward hedging income was 3.38% on 31 December 2015.
6 USD high yield corporate bond yield is represented by The BofA Merrill Lynch Asian Dollar High Yield Corporate China issuers Index whose duration was 2.59 as of 31 December 2015. The 12 month CNH forward hedging income was 3.38% on 31 December 2015.

Potential inclusion in major indices

China's bond market has yet to be included in the major local currency bond indices, partly due to the lengthy approval process, quota and repatriation constraints previously applicable to foreign investors. Although further details and final confirmation regarding the "lock-up" period and repatriation are still under consideration, the PBOC's recent announcement has brought China's onshore bond market closer to being considered for inclusion in major global bond indices. While the certainty, extent and timing of any such move remains unclear, if major bond indices do incorporate China's bond market, investment portfolios tracking the relevant indices would need to increase their purchases of onshore Chinese bonds accordingly. We estimate that related inflows could ultimately reach USD200-400 billion from fund managers alone, based on the potential weight of Chinese onshore bonds in the indices and the estimated size of assets tracking these indices.

Uncertainties remain

We believe investing in China's onshore bond market presents attractive opportunities compared to global peers as discussed above. However, it is important to highlight that some areas still require additional clarification from the PBOC, such as tax treatment and registration. And, of course, when considering potential investments in Chinese bonds, global investors should bear in mind the investment risks associated with such investments. Key risks, in our view, revolve around the macro environment and policy direction, corporate credit risk and the need for greater objectivity in local credit ratings and regulatory complexity.

Ken Hu, CIO Asia Pacific, Chris Lau, Senior Portfolio Manager, Yi Hu, Senior Analyst, Yifei Ding, Analyst

Ken Hu,
CIO Asia Pacific currently

We speak with Ken Hu, CIO of Asia Pacific, about his views on China's recent bond market opening.

Q: Why should investors consider Chinese bond markets?

A: Currently, foreign investors only account for only around 2% of the onshore RMB bond market. We think this is likely to change. As more foreign investors are potentially attracted to the Chinese onshore RMB bond market, global capital flow dynamics are likely to change.

Q: What are the important things investors should know about onshore Chinese bonds?

1. First, they had a relatively low correlation to major global bond markets in the last five years.[4]
2. Chinese government bonds provided higher yields than the government bonds of the US, UK, Germany, Japan, South Korea and Singapore for the same maturities as of the end of May of this year. (Figure 1)
3. Chinese government bonds were less volatile than the major global bond markets in the last five years.[6]
4. Trading volumes and turnover ratios of Chinese onshore government bonds were historically strong in the last year according to our assessments.[7]

Q: How is Invesco thinking about this opportunity?

A: The opening of such a big bond market represents important new alpha sources to global investors. We liken the magnitude of this investment opportunity to that associated with the introduction of the euro at the beginning of this century.

Q: Where do you see the investment opportunities currently?

A: In addition to attractive yield levels, we believe there are some interesting relative value opportunities among the three Chinese bond markets, namely the onshore RMB bond market, the offshore RMB bond market and the RMB hedged USD bond market. As these markets become more open, we believe foreign investors will likely take fuller advantage of potential arbitrage opportunities across the three markets, potentially causing yields in the three markets to converge.

Q: What are some of the risks investors should currently be aware of?

A: First, the onshore credit rating system is different from the international system, and tends to be more lenient. We expect corporate default rates in the onshore RMB bond market to rise as the Chinese economy slows and government policy focuses on curbing leverage in the system. Therefore, we as global investors would need to pay extra attention to the credit risk of onshore corporate bonds. We also need to recognize the operational risk due to different market dealing and settlement practices in the Chinese onshore bond market.

1 Source: Bank for International Settlements (BIS), as of Sept. 30, 2015.
2 Source: HSBC, as of Dec. 31, 2015.
3 Significant efforts by the Chinese government to internationalize the renminbi (RMB) began in 2010 with the creation of the offshore RMB (known as the CNH) and related offshore (or "dim sum") bond markets. Another notable step was taken in April 2014, when the government approved of the Shanghai-Hong Kong Stock Connect program in April 2014 to facilitate wider foreign investment in onshore Chinese equities.
4 Source: Bloomberg L.P., Invesco, data from Dec. 2010 to Dec. 2015.
5 Source: People's Bank of China, as of April 30, 2016.
6 Source: Bloomberg L.P., Invesco, data from Dec. 31, 2010 to Dec. 31, 2015.
7 Source: Wind, SIFMA, ECB, Trax, IIROC, Statistics Canada, Asian Development Bank, Invesco, as of Dec. 31, 2015.

Has US financial sector reform created excess demand for US government securities?

The final stage of US money market reform is on the horizon - reforms must be implemented by Oct. 14, 2016. Already, these new regulations, designed to protect investors and strengthen the US money market, have driven assets from prime money market funds (MMFs) toward government MMFs – with more likely to come. This shift has raised concerns about the supply of US government securities in the money market – will there be enough to meet demand?

Dodd-Frank (legislation aimed at protecting US consumers and promoting financial stability) and Basel III (regulatory framework designed to strengthen the global banking system) add to these concerns since new banking regulations are also expected to raise the demand for US government securities.

We believe the supply of US government securities will be generally sufficient to meet expected rising demand in the coming months. The following factors are likely to ease supply concerns, in our view:

Anticipated increase in US Treasury bill supply

The US Treasury has estimated that it can meet demand for government instruments by increasing Treasury bill issuance by USD230 billion in 2016 and an additional USD65 billion in 2017 (at the same time, the issuance of certain longer maturity paper is slated to be reduced).[1] Increased issuance of Treasury bills should alleviate downward pressure on Treasury bill yields and keep them from entering negative territory.

Estimated imbalance for short-term safe assets (USD billion)

	2016	2017
Demand for short-term safe assets		
Government-only money fund balances	300	100
Bank deposit outflows	150	0
Other demand (HQLA, margin)	50	50
Total	500	150
Supply of safe short-term assets		
Private sector repo	-90	-90
FHLB issuance	75	25
RRP usage	285	150
Total	270	85
Projected supply imbalance	**-230**	**-65**

Source: The Treasury Borrowing Advisory Committee presentation, Feb. 2, 2016.

Expected issuance of US Federal Home Loan Bank (FHLB) notes

Increased issuance of agency discount notes by the FHLB in recent years has largely replaced the reduction in issuance by US government sponsored enterprises and mortgage securitizers, Fannie Mae and Freddie Mac. As a result, total issuance of US government agency notes has remained relatively stable.[2]

Advent of US Federal Reserve's RRP

The Fed's Reverse Repurchase Program (RRP) is an important source of supply for liquidity investors seeking short-term investments. While this program was previously capped at a maximum daily capacity of USD300 billion, it is now unlimited to eligible participants (large MMFs).[3] Eligible institutions now have the option to invest at the RRP rate (currently 0.25%), creating a potential floor under money market rates.[3]

Increased availability of short-term investments to foreign investors

The Fed has reduced constraints on an overnight investment facility open to foreign central banks, governments and international official institutions, known as the foreign repurchase pool. The use of this facility has increased from around USD100 billion in 2014 to around USD250 billion as of early 2016.[4] We believe the increased availability of this important short-term investment to foreign investors should help alleviate demand pressure on US Treasuries.

Supportive factors underpinned by US government assurance

We believe increased US Treasury bill issuance plus the Fed's RRP will together largely accommodate the increased demand for government securities as a result of money market and banking sector reform. While the total volume of assets that will ultimately shift out of prime MMFs into government MMFs is difficult to quantify, we believe the range of supportive factors outlined above should help alleviate supply concerns. In particular, the US Treasury and Fed have assured market participants that they are committed to ensuring that money markets remain functioning and efficient, through modifications in their issuance structure and through the implementation of key monetary tools, such as the RRP.[5]

Justin Mandeville, Portfolio Manager

1 Source: US Treasury Borrowing Advisory Committee minutes, Feb. 3, 2016.
2 Source: Barclays, Jan. 31, 2013 to April 30, 2016.
3 Source: Federal Reserve Bank of New York, as of June 15, 2016.
4 Source: Credit Suisse, as of Feb. 7, 2016.
5 Source: US Treasury Borrowing Advisory Committee minutes, Feb. 2, 2016. Remarks by Simon Potter, Executive Vice President of the Markets Group of the Federal Reserve Bank of New York, at the 70th Anniversary Celebration of the School of International and Public Affairs at Columbia University, New York City, Feb. 22, 2016.

Matt Brill,
Senior Portfolio Manager

Chris Maurice,
Trader

Paul Bayley,
Senior Trader

Karim Awenat,
Senior Trader

The Bottom Line

We speak with IFI traders about foreign interest in US credit markets in light of monetary easing in Europe and Japan and the search for yield among global investors.

Q: Are you seeing growing foreign interest in US credit markets?

Matt Brill (investment grade): We are seeing heavy interest from foreign investors in US investment grade. We are receiving new inquiries daily from potential clients and have seen strong interest in the investment grade market - we recently relocated a Japanese colleague full-time to Atlanta to help service Japanese clients 24 hours a day. We continue to hear from Wall Street strategists that the market is being supported and bid up by foreign investors and that this wave of money does not appear to be slowing. More than 25% of global bond yields are currently negative.[1] The positive yield that the US market offers will likely continue to be attractive to foreign investors and we believe their demand will likely be supportive for US credit spreads and yields going forward.

Chris Maurice (high yield): Anecdotally, we are hearing that European investors are coming to the US high yield market to pick up yield and that flows are strong. One trade in particular seems to be getting a lot of focus. As the ECB's bond purchase program gets underway, European investors are selling corporate bonds to the ECB then using the proceeds to invest in "yield-to-call" bonds in the US high yield market. Yield-to-call bonds are bonds that have either been called or have a short time until being called and are trading above their call price. These bonds typically offer little yield to the traditional US high yield investor, but represent a nice yield pickup compared to the European market, while maintaining a relatively low amount of risk. This way, European investors are able to pick up yield while still being able to maintain their portfolios' risk-return profiles.

Q: Are foreign investors focused on any particular sectors?

Matt: Within investment grade, foreign investors appear mainly focused on yield, diversification, and occasionally quality. They would prefer fewer financials, but the financial sector has attractive yields that are hard to ignore. When we see an inaugural deal from a US industrial company, there is strong foreign demand due to the diversification this new company provides. Foreign investors are "full" on some names, so they seem excited to have the opportunity to invest in a new name. Energy and metals have been two areas they have been seeking to avoid due to the volatility. This tendency to avoid the higher beta sectors does show, in our view, that foreign investors are not simply focused on buying the highest yielding assets. They seem to be very cautious and prudent in their investment approach.

Q: Do you see increased interest among US companies to issue bonds in Europe?

Matt: We have been seeing more US companies issue in Europe, however, we have seen more European companies issue in USD as well, as companies seek to diversify their funding bases. European companies find the size and depth of the US markets attractive, and US companies see benefits in the overall lower funding costs in euros.

Q: Chris, are you seeing US high yield issuers turning to the European market to take advantage of lower funding costs?

Chris: Most of the high yield asset class involves businesses based in the US that primarily sell to US customers. These companies with domestic operations and customers have generally not been tapping the European markets. With that being said, we have seen almost every high yield company with operations in both the US and Europe favor issuing in the European market, as the ECB bond purchase program has driven yields down and improved the cost of capital for these companies.

Q: Could you provide color on the US corporate issuance taking place in Europe? Does it have an impact on your market?

Paul Bayley (global): As of mid-June, so far there has been USD61 billion of reverse Yankee issuance – i.e. US companies issuing in euros.[2] By comparison, in 2014 there was USD85 billion of US company issuance in euros. So in general, there has been a large amount of reverse Yankee issuance in the European market due to the favorable yields that can be obtained by US issuers. Additionally, due to the relatively cheap funding levels for US issuers coming in euros, the tenors on the bonds have tended to be generally much longer than for typical European bond issues. Although they have tended to bring larger deal sizes with longer tenors than the market is used to absorbing, oftentimes investors are incented to buy since they can be a large part of the major indices.

Q: Do you see evidence of European investment going abroad searching for yield?

Karim Awenat (global): Certainly global investors appear to be avoiding reverse Yankee issuance (in euros) and attempting to buy the same issuer in US dollars for yield pick-up. But we are also seeing more value in the general US dollar market. As Matt mentioned, the depth and liquidity of the US market is attractive for European investors. The US markets are becoming even more attractive as it becomes more difficult to source bonds at attractive levels with the ECB bond buying program (CSPP) commencing in earnest. We believe the ECB purchases will likely constrain liquidity even further and potentially drive more global investors into the US dollar market.

1 Source: Bloomberg L.P., Invesco, as of June 13, 2016.
2 Source: JPMorgan, June 8, 2016.

Recent IFI publications

1. **Emerging markets' alpha beta soup,** June 2016, Arnab Das, Head Emerging Markets and Sovereign Macro Research, Rashique Rahman, Head of Emerging Markets, Jay Raol, Senior Macro Analyst
2. **Has US financial sector reform created excess demand for government securities?**, May 2016, Justin Mandeville, Portfolio Manager
3. **The 2016 IMF-World Bank Spring Meetings,** May 2013, Arnab Das, Head of Emerging Markets and Sovereign Macro Research
4. **Metals and mining – The worst appears over but risks remain,** April 2016, Rahim Shad, Senior Analyst, and Jason Trujillo, Senior Analyst
5. **Corporate hybrids offer potential opportunities in low interest rate environment,** April 2016, Samira Sattarzadeh, Senior Analyst
6. **The corporate hybrid: Expanding market offers opportunities,** April 2016, Samira Sattarzadeh, Senior Analyst, Lyndon Man, Senior Portfolio Manager, and Luke Greenwood, Senior Portfolio Manager
7. **Currency management: A simple roadmap,** April 2016, Ray Uy, Head of Macro Research
8. **European banks' balance sheets strongest for a generation,** April 2016, Ian Centis, Senior Analyst
9. **The UK reconsiders its membership in the European Union,** February 2016, Sean Connery, Portfolio Manager
10. **Investor double-take: US Agency MBS,** December 2015, Rich King, Head of Structured Investments
11. **Invesco Fixed Income: Investor's Summit Outlook November 2015,** December 2015, CEO Greg McGreevey and Chief Strategist Rob Waldner
12. **Understanding the emerging markets credit cycle, Part 1,** December 2015, Rashique Rahman, Head of Emerging Markets, Jay Raol, Analyst

Market monitors

Fixed income market monitor

	Coupon (%)	Yield to worst (%)	1 month change in YTW	Option-adjusted spread: current	1 month change in spread	10 year range: min	10 year range: max	Returns: 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
Global Aggregate (USD hedged)	2.86	1.38	0.00	48	1	23	156	0.42	1.42	3.89	4.06
U.S. Aggregate	3.14	2.20	0.05	51	0	32	258	0.03	1.33	3.45	2.99
U.S. Mortgage-backed	3.66	2.37	0.01	18	-2	-16	181	0.13	0.59	2.27	2.71
Global Inv Grade Corporate (USD hedged)	3.82	2.60	0.04	146	3	55	515	0.16	3.56	4.61	3.28
U.S. Investment Grade Corporate	4.18	3.14	0.07	149	3	76	618	-0.08	4.10	5.31	3.62
Emerging Market USD Sovereign	n/a	5.80	0.09	397	8	157	906	-0.18	4.91	6.71	4.55
Emerging Market Corporate	n/a	5.35	0.06	375	1	120	1,032	0.21	5.20	5.91	2.52
Global High Yield Corporate (USD hedged)	6.36	6.74	-0.06	546	-9	231	1,845	0.54	8.43	7.24	-0.08
U.S. High Yield Corporate	6.59	7.31	-0.06	566	-11	233	1,971	0.62	9.20	8.06	-0.81
Bank Loans	4.84	5.15	-0.01	n/a	n/a	n/a	n/a	0.91	5.54	4.19	0.58
Municipal Bond	4.78	1.85	0.01	n/a	n/a	n/a	n/a	0.27	1.33	2.70	5.87
High Yield Municipal Bond	5.36	6.43	-0.07	n/a	n/a	n/a	n/a	1.32	3.01	4.73	4.70

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	1.42	0.07	0.00	0.05	3.09	3.01
Canada	2.54	1.07	-0.12	1.16	0.15	1.48	2.96
United Kingdom	3.74	1.45	-0.12	1.86	0.38	5.77	5.77
Germany	2.28	-0.08	-0.10	1.02	-0.19	3.90	3.09
Italy	3.77	0.93	-0.07	0.76	0.46	1.89	4.95
Japan	1.14	-0.09	-0.03	0.39	2.33	5.66	7.61
China	3.63	2.91	0.01	-0.02	0.45	1.31	7.00
EM Local Currency Governments	n/a	n/a	n/a	-0.37	3.15	5.26	6.68

FX market monitor[1]

	Current	10 year range: min	10 year range: max	Returns: 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
EURUSD	1.11	1.06	1.60	-2.79%	2.38%	2.49%	1.88%
USDJPY	110.73	75.82	124.77	-3.97%	1.77%	8.60%	12.69%
GBPUSD	1.45	1.38	2.11	-0.88%	4.07%	-1.72%	-4.72%
USDCNY	6.59	6.04	8.28	-1.61%	-0.43%	-1.35%	-5.80%
USDCHF	0.99	0.75	1.39	-3.48%	0.46%	0.84%	-4.82%
AUDUSD	0.72	0.60	1.10	-4.85%	1.30%	-0.71%	-4.89%
CADUSD	0.76	0.72	1.09	-4.11%	3.44%	5.69%	-4.36%
EURJPY[2]	123.25	94.31	169.49	-1.06%	-0.58%	6.00%	10.62%
EURGBP[2]	0.77	0.70	0.84	1.96%	1.65%	-4.11%	-6.47%

Sources: Barclays, J.P. Morgan, Bloomberg L.P., as of May 31, 2016. Credit Suisse Leveraged Loan data as of May 31, 2016. Within the Treasury monitor, United States is represented by Barclays US Treasury Index; Canada is represented by Barclays Global Treasury Canada Index; United Kingdom is represented by Barclays Sterling Gilts Index; Germany is represented by Barclays Global Treasury Germany Index; Italy is represented by Barclays Global Treasury Italy Index; Japan is represented by Barclays Global Treasury Japan Index; China is represented by 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 Barclays Global Aggregate (US$ Hedged) Index; US Aggregate is represented by Barclays US Aggregate Index; US Mortgage-backed is represented by Barclays US Mortgaged-backed Index; Global Investment Grade Corporate is represented by Barclays Global Aggregate Corporate (US$ hedged) Index; U.S. Investment Grade Corporate is represented by 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 Barclays Global High Yield Corporate (US$ hedged) Index; U.S. High yield Corporate is represented by Barclays U.S. Corporate High Yield Index; Bank Loans is represented by the Credit Suisse Leveraged Loan Index; Municipal Bond is represented by Barclays Municipal Bond Index; High Yield Municipal Bond is represented by 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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