Invesco Fixed Income

Global Fixed Income Strategy

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Global macro strategy

China's letter to markets - what does it mean for global investors?

A front-page article attributed to high-ranking Chinese policy officials was recently published in the People's Daily, a communist party official newspaper, surprising markets with suggestions of a revised approach to economic growth. The May 9 article provided rare insight into the authorities' macro thinking – especially the dangers of boosting growth with increasing leverage – and emphasized the need for structural reform over short-term stimulus to achieve sustainable growth. Depending on how this new approach is implemented, IFI believes this new information could have significant repercussions for global financial markets and economies.

Below are the main points of the article:

- Excessive easing needs to be avoided, growth cannot be achieved via higher leverage, and supply-side reforms (for example, the allowance of corporate bankruptcies rather than forms of debt relief) will be firmly implemented.
- China's growth path is likely to be L-shaped, not U- or V-shaped. The L-shape is likely to last for some time, although China's solid potential growth should provide a floor.
- In the near term, supply-side reform will be the major focus. Investment expansion should be moderate, not excessive. Massive easing to stimulate the economy should be avoided, as excessive easing would leave undesirable effects after a short-term rebound.
- High amounts of leverage bring high risks, which, if not controlled, could lead to systemic financial crisis or even negative economic growth.
- The equity, currency and property markets should revert to their original functions rather than serve as vehicles to provide stimulus. The equity market needs to recover its financing function, the currency market needs to be based on greater monetary policy autonomy, and the property market's inventory de-stocking should be achieved via urbanization rather than supported with increased leverage. Excessive stimulus risks creating bubbles, which should be avoided.
- Volatility in the stock and currency markets earlier this year reflected the financial system's vulnerability to high amounts of leverage. The idea of increasing gross domestic product via massive monetary easing should be abandoned in favor of reduced leverage. Non-viable companies should be shut down or entered into bankruptcy, rather than supported via forms of debt relief. Workers made redundant via closures of failing companies should be supported with job training and transfers.

What are the implications for Chinese growth?

While the approach outlined above is likely positive for China's longer-term growth outlook, we believe it could be quite negative for short-term growth. A slowdown in China's stimulus could have negative implications for China's construction and property sectors (which have been providing much-needed economic support of late) and lead to renewed market focus on deflationary pressures emanating from Asia (we have been cautious on China for some time and continue to view Asia as the epicenter of deflation). Perhaps most significantly, these measures —namely curbing leverage in the Chinese economy — could lead to renewed tightening of global financial conditions, an issue we have monitored closely. We believe that tighter global financial conditions have played an important role in softening monetary policy among the major central banks in recent months, including the US Federal Reserve (Fed).

Fed complicates the picture

That said, the Fed recently surprised markets with its hawkish tone. The Fed's April minutes were surprisingly hawkish, especially regarding the potential for a June interest rate hike. The minutes stated that "most participants" believed that a June hike would be appropriate if data continue to come in in line with targets. This appears to put June on the table. However, we believe it would be difficult for the Fed to raise rates in June for several reasons. First, we do not believe the Fed wants to surprise the markets (the bond market currently puts the odds of a June rate hike at only around 30%).[1] A surprise would likely spark a US dollar rally and sell-off in commodities and risky assets, resulting in tighter financial conditions, ultimately dissuading the Fed from hiking. Second, if the data continue to come in as we expect, this would likely be consistent with a July hike (current odds are around 50%).[1] It is possible the Fed will use the June meeting to telegraph a July rate hike. Furthermore, the looming UK referendum vote (a concern stated in the minutes) adds a significant amount of uncertainty to the Fed's playbook. A hike followed by a subsequent "leave" vote would likely be debilitating to financial markets.

What are the market implications?

IFI has believed that global market stability was likely temporary and vulnerable to a number of potential negative catalysts that could disrupt markets — such as a more hawkish Fed or renewed pressure from China. We believe the views expressed in the People's Daily article plus the more hawkish tone reflected in the latest Fed minutes could represent such negative catalysts. Renewed concerns over Chinese growth could reverse global markets' current "risk-on" sentiment.

China's new approach could also further tighten financial conditions, which could threaten reflation globally, exert downward pressure on global interest rates and drive peripheral Asian currencies weaker against the US dollar. This could have negative implications for commodity prices, risk assets and other financial markets. As such, we advocate caution with respect to risky asset exposure.

Ray Uy, Head of Macro Research, Arnab Das, Head of EM Macro Research,
Yi Hu, Senior Credit Analyst, Rob Waldner, Chief Strategist, James Ong, Senior Macro Strategist, Noelle Corum, Analyst

1 Source: Source: Bloomberg L.P., May 23, 2016.

Interest rate outlook

US: Estimates of US growth and inflation have firmed over the past month driven by strong retail sales and core inflation. If the US economic economy evolves positively, as we expect, the US yield curve may steepen as inflation risk rises. 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. Nevertheless, demand for Treasuries has remained strong, depressing yields. We expect the 10-year US Treasury bond to trade around 1.75-2.25% over the next month.

Europe: With the June European Central Bank (ECB) decision still a few weeks away, markets are focused on other issues such as whether the reflation in China is already petering out, the likelihood of the UK quitting the European Union (EU) and the evolving political situation in Spain. These issues are putting downward pressure on nominal bund yields and inflation breakeven rates in the eurozone. Over the summer months, we expect net negative supply of core European bonds and heightened volatility to benefit bunds, which are typically viewed as a "safe haven." We expect the 10-year bund to trade in a range of 10-20 basis points over the next month.

China: The Chinese authorities recently implied that monetary easing has peaked due to concerns over high financial leverage and asset bubbles. Although growth in total social financing (a measure of lending to non-state entities) moderated somewhat in April, overall credit growth remained strong, if local government bond issuance is included. We believe fiscal stimulus will likely continue in the form of more government spending and tax cuts. April consumer price inflation was in line with market consensus at 2.3% and unchanged from March, while producer price deflation continued to ease in April to -3.4% from -4.3% in March.[1] 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 3.67% versus 2.9% for the 10-year onshore Chinese government bond.[2]

UK: The Financial Times poll of polls suggests that the EU referendum is still too close to call. However, phone polls indicate that the "remain" camp has a clear lead. This is significant, not only because it aligns with the views of UK bookmakers (who also expect a "remain" outcome), but because phone polls (versus online polls) better predicted the outcome of the 2015 UK general election. Economic data has disappointed of late. This may be due partly to apprehension over the referendum outcome, however, weaker data around housing will require closer scrutiny over the coming months for signs of a deeper slowdown. We expect gilt yields to trade in a 1.35-1.7% range over the coming month.

Japan: The Bank of Japan (BoJ) kept policy unchanged at its April meeting, despite lowering its inflation forecasts. This was in line with our expectations, but disappointed many market participants. The BoJ's explanation for its inaction was that it wanted to fully assess the impact of negative interest rate policy (NIRP) introduced in January. NIRP continues to have a positive impact by bringing down bond yields and helping to increase loan demand, however, the positive impact on the yen has been less desirable. The BoJ attributes recent yen strengthening to external issues (concerns of a slowdown in China, for example) and thus sees yen appreciation as a flight to quality. The bottom line is that further yen strength will likely have a further dampening impact on inflation if not offset by increases in wages or oil prices. We continue to expect further easing from the BoJ, most likely at the July meeting.

Canada: Canada's growth outlook is weaker following the tragic fire in Alberta. We estimate that lost oil production will cost the economy around 1% of GDP in 2016 but rebuilding and a return to full oil production should cause growth to bounce back next year. The weakness in the Canadian dollar has not provided a sustainable support for Canadian output and inflationary pressures caused by a weaker currency have now abated. In this environment, we expect demand for longer-dated bonds to remain strong. We expect 10-year Canadian government bond yields to trade in a range of 1-1.8% in 2016.

Australia: The Reserve Bank of Australia (RBA) shocked markets by unexpectedly easing when it met on May 3. The RBA was reacting to very weak inflation and a subdued economic outlook. The fact that the RBA acted solely based on inflation, even when the jobs market remains healthy, has caused investors to price in further easing. We tend to agree with this view as the desired rebalancing away from mining jobs is happening but aggregate employment income is falling. In this environment, consumer expenditure will likely remain under pressure. With property prices softening, the RBA can take a more relaxed approached to policy rates thus lending support to Australian government bonds. We expect Australian government bonds to trade around 2.2-2.4% over the next month.

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

1 Source: National Bureau of Statistics of China, April 29, 2016.
2 Source: Bloomberg L.P., May 16, 2016.

Currency outlook

USD: Global monetary policy divergence has paused as the Fed relents on its tightening bias and global central banks target credit easing measures rather than currency weakness. Although we expect positive US economic performance to diverge from the rest of the world, we expect limited upward pressure on the US dollar until stronger US economic data causes the market to price in further interest rate hikes. If stronger economic growth and inflation cause the Fed to assume a more hawkish stance, the US dollar will likely begin to appreciate broadly once again.

EUR: If a potentially more assertive Fed emerges, it could bring the theme of divergence in monetary policy back into play. If this were to happen, we would expect the euro to come under some pressure. That said, we believe the global macro risk environment remains challenging. 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 Japanese yen has been supported by the BoJ's decision not to ease monetary policy further at its April meeting. Policy officials have verbally intervened in response, suggesting that they stand ready to unilaterally intervene in currency markets if "disorderly movement" does not subside. It is difficult to see the government carrying out such a threat - Japan is due to host a G7 meeting in late May and it will likely want to avoid being the focus. Over the longer term, we await the ratification of the Trans-Pacific Partnership deal. Countries unilaterally influencing the level of their own currency is a very sensitive topic, so, again, any intervention could put ratification at risk. If the Japanese want to weaken the yen, further easing appears to be the only course of action. This is unlikely to happen before July. The currency could find additional support in the interim.

GBP: We continue to be overweight sterling, based on the expectation that the UK will vote to stay in the EU in its June 23 referendum. Interest rate hike expectations would likely be brought forward in the event of such an outcome, particularly given that inflation looks increasingly likely to hit its 2% target (on a two year horizon) as unit labor costs increase, oil prices move higher and declines in food and energy prices abate. Sterling's path higher will likely continue to be volatile, but we would favor this position until referendum day, providing polls do not start to suggest a "leave" outcome.

CAD: The Canadian dollar has been well supported by a less dovish Bank of Canada and higher oil prices. The production shutdown in Alberta will, however, have a long lasting negative impact on the currency as production will take time to come back online. The deterioration in Canada's balance of payments also remains a concern. The direction of commodity prices will likely be a key a driver of portfolio flows and consequently the currency. We believe the market is underpricing potential monetary easing by the Bank of Canada and the currency's valuation is not attractive, in our view. We have recently rebuilt our bearish positioning in the Canadian dollar.

AUD: The Reserve Bank of Australia (RBA) shocked markets by unexpectedly easing when it met on May 3. The RBA was reacting to very weak inflation and a subdued economic outlook. The fact that the RBA acted solely based on inflation, even when the jobs market remains healthy, has caused investors to price in further easing. We tend to agree with this view as the desired rebalancing away from mining jobs is happening but aggregate employment income is falling. In this environment, consumer expenditure will likely remain under pressure. With property prices softening, the RBA can take a more relaxed approached to policy rates thus keeping the Australian dollar under pressure.

Ray Uy, Head of Macro Research and Global Multi-Sector Portfolio Management,
James Ong, Senior Macro Strategist, Avi Hooper, Senior Portfolio Manager,
Sean Connery, Portfolio Manager, Josef Portelli, Portfolio Manager,
Alex Schwiersch, Portfolio Manager

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

A dovish Fed, no more rate cuts from the ECB and China easing combined with capital controls should help support US dollar stability.

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. Renewed volatility in oil and industrial metals would give markets pause. We favor risk-on posture but aware of risk factors. Potential for rising global manufacturing, global trade to support EM growth.

IFI strategy: Prefer to add risk through high conviction views, not high beta exposure. Keeping China beta low. Prefer consumer and Latin America exposures as potential Brazil regime change creates opportunities with valuations at extreme levels.

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

Rationale: Expect heightened near-term macroeconomic volatility to limit potential for credit spread tightening. Cautious on exposure to energy-sensitive regions. Dwindling supply creating good technicals.

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 lagged market recently, 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. Favor avoiding sub-prime, option adjustable rate mortgages. Favor BBB-rated CRT over below-investment grade.

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 supportive.

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

Sector themes

Commodities: Global rebound in energy, metals, volatility remains

Rationale: Expect global IG credit risk premiums to improve in next quarter 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 low 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

US CMBS - market and strategy update

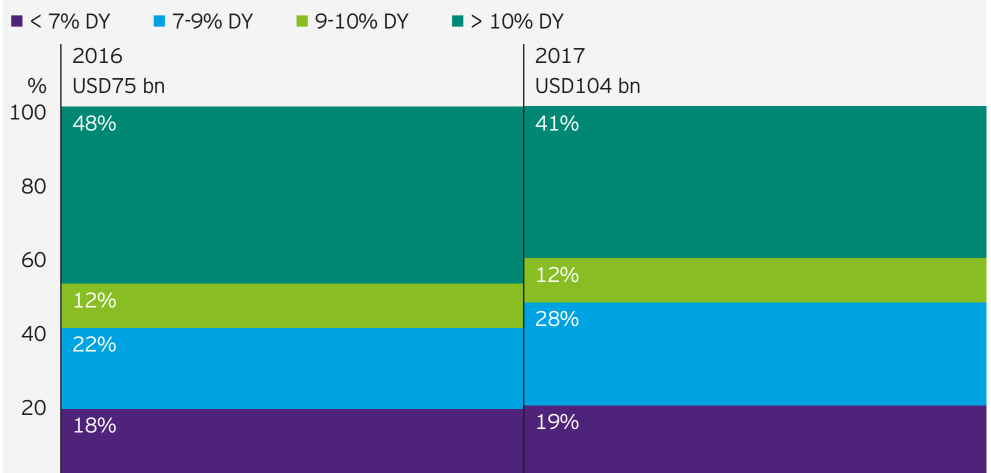
Despite some fundamental challenges facing the US real estate market, we see opportunities in US CMBS collateralized by loans originated in 2006 and 2007. We expect commercial real estate borrowers to face rising challenges this year as financial conditions display early signs of tightening and stricter regulations on US CMBS transactions take effect in December. Commercial real estate lenders are also likely to take a more conservative stance as the credit cycle progresses and new banking sector regulations increase the amount of capital banks must set aside for commercial real estate debt. Indeed, the recently released Federal Reserve Senior Loan Officer Survey on Bank Lending Practices shows early signs of credit tightening.[1]

Despite these challenges, we currently favor selected bonds within the 2006 and 2007 "vintages" that benefit from relatively higher debt yields (i.e. loans with relatively low balances relative to the level of income generated by the properties that secure them). Specifically, we think bonds that are first, second and, in some cases, third in line to receive principal proceeds offer attractive risk-adjusted returns and benefit from enough subordination to be protected from potential losses.

This is because today's relatively low interest rate environment should allow owners of stronger properties to find financing upon loan maturity. In addition to benefitting from principal received from re-financing underlying loan maturities, we expect a portion of the bonds to be paid off with principal returned well after scheduled maturities (i.e. "extended loans") or from default recovery proceeds (see discussion with IFI Portfolio Manager, Mike Hyman, below). Importantly, our credit analysis assesses each underlying loan's likelihood of obtaining financing upon maturity and the potential negative impact that loan extensions or defaults might have across a wide range of scenarios.

As shown in Figure 1 below, USD179 billion of US CMBS loans are scheduled to mature in 2016 and 2017. Each maturing loan's debt yield is also shown. Generally speaking, we think loans with debt yields greater than 9% have a high probability of finding re-financing upon maturity. However, we believe loans with debt yields below 9% (especially those below 7%) are the most likely to face challenges finding financing (i.e. maturity extensions, experience defaults, and/or need borrowers to contribute additional equity).

Figure 1: US CMBS maturity schedule



Source: Invesco and Trepp, as of March 11, 2016. DY is debt yield.

Kevin Collins, Head of CMBS Credit

We speak with Mike Hyman, IFI Portfolio Manager and Head of Investment Grade, about opportunities in US CMBS.

Q: Mike, how have you been looking at US CMBS as an asset class?

Mike: Over the last year, as Kevin mentions above, we have seen value in "vintage" US CMBS deals (older US CMBS deals) that offer attractive yields and short maturities. We currently favor 2006 and selected 2007 "AJs" (the most subordinate of the tranches originally rated AAA) and other subordinate tranches. These are bonds with one-two year average life and are generally first or second in line to receive principal proceeds, so will start paying down soon.

Q: Why are they attractive?

Mike: The reason we have been focused on them is that their yields are attractive compared to yields on short-term corporate bonds. We see very little value in short-term corporate credit because spreads have become very tight at the short end of the yield curve. A typical investment grade corporate bond would yield around 1.25% for a two-year bond, for example.[2] This is generally the case because corporate bonds can become money market eligible and, therefore, we have seen downward pressure on their yields. As a result, our alternative would probably be to invest in cash or US Treasuries.

Structured securities, on the other hand, do not become money market eligible because their final maturities are typically 30 years, even if their underlying collateral is shorter, so even shorter term yields remain attractive, in our view. These vintage US CMBS bonds generally trade around par with a yield of 5-5.5% (investors generally will not pay much above par for these bonds due to the inherent prepayment risk - US CMBS prepay at par).[3] This represents a substantial yield premium versus other investment grade alternatives with a similar average life, in our view.

Q: Is this market well-known?

Mike: This segment of the US CMBS market is sponsored mainly by investment managers. These bonds can be a challenge to source. We evaluate these securities down to the loan level to ensure that the collateral would be sufficient to repay the tranche we buy.

Q: What are the advantages of buying vintage deals?

Mike: By buying the "vintage" deals, the loans are near their maturities, so the value of the loans is more quantifiable versus new deals where future stress scenarios need to be considered. One of the things that can benefit the trade is if the deals "extend" as property owners delay the refinancing of their loans for various reasons - they may need additional equity, or financing terms have tightened or collateral may need to be liquidated. This is actually a nice benefit to investors since they can potentially receive the roughly 5% return for longer. It is, of course, important to know that the collateral will likely cover the tranche. This is a not a "home run" trade, i.e. does not offer the potential for significant price appreciation, but it is an opportunity to earn an attractive yield with potentially low volatility, in our view. It is a nice example of using a fairly niche part of the market to generate alpha.

1 Source: US Federal Reserve Board, as of April 2016.
2 Source: Barclays US Investment Grade Bond Index, Bloomberg L.P., as of May 16, 2016.
3 Source: Barclays US Aggregate Index, as of May 16, 2016.

CLOs rebound - we see opportunities in higher-quality deals

The collateralized loan obligation (CLO) market enjoyed a strong rebound in March and April driven by global risk-on sentiment - almost fully offsetting the losses incurred in the beginning of the year. Strength in underlying loan prices has improved the market value of the collateral for the deals and loan default concerns have eased (the current trailing 12-month loan default rate was 1.72% as of May 9).[1] Other structured finance products have rallied as well, providing relative value support – US CMBS spreads in particular have tightened significantly (AAAs tightened from a year-to-date wide of 174 basis points on Feb. 11 to 111 basis points on April 20. BBBs tightened from a year-to-date wide of 836 basis points on Feb. 11 to 532 basis points on April 22).[2]

Market technicals have also provided support as CLO supply has been weak this year with only USD13.5 billion priced by the end of April. This total is only one-third of the issuance in the first four months of last year.[3] At the same time, we are seeing an acceleration of calls of 1.0 deals (deals issued pre-financial crisis), as equity investors in those deals view the rebound in loan prices as an opportunity to exit.

While loan defaults and downgrades have picked up, CLO structures have held up so far with only 1% of post-crisis CLOs breaching their collateral coverage tests (meaning that only 1% of these deals can be described as stressed) to date.[4] An additional 14% of all 611 CLOs priced post-2010 may be characterized as stressed or coming under pressure).[4] This means the majority (around 85%) of structures remain in very good shape.[4] However, credit selection remains important. We continue to observe very strong bifurcation between the weaker deals and smaller managers and the rest of the market.

CLO 2.0* Historical annual returns (%) – post-financial crisis

	YTD 2016	2015	2014	2013	2012
AAA	1.02	1.45	1.25	0.32	3.88
AA	1.84	1.99	0.64	0.99	9.43
A	0.68	2.99	1.15	2.96	17.15
BBB	1.90	-0.78	2.70	7.14	24.18
BB	2.20	-5.77	1.85	10.82	29.23

Source: JP Morgan CLO Research & Global Index Research, May 2, 2016. AAA is JP Morgan CLOIE AAA Post-Crisis Index. AA is JP Morgan CLOIE AA Post-Crisis Index. A is JP Morgan CLOIE A Post-Crisis Index. BBB is JP Morgan CLOIE BBB Post-Crisis Index. BB is JP Morgan CLOIE BB Post-Crisis Index. YTD 2016 is Jan. 1, 2016 to April 29, 2016. All other data as of December 31.

*CLO 2.0 is a CLO issued after 2009, after the financial crisis.

Based on historical trading levels, we currently find the most attractive opportunities to be AAAs and short-dated, pre-crisis investment grade paper that has the potential to be called early, enhancing returns. Given that we believe we are in the later stage of the credit cycle, we continue to favor stronger deals from top-tier managers.
We are cautious on the riskier parts of the capital stack (BBB-Bs).

CLO discount margins have tightened

Tranche	4/29/16 Discount Margins	2/15/16 Discount Margins	WAL	2012-YTD 2016 Range Discount Margins
AAA	L+150-180	L+170-220	5.5	L+110-220
AA	L+210-250	L+240-300	7.0	L+150-340
A	L+325-400	L+400-600	7.8	L+275-600
BBB	L+475-650	L+550-850	8.5	L+375-850
BB	L+775-1100	L+900-1400	9.0	L+550-1400
B	L+1200-1600	L+1400-2000	9.5	L+900-2000

Source: Invesco Estimates, Wells Fargo Research. AAA is JP Morgan CLOIE AAA Post-Crisis Index. AA is JP Morgan CLOIE AA Post-Crisis Index. A is JP Morgan CLOIE A Post-Crisis Index. BBB is JP Morgan CLOIE BBB Post-Crisis Index. BB is JP Morgan CLOIE BB Post-Crisis Index. BB is JP Morgan CLOIE BB Post-Crisis Index. B is JP Morgan CLOIE BB Post-Crisis Index. B is JP Morgan CLOIE B Post-Crisis Index. WAL is weighted average life. 2012-YTD 2016 is Jan. 1, 2012 to April 29, 2016.

Ivo Turkedjiev, Senior Trader

1 Source: S&P Global Market Intelligence, as of May 9, 2016.
2 Source: Bloomberg L.P., AAAs are represented by MARKIT CMBX AAA CDSI S9 Index. BBBs are represented by MARKIT CMBX BBB- CDSI S9.
3 Source: S&P Global Market Intelligence, as of April 31, 2015 and April 31, 2016.
4 Source: Wells Fargo, as of April 22, 2016.

The Bottom Line

Arnab Das,
Head of Emerging Markets
Macro Research

Sujoy Das,
Head of India Fixed Income

Krishna Cheemalapati,
Portfolio Manager

Nitish Sikand,
Portfolio Manager

We speak with Arnab Das, Head of Emerging Markets Macro Research, and India specialists Sujoy Das, Head of India Fixed Income and Krishna Cheemalapati and Nitish Sikand, Portfolio Managers, India Fixed Income, about their outlook for India's economy and markets:

Q: How would you describe India today in macro terms?

Arnab: India has shown significant improvement since 2013. In mid-2013, India seemed like the most fragile of the 'Fragile Five' EM economies hardest hit by the Fed's plans to taper monetary easing. But by the end of 2013, good policy and good luck started a reversal of fortune, which continues today. In two years, the monthly trade deficit halved to USD5-7 billion; the current account deficit fell sharply from 4.8% to 1.3% of gross domestic product (GDP); and the federal fiscal deficit fell by about 1% to 4% of GDP.[1] Our analysis of EM national balance sheets shows that India's overall public and private debt ratios are stable and external debt ratios are falling swiftly – and are also lower than most EMs. Additionally, India has arguably gained more than any other EM since oil prices began to fall in Q4-2014.

Q: Is India vulnerable to recent tightening in global financial conditions, the possibility of further Fed tightening and China's deceleration?

Sujoy: While there may be volatility, India's fundamentals are generally sound. Foreign exchange reserves, now about USD360 billion (10 months of import coverage), are high enough, in our view, to cushion the rupee and, therefore, inflation expectations during high volatility periods.[2] Future commodity-price, dollar or risk-aversion shocks could, however, have offsetting effects on India's economic and financial performance. Foreign bond quotas would also potentially reduce the impact of risk aversion on local bond yields and the fiscal deficit, but we would expect equities and the rupee to suffer.

Q: Can India follow in the footsteps of China and the smaller EM Asian economies, which grew rapidly and made their mark through exports?

Arnab: We think of this as the 'Chindia' fallacy. China and India have little in common, other than starting out as very large, mainly agrarian populations when reform began in the 1970s and 1990s, respectively. India has even less in common with most other Asian or EM countries. Instead of pursuing an off-the-shelf, export-led growth model, we expect India to balance domestic priorities with international objectives, including catching up with China and the West.

Sujoy: Prime Minister Modi's 'Make in India' campaign aims to attract manufacturing foreign direct investment (FDI), but we think this will be directed at domestic demand as much as exports, for two reasons: sluggish global trade implies that there simply is not room for another major economy to take off through exports. As important, India's complexities imply that domestic stability trumps international competition.

Q: India has become a global investor favorite. Do you think this will continue?

Nitish: We think India offers unique characteristics that will continue to attract all types of foreign investors over the long haul. India's young demographic points to strong demand for investment in infrastructure, education, services, retail, tourism, you name it. However, structural impediments to rapid expansion – restrictive labor, tax, land acquisition, licensing and operating rules – are pervasive. They add up to major supply-side bottlenecks that can collide with strong underlying demand dynamics to compound inflation pressures.

Krishna: The immediate outlook is very favorable, in our view, especially for local government bonds, given our outlook for sustained disinflation amid robust growth. Trend growth can potentially remain high with structurally lower inflation thanks to improving demand-management policies and efforts toward structural reform on the supply side, as well as low commodity prices and US dollar pull-backs on delays in Fed tightening. These developments are reducing country risk, as reflected in lower real interest rates and greater domestic financial stability, including a less volatile rupee.

The bottom line continued

Q: How do valuations stack up across domestic asset classes and against other countries?

Nitish: We believe India's local government bond yields and currency valuations are attractive. The benchmark 10-year Indian government bond yields around 7.5%, while high-quality corporate bonds yield around 8.2%.[3] Local government bonds currently offer among the highest nominal and real rates for a large economy with moderate imbalances and macro risks, in our view. The rupee has depreciated significantly in recent years.

Q: How well is the Modi administration living up to its promises of reform?

Krishna: Structural reform and fiscal adjustment have picked up under the new Modi government, albeit more slowly than touted by his campaign. Public agricultural procurement and distribution have been restructured to smooth the impact of the monsoons on food inflation. Federal fiscal consolidation continues despite state elections and the Reserve Bank of India's (RBI) inflation targeting plan has been legislated in parliament and institutionalized in the Monetary Policy Council. Subsidy reform is helping to reduce the budget deficit and to better target public spending, freeing up resources for the National Infrastructure and Investment Fund and other public capital spending – all within the framework of medium-term fiscal consolidation.

Q: You've outlined a balanced but essentially positive view. What do you see as the risks?

Arnab: We believe the major risks fall into three main areas: 1) macro policy; 2) politics and reform; and 3) external risks.

1. Macro policy errors would likely hit all asset classes hard. India's political elites have shown "China envy" before, so may again tolerate or even encourage overheating. A specific risk is RBI Governor Rajan's reappointment in September. Hints that he might not receive the customary reappointment suggest political pressure to cut interest rates and drive growth higher, or to avoid full recognition of bank non- performing loans and fiscal recapitalization of state banks. These concerns are now receding, but warrant close monitoring.
2. Reform setbacks would likely constrain growth, which could affect the currency - and bonds to a lesser degree, in our view. Recent progress is encouraging, such as passage of a new bankruptcy code, which should accelerate the resolution of insolvent firms – currently among the slowest anywhere. But major reforms are politically complicated. The Goods and Services Tax would unify India's state value added tax (VAT) into a single federal VAT and could significantly increase trade across state boundaries. However, many states oppose it because they might lose revenue and political control. In the private sector, barriers to corporate restructuring, including restrictions on downsizing or moving plants, can prevent firms from improving operating performance.
3. External shocks would likely hit equities and the currency more than local government bonds. We judge local government bonds in India to be among the most insulated within EM. But India is hardly immune. Renewed global financial tightening could once again precipitate selling of equities and the rupee, indirectly raising bond yields temporarily via imported inflation. Foreign investment quotas limit this impact (non-residents hold only about 5% of the bond market capitalization as a result), but India is gradually opening up its domestic fixed income market, which will likely gradually increase the exposure of local bonds to global forces.[4] Geopolitics poses a moderate risk of significant losses across Indian asset classes.

1 Source: Trade and current accounts: Bloomberg L.P., April 16, 2016. Fiscal balance: Ministry of Finance, Feb. 29, 2016.
2 Source: Bloomberg L.P., Foreign reserves: May 6, 2016. Imports: April 30, 2016.
3 Source: Bloomberg L.P., as of May 24, 2016. 10-year government bonds represented by India Govt. bond generic bid yield 10 year. Benchmark high-quality corporate bonds represented by Bloomberg FIMMDA India Corporate Bond Curve AAA 10 year Public Sector Units Index.
4 Source: Bloomberg L.P., May 17, 2016.

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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)	2.87	1.38	0.00	47	-4	23	156	0.17	1.97	3.46	3.19
U.S. Aggregate	3.15	2.15	-0.02	50	-5	32	258	0.38	2.02	3.43	2.72
U.S. Mortgage-backed	3.67	2.36	0.01	20	-3	-16	181	0.16	0.83	2.14	2.56
Global Inv Grade Corporate (USD hedged)	3.84	2.56	-0.11	143	-15	55	515	1.03	3.97	4.44	2.70
U.S. Investment Grade Corporate	4.19	3.07	-0.14	146	-17	76	618	1.37	5.02	5.39	3.03
Emerging Market USD Sovereign	n/a	5.71	-0.15	389	-20	157	906	1.77	7.10	6.90	4.33
Emerging Market Corporate	n/a	5.29	-0.31	374	-36	120	1,032	1.91	6.66	6.35	2.96
Global High Yield Corporate (USD hedged)	6.39	6.80	-0.69	555	-67	231	1,845	3.38	8.16	6.67	-0.27
U.S. High Yield Corporate	6.61	7.37	-0.82	577	-78	233	1,971	3.92	9.15	7.40	-1.12
Bank Loans	4.82	5.15	-0.07	n/a	n/a	n/a	n/a	1.90	4.01	3.25	-0.13
Municipal Bond	4.79	1.84	-0.09	n/a	n/a	n/a	n/a	0.74	1.21	2.42	5.29
High Yield Municipal Bond	5.38	6.49	-0.09	n/a	n/a	n/a	n/a	0.61	2.79	3.37	4.51

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	2.06	1.35	0.04	-0.11	0.94	3.09	2.83
Canada	2.54	1.19	0.13	-0.80	-0.68	0.31	1.89
United Kingdom	3.75	1.57	0.14	-1.31	0.02	3.84	4.31
Germany	2.31	0.02	0.08	-0.92	0.33	2.85	0.97
Italy	3.79	0.99	0.15	-1.39	-0.02	1.13	2.02
Japan	1.15	-0.05	-0.06	0.98	3.82	5.25	6.65
China	3.65	2.89	0.18	-0.77	1.07	1.34	7.45
EM Local Currency Governments	n/a	n/a	n/a	1.39	4.73	6.45	7.07

FX market monitor[1]

	Current	10 year range min	10 year range max	Returns 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
EURUSD	1.15	1.06	1.60	0.62%	5.17%	5.42%	2.02%
USDJPY	106.50	75.82	124.77	5.87%	13.78%	13.08%	12.26%
GBPUSD	1.46	1.38	2.11	1.75%	1.24%	-0.84%	-4.81%
USDCNY	6.48	6.04	8.28	-0.43%	1.57%	0.26%	-4.26%
USDCHF	0.96	0.75	1.39	0.26%	6.30%	4.48%	-2.78%
AUDUSD	0.76	0.60	1.10	-0.71%	6.87%	4.35%	-3.82%
CADUSD	0.80	0.72	1.09	3.58%	11.09%	10.21%	-3.84%
EURJPY[2]	121.94	94.31	169.49	5.06%	8.04%	7.13%	9.88%
EURGBP[2]	0.78	0.70	0.84	1.14%	-3.73%	-5.95%	-6.71%

Sources: Barclays, J.P. Morgan, Bloomberg L.P., as of April 29, 2016. Credit Suisse Leveraged Loan data as of April 29, 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.

Invesco's fixed income team contributors

Atlanta

Rob Waldner
Invesco Fixed Income Chief Strategist
+1 404 439 4844
robert.waldner@invesco.com

Ray Uy
Head of Macro Research
+1 404 439 4822
raymund.uy@invesco.com

James Ong
Senior Macro Strategist
+1 404 439 4762
james.ong@invesco.com

Avi Hooper
Senior Portfolio Manager
+1 404 439 4877
avi.hooper@invesco.com

Tony Wong
Head of Global Research
+1 404 439 4825
tony.wong@invesco.com

Joseph Portera
Head of Global High Income
+1 404 439 4814
joseph.portera@invesco.com

Michael Hyman
Head of Investment Grade
+1 404 439 4827
michael.hyman@invesco.com

Ann Ginsburg
Senior Market Analyst
+1 404 439 4860
ann.ginsburg@invesco.com

Carolyn Gibbs
Senior Strategist
+1 404 439 4848
carolyn.gibbs@invesco.com

Noelle Corum
Analyst
+1 404 439-4836
noelle.corum@invesco.com

London

Sean Connery
Portfolio Manager
+44 20 3219 2714
sean.connery@invesco.com

Josef Portelli
Portfolio Manager
+44 20 3219 2709
josef.portelli@invesco.com

Arnab Das
Head of Macro Research
+44 20 7959 1698
arnab_das@ldn.invesco.com

Louisville

Kevin Collins
Head of CMBS Credit
+1 502 561 3260
kevin_collins@invesco.com

New York

Ivo Turkedjiev
Senior Trader
+1 212 278 9611
ivo.turkedjiev@invesco.com

Hong Kong

Ken Hu
CIO Asia Pacific
+852 3128 6886
ken.hu@invesco.com

Yi Hu
Senior Credit Analyst
+1 852 3128 6815
yi.hu@invesco.com

Invesco's fixed income team contributors continued

Toronto

Alexander Schwiersch
Portfolio Manager
+1 416 324 6187
Alexander.schwiersch@invesco.com

Mumbai

Sujoy Das
Head of India Fixed Income
+91 96 1989 5129
sujoy.das@invesco.com

Krishna Cheemalapati
Portfolio Manager
+91 91 6721 6681
krishna.cheemalapati@invesco.com

Nitish Sikand
Portfolio Manager
+91 98 3380 1842
Nitish.sikand@invesco.com

Invesco Fixed Income: Global perspective and deep local market knowledge

Global presence

- Regional hubs in Atlanta, London and Hong Kong
- Local knowledge in 12 locations
- Over USD 233.8 billion in assets under management

Experienced team

- Over 160 investment professionals
- Averaging 17 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 & trading	74	12	20
Global research	87	8	15
Total investment professionals	161	10	17
Business professionals	61	12	19
Total fixed income employees	222	11	18

Source: Invesco.

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

Important information

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