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Global macro strategy

Brave new world order: yield starvation versus (geo) political and policy risks

The world economy and financial markets have been buffeted over the past year by national and geopolitical shocks, yet the current synchronized upswing across the world's largest economies – the first since the Global Financial Crisis (GFC) – so far, remains unscathed. Growth is up but inflation is low, and major central banks remain accommodative amid monetary policy normalization in the US. Asset price valuations are stretched, yet yield hunger – if not outright yield starvation – persists.

Three key themes have emerged, in our view, across geopolitics, national economic policies and the financial markets. We call them the "good, the bad and the ugly":

- **The good:** The synchronized global cyclical upswing will likely continue. This means good growth but inflation generally below major central banks' targets, encouraging policy normalization but without tightening too much.
- **The bad:** Global nominal growth is weak due to trends and structural realities in the developed and emerging markets – adverse demographics and low productivity growth restrict growth.
- **The ugly:** Key political and policy threats represent downside risks to the current cyclical upswing: US President Trump's rhetoric may yet become policy and undermine globalization; China's monetary tightening to promote financial stability and structural reform may slow global growth; the eurozone is growing above trend, but inflation is below desired levels and Brexit looms as the European Central Bank (ECB) embarks on tapering.

The good: first synchronized cyclical global upturn across major economies since the GFC
Easy monetary policy is helping to drive above-trend growth in the US and the eurozone. Even though the US Federal Reserve (Fed) has tapered, is now tightening and is likely to reduce its balance sheet size, financial conditions remain fairly easy with a soft US dollar, relatively low real interest rates and buoyant stock markets – all supporting growth. Easy money has also helped support UK growth, despite the risks from Brexit, though now, the UK economy is slowing amid rising inflation. Japan is finally growing above trend, benefiting from both easy money and global recovery. China is the one large economy where easier policy has arguably worked too well, with growth and inflation running above target – hence the People's Bank of China (PBoC) is actively tightening.

While growth is perking up, inflation has been largely missing in action. With inflation expectations already subdued, labor productivity low and credit trends in many major economies modest after the housing bubble excesses, the risks are asymmetric: Inflation expectations are more likely to shift downward into disinflation – even toward deflation – than upward to high and rising inflation.

Low inflation means that major central banks are duty-bound to maintain relatively loose monetary conditions. An environment of low inflation and steady growth could help elongate the credit cycle by allowing central banks to maintain easy monetary stances for longer, which we believe sets up a supportive environment for credit assets.

The bad: the productivity puzzle, declining trend growth, and "low-flation"
The long-term outlook is not as bullish, however, because so-called "potential," or long-term growth, in the major developed markets is declining. This owes to weak labor force and productivity growth and because inflation is likely to remain low – perhaps below targets. There is as yet no convincing explanation or solution for the fall in productivity growth since the GFC, but it does seem to be a fact of life – as do deteriorating demographics. Following the baby boom generation, labor forces across most developed countries have peaked or are already shrinking and populations are aging. Some key emerging markets are already following the same path for various reasons – notably China, Russia and Central Europe, and others will likely follow, notably Brazil.

The ugly: (geo)political and policy risks threaten developed market deflation and emerging markets inflation expectations

Threats to the current cyclical recovery and the long-run outlook are skewed toward deceleration and deflation rather than overheating, given already low potential growth and inflation. The resulting gradual, limited monetary policy normalization by major central banks serves as insurance against growth and inflation downside pressures – by encouraging yield seeking. But when and if risks materialize, market participants may be heavily exposed to risky asset classes. Exits or hedging will likely be costly and losses may be significant. So it's critical to be mindful of the risks, especially in China, the US and Europe:

China monetary over-tightening could endanger the global upturn, especially in emerging markets

China has supported the current global upswing by addressing its growth and economic rebalancing challenges of 2015-16 that had threatened to export a deflationary shock by a sharp devaluation. In doing so, however, it has reflated growth through rapid credit growth, which may have gone too far. So the PBoC is now tightening monetary and credit policies, creating concern about over-tightening. In addition, supply-side and state enterprise reform might accelerate after the October-November National Party Congress, which might also slow global growth. These risks are worth monitoring very closely, though the likelihood is that the PBoC will ease up on the brakes if the economy starts to slow too rapidly, given the high priority of its 6.5% growth target.

US President Trump's campaign rhetoric moderated by checks and balances but risks remain

The threat of restrictive trade and immigration policies, which could have severely undermined globalization, has moved from a central scenario during the early days of President Trump's term, to a risk scenario. In addition, the president will likely need to recast much of the Fed Open Market Committee in the coming year. Some members of Congress would like a more hawkish, rules-based Fed, but others might want easier policy and a weak dollar to encourage investment and hiring in the manufacturing sector, as they eye the 2018 mid-term elections. In all likelihood, the difficulty of radical policy change in the US political system suggests there is more noise than signal. Indeed, equities had been priced for deregulation, tax reform, fiscal stimulus, and bonds and currencies for low inflation and no real change in trade policies. The risk is that a political shift could disrupt this consensual complacency.

Eurozone event risks sharply reduced by the French election, but reform is still a major challenge
The balance of these risks points to sub-par growth, rather than event risk or disintegration of the European Union (EU). The election of Emmanuel Macron as French President on a pro-EU/eurozone and open economy platform and his large majority in parliament significantly reduces short-term event risk. Italy will probably resist radical reform and may yet represent an existential threat to the euro; the coming election due in early 2018 could be another crucial milestone in both Italian politics and EU integration. Germany is likely to maintain a preference for harmonization of major budget, social security and financial-sector policies instead of full EU integration. This policy outlook suggests continued eurozone stability amid low inflation and the continuation of easy ECB policies, allowing scope for the tapering that is around the corner. Here again, the longer-term risk is that markets are lulled into yield seeking, raising the risk that the eurozone is not robust enough for the next shock or slowdown.

There is also a near-term risk that the ECB may overdo it as it embarks on its own tapering, in a potential re-run of the Fed-triggered "taper tantrum" that undermined risk appetite in 2013-14. However, we believe this risk will be well managed by the ECB, which has the Fed's playbook to build on. Furthermore, as the ECB catches up to the Fed, the dollar is likely to remain soft, which is typically very supportive for global financial conditions and growth, because of the dollar's role in international finance and in commodity and goods trade.

UK election surprise raises both hope of avoiding Brexit and risk of disruptive Brexit
Delays are likely in Brexit negotiations due to UK domestic political instability, in turn raising both the hope that Brexit might not happen after all, and the chance of the most negative scenario – that the UK "crashes out" of the EU with no deal or transition period. This risk is mostly UK-specific, though there might be some spill-over to the rest of the EU and some fear of global risks if talks are acrimonious, or if there are hints of trade war.

The long term outlook: yield starvation despite risks
The combination of a decent but non-inflationary growth cycle and deflationary risks implies gradual, limited monetary policy normalization by major central banks. Beyond the current cycle, steady-state global interest rates will likely remain low compared to history in nominal terms, given low trend growth and inflation. Our low-growth, "low-flation" world will likely remain starved for yield, driving funds flows into risky asset classes, despite the event risks that almost surely lie ahead.

Arnab Das, Head of EMEA and Emerging Market Macro Research

Global macro strategy (continued)

Interest rate outlook

US: While we expect US growth to continue at a solid pace, inflation is likely to stay low for the next several months before moving higher in 2018. This does not affect our forecast for the Fed to begin tapering its reinvestment program in September. However, the inflation outcome will be critical in determining when the Fed raises the fed funds rate again. If inflation stays low, this may not occur until the middle of 2018. Global monetary policy will continue to have a larger effect on long-term US rates, in our view. Tighter ECB policy and a rising global term premium are likely to push US interest rates higher by the end of the year.

Europe: Economic growth in the euro area has continued to improve. The rebound in growth and inflation (albeit still below the ECB target) has elicited some less dovish rhetoric from ECB governing council members. We now expect the ECB to taper its quantitative easing program further in January, lowering bond purchases to EUR40 billion a month. There is a possibility that it may increase interest rates at some point in the next 12 months but the probability of such a move has fallen over recent weeks, as the euro has continued to appreciate and euro area inflation slipped back to 1.3% in June from 1.4% in May and 1.9% in April.[1]

China: The onshore Chinese government bond (CGB) yield curve bull steepened as short-term rates fell faster than long-term rates in the first half of July. Short-term rates dropped thanks to abundant liquidity earlier in the month, while long-term rates were relatively stable. Risk appetite is expected to fall sharply following the strong remarks in the National Financial Work Conference, which is positive for government bonds in the medium term. In the near term, strengthening financial regulation and deleveraging efforts together with tax payments are likely to create short-term volatility in liquidity conditions. Following the conference, we expect government bonds to outperform in the second half of 2017 while credit spreads, especially for lower credit quality issuers, likely have room to widen.

Japan: The Japanese economy continues to grow in excess of its potential with leading indicators pointing to a likely continuation of this recent trend. Prime Minister Abe's approval rating has deteriorated somewhat recently as his name has become associated with a number of domestic scandals. However, we believe that Abe will switch his focus from his personal agenda preferences, such as constitutional reform, and focus more on growth-enhancing measures going forward. If he does, Japanese voter support should resume. Japanese government bond yields continue to trade in a very tight range of 0-0.1%, and we expect that range to hold.[2] The Bank of Japan (BoJ) will likely keep policy on hold, but continue to reduce the monthly rate of asset purchases as long as conditions permit.

UK: The consumer could struggle to contribute to UK growth over the coming years. Against a backdrop of rising house prices, rising real wages and low inflation, consumers have been happy to spend down savings or take on increased levels of credit card debt. The good times are potentially coming to an end, however. Savings are now down at all-time lows, real wage adjustments have turned negative, banks are tightening lending criteria and the housing market is facing a lack of buyers. A pick-up in exports (on the back of a weaker pound) or a new minority government that places less focus on austerity is unlikely to be able to make up for a shortfall. Business investment is also likely to remain subdued while the UK's ongoing relationship with the EU remains unclear. We remain constructive on Brexit longer term, with the view that the UK will eventually agree to a softer Brexit or eventually opt to remain in the EU. While the drama plays out, we continue to favor remaining underweight gilts relative to US Treasuries. We expect the Bank of England to keep policy on hold through 2018.

Interest rate outlook

Canada: After hitting lows for the year in June, 10-year government bond yields hit a two-year high of 1.89% in July.[3] The Bank of Canada (BoC) expectedly increased its benchmark rate by 0.25% to 0.75% at its July meeting.[4] The statement was upbeat as well, brushing off softer inflation numbers as likely temporary. The BoC's optimism will likely keep the possibility of another rate hike alive at each of its upcoming meetings. We expect interest rates in Canada to rise from current levels, but are looking for signs that interest rates may have topped out in the short term.

Australia: The Reserve Bank of Australia (RBA) held its benchmark interest rate steady at 1.50% as expected in July.[5] The statement was unexpectedly neutral in tone, giving no hint of a rate hike anytime soon. The RBA continues to be concerned with the leverage-driven housing market. This concern will likely keep the RBA from lowering interest rates while stubbornly low inflation, especially in wages, may keep it from raising rates. While there have been a few signs of economic improvement, the bank will likely be on hold for the foreseeable future. We, therefore, remain neutral on Australian interest rates.

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

1 Source: Eurostat, data as of June 30, 2017.
2 Source: Bloomberg L.P. as of June 19, 2017.
3 Source: Bloomberg L.P., July 19, 2017.
4 Source: Bank of Canada, July 12, 2017.
5 Source: Reserve Bank of Australia, July 4, 2017.

Currency outlook

USD: Our expectation of a strong global growth environment suggests that the performance of the US dollar should be mixed. Strong global growth implies that non-US growth should be accelerating. This means that foreign central bank policy is likely to converge toward the Fed's. This should drive an environment where the US dollar underperforms countries experiencing economic convergence.

EUR: We remain constructive on the prospects for further euro appreciation. The European fundamental backdrop continues to be supportive of a stronger euro, in our view. In general, we believe that the US dollar cycle has reached its zenith, due to global growth convergence, and that ECB policy adjustments going forward are likely to be skewed toward supporting longer-term euro strength as political risks recede.

RMB: We expect the CNY/CNH currency pair to trade relatively strongly in the weeks ahead. Softness in the US dollar is expected to continue to support the renminbi. The gradual pace of renminbi internationalization and capital account opening emphasized by President Xi in the National Financial Work Conference indicates continued capital controls in the foreseeable future and potential stability in the RMB/USD exchange rate. Our expectation that the exchange rate will likely trade in a range of 6.80-6.99 in the second half of 2017 remains unchanged, with the direction within the range subject to US dollar strength.

JPY: We expect the yen to be more influenced by non-domestic drivers in the near term. If global central bankers do not tighten policy by as much as is currently anticipated, this could be a catalyst to support the yen. We expect the yen to trade against the US dollar in a range of 110-115, but with yen positioning at its most underweight in a year, it may trade toward the lower end of that range in the month ahead.

GBP: Our longer-term view on sterling remains constructive, based on our more optimistic view of how the Brexit discussions will likely conclude (soft Brexit or UK remains in the EU). Indeed, it has been interesting to see sterling strengthen quite meaningfully (against the US dollar) since the start of the year as the probability of a hard Brexit has diminished somewhat. The headwinds to our longer-term view are likely to come in the form of fractious Brexit discussions (pointing to an increased possibility of "no deal") or the new minority government overly loosening the purse strings to ward off the threat of losing power before the year is out (causing an increased budget deficit).

CAD: The Canadian dollar has been in a slow decline over the last year. While the BoC increased the benchmark interest rate as expected by 0.25% to 0.75% at its July meeting, oil prices appear to have peaked for the year due to US oil production, presenting a headwind for the currency.[1] We are neutral on the Canadian dollar, and concerns about overleveraged Canadian consumers leave us looking for opportunities to go short the currency.

AUD: The RBA held its benchmark interest rate steady at 1.50% as expected at its July meeting.[2] The statement was neutral overall and acknowledged the economic weakness in the first quarter. The RBA continues to be concerned with the housing market and that concern, combined with stubbornly low inflation, should keep it on hold and keep its target rate at 1.50% for the foreseeable future. We remain neutral on the Australian dollar.

Ray Uy, Head of Macro Research and Currency Portfolio Management, James Ong, Senior Macro Strategist, Brian Schneider, Head of North American Rates, Scott Case, Portfolio Manager, Sean Connery, Portfolio Manager, Yi Hu, Senior Credit Analyst, Ken Hu, CIO Asia Pacific, Alex Schwiersch, Portfolio Manager

1 Source: Bank of Canada, July 12, 2017.
2 Source: Reserve Bank of Australia, July 4, 2017.

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

Global credit themes

Geographical themes

Investment grade (IG): Global central bank forces, global growth impulse, fiscal policy changes

Rationale

US, Europe and Asia IG have seen strong investor demand due to easy global monetary policy, so tracking any changes in policy guidance is crucial. Fundamentals are stable to improving due to positive global growth outlook. Leverage remains at cycle highs but is stabilizing. US tax policy changes could lead to less issuance going forward. European credit markets are generally earlier in the cycle and less levered, although Brexit and political uncertainties remain.

IFI strategy

Favor gaining exposure to selected senior and higher quality subordinate financials, consumer cyclical, technology, media and telecommunications (TMT) and pipelines. Remain cognizant of selective tight valuations.

Emerging markets (EM): Reversal of reflation trade, favorable financial conditions supportive

Rationale

Rise in core government yields indicates early sign of trend reversal in EM credit and currencies, but no strong evidence yet of overt tightening in financial conditions. Global inflation pressures remain conspicuously absent.

IFI strategy

Signs of market trend reversal argue for maintaining a broadly defensive posture until valuations adjust. That said, as yet there is no proximate trigger for going underweight absent more obvious catalysts, such as a breakdown in oil prices or core duration.

US commercial mortgage backed securities (US CMBS): Notable decline in primary market issuance, watching retail industry fundamentals

Rationale

Negative retail news has recently dominated the headlines. However, we are generally not advocates of selling stronger US CMBS credits given they are often difficult to replace. Further, we think the space should continue to benefit from limited supply as property price growth continues.

IFI strategy

We think AAA-rated US CMBS look less attractive. Given the significant move in spread tightening we prefer seasoned US CMBS as cycle progresses. Credit-differentiation is accelerating, placing a premium on selection. Rich valuations and poor hedge-adjusted carry weigh on shorter-term high quality paper.

US residential mortgage backed securities (US RMBS): Favorable fundamentals, valuations fair, Credit Risk Transfer (CRT) securities market depth improving

Rationale

Mortgage underwriting quality remains high, the home price outlook remains supported by limited housing supply, and long-term negative net issuance remains the dominant force in US RMBS. But following outperformance in recent months in legacy US RMBS and below-IG CRT, valuations appear stretched relative to other asset classes.

IFI strategy

Favor higher quality legacy prime, alt-A, and seasoned BBB-rated CRT. Avoiding sub-prime, coastal concentrations, and option adjustable rate mortgages.

US asset backed securities (US ABS): Value in floaters, fundamentals normalizing, favorable technicals

Rationale

Normalization of credit underwriting and forecast for a healthier economy should support consumer credit performance in 2017. Recent widening in swap spreads and LIBOR rates provide an opportunity to add at fairly attractive levels. As the overall market continues to weigh the longer-term impact of a Trump administration and additional rate hikes this year, such uncertainty should be supportive of a more stable, shorter-duration US ABS market.

IFI strategy

Favor adding exposure to floaters where collateral performance remains stable. Believe senior prime auto US ABS and esoteric issuers can provide opportunities. Avoiding deep subprime auto US ABS.

Sector themes

Commodities: Global supply concerns creating energy volatility, prefer pipelines

Rationale

Expect global IG credit risk premia to remain volatile as energy and metals credits reflect supply imbalances, offset by credit friendly financial engineering. Credit quality in focus due to still-modest economic growth and risk of volatility due to OPEC, US crude supply, fiscal policy implementation and Fed uncertainty.

IFI strategy

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

Consumer story more nuanced globally, watching US fiscal policy influences

Rationale

Solid US labor market and consumer confidence are supportive, but consumers more value and delivery conscious, while international retail demand remains uneven, due partly to the strong US dollar and volatile capital markets. Watching European consumer for post-Brexit behavior shift.

IFI strategy

Favor selected US consumer sectors including leisure and housing-related sectors. Negative on "big box" retailers that lack differentiated products. Favor EM consumer sectors on a selective basis. Incrementally more cautious on automotive original equipment manufacturer (OEM) sector.

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

Rationale

M&A activity has moderated but remains a risk, driven by large overseas cash balances, low all-in financing cost, still soft organic revenue 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. Believe a discriminating approach to this strategy is warranted due to lower, but still large, M&A-related pipeline.

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, cell towers and select wireless issuers. Have avoided hardware original equipment manufacturers.

Yield curve themes

Credit curve positioning, long end valuations getting full

Rationale

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

IFI strategy

Favor 7-10 and select 30-year points on US IG and EM credit yield curve. New issuance has remained strong year-to-date, but is expected to decline as the pace of mergers returns to normal.

Tony Wong, Head of Global Research, Joe Portera, CIO High Yield and Multi-Sector Credit, Michael Hyman, CIO Global Investment Grade and Emerging Markets, Mario Clemente, Head of Structured Investments

This section highlights the views of Invesco Fixed Income's credit analysts across a broad range of fixed income assets managed by Invesco.

Global credit strategy

Outlook for US credit in the second half of the year

No help from Washington yet, but US credit supported by fundamentals and global demand

The financial markets started the year enthusiastically after the US presidential election, but momentum appears to have peaked as reality has set in. Investors had high expectations for policy changes but have since been disappointed with the follow through. Healthcare has been a perfect example, as policy proposals marketed as a quick "repeal and replace" have turned into a lengthy debate, potentially resulting in another compromise that will only place more bandages on an ailing system. In addition, tax reform will likely not get any easier, as the new Congress has initially proven to be a headwind to change.

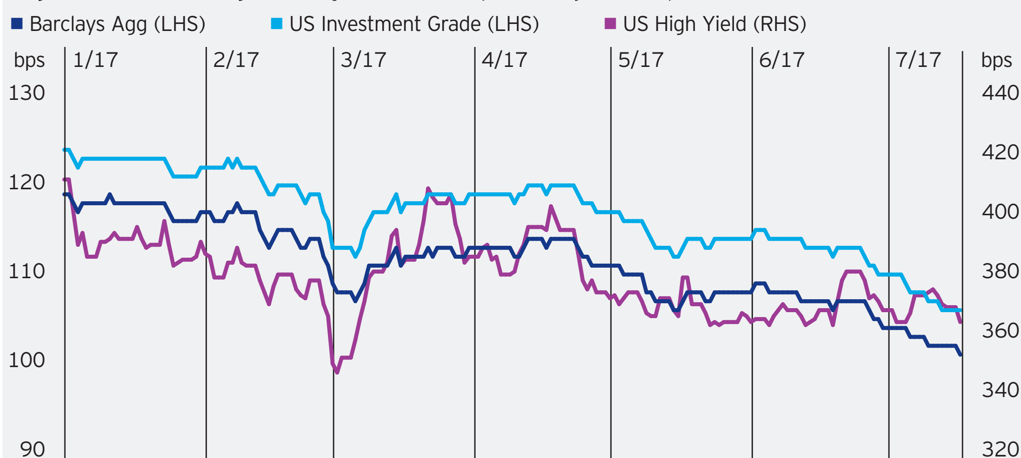
We continue to think that some version of tax reform will eventually get passed, potentially in the form of reduced corporate taxes and/or a tax holiday for repatriated income that would likely be positive for US companies. We also believe that progress toward establishing a less stringent regulatory environment could aid future economic growth.

As political debates play out, we expect credit markets to remain well supported by foreign demand as global central bank policies have produced meaningful interest rate differentials, despite growing hedging costs. In addition, debt issuance will likely be contained, as debt-funded merger activity is anticipated to decline with the return of global growth impulses.

Global growth remains supportive of corporate credit

There were some bright spots in the first half of the year, as the US economy and employment continued to show steady growth. Both of these trends were supportive of credit fundamentals and investor sentiment, and spreads ground tighter across all credit sectors.

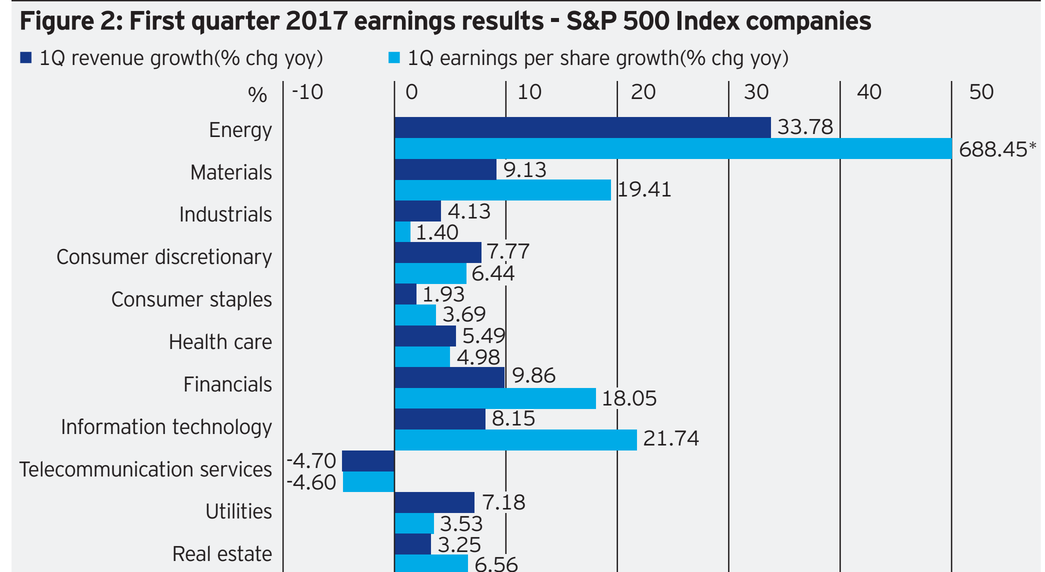
Figure 1: Bloomberg Barclays Indices - option adjusted spreads



Source: Bloomberg L.P., Barclays, data from Jan. 1, 2017 to July 11, 2017. Indices are: Bloomberg Barclays US Aggregate Credit Index, Bloomberg Barclays Investment Grade Corporate Index, Bloomberg Barclays US High Yield 2% Issuer Cap Index.

First quarter earnings for the Standard and Poor's (S&P) 500 Index companies were up over 14% year-over-year, with revenue growth of 7.8% (just under 4% excluding energy and finance). We expect second quarter 2017 earnings growth of around 6.7% year-over-year and revenue growth of around 4.8%. While these forecasts represent a decline in sequential growth expectations, they remain above fourth quarter 2016 growth rates.

Figure 2: First quarter 2017 earnings results - S&P 500 Index companies



Source: Bloomberg, L.P., data from Jan. 1, 2017 to March 31, 2017.
The Global Industry Classification Standard was developed by and is the exclusive property and service mark of MSCI, Inc. and Standard & Poor's.
*Bar has been shortened to fit graph.

Sector outlooks

As active managers, we are focused on rigorous fundamental research and our bottom-up analysis continues to drive our portfolio positioning and security selection. Here are some of our forward views on key sectors:

Energy – We continue to prefer cash-generative, midstream assets with less direct commodity exposure. We also prefer higher quality exploration and production (E&P) companies with the flexibility to sustain periods of weak commodity prices.

The global oil supply/demand imbalance remains pressured, with the positive impact of OPEC production reductions being partially offset by increasing US drilling activity. Any further production cuts could result in market share losses to other worldwide producers, while potentially benefiting US shale, whose breakeven costs have fallen dramatically due to both continued technological innovation and oil field servicer cost deflation. However, we think the Saudi Kingdom will attempt to defend the oil price level in advance of an expected 2018 initial public offering of Saudi Aramco. Thus, prices in the medium term may remain volatile and range-bound.

Retail – We remain cautious on the sector, particularly on apparel retailers, while favoring companies that are internet-resistant, including discount stores and companies with well-defined e-commerce strategies.

The consumer continues to reduce discretionary spending while increasing spending on non-discretionary expenses, like healthcare and housing. Within discretionary spending, consumers appear to prefer experiences over goods. As a result, the traditional retail sector has struggled against a relentless onslaught from online competition. We expect this ongoing secular change to have a meaningful impact on traditional retailers for some time. The number of store closures and bankruptcies will likely continue to mount this year with many stores and companies likely headed toward liquidation. This will likely negatively impact both retail operators and retail real estate owners facing lower retail square footage demand across the US.

Healthcare – We expect volatility in healthcare credit to remain high, but most sub-sectors within healthcare remain investable and we believe volatility should be viewed as a buying opportunity.
The sectors with the most risk continue to be highly leveraged acute care hospitals that are more exposed to cuts in Medicaid coverage (federal health insurance for those needing financial assistance). Also at risk are less innovative specialty pharmaceutical companies that are losing revenues, due to generic competition and pricing pressure, faster than they can be replaced by development pipelines. Changes in healthcare policy remain uncertain and the proposals seem to change depending on the day. What we do know is that Republicans are having a much more difficult time agreeing on what should be changed under the Affordable Care Act than many observers expected. The debate is complicated by the fact that healthcare is expensive, particularly for an aging population.

Telecommunications, media and technology (TMT) – While "cord-cutting" (the practice of canceling or forgoing cable television subscriptions or landline telephone connections in favor of alternative internet-based or wireless service) continues to be a risk, we like the sector for its stable earnings profile, driven by growth in broadband.
We expect mergers and acquisitions (M&A) to continue to drive the TMT sector as Washington promotes a more favorable regulatory environment. In the wireless segment, M&A risks have risen and will likely remain high, driven by strategic positioning in preparation for fifth generation wireless and mobile systems. The cable sector is also likely to continue to see M&A, driven by strategic interest in content and the consolidation of technologies.

Financials – Spread premiums available in subordinate securities are currently very tight after a lack of supply in the first half of 2017, but we expect issuance to pick up in this space in the second half of the year.
We expect continued easing of regulations even without a full repeal of the Dodd-Frank Act (legislation to regulate the financial industry), and much can be done by political appointees without approval from Congress. Banks have built strong capital and liquidity positions over the past few years, as evidenced by the recent Fed stress tests (Comprehensive Capital Analysis and Review tests) and subsequent regulatory approval of shareholder distributions. A higher and/or steeper yield curve coupled with improving growth bodes well for continued strength in the sector.

Positive on US credit overall
We remain positive overall on US credit fundamentals, driven by supportive economic growth in the US and globally. The healthy US labor market should continue to provide the foundation for ongoing recovery in consumer confidence and ultimately spending. We expect global demand for credit assets to remain strong and believe new issue supply is likely to be contained. Our optimism is tempered, however, by valuations that, in most markets, are approaching historically tight levels. Our largest concern centers on the potential for a Fed policy error that could tighten financial conditions in the face of still-modest economic growth. In addition, limited progress on US healthcare and tax legislation could dampen investor confidence and result in higher risk premiums.

Tony Wong, Global Head of Credit Research, Liquidity and Municipals

Ray Uy,
Head of Macro Research and Currency Portfolio Management

James Ong
Senior Macro Strategist

Jay Raol, Ph.D.
Senior Macro Analyst

Read more about IFI's quality currency strategy in "Quality currencies can potentially diversify against growth risk."

The bottom line

Quality currencies can potentially help investors diversify credit portfolios against "growth risk"

We speak with Ray Uy, Head of Macro Research and Currency Portfolio Management, James Ong, Senior Macro Strategist and Jay Raol, Senior Macro Analyst, about an approach to portfolio diversification utilizing "quality currencies." The approach aims to help diversify global credit portfolios using currencies that offer a good store of value during times of market stress.

Q: When we talk about the need to diversify investment portfolios, what is a key risk that investors are trying to guard against?
Ray: Some of the most common assets that investors own, such as equities, high yield bonds and real estate, have historically had high correlations to each other. The reason for this high correlation is that all of these asset classes are dependent upon growth. For example, during the global financial crisis, as the world tipped into recession, all of these assets experienced very negative returns. Traditionally, government bonds have been used to hedge against this "growth risk." However there have been long periods when government bonds did not provide good protection. We believe investment portfolio performance is improved by seeking alternate forms of diversification. We believe "quality currencies" are a very good alternative.

Q: What are "quality currencies"?
James: Quality currencies are currencies that are likely to hold their value during times of market stress. Quality currencies tend to be found in countries with stable-to-falling inflation and high, or rising, rates of productivity. An important feature of quality currencies in general is consistency of performance through the market cycle – similar to other quality assets such as high quality credit.

Q: How can adding quality currencies to credit portfolios aid diversification and potentially provide some downside protection to portfolios?
Jay: We have found that quality currencies have historically tended to appreciate when risky assets declined. Combining these two return profiles has yielded a portfolio with higher risk-adjusted returns and lower drawdowns, compared to a portfolio of only risky assets.[1]

Q: Why is the quality currency factor complementary to utilizing government bonds in a diversification strategy?
Jay: At current low yields, it is not clear that government bonds will be an effective hedge for risky assets. This is because it is not certain how much lower bond yields can go (and how much higher bond prices can rise) to offset any drop in risky asset prices. To give an idea, short-term US Treasury rates fell by over five percentage points in the past two recessions.[2] This is not possible at current levels of short-term US interest rates of around 1%.[3]

Q: Why use quality currencies as a portfolio hedge instead of options, such as put options on the S&P 500 Index?
James: Quality currencies have displayed a long-term positive return. Put options, on the other hand, have historically detracted from portfolio returns because they have tended to be an expensive form of insurance. A risky portfolio that includes a quality currency allocation has the potential to outperform a portfolio of risky assets with an allocation to put options, in absolute return terms.

Q: Why is Invesco Fixed Income uniquely positioned to implement the quality currency strategy?
Ray: Invesco Fixed Income's (IFI) research platform is designed to evaluate currencies from a both a top-down, quantitative perspective and a bottom-up, qualitative standpoint. Our strong macro-oriented research process is the foundation of our quality currency factor. Identifying countries with falling structural inflation and rising productivity is the basis of identifying quality currencies. IFI has 26 macro research professionals located in the US, the UK and Hong Kong, analyzing more than 20 countries.[4] In addition, IFI's Currency Portfolio Management team has managed currency strategies for over a decade.

1 Source: Invesco Fixed Income calculations, Feb. 1, 1995 to Sep. 30, 2016.
2 Source: Bloomberg L.P., Last two recessions according to the National Bureau of Economic Research: March 2001 to Nov. 2001 and Dec. 2007 to June 2009.
3 Source: Bloomberg L.P, July 19, 2017.
4 Source: Invesco, June 30, 2017.

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)	2.71	1.62	0.10	40	-2	23	156	-0.28	0.98	1.43	-0.41
U.S. Aggregate	3.06	2.55	0.09	43	1	32	258	-0.10	1.45	2.27	-0.31
U.S. Mortgage-backed	3.53	2.87	0.13	32	7	-16	181	-0.40	0.87	1.35	-0.06
Global Inv Grade Corporate (USD hedged)	3.58	2.56	0.07	109	-5	55	515	0.02	1.91	3.14	2.84
U.S. Investment Grade Corporate	4.01	3.19	0.04	109	-4	76	618	0.31	2.54	3.80	2.28
Emerging Market USD Sovereign	n/a	5.38	0.12	310	5	157	906	-0.14	2.24	6.19	6.04
Emerging Market Corporate	n/a	4.61	0.06	254	-3	120	1,032	0.20	1.98	5.01	6.81
Global High Yield Corporate (USD hedged)	6.15	5.04	0.12	353	-1	231	1,845	0.16	2.21	5.00	12.39
U.S. High Yield Corporate	6.45	5.62	0.13	364	1	233	1,971	0.14	2.17	4.93	12.70
Bank Loans	4.92	5.07	0.03	n/a	n/a	n/a	n/a	-0.06	0.75	1.96	7.49
Municipal Bond	4.75	2.27	0.14	n/a	n/a	n/a	n/a	-0.36	1.96	3.57	-0.49
High Yield Municipal Bond	5.15	6.10	0.05	n/a	n/a	n/a	n/a	-0.22	1.99	6.13	1.22

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	2.09	1.90	0.09	-0.16	1.19	1.87	-2.32
Canada	2.22	1.50	0.35	-1.52	0.33	0.94	-2.51
United Kingdom	3.49	1.21	0.20	-2.08	-1.34	0.16	-1.00
Germany	2.09	0.09	0.18	-1.17	-1.15	-1.88	-4.46
Italy	3.45	1.35	0.01	0.15	1.05	-0.93	-3.07
Japan	1.06	0.16	0.04	-0.27	0.04	-0.34	-3.94
China	3.46	3.59	-0.14	1.02	-0.86	-1.06	-1.03
EM Local Currency Governments	n/a	n/a	n/a	0.67	2.38	5.69	6.68

FX market monitor[1]

	Current	10 year range: min	10 year range: max	Returns: 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
EURUSD	1.14	1.05	1.60	1.35	6.50	8.69	2.05
USDJPY	113.38	75.82	124.77	-1.77	-2.18	3.69	-9.57
GBPUSD	1.29	1.22	2.11	0.45	3.64	5.39	-2.46
USDCNY	6.79	6.04	8.28	0.28	1.39	2.50	-1.91
USDCHF	0.96	0.75	1.39	0.84	3.94	6.24	1.03
AUDUSD	0.77	0.60	1.10	3.89	0.74	6.64	2.17
CADUSD	0.77	0.72	1.09	3.91	2.88	3.35	-0.74
EURJPY[2]	128.85	94.31	169.49	-3.08	-8.16	-4.60	-11.38
EURGBP[2]	0.88	0.70	0.88	-0.88	-2.67	-3.01	-4.43

Sources: Bloomberg Barclays, J.P. Morgan, as of June 30, 2017. Credit Suisse Leveraged Loan data as of June 30, 2017. Within the Treasury monitor, United States is represented by Bloomberg Barclays US Treasury Index; Canada is represented by Bloomberg Barclays Global Treasury Canada Index; United Kingdom is represented by Bloomberg Barclays Sterling Gilts Index; Germany is represented by Bloomberg Barclays Global Treasury Germany Index; Italy is represented by Bloomberg Barclays Global Treasury Italy Index; Japan is represented by Bloomberg Barclays Global Treasury Japan Index; China is represented by Bloomberg Barclays China Aggregate Treasuries Index; EM Local Currency Governments is represented by J.P. Morgan GBI_EM Broad Diversified Index. In the Fixed Income Monitor, Global Aggregate is represented by Bloomberg Barclays Global Aggregate (US$ Hedged) Index; US Aggregate is represented by Bloomberg Barclays US Aggregate Index; US Mortgage-backed is represented by Bloomberg Barclays US Mortgaged-backed Index; Global Investment Grade Corporate is represented by Bloomberg Barclays Global Aggregate Corporate (US$ hedged) Index; U.S. Investment Grade Corporate is represented by Bloomberg Barclays Aggregate Corporate Index; Emerging Market USD Sovereign is represented by the J.P. Morgan EMBI Global Diversified Index; Emerging Market Corporate is represented by J.P. Morgan CEMBI Broad Diversified Index; Global High Yield Corporate is represented by the Bloomberg Barclays Global High Yield Corporate (US$ hedged) Index; U.S. High yield Corporate is represented by Bloomberg Barclays U.S. Corporate High Yield Index; Bank Loans is represented by the Credit Suisse Leveraged Loan Index; Municipal Bond is represented by Bloomberg Barclays Municipal Bond Index; High Yield Municipal Bond is represented by Bloomberg Barclays Municipal Bond High Yield Index. Yield to Worst (YTW) is the lowest expected yield calculation given maturity and call features. Option Adjusted Spread (OAS) is the yield difference relative to similar maturity Treasuries that incorporates call, put, sinking fund or paydown features of a bond. Past performance cannot guarantee future results. An investment cannot be made directly in an index. Returns less than one year are cumulative.

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

Invesco 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 and Currency Portfolio Management
+1 404 439 4822
raymund.uy@invesco.com

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

Jay Raol
Senior Macro Analyst
+1 404 439 4840
jay.raol@invesco.com

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

Joseph Portera
CIO, High Yield and Multi-Sector Credit
+1 404 439 4814
joseph.portera@invesco.com

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

Brian Schneider
Head of North American Rates
+1 404 439 4773
brian.schneider@invesco.com

Scott Case
Portfolio Manager
+1 404 439 4775
scott_case@invesco.com

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

Carolyn Gibbs
Head of Investor Engagement
+1 404 439 4848
carolyn.gibbs@invesco.com

Ann Ginsburg
Senior Market Analyst
+1 404 439 4860
ann.ginsburg@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 EMEA and EM Macro Research
+44 20 7959 1698
arnab_Das@ldn.invesco.com

Team contributors

Hong Kong

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

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

Toronto

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

Recent IFI publications

1. **IFI Global Investors' Summit June 2017,** Rob Waldner, Chief Strategist, Head of Multi-Sector, Tony Wong, Global Head of Credit Research, Liquidity and Municipals
2. **Quality currencies can potentially diversify against growth risk,** June 2017, Ray Uy, Head of Macro Research and Currency Portfolio Management, James Ong, Senior Macro Strategist
3. **When US rates rise, it may be time to consider adding emerging market bonds,** May 2017, Julie Salsbery, Senior Client Portfolio Manager
4. **Getting familiar with global portfolio hedging,** April 2017, James Ong, Senior Macro Strategist, Nicole Corum, Macro Analyst
5. **Currency management: a simple roadmap,** April 2017, Ray Uy, Head of Invesco Fixed Income Macro Research
6. **Sizing up Europe's corporate pension gap,** March 2017, Michael Booth, Credit Analyst, Fabrice Pellous, Senior Credit Analyst, David Todd, Head of Global Investment Grade and Emerging Markets Research
7. **Municipal bond market watch Q&A**, March 2017, Stephanie Larosiliere, Senior Client Portfolio Manager
8. **Prime institutional funds may offer renewed value in a post-ZIRP, post-reform world**, January 2017, Robert Corner, Senior Client Portfolio Manager

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