



Global Fixed Income Strategy

February 2016





Invesco Fixed Income

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February takeaways

- US municipal bonds were the top performing asset class in 2015. We expect the drivers of performance, including positive supply/demand technicals, low interest rates and constructive US economic conditions, to persist in 2016. (page 10)
- US residential and commercial real estate performed well in 2015. We expect US real estate prices to continue their rise in 2016, although at a slower pace. (page 12)
- We believe the current market dislocation in collateralized loan obligations (CLOs) may provide investment opportunities across the CLO capital structure. (page 15)

Global strategy perspective

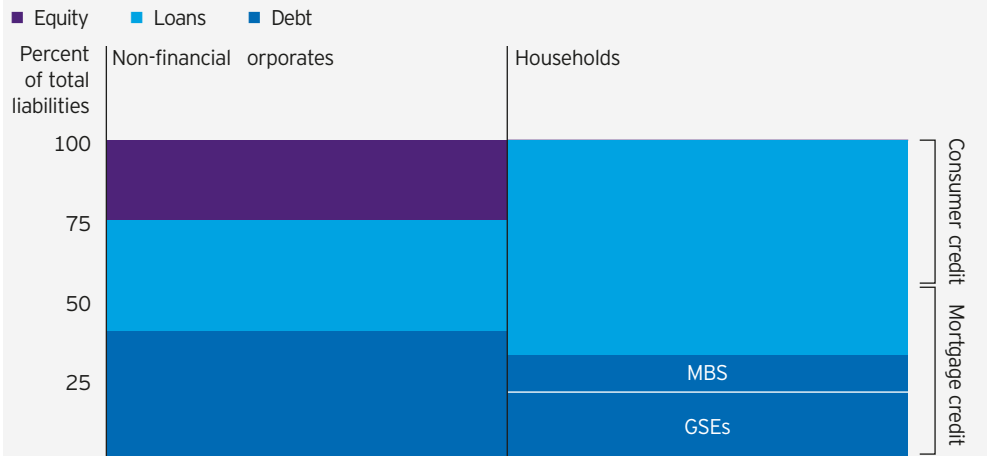
Are US financial conditions too tight?

A number of recent events indicate that financial conditions (lending conditions) have tightened in the United States: declining equity prices, widening credit spreads and increased volatility in financial markets. In general, financial conditions summarize the current state of financial variables such as money market interest rates, long-term interest rates, stock prices, credit spreads and the value of the dollar. These financial variables represent funding costs to companies and households. The tightening of financial conditions may signal stresses in the real economy and may also themselves create stresses that may go beyond financial markets to the real economy. Last month we identified the excessive tightening of financial conditions as a key risk to our US growth forecast. This month we look at financial conditions in detail from a macro and credit perspective, to assess current US lending conditions and their implications for US growth and monetary policy.

Lending conditions provide key to growth outlook

Households and corporates access financing from three major sources: capital markets debt, equity and loans, as shown in Figure 1. Debt includes short-term financing such as commercial paper as well as longer maturity bonds. Loans refer primarily to bank loans, but also include other financial companies. We can see that bank lending is very important for both consumers and corporates, with consumers utilizing banks more heavily while corporates have depended more on capital markets. The importance of these financing channels to both corporates and households means that changes in either their price or availability may significantly impact the level of real economic activity. Thus the recent volatility in equity and debt markets raises some questions about the US growth outlook.

Figure 1: Estimated breakdown of financing sources for corporates and households



Source: Federal Reserve, Russell, Invesco Calculations. As Of Dec. 31, 2015. MBS is mortgage backed securities. GSEs are government sponsored enterprises.

Below we break down US “financial conditions” into three main categories: equity, bank lending and capital markets and examine each one in turn to answer two questions: 1) are US financial conditions too tight? 2) Do current financial conditions pose a risk to our positive US growth outlook?

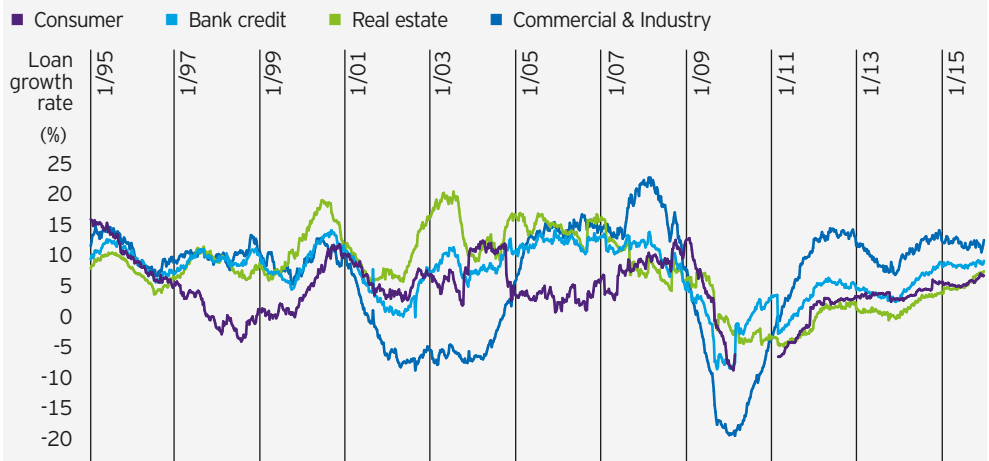
Equity financing

In August 2015, global equity market volatility picked up significantly.¹ At the same time, equity issuance slowed by the second half of 2015.¹ Currently, equity issuance is running at its slowest pace since the 2008 financial crisis.¹ It is clear that equity volatility, driven by the drop in oil prices and global growth concerns, has negatively impacted the equity financing channel.

Bank loans

Recent loan officer surveys point to continued growth and access to loans for households and businesses.² Generally speaking, the overall level of credit standards appears very accommodative. The most recent survey pointed to some weakness in commercial and industrial loans, although we believe this is likely due to the US dollar shock, falling oil prices and weak export markets. In addition, US commercial bank reports of net loan origination continue to run at cyclically high levels. This data is updated weekly by the US Federal Reserve (Fed) and should be a timely indicator if lending conditions deteriorate rapidly. Overall, the US bank loan channel looks quite healthy, in our view.

Figure 2: Loan growth, all US commercial banks



Source: Federal Reserve, data from Jan. 18, 1995 to Feb. 3, 2016.

Capital markets debt

Credit markets

Widening credit spreads have recently been a source of investor concern. Since January 2015, high yield, investment grade and commercial real estate spreads have increased by over 40%.³ This reflects the market's concerns about US growth, the oil shock and global growth. For high yield companies, the spread widening has had a material impact on absolute yield levels as shown in Figure 3. But for the other markets, even though spreads have widened, absolute yields are still historically very low.

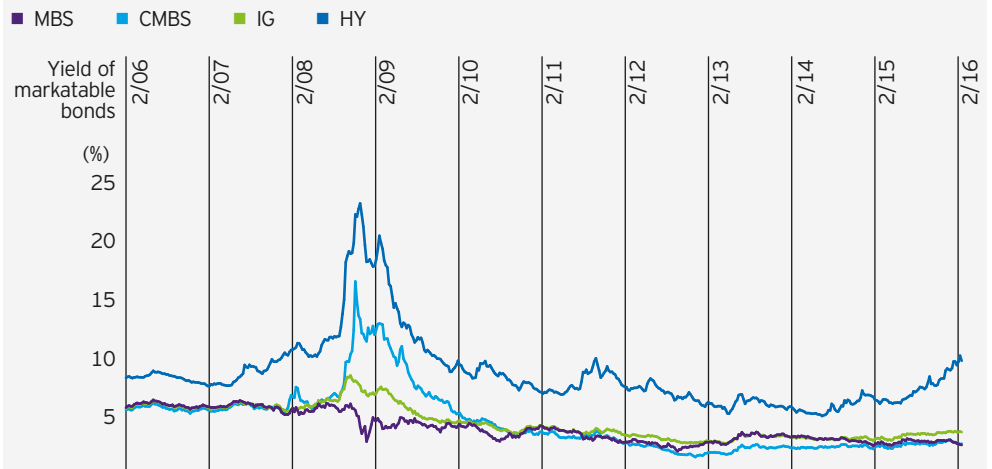
Not surprisingly, in 2016, the pace of high yield debt issuance is running at half the historical pace. In 2015, only USD88 billion dollars in high yield financing was raised compared to a 10-year average of USD125 billion per year - only during the 2008 financial crisis and 2011 European debt crisis were lower amounts raised.¹

For investment grade companies, on the other hand, 2015 issuance was very robust with a record USD1.3 trillion in bonds issued.¹ Issuance has recently slowed to half the historical pace.¹ In 2015, issuance of commercial mortgage backed securities (CMBS) hit a post-recession record of USD101 billion, however, year-to-date issuance is running at its slowest pace in three years.⁴ Finally, mortgage-backed security (MBS) issuance in 2015 was quite robust at a three-year high of USD169 billion and continues to be healthy year-to-date.⁵

Money market

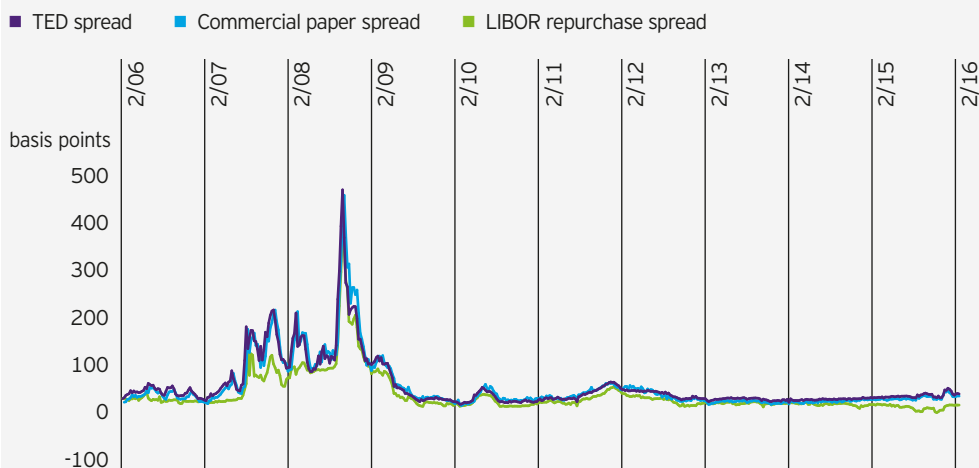
Finally, we consider money market interest rates. Invesco Fixed Income's Global Liquidity team reports that volumes and prices in money markets have been relatively unaffected by the recent volatility in stocks and bonds. Figure 4 shows that the traditional signs of stress in short-term funding markets are absent so far. These data indicate that banks and intermediary financial companies, that borrow at short-term rates and lend at long-term rates, are able to readily access short-term financing necessary for funding loan origination.

Figure 3: US bond yields



Source: Barclays, data from Feb. 24, 2006 to Feb. 18, 2016. The graph shows yield to worst for Barclays indices: High Yield (HY), Investment Grade (IG), Commercial Real Estate-backed Securities (CMBS) and Mortgage-backed Securities (MBS). Indices are as follows: HY is Barclays US Corporate High Yield Index; IG is Barclays US Aggregate Credit Index; CMBS is Barclays CMBS Investment Grade Index; MBS is Barclays US MBS Fixed Rate Agency Index.

Figure 4: Money market spreads



The TED spread is the difference between 3M Libor and 3M Treasury bill. The Libor Repurchase spread is the difference between 3M Libor and the 3M repo rate for US Treasuries. The commercial paper spread is the difference between the 3M commercial paper yield and the 3M US Treasury bill. Indices are as follows: TED Spread: Treasury Euro Dollar Spread Index; LIBOR repo spread: ICE LIBOR USD 3M Rate minus USD 3M General Collateral Repurchase Agreement Rate; commercial paper spread is US Commercial Paper 3M Spread Index: 3M US Commercial Paper Index minus 3M US Treasury Bill yield.

Conclusion

Our assessment of the US equity, bank loan and capital markets financing channels indicate that overall US financial conditions are healthy. While financial conditions have tightened in recent months, on balance, we do not believe they are “too tight” or currently pose a significant risk to real economic growth. We continue to expect private final demand in the United States to be quite solid. For example, we think the positive outlook indicated by the bank loan data is more indicative of future financing conditions than some of the capital markets data. As growth expectations stabilize, we believe Fed policy makers will modulate the expected path of interest rate hikes to provide stability to credit spreads and market volatility. In this scenario, we expect corporate bond issuers to return to the capital markets. We expect 2016 issuance to be healthy, although at a slightly weakened pace relative to the recent three-year average. We do not expect credit growth to return to levels seen in the last few years - policy makers have embarked on a tightening cycle and are seeking to contain the growth in credit. In the minutes of the January Fed policy meeting, committee participants acknowledged “the possible adverse effects of tightening of financial conditions that had occurred” but that the implications “for the [economic] outlook were unclear” and did not warrant a change in their outlook. Many committee participants felt a continuation of these conditions would be equivalent to a further tightening of monetary policy. We think the economy should be able to withstand the current level of financial conditions tightening. We continue to monitor debt issuance and loan growth for any changes to our outlook.

Jay Raol, Senior Macro Analyst

1 Source: Bloomberg L.P., Feb. 18, 2016.
 2 Source: US Federal Reserve, Jan. 31, 2016.
 3 Source: Barclays, Feb. 18, 2016.
 4 Source: Commercial Mortgage Alert, Feb. 18, 2016.
 5 Source: Nomura, Feb. 18, 2016.

Interest rate outlook

US: Volatility in financial markets continues, driving US Treasury yields lower as investors gravitate toward high-quality assets. Although our positive US growth outlook continues to play out as we expected, we could see an adverse impact on growth through the consumption and consumer confidence channels, given heightened uncertainty around financial markets and the global growth outlook. We expect market volatility to persist given a data-dependent Fed and global macro stresses. Therefore, as a hedge, we favor buying US interest rates on any dips.

Europe: Global risk aversion has spread to European assets with European banks and periphery sovereign bonds taking the brunt of the weakness. Given the low levels of growth and inflation in Europe and the level of public and private indebtedness, the threat of a hard landing in China and/or devaluation of the renminbi (RMB) is having a stark impact on European assets. It is important to note that this weakness is a symptom of global concerns around soft emerging market growth and monetary tightening and is not emanating from Europe itself. However, given the impact on financial conditions, the European Central Bank (ECB) is likely to ease further at its March meeting. Aside from asset purchase increases and potential deposit rate cuts, unlimited long-term financing operations (LTRO) might also be offered to prevent any liquidity crisis emerging in the banks until market pressure subsides. It is our opinion that European fundamentals are strong but financial sector pressures and poor liquidity are having a potentially dangerous impact. If action is not taken globally, negative sentiment could become self-fulfilling for domestic growth prospects so we are cautious here.

China: We expect the central bank of China to further ease monetary policy. Consumption and service sector indicators point to robust consumption and services activity, however, inflation, manufacturing and capital expenditures remain weak. Consumer price inflation continues to fall well below the central bank's target and the producer price inflation data continue to signal deflation. Foreign exchange intervention by the Chinese central bank has led to higher offshore RMB interest rates amid tightening offshore RMB liquidity conditions. We currently see more value in offshore Chinese yuan-denominated bonds than onshore bonds.

Japan: The Bank of Japan (BoJ) eased monetary policy at its January meeting in an attempt to get both inflation and inflation expectations back on track. Japanese government bond (JGB) yields tumbled post the meeting, however, the reaction of the Japanese yen (stronger), brought about by concerns over a global economic slowdown, was not anticipated or welcomed by policy officials. Given that oil prices have continued to decline during the first part of the new year, pressure will likely mount on monetary policy officials to undertake even further action, if confidence in the central bank's ability to achieve its 2% inflation target is not to diminish. We expect 10-year JGB yields to trade in a -0.15 - 0.15% range over the near term.

UK: The Bank of England is currently not expected to hike rates until well into 2018, although there is the potential for a re-pricing of these expectations if the European Union (EU) referendum results in a decisive victory for the "remain" campaign. We believe gilt yields continue to be driven more by global concerns at this time, with the additional yield available (relative to bunds) appearing attractive to foreign investors. We would expect gilts to underperform the bonds of other core European markets should tensions in global financial markets abate somewhat or if concerns over a British exit from the EU increase, but the level of uncertainty at this time makes us apprehensive of such a position, so we favor remaining on the sidelines for now. We expect 10-year gilt yields to trade between 1.15-1.6% through Q1.

Go to The Bottom Line

We speak with IFI Portfolio Manager, Sean Connery, about his views on the UK referendum on European Union membership.

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Canada: The Canadian economy remains weak. Energy exports continue to decline and business investment is expected to remain soft as prospects for growth are absent. On a positive note, non-energy exports continue to stabilize as a weaker Canadian dollar is helping net trade overall. Residential property prices are beginning to come under pressure, especially in the province of Alberta where the oil-sensitive economy is suffering. We expect broader housing market weakness to be limited in the near term, however, as foreign investors provide support and interest rates remain extremely low. Any signs of labor market pressures should be seen as a red flag for the heavily leveraged household sector. 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) advised the markets to “enjoy Christmas” but they likely did not expect such a turbulent start to this year. Investors cite rapidly falling oil prices, pressures on bank shares and capital outflows from China as sources of market volatility. Ultimately we believe there is one common denominator: an over-indebted world economy. As the pressure to de-lever continues, we believe bond yields will be pulled lower and a relatively high-yielder like Australia is likely to be attractive, in our view. We expect such global pressures to continue to direct the performance of Australian government bonds as opposed to domestic factors.

Rob Waldner, Chief Strategist, James Ong, Senior Macro Strategist, Mark Nash, Head of Global Multi-Sector Portfolio Management, Nick Wall, Portfolio Manager, Sean Connery, Portfolio Manager, Avi Hooper, Senior Portfolio Manager, Josef Portelli, Portfolio Manager, Ken Hu, CIO Asia Pacific

Currency outlook

USD: Although our positive US growth outlook remains intact, financial market volatility and the extent to which it feeds through to US growth performance increases the risk of a downside surprise in our forecast. If we see a significant deterioration in US data, the Fed is likely to remain on hold, thus challenging US dollar strength in the near term. Given this backdrop, we have reduced our long US dollar exposure and will look to add it back if our divergence theme between the US and the rest of the world's major economies begins to re-emerge.

EUR: We have moderated our stance on the euro given the magnitude of the adjustment seen over the past year. The macro risk environment has become more challenging in the aftermath of the most recent commodity and emerging markets shocks. The euro will likely continue to trade as a funding currency while negative policy rates are in effect and will likely be prone to sharp rallies in negative macro risk environments, in our view. Given our cautious macro outlook on market sentiment, we are staying on the sidelines.

JPY: The easing action undertaken by the BoJ at its January policy meeting took many market participants by surprise, but served as a reminder that the central bank is very serious about achieving its 2% inflation target. The impact on currency markets was short lived, however, as concerns over a global slowdown in both growth and inflation caused investors once again to seek the security of the yen. The pace of the currency's appreciation during February will, no doubt, have caught the eye of policy officials. So much so, that the chances of an official response by way of coordinated central bank policy action, additional unilateral easing by the BoJ or currency intervention by the Ministry of Finance have significantly increased, in our view. We believe the potential for meaningful yen gains from here are limited in the shorter term.

GBP: Sterling has come under significant pressure in recent months as expectations for the timing of the BoE's first interest rate hike have been pushed out and concerns over a British exit from the EU have intensified. We maintain that the UK will opt to stay in the EU and that, against a solid economic backdrop, sterling will rally when this outcome appears more likely. A dovish Fed would also likely benefit such a trade. We seek an opportunity to move overweight sterling, but are mindful of the fact that the currency will likely continue to struggle if the "risk-off" environment markets are currently experiencing becomes more entrenched.

CAD: Pressure on the Canadian dollar has abated more recently as the gap between US and Canadian monetary policies has narrowed - markets have discounted the probability of further US rate hikes and reduced expectations for further rate cuts by the Bank of Canada. Imported price inflation has become a concern for the Bank of Canada, highlighting the declining benefit of further currency weakness. The external account is expected to remain vulnerable as commodity prices remain low, but falling imports have lessened these pressures. We continue to remain negative on the Canadian dollar against both the US dollar and Mexican peso, but have recently reduced our short exposure.

AUD: It appears the market is becoming concerned that the US will not come out unscathed from recent concerns over global growth and market volatility. This is pushing interest rate expectations in the US lower and upending previous relationships the AUD had with risk sentiment - previously the AUD would have suffered in a risk-off environment. However, we are seeing the AUD remain stable despite a very challenging backdrop for risk. We think that, as long as the Fed is pressured to remain on hold, the AUD could find support. However, we would expect the AUD to struggle versus the yen and euro since these currencies tend to be supported or strengthened when risk is off.

Ray Uy, Head of Macro Research, James Ong, Senior Macro Strategist, Avi Hooper, Senior Portfolio Manager, Sean Connery, Portfolio Manager, Josef Portelli, 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 increasing

Rationale

We are focused on global developments and tighter financial conditions going into March, as Fed Chair Yellen made it clear these were concerns for the Fed.

IFI Strategy

IFI allocations to currency and interest rate risk remain at the low end of the range. We have reduced long USD exposure against EUR. We favor adding JPY exposure on weakness as a portfolio hedge, and possibly US duration.

Asian deflation

Rationale

Slowing growth in China combined with the USD appreciation cycle continues to put pressure on Asian economies. Growing inflation and policy differentials will likely put pressure on Asian currencies.

IFI Strategy

Growth and currency volatility, including potential Chinese currency depreciation, may cause macro level volatility that puts pressure on risk assets.

Global credit themes

Geographical themes

Investment grade (IG): Europe and Asia over US

Rationale: Europe remains at earlier stage of credit cycle and ECB quantitative easing provides tailwind, supporting valuations. Asia benefits from a more supportive technical situation with lower supply expectations and strong Asian demand for USD denominated bonds. US valuations may offer the potential for higher yield, but reflect rising fundamental and supply pressures.

IFI Strategy: We favor gaining exposure to select European and Asia issuers in British pounds and US dollars where valuations have cheapened despite their stable balance sheets.

Emerging markets (EM) - Bond picker's market

Rationale: EM fundamentals remain challenged with disinflation and demand destruction, but new debt supply should be low and valuations have improved. We expect continued commodity price volatility, but attractive opportunities may exist in select countries and credits as re-pricing has been uneven.

IFI Strategy: We remain market weight EM across the board in sovereign and corporate credit, investment grade and high yield, but expect local currency sovereign bonds to provide attractive risk/return opportunities.

Sector themes

Moving to neutral on US financials

Rationale: Capital, asset quality and liquidity remain very strong for both US and European banks and concerns around energy exposure are overblown, in our view. However, lower global interest rates place more pressure on already challenged revenues and earnings. While this is more important for equities than credit, the degree of stress in equities cannot be ignored by credit markets. Concerns over global growth and inflation and risk positioning have become the primary drivers of financial credit spreads rather than strong credit metrics and cheaper valuations.

IFI Strategy: We respect what market price action is telling us about global growth concerns, while remaining patient for improving risk sentiment to get exposure closer to neutral. We anticipate returning to an overweight position when the global growth outlook stabilizes, given banks' strong fundamental credit profiles and attractive valuations, in our view.

Commodities: Still cautious, key call for 2016

Rationale: Excess supply and moderating demand continue to plague commodity prices and related corporate bonds. Valuations have become extreme in areas, in our view, and will likely remain highly correlated with underlying commodity prices. Identifying an inflection point in supply/demand imbalances, if one occurs in 2016, could be a key call for global credit markets.

IFI Strategy: We see better risk-adjusted opportunities in certain energy markets versus metals. We focus on exposure to lower cost production geographies including the Permian Basin. The pipeline sector, which typically generates a high degree of revenue from volume, is generally less reliant on strong commodity prices. In addition, we prefer large, integrated energy companies, as we see less volatility in this space.

Consumer story more nuanced globally

Rationale: The US labor market and low gas prices remain supportive to consumption, but consumers are more value-conscious and retail demand from international consumers is deteriorating due in part to the strong dollar. EM consumer retrenchment has played out as expected, but beginning to see opportunities in specific names.

IFI Strategy: Consumer sectors we favor in the US include autos, restaurants, leisure and housing-related sectors, but we are negative on “big box” retailers that lack differentiated products.

Post mergers and acquisitions (M&A) deleveraging plays

Rationale: M&A activity is at a post-recession high, driven by large cash balances, a low all-in financing cost, lack of organic growth, and need to reposition business portfolios.

IFI Strategy: Preference to play post-transaction bond issuance, which is typically characterized by size, liquidity, concessions and a plan to deleverage. Due to a recent ramp-up in M&A related issuance, we believe a more discriminating approach to this strategy is warranted.

Credit quality themes

Upward bias to quality, BBB-A spread differential approaching recessionary level

Rationale: We believe sector and security selection offer better opportunities than overweighting any rating bucket. The energy sector is driving historically wide differential in BBB-A rated corporate spreads. Liquid, single-A industrials are becoming attractive, in our view.

IFI Strategy: Due to their favorable liquidity, we favor overweighting larger, liquid single-A issuers that have been disproportionately sold. Awaiting peak of BBB-A spread differential.

Yield curve themes

Credit curve positioning

Rationale: Zero interest rate policy globally has forced cash investors and sovereign wealth funds into the 3-5 year part of the credit yield curve, creating a steep 5-7 year part of the curve. As the Fed normalizes policy and money market rates become more attractive, we expect some outflows from the 1-3 year part of the curve into money market funds, but expect demand for 5-year paper to remain resilient.

IFI Strategy: We prefer 5-7 and select 30-year points on the US IG credit yield curve. New issuance at longer maturities comes at healthy concessions.

Rob Waldner, Chief Strategist, Ray Uy, Head of Macro Research, Tony Wong, Head of Global Research, Joe Portera, Head of Global High Income, Michael Hyman, Head of Investment Grade

Global strategy forum

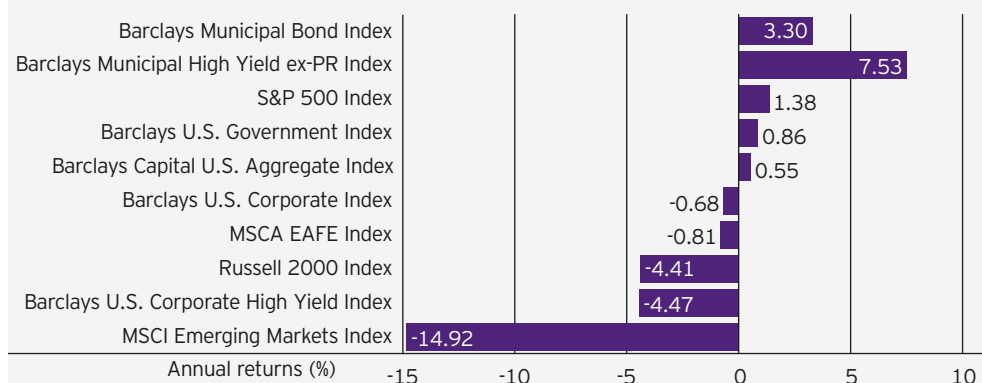
This section highlights the views of Invesco Fixed Income's credit analysts across a broad range of fixed income assets managed by Invesco. The Bottom Line highlights the views of a different investment team each month.

Municipals

2016 likely to extend 2015's solid performance

Arguably the most distinguishing aspect of 2015 was the scarcity of positive returns across various asset classes. The sleepy US municipal bond market, however, was one of the few sectors that exhibited relative stability in the midst of a global selloff in equities, commodities and high yield corporate bonds. US tax-exempt bonds emerged as the best performing asset class in 2015, as shown in the figure below, bolstered by positive supply and demand technicals, low US interest rates and constructive US economic conditions.

Municipals showed strong relative performance in 2015



Source: Barclays, data from Jan. 1, 2015 to Dec. 31, 2015.

Since the expiration of the Build America Bond program¹ in 2010, new money issuance (new borrowing versus re-financing) in the municipal bond market has fallen below historical averages, and 2015 was no exception. New money issuance in the tax-exempt market totaled just USD151 billion in 2015, compared to an average of nearly USD200 billion over the last two decades.² Under normal market conditions, new money tends to comprise the majority of total bond issuance, however, since 2012, there has been a shift and re-financings have represented the bulk of total new issuance.

The low level of new money issuance in recent years has puzzled many investors. We believe there are a few factors that have deterred new money bond issuance in the municipal market:

1. The fiscal health of many US cities has improved since the depths of the great recession. But, like many other metrics that have tracked economic recovery, fiscal revenues have shown a very slow and extended period of improvement. This has led to cautious behavior by many finance officers at state and local government levels. Many officials have decided to proceed carefully with spending programs as the recovery slowly proceeds.
2. In recent years, many state and local governments have focused on channeling their resources and capital toward meeting unfunded pension liabilities and increased Medicaid costs rather than borrowing to fund projects such as infrastructure rebuilding.
3. States appear reluctant to, and, in many cases, philosophically against imposing tax increases.

This limited supply backdrop combined with strong investor demand benefited tax-exempt bond prices in 2015. It is also important to note that, especially among retail investors, positive mutual fund flows have historically followed positive returns. Therefore, after several quarters of positive returns in 2015, it is not surprising that demand for municipals grew last year, generating net inflows into tax-exempt mutual funds totaling USD16 billion.³

Although municipal bonds emerged relatively unscathed from the energy-related jitters of the second half of 2015, the tax-exempt market was not without its ups and downs during the year. Dominating the municipal headlines were the budget impasses in the states of Illinois and Pennsylvania, news of Chicago's unfunded pension liabilities and the threat of default from Puerto Rico. However, while these issues were worrisome, they were not sufficient to outweigh the benefits of positive US economic performance.

We expect many of the factors that drove the positive performance of municipals in 2015 to persist in 2016. Expectations of a flatter US yield curve and another year of slow but steady modest economic growth bode well for municipal bonds, in our view. As such, our outlook for 2016 is similar to 2015, with performance expected to be predominately driven by coupon return. Our view rests on the assumption that inflation remains relatively subdued and the Fed raises interest rates gradually. We expect new bond supply to remain below historic averages as issuers face a variety of spending and other constraints, as noted above, and investors find themselves faced with an ever increasing tax burden, which, we believe, is likely to reinforce demand for municipal bonds.

Stephanie Larosiliere, Senior Client Portfolio Manager

1 Build America Bonds were issued between 2009 and 2010 to help municipal issuers raise capital to fund public projects after the traditional tax-exempt municipal-bond market froze during the 2008 financial crisis.
2 Source: The Bond Buyer, as of Jan. 29, 2016.
3 Source: SIMFUND, as of Dec. 31, 2015.

Structured

US property sector update

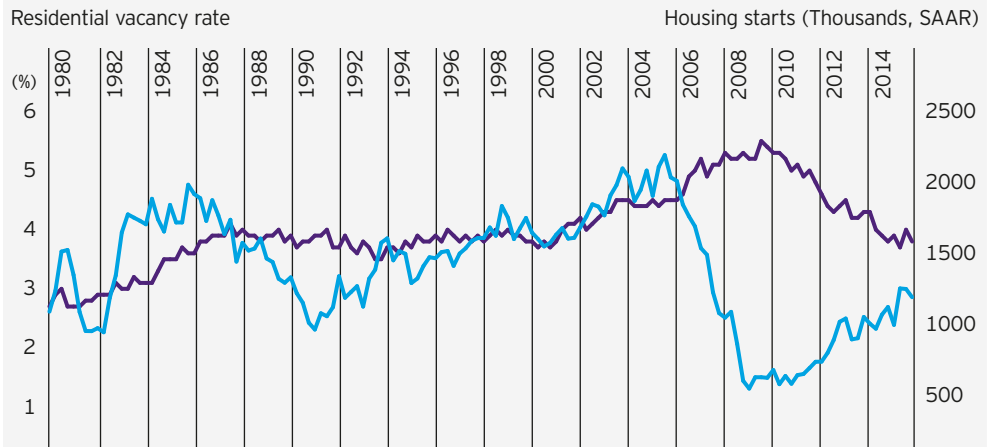
Despite volatility in financial markets and slowing economic growth during the fourth quarter, US real estate performed well in 2015. Home prices and residential construction activity both rose last year, with a 5.3% increase in the S&P Case-Shiller Index¹ and a 10.4% gain in housing starts.² Commercial real estate values were also healthy, rising 12.7%.³ We expect real estate prices to continue to rise in 2016, albeit at a slower pace. In particular, despite strong fundamentals, we think the rapid price appreciation experienced by commercial real estate properties over the last several years will likely decelerate as Fed policy becomes less accommodative and market volatility has increased.

US residential real estate update

Our constructive view on US home prices is predicated on rising demand for housing in an environment of limited supply. Improved US economic conditions, especially low unemployment and the transition of the large millennial generation into adulthood, are contributing to an increase in household formation. At the same time, housing supply conditions are tight, with the vacancy rate near its lowest level in 15 years and home construction well below its historical average, leaving room for meaningful growth over the next several years.⁴

Figure 6: US residential supply conditions are tight

■ Vacancy rate ■ Housing starts



Source: US Census Bureau, Bloomberg L.P., data from Mar. 31, 1980 to Dec. 31, 2015. Residential vacancy is rental and home owner vacancy, weighted by home ownership rate.

Impact of oil

The dramatic decline in oil prices certainly plays a role in our extended view, and overall, we expect low oil prices to have a modestly positive impact on the US real estate market. However, commercial real estate properties that are heavily reliant on the energy sector have reported notable declines in rent and occupancy levels. Further, certain markets where those properties are located are starting to see new supply outpace tenant demand for additional space. As long as oil prices stay at depressed levels, we think this trend is likely to have the greatest impact on Houston office properties, despite the greater diversification if its economy relative to prior oil-driven downturns. To a lesser extent, residential real estate markets that are more exposed to declines in energy sector employment will likely face similar challenges. North Dakota has been the hardest hit to date, but it constitutes a relatively small component of the total US real estate market. Texas, on the other hand, accounts for nearly 8% of the national housing stock.⁵ While Texas has shown some recent employment weakness, job growth remains just shy of the national average⁶ and new residential mortgage delinquencies have increased only slightly.⁷ We believe that a housing crisis in Texas remains unlikely thanks to greater diversification of the state's economy since the 1980's oil bust, considerable gains in borrower equity due to recent home price appreciation, and the historically high quality of mortgage loans originated over the last several years.

While overall US property fundamentals are reasonably strong, in our view, we will be following local employment trends closely and carefully weighing the risks posed by investments with outsized exposure to oil-dependent areas. For example, certain credit risk transfer securities issued by US government sponsored enterprises, Fannie Mae and Freddie Mac, and single family rental bonds have significant concentrations of collateral located in vulnerable markets, while higher quality, pre-crisis residential mortgage-backed securities generally have relatively limited exposure.⁸

US commercial real estate update

In the US commercial real estate market, office, retail, industrial and multi-family property occupancy rates and rents moved higher in 2015 and numerous lodging markets also reached historical peaks in occupancy, driving notable revenue growth.⁹ Expectations for continued US labor market improvement should continue to provide support for commercial real estate fundamentals in 2016. However, we think the pace of rent growth is likely to slow as development increases and tenant demand for new space moderates.

After five consecutive years of property price increases, in February, the Moody's/RCA commercial property price index posted its first month without an increase since the economic recovery began.¹⁰ At this point, we do not anticipate a notable reversal in the trend toward higher valuations, as foreign buyers appear to continue to view US properties as a safe haven and the differential between property yields and US Treasury yields remain at historically wide levels.¹¹ However, we do expect the rapid pace of property price appreciation to decelerate as Fed policy becomes less accommodative, market volatility has increased, commercial mortgage credit shows early signs of tightening and the premium of below-investment grade bond yields over un-levered real estate yields has widened.¹² As a result, we think property, loan and security selection has become increasingly important.

In the near-term, we expect US commercial mortgage backed securities (US CMBS) to continue to face headwinds as a result of heightened macro-economic volatility. However, we expect declining new issuance volumes to create a more favorable backdrop later this year. Looking forward, we prefer 2014 vintage and earlier US CMBS as they benefit from property price appreciation since origination. In more recent vintages, we favor investing higher in the capital structure. In particular, we prefer single asset/single borrower transactions, as this sector tends to benefit from lower historical price volatility, less supply and a more traditional "buy-and-hold" investor base. In bonds originated prior to the credit crisis, we are focused on identifying select subordinate credit that has exhibited less spread volatility than more recent vintage US CMBS.

Focus on US homebuilders

We believe the attractive US housing backdrop provides an opportunity for homebuilders. Most of them have spent recent years buying land and opening new communities, positioning them to take advantage of rising demand. Homebuilders can also position their product to match current buyer tastes, floor plans and price points - something the existing (used) home market cannot do. Almost all of the public homebuilders are issuers in the high yield market. This fact complicates the investment thesis for the sector. In a typical housing recovery, growth accelerates quickly, allowing all builders to experience rapid acceleration in both revenue and income. The best investment opportunities in these cases have historically tended to be lower quality homebuilders. With wider spreads and more rapidly improving credit profiles, their bonds have typically outperformed as the cycle matured.

The current housing recovery, though, much like the broader US economic recovery, has progressed more slowly than in prior cycles. While this is not necessarily a bad thing - the slow pace has kept companies from making bad decisions and misallocating capital - we believe we have yet to reach an inflection point confirming the sustainability of housing demand. It is in this vulnerable state that homebuilder bonds faced the commodity-driven volatility experienced in 2015 by the broader high yield market. Increasing bouts of volatility and spreading economic concern in recent months has caused a risk-off tone to dominate high yield, resulting in a shunning of lower quality bonds.

This sentiment has overpowered signs that the US consumer is steadily returning to the housing market. As a result, homebuilder bonds have become wildly bifurcated with lower quality (generally CCC-rated) bonds trading at distressed levels, while higher quality builders (BB-rated) trade at much higher levels.¹³ Concerns are growing that the capital markets dislocation could infect the real economy. Should this occur, prospects for the housing recovery would likely dampen and homebuilder bonds would likely weaken across the board. That said, we believe most of the higher quality homebuilder bonds would outperform the lower quality builders and potentially beat the overall high yield market. On the other hand, if US businesses and the consumer can shrug off the capital markets noise, housing will likely continue to strengthen, making the battered low quality homebuilder bonds potentially attractive total return plays, in our view.

David Lyle, Head of RMBS Credit, Kevin Collins, Head of CMBS Credit,
Andy Geryol, Head of High Yield Credit Research

- 1 Source: S&P/Case-Shiller US National Home Price Index year-over-year percent change, Bloomberg, L.P., as of Nov. 30, 2015. The S&P/Case-Shiller Home Price Index is a measure of US residential real estate prices, tracking changes in the value of residential real estate nationally.
- 2 Source: US Census Bureau, Bloomberg, L.P., Total new privately owned housing units started, twelve months ended December 2015 versus December 2014.
- 3 Source: Moody's/RCA Commercial Property Price Index as of Dec. 31, 2015.
- 4 Source: US Census Bureau, Bloomberg L.P., data from Mar. 31, 1980 to Dec. 31, 2015. Rental vacancy and homeowner vacancy, weighted by homeownership rate.
- 5 Source: US Census Bureau, as of Dec. 31, 2014.
- 6 Source: Bureau of Labor Statistics, Bloomberg, L.P., as of Dec. 31, 2015.
- 7 Source: Barclays, Jan. 1, 2016.
- 8 Source: BofA Merrill Lynch, as of Feb. 5, 2016.
- 9 Source: Bloomberg L.P., REIS, Smith Travel, Dec. 31, 2015.
- 10 Source: Moody's Investors Service, RCA Commercial Property Price Index, Dec. 31, 2015.
- 11 Source: Bloomberg, US Federal Reserve, REIS and Invesco Fixed Income, Feb. 17, 2016.
- 12 Source: Bloomberg, REIS and Barclays as a source. Data from Mar. 1, 2007 to Dec. 31, 2015.
- 13 Source: Barclays US Corporate High Yield 2% Issuer Capped Index, Feb. 17, 2016.

Structured

US collateralized loan obligation (CLO) market dislocation may provide opportunities

The CLO segment of the US structured products market was off to a very weak start in January with pressure on spreads across the entirety of the CLO capital structure. While the credit fundamentals have weakened somewhat - the increased default outlook for loans and the lower average prices on the underlying loan portfolios have eroded the market value overcollateralization coverage - we believe the recent selloff in CLOs has mostly been technically driven. In our view, spread widening across other structured products (including US commercial mortgage backed securities (US CMBS) AAAs at spreads over US Treasuries of 150-175 basis points and US CMBS BBBs at spreads in the 650-700 basis point range) is having an impact on CLO liability spreads. The two markets have an overlapping buyer base and US CMBS have historically traded at tighter spreads to US Treasuries than CLOs.

The biggest factor behind the widening of CLO spreads in January, however, was selling pressure from credit hedge funds, in our view. Hedge funds constitute the majority of market investors in BB-rated and B-rated CLO liabilities and also invest by using leverage. Several funds closed and liquidated portfolios in December and January, which spooked the market and drained market liquidity somewhat. With bids sharply down in January, fear of more hedge fund failures and liquidations created further nervousness among investors.

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

	Jan. 2016	2015	2014	2013	2012
AAA	-0.42	1.45	1.25	0.32	3.88
AA	-1.24	1.99	0.64	0.99	9.43
A	-2.45	2.99	1.15	2.96	17.15
BBB	-3.29	-0.78	2.70	7.14	24.18
BB	-8.13	-5.77	1.85	10.82	29.23

Source: J.P. Morgan CLO Research & Global Index Research. Except 2016, all data as of Dec. 31. CLO 2.0 is a CLO issued after 2009, after the financial crisis.

We believe that the current market dislocation provides attractive investment opportunities across the CLO capital structure stack. Based on historical trading levels, we believe AAAs, BBBs and BBs look the most compelling at current levels.¹ We remain concerned about technical pressures on the lower end of the capital stack in the near term, but believe that there are attractive long-term opportunities to earn excess returns in BBs and BBBs. On average, Invesco Fixed Income estimates that BB and BBB tranches can potentially absorb 7-8% and 15-16% constant annual default rates, respectively, in the underlying loan portfolio over the life of the deal at a 60% recovery rates without a negative impact on yields. We believe there is only a small chance for such a dramatic spike in defaults over the next couple of years.

Tranche	2/5/16 discount margins	11/6/15 discount margins	WAL	2012-2015 range discount margins
AAA	L+170-220	L+160-190	5.5	L+110-170
AA	L+240-300	L+220-240	7.0	L+150-340
A	L+400-600	L+320-350	7.8	L+275-450
BBB	L+550-850	L+460-550	8.5	L+375-650
BB	L+900-1400	L+750-900	9.0	L+550-900
B	L+1200-1700	L+900-1100	9.5	L+900-1100

Source: Invesco Estimates, Wells Fargo Research. L is Libor. WAL is weighted average life in years.

Ivo Turkedjiev, Senior Trader, David Hughes, Portfolio Manager

1 Source: JPMorgan CLO Indices: JPMorgan CLO AAA Total Return Level Index, JPMorgan CLO AA Total Return Level Index, JPMorgan CLO A Total Return Level Index, JPMorgan CLO BBB Total Return Level Index, JPMorgan CLO BB Total Return Level Index, JPMorgan CLO B Total Return Level Index, as of Feb. 13, 2016.



Sean Connery,
Portfolio Manager

Sean Connery is lead Invesco Fixed Income portfolio manager for a number of European and global institutional mandates and is responsible for decisions pertaining to bond duration and currencies in Japan and the UK.



Read more about IFI's views on the EU referendum in, "The UK reconsiders its membership in the European Union," by Sean Connery, Portfolio Manager, February 2016.

The Bottom Line

We speak with Invesco Fixed Income Portfolio Manager, Sean Connery, about his outlook for the UK referendum on EU membership and its implications for currency and bond markets.

Q: What has led the UK to hold a referendum on EU membership and what are the major arguments for and against EU membership?

Sean: EU membership has long been a political issue in the UK and was a key campaign issue in the 2015 general election. Those who argue against membership focus on issues of immigration, its strain on the UK's social infrastructure, the high financial cost of EU membership, and limits on the UK's ability to forge trade agreements with non-EU nations independently of the EU.

Proponents of EU membership point to the ease of trade and travel within the EU - i.e. no tariffs or immigration restrictions. They argue that a British exit from the EU, a "Brexit," could lead to significant political and economic uncertainty, potentially thwarting growth and threatening the status of the UK as a major financial center.

Q: When is the referendum likely to be held?

Sean: The planned date of the referendum is June 23rd of this year - it must be held before the end of 2017. We believe it is important that it is held while consumer confidence is elevated, as there appears to be a strong relationship between the level of consumer confidence and the likelihood of voters opting to "remain" in the EU.

Q: What is the likely outcome of the vote?

Sean: Recent polls show that the vote is likely to be very close, with many voters still undecided. Prime Minister Cameron has renegotiated the terms of the UK's membership in the EU. More palatable terms of membership could convince undecided voters that continued EU membership is the best way forward for the UK. However, opposition to the agreement could strengthen the "leave" vote. We believe the UK will vote to stay within the EU.

Q: What are the implications of the referendum for UK monetary policy?

Sean: We believe the Bank of England (BoE) is likely to keep interest rates on hold prior to the referendum vote, due to the uncertainty regarding the outcome. Nevertheless, we expect inflation to remain significantly below the BoE's 2% target in the near term, which would provide the bank with the necessary leeway to keep monetary policy on hold.

Q: What are the implications for UK asset prices?

Sean: Recent sterling depreciation may be the result of markets starting to price in Brexit risk. If Prime Minister Cameron's "deal" is largely viewed as acceptable, sterling may strengthen into the referendum vote. But if the referendum appears "too close to call," we believe sterling is likely to struggle.

We believe there is potential for foreign investors to sell UK gilts if the referendum outcome is in doubt. That said, in such an environment, we would expect domestic equity holders to re-allocate their holdings into gilts, which may result in little change in gilt yields.

The bottom line
continued

Q: In your view, what would be the impact of a Brexit?

Sean: If the UK decides to leave the EU, the economic and political picture would likely become unclear and possibly, for quite some time, in our view. The UK would potentially need to build a different relationship with its EU counterparts and the rest of the world. A Brexit may lead to another Scottish referendum, injecting further political uncertainty.

The referendum's implications may also reach beyond the UK. A Brexit could spur nationalist parties and euroskeptic movements in other parts of the EU, prompting similar initiatives and raising the question of continued membership among other non-eurozone states. We will be closely monitoring the referendum's outcome and its impact on other countries where the UK referendum may resonate.

Recent IFI publications

1. **The UK reconsiders its membership in the European Union**, February 2016, Sean Connery, Portfolio Manager
2. **Investor double-take: US Agency MBS**, December 2015, Rich King, Head of Structured Investments
3. **Invesco Fixed Income: Investor's Summit Outlook November 2015**, December 2015, CEO Greg McGreevey and Chief Strategist Rob Waldner
4. **Understanding the emerging markets credit cycle, Part 1**, December 2015, Rashique Rahman, Head of Emerging Markets, Jay Raol, Analyst
5. **IMF and World Bank annual meetings recap**, October 2015, by Arnab Das, Head of EM Macro, Sean Newman, Senior Portfolio Manager
6. **What are US Commercial Mortgage-Backed Securities (US CMBS)?**, October 2015, by Kevin Collins, Head of CMBS Credit and Daniel Saylor, Senior Analyst
7. **What are GSE Credit Risk Transfer securities?**, October 2015, by David Lyle, Head of RMBS Credit
8. **Structured Convertibles: A Custom Portfolio Solution**, September 2015, by Robert Young, Senior Portfolio Manager
9. **What investors need to know: US mortgage-backed securities**, June 2015, by Rich King, Head of Structured Investments, John Anzalone, Head of Structured Securities Portfolio Management and Jason Marshall, Head of MBS Portfolio Management

Market monitors

Fixed income market monitor

	Coupon (%)	Yield to worst (%)	1 month change in YTW	Option-adjusted spread				Returns			
				1 month		10 year range		1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
				current	change in spread	min	max				
Global Aggregate (USD hedged)	2.94	1.57	-0.19	56	6	23	156	1.46	1.23	1.46	0.62
U.S. Aggregate	3.18	2.34	-0.25	63	6	32	258	1.38	0.78	1.38	-0.16
U.S. Mortgage-backed	3.69	2.47	-0.30	21	-3	-16	181	1.30	1.13	1.30	1.96
Global Inv Grade Corporate (USD hedged)	3.93	3.02	-0.05	183	24	55	515	0.46	-0.11	0.46	-2.15
U.S. Investment Grade Corporate	4.24	3.62	-0.05	193	28	76	618	0.35	-0.65	0.35	-3.27
Emerging Market USD Sovereign	n/a	6.50	0.11	463	48	157	906	-0.18	-1.63	-0.18	0.07
Emerging Market Corporate	n/a	6.46	0.19	485	54	120	1,032	-0.36	-2.09	-0.36	0.26
Global High Yield Corporate (USD hedged)	6.51	8.42	0.41	697	68	231	1,845	-1.38	-5.18	-1.38	-4.74
U.S. High Yield Corporate	6.70	9.17	0.43	734	73	233	1,971	-1.61	-6.22	-1.61	-6.62
Bank Loans	4.79	5.27	0.06	n/a	n/a	n/a	n/a	-0.73	-2.54	-0.73	-1.36
Municipal Bond	4.80	1.91	-0.20	n/a	n/a	n/a	n/a	1.19	2.31	1.19	2.71
High Yield Municipal Bond	5.39	6.65	-0.10	n/a	n/a	n/a	n/a	0.57	1.13	0.57	0.59

Treasury market monitor

	Coupon (%)	Yield to worst (%)	1 month change in YTW	Returns in local currency			
				1 month			
				1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
United States	2.08	1.40	-0.32	2.13	1.55	2.13	0.39
Canada	2.60	0.98	-0.11	1.00	2.24	1.00	0.48
United Kingdom	3.79	1.54	-0.32	3.82	3.63	3.82	-0.51
Germany	2.30	0.03	-0.25	2.51	1.61	2.51	0.54
Italy	3.88	0.93	-0.14	1.15	1.16	1.15	3.60
Japan	1.17	0.21	-0.11	1.38	2.03	1.38	2.53
China	3.68	2.90	0.01	0.26	1.85	0.26	7.26
EM Local Currency Governments	n/a	n/a	n/a	0.35	-4.01	0.35	-14.91

FX Market Monitor¹

	10 year range			Returns			
	Current	min	max	1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
EURUSD	1.09	1.06	1.60	0.24%	-1.16%	0.24%	-3.57%
USDJPY	121.00	75.82	124.77	-0.63%	-0.21%	-0.63%	-2.87%
GBPUSD	1.44	1.38	2.11	-2.48%	-6.78%	-2.48%	-4.58%
USDCNY	6.58	6.04	8.28	-1.29%	-3.70%	-1.29%	-4.93%
USDCHF	1.02	0.75	1.39	-1.48%	-2.99%	-1.48%	-9.54%
AUDUSD	0.71	0.60	1.10	-2.76%	-0.87%	-2.76%	-8.72%
CADUSD	0.71	0.72	1.09	-1.27%	-6.57%	-1.27%	-9.15%
EURJPY ²	131.75	94.31	169.49	-0.84%	0.96%	-0.84%	0.68%
EURGBP ²	0.76	0.70	0.84	-2.72%	-5.69%	-2.72%	-1.07%

Sources: Barclays, J.P. Morgan, Bloomberg L.P., as of Jan. 31, 2015. Credit Suisse Leveraged Loan data as of Jan. 31, 2015. 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 payoff 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 Postive number represents the currency appreciated against USD, negative number represents currency depreciated against USD.

2 Postive number represents the currency appreciated against EUR, negative number represents currency depreciated against EUR.

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