Assessing the landscape for policy changes and asset class fundamentals

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Key takeaways

- We expect fiscal easing, deregulation and trade to be the focus of new US policies.
- Stronger growth in the US should pressure US interest rates up across the board.
- We look for continued headwinds for emerging markets growth.

Macro
Invesco Fixed Income's 2017 macro outlook is likely to be significantly influenced by the policy direction of the newly elected US President Donald Trump and his administration. We believe there are a few key policy elements that will likely be implemented early in the Trump administration. First, fiscal easing: Proposed tax cuts and possible infrastructure spending would potentially boost growth across the board in the US. Second, Mr. Trump has promised deregulation of the US economy. In particular, he has indicated a desire to reform the Affordable Care Act (also known as Obamacare), reduce regulation on the energy industry and amend the Dodd-Frank Act. These changes are also likely to boost US growth in the near term, in our view. Third, Mr. Trump won using an anti-trade message. We would expect some impediments to free trade to be implemented in the near term. Such measures may have a medium-term negative impact on global growth.

In the near term, we expect higher US interest rates. Stronger growth in the US should pressure US interest rates up across the board. While volatility could concern the US Federal Reserve (Fed), we believe the Fed will still raise rates in December and will likely raise rates in 2017. Stronger US growth, fiscal stimulus and higher US interest rates all point to the likelihood of a stronger US dollar across currencies. A stronger dollar and potential action on trade are all negative for emerging markets. We look for weaker emerging markets currencies and continued headwinds for emerging markets growth.

Bank loans
We expect the bank loans asset class to perform in line with the coupon in 2017, as prices hovered around par during the fourth quarter of 2016. Loan fundamentals should continue to be supported by a slow but positive gross domestic product (GDP) growth environment in the US, in our view, as company balance sheets are generally healthy and issuers are operating with a free cash flow cushion, aside from a few "pockets of weakness." We expect technical factors to remain firm as demand from long-term investors remains solid. Key risks to our view are generally not loan-specific. Rather, broader macroeconomic weakness could lead to a "risk-off" tone, and a recessionary environment could induce an uptick in defaults. Even under this scenario, however, senior secured loans remain relatively defensively positioned at the top of the capital structure.

Emerging markets
Emerging markets (EM) are unlikely to repeat the stellar 2016 performance they've experienced at the time of this writing, but we expect a year of low- to middle-single-digit returns, supported predominantly by positive carry. Given that EM assets are largely dependent on the global environment, we believe that sustained central bank accommodation; relatively stable, if subdued, growth and still-moderate inflation provides a favorable backdrop for EM assets. Additionally, investors' ongoing reach for yield, their preference for income and emerging markets' continued attractiveness versus developed markets suggest the momentum behind flows into EM assets will likely continue. Discernment in outlook is a key theme for EM countries. Now, as always, we focus on EM countries and credits with a variety of perceived catalysts (credible, active central banks, fiscal responsibility, etc). The main risks to our relatively sanguine view are a significant sell-off in US Treasury yields, unanticipated central bank policy shifts, significantly slower global growth or a sharp acceleration in US dollar strength.

European fixed income
European fixed income in 2017 will continue to be challenged by macroeconomic headwinds coupled with a number of elections that are scheduled across the region. The rise of anti-establishment parties, primarily linked to the poor sustained economic performance over past years, will mean we are likely to face another year scattered with bouts of heightened volatility. The European Central Bank (ECB) has enjoyed some success from monetary policy actions, with reduced fragmentation, but bank lending remains lackluster and we expect Brexit to be a drag on European growth. However, Europe remains in the early stages of the economic cycle, and we expect the ECB's quantitative easing (QE) program to be extended beyond March 2017 as inflation continues to disappoint and growth stays low. Hence, we are constructive on core government duration and expect future opportunities will likely arise from domestic political events and/or central bank action. Moreover, we are neutral in the periphery and remain cautious on the outlook

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of Italy and Portugal, which is tempered by seeing value in Irish and Spanish bonds. In the currency space, we see limited opportunities, although we expect the euro to benefit from risk-off moves given its funding currency status. However, the challenging political calendar will likely prevent any material euro strength. Risks to our view would be an abrupt ending to QE or indeed any tapering of QE announced by the ECB in the near term.

Global high yield
We expect US high yield to perform well in 2017, albeit with limited room for spread tightening, given the current fair value level of spreads. Outside the US, high yield performance will be dependent on developments at the local level. Most corporate revenue in the US high yield market is tied to the health of the US consumer, which, we believe, will likely remain stable in 2017. The outlook for corporate revenue and profitably outside the US is more idiosyncratic and dependent on the country/region. Actions by the Fed could have an important impact on global high yield sentiment and the US dollar, which could lead to volatility in commodity prices and commodity-related high yield assets. Soft Chinese demand could also weigh on global high yield, as could disappointing growth outcomes in Europe. However, we are constructive on a number of developments in the US high yield market: Many US high yield companies have navigated the commodity price downturn successfully by cutting costs and improving balance sheets, debt-financed mergers and acquisition activity has been fairly muted, and default levels have ticked up only slightly. These developments are all likely to be supportive for US high yield bonds in 2017.

Global investment grade
We anticipate global investment grade credit will outperform sovereign counterparts in 2017 due to the favorable macroeconomic backdrop and continued market demand for yield. The expectation of a global recession remains low as liquidity, particularly outside the US, remains high. In the US, although rhetoric from the Fed is expected to target higher interest rates, we expect tightening to be limited. Additionally, the European Central Bank and Bank of England are expected to continue their quantitative easing efforts. The inclusion of corporate debt in their purchase programs further restricts the supply of yield-based assets available to investors and potentially supports global investment grade bonds.

The risks to our views include an unexpected deceleration in global growth, which could pressure credit fundamentals and risky assets. Alternatively, an acceleration in global growth and inflation could lead to higher interest rates, which could be particularly challenging for sovereign bonds given the limited protection provided by their very low yields. As we enter 2017, the investing landscape for corporate credit is marked by low credit spreads and absolute yields. Performance of the asset class may depend largely on avoiding problem sectors and issuers and capitalizing on opportunities as they arise.

Global liquidity
The year ahead should allow US money market fund managers to resume focus on adding value in a post-reform world. Short-term credit spreads could remain elevated if supply/demand imbalances persist as a result of reform, potentially presenting a continued attractive yield opportunity for prime and ultra-short strategies. Sufficient supply of US government securities should keep a floor under short-term interest rates; however, we will be watching potential developments around the US debt ceiling in early 2017, which could affect the supply of US Treasury securities in the short run. A slow-growing US economy will likely keep the focus on the Fed in 2017, but similar to recent years, forward guidance and a gradual approach to rate hikes with the least amount of disruption is likely the Fed's preferred path. Money market reform in Europe should start to take shape in 2017, but with a long path to implementation (similar to the US), the impact on markets might not be evident until 2018.

Structured
We expect the macroeconomic and capital market environment in 2017 to be generally supportive for structured securities as a slow macroeconomic growth trajectory and generally range-bound interest rates are traditionally conducive to lower prepayment risk and tighter credit spreads. We believe underlying residential and commercial real estate fundamentals in the US will be positive factors for the asset class as housing supply is expected to remain tight and consumer conditions will likely be healthy.

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Data as of November 30, 2016 unless otherwise stated.

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