Invesco Fixed Income

Global Fixed Income Strategy

July 29, 2019

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Global macro strategy

Fed ahead: Beyond a July rate cut

At its June meeting, the Fed affirmed its commitment to extending the US economic cycle, defined as a strong labor market and symmetrical path of inflation around 2%. It also signaled its willingness to cut interest rates at its July 30-31 meeting, which now appears to be a foregone conclusion. We believe this dovish policy turn has set up a benign environment for credit bonds, as slowing (but not recessionary) growth, combined with a responsive Fed, should support risk assets. But after a rate cut at the end of July (probably 25 basis points) what is likely to follow?

Below, we lay out a framework for thinking about possible outcomes for rate cuts and markets. As we wrote in April, the Fed appears to be following a new reaction function centered on average inflation targeting (Global Fixed Income Strategy April 2019). This framework would allow the Fed to move inflation toward its mandated target of 2%, and even allow it to fluctuate above 2%, as long as inflation averages 2% over a given business cycle. The market has already tested the Fed - as inflation headed lower in early 2019, bond markets began pricing rate cuts.[1]

By March, the front end of the yield curve had inverted, while the long end remained steep.[2] In other words, markets began pricing in rate cuts at the front end of the curve without a recession indicated by the longer end. This price action occurred amid a relatively small downgrade in growth expectations - but softer inflation.[3]

Trade tensions have played a role in this market pricing (three cuts priced for 2019), and matter to the Fed, but they do not fully explain the market's reaction. Although uncertainty was acknowledged at the June Fed meeting, trade was not the focus. Instead, Fed Chairman Jerome Powell focused on the Fed's commitment to extending the economic cycle.

We noted a similar tone (although with more mention of trade concerns) in the June FOMC meeting minutes and Chairman Powell's July testimony before Congress. The minutes suggested that many FOMC members believe near-term rate cuts are appropriate if uncertainty continues to weigh on the economic outlook and inflation risks are skewed to the downside. Powell's communication has remained steady despite a de-escalation in US-China trade negotiations and a solid June jobs report.[4]

What can we expect from the July Fed meeting?
Looking to the July 30-31 Fed meeting, at which a rate cut is already fully priced, the Fed has a tough assignment ahead. Either it needs to deliver a rate cut given current market expectations, which we believe it will, or disappoint by delivering no cut while seeking to convince the market that it is committed to its new framework. In the second case, communication would be key.

What can we expect in the months that follow?
With a July rate cut all but cemented (unless economic data strongly surprise to the upside), what should we expect in the ensuing months? How will the macro data evolve and what would different macroeconomic outcomes mean for Fed policy and markets? Below, we lay out four scenarios for trend growth and inflation over a six-month horizon and their projected probabilities. We also provide a framework for projecting the Fed's reaction based on its new average inflation framework, and implications for risk asset performance.

Macro scenarios and Fed reaction function
Table 1 highlights our base case: 2% trend growth and 2% trend inflation over the next six months.

Table 1: Macro data scenarios
(trend over next six months)

Trend growth scenarios		**IFI base case**		
Trend growth (%)	2.75	2	1.25	< 1.25
Probability (IFI forecast) (%)	25	50	15%	10
Trend inflation scenarios		**IFI base case**		
Trend inflation (%)	2.5	2	1.5	< 1.5
Probability (IFI forecast) (%)	10	60	20	10

Our base case scenario implies two Fed rate cuts over the next year, as shown in Table 2. This compares to the market's current pricing of four cuts. According to our model, annual trend growth below 1.25% or inflation below 1.5% would imply a much larger number (10) of cuts. Boxes marked n/a represent rare scenarios that we believe are unlikely to occur in the near term.

Table 2: Potential Fed rate cuts

		Trend growth (%)			
		2.75	2	1.25	<1.25
Trend inflation (%)	2.5	0	0	n/a	n/a
	2	2	2	4	10
	1.5	4	4	5	10
	<1.5	n/a	n/a	10	10

What do these scenarios imply for asset performance? In Table 3, we forecast asset performance using our macro factor analysis framework. In the top left of Table 3, tighter financial conditions may cause risk assets to underperform. In the bottom right, low growth would likely cause risk assets to underperform. Our base case scenario (2% trend growth and inflation), suggests neutral performance of risk assets in the near term. However, if growth falls sharply (below 1.25%), or if inflation rises sharply (2.5%), we would expect risk assets to perform poorly.

Table 3: Risk asset performance

		Trend growth (%)			
		2.75	2	1.25	<1.25
Trend inflation (%)	2.5	-	-		
	2	+	=	=	-
	1.5	+	+	=	-
	<1.5			-	-

Conclusion

In our base case of 2% trend growth and inflation, we believe credit investors can expect to collect coupons but price returns will likely be limited. In other words, if growth and inflation do not "break out" higher or lower, the Fed should remain responsive for the majority of 2019, but not cut aggressively. The red boxes in Table 3 represent scenarios in which the market perceives the Fed to be behind in its policy action. This would likely add volatility to markets as the probability of a policy error begins to increase. We do not see evidence in the underlying data to make a strong case for these scenarios, but we continue to monitor these risks closely.

Noelle Corum, Associate Portfolio Manager, James Ong, Director Derivative Portfolio Management, Rob Waldner, Chief Strategist

1 Bureau of Labor Statistics, Bloomberg L.P., Jan. 31, 2019 - March 31, 2019.
2 Bloomberg, L.P., March 20, 2019.
3 Bloomberg, Jan. 1, 2019 through July 10, 2019.
4 Bureau of Labor Statistics, June 30, 2019.

Interest rate outlook

US: Neutral. We expect US growth to moderate in the near term due to trade uncertainty but be supported by Fed policy in the medium term. Despite noise from tariffs, inflation should remain range-bound. This growth and inflation environment creates a case for two Fed rate cuts this year, in our view. While market pricing implies additional cuts over the next year, we do not believe the risk/reward is sufficiently compelling to underweight US Treasuries, since many exogenous risks still exist, such as trade and Brexit.

Europe: Underweight. We saw some stabilization in eurozone survey data in the second quarter, but industrial output data still points to weakness in Germany. We expect this to weigh on eurozone growth, which should decline to 0.2% quarter-over-quarter in the second quarter, down from 0.4% in the first quarter. Market focus has now shifted to the ECB with the appointment of Christine Lagarde to replace President Mario Draghi in November. The market expects the ECB to restart net asset purchases, cut the deposit rate and provide more dovish forward guidance. We remain tactically short European duration; at current rich valuations and with markets pricing a 20 basis point rate cut this year, the bar for more dovish repricing seems high.

China: Overweight. Tax payment season may cause tighter near-term liquidity conditions in the interbank market, but we are positive on onshore rates bonds in the medium term thanks to accommodative Chinese monetary policy and generally dovish global central banks. Chinese onshore rates bonds may be subject to near-term volatility, however, given widely held long positions and uncertainty over the central bank's ability to deliver or beat expectations already priced in by the market. But we expect the significant yield pickup of Chinese onshore government bonds versus global peers (such as the US, Japan and Germany) to lead to further inflows into China.

Japan: Neutral. Japanese government bond (JGBs) yields are essentially unchanged over the last month. JGBs have significantly lagged the rally in European bonds - in anticipation of ECB easing - leaving JGB yields well above those offered by bunds. The shrinking yield pickup offered by international bonds could lead to the repatriation of funds into JGBs.

UK: Overweight. The combination of weaker UK economic data, rising "no deal Brexit" risk and a deteriorating global picture support a more dovish stance by the Bank of England (BoE). The scale of BoE easing priced in by the market is relatively moderate compared to other central banks. In addition, technical factors are very supportive of gilts over the next three months, with significantly negative net supply. It is possible, however, that a fiscal risk premium could build if an early election occurs.

Canada: Neutral. The Bank of Canada (BoC) will need to balance unusually strong Canadian growth with slowing global growth and headwinds due to global trade tensions. Ten-year Canadian sovereign bond yields have bounced off their lows and sit near 1.5%. [1] Rate cuts have been priced out of the market for the remainder of the year and we expect Canadian rates to remain subject to global rate pressures.

Australia: Neutral. After two consecutive rate cuts, the Reserve Bank of Australia appears to be moving toward a more conditional easing bias. Further rate cuts do not appear likely before November, unless there is a substantial downside shock. Easier fiscal policy and the partial easing of macro prudential measures have also reduced the need for monetary policy to shoulder the full burden of economic support. Australia's historically unprecedented move toward a current account surplus should reduce the scope for Australian dollar weakness to drive inflation higher, limiting the yield premium versus off-shore markets.

Interest rate outlook

India: Neutral. The policy and macro environment is generally supportive for bonds. Recent data paint a picture of softer inflation and growth, which will likely lead the Reserve Bank of India (RBI) to cut its policy rate again in August after three cuts during this easing cycle. Nevertheless, we have downgraded our stance from overweight to neutral due to the strong rally over the past ten months. A poor monsoon and higher fiscal deficit might also pose headwinds to an otherwise benign inflation environment. Yields are now near five-year lows and we believe upside is limited.

Rob Waldner, Chief Strategist, James Ong, Director Derivative Portfolio Management, Noelle Corum, Associate Portfolio Manager, Reine Bitar, Portfolio Manager, Yi Hu, Senior Analyst, Michael Siviter, Senior Portfolio Manager, Brian Schneider, Senior Portfolio Manager, Scott Case, Portfolio Manager, Amritpal Sidhu, Quantitative Analyst

1 Bloomberg L.P., July 22, 2019.

Currency outlook

USD: Neutral. Fed interest rate cuts are potentially negative for the US dollar as investors may leave the US for higher yielding opportunities elsewhere. However, many other central banks are considering easing as well, leaving investment opportunities potentially limited. With trade and Brexit risks still looming in the near term, the dollar could get caught between its "safe-haven" status and Fed easing.

EUR: Neutral. The ECB is likely to ease this year which may weigh on the euro, despite improving fundamentals. We expect European growth to stabilize over the course of the year as the external sector recovers on the back of an improved global growth backdrop. The domestic sector of the economy continues to show signs of life, which gives us confidence in this view over the longer term. These factors are likely to keep the euro range-bound against the US dollar in the near term.

RMB: Neutral. The renminbi/US dollar exchange rate traded in a tight range in July, remaining below 6.9 after the resumption of US-China trade talks and dovish Fed statements offered support. Markets are closely watching trade-related headlines and investors preparing to increase allocations to Chinese assets may view renminbi deprecation as a buying opportunity. The renminbi could be volatile if there is less than expected progress on trade, potentially trading to mid-6.90 versus the US dollar, but we continue to view 6.60-6.80 as our base case for the exchange rate in the medium term.

JPY: Overweight. The yen has performed relatively well over the past month despite an improvement in risk sentiment, perhaps reflecting tighter interest rate differentials between Japan and the US. Going forward, the yen should be supported by declining foreign direct investment and portfolio outflows and a larger current account surplus due to lower commodity prices and higher savings driven by the upcoming consumption tax hike.

GBP: Underweight. Boris Johnson is the new UK Prime Minister, increasing the probability of a "no deal Brexit" outcome in October. Parliamentary members opposed to "no deal" lack an obvious mechanism to stop it, short of a no confidence vote in the government, but this isn't certain to work either. This uncertainty, the slowdown in the economy and the dovish shift by the BoE undermine the appeal of sterling, in our view.

CAD: Neutral. The Canadian dollar has rallied on the back of positive Canadian economic growth and a more dovish monetary policy outlook for other major central banks. But any softening of the economic data should be a headwind for the Canadian dollar.

AUD: Overweight. High commodity prices and strong foreign direct investment inflows are moving Australia to an almost unprecedented balance of payments surplus. This should support the Australian dollar, despite recent RBA interest rate cuts. Fiscal easing and the end of macro prudential tightening also reduce pressure on the RBA to further cut rates, limiting the scope for interest rate differentials to move against the Australian dollar. If global growth remains weak, the Australian dollar is unlikely to substantially outperform the US dollar, but we believe it can outperform other risk-sensitive currencies, such as the New Zealand and Canadian dollars.

INR: Neutral. We expect the Indian rupee to move sideways with a slight appreciation bias in the near term due to India's supportive policy environment and the fact that an August rate cut is largely priced in. We do not expect meaningful appreciation from its current valuation and expect RBI intervention if the rupee appreciates. Despite our neutral stance, we believe the rupee potentially offers good carry since we expect low rupee volatility in the coming months.

Rob Waldner, Chief Strategist, James Ong, Director Derivative Portfolio Management, Noelle Corum, Associate Portfolio Manager, Yi Hu, Senior Analyst, Michael Siviter, Senior Portfolio Manager, Brian Schneider, Senior Portfolio Manager, Scott Case, Portfolio Manager, Amritpal Sidhu, Quantitative Analyst

This section highlights the key themes driving Invesco Fixed Income's global credit research process and views.

Global credit themes

Asset class themes

Investment grade (IG): Easing financial conditions and technicals are supportive but trade and earnings remain uncertain

Rationale

We continue to believe US corporate credit fundamentals will improve across most sectors heading into the second half of 2019. First-half operating results in the US were dragged down by the government shutdown, trade policy uncertainty and a stronger US dollar, but earnings growth is still positive and we expect companies to increasingly focus on deleveraging. Despite a potential delay in our thesis due to trade-related earnings pressure, we believe companies remain committed to decreasing their debt burdens following years of elevated merger, acquisition and share repurchase activity. We are now seeing pressure from shareholders to decrease leverage and limited appetite for below investment grade credit ratings. Additionally, the Fed's dovish language favors a lower fed funds rate, a favorable development for market stability as we enter the second half of the year.

The return of hawkish rhetoric from both sides of the US-China trade negotiations injected volatility into credit markets in May but they have since stabilized. Most investors still expect an agreement to be reached, although the timeline is uncertain. The June G20 meetings did not produce meaningful progress in trade discussions, but policymakers in both countries are likely to implement easing measures to support their economies and financial markets in the short run.

Positive technical conditions for US dollar credit markets have returned recently and remain supportive. A flurry of large bond issues to fund mergers and acquisitions transactions in April and May increased the pace of supply but the deals exhibited a more prudent balance of debt and equity funding. The pipeline of future deals is much smaller, so supply pressures should abate. Foreign investor demand for US IG has also returned as currency hedging costs have declined and non-US yields remain extremely low.

European credit markets are generally earlier in the credit cycle compared to the US and are less levered, though risks of a "no-deal" Brexit and political uncertainty in Italy and other countries remain elevated. European growth concerns and trade policy issues continue to present headwinds for large multinational issuers.

IFI strategy

We have increased credit market exposure on the heels of a more accommodative Fed and more favorable supply/demand conditions, but we continue to monitor the impact of global trade policy on fundamentals. We favor the US and Europe over the UK and Asia. Key market drivers we are monitoring include 1) the pace at which the Fed, ECB, BoJ, BoE and PBoC respond to slower global growth and the impact on the US dollar and global credit flows 2) potential US fiscal and regulatory policy changes and 3) the impact of still-uncertain trade policy with China and Europe on costs, margins, demand and investment and the potential for a more destabilizing global trade war.

High yield (HY): Technical backdrop remains strong as valuations hover toward the tighter end of the ranges

Rationale

We remain constructive on high yield as the search for income remains a dominant theme. Overall, HY fundamentals have taken a slight step back but remain in good shape. The technical picture remains supportive amid brisk new issuance and strong demand for paper. Early indicators suggest that the consumer remains in good shape but corporates are hesitant to deploy and increase capital expenditure due to trade uncertainty. We will look to Q2 earnings for more color on this issue and whether the impact of trade on fundamentals causes us to take a more cautious tone on the asset class. While performance so far this year is unlikely to repeat itself in the second half, we think high yield's strong coupon income bodes well for a respectable full-year total return.

IFI strategy

Both technicals and fundamentals remain supportive of high yield. Excluding an exogenous event or a turn for the worse on the trade front, we expect high yield to provide strong income for the balance of the year. We remain positioned to benefit from this backdrop and continually look for opportunities to optimize risk-adjusted returns as valuations move toward the tight end of the recent range.

Emerging markets (EM): Fed easing likely to provide breathing space for EM

Rationale

Thanks to developed market central banks' dovish turn and the "cease fire" in the US-China tariffs exchanges, EM debt has extending its rally. However, June data are confirming a "double-dip" in manufacturing-related sectors, especially in EM Asia. So, the upcoming Fed cut is helpful, but, will not likely lead to a growth resurgence in EM.

Worsening economic activity and mostly benign inflationary pressures suggest there is scope for a more aggressive easing response from many EM central banks. In the past few months, India, Russia, Malaysia, Chile, and the Philippines cut policy rates. South Africa, Indonesia, South Korea recently did the same and Brazil and Turkey appear next in line.

IFI strategy

While we await further clarity on trade, we continue to favor adding risk selectively, focusing on countries that are less externally vulnerable or that have solid policy anchors. Select EM high yield credits offer more compelling value than investment grade, in our view.

US commercial mortgage backed securities (US CMBS): Positioning is key as the commercial real estate cycle progresses

Rationale

We expect commercial real estate rent growth and property price appreciation to continue. However, we believe the pace of appreciation will slow as new supply hinders space absorption. Further, we expect growth in e-commerce to remain a headwind for the retail property sector. On a positive note, today's relatively lower interest rate environment and favorable lending conditions should support investor demand. Lending conditions remain broadly accommodative across property markets despite moderately tighter credit standards. We expect modest new issuance volumes to be absorbed by investors.

IFI strategy

We believe senior non-agency US CMBS offers attractive carry and, in the near-term, potential for incremental spread tightening. In subordinate CMBS, we believe security selection will become increasingly important as the real-estate cycle continues to extend. We currently prefer seasoned subordinate credits that benefit from embedded property price appreciation and declining spread duration.

US residential mortgage backed securities (US RMBS): Credit profiles remain solid; better value in senior classes

Rationale

A robust labor market, positive demographic trends and lower mortgage rates are supporting housing demand and mortgage borrower performance. RMBS credit profiles are strong due to conservative capital structures and low default rates. Technicals have weakened somewhat due to a meaningful increase in supply, preventing tightening in new issue spreads and presenting opportunities, in our view, for compelling carry in securities with low credit risk and limited spread duration.

IFI strategy

We believe value in AAA rated prime jumbo securities has moderated as the credit spread premium over agency mortgage-backed securities has declined. We believe senior classes collateralized by non-qualified mortgages and reperforming loans offer substantial carry, potential for moderate spread tightening, and limited exposure to broader market volatility. Government Sponsored Enterprise Credit Risk Transfer securities appear fairly valued, in our view.

US asset backed securities (US ABS): Improved technical and fundamental trends remain supportive

Rationale

Broad market stability and improved technical trends have led to modest spread tightening across several benchmark ABS assets. In addition, primary market supply has been met with strong investor demand. Fundamentals remain supportive for the consumer and near-term collateral performance trends while credit quality and other pool characteristics are stable for most assets. Given the shape of the yield curve, we expect short-duration, benchmark ABS to remain in high demand.

IFI strategy

We see value at the top of the capital structure in liquid, amortizing benchmark and certain non-benchmark sectors, which continue to benefit from an inverted short-end of the yield curve and relatively attractive all-in yields. We also see value in adding certain subordinate exposures where structures quickly de-lever. The relative value proposition for certain benchmark and esoteric ABS strengthened on the rally in corporate spreads in recent weeks. We expect to remain highly selective in adding esoteric ABS given limited tiering to-date and where we are in the credit cycle.

Sector themes

Commodities: Supply conditions may drive near-term pricing; monitoring trade, global growth, tensions with Iran and Chinese manufacturing

Rationale

Commodities have generally benefited from broad global growth, which has increased global commodity demand. However, tariff-related uncertainties pose near-term risks to the commodity space, coupled with broader concerns about slowing global growth. With that said, financial conditions have loosened, and global policy rhetoric has softened over the past several months, helping to stabilize and strengthen commodity prices.

Chinese policies may improve demand in the second half of 2019, despite the potential for near-term weakness as their impact remains unclear. We expect corporate and credit fundamentals to remain supportive, given anticipated organic deleveraging, although managements' policies continue to become increasingly shareholder friendly. While we are actively monitoring commodity demand risks, we believe shifts in the commodity supply backdrop will continue to be the key near-term price driver.

IFI strategy

We favor copper producers, which tend to benefit from better supply/demand dynamics and have more attractive bond valuations. We like selective exploration and production oil companies located in Latin America as well as certain Russian oil and gas producers. We also remain constructive on select US midstream companies that are focused on cost of capital optimization and active deleveraging to stabilize or maintain investment grade ratings.

Consumer story nuanced globally, monitoring impact of US fiscal policy

Rationale

The solid US labor market and consumer confidence are supportive of the consumer sector, but US consumers are more value and delivery conscious while international retail demand remains uneven. We are watching the European consumer for post-Brexit behavior shifts.

IFI strategy

We favor internet-resistant and value-based US consumer sectors, such as dollar stores and aftermarket auto part retailers, but remain cautious on department stores and mall-based retailers that lack differentiated products. In EM, we have turned slightly more defensive due to a relatively muted growth outlook. As such, we prefer investment grade credits with a global footprint and multi-product offering. We expect US automotive original equipment manufacturers (OEM) sector fundamentals to weaken, given an adverse trade environment. Longer-term, however, we favor the sector on the margin, given our confidence that OEMs will be able to maintain an IG profile. European auto demand is proving resilient, which creates some potential in the European crossover segment (the border between investment grade and high yield). We are cautious on European consumer goods companies, as low growth continues to pressure management toward shareholder returns and mergers and acquisitions, slowly deteriorating the credit quality of the sector.

Technology, media and telecommunications (TMT): Merger decisions will likely drive the sector

Rationale

We are currently awaiting a ruling from the US Department of Justice on the pending merger of two major telecom providers. This will have a significant impact on shaping actions within the entire communications sector, as convergence plays out between cable and wireless. We continue to monitor headlines from Washington and believe decisions that favor a swifter rollout of 5G wireless technology in the US will likely prevail at the end.

IFI strategy

We prefer exposure to spectrum owners, equipment manufacturers, and tower owners, which, we believe, remain in a good position to benefit from the rollout of 5G.

Post-M&A deleveraging plays

Rationale

M&A activity remains a moderate risk, driven by large cash balances and the need to reposition business portfolios. Debt financing costs remain manageable given low interest rates and tight credit spreads. Some recent transactions have elevated leverage profiles and seem inconsistent with historical rating agency methodologies. Therefore, we have become very selective in deal participation.

IFI strategy

We prefer to play post-transaction bond issuance which is typically characterized by size, liquidity, concessions and credible plans for deleveraging. We believe an increasingly discriminatory approach to this strategy is warranted due to seemingly more relaxed credit agency ratings during what is potentially the later stages of the credit cycle.

Yield curve themes

Search for yield creating demand further out the curve. Longer dated corporates attractive.

Rationale

With the market pricing in three-to-four Fed rate cuts over the next year, the low yield on shorter-term credit has incentivized US and global investors to seek longer-dated corporate debt to garner additional yield. We expect this trend to continue amid falling interest rates and a rising supply of negative yielding global debt. If central banks can engineer a steepening in the yield curve, we would expect to see this trend gain further traction.

IFI strategy

We had been focused on the 6-7 year part of the curve, however, upside from here appears limited, in our view. We have been looking at 10 and 30-year corporates as a potential source of value and added alpha. We expect longer-term maturities to perform well as investors move out the curve to search for yield.

David Todd, Head of Global Corporate Credit Research, Paul English, Head of US IG Research, Mike Kelley, Head of Global High Yield 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 the broad range of fixed income assets managed by Invesco.

Global credit strategy

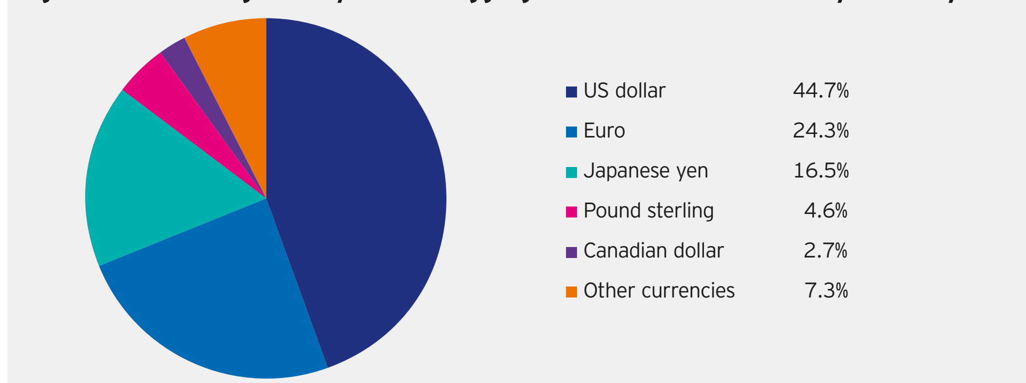
Don't be so negative: Finding value in US corporate bonds

As yields across the globe plummet, many investors are now actually paying someone to take their money. Currently, there are more than USD12 trillion of bonds with negative yields outstanding, which equal 24% of the global bond market.[1] In Europe, the search for positive yield is especially challenging. Over half (51%) of the European bond market now yields a negative rate.[1] Germany recently issued €5 billion of bunds at a price of €101.5, but these will only return €100 in two years with zero coupons paid.[2] And according to Reuters, Austria is also rumored to be planning to issue a 100-year bond at roughly 1% to feed yield-hungry investors.

The US is currently the largest contributor of global fixed income yield

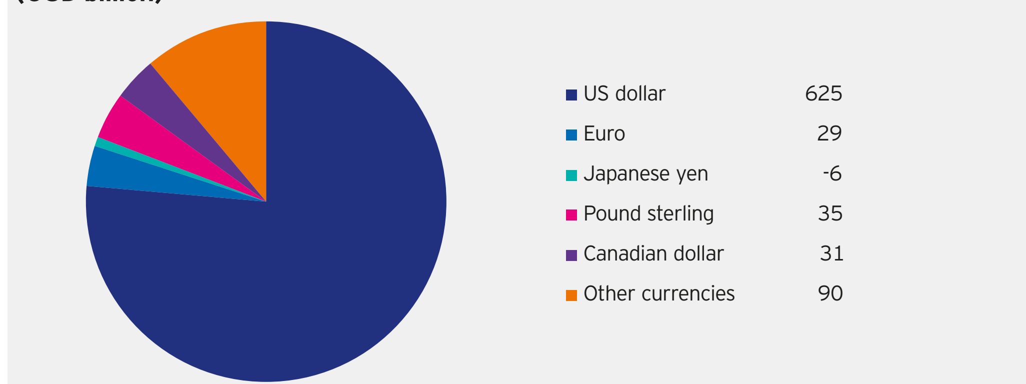
While Europe and Japan account for 40.8% of the global bond market by market value, they generate only 2.8% of the income (figures 1 and 2).[1] So where can yield-starved European and Asian investors find positive yields? Emerging markets like South Korea, China, Thailand and Indonesia have been positive yielding and account for 6.1% of global income generated from bonds.[1] Developed but smaller debt markets such as the UK and Canada account for 8.1% of global income. The biggest source of yield is the United States, which contributes 77.9% of the globe's fixed income yield, on only 44.7% of the debt.[1]

Figure 1: Bloomberg Barclays Global Aggregate Index – Market value by currency



Source: Bloomberg L.P., data as of June 28, 2019.

Figure 2: Bloomberg Barclays Global Aggregate Index – Yield generated by currency (USD billion)



Source: Bloomberg L.P., data as of June 28, 2019.

As the ECB considers rate cuts and additional bond purchases, Europe's negative yield problem may only get worse. Potential interest rate cuts by the central banks of England, Australia, and Canada could compound the problem. To top it off, fixed income traders expect (per the CME FedWatch Tool) the Fed to cut interest rates by 25 to 50 basis points at its July meeting.

Summary

At Invesco Fixed Income, our view is the global search for yield will continue to lead fixed income investors to the US. We see high-quality US corporates as "the only game in town," and believe these issues should continue to benefit from ongoing downward pressure on sovereign bond yields. This "quality trade" is likely to persist in the coming months and, as negative-yielding global bonds raise interest in the US market, we expect investment grade corporate yields to test their 2016 lows.[3]

Matt Brill, Head of US Investment Grade

1 Source: Bloomberg L.P., data as of June 28, 2019.
2 Source: Bundesrepublik Deutschland Finanzagentur GmbH, June 25, 2019.
3 Source: Bloomberg Barclays US Aggregate Corporate Yield to Worst, July 8, 2016.

The bottom line

Invesco Fixed Income's approach to ESG

Rob Neilson
Head EMEA Product Strategy and Solutions

Sam Morton
Head European Investment Grade Research

Kevin Petrovcik
Senior Client Portfolio Manager

Invesco Fixed Income (IFI) has worked hard in recent years to integrate environmental, social and governance (ESG) factors into our credit research process. ESG is now a focus of all IFI credit analysts globally. Analysts factor ESG considerations into their analysis of all companies and sovereigns, making sure that we have - what we believe - is a state-of-the-art implementation of ESG factors in the credit investment process. Below, we speak with leaders in IFI's implementation of ESG about its methodology and how ESG has become embedded in IFI's credit research process.

Q: Why is ESG a focus and what structures have you put in place to support it?
Rob Neilson: ESG is one of the most prevalent trends in our industry today. Looking at any number of estimates suggests that multiple billions of client assets are going to be moving into ESG-aligned mandates over the next few years.

To compete for those assets, our investment teams have worked extremely hard to integrate ESG into the daily workflows that support our investment process.

Integrating ESG successfully also involves having the support of the firm behind you. Our investment teams can do a lot in terms of analysis, but engagement with issuers and the awareness of regulation requires a firmwide support network. We have that in Invesco's Global Responsible Investment team, headed by Bonnie Saynay.

Q: What has been done to integrate ESG into IFI?
Rob Neilson: Within IFI, we have achieved several milestones in the past year. First, we have gone beyond core investment grade corporate bonds and integrated ESG into our sovereign debt and high yield platforms. We have also now incorporated ESG into our private debt markets and bank loan strategies. Second, we have achieved critical mass in our issuer-level research. Today we have over 1300 public issuers under IFI proprietary ESG research. On the private bank loan side, we have over 600 issuers under coverage. That's where the power and scale of our platform comes in, giving us the ability to cover a tremendous amount of ground for our clients.

Third, we have built, along with our colleagues in the Henley Investment Center, a sustainability bond evaluation framework. Finally, IFI has started to systematically engage with issuers on ESG matters in concert with Invesco's Responsible Investment team. These efforts have given us a broadening footprint to manage multiple types of ESG-related mandates for clients.

Q: What does the integration of ESG in the investment process mean in practical terms?
Sam Morton: Our ESG-related research process takes a numerical score for each of the E, S and G factors and culminates into an overall letter score for the ESG rating.

By weighting the individual E, S and G factors by industry, our ratings process reflects the idea that different industries have different levels of reliance on different factors. For example, the media industry has a very small environmental impact, but the mining sector has a huge environmental impact.

The benefit of our scoring system is that we can run mandates on a "best-in-class" basis based on our own ratings and we are not reliant on third party ratings. But there is always more work to do. We are still expanding our coverage, so every week the number of credits we cover from an ESG perspective goes up. That means our value proposition is becoming more interesting for clients.

We are also becoming more experienced, which means we should increasingly be able to identify red flags through our research process. And we are improving client reporting. Going forward, we hope to be able to tell clients that their portfolio is either outperforming or underperforming their benchmark from an ESG perspective.

Q: How has IFI benefited from Invesco's firmwide responsible investing efforts?
Sam Morton: The way we engage with issuers has improved greatly. In the past, if I wanted to speak to a company I would email them directly and they may or may not reply. By being centralized, we take advantage of Invesco's scale, which increases the chance of meaningful engagement, such as a meeting with management.

Through engagement and dialog, we can get more clarity on the way a company works, and become comfortable investing, which can lead to interesting opportunities we might have otherwise passed up.

Q: Are there trade-offs when rating issuers according to ESG factors?
Sam Morton: One of the concerns when we started this process was that we would have a lot of companies with poor ESG ratings, which would mean a much smaller investable universe. Fortunately, this has so far not been the case. We can avoid the very worst credits from an ESG perspective because they represent only a small percentage of issuers. Therefore, it does not appear that we have to sacrifice too many investment opportunities to improve the ESG characteristics of a portfolio.

Q: What is the importance of sustainability bonds?
Sam Morton: Sustainability bonds represent one of the hottest topics in the ESG world today. Sustainability is somewhat of a catch-all phrase - it means project bonds used to invest in ESG-friendly segments, such as green and socially responsible projects. This market is already massive. It totaled USD520 billion at the end of 2018 but is growing at a rate of around USD200 billion a year.[1]

Like with any hot trend, the risk is that issuers might try to bend the rules somewhat to take advantage of a large pool of investors seeking to ethically invest. To protect our portfolios and our clients, we have developed a sustainability bond framework with the EMEA Responsible Investment team in which we judge an issue based on four key factors.

The most important factor is use of proceeds. What is the issuer spending the money on? Second, how is the issuer managing those proceeds? Third, will the issuer report - i.e. tell bondholders what it is doing? And the fourth, will reporting be independently verified? Analysts combine these components into an overall score which tells us whether the sustainable bond is in line with these criteria and with the widely followed United Nations Sustainable Development Goals.

Again, it's all about seeking to protect our clients, making sure that we are not invested in issuers with questionable sustainability practices, which could emerge with such rapid growth in the asset class.

Q: Turning to the bank loans space - Invesco is one of the first movers in ESG in bank loans. What has been your experience so far?
Kevin Petrovcik: Bank loans are private debt instruments and very different from other asset classes–f or example, we don't enjoy the benefit of public ESG ratings such as MSCI. We had to take a fundamental bottom-up approach, conducting independent research on every issuer we cover. Issuers have learned along with us, and many are now more prepared to share the kind of ESG-related information that clients value.

We rate each individual company on a scale of one to five, where five represents the highest risk from an ESG perspective, for sixteen separate ESG factors. For example, under governance, we not only look for and rate for board independence, but we also look for and rate on board diversity. We determine an individual score for E, S and G and then, like our public debt colleagues, we weigh the E, S and G for different industries to come up with a composite score. Our senior investment committee is actively involved and must approve each issuer ESG rating; ESG ratings have become an integral part of our investment process.

Q: What has stood out from this process?
Kevin Petrovcik: There have been many successful outcomes from undertaking this ESG initiative for bank loans. First and foremost, we have provided an investment solution that satisfies the increasing ESG focus of our clients. We believe we have created the first ESG bank loan strategy available to smaller investors who were not able to follow through on their own ESG mandates due to investment size. Working with larger seed investors, we can provide immediate portfolio diversification for this strategy and offer the daily liquidity that investors require. We have received significant interest in our ESG strategy from both existing clients and prospective clients and look to broaden this capability to other strategies and geographies.

The second, and more impactful outcome of the ESG initiative is that we have enhanced Invesco's analytical skills related to ESG risk factors. The process of rating each issuer has been time consuming and complex, but our analysts are now leaders in understanding the implications of ESG issues across the investable universe. As such, they are prepared to make more impactful investment decisions.

A third benefit of Invesco's ESG initiative for bank loans is that we have been able to engage management teams on the importance of ESG from an investor perspective. As bank loan investors, we do not have voting rights or control over an issuer's ESG activities or conduct. But as one of the largest managers of senior secured bank loans, we can emphasize the importance of ESG issues to management teams as it relates to their ability to raise capital in the senior secured bank loan market.

Last, we can leverage the ESG initiative work done in bank loans across Invesco's other investment platforms. We are now working with other groups within Invesco Fixed Income and Invesco Alternative Products to educate these investment centers on both the importance of ESG and how we developed our ESG framework and process.

Our ESG initiative is just beginning. We have designed the strategy specifications to be flexible enough to change over time as we continue to refine our ESG investment process. We have also begun product development discussions to extend our ESG strategy and add a European bank loan strategy to our ESG platform.

Please read the Investment risk section at the end of this publication.

1 Source: HSBC, "Green Bond Insights: 2019 market outlook: Rise of the ESG investor," Jan. 9, 2019.

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