Invesco Fixed Income

Global Fixed Income Strategy

January 2016

January takeaways

- The strong US dollar has temporarily damaged US manufacturing and exports but we believe the overall US economy remains on solid footing. (page 3)
- Recent softness in bank loan prices may provide opportunities, in our view, given bank loans' limited exposure to commodities and our relatively healthy outlook for fundamentals and market technicals. (page 11)
- We are cautious on the high yield metals and mining sector. However, 2016 may bring opportunities in the form of "fallen angels," former investment grade firms downgraded to high yield. (page 13)

Global strategy perspective

Finding opportunity in a low-return world

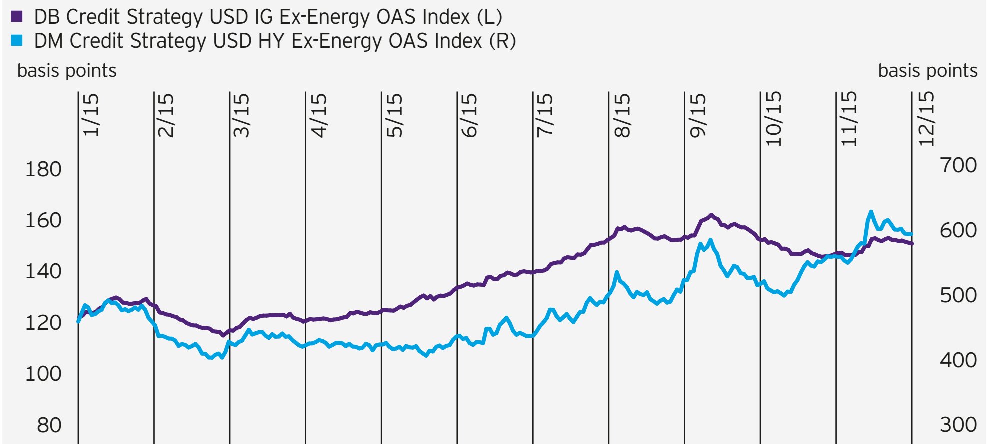
Returns from the major fixed income and equity markets were low in 2015. Most European equity markets generated small positive returns while the US market finished the year close to flat. Fixed income did little better with the Barclays US Aggregate Bond Index up 0.55% and the B arclays Euro Aggregate Bond Index up 1.00%. [1] These returns are disappointing relative to most investors' historical return expectations. 2016 has started out weak and returns are likely to be relatively low across most traditional asset classes, in our view. Global deflation, low nominal growth, US Federal Reserve (Fed) rate hikes, and profit margins that are unlikely to expand from current levels argue for low returns in 2016.

In a low-return world, fixed income is likely to offer some compelling investment opportunities in 2016, in our view. While the Fed has begun to raise rates, and may hike them further in 2016, increases in longer-term bond yields should remain restrained due to global deflationary pressure and slower potential growth in the US and Europe. If the yield curve flattens, longer-maturity bonds may still be able to generate reasonable returns despite rate increases at the short end.

Credit offers opportunities

Within fixed income asset classes, there are opportunities within credit. As we anticipated this time last year, 2015 was a tough year for credit due to an increase in volatility, depressed corporate earnings and energy prices. Credit spreads widened out across investment grade and high yield, overshooting our expectations and getting to levels that, we believe, offer value. Today, we are still cautious on commodity sectors, but favor investment grade and high yield debt of corporate issuers that are focused on the US and European economies. Credit spreads are currently at levels normally associated with recession, but we believe that growth in Europe and the US will be solid in 2016. Yield spreads have been dragged out to current levels by large amounts of issuance and credit stress in the commodity sectors, and offer opportunity in our view. We slightly favor European credits over the US, as the European Central Bank continues to be supportive and Europe is earlier in the economic and credit cycle than the US.

Last year's credit spread widening, minus energy, created value



Source: Deutsche Bank, Jan. 2, 2015, to Dec. 31, 2015. The purple line is the Deutsche Bank Credit Strategy DM USD IG Ex-Energy OAS Index, which represents the market-value weighted, average option-adjusted spread of developed market USD investment grade (ex-energy) corporate bonds. The blue line is the Deutsche Bank Credit Strategy DM USD HY Ex-Energy OAS Index, which represents the market-value weighted, average option-adjusted spread of developed market USD high yield (ex-energy) corporate bonds. The option-adjusted spreads take into account embedded options.

Go to the bottom line

We speak with the EM team about its research process and role in the portfolio investment process.

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Select opportunities emerge in EM

As we noted in 2015, we have been cautious on emerging markets (EM) due to the substantial amount of domestic debt built up since the Global Financial Crisis. Dealing with this debt build-up continues to be a headwind for EM going forward. That being said, adjustment has begun, particularly in currencies, and some opportunities are likely to present themselves in 2016 in currency. Country and issuer selection in 2016 is likely to be key to EM performance, in our view.

One area of EM where we believe adjustment has only just started is Asia. As a region, Asia has seen increases in debt in recent years, and now suffers from slowing growth and disinflationary pressures. This is a difficult macro mix and requires much easier policy. We anticipate easier policy in Asia and associated currency weakness in 2016. China is a clear example of this, but we anticipate these trends will impact most Asian currencies. We see a benefit to being short in Asian currencies, which could generate returns while helping to buffer investors' portfolios in the event of an economic "hard landing" in China that impacts global risk assets.

Return potential for 2016

In a world of lower return expectations, we believe fixed income has the potential to generate relatively attractive returns. We believe corporate bonds issued by US and European domestic companies, paired with an underweight in Asian currencies, may provide a solid foundation for a global fixed income portfolio in 2016 that can potentially generate solid income and return.

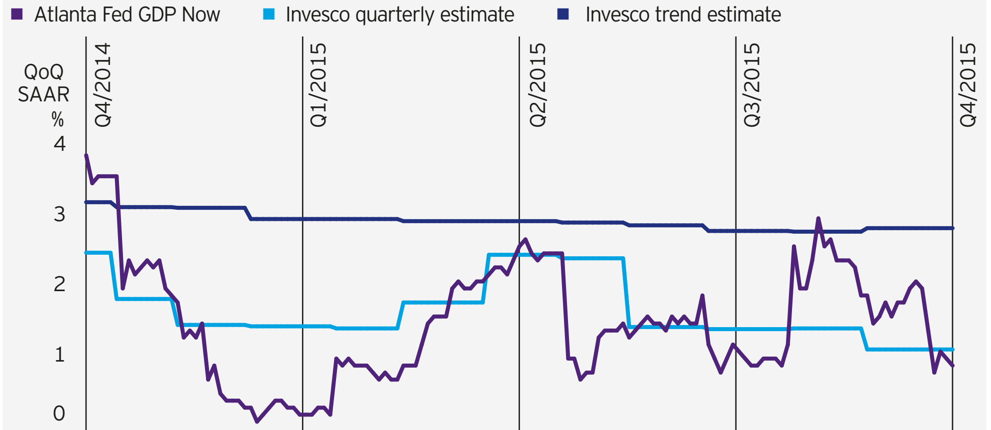
Rob Waldner, Chief Strategist

1 Source: Barclays Live as of Dec. 31, 2015

US growth outlook strong, despite global woes

In the first weeks of 2016, many market participants were surprised and unnerved by negative headlines surrounding the US economy. The ISM Manufacturing Purchasing Managers' Index (PMI), a key measure of manufacturing activity, fell to 48.2 in December (a reading under 50 signals that the manufacturing sector is in contraction) and the Atlanta Federal Reserve's estimate of Q4 GDP growth fell sharply from 2% t o less than 1% o ver the space of two weeks (see chart below).[1]

US GDP growth: Atlanta Fed and Invesco Fixed Income (IFI) forecasts in line



Source: Atlanta Federal Reserve Bank, Invesco, Jan. 13, 2015 to Jan. 8, 2016. SAAR is seasonally adjusted annual rate.

The Atlanta Fed's estimate of the current quarter's growth rate (Atlanta Fed GDPNow) is shown in purple along with IFI's estimate in light blue. We use a similar methodology as the Atlanta Fed to build our estimate shown in light blue but emphasize looking at high frequency indicators that are stable and unrevised (hig frequency estimates of growth utilize the daily release of economic information to continually update estimates of quarterly growth rates). IFI's annual trend estimate shown in dark blue is the rate of growth we expect GDP to average over the next two-four quarters. There is no guarantee these views will come to pass.

However, despite the strong US dollar's temporary damage to manufacturing and exports, we believe the overall US economy remains on solid footing. Our model of economic activity has projected the US dollar's negative impact on manufacturing and exports for some time. This effect is not unprecedented; past periods of sustained US dollar rallies have all seen large drops in the ISM manufacturing PMI. However, we believe this weakness will likely be transitory. Manufacturing still represents a small portion of the economy relative to the much larger consumption sector and we foresee a slower pace of US dollar appreciation in 2016 compared to 2015. After what we expect to be a weak Q4, a more stable US dollar should provide some relief to the manufacturing sector going forward.

IFI's estimate of US trend growth remains strong (see chart above) - we expect the trend in annualized growth to bounce back to 2.7% in Q1 2016. T he US consumer is a key factor in our constructive outlook. Strong consumption growth is being powered by consumer confidence and robust job growth. We are especially seeing sustained and growing strength in the services sector. Together, these factors are fueling a strong housing market and brisk vehicle sales. Our confidence in our estimate comes from the over 70 indicators we track to estimate the health of the economy - only 25% o f our indicators point to growth below 1% o ver the coming few quarters. The 10 most bullish indicators and 10 most bearish indicators of growth are shown in the table below. Notably, many of the bullish indicators are consumption-related while many of the bearish indicators are manufacturing-related. We continue to believe that the fall in oil prices is a net benefit to consumers and should help to offset the impact of the stronger dollar going forward.

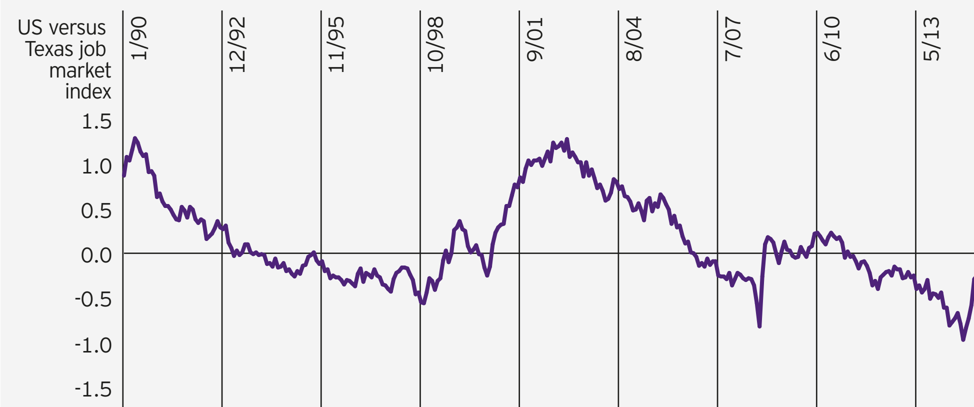
The 10 most bullish and bearish indicators in IFI growth model

Top 10 Indicators	Implied Annualized GDP growth	Bottom 10 Indicators	Implied Annualized GDP growth
LVCVA Las Vegas Visitor Volume	1.84	US Empire State Manufacturing Survey	-0.09
US Architecture Billings Index	2.40	American Iron and Steel Institute Survey	0.22
National Restaurant Performance Index	2.64	Kansas City Federal Reserve SA	0.24
Private Housing Starts	2.79	ICSC US Retail Chain Store Sales	0.50
ISM Milwaukee Employment SA	2.80	Merchant Wholesalers Inventories	0.54
State Street Investor Confidence	2.86	ISM Milwaukee Purchasers Manufacturing PMI	0.68
US Auto Sales Domestic Vehicle	2.88	ASA Staffing Index	0.75
ISM Non-Manufacturing PMI	3.20	US Manufacturers New Orders	1.03
Markit US Service PMI	3.30	US Commercial Bank Assets Loan Growth	1.19
University of Michigan Survey	3.33	Dallas Fed Manufacturing Outlook Survey	1.19

Source: Bloomberg L.P., Jan. 14, 2016. The 10 most bullish indicators have the highest implied growth rates of the 70 indicators we track. They are ordered from lowest to highest implied growth rate. The bottom 10 indicators have the lowest implied growth rates of the 70 indicators we track and are also ordered from lowest to highest implied growth rate.

Dents in consumer confidence, therefore, represent the biggest risk to our view. Defaults among oil and gas companies, for example, and their knock-on effects to the broader economy, could tip the US into recession. We are closely watching consumption in the five largest Texas cities for signs that low oil prices may negatively affect broader US consumption patterns. The chart below shows there has been some employment weakness recently in Texas, but the Texas job market is still as strong, or stronger, than the country's. Until Texas employment weakens significantly, we believe it is unlikely that the broader US economy will be negatively affected by low oil prices.

Texas job market on the mend, still stronger than US job market



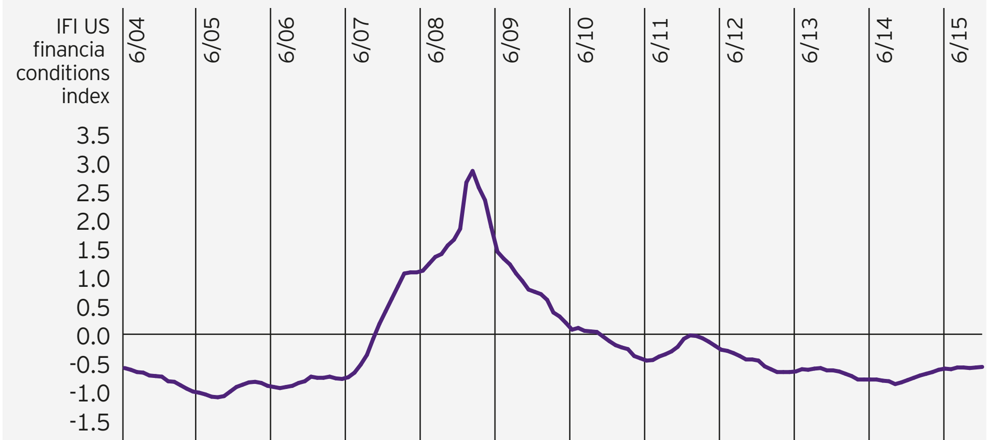
Source: Invesco, Jan. 1, 1990 to Nov. 1, 2015.

The Texas Job market Index tracks unemployment in the Texas cities of Houston, Dallas, San Antonio, El Paso, Austin and Midland relative to the US. A value greater than 0 indicates a stronger job market in the US versus Texas. A value less than 0 indicates a stronger job market in Texas versus the US.

Finally, we believe US consumer confidence is vulnerable to sustained financial market volatility, caused, for example, by negative news as growth slows in China and other emerging markets. Uncertainty over global events could cause financial market stress that would likely first manifest in US financial conditions (lending conditions).

We have constructed a US financial conditions index, shown in the chart below, which summarizes the cost, quantity and risks to credit growth. When the value is significantly above zero, it is difficult for business and consumers to obtain credit. A value below zero indicates that it is relatively easy. Since the US dollar's strong rally in early 2015, financial conditions have tightened, but credit conditions still remain easier relative to historical standards.

US financial conditions have tightened but remain relatively easy



Source: Invesco, Jun. 30, 2004 to Dec. 31, 2015.

The IFI financial conditions index summarizes the cost and quantity of credit as well as the willingness of banks to create credit. We track various money market interest rates, overall debt growth and leverage and as well as the survey of lending activity. The index is created by a weighted average of the underlying components.

2016 outlook

We continue to expect strong growth in the coming year. Over the next six months, barring a shock to confidence, service sector business and consumer confidence levels indicate continued strong consumption growth. Further out, we think the gradual pace of monetary tightening communicated by the Fed should be supportive of growth. We will be watching closely the impact of interest rates on auto and housing lending but, with healthy job gains and rising wages, we see a muted impact from anticipated policy tightening. Finally, the external picture is not all negative. European growth is strong and we expect it to continue, given the simulative environment of the ECB. Together, we believe Europe and the US have formed a strong wall of consumption to shelter themselves from the emerging market slowdown.

Jay Raol, Senior Macro Analyst

1 Source: Institute for Supply Management, December PMI, Jan. 4, 2016.

Interest rate outlook

US: US interest rate volatility persists as commodity price volatility and global macro stress weigh on markets. Current valuations on the 10-year US Treasury appear rich in the face of a US tightening cycle. However, this will likely persist until the US economy can generate increasing inflation. The bond market appears to be underpricing the Fed's forecast of future rate hikes. The rate of inflation over the next year will be critical in determining if the market moves toward the Fed's forecast. A data-dependent hiking cycle will likely keep volatility elevated.

Europe: While the data continue to support our outlook for above-potential growth in the eurozone this year, risk assets have performed badly due to the precipitous decline in oil and the heightened degree of policy uncertainty in China. This made this month's European Central Bank (ECB) meeting very interesting and President Draghi adopted a very dovish tone, as we expected. Draghi reiterated the ECB's ability to do more and reminded markets that ECB operations will be reviewed in March, one year into the program (at the six-month review, the individual bond issue limit for ECB purchases was raised from 25% t o 33%). He r eiterated that all policy measures will be on the table and that the ECB "wouldn't surrender." While it can be argued that the new sources of deflation risk are exogenous, this is the risk the ECB took when it kept monetary policy too tight for too long, in our view. We believe Europe is too heavily indebted and many sovereigns would be at risk of insolvency if deflation were allowed to materialize. Therefore, we expect further easing action in March.

China: The recent sharp plunges in Chinese domestic stocks, the quick reversal of the regulators' "circuit-breaker" mechanism for the domestic stock market, depreciation of the Chinese renminbi (RMB) against the US dollar and its rising volatility have led to intensifying global investor concern about policy opaqueness in China. The Chinese authorities have been tightening up administrative measures to control capital outflows from households. Onshore Chinese government bond yields have been declining amid soft consumer and producer inflation reports. Meanwhile, offshore Chinese government bond yields have risen. We believe the divergence is due to the tightening offshore RMB liquidity conditions as a result of currency interventions by the Chinese central bank. We expect the offshore and onshore yields to converge when the RMB stabilizes with greater clarity on Chinese administrative and economic policies.

UK: Economic data releases in early 2016 have been slightly disappointing, but with house prices continuing to rise and oil prices continuing to decline, we expect the UK consumer's contribution to growth to remain solid in the near term. We believe it is increasingly likely that the UK will hold its referendum on EU membership in 2016. We expect the UK to stay in the EU, but uncertainty regarding the outcome of the vote could negatively impact business sentiment and dampen investment temporarily. The Bank of England is highly unlikely to hike interest rates before the referendum result is known, in our view, and with inflation data still well short of its 2% in flation target, we believe it is unlikely that that there will be a need to hike rates before Q1 2017. We expect ten-year gilt yields to trade between 1.65-1.95% thr ough Q1.

Japan: Lower oil prices and the strength of the Japanese yen are testing the patience of Bank of Japan (BoJ) officials. Both factors are pushing inflation further away from its 2% in flation target and may force it to adjust policy if recent price trends do not abate. An increase in oil prices and/or an in increase in wages would alleviate concerns somewhat. However, given the ongoing supply/demand imbalance and the profitability of smaller and medium sized businesses, it is unlikely that either will come about soon. We expect Japanese 10-year government bond yields to remain range-bound in Q1 between 0.15-0.3%.

Global strategy perspective continued

Canada: We continue to see signs of weakness in the Canadian economy. Business investment and hiring intentions are now expected to decline in 2016, something we only tend to see during recessions. Due to fragile household balance sheets, consumer spending will not likely provide the needed contribution to growth. We expect the Bank of Canada to cut interest rates further amid this backdrop. The output gap will likely widen further and wages will likely remain depressed. This disinflationary backdrop remains supportive of fixed income assets. 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 likely did not expect such a turbulent start to the year. The source of volatility remains capital outflows out of China. Domestically, there are clear signs that the domestic economy is doing well with job prospects looking up, meaning any interest rate policy changes are likely on hold until after Q1 2016. Australian interest rates will, therefore, likely respond to the ebbs and flows in yields globally, which currently appear to be trending lower.

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: We continue to think the US dollar will be supported by policy and economic divergence relative to the rest of the world. The US has begun tightening monetary policy while other global central banks remain accommodative. We also expect US growth to continue to diverge from global growth, specifically in Asia. Given this divergence, foreign investors will likely seek higher yielding assets in the US, supporting the US dollar. Given our outlook on both US and Asian growth, we continue to favor being long the US dollar against select Asian currencies (excluding Japan).

EUR: Our negative stance on the euro remains but has moderated given the magnitude of the adjustment over the past year. We expect the scope of the decline to be more muted going forward. While the ECB remains highly accommodative, and the Fed has achieved lift-off, the underlying growth momentum in the eurozone has accelerated, diminishing the probability of further aggressive easing by the ECB. The euro will 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.

JPY: The yen has appreciated meaningfully since early December as a combination of declining oil prices, concerns over China and geopolitical concerns have seen markets move into "risk off" mode. While we believe that a stronger yen will likely prove beneficial to smaller and medium-sized Japanese companies over the medium term (cheaper import costs help increase profit margins), and thus provide them with the capacity to pay their staff higher wages, this improvement may come at the expense of continued declines in inflation. The recent fall in oil prices, therefore, will not have gone un-noticed by the Bank of Japan. We believe it would like to refrain from further easing if possible, but may be forced to ease policy further if currency strengthening and oil price declines persist. We expect the Japanese yen to give up some of its recent gains over the near term.

GBP: Concerns over the UK's European Union membership are expected to intensify over the coming months. It is our view that negotiations with the EU over the terms of the UK's membership will be heralded as much more of a success than they actually are. However, they should be sufficient for the "staying in" campaign to gain a clear lead a couple of months ahead of the actual vote and reduce uncertainty regarding the outcome. While we remain negative on sterling over the longer term (due to over-reliance on the contribution of the consumer), a "yes" vote would likely be positive for the currency over the shorter term, particularly given the declines already seen.

CAD: Headwinds facing the Canadian dollar continue. Oil price declines, diverging monetary policies and weak economic activity will likely keep pressure on the Canadian dollar going forward. Foreign investment is expected to retreat further as the energy sector remains in freefall and Canada's manufacturing sectors are challenged. We expect the Canadian dollar to cheapen further and remain short against the US dollar and Mexican peso.

AUD: The Reserve Bank of Australia (RBA) advised the markets to "enjoy Christmas" but likely did not expect such a turbulent start to the year. The source of volatility remains capital outflows out of China. Domestically, there are clear signs that the domestic economy is doing well with job prospects looking up. Therefore, we believe any interest rate policy changes are likely to be on hold until after Q1 2016. We believe if risk sentiment worsens, the Australian dollar will suffer.

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 Divergence: US Fed begins tightening while ECB eases

Rationale

Policy divergence between Europe and the US remains intact even as their growth outcomes begin to converge

IFI Strategy

We continue to favor long-dated inflation protected bonds in both Europe and US but believe current commodity weakness warrants staying on the sidelines. In the near term, these bonds may be challenged while markets adapt to below USD40 oil.

Asia is the epicenter of global 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 the apparent acceleration of 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 QE provides tailwind, supporting valuations. Asia has the benefit of a more supportive technical situation with lower supply expectations. US valuations may offer the potential for more yield, but reflect rising fundamental and supply pressure.

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

Emerging markets – A bond picker's market

Rationale: Fundamentals remain challenged but have stabilized, while supply should be low and valuations have improved. Expect volatility around commodities to continue, but attractive opportunities may exist in select countries and credits.

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

Sector themes

US and European financials offer improving fundamentals and attractive valuations

Rationale: Capital, asset quality and liquidity have improved significantly in both US and European banks, and the strict regulatory environments ensure stronger credit fundamentals are likely to remain intact. Valuations in subordinated bonds remain compelling, in our view.

IFI Strategy: Clarity in the fundamental and regulatory outlook and healthy subordination premiums lead us to favor securities lower in the capital structure in both the US and Europe. Recent clarity on regulations has reduced market concern around a significant increase in supply of senior debt.

Commodities: Still cautious, key call for 2016

Rationale: Excess supply and moderating demand continue to plague commodity prices and related corporate bonds across IG, HY and EM. Valuations have become extreme in areas, and will likely remain highly correlated with underlying commodity prices. Identifying any 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 over metals. 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 and gas-centric exploration companies, as we see less volatility in this space.

Consumer story now more nuanced globally

Rationale: The US labor market and low gas prices remain supportive, 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 like 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, 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 plan to deleverage. Due to recent ramp-up in M&A related issuance, a more discriminating approach to this strategy is now warranted, in our view.

Credit quality themes

Neutral quality bias in US, down in quality in Europe

Rationale: We previously favored A's over BBB's in US, but now see relative value as more balanced and believe sector and security selection offer better opportunities than overweighting any rating bucket. In Europe, we believe lower credit quality names will continue outperforming.

IFI Strategy: In Europe, we favor overweighting BBB bucket, while in US we seek to remain neutral positioning in ratings buckets despite steeping BBB/A curves.

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.

Bank loans

Fundamentals and technicals appear supportive in 2016

We expect credit risk to be a big focus in 2016 as investors remain vigilant and riskier issuance is met with resistance. However, the fundamental environment for bank loans remains generally healthy as slow but positive GDP growth is likely supportive of a benign default rate. Many bank loan issuers have used the last few years to strengthen their balance sheets- improving profit margins, generating strong free cash flow and refinancing debt at cheaper rates. We believe the probability of a recession - the primary driver of elevated defaults - is low.

Energy and commodities remain a big question mark heading into 2016 and are expected to heavily influence overall market returns and default expectations. However, exposure of the bank loan asset class to commodities is relatively low. Moreover, we believe that some names in the commodities sector are trading below fair value and could potentially provide upside from current levels.

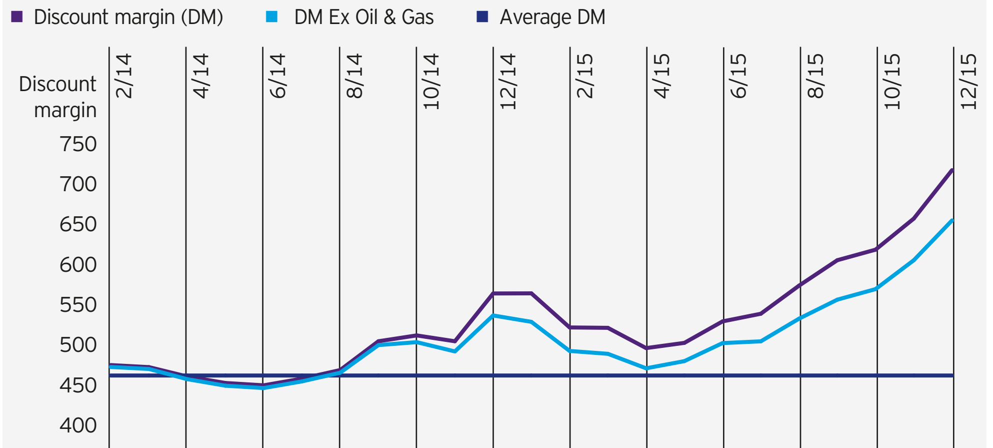
Our outlook for defaults remains in the 2-2.5% r ange, below the long term average of 3.1%. [1] To induce a default, a company either (1) cannot service its debt or (2) cannot refinance its debt at maturity. Near-term maturities represent only 1.4% o f the market maturing in 2016, which we believe bodes well for default risks.[1] Also, we expect defaults to be heavily weighted toward energy and commodity-related names. Given the asset class's low exposure to these troubled sectors, we expect bank loan defaults to remain low.

Throughout most of 2015, bank loan market technicals were stable - benefiting from supportive collateralized loan obligation (CLO) issuance and institutional allocations - offsetting outflows from retail mutual funds. CLO issuance of USD111 in 2015 slowed from last year's record pace of USD124 billion but remained well above historical long-term averages.[2] Our expectations for 2016 are for CLO issuance to normalize at USD50-70 billion as new regulations become effective requiring CLO managers to retain ownership in each new transaction. We expect CLO issuance as well as demand from institutional accounts to remain the cornerstone of the loan investor base.

Outflows from retail mutual funds have been elevated since early 2014. We find this trend surprising given the diversification benefits of the loan asset class and the fact that institutional investors have taken the opposite tact, moving heavily into loans during this same period. We do not think retail outflows are likely to reverse until there is more clarity around the pace of US interest rate increases later in 2016. Incremental demand or even the stabilization of retail outflows may provide potential upside to return expectations.

Relatively small ''pockets of weakness'' in the lower quality end of the spectrum have dragged down the average price in the bank loans market (to USD91.72 for the overall markets and USD93.35, excluding the energy sector).[3] However, the vast majority of the market still trades above USD90. Despite recent softness in bank loan prices, we believe overall fundamentals and technicals of the loan market remain supportive. We believe loans remain well positioned to provide a relatively high level of current income with short duration and potential for price appreciation due to current discounted prices.

The loan asset class is offering discount margins in excess of historical averages even excluding the energy sector



Source: S&P/ LSTA Leveraged Loan Index from Jan. 31, 2014, to Dec. 31, 2015. Average represents the periods Jan. 31, 2000, to Dec. 31, 2015, excluding 2008-2009.

Scott Baskind, Head of Global Senior Loans, Jeffrey Reemer, Senior Analyst

1 Source: S&P LCD, as of Dec. 31, 2015.
2 Source: S&P LCD, data from January 2001 through December 2015.
3 Source: S&P LCD, as of Dec. 31, 2015

High yield

Cautious on metals and mining after a difficult year

An unhealthy dependence on easy capital over the past several years has created a major challenge for the metals and mining sector. Invesco Fixed Income (IFI) believes the mixture of high leverage and slowing demand for commodities is proving to be a lethal combination that warrants continued close attention in 2016.

Last year was very difficult for high yield investors, especially those with exposure to metals and mining. For example, the metals and mining sector was the worst high yield performer of the year, with total returns of -27.94% v ersus -4.99% f or the broader high yield market.[1] The US investment grade metals and mining sector also weakened, declining by 14.51% and signif icantly underperforming the broader index, which was down by only 0.77%. [2]

In our view, the metals and mining sector remains vulnerable this year as well, as Chinese demand continues to slow due to a shift away from fixed asset spending. At the same time, after years of global investment in capacity expansion, which was mostly debt-funded, the supply of most commodities continues to surge, depressing commodity prices. Against this backdrop, we believe investors need to approach the metals and mining sector with caution. We favor participating only in companies with the balance sheet strength and cash liquidity necessary to survive the downturn.

Default expectations increased

As we look at the distressed part of the high yield metals and mining sector today (defined as bonds trading with spreads wider than 1000 basis points), the distressed percentage stands at 66% o f the sector and around 4% o f the overall high yield index.[3] Under the current commodity price regime (our base case), we could see a quarter of the metals and mining sector in default this year, representing roughly 1% of the overall high yield index.[4] However, if prices continue to fall sharply, (our more bearish scenario), close to half of the sector could default, representing roughly 2% o f the overall high yield index.[4]

IFI's approach to investing in the metals and mining sector

While we remain cautious on the metals and mining sector in high yield and investment grade, we continue to seek exposure to select companies that we think can weather the storm. Our preference is weighted toward companies with strong balance sheets, leaders in cost structure, free-cash flow generators and, in certain cases, companies with strategic assets. More than anything, we look for prudent management and companies that are likely to allocate capital appropriately in these challenging times.

Migrants to high yield may provide opportunity

One segment of the metals and mining sector that could potentially offer opportunities for high yield investors this year may be so-called "fallen angels" – that is, investment grade companies downgraded to high yield. We would expect to see investor interest in these former investment grade companies that, in most cases, still carry better balance sheets than their high yield counterparts, in addition to more diverse product lines and opportunities to gain access to liquidity due to their favorable asset profiles. We believe this potential credit migration may especially be of interest to investors given the limited new issuance currently seen in the high yield market.

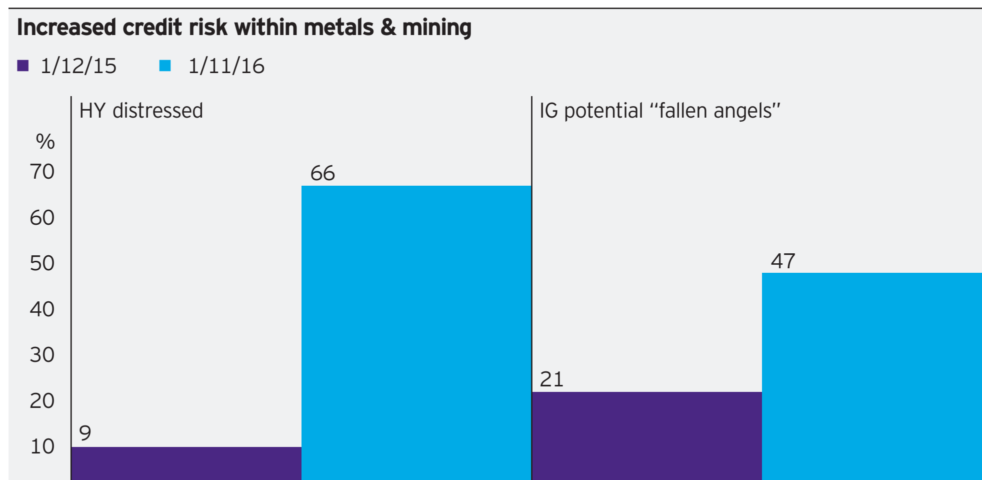
The main downfall of "fallen angels" in the metals and mining sector has been their willingness to invest in or acquire assets, often energy-related, in an attempt to diversify their existing portfolios of base metals or bulk commodities. Unfortunately, they paid top dollar at the peak of the credit cycle, using debt for easy funding. Such companies relied on sustained commodity prices to generate sufficient cash flows and subsequently reduce leverage. At current commodity prices, "fallen angels" now often rely on asset sales and other sources of cash to improve their balance sheets, which is not sustainable. However, we expect that some will likely begin to reap the benefits of their investments in the next few years as their assets begin production, making these companies potentially appealing to high yield investors.

We estimate that about 15% to 25% of the metals and mining component of the Barclays US Credit Index will transition to the high yield index (based on the number of companies trading with spreads wider than BB and individual company analysis), potentially reducing the metals and mining exposure of the overall investment grade index from 1.34% to 1%.[5]

Signs of potential recovery in the sector

We believe the outlook for metals and mining must include China as part of the equation. At a minimum level, we need to see Chinese growth stabilize in order to upgrade our outlook for metals and mining. One of the early telltale signs of a possible turnaround in metals and mining prices would be "end of cycle" behavior — typically a pull-back in commodity supply, either due to producer consolidation via acquisitions or outright credit defaults. Each of these, while disruptive in the short term, could be a healthy indication that supply and demand are finally rebalancing, painting an improved picture for the health of the sector going forward.

Increased credit risk within metals & mining



Source: Barclays High Yield Index – Metals and Mining sector, Barclays US Credit Index - Metals and Mining sector, Invesco, Jan 12, 2015 and Jan 11, 2016.

Note: Investment grade potential "fallen angels" are defined as investment grade bonds with spreads greater than the spread of the BB component, within the Barclays High Yield Credit Index. For reference, BB spreads were 453 bps on 1/11/2016 and 345 bps on 1/12/2015. Barclays Live.

Rahim Shad, Senior Analyst, Peter Wietrak, Analyst

1 JP Morgan HY Index, Dec. 31, 2015.
2 Barclays US Credit Index – Metals and Mining sector, Barclays US Credit Index, Dec. 31, 2015.
3 Barclays High Yield Index – Metals and Mining sector, Barclays High Yield Index - , Jan. 11, 2016.
4 Barclays High Yield Index - Metals and Mining sector, Barclays High Yield Index, Invesco, Jan. 6, 2016.
5 Barclays US Credit Index, Dec. 31, 2015.

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The bottom line

We speak with Invesco Fixed Income's (IFI) Emerging Markets (EM) Research team about its role in the portfolio investment process.

Q: How does EM debt fit in to the broader IFI platform?

Rashique (Head EM): EM debt is broad and diversified as an asset class. Not only is EM global in scope, covering Asia, Europe, the Middle East, Africa and Latin America – but it encompasses hard-currency (predominantly USD-denominated) bonds issued by both corporates and sovereigns, local-currencies and local-currency denominated bonds and is both investment-grade and sub-investment grade (high yield).

Arnab (Head EM Macro): Moreover, as these are developing economies, political dynamics tend to influence economic and market outcomes more so than in developed economies and markets. It therefore requires a multi-disciplinary approach to investing, requiring analysis and understanding of sociopolitical, economic as well as market factors.

Rashique (Head EM): EM debt is broadly integrated in to the IFI platform on three key levels. First, the research processes encompass both developed and emerging markets – both from a macro and credit perspective. Second, investment decision-making is driven by experienced PMs that take account of these value-added inputs. Third, risk management and assessment are done not only by the EM team itself, but by independent surveillance and monitoring of IFI stakeholders looking cross-market and as well by independent units within Invesco.

Q: How have you navigated what have been challenging markets for EMD and what do you believe gives you an edge?

Avi (Senior PM): The EM portfolio decision-making process is aligned with that of the broader IFI effort, in that it emphasizes accountability, rigor and transparency. The EM team is particularly attuned to the measurement and assessment of risk in portfolios. In conjunction with an overarching assessment of portfolio risk, both top-down macro-thematic work and deep-dive fundamental bottoms-up analysis are critical components in constructing our portfolios.

George (Senior PM Credit): We believe integration across the IFI platform provides EM specialists with an edge; we gain value-added insight from senior strategists across IFI, leveraging specialist views on global economies and markets. We seek independence of thought, via structured debate across the EM team – to ensure we've covered investment opportunities and uncovered potential risks from all vantage points.

Q: What is your research process?

Arnab (Head EM Macro): Our macro and sovereign research process is driven by the global research team within IFI, leveraging the expertise of the broader platform – and of both developed and emerging market specialists. We consider the overall macro and policy-making context, to provide a view on the setting for global interest rates. From there, we investigate the credit cycle for EM in aggregate and for individual economies.

Sean (Senior PM): This analysis provides insight in to how various currencies, local interest rate and credit markets are likely to respond, depending on where we are at in the credit cycle. Sovereign research analysts do the bottom-up credit work on individual EM sovereigns, linking fundamental creditworthiness factors to specific valuation and technical considerations.

Jason Trujillo,
Senior Credit Analyst

Mark Yu,
Senior Credit Analyst

Read more about the EM team's credit cycle framework in, "Understanding the emerging markets credit cycle," November 2015, by Rashique Rahman Head of Emerging Markets and Jay Raol, Senior Macro Analyst.

Jason (Senior Analyst Credit): Our corporate credit research process is centered on bringing together the top down work of our macro research team with fundamental company analysis in order to find those opportunities that are attractive both from an idiosyncratic stand point as well as in the context of the macro backdrop. The depth of the fundamental company analysis can vary, given the quality and complexity of the credit but the framework is the same no matter the credit with a host of issuer and security specific factors taken into account and summarized in a standardized format. That is combined with the relevant macro/sovereign considerations to develop a complete fundamental view of the credit.

Mark (Senior Analyst Credit): We then take into account valuation and technicals to derive an investment recommendation. Ultimately, the goal is to have a complete view of the credit. It is not enough to just have a deep understanding of the company. You must also understand the company in the context of macro backdrop, the specific attributes of the security being analyzed, valuation and technicals. It also important to emphasize that this is not a one-time effort but rather an ongoing process that is continually refined.

What opportunities do you see presenting themselves in the EMD market?

Rashique (Head EM): The fundamental landscape has been challenging for EM, as economic growth has slowed and as external risk factors have become more prominent – this includes the recent decline in commodities prices and Fed monetary policy tightening. Our recent work suggests that EM economies are likely in the midst of a downturn in their credit cycles, which could place more pressure on their domestic economies as private balance sheets are impaired, further adversely impacting growth outcomes over the medium term.

Avi (Senior PM): As a result we cannot rule out further volatility in 2016. That said, valuations in both credit and local currency have, nevertheless, improved and are increasingly reflecting these underlying risks. Moreover, with EM being such a diverse asset class, we believe there are pockets of opportunity – even in the prevailing market context.

George (Senior PM Credit): We see a year of two halves – 1H16 we may see further market volatility, as markets price-in EM domestic demand weakness, China concerns and uncertainty regarding the FOMC. We believe valuations will adjust further, opening up the opportunity to assess EM on more-favorable risk/reward grounds, particularly in to 2H16 given (1) natural stabilizers that improve the current account and stabilize EM currencies; (2) a leveling-off of capital flows; and (3) scope for more assertive EM fiscal and monetary policy action.

Recent IFI publications

1. **Investor double-take: US Agency MBS,** December 2015, Rich King, Head of Structured Investments
2. **Invesco Fixed Income: Investor's Summit Outlook November 2015,** December 2015, CEO Greg McGreevey and Chief Strategist Rob Waldner
3. **Understanding the emerging markets credit cycle, Part 1,** December 2015, Rashique Rahman, Head of Emerging Markets, Jay Raol, Analyst
4. **IMF and World Bank annual meetings recap,** October 2015, by Arnab Das, Head of EM Macro, Sean Newman, Senior Portfolio Manager
5. **What are US Commercial Mortgage-Backed Securities (US CMBS)?,** October 2015, by Kevin Collins, Head of CMBS Credit and Daniel Saylor, Senior Analyst
6. **What are GSE Credit Risk Transfer securities?,** October 2015, by David Lyle, Head of RMBS Credit
7. **Structured Convertibles: A Custom Portfolio Solution,** September 2015, by Robert Young, Senior Portfolio Manager
8. **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: current	Option-adjusted spread: 1 month change in spread	Option-adjusted spread: 10 year range min	Option-adjusted spread: 10 year range max	Returns: 1 mth (%)	Returns: 3 mth (%)	Returns: YTD (%)	Returns: 12 mth (%)
Global Aggregate (USD hedged)	2.96	1.77	0.07	50	2	23	156	-0.27	0.10	1.02	1.02
U.S. Aggregate	3.18	2.59	0.10	56	3	32	258	-0.32	-0.57	0.55	0.55
U.S. Mortgage-backed	3.69	2.77	0.06	24	1	-16	181	-0.03	-0.10	1.51	1.51
Global Inv Grade Corporate (USD hedged)	3.95	3.07	0.15	159	8	55	515	-0.69	0.07	-0.24	-0.24
U.S. Investment Grade Corporate	4.25	3.67	0.18	165	11	76	618	-0.78	-0.58	-0.68	-0.68
Emerging Market USD Sovereign	n/a	6.39	0.31	415	25	157	906	-1.39	1.25	1.18	1.18
Emerging Market Corporate	n/a	6.27	0.34	431	28	120	1,032	-1.23	0.45	1.30	1.30
Global High Yield Corporate (USD hedged)	6.50	8.01	0.67	629	54	231	1,845	-2.41	-1.08	-2.82	-2.82
U.S. High Yield Corporate	6.70	8.74	0.72	660	58	233	1,971	-2.52	-2.07	-4.47	-4.47
Bank Loans	4.79	5.21	0.08	n/a	n/a	n/a	n/a	-0.95	-1.96	-0.38	-0.38
Municipal Bond	4.80	2.11	-0.05	n/a	n/a	n/a	n/a	0.70	1.50	3.30	3.30
High Yield Municipal Bond	5.41	6.76	0.00	n/a	n/a	n/a	n/a	0.15	1.78	1.81	1.81

Treasury market monitor

	Coupon (%)	Yield to worst (%)	1 month change in YTW	Returns in local currency: 1 mth (%)	3 mth (%)	YTD (%)	12 mth (%)
United States	2.07	1.73	0.10	-0.16	-0.94	0.84	0.84
Canada	2.63	1.09	-0.15	1.16	0.67	3.72	3.72
United Kingdom	3.75	1.86	0.11	-1.13	-1.34	0.49	0.49
Germany	2.36	0.28	0.13	-1.03	-0.36	0.33	0.33
Italy	3.91	1.08	0.11	-0.73	1.64	4.83	4.83
Japan	1.18	0.32	-0.04	0.67	1.06	1.15	1.15
China	3.68	2.89	-0.21	1.64	2.99	8.43	8.43
EM Local Currency Governments	n/a	n/a	n/a	-0.36	1.44	4.05	4.05

FX Market Monitor[1]

	Current	10 year range: min	10 year range: max	Returns: 1 mth (%)	Returns: 3 mth (%)	Returns: YTD (%)	Returns: 12 mth (%)
EURUSD	1.09	1.06	1.60	2.81%	-2.82%	-10.22%	-10.22%
USDJPY	120.22	75.82	124.77	2.38%	-0.31%	-0.47%	-0.47%
GBPUSD	1.47	1.38	2.11	-2.13%	-2.59%	-5.40%	-5.40%
USDCNY	6.49	6.04	8.28	-1.48%	-2.11%	-4.42%	-4.42%
USDCHF	1.00	0.75	1.39	2.65%	-2.89%	-0.80%	-0.80%
AUDUSD	0.73	0.60	1.10	0.82%	3.82%	-10.87%	-10.87%
CADUSD	0.72	0.72	1.09	-3.43%	-3.79%	-16.01%	-16.01%
EUR/JPY[2]	130.64	94.31	169.49	-0.45%	2.56%	10.88%	10.88%
EUR/GBP[2]	0.74	0.70	0.84	-4.78%	0.24%	5.36%	5.36%

Sources: Barclays, J.P. Morgan, Bloomberg L.P., as of Dec. 31, 2015. Credit Suisse Leveraged Loan data as of Dec. 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 paydown features of a bond. Past performance cannot guarantee future results. An investment cannot be made directly in an index. Returns less than one year are cumulative.

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

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