

Applied philosophy

The red and the blue

Chinese sovereign bonds have outperformed US Treasuries since the middle of 2020. An earlier reopening and more generous fiscal and monetary easing boosted consumer spending in the US and added to inflationary pressures triggering a sharp rise in yields. Meanwhile, longer lockdowns in China and less generous support kept yields there in check. We think that our base case of an end to rate rises in the US and a re-synchronisation of economic growth imply an outperformance of Treasuries over the next 12 months.

Both China and the US have defied our expectations of the path they would take in 2023. We thought the US economy would struggle with one of the sharpest rate hiking cycles ever, but it has been motoring on boosted by excess savings accumulated during COVID-19 lockdowns. At the same time, we expected the Chinese economy to boom after its official reopening and pent-up demand to fuel consumer spending, but that has not been the case so far (relative to its pre-COVID pace).

The latest retail sales figures seem to highlight a divergence in the two largest economies of the world. The US number surprised on the upside and after a brief wobble in Q2 2023, returned to its pre-pandemic rate of growth around 3% year-on-year. The Chinese figure at 2.5% year-on-year, however, was lower than both the Reuters consensus estimate at the time and well below the pre-pandemic trend of double-digit growth rates, while it is also lower than the corresponding figure in the US (although the US figure

is boosted by higher inflation, as both are in nominal terms).

On the other hand, industrial production has been weak in both economies this year (as highlighted by July's figures), consistent with negative sentiment in surveys of purchasing managers. Although Chinese output growth is positive year-on-year, that is nowhere near pre-COVID rates (similar to retail sales). Weakness is also evident in the US, where year-on-year industrial output growth has been hovering around 0% year-to-date.

It is hard to say which indicator is a better reflection of the overall economic performance of these countries at this stage. Although Chinese GDP growth in Q2 2023 was above the official target of 5% (which was lower than in previous years), further weakness in consumer spending could make reaching that target more challenging. US GDP growth in Q2 2023 of 2.6% year-on-year suggests an economy perhaps inching closer to the "soft landing" the Federal Reserve (Fed) hopes for, and a strong start to Q3 – based on retail sales growth – bodes well for the short term, in our view.

Part of the answer why both economies have surprised us and how to view their prospects for growth lies in their approach to handling the pandemic, in our opinion. Support in the US was not only generous, but also reached consumers directly during the initial lockdowns. On the other hand, Chinese lockdowns were more stringent and longer lasting, but the rapid

Figure 1 – China and United States government bond yields and relative returns since 2005



Notes: **Past performance is no guarantee of future results.** Data as of 17 August 2023. All indices use daily data from 3 January 2005 to 17 August 2023. The China government bond yield series shows the yield-to-maturity of the ICE BofA China Government Index. The US 10-year Treasury yield shows the Datastream benchmark 10-year Treasury yield. We calculate the relative total returns by dividing the ICE BofA China local currency government index by the Datastream benchmark US Treasury index rebased to 100 on 3 January 2005.

Source: Refinitiv Datastream, Intercontinental Exchange, Invesco

response kept the virus more contained requiring less fiscal support. This meant that the resulting decline in GDP was somewhat smaller in China than the US, and therefore it is perhaps no surprise that the rebound is also less sharp (US consumers also accumulated more in excess savings).

At the same time, US monetary policy became extremely loose, while the People's Bank of China (PBoC) cut its main policy rate only slightly during 2020 and 2021. Even its other important policy tool, the reserve requirement ratio was cut by only one percentage point between the start of 2020 and the end of 2021. The looser policy in the US (both fiscal and monetary) has required a harsher reset, but the effect on consumer spending from this was offset by excess savings, while China retained its capacity to react to any slowdown in growth, even if any loosening in 2023 so far has had minimal visible impact on the economy.

The way these economies perform has big implications for their respective sovereign bond markets and their returns relative to each other, in our view. We have identified five broad periods since the end of 2004 in their relative returns (see **Figure 1**): 1) Chinese outperformance from the beginning of 2005 to March 2006 during late-stage tightening in the US and falling bond yields in China; 2) US outperformance from March 2006 to September 2011 around the Global Financial Crisis (GFC) when the US introduced several rounds of Quantitative Easing, while China increased interest rates in 2010-2011 (partly to offset a big fiscal boost); 3) Chinese outperformance from September

2011 to November 2018 driven by higher Chinese bond yields; 4) US outperformance from November 2018 to September 2020 in a period of global economic slowdown and US yields falling faster than those of China; 5) Chinese outperformance since September 2020 as yields in the two markets have moved in opposite directions reinforced by monetary tightening in the US and cautious loosening in China.

Can this period of Chinese outperformance continue? To a certain extent the current environment is unprecedented. For the first time in the last 20 years, the Fed's main policy rate is higher than that of the PBoC (the 1-year loan prime rate). Also, the spread between US Treasury yields and Chinese government bonds has not been this wide since before the GFC (**Figure 2**). If we accept the view that starting yields determine long-term returns, this seems to signal that a reversal of fortunes may be on the cards.

However, there are risks to this view in the short term mainly stemming from a potential divergence in economic performance. If US economic growth reaccelerates (with perhaps a corresponding rise in inflation), while the Chinese economy continues to underperform, this could imply further outperformance by Chinese bonds.

The opposite of that (US slowdown, Chinese reacceleration) would likely mean rising yields in China and falling US yields, in our opinion. Our base case, however, is that the US will re-synchronise with the rest of the world and that its growth will slow before

Figure 2 – United States versus China government bond yield spread since 2005 (percentage points)



Notes: **Past performance is no guarantee of future returns.** Data as of 17 August 2023. We use daily data from 3 January 2005 to 17 August 2023. The spread shown is the difference between the Datastream benchmark 10-year Treasury yield and the yield-to-maturity of the ICE BofA China Government Index.

Source: Refinitiv Datastream and Invesco

recovering again. That could allow the Fed to signal its willingness to first stop and then partially reverse its monetary tightening. At the same time, we think it unlikely that the PBoC will start rapidly loosening policy despite its larger potential toolkit to counteract economic weakness (mindful that it will boost the

property sector that it is determined to de-risk). Finally, higher starting yields in the US could allow a period of outperformance even if Chinese yields fell at the same time. Thus, at this point, our preference is for US Treasuries versus Chinese sovereign debt over the next 12 months.

Figure 3 – Asset class total returns (% annualised)

Data as at 17/08/2023	Index	Current Level/Ry	Total Return (USD, %)					Total Return (Local Currency, %)				
			1w	1m	QTD	YTD	12m	1w	1m	QTD	YTD	12m
Equities												
World	MSCI	668	-2.8	-3.9	-1.9	12.1	4.4	-2.4	-2.8	-1.6	12.5	4.4
Emerging Markets	MSCI	974	-3.4	-5.0	-1.0	4.1	-1.1	-2.6	-3.0	0.2	6.0	1.1
China	MSCI	60	-5.0	-4.0	0.9	-4.5	-6.0	-4.7	-3.6	0.9	-3.4	-5.0
US	MSCI	4152	-2.2	-3.5	-1.6	15.2	3.7	-2.2	-3.5	-1.6	15.2	3.7
Europe	MSCI	1879	-3.9	-4.2	-2.3	11.6	14.1	-3.0	-1.4	-2.5	8.4	7.5
Europe ex-UK	MSCI	2330	-3.9	-4.6	-2.4	13.2	16.5	-2.8	-1.6	-2.6	10.9	9.6
UK	MSCI	1110	-3.8	-2.9	-1.9	6.4	6.7	-3.9	-0.5	-2.2	0.4	0.8
Japan	MSCI	3394	-3.4	-4.7	-3.2	9.6	6.2	-2.3	0.1	-2.2	21.3	14.5
Government Bonds												
World	BofA-ML	3.47	-1.6	-3.9	-2.4	-2.0	-5.8	-1.0	-1.9	-2.1	-0.4	-5.8
Emerging Markets	BBloom	8.34	-3.0	-3.5	-1.9	3.5	2.3	-3.0	-3.5	-1.9	3.5	2.3
China	BofA-ML	2.41	-1.0	-1.1	0.6	-1.2	-3.6	0.4	0.8	1.2	3.9	4.0
US (10y)	Datastream	4.30	-1.4	-3.6	-3.4	-1.2	-7.6	-1.4	-3.6	-3.4	-1.2	-7.6
Europe	Bofa-ML	3.39	-2.3	-4.1	-1.7	2.5	-1.7	-1.2	-1.1	-1.5	0.5	-8.2
Europe ex-UK (EMU, 10y)	Datastream	2.68	-2.5	-4.6	-2.2	3.0	-4.7	-1.4	-1.6	-2.0	1.0	-11.1
UK (10y)	Datastream	4.74	-2.7	-4.5	-1.9	0.4	-10.8	-2.9	-2.1	-2.2	-5.3	-15.8
Japan (10y)	Datastream	0.65	-1.6	-6.1	-3.1	-8.5	-7.9	-0.6	-1.5	-2.1	1.3	-0.8
IG Corporate Bonds												
Global	BofA-ML	5.48	-1.4	-2.6	-1.3	2.1	-0.9	-1.0	-1.6	-1.2	1.5	-2.5
Emerging Markets	BBloom	7.80	-1.5	-2.4	-1.8	2.2	2.2	-1.5	-2.4	-1.8	2.2	2.2
China	BofA-ML	3.23	-1.1	-1.4	0.2	-1.6	-4.8	0.3	0.5	0.8	3.5	2.7
US	BofA-ML	5.88	-1.1	-2.3	-1.9	1.2	-2.5	-1.1	-2.3	-1.9	1.2	-2.5
Europe	BofA-ML	4.42	-1.9	-3.3	0.1	4.4	3.9	-0.7	-0.2	0.3	2.3	-3.0
UK	BofA-ML	6.58	-2.0	-3.1	0.3	5.0	-2.7	-2.1	-0.6	0.0	-1.0	-8.1
Japan	BofA-ML	0.84	-1.3	-5.1	-1.7	-8.7	-7.9	-0.2	-0.4	-0.7	1.0	-0.7
HY Corporate Bonds												
Global	BofA-ML	8.79	-1.0	-1.1	0.4	5.7	4.4	-0.8	-0.4	0.4	5.1	2.9
US	BofA-ML	8.70	-0.9	-0.5	0.4	5.9	2.2	-0.9	-0.5	0.4	5.9	2.2
Europe	BofA-ML	7.57	-1.4	-2.6	0.7	7.4	10.5	-0.3	0.5	0.9	5.3	3.1
Cash (Overnight LIBOR)												
US		5.06	0.1	0.4	0.7	3.1	4.3	0.1	0.4	0.7	3.1	4.3
Euro Area		3.65	-0.9	-2.9	0.1	3.4	9.1	0.1	0.3	0.5	1.8	2.1
UK		5.18	0.7	-2.1	1.0	8.2	9.6	0.1	0.4	0.7	2.7	3.6
Japan		-0.06	-0.8	-4.9	-1.0	-10.1	-7.5	0.0	0.0	0.0	0.0	0.0
Real Estate (REITs)												
Global	FTSE	1498	-3.5	-5.4	-2.2	-1.1	-13.0	-2.4	-2.4	-2.0	-3.1	-18.8
Emerging Markets	FTSE	1239	-3.3	-2.7	-1.4	-5.9	-4.3	-2.2	0.4	-1.2	-7.8	-10.7
US	FTSE	2818	-3.3	-5.9	-3.1	2.0	-13.6	-3.3	-5.9	-3.1	2.0	-13.6
Europe ex-UK	FTSE	2040	-5.8	-3.1	5.1	-1.9	-15.3	-4.6	0.0	5.3	-3.9	-21.0
UK	FTSE	715	-5.0	-2.6	2.3	-0.7	-20.7	-5.2	-0.1	2.0	-6.3	-25.1
Japan	FTSE	2032	-3.0	-3.7	-0.3	-4.1	-9.2	-1.9	1.1	0.8	6.1	-2.1
Commodities												
All	GSCI	3507	-2.3	4.8	8.5	0.3	-3.0	-	-	-	-	-
Energy	GSCI	626	-2.4	11.0	15.8	2.5	-5.6	-	-	-	-	-
Industrial Metals	GSCI	1524	-2.1	-3.4	-0.7	-9.1	-4.1	-	-	-	-	-
Precious Metals	GSCI	2129	-1.5	-4.1	-1.9	2.4	7.6	-	-	-	-	-
Agricultural Goods	GSCI	529	-2.3	-4.3	-2.1	-5.4	-1.1	-	-	-	-	-
Currencies (vs USD)*												
EUR		1.09	-1.0	-3.2	-0.4	1.6	6.8	-	-	-	-	-
JPY		145.85	-0.8	-4.9	-1.0	-10.1	-7.4	-	-	-	-	-
GBP		1.28	0.2	-2.5	0.3	6.1	5.9	-	-	-	-	-
CHF		1.14	-0.2	-2.0	2.0	5.3	8.4	-	-	-	-	-
CNY		7.29	-1.0	-1.6	-0.5	-5.4	-7.0	-	-	-	-	-

Notes: *The currency section is organised so that in all cases the numbers show the movement in the mentioned currency versus USD (+ve indicates appreciation, -ve indicates depreciation). **Past performance is no guarantee of future results.** Please see appendix for definitions, methodology and disclaimers.
Source: Refinitiv Datastream and Invesco

Figure 4 – Global equity sector total returns relative to market (%)

Data as at 17/08/2023	Global				
	1w	1m	QTD	YTD	12m
Energy	2.7	9.2	8.7	-1.1	3.1
Basic Materials	-1.5	-1.9	-0.6	-8.8	-0.1
Basic Resources	-2.2	-3.6	-1.0	-10.5	4.1
Chemicals	-0.5	0.2	0.1	-6.5	-5.3
Industrials	-0.8	-0.7	-0.6	-1.5	2.0
Construction & Materials	-0.5	0.8	1.6	5.9	9.8
Industrial Goods & Services	-0.8	-0.9	-1.0	-2.5	1.0
Consumer Discretionary	-1.6	-2.3	-1.8	6.5	-1.6
Automobiles & Parts	-3.4	-8.7	-6.4	16.9	-12.7
Media	-2.6	-3.4	-3.6	1.0	-2.7
Retailers	-0.2	2.5	2.5	7.0	-4.0
Travel & Leisure	-1.5	-1.7	-1.2	4.9	10.9
Consumer Products & Services	-1.9	-3.2	-3.3	1.8	5.2
Consumer Staples	0.1	0.7	-0.6	-9.6	-5.0
Food, Beverage & Tobacco	0.3	0.4	-0.7	-9.3	-4.4
Personal Care, Drug & Grocery Stores	-0.3	1.3	-0.3	-10.2	-6.2
Healthcare	1.2	4.4	1.5	-8.3	-0.9
Financials	-0.3	1.2	1.7	-6.2	-0.4
Banks	-0.7	0.3	1.4	-7.4	-1.8
Financial Services	-0.1	2.0	2.5	-3.5	-1.4
Insurance	0.5	2.4	1.2	-7.3	5.2
Real Estate	-0.7	-1.7	-1.1	-11.5	-16.3
Technology	0.4	-3.8	-2.5	20.3	7.2
Telecommunications	1.2	1.2	-0.7	-6.0	-5.6
Utilities	0.4	-0.5	-1.9	-11.1	-9.9

Notes: Returns shown are for Datastream sector indices versus the total market index. **Past performance is no guarantee of future results.** Source: Refinitiv Datastream and Invesco

Figure 5a – US factor index total returns (%)

Data as at 17/08/2023	Absolute					Relative to Market				
	1w	1m	QTD	YTD	12m	1w	1m	QTD	YTD	12m
Growth	-2.4	-3.7	-1.1	18.4	6.0	-0.2	-0.5	0.5	3.0	1.9
Low volatility	-1.8	-3.6	-3.2	-0.9	-2.4	0.3	-0.4	-1.7	-13.8	-6.2
Price momentum	-3.2	-5.3	-3.1	2.3	3.8	-1.0	-2.1	-1.6	-11.1	-0.2
Quality	-2.3	-1.0	1.1	12.1	9.3	-0.1	2.3	2.7	-2.5	5.1
Size	-3.7	-2.8	-0.1	5.6	-2.6	-1.6	0.4	1.6	-8.2	-6.3
Value	-3.4	-0.9	1.6	-0.2	-7.2	-1.3	2.4	3.2	-13.3	-10.8
Market	-2.1	-3.2	-1.6	15.0	4.0					
Market - Equal-Weighted	-2.8	-3.5	-1.8	5.1	-0.7					

Notes: All indices are subsets of the S&P 500 index, they are rebalanced monthly, use data in US dollars and are equal-weighted. Growth includes stocks in the top third based on both their 5-year sales per share trend and their internal growth rate (the product of the 5-year average return on equity and the retention ratio); Low volatility includes stocks in the bottom quintile based on the standard deviation of their daily returns in the previous three months; Price momentum includes stocks in the top quintile based on their performance in the previous 12 months; Quality includes stocks in the top third based on both their return on invested capital and their EBIT to EV ratio (earnings before interest and taxes to enterprise value); Size includes stocks in the bottom quintile based on their market value in US dollars. Value includes stocks in the bottom quintile based on their price to book value ratios. The market represents the S&P 500 index. **Past performance is no guarantee of future results.**

Source: Refinitiv Datastream and Invesco

Figure 5b – European factor index total returns relative to market (%)

Data as at 17/08/2023	Absolute					Relative to Market				
	1w	1m	QTD	YTD	12m	1w	1m	QTD	YTD	12m
Growth	-4.1	-3.2	-2.8	5.8	-3.1	-1.4	-2.0	-0.8	-3.1	-8.7
Low volatility	-2.2	-1.8	-3.2	7.0	1.3	0.6	-0.6	-1.2	-2.1	-4.6
Price momentum	-2.2	-1.2	-1.6	4.2	0.6	0.6	0.0	0.4	-4.6	-5.3
Quality	-3.0	-1.1	0.3	5.8	0.0	-0.2	0.2	2.3	-3.1	-5.8
Size	-3.4	-1.0	-0.1	3.5	-2.8	-0.7	0.2	2.0	-5.2	-8.5
Value	-3.0	-1.0	1.5	7.1	6.9	-0.3	0.3	3.6	-1.9	0.6
Market	-2.8	-1.2	-2.0	9.2	6.2					
Market - Equal-Weighted	-3.1	-1.6	-1.2	7.0	1.2					

Notes: All indices are subsets of the STOXX 600 index, they are rebalanced monthly, use data in euros and are equal-weighted. Growth includes stocks in the top third based on both their 5-year sales per share trend and their internal growth rate (the product of the 5-year average return on equity and the retention ratio); Low volatility includes stocks in the bottom quintile based on the standard deviation of their daily returns in the previous three months; Price momentum includes stocks in the top quintile based on their performance in the previous 12 months; Quality includes stocks in the top third based on both their return on invested capital and their EBIT to EV ratio (earnings before interest and taxes to enterprise value); Size includes stocks in the bottom quintile based on their market value in euros; Value includes stocks in the bottom quintile based on their price to book value ratios. The market represents the STOXX 600 index. **Past performance is no guarantee of future results.**

Source: Refinitiv Datastream and Invesco

Figure 6 – Model asset allocation

	Neutral	Policy Range	Allocation	Position vs Neutral	Hedged	Currency
Cash Equivalents	5%	0-10%	10%			
Cash	2.5%		10%			
Gold	2.5%		0%			
Bonds	40%	10-70%	46%			
Government	25%	10-40%	20%			
US	8%		11%			
Europe ex-UK (Eurozone)	7%		2%			
UK	1%		1%			
Japan	7%		2%			
Emerging Markets	2%		4%			
China**	0.2%		0%			
Corporate IG	10%	0-20%	18%			
US Dollar	5%		10%			40% JPY
Euro	2%		3%			
Sterling	1%		2%			
Japanese Yen	1%		0%			
Emerging Markets	1%		3%			
China**	0.1%		0%			
Corporate HY	5%	0-10%	8%			
US Dollar	4%		6%			
Euro	1%		2%			
Equities	45%	25-65%	34%			
US	25%		12%			
Europe ex-UK	7%		6%			
UK	4%		4%			
Japan	4%		4%			
Emerging Markets	5%		8%			
China**	2%		4%			
Real Estate	8%	0-16%	10%			
US	2%		4%			
Europe ex-UK	2%		1%			
UK	1%		2%			
Japan	2%		1%			
Emerging Markets	1%		2%			
Commodities	2%	0-4%	0%			
Energy	1%		0%			
Industrial Metals	0.3%		0%			
Precious Metals	0.3%		0%			
Agriculture	0.3%		0%			
Total	100%		100%			
Currency Exposure (including effect of hedging)						
USD	50%		42%			
EUR	19%		17%			
GBP	7%		12%			
JPY	14%		14%			
EM	9%		17%			
Total	100%		100%			

Notes: **China is included in Emerging Markets allocations. This is a theoretical portfolio and is for illustrative purposes only. See the latest [The Big Picture](#) document for more details. It does not represent an actual portfolio and is not a recommendation of any investment or trading strategy. Arrows indicate the direction of the most recent changes.

Source: Invesco

Figure 7 – Model allocations for Global sectors

	Neutral	Invesco	Preferred Region
Energy	7.3%	Underweight	EM
Basic Materials	4.1%	Neutral	Europe
Basic Resources	2.3%	Neutral	Europe
Chemicals	1.8%	Neutral	US
Industrials	13.0%	Neutral	Europe
Construction & Materials	1.6%	Underweight	US
Industrial Goods & Services	11.4%	Neutral	Europe
Consumer Discretionary	14.9%	Neutral	Europe
Automobiles & Parts	2.9%	Underweight	Japan
Media	1.0%	Underweight	Japan
Retailers	4.8%	Overweight	Europe
Travel & Leisure	2.2%	Underweight	EM
Consumer Products & Services	4.0%	Neutral	Europe
Consumer Staples	6.1%	Overweight	Europe
Food, Beverage & Tobacco	4.0%	Overweight	Europe
Personal Care, Drug & Grocery Stores	2.1%	Overweight	US
Healthcare	9.7%	Overweight	US
Financials	14.7%	Neutral	Europe
Banks	7.1%	Neutral	Europe
Financial Services	4.7%	Underweight	US
Insurance	2.9%	Neutral	Europe
Real Estate	2.9%	Overweight	US
Technology	20.5%	Neutral	US
Telecommunications	3.3%	Overweight	Europe
Utilities	3.4%	Underweight	Europe

Notes: These are theoretical allocations which are for illustrative purposes only. They do not represent an actual portfolio and are not a recommendation of any investment or trading strategy. See the latest [Strategic Sector Selector](#) for more details.

Source: Refinitiv Datastream and Invesco

Appendix

Definitions of data and benchmarks for Figure 3

Sources: we source data from Datastream unless otherwise indicated.

Cash: returns are based on a proprietary index calculated using the Intercontinental Exchange Benchmark Administration overnight LIBOR (London Interbank Offer Rate). From 1st January 2022, we use the Refinitiv overnight deposit rate for the euro, the British pound and the Japanese yen. The global rate is the average of the euro, British pound, US dollar and Japanese yen rates. The series started on 1st January 2001 with a value of 100.

Gold: London bullion market spot price in USD/troy ounce.

Government bonds: Current levels, yields and total returns use Datastream benchmark 10-year yields for the US, Eurozone, Japan and the UK, and the Bank of America Merrill Lynch government bond total return index for the World and Europe. The emerging markets yields and returns are based on the Bloomberg Barclays emerging markets aggregate government bond index.

Corporate investment grade (IG) bonds: Bank of America Merrill Lynch investment grade corporate bond total return indices. The emerging markets yields and returns are based on the Bloomberg Barclays emerging markets aggregate corporate bond index.

Corporate high yield (HY) bonds: Bank of America Merrill Lynch high yield total return indices

Equities: We use MSCI benchmark gross total return indices for all regions.

Commodities: Goldman Sachs Commodity total return indices

Real estate: FTSE EPRA/NAREIT total return indices

Currencies: Global Trade Information Services spot rates

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Data as of 17 August 2023 unless stated otherwise.

Important information

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