Invesco

Global Fixed Income Strategy

Monthly report

Invesco Fixed Income

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Turgut Kisinbay
Chief US Economist

James Ong
Senior Portfolio Manager

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Global macro strategy

January inflation higher than expected but US inflation trends still intact, rates attractive

January's higher than expected inflation report raised questions about the path of US inflation and what it might mean for Federal Reserve (Fed) policy. Consumer prices rose 0.5% in January on a seasonally adjusted basis, the largest monthly increase since August 2023 and above economists' expectations for a smaller increase of 0.3%. Annual inflation rose to 3% in January, up from 2.9% in December.[1] Nevertheless, we view the recent report as broadly in line with our medium-term inflation outlook. In our view, the composition of the underlying price moves does not indicate a fundamental shift in inflation trends, as we explain below.

Components of the January inflation report reflect ongoing trends

One of the most notable aspects of the January report was owners' equivalent rent (OER) - the amount of rent a homeowner would receive if they rented out their current home. Both OER and rent inflation continued to slow. The most recent month-over-month changes are significantly below the highs of 2022 and 2023, though modestly above pre-pandemic norms. We expect the monthly pace of shelter inflation to remain around current levels going forward, which should lower the annual inflation rate in this category until the summer.

The main surprise in the report came from higher than expected price increases in transportation services, which have volatile components but generally had shown declining inflation in recent months. On the goods side, cars, medical care, and recreational commodities posted unexpected inflation. While we do not expect inflation in the latter two segments to be persistent, car prices may rise this year due to tariffs on imports and improving affordability.

Overall, while the overall report was an upside surprise, its composition does not indicate a fundamental shift in inflation trends. The opposing forces on display in the report - moderate goods inflation emerging from deflation, ongoing disinflation in shelter and stabilizing non-shelter core services prices - suggest that inflation will likely remain sticky and move broadly sideways in early 2025, in line with our expectations.

2025 inflation outlook and the potential impact of tariffs

US inflation has remained sticky over the past six months, whether measured by the core Consumer Price Index (CPI) or the core Personal Consumption Expenditures Price Index (PCE).

On one hand, we continue to see support for disinflation from the OER and rent components. Additionally, we expect non-shelter core services to contribute to disinflation in the first half of the year due to moderating wage growth.

However, goods deflation is now fading.

1. Source for all inflation data: US Bureau of Labor Statistics, Feb. 12, 2025. Wall Street Journal, Inflation heated up in January, freezing the Fed, Feb. 12, 2025.

Supply-side improvements contributed significantly to disinflation in core goods prices after mid-2023. But as the supply side has largely normalized, the benefits from those improvements are diminishing. Demand for durable goods became muted following strong consumption during the pandemic but the relative demand for goods and services has now normalized, and demand for durables has picked up. The supply-side-driven disinflation, which had reversed the unusual price increases during the pandemic and its immediate aftermath, has come to an end.

Tariffs and tariff expectations further complicate the goods inflation story. Tariffs potentially influence goods prices by pulling demand forward and increasing prices. The auto sector is one example. Tariffs have already been announced for Canada and Mexico, though not implemented. Other countries with which the US has a trade deficit—such as Japan and the eurozone—may be next in line for tariffs. Consumers and car dealers are, of course, aware of this possibility, which may encourage them to purchase or import cars ahead of potential tariff implementation. Indeed, auto sales increased after the election, following a year of stability. Car prices have risen recently, after a year of deflation. We may see similar developments for other goods that are exposed to tariffs.

Federal Reserve policy outlook

For the Fed, the combination of solid growth, a tight labor market, and stable inflation means that policymakers will likely remain cautious and wait for further evidence of progress toward price stability. Growth has not been a concern in this hiking cycle, and the labor market appears to have stabilized in recent months, allowing the Fed to take a patient approach.

Our projections suggest that growth will slow in the second half of the year as it converges toward its long-term potential rate after the elevated levels seen over the past two years. Slowing immigration will likely also contribute to slower expansion of the labor force. Additionally, we expect productivity growth, which has been high, to moderate toward its longer-term trend - though it may still outperform the weak productivity growth observed in the decade following the global financial crisis.

Tariffs will likely further complicate the Fed's inflation outlook due to their unpredictability. Trade tensions have escalated quickly, introducing uncertainty around price pressures and potential supply chain disruptions. The standard central bank mantra is to consider tariff impacts as one-off changes in the price level, not sustained inflation, and to "look through" them. However, that is easier said than done. The Fed will likely need time to assess the impact of tariffs and other policies on the economy, especially when inflation remains above target and has not shown signs of progress lately.

In the second half of the year, the Fed may have more clarity on trade and other policy actions, given the administration's proactive, front-loaded approach. Additionally, we expect economic growth to slow in the latter half of the year, which could help offset some inflationary pressures. Taken together, these factors suggest that, while the Fed will likely resume its rate-cutting cycle, it will likely wait until at least the June meeting—and possibly later—to act.

What could cause the Fed to hike?

Some market participants believe the Fed may not cut rates at all this year, or that the next move could even be a rate hike, due to persistent inflation. However, we believe the bar for a rate hike is high. For the Fed to consider raising rates, core inflation net of tariff effects would likely need to increase significantly. There would likely also need to be evidence of second-round effects, such as a deterioration in inflation expectations.

The Fed's first line of defense against inflation persistence would likely be to remove its easing bias and signal an extended pause in the policy rate. Only if clear evidence emerges of second-round inflation effects and rising core inflation would the Fed likely consider hiking rates. At this point, that scenario is not part of our baseline. As outlined above, our projections suggest that inflation will remain broadly stable in the first two or three quarters of 2025, with disinflation resuming later in the year as the economy converges to its potential.

Market impact of inflation and Fed policy developments

Medium and long-term Interest rates have risen significantly since the lows set in September before the election. The higher yields seen in the fourth quarter of 2024 and first quarter of 2025 reflect market expectations of increased growth and inflation. At the end of the third quarter of 2024, the market was expecting nearly eight interest rate cuts before the end of 2026. In current market pricing, this expectation has dropped to just one or two.

This change in pricing suggests the market has largely priced in the effects of temporarily increased inflation. Because of the change in pricing, we would not expect the interest rate market to be adversely affected if the Fed does not cut in the first half of the year. Cheaper prices in the interest rate market also mean that, as the year progresses, the market will potentially have more room to react if growth slows. If slowing immigration and rising tariffs adversely affect growth later in the year, the interest rate market stands to benefit. As always, it is difficult to time exactly when the market will price in these effects, therefore, we favor beginning to position now.

In the near term, the primary risks to interest rate positions are around inflation data. Strong inflation is the most likely reason why the Fed may shift from a neutral stance toward a hawkish one. While we believe longer-term returns in interest rates are likely to be strong, we expect volatility to be elevated around inflation data releases.

Rob Waldner
Head of IFI Strategy and Macro Research

James Ong
Senior Portfolio Manager

Gareth Isaac
Head of Multi-Sector Portfolio Management

Tom Sartain
Senior Portfolio Manager

Michael Siviter
Senior Portfolio Manager

Yi Hu
Head of Asia Credit Research

Interest rate outlook

US: Overweight. In the near term, we anticipate heightened rates volatility driven by the new administration's policies and seasonal inflation effects. In the medium-term, US rates exhibit the highest risk premium in a decade, with the market adjusting to stronger economic data by delaying expectations of Fed rate cuts until the fall. We expect robust growth in the first half of the year, tapering to moderate growth in the second half, with supply risks remaining a key focus. However, significant increases in Treasury duration supply are unlikely until early 2026. As near-term risks recede, we foresee the rates market delivering strong excess returns compared to cash. Over the long-term, Treasuries appear undervalued relative to fundamental drivers, with any substantial yield increases likely spurred by debt concerns. However, the narrow Republican majority in the House may impede legislation that significantly raises the debt/GDP ratio. Overall, we maintain a positive outlook on long-term rate returns based on current valuations.

Europe: Overweight. European macroeconomic data have stabilized following a weak 2024, although potential tariffs present clear headwinds. The outlook for European growth is uninspiring, with a downside bias contingent on US trade policy.

Political challenges persist within the European Union. Elections in Germany suggest a potential weak coalition, and although political instability in France has temporarily receded, another crisis and possibly disruptive parliamentary elections may occur during the summer. Additionally, President Trump's involvement in the Ukraine conflict has introduced further uncertainty and confusion among European investors.

Inflation in the region has continued to gradually fall towards the target, and this trend is expected to persist. However, there are risks that the European Central Bank (ECB) may be behind the curve, and inflation could fall below the target in the second half of the year. Consequently, the ECB may need to lower rates more aggressively than is currently anticipated by market participants.

China: Neutral. Bullish stock market sentiment is likely to lead to asset reallocation among local investors and could cause an adjustment to the long bull run in the onshore bond market. At the same time, accommodative central bank policy, potentially slowing loan growth and likely tempered fiscal measures are expected to limit the downside of onshore bond market performance. The macro direction expected to be set at the National People's Congress in early March will likely be closely watched.

Japan: Underweight. 10-year Japanese government bond (JGB) yields have jumped by 20 basis points over the last month, driven by the Bank of Japan's (BoJ) decision to hike rates and stronger than expected wage and GDP growth.[2] In the current economic backdrop, the risk is skewed toward faster than expected BoJ normalisation. Markets continue to price a slow path of rate hikes, to a terminal rate that remains low relative to the BoJ's own neutral estimate. There is, therefore, further upside for JGB yields, in our view, in the under 10-year sector. Longer maturities are already trading at yields above 2%. Consequently, we expect the 10-year to 30-year/40-year slope to continue to flatten.

UK: Overweight. UK gilt yields have declined 30 basis points from their mid-January peak of 4.9%, due to a combination of relatively soft domestic growth data, a broader consensus at the Bank of England (BoE) to ease policy and a global decline in bond yields.[3] GDP growth was somewhat stronger in Q4 than expected on a headline basis, but underlying domestic private demand was very weak. Most surveys of business and consumer confidence have deteriorated in recent months or flatlined, suggesting an uptick in private sector growth remains unlikely. Public spending and still elevated real income growth are supportive for growth in the near term, but this support will likely fade, as most indicators point to a decline in employment and the government is being forced to curtail spending plans due to the spike in bond yields since last October's budget. Inflation and wage data remain relatively sticky compared to the BoE's earlier forecasts and international comparisons. However, signs of weaker employment should cap wage pressures going forward and some underlying inflation measures have moderated more rapidly than the core or services Consumer Prices Index series. Furthermore, the BoE's decision to cut in February, with a unanimous vote to ease, suggests policymakers are becoming more willing to look through near term inflation stickiness in the face of a deteriorating growth and labour market outlook. The BoE's dovish reaction

2. Source: Bloomberg L.P. Data as of Feb. 17, 2025.
3. Source: Bloomberg L.P. Data as of Feb. 19, 2025.

function creates a downside asymmetry to front end yields should signs of labour market deterioration and/or waning inflation pressures build. Long-term yields will likely be more influenced by international factors and the fiscal premium, particularly heading into the Office for Budget Responsibility's updated projections in March. However, the impact of any budget slippage might be reduced if the Debt Management Office chooses to skew increased issuance to the short end of the yield curve. In the long-term, if inflation moderates in line with BoE expectations, long-term gilt yields at over 4.5% offer relatively attractive real returns, in our view.

Australia: Overweight. The Reserve Bank of Australia (RBA) has finally started cutting rates but will likely proceed gradually until inflation is clearly on a trajectory to 2.5% or below, and/or the labour market shows clear signs of softening. Activity and labour market data are currently relatively solid, limiting the scope for a faster cutting cycle. Although short-term rates might have relatively limited downside in the short term, we believe longer-term yields are relatively attractive over the long term. The RBA's focus on lowering inflation will likely constrain activity and upside inflation risks, which should limit the upside for long-term rates. The Australian curve is relatively steep on a cross market and absolute basis, leaving long forwards for swaps and bonds at around 5%, which seems high compared to an inflation rate averaging 2.7% over the last six months.

Rob Waldner
Head of IFI Strategy and Macro Research

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Senior Portfolio Manager

Yi Hu
Head of Asia Credit Research

Currency outlook

USD: Neutral. We remain broadly neutral on the US dollar, given the uncertainty surrounding the potential new policies of the Trump administration. While the US domestic economy looks well positioned, the potential for trade disruption and its corresponding impact on growth and inflation are a concern. If the US economy can continue to deliver growth in line with the past few years, it is difficult to see an environment in which the US dollar doesn't perform well. But we are in uncertain times and we need to see some clarity on policy before we can more accurately assess the implications for the currency.

EUR: Underweight. Given the myriad headwinds to the growth outlook for the euro area, we remain underweight the euro. We expect the ECB to lower interest rates much more than implied by current market pricing and the corresponding decline in government bond yields in the region may be a challenging environment for the currency, as investors look for higher yields available elsewhere.

RMB: Overweight. We are overweight the renminbi, as we expect it to be resilient amid market volatility relative to peers on a basket basis, and despite moves in the USD/RMB exchange rate. Strong stock market sentiment and milder than expected trade tariffs on China's exports should support the renminbi's performance. Positions appear to remain light, and we could see an adjustment if the above two factors are further amplified in the months ahead.

JPY: Overweight. The yen is increasingly supported by the narrowing interest rate differential between Japan and other developed market countries, particularly in Europe. This should put downward pressure on the EUR/JPY exchange rate and other European crosses. The position versus the US dollar is more ambiguous due to the Fed's pause in the cutting cycle and the threat of trade tariffs. However, risks are increasingly skewed to disappointment in US growth, as the Trump administration appears to be pursuing trade and immigration controls more aggressively relative to fiscal easing, potentially limiting the upside for the USD/JPY exchange rate. Japan might also choose to appreciate the yen as a means of heading off the threat of US tariffs. At present there has only been limited repatriation by Japanese investors and hedge ratios remain low on foreign assets, particularly in US dollars. However, lower interest rates abroad and potentially lower appetite for US equities, could lead to greater hedging and/or repatriation flows.

GBP: Underweight. The combination of weak domestic growth and falling yield premia, as the BoE cuts interest rates, should continue to weigh on the British pound. In addition, to the extent the deterioration in growth calls into question the credibility of the Labour government's fiscal policy, the increase in fiscal risk premia will likely lead to outflows from UK assets, putting further pressure on the pound. The UK might not be as directly impacted by US tariffs as other countries, but the broadening of the tariff threat relative to pre-election forecasts probably kills any expectations that it will escape completely unscathed. It is possible that the situation in Ukraine might push the European Union to seek greater cooperation with the UK on security policy, which could improve the UK's leverage in talks about trade, but this is a long-term development. Last, the pound remains relatively richly valued on most valuation measures, in our view, particularly against the euro and Asian currencies.

AUD: Neutral. The upside for the Australian dollar versus the US dollar is limited in the short term, in our view, due to the Fed's pause in the cutting cycle at the same time the RBA has started easing and the global growth outlook has become uncertain, especially in the context of US tariff threats. However, the RBA's reluctance to cut quickly and its insistence on maintaining restrictive interest rates, should mean that interest rate differentials versus European and Non-Japan Asian currencies should move in a more favourable direction for the Australian dollar. In addition, Australia's position as a commodity exporter with relatively few trade linkages with the US should shield it from the direct impact of tariffs relative to Europe, Canada, Mexico and East Asia. There is, therefore, scope for the Australian dollar to outperform the euro, British pound, Canadian dollar and renminbi going forward, which have weaker growth trajectories, lower interest rates and more exposure to downside risks posed by US tariffs.

Ken Vereen
Head of Non-Agency RMBS

Global credit strategy

Home equity loan-backed securities: A growing asset class in residential structured credit

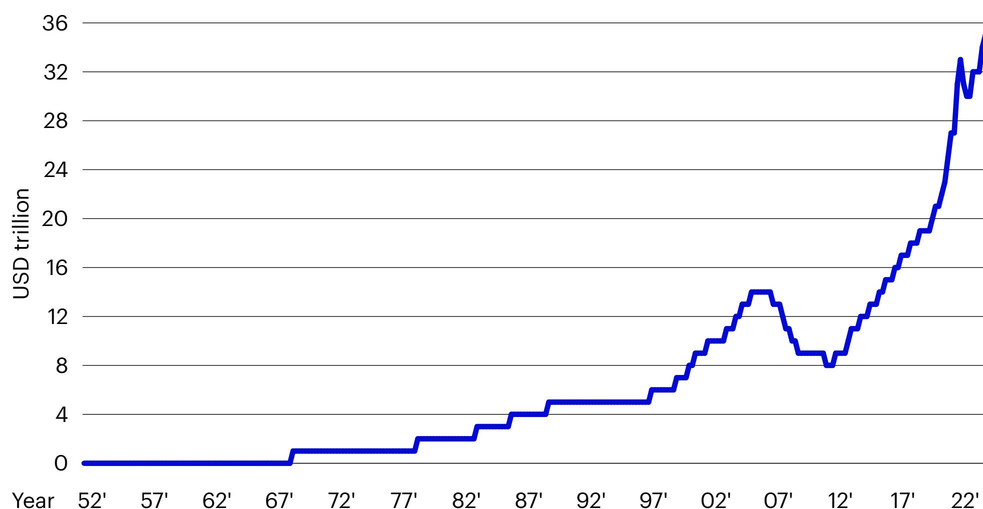
This section highlights the views of Invesco Fixed Income's credit analysts across a broad range of fixed income assets managed by Invesco.

Growing securitization of home equity loans

US homeowners have amassed a vast amount of home equity as home prices have increased significantly over the past decade. Traditionally, homeowners have sought to tap this equity through cash-out refinancing. However, the increase in mortgage rates since 2021 has caused homeowners to look for other means to access this equity without giving up their existing low rates. As a result, many have turned to home equity loans. With the rise in popularity of home equity loans there has been a corresponding surge in the issuance of non-agency residential mortgage-backed securities (RMBS) backed by these loans.

As interest rates on first lien mortgages are likely to remain elevated for the foreseeable future, we expect homeowners to continue to choose home equity loans over traditional mortgage refinancing to monetize their home equity. The securitization of home equity loans is also expected to rise, expanding their share of the private label RMBS market.

Figure 1: US homeowners' equity has risen sharply in recent years



Source: US Federal Reserve. Data from Jan. 1, 1952 to July 1, 2024.

CES and HELOCs

The two most common home equity loans are closed-end seconds (CES) and home equity lines of credit (HELOCs). CES, often called "second mortgages", work much like a typical first lien mortgage loan. Borrowers receive one lump sum at origination and pay the loan back over [10] to 30 years.

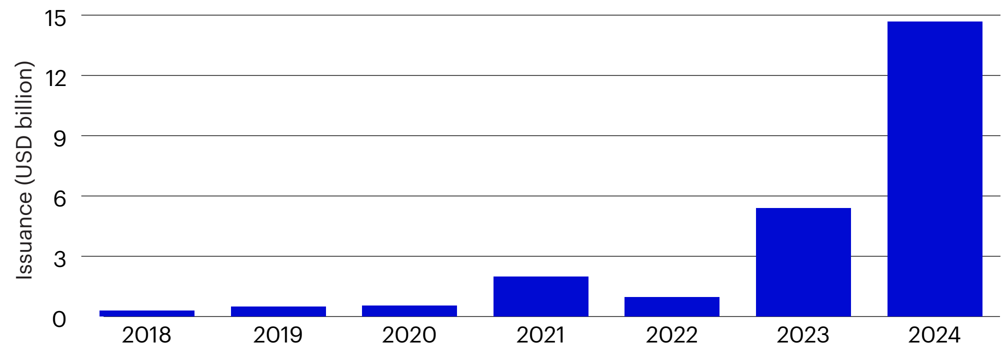
HELOCs function more like credit cards. The borrower may draw down a line of credit as needed during a "draw period" and subsequently enter a repayment period. Borrowers pay interest on amounts borrowed during the draw period, with repayment periods generally spanning 10 to 20 years.[4]

4. Source: Wall Street Journal, "Heloc vs. Home Equity Loan: Which One Is Right for You?", Jan. 29, 2025.

Securitization of home equity mortgage-backed securities

On the back of CES and HELOCs' rising popularity, the issuance of securities collateralized by home equity products has increased significantly in recent years. In 2024, the issuance of home equity mortgage-backed securities reached almost USD15 billion (Figure 2).

Figure 2: Home equity securitization has climbed in recent years



Source: Intex. Data from Dec. 31, 2019 to Dec. 31, 2024.

Advantages of home equity loan securitizations

Several features of CES- and HELOC-backed securities make them attractive investment options, in our view:

CES securitizations

More predictable prepayment behavior

Investors in CES securitizations stand to benefit from more predictable borrower prepayment behavior that is less sensitive to changes in interest rates. Similar to the behavior of agency mortgages, prepayment speeds of low balance loans tend to be less sensitive to declines in mortgage rates due to smaller financial incentives relative to the fixed costs of refinancing. This is also the case for home equity loans, which tend to have a smaller balance than first lien mortgages

Strong borrower profile and underwriting

Borrowers approved for home equity loans are generally well-qualified. They have exhibited strong payment history and are current on their first lien mortgage. Approval for CES as well as HELOCs requires full documentation of a borrower's current financial condition, including verification of income and assets. Lenders have minimum standards with regard to the applicant's current credit score, payment-to-income ratio with the new loan, and usually limit proceeds such that the borrower maintains at least 20% equity in their home after receiving the new loan. Home equity loan underwriting also requires a new appraisal of the property, with CES loans tending to require an in-person appraisal, while HELOC underwritings generally use automated valuation models.

Substantial protection to the AAAs

It is common in RMBS for principal payments to be received by AAA-rated senior tranches as well as some junior bonds simultaneously so long as the underlying loans are performing adequately. CES securitizations however are structured sequentially, which means the AAA securities receive all principal payments until they are completely paid off before any junior securities receive any principal payments. CES and HELOC securitizations also benefit from a concept known as excess spread, where the interest collections remaining after paying all the interest owed to the securities is available to offset any principal losses on underlying loans. Given that interest rates on home equity loans typically range from 9% to 11%, while the coupon on the related RMBS is generally less than 6%, according to recent issuer documentation, the amount

of excess spread available after paying interest to all of the bonds is substantial, offering more credit protection to the bonds in these securitizations.

Less extension risk

Extension risk, which generally results from borrowers prepaying their loans at a slower rate than initially expected, is common to RMBS. Home equity securitizations, however, have an option built in called a collateral call, whereby the issuer has the right, but not the obligation, to re-purchase the collateral and pay off all the bonds after an initial period (typically three years). It is economical for the issuer to exercise this call when the value of the underlying collateral increases. It is our expectation that because home equity loans have high interest rates, calling the transaction at par will likely be economical for the issuer, thus reducing the extension risk of these securities.

HELOC AAAs provide a scalable floating rate option

In our view, senior classes of HELOC securitizations provide an interesting opportunity to invest in floating rate AAA-rated bonds. In recent years, the supply of AAA-rated floating rate RMBS bonds has been limited, given that most of the underlying mortgages are fixed rate. However, given HELOCs are usually floating rate loans in which the borrower pays a spread above the one-year prime rate, it is a more natural fit for bonds backed by HELOCs to pay investors floating rate coupons.

Relative value proposition

From our perspective, yields on AAA rated securities backed by CES and HELOC loans offer a compelling spread pickup versus investment grade corporate bonds. In the table below, we show that CES and HELOC AAAs offer roughly 25 to 70 basis points in extra yield versus comparable investment grade corporate bonds. These securities provide an opportunity to earn attractive carry in short duration bonds while also offering diversification away from risks associated with corporate bonds.

Table 4: Relative value comparison of key mortgage-backed securities

Subsector	Rating	Coupon type	Spread or Discount margin	Yield	Weighted avg. life	Spread duration
CES	AAA	Fixed	130	5.51%	2.00	1.82
HELOC	AAA	Float	107	5.12%	2.00	1.86
IG Corps	A	Fixed	52	4.82%	2.01	1.85
IG Corps	A+	Float	39	4.89%	2.57	1.88

Source: Bloomberg L.P., JP Morgan, Wells Fargo. Data as of Jan. 31, 2025.

Panelists

Matt Brill
Head of North America Investment Grade

Todd Schomberg
Head of Investment Grade Portfolio Management

Craig Altholz
Client Portfolio Manager

The bottom line: Investment grade starts 2025 on solid footing

January was a full month for the bond markets. We started the year with an interest rate selloff and a CPI report that first spooked and then calmed inflation worries. January also saw events like the equity selloff on the back of Chinese DeepSeek concerns, the tragic wildfires in California and the first Federal Reserve (Fed) meeting of the year. A new administration took office, announcing a slew of policies that could have ramifications for the investment grade asset class – many of them positive, in our view. We speak with Matt Brill, Head of North America Investment Grade, and Todd Schomberg, Senior Portfolio Manager, about how US investment grade is set up for 2025.

Craig: How is fixed income starting the year amid the market's various crosscurrents?

Matt: Among the events mentioned above, one of the most important factors for the bond market is the starting yield. Looking at the Bloomberg Aggregate Bond Index, which is a good proxy for the US bond market, it began the year with a starting yield of just under 5%.[5] This is the highest yield to start a year since 2007. We've reached above it a few times, but we haven't started the year at this level since 2007. This is important because one of the best indicators of investment grade performance over the course of a year has historically been the starting yield.[6] I expect some volatility around this level, but I would rather start the year with a high yield than a low yield!

Craig: How does improved liquidity for the asset class factor into your view?

Matt: In general, credit spreads have been tight, but a bond's spread over Treasuries compensates for more than just credit risk. For example, we estimate loss from defaults in investment grade corporate bonds to be less than 10 basis points a year. Yet spreads over Treasuries, for even the highest quality issuers, are substantially more than that. A big part of the spread premium is to compensate for lower liquidity compared to Treasuries. However, liquidity in our market has improved significantly in recent years largely due to the adoption of portfolio trading. Portfolio trading is the ability to sell large baskets of bonds to a single counterparty who can efficiently offload risk to a highly liquid exchange traded fund (ETF). For example, in years past, if we wanted to sell USD500 million of corporate bonds to reduce risk, we would have to do those sales bond by bond. The process would take a day or two and be somewhat costly. Now, we can get competitive bids on the entire basket from multiple sources in minutes at a better price than we have gotten selling bond by bond. Effectively, large liquid ETFs plus technology have reduced the costs and time needed to transact in our market, and therefore the liquidity premium investors demand should be lower than it has been historically.

Craig: How would you describe current investment grade market "technicals", namely the balance of new issue supply and demand?

Todd: A high starting yield has not derailed new issuance so far this year. We have seen almost USD175 billion of investment grade new issuance in January alone, which may set a record for the month.[7] A notable feature of this new issuance has been a shift away from longer maturities toward shorter maturities, and more floating rate note issuance.

This is telling us that corporate treasurers think rates will move lower in the next few years, and they don't want to lock in today's higher yields for 10 to 30 years. Demand for this paper has been strong. There have been about USD14 billion of inflows into the asset class so far this year.[8]

Much of the demand has been driven by yield. Even though issuers may not want to lock in elevated yields on their debt, investors do! So, the market is finding a supply-demand balance.

This dynamic is pushing investors further out the yield curve. They're selling some of their front end bonds and buying more 10- and 30-year bonds, which is very good from a technical standpoint and is helping the market absorb the supply issued by companies. Much of the new issuance has been from the banking sector, which has made up around USD125 billion of the USD175 billion total this year.[9] This is a good sign for the economy and credit fundamentals.

Craig: What is the banking sector telling us about the economy?

Matt: The fact that banks are borrowing money is a good indicator that the demand for loans is solid, which suggests the economy is healthy. Bank earnings have come in strong this

5. Source:Bloomberg L.P., Bloomberg US Aggregate Bond Index yield to worst. Data as of Dec. 31, 2024.
6. Source: JP Morgan, NA Credit Research, "When it comes to HG returns, the starting yield matters." Jan. 14, 2025. According to JP Morgan, the relationship between starting high grade yields and returns is reasonably strong: A regression of total returns on starting yield has an R-Squared of 39% over the past 40 years (versus 50% for Treasuries).
7. Source: JP Morgan. Data as of Jan. 31, 2025.
8. Source: Invesco. Data as of Jan. 31, 2025.
9. Source: JP Morgan. Data as of Jan. 31, 2025.
10. Source: Invesco. Data as of Feb. 3, 2025.

quarter bolstered by a steeper yield curve. A steeper curve allows banks to borrow at lower rates and lend at higher rates. This "net interest income" has picked up, supporting banks' business activity. Healthy banks suggest a healthy economy, and macroeconomic data were quite strong in the fourth quarter.

From an investment perspective, high quality banks have been issuing preferred securities at yields of around 6.5%.[10] This means that high quality credits are offering yields comparable to the high yield market. Overall, the value proposition of investment grade has started the year quite attractive, in our view, with strong technicals, solid fundamentals and a high level of income.

Craig: Why are bonds important from an asset allocation perspective?

Todd: One of the current benefits of bonds is that they are acting like bonds again – in other words they have been a diversifier to equities. The recent equity market selloff sparked by news that the Chinese AI company, DeepSeek, could deliver AI more cheaply, tested this feature. On the day of the DeepSeek-related selloff, bonds were up while stocks were down, which was a good sign that bonds offer potential diversification benefits. Credit spreads essentially shrugged off the equity volatility, partly due to the credit market's ties to the overall strong US economy and its broad level of diversification.

Craig: Speaking of the strong US economy, what are your views on Fed policy?

Matt: The Fed decided to stay on hold in January, which was expected, given that inflation remains above target and growth is solid. We believe disinflationary forces will continue to play out through the year, especially in the goods and housing markets. That said, we believe the Fed wants to see evidence that inflation is coming down before it cuts rates further. Given our view that inflation will continue to decline, we expect two more rate cuts this year, which is in line with market pricing.

Equally important is what is happening outside the US. In Canada, the Bank of Canada cut rates by 25 basis points in January and noted that threatened tariffs could damage Canada's growth prospects. The European Central Bank also cut rates by 25 basis points, highlighting concerns on tariffs. Concerns about global growth and central bank responses are arguably easing some of the Fed's burden by pushing global rates lower. As long as inflation continues to come down in the US, which is our base case, we believe we are being paid to hold bonds. As bond managers, we feel comfortable in an environment of 5% nominal growth and 2.5% inflation.

Craig: With a new administration in Washington, policy changes have become part of the equation when it comes to future market performance. What policies are you focused on as they relate to investment grade?

Todd: Our biggest focus, aside from the Fed's independence, which we believe will stay intact, are four main policy areas: taxes, tariffs, immigration and deregulation. In addition to President Trump's policy initiatives, we think Treasury Secretary Scott Bessent's "3-3-3" economic plan is critical. His proposal aims to achieve 3% real GDP growth, a 3% of GDP budget deficit and an additional 3 million barrels of oil production per day. In other words, Bessent wants above-potential growth, lower oil prices and, perhaps most important to the bond market, a lower budget deficit, which is currently running between 5% and 7% of GDP.[11]

Hearing the Treasury Secretary state that getting the budget deficit under control is a priority is very powerful for the bond market. It could enable the Fed to cut rates and also bring longer-term rates down. If Bessent is successful, yields across the yield curve would probably decline, which would likely support overall bond market performance in 2025.

Craig: What are some of the trades you currently find attractive and some you plan to avoid in 2025?

Matt: One of the trades we like this year is in the power generation space. The idea is based on the AI theme, namely that demand for power will likely be elevated as companies ramp up their AI capabilities. We particularly like hybrid bonds in the utility space, which combine debt and equity features. We are less positive on the traditional exploration and production component of energy, which involves the extraction of oil and natural gas. A policy focus on oil production may be good for the consumer, as it would likely drive down oil prices, but it may not be good for exploration and production credits. Outside the corporate space, we see value in agency mortgages and idiosyncratic opportunities in asset-backed securities.

In terms of sectors we are avoiding, we would count the insurance sector, where we expect large insured losses as

11. Source:US Department of the Treasury. Federal Budget Deficit/Nominal GDP. Data as of Jan. 31, 2025.

a result of the tragic California wildfires, and emerging markets, due to the headline risk around tariffs. The Trump administration has said it is taking an "America first" approach. To us, that suggests that a US-centric portfolio built around US high yield, US investment grade, and US agency mortgages, will most benefit from a strong US economy down the road, and a deflationary or disinflationary environment, which would likely support the overall US bond market.

Team contributors

Senior Editor — Ann Ginsburg

Atlanta

Rob Waldner
Head of IFI Strategy and Macro Research
+1 404 439 4844
robert.waldner@invesco.com

James Ong
Senior Portfolio Manager
+1 404 439 4762
james.ong@invesco.com

Ken Vereen
Head of Non-Agency RMBS
+1 404 439 4854
ken.vereen@invesco.com

Matt Brill
Head of North America Investment Grade
+1 404 439 4829
matthew.brill@invesco.com

Todd Schomberg
Head of Investment Grade Portfolio Management
+1 404 439 3455
todd.schomberg@invesco.com

Craig Altholz
Client Portfolio Manager
+1 404 439 3261
craig.altholz@invesco.com

Ann Ginsburg
Head of Thought Leadership Fixed Income
+1 404 439 4860
ann.ginsburg@invesco.com

New York

Turgut Kisinbay
Chief US Economist
+1 212 323 0460
turgut.kisinbay@invesco.com

London

Gareth Isaac
Head of Multi-Sector Portfolio Management
+44 20 7959 1699
gareth.isaac@invesco.com

Tom Sartain
Senior Portfolio Manager
+44 20 7034 3827
thomas.sartain@invesco.com

Michael Siviter
Senior Portfolio Manager
+44 20 7959 1698
michael.siviter@invesco.com

Hong Kong

Yi Hu
Head of Asia Credit Research
+852 3128 6815
yi.hu@invesco.com

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