Invesco Fixed Income

Multi-sector asset allocation outlook

Q2 2020

Contents

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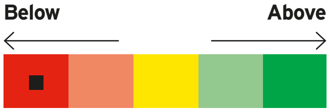
IFI multi-sector asset allocation overview

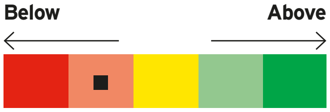
- **Macro factor summary:** The coronavirus crisis has delivered a shock to the global economy that is unprecedented in size and cause. Methods of economic forecasting based on standard economic variables are not sufficient to analyze global economic growth. We have adapted by utilizing a framework based on the path of infections to help forecast macro fundamentals. Evidence from China suggests that, once infections have been controlled, some back-to-work can be reintroduced. Fiscal and monetary stimulus adds fuel to the back-to work-process, but we believe it will take time and likely be a prolonged process to get back to work fully around the world. Global inflation remains low and we do not expect inflation to rise in the near term. Global policy has been eased substantially but the pace of economic recovery will likely depend on developments surrounding the containment of the virus.
- **Asset allocation summary:** Our macro factor framework implies neutral positions in duration, the US dollar and credit.
- **Risk position summary:** We support risk taking in high quality sectors that are benefiting from the support of the US Federal Reserve (Fed), like investment grade credit and selected asset-backed securities, but continue to be cautious on lower quality structured and credit assets and industries most directly impacted by the shutdowns.

Factors vs. market expectations

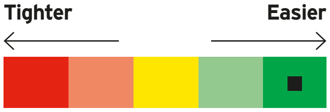
IFI macro factor outlook (3-month outlook)



Global growth: Below market expectations
There is considerable uncertainty around the ultimate growth impact of the coronavirus. We believe the growth impact will be severe. There are many uncertainties currently, but we expect an historic drop in growth as containment measures are implemented. Much of this impact will likely be in Q1 in China, and in Q2 in the US and Europe. While there are many unknowns, we are cautiously optimistic that globally we will be successful in containing the spread of the virus and hopeful we will begin to pivot toward more growth-oriented policies toward the end of Q2.



Global inflation: Below market expectations
US and European inflation remain low. Global inflation expectations have fallen sharply as coronavirus uncertainty continues to be elevated. We are monitoring inflation expectations, particularly in the US, as the Fed aims to combat falling expectations with a dovish response. Chinese inflation remains above policy makers' preferred level due to idiosyncratic and exogenous factors, but we do not expect an increase in global inflation in the near term.



Global policy and financial conditions: Easier than market expectations
Global policymakers have eased sharply in recent months and are expected to continue easing given heightened growth uncertainty around the coronavirus and energy and oil. That said, financial conditions are not the main driver of markets currently, and central banks are unlikely to be able to resolve all coronavirus and energy-related problems.

IFI 2020 macro outlook

	Growth (%)		Inflation (%)		Policy (next move)	
	IFI Forecast	Consensus	IFI Forecast	Consensus	Next move	Consensus
US	-6.6	-3.2	0.8	1.2	Ongoing credit easing and liquidity provision through 2021	Consensus broadly in line with our forecast
Europe	-7.2	-5.0	0.3	0.6		
China	1.5	3.0	3.0	3.3		
Japan	-6.0	-2.2	0.1	0.1		

Source: Invesco Fixed Income, Bloomberg L.P., data as of April 15, 2020. IFI forecasts are 6-month trend forecast.

IFI broad asset allocation (3-month outlook)

		Macro factor vs. market expectations			
		Growth: Below expectations	**Inflation: Below expectations**	**Policy: Easier than expectations**	**Asset allocation**
Market impact	**Global duration**	Neutral	Neutral	Neutral	Neutral
	US dollar	Neutral	Neutral	Negative	Neutral
	Global credit	Negative	Neutral	Positive	Neutral

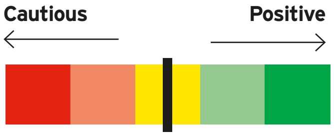
Asset allocation (3-month outlook)

Global duration: Neutral
Easier financial conditions will likely support interest rates globally, but we believe this expectation is largely priced in. Given the potential widespread contraction in global growth due to the pandemic, we believe there is unlikely to be upward pressure on bond yields in the near term.

US dollar: Neutral
As the Fed cuts rates, the interest rate differential between the US and other developed markets will likely continue to decline. This should detract from the attractiveness of the US dollar and cause the US dollar to decline against developed market currencies. Easier financial conditions should also be supportive of emerging market currencies. However, we remain neutral the US dollar as severe growth weakness will likely be a drag in the near term.

Global credit: Neutral
Tight financial conditions and uncertainty regarding the path of economic fundamentals have caused elevated market volatility, making investing difficult. Valuations are now compelling in a number of asset classes relative to a month ago, in our view. We favor using a framework that looks to infection rates in the US and Europe to understand developing fundamentals as a necessary requirement for putting risk assets to work. In addition, we view proactive central banks as necessary to help the financial markets navigate through this current sudden stop in the global economy. Attractive investment opportunities are likely to be available as we gain more clarity on the outcomes of government strategies to flatten the infection curve. We believe this will provide a better indication of the business disruption time frame to factor into our growth projections.

IFI risk position (3-month outlook)



The sudden stop in the US economy and associated credit crunch have generated extremely sharp moves in markets in recent months. The Fed has announced a range of programs to support the market for higher quality credit assets in the US. We support risk taking in high quality sectors that enjoy Fed support, such as investment grade credit and AAA commercial mortgage-backed securities, but are cautious about lower quality structured and credit assets and industries most directly impacted by the shutdowns.

Underweight ← → **Overweight**

🟥 🟧 🟨 🟩 🟩

IFI multi-sector asset allocation (3-month outlook)

Long-term government interest rates

US			■		
Fundamentals			■		
Valuations		■			
Technicals				■	

US Treasury yields are likely to stay low for a significant period of time. The deflationary growth shock unleashed by the coronavirus will likely drag down fair value levels in the US Treasury market for the foreseeable future. We expect the federal funds rate to stay near zero as well. Treasury issuance in the long end may cause the yield curve to steepen in the 10-year to 30-year portion of the curve.

Europe			■		
Fundamentals		■			
Valuations		■			
Technicals				■	

European Union (EU) sovereign bond markets will likely be driven in the short term by the magnitude of European Central Bank (ECB) support. Economic growth is collapsing and sovereign debt issuance is set to soar as a consequence of the coronavirus. Quantitative easing (QE) will need to absorb much of the increase in supply. Against that backdrop, and despite stretched valuations, bond yields are likely to remain within a narrow range. That said, the disappointing magnitude and scope of the fiscal package announced by the EU may be the catalyst for further volatility in spreads in countries such as Italy, where the call for a more collective response, such as corona bonds, was rebuffed.

Japan				■	
Fundamentals				■	
Valuations				■	
Technicals				■	

In striking contrast to other developed bond markets, Japanese Government Bond (JGB) yields are now approaching the high end of their 12-month range. The approximate cause for the selloff in JGBs over March has been the reluctance of the Bank of Japan (BoJ) to ease policy either by cutting rates or increasing asset purchases, and the selling of JGBs by international investors Japanese investors due to the freezing up of funding markets in recent weeks.

Going forward, it appears unlikely JGB yields will rise much further. The market now offers attractive yields for international and domestic investors relative to other liquid developed markets and less funding stress has reduced one source of selling. It also appears likely that the BoJ will ease eventually, as the yen is likely to appreciate substantially if it doesn't, given the context of huge monetary stimulus from the Fed, ECB and Bank of England. Currency appreciation would likely only exacerbate deflationary forces in Japan, resulting in potentially more attractive Japanese real yields.

China				■	
Fundamentals				■	
Valuations				■	
Technicals				■	

Given the contraction of economic activity in Q1 and deterioration in the external environment, we think it is a matter of time for the long end of China's government bond yield curve to decline. Although supply is expected to be stronger on the back of upcoming issuance of special central government bonds and local government special project bonds, we expect the central bank to cut the required reserve ratio sufficiently to ensure enough liquidity to absorb the larger supply. The cut of the 7-day reverse repo rate in late March was seen as the start of a series of rate cut moves by the central bank. In addition, the yield pick-up of China onshore rates bonds over developed market government bonds has reached a multi-year high. We see room for China onshore rates bonds to catch up with global major rates bonds in terms of performance.

Currencies

USD			■		
Fundamentals			■		
Valuations		■			
Technicals			■		

We remain neutral the US dollar versus emerging and developed market currencies. Although interest rate differentials have compressed to record tights, the US dollar would likely still benefit from a global flight to quality if the pandemic worsens. Over the longer term, we expect the US dollar to soften versus emerging and developed market currencies, but only after risk aversion subsides and market liquidity becomes less problematic.

EUR				■	
Fundamentals			■		
Valuations				■	
Technicals				■	

Despite the significant headwinds to growth and lack of an EU corona bond response to the pandemic, we remain positively biased to the euro but we broadly expect a weaker US dollar environment in general in the coming months. The lockdown is now slowly being relaxed and we are hopeful that the region's economy can return to some sort of normality in the third quarter, although uncertainty is high. There are risks to our positive outlook for the euro, the most prominent being an adverse political reaction, led by Italy, to the fiscal package announced by the EU, which was seen as underwhelming by some southern countries.

JPY				■	
Fundamentals				■	
Valuations				■	
Technicals				■	

The yen failed to act as a risk hedge in March, remaining largely unchanged versus the US dollar, though it outperformed most other developed and emerging market currencies. However, the reasons for USD/JPY stickiness are subsiding, resulting in potential upside for the yen versus the US dollar, in our view. We believe interest rate differentials no longer make the USD/JPY exchange rate an attractive carry position and the Fed is expanding its balance sheet far faster than the BoJ. Furthermore, capital outflows from Japanese investors and corporates are likely to slow going forward, as foreign yields look less attractive and lower profitability dents corporate merger and acquisition and foreign investment activity.

RMB			■		
Fundamentals				■	
Valuations			■		
Technicals		■			

As China has contained the coronavirus outbreak with a significantly reduced number of new cases, we see room for China's assets, including the renminbi, to outperform. In the medium term, we see room for the renminbi US dollar exchange rate to trade down to 6.7-6.8; however, in the near term, it may continue to trade in the range of 6.90-7.15, given the concern over the impact of the pandemic on the global economy and market sentiment.

Credit

Investment grade (IG)

US				■	
Fundamentals		■			
Valuations					■
Technicals			■		

Macro and corporate fundamentals will likely weaken due to the virus-related slowdown, the degree of which will depend largely on the trajectory of the virus, the full government response and the duration of the demand shock. Depending on how proactively credit rating agencies approach the current environment, we expect downgrades to spike across affected sectors, such as energy, transportation and leisure. Forced selling of liquid bonds to raise cash has increased price volatility and new issuance has been sporadic amid a heavily volatile investment grade and broader risk market backdrop. Issuers have been opportunistic when primary markets have been accommodating and deals have been well subscribed. We expect issuance to continue as the new issue backlog builds, but expect a greater ability to issue in the near term, on the heels of supportive Fed policy. We believe the historic size and velocity of spread widening - partly due to a weakening corporate fundamental outlook, but also asset class outflows resulting in forced selling to raise cash - suggest potential for attractive future total returns.

Canada				■	
Fundamentals			■		
Valuations				■	
Technicals				■	

Economic growth in Canada was already softening when the pandemic began and our expectation for interest rate cuts by the Bank of Canada was accelerated. Additional monetary support via quantitative easing and fiscal support from the federal government have been implemented to prevent a deeper economic contraction. Valuations quickly re-priced in corporate credit to levels that we believe are attractive in an extended environment of close to 0% policy rates. We believe supportive technicals and structural investor demand for high quality income continue to support our overweight view.

Europe			■		
Fundamentals		■			
Valuations					■
Technicals		■			

The coronavirus pandemic has caused a sharp collapse in both trade and service sectors (especially the latter), which will likely result in a material hit to companies' liquidity in the short term. We expect corporate fundamentals to deteriorate as a result, with the greatest pressure likely on industrial and cyclical firms along with the leisure and travel industries. Bank regulation has been temporarily relaxed and balance sheets are much stronger versus 2008/09, but loan loss provisioning will likely increase as small and medium-size enterprises feel the greatest pressure on funding lines. At current valuations, we believe this credit deterioration is being priced in. Although technicals are currently negative, they are likely partially mitigated by the ECB's Pandemic Emergency Purchase Program (PEPP).

UK			■		
Fundamentals		■			
Valuations					■
Technicals	■				

Sterling investment grade credit is experiencing similar fundamental trends to European investment grade, but its higher weighting in more defensive sectors (such as utilities and communications) should help to partially insulate it against a coronavirus-driven downturn. Valuations are now back to levels last seen during the European sovereign and global financial crises. The BoE has responded by resuming its Asset Purchase Facility, but the scale of this scheme is modest compared to the ECB's PEPP, which means that technicals are likely to remain negative.

Asia		■			
Fundamentals		■			
Valuations			■		
Technicals		■			

The negative economic impact caused by the coronavirus will likely continue to put pressure on Asian investment grade fundamentals. But liquidity and refinancing concerns have not yet surfaced for Asian investment grade corporates, especially those with strong government support. Although Asian credit market liquidity has diminished in recent weeks and emerging market flows in general have turned negative, valuations have started to become attractive, in our view, since we do not see significant downgrade risk in Asian investment grade.

High yield (HY)

US			■		
Fundamentals		■			
Valuations				■	
Technicals		■			

The coronavirus has wreaked havoc on US high yield along with other global markets. Heading into 2020, we expected moderate US growth as the economic expansion continued. However, virus mitigation efforts around the world have caused economic pain for many high yield companies and sectors. Markets have reacted negatively and spreads have widened across high yield. While substantial uncertainty remains about the economy in the coming months, a great deal of default risk is currently priced into the high yield market – implying roughly twice the credit losses ultimately incurred during the global financial crisis. We believe there is further downside risk due to either general market illiquidity or a prolonged economic downturn, but our base case calls for some improvement in the second half of this year, supporting our generally constructive view on spreads over the medium term. While recessions are difficult, they can represent attractive investment opportunities as fear grips markets. There have only been a few times in history when high yield spreads have been wider than they are now. In each previous occasion, the market was able to generate substantial gains as investors scooped up bargains not typically available under normal market conditions.

Europe			■		
Fundamentals		■			
Valuations				■	
Technicals		■			

We expect European growth to be weaker compared to the US. However, an offset to that fundamental disadvantage is a relatively larger weighting of BB credits and fewer CCC rated names in European high yield.

Asia			■		
Fundamentals		■			
Valuations			■		
Technicals			■		

The overall credit worthiness of Asian high yield will likely deteriorate in the coming months due to lower growth in the region. Liquidity conditions have worsened and we do not see the trend reversing yet. Asian high yield credit spreads have widened significantly but still have not approached the levels seen in 2008. We are generally cautious regarding Asian high yield.

Emerging markets (USD)

Sovereign			■		
Fundamentals		■			
Valuations				■	
Technicals	■				

Although emerging market (EM) hard currency valuations have improved, we have downgraded our fundamental and technical outlooks. The change in our fundamental view reflects the coronavirus-driven global growth slowdown, the unexpected geopolitically-driven drop in the oil price and an EM capital flow "sudden stop" in the making. All of these shocks seem exogenous and we think they are likely to fade over a 9-12 month horizon. Valuations have improved sharply, especially for the non-oil segment of the EM universe, but also across oil names with stronger buffers and policies in place. However, we are concerned about the technical picture and prefer to focus on liquidity. At this stage, we are over-weighting the "sudden stop" risks relative to improvements in valuations. On balance, looking across the mix of improved valuations and the exogenous, and potentially temporary, nature of the fundamental weakness against a difficult technical backdrop, we maintain our overall position at neutral. This means, beyond liquidity management, we do not anticipate making big changes in portfolios at this stage. Going forward, in terms of directional bias, we are leaning toward upgrading our stance on EM credit.

Municipals

IG			■		
Fundamentals			■		
Valuations				■	
Technicals			■		

HY			■		
Fundamentals			■		
Valuations				■	
Technicals		■			

Municipal bond funds experienced significant outflows in March, beginning mostly in high yield funds, forcing fund managers to sell bonds to meet redemptions. As markets tumbled, investors shifted from a "flight to quality" to a "flight to cash" stance, putting pressure on short-term municipal securities. We believe the market has repriced to a level below that warranted by current fundamentals due to elevated fear and uncertainty. Most municipal issuers were in strong financial shape heading into the coronavirus pandemic and many issuers are essential service providers. While there could be small, isolated pockets of default in the near future, we believe the vast majority of municipal bonds will not default, as history has shown.

Structured

Agency MBS[1]				■	
Fundamentals			■		
Valuations				■	
Technicals					■

Despite low US Treasury yields, Agency MBS posted excellent performance in late March after the Fed purchased roughly USD250 Billion of Agency MBS and has committed to support this market with whatever is required. Our current view of this asset class is positive, given strong Fed support, which provides downside protection, US government credit quality in a time of credit dislocation, and slower prepayment speeds due to social distancing, which has led to a very subdued mortgage refinancing environment compared to expectations. Eventually, we expect low rates to cause faster speeds as individuals are able to return to more normal working conditions. Nevertheless, we expect demand for refinancing to outpace industry capacity for some time.

RMBS[1]			■		
Fundamentals		■			
Valuations					■
Technicals		■			

Short-term fundamentals are negative, in our view, given the impact of the coronavirus on sentiment and housing activity. Mortgage loan delinquencies are likely to increase, although we expect loan losses to be contained, given strong underwriting, embedded home price appreciation, and assistance programs for affected borrowers. Technical conditions have improved from their worst point around March 25, as forced selling has abated and we have seen buyer interest in the market. Valuations reflect illiquidity across the residential sector, but we believe valuations have overshot. We believe an extremely dire outcome for borrower performance has been priced in that we do not expect to materialize, especially for higher-rated non-agency RMBS.

ABS[1]			■		
Fundamentals			■		
Valuations				■	
Technicals			■		

The ABS market is comprised of many different sub-sectors that have various exposures to the consumer and corporate markets. Some areas of the ABS market enjoyed relatively strong fundamentals before entering the crisis. Other areas of the market could see potential near-term stress depending upon the depth and duration of the impact of the coronavirus on growth and travel-related ABS. Therefore, we continue to remain a neutral position on traditional ABS fundamentals and technicals, while we see valuations as cheap relative to corporate bonds, resulting in an overweight grade on valuations. In esoteric ABS, differences between individual assets may vary, but overall, we have been and continue to be cautious, as some of these subsectors, such as aircraft and shipping container ABS, are under severe stress.

Bank loans

US		■			
Fundamentals	■				
Valuations		■			
Technicals		■			

Credit fundamentals have gone from stable to highly vulnerable in a matter of weeks due to the anticipated earnings shock from the coronavirus and related social distancing measures. While the disruption to supply chains and aggregate demand impacts the outlook for the entire universe of loan issuers, certain sectors such as airlines, energy and travel and leisure are most squarely in the crosshairs. Valuations repriced rapidly amid elevated volatility for all risk assets, especially for issuers in these affected sectors as well as those with limited financial flexibility. Given the high degree of uncertainty regarding when economic life will "return to normal," it is difficult to argue with conviction that the market as a whole has overcorrected, although we believe that case can be made on a credit-by-credit basis. Assuming a 60% recovery rate (well below the historical average), we believe the loan market is priced to compensate investors for around a 22% default rate versus a previous peak of around 11% in November 2009.[2] From a technical standpoint, the new issue market is shut down, but retail and institutional outflows have moderated from initial extremes and collateralized loan obligations and opportunistic buyers have stepped in as prices have declined.

Europe		■			
Fundamentals	■				
Valuations		■			
Technicals		■			

We believe that default rates will increase over the medium term. That said, companies and sponsors are actively and aggressively addressing liquidity needs via internal cost reductions and utilizing numerous governmental aid packages. Leisure and travel sectors will likely be in focus, with social distancing and lockdowns curtailing demand as we approach the key summer period of peak patronage and discretionary consumer spending. First quarter earnings results begin around May and should provide some indication of the severity of the economic slowdown given the onset of the pandemic in March. Fundamentals and valuations are expected to weaken. Technicals will likely be driven by higher rated and/or less exposed sectors and be influenced by potential further volatility across other asset classes, especially the equity and commodity markets.

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[1] MBS is mortgage-backed securities. ABS is asset-backed securities. RMBS is residential mortgage- backed securities.

[2] Source: S&P Leveraged Loan Index, Invesco, data as of Nov. 30, 2009.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Past performance is not a guide to future returns.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

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Mortgage- and asset-backed securities, which are subject to call (prepayment) risk, reinvestment risk and extension risk. These securities are also susceptible to an unexpectedly high rate of defaults on the mortgages held by a mortgage pool, which may adversely affect their value. The risk of such defaults depends on the quality of the mortgages underlying such security, the credit quality of its issuer or guarantor, and the nature and structure of its credit support.

Asset-backed securities are subject to prepayment or call risk, which is the risk that the borrower's payments may be received earlier or later than expected.

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/ or interest.

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