Invesco

Executive Summary Report

Invesco Global Fixed Income Study 2020

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Welcome

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Welcome to Invesco's third annual Global Fixed Income Study, part of a suite of thought leadership studies including the Global Sovereign Asset Management Study and the Global Factor Investing Study. These are all data-driven studies based on face-to-face interviews that add depth, colour and context to the findings.

In 2019, the number of respondents grew from 145 to 159 fixed income professionals, to incorporate the views of 121 institutional and 38 wholesale investors that are together responsible for managing over $20 trillion in assets (as of 31 December 2019). It is a uniquely large and in-depth examination of global fixed income investing.

These investors are employed by pension funds (both defined benefit and defined contribution), sovereign wealth funds, insurers and wholesale investors, including private banks, diversified fund managers, multi-managers and model builders. They are located across all the major regions of North America, Europe and Asia-Pacific.

This year's interviews were conducted in October and November 2019, before the onset of the COVID-19 crisis. The Study offers insights into asset allocation decisions, strategies, and methods of implementation, as well as future

Theme 1

"The definition of a bubble is that it will pop, and I don't see how that can happen with rates so low."

Insurer, EMEA

Theme 2

"The low interest rate environment means we have included more alternative fixed income, this includes rotating out of investment grade corporate bonds and into high yield."

Insurer, APAC

intentions of investors within the fixed income asset class, and reveals how they were positioned in the lead-up to the market turmoil arising from the COVID-19 pandemic.

Although the continued widespread use of unconventional monetary policy and low levels of inflation meant that for many the cycle was seen as hard to compare to those of previous decades, the Study reveals an underlying increase in risk aversion among respondents as they anticipated that a record run in fixed income markets might be coming to an end. This underlying risk aversion likely better positioned many investors for an unprecedented exogenous shock than have otherwise may been the case.

The behaviour of markets since the onset of the crisis suggests that the caution displayed by many of our respondents was not universal. Quantitative easing initially sent US government bond yields lower as intended. However, yields subsequently rose at the short and medium areas of the curve with less cautious investors likely forced to sell their most liquid positions in order to meet withdrawals, as well as to close out riskier positions and strategies.

At the time of writing in April 2020, a halt to economic activity from global shutdowns generally remains in place and there is still some way to go before we will know the full impact of this crisis on the economy, markets and portfolios, or the timing of the recovery. The quick, emergency interventions by central banks, including widespread quantitative easing, massive securities purchases, and the reopening of finance windows have accelerated already tumbling yields in some markets.

This will have compounded problems for some respondents such as defined benefit pension funds whom the Study found were already straining to match their liabilities. They were among respondents increasing allocations to less liquid alternative credit assets such as emerging market and high yield debt despite wariness at the impending end of the cycle. A notable exception to the allure of US high yield was US investors themselves, who had been selling down exposures, motivated by concerns over rich valuations and the late stage of the cycle.

One concern firmly on the radar of respondents was bond market liquidity. While regulations that followed the global financial crisis such as Dodd-Frank were seen as adding stability to the financial system, they have also led to banks holding less inventory on their balance sheet and playing a reduced role as market makers. The slack has been picked up by customer-to-customer platforms managed through intermediaries, such as ETFs and credit portfolio trading. However, this model had previously not been tested by significant market stress, with questions arising over the difference between the liquidity of ETFs and their individual constituents.

Theme 3

"Credit portfolio trading reduces market risk. The basket of bonds being traded has also gone through an assessment and this also reduces your risk to some extent."

Insurer, APAC

Theme 4

"Emerging markets are a lot less correlated than they used to be as they have become better developed."

DB Pension Plan, EMEA

Theme 5

"It's even more important for a fixed income investor to consider ESG than an equity investor."

Wholesale, US

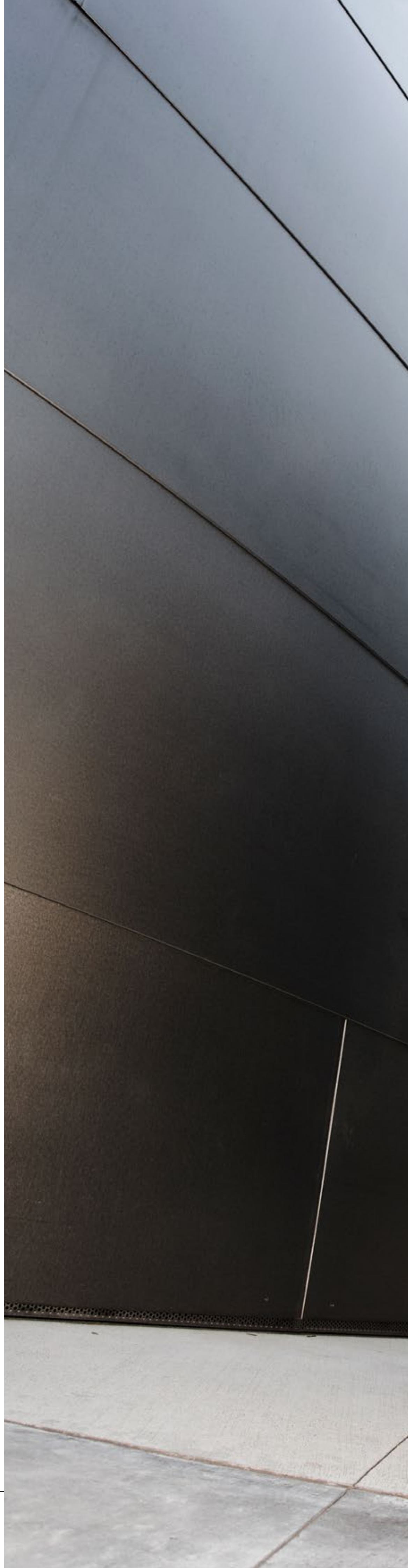
Volatility arising from COVID-19 has led to regular price discounts between fixed income ETFs and their component securities. But by facilitating continued trading during a period of significant uncertainty, ETFs have acted as a key source of price discovery and played an important role in keeping markets moving. As such, this model can be said to have passed its first significant test.

In our penultimate theme, the Study focuses on allocations to emerging market debt and Chinese debt, with the rise in interest and allocations we observed in our 2018 Study continuing to grow at a rapid pace in 2019. Overall, we found a continuing shift away from viewing emerging market debt as a monolithic asset class and growing interest in more country-specific allocations. We found APAC and EMEA investors were most inclined to be allocating to emerging markets, with US investors less likely to be making active decisions and generally following benchmark weights. That said, the rationale among EMEA and APAC investors for these allocations and the way they are being implemented differ widely with a mix of local currency, dollar and euro-denominated exposures and varying preferences for regional and single-country allocations.

In our final theme, we continue the review of ESG's evolution in fixed income portfolios from our previous studies and find investors continuing to move beyond performance concerns relating to ESG, to a recognition that managing issuer-related ESG risks has the potential to enhance returns. Very few respondents now view ESG as hindering performance. This evolved thinking is taking investors from niche approaches such as using ESG-specific products and securities to more thorough integration into core fixed income mandates. The majority are anticipating making new/additional investments in the future, with interest extending beyond green bonds, the most common instrument, to include social and sustainable bonds.

The economic upheaval induced by the global COVD-19 pandemic brought the end of the cycle to the forefront much more quickly than the soft landing most had anticipated. Over half of our investors believed any sell-off in bond markets would be short lived. While the accuracy of this view remains to be seen at the time of writing, the Study provides a unique window into the attitudes, asset allocations and strategies of fixed income professionals in a record-long cycle just prior to its historical climax.

We hope you find the Study useful in understanding how fixed income is developing and the evolving approaches of this asset class's professionals.



Theme 1

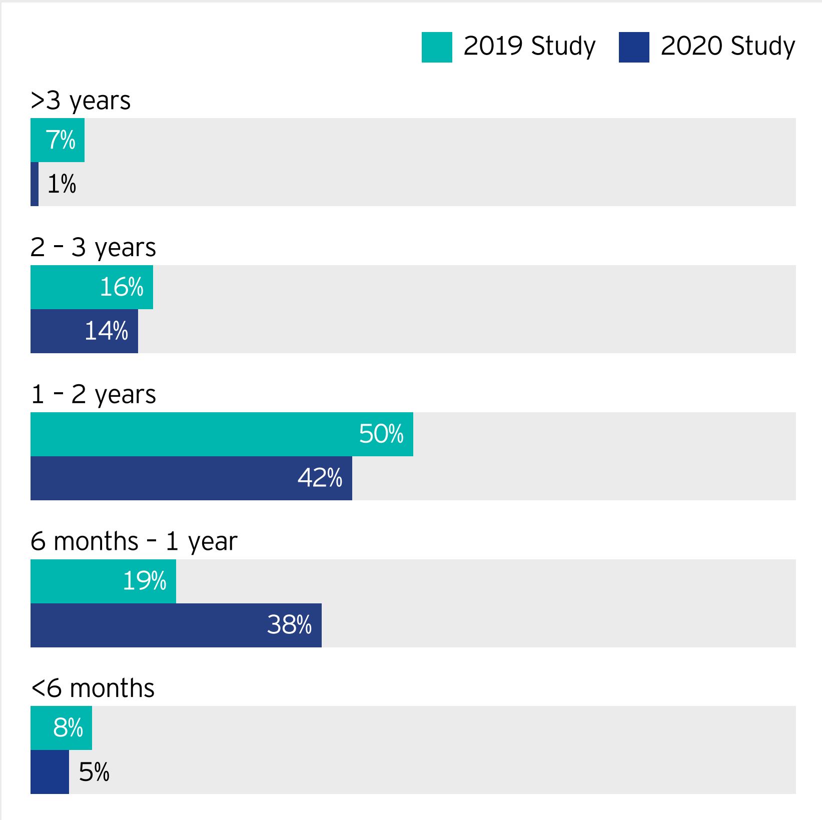
Greater caution in advance of market turmoil

Theme one focuses on how investors were positioning themselves in the lead up to market turmoil arising from the COVID-19 pandemic.

We found that even before the dramatic falls in markets globally in Q1 2020, fixed income investors were becoming increasingly risk averse. Almost half (43%) of respondents, when interviewed in late 2019, thought the economic cycle had a year or less to run and many were adapting their portfolios accordingly. This more cautious positioning was a potential positive for professional institutional investors, helping to protect portfolios and providing a defensive anchor in the face of the unanticipated risk of a global pandemic.

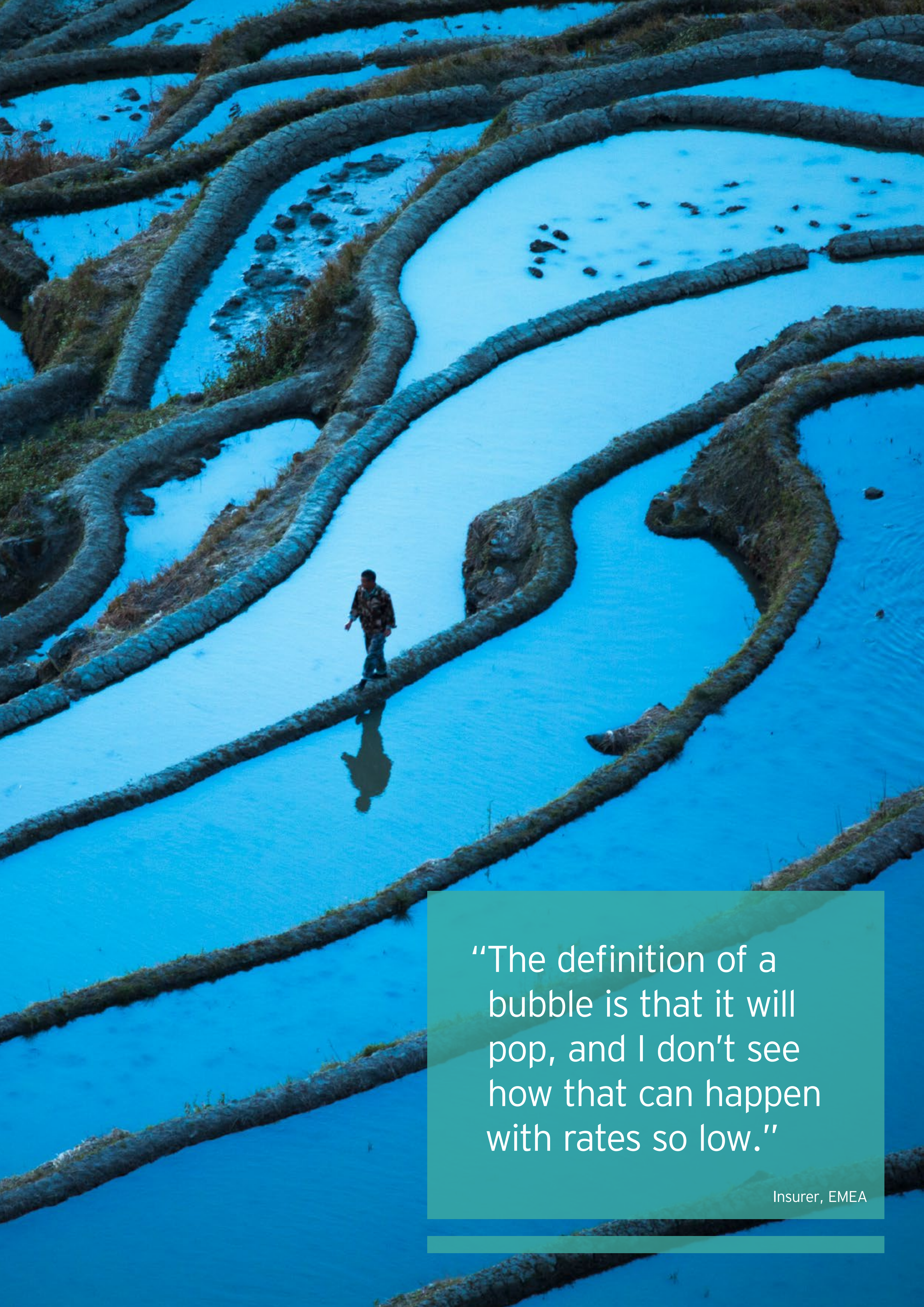
While there were a variety of views on the proximity of the end of the cycle, the fastest growing cohort was those who expected to see the end of the cycle reached within one year (**Figure 1.1**). Concerns were focused on credit spreads and liquidity, areas that have been significantly tested across the market by the COVID-19 crisis. Widening spreads were the biggest macro concern, and this has come to the fore quickly, with sectors exposed to the pandemic such as consumer goods, autos and oil & gas experiencing widening spreads and steepening curves.

Figure 1.1
Expected time until end of economic cycle (% citations, global)



How much longer do you expect the current global economic cycle to last?

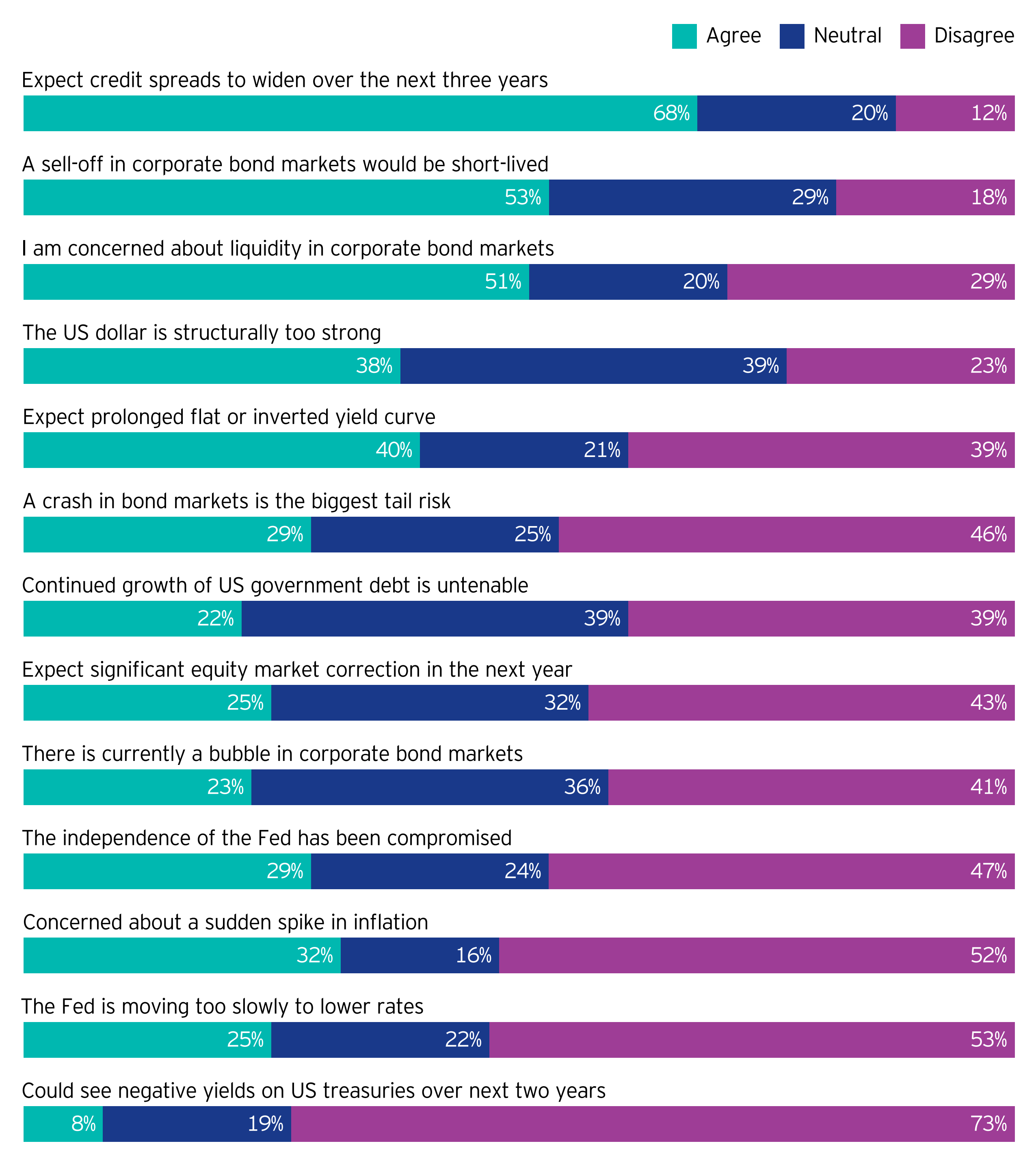
Sample size: 2019 = 100
2020 = 151



> “The definition of a bubble is that it will pop, and I don’t see how that can happen with rates so low.”
>
> Insurer, EMEA

Figure 1.2

Agreement with macro statements (% citations, global)

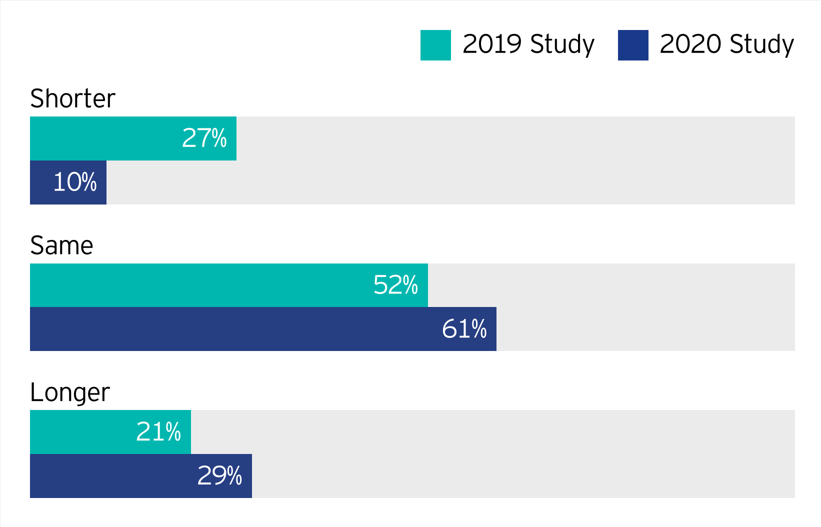


To what extent do you agree with the following statements?

Sample size: 152

Figure 1.3

Expected change in duration over next 12 months (% citations, global)



How do you expect to change your duration over the next 12 months?

Sample size: 2019 = 108
2020 = 154

Increased pessimism was also reflected in intentions for duration, with a bias towards lengthening rather than the marginal bias to shortening seen 12 months ago (**Figure 1.3**). Despite a record fall in yields, expectations were that yields could fall even further, as has proven to be the case. That said, only 8% believed that US rates could turn negative (**Figure 1.2**). While still a low probability, it is now more likely US rates will turn negative and it's notable that few investors had given weight to this scenario in their list of possibilities.

Despite a strong market for bonds, rising prices and negative nominal yields on $12 trillion of global debt (including around $1 trillion of corporate debt) as of January 2020[1], less than a quarter of investors described conditions as a bubble. Only 29% believed a sharp decline in bond prices was an exigent threat (**Figure 1.2**). With defaults likely to rise in sectors exposed to the COVID-19 pandemic this view will come under pressure and may test the liquidity of the riskier fixed income securities receiving some late-cycle attention.

Only 29% believed a sharp decline in bond prices was an exigent threat.

[1] Bloomberg L.P. data

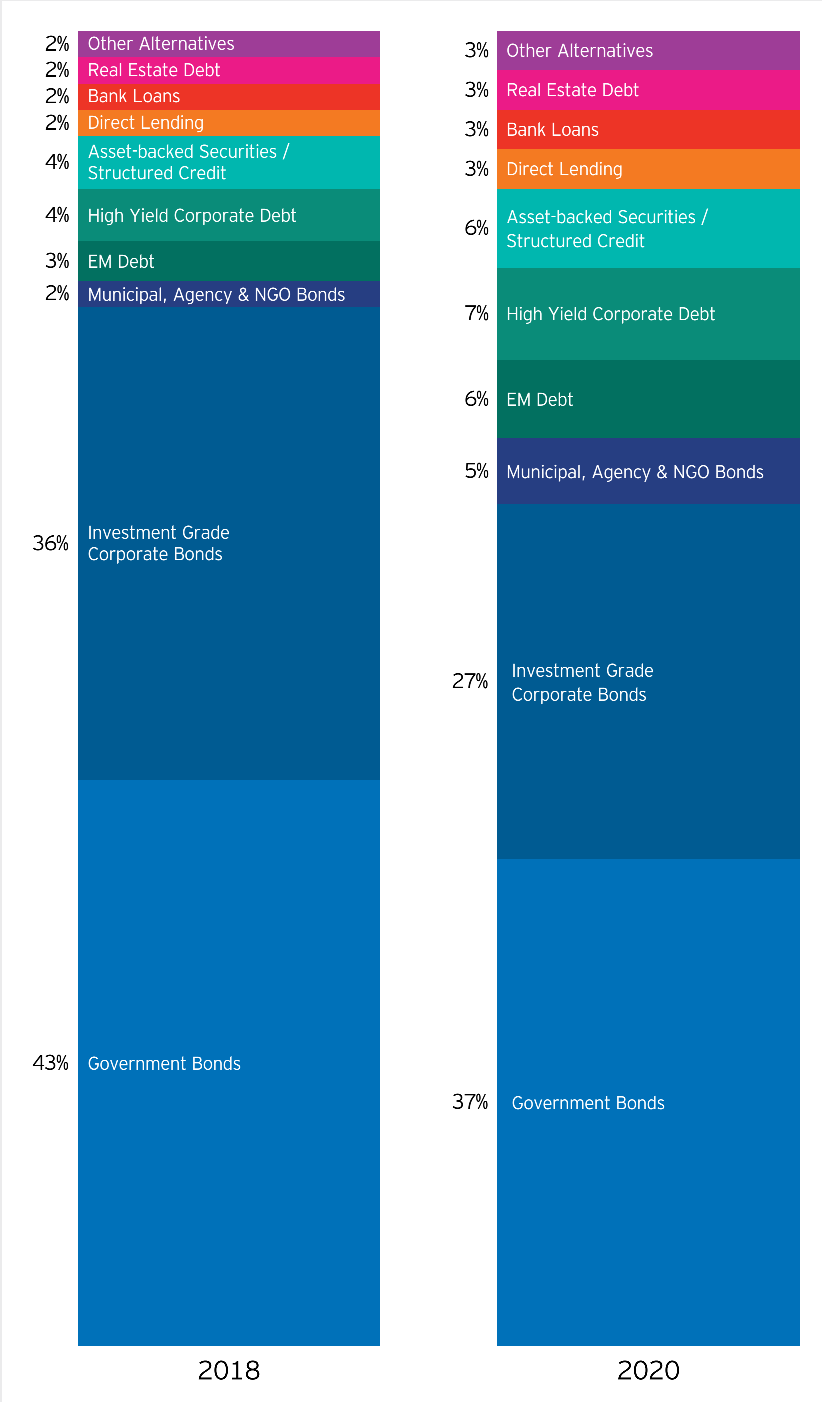
Theme 2

Contrast between cautious and yield-seeking investors grows

In theme two we identify the growing contrast between risk-averse and yield-seeking investors in their approach to asset allocation.

With low yields the dominant driving force of asset allocation decisions within the fixed income space there has been a significant trend towards alternative sub-asset classes, with the highest levels of growth in asset classes with higher yields, notably emerging market (EM) and high yield (HY) debt (**Figure 2.1**).

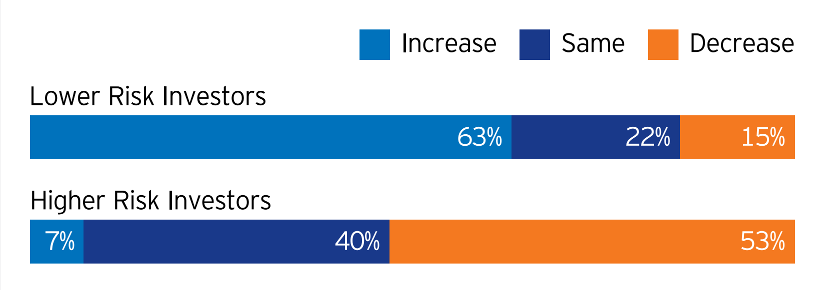
Figure 2.1
Allocation to sub-asset classes (average %, global)



What is the current allocation between asset classes within your fixed income portfolio?

Sample size: 2019 = 85
2020 = 104

Figure 2.2
Changes in allocation to core fixed income (vs alternative) by risk segment (% citations, global)

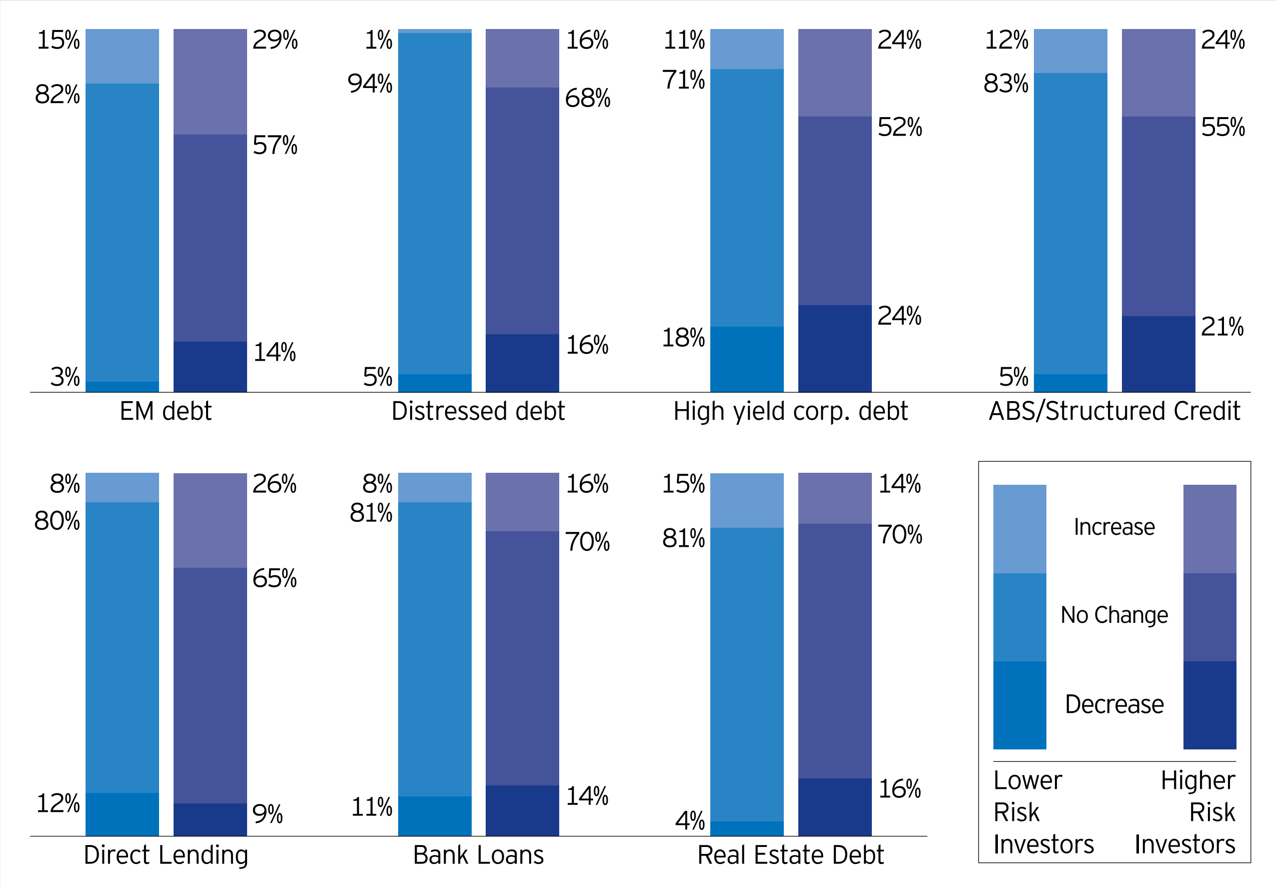


How has this allocation changed over the past three years? Sample size: 110

However, as investors became increasingly concerned about the looming end of the cycle, we found that this pattern was no longer universal, with investors diverging based on their underlying risk tolerance. 54% of investors surveyed self-identified as being 'cautious' and 46% as 'adventurous'.

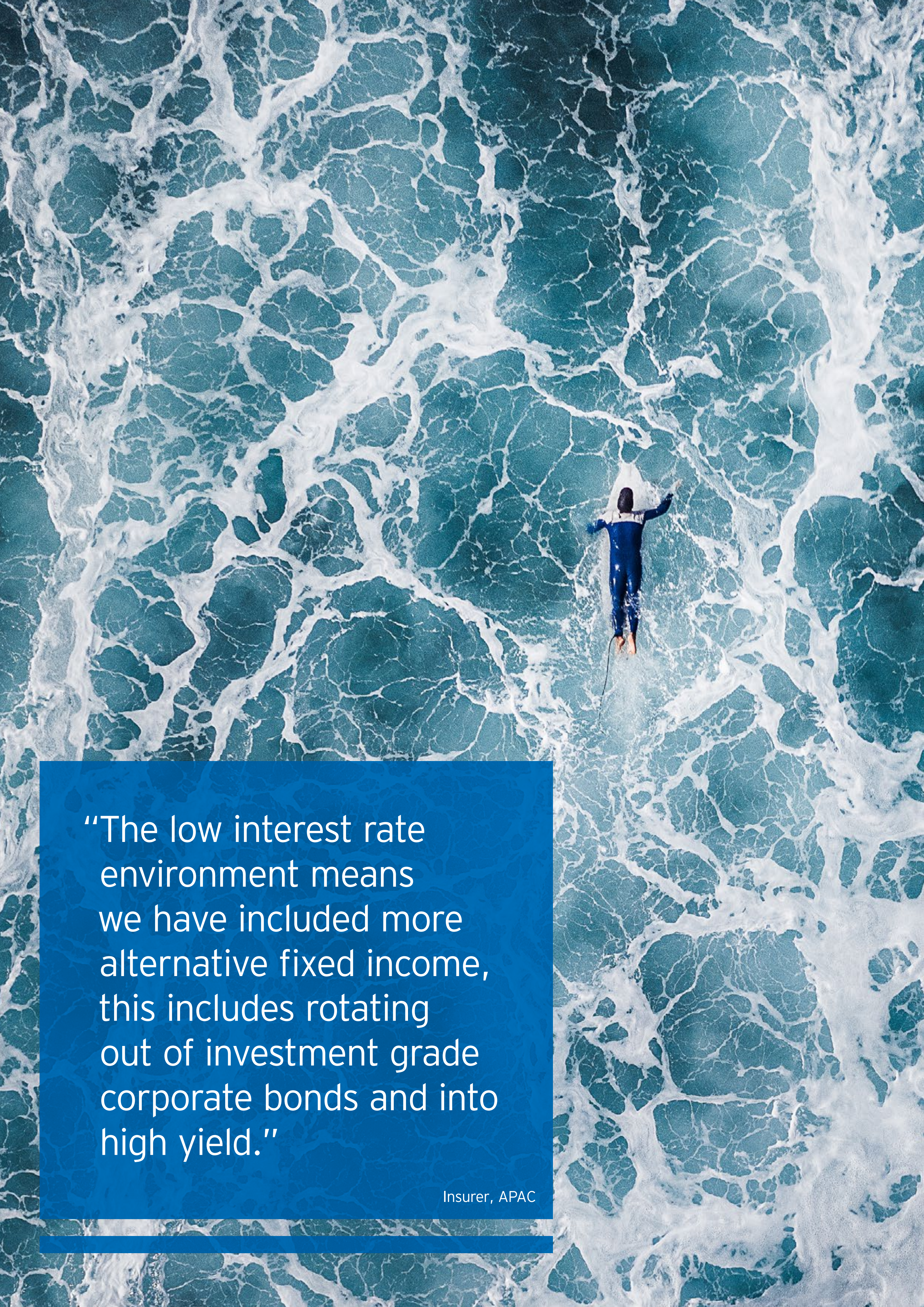
Within the 'cautious' segment some 63% of investors had spent the past three years winding down their exposure to alternatives (**Figure 2.2**), with government bonds the most attractive replacement and supplemented by increased

Figure 2.3
Planned change in allocations to alternative FI in next three years by risk segment (% citations, global)



How will this allocation change over the next three years? Sample size: 138

54% of investors surveyed self-identified as being 'cautious' and 46% as 'adventurous'.

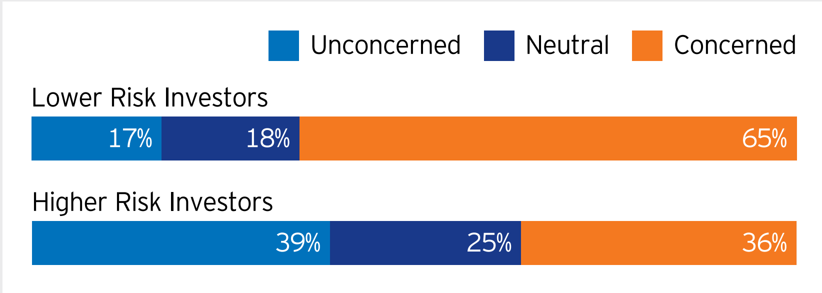


"The low interest rate environment means we have included more alternative fixed income, this includes rotating out of investment grade corporate bonds and into high yield."

Insurer, APAC

Figure 2.4

Concern about liquidity by risk segment (% citations, global)



I am concerned about liquidity in corporate bond markets

Sample size: 110

allocations to investment grade corporates. Liquidity was a major concern for 65% of these investors and, as a result, many were increasing the active management of their bond portfolios to navigate an anticipated increase in uncertainty.

In contrast 'adventurous' investors described themselves as able to bear more risk, either because they have longer time horizons (such as sovereigns), or because they are under significant pressure to make returns. They planned to continue increasing allocations to less liquid sub-asset classes, with 26% increasing allocations to direct lending, 24% to high yield credit, and 29% to EM debt. Many of these investments require investors to take on additional risk that is only palatable given faith in bond market stability, something which has been tested thoroughly in the months following the survey.

Overall a quarter of investors had increased allocations to HY debt over the past three years. Demand for USD HY debt was especially prevalent in EMEA and APAC, propelled by low and negative yields in domestic markets and the need to generate a return, with under-funded pension schemes especially prominent in this cohort.

In contrast, many US investors were reducing their exposure to HY in preparation for the end of the cycle. We identified a big shift away from HY positions and a movement towards more secure bonds such as Treasuries. With spreads tight, and pricing high, many US investors believed that they were not being well compensated for the risk they were taking - concerns that look justified by the market instability and widening spreads in early 2020 resulting from the COVID-19 pandemic.

Demand for USD HY debt was especially prevalent in EMEA and APAC, propelled by low and negative yields in domestic markets and the need to generate a return.

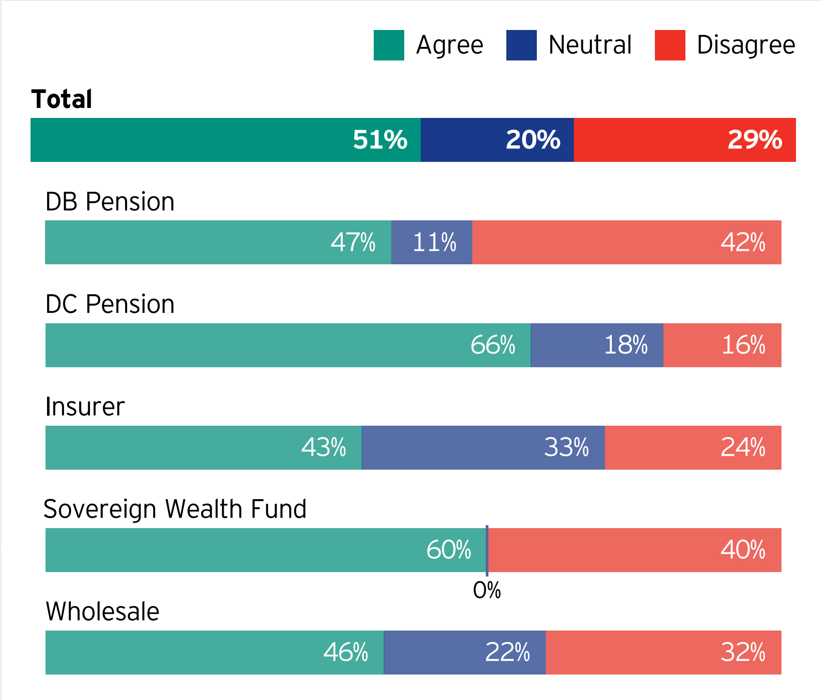
Theme 3

New approaches help to address a bond market liquidity paradox

In our third theme, we examine the paradox of investors continuing to increase allocations to more illiquid asset classes, despite heightened concerns related to liquidity.

We found that despite anticipation that the end of the cycle was approaching, many investors had been increasing allocations to riskier and more illiquid asset classes for return and, in some cases, to close widening liability funding gaps. At the same time, investors across all segments highlighted liquidity in fixed income markets as one of their biggest concerns (**Figure 3.1**).

Figure 3.1
Concerned about liquidity (% citations, global)

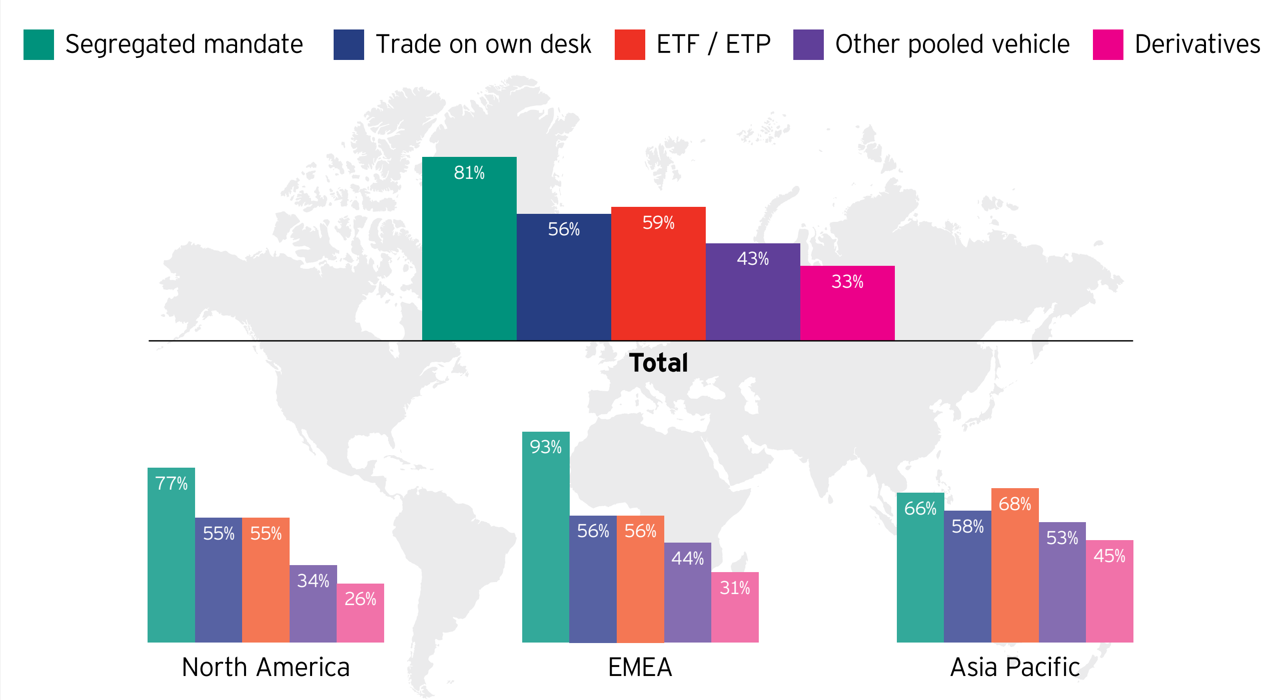


To what extent do you agree with the following statements?

Sample size: Total = 152, DB Pension = 38 DC Pension = 32, Insurer = 37, SWF = 5, Wholesale = 37

Investors across all segments highlighted liquidity in fixed income markets as one of their biggest concerns.

Figure 3.2
Vehicles used in fixed income (% citations)



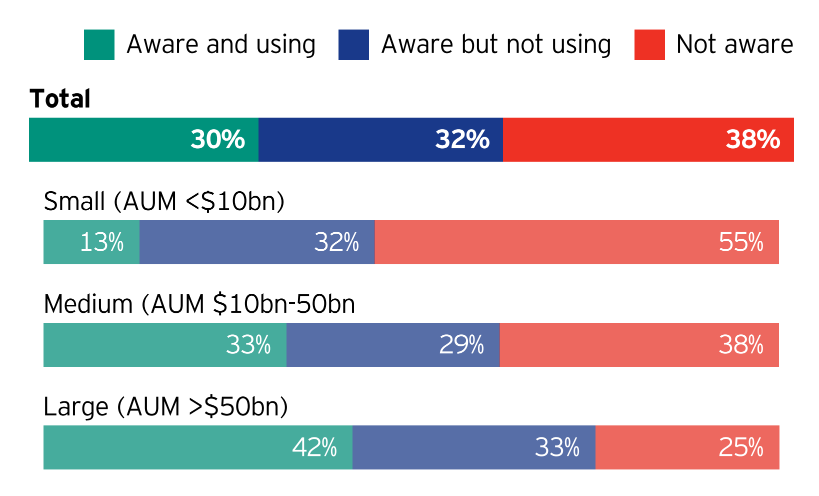
Which vehicles do you use in your fixed income portfolio?

Sample size: Total = 152, North America = 53, EMEA = 61, Asia Pacific = 38

Since the global financial crisis, regulations such as Dodd-Frank have led to reshaping of fixed income markets, with banks holding less inventory on their balance sheets and much of the slack picked up by customer-to-customer platforms managed through intermediaries. By facilitating trading directly between customers, this model has helped bring down spreads and reduce costs. However, volatility in the opening months of 2020 is proving the first serious test of this model, and the ecosystem of products within it.

This transformation in the way fixed income securities are traded has been aided by the development of exchange traded funds (ETFs), which are widely used across the sample (**Figure 3.2**). ETFs are valued for offering liquidity alongside the convenience of instant diversification at relatively low cost. This is seen as valuable in allowing investors to quickly target a diverse range of interest-rate and credit risks, facilitating a range of new strategies. In the face of volatility arising from the COVID-19 pandemic this liquidity is being tested. However, by facilitating continued trading during a period of significant uncertainty ETFs have acted as a key source of price discovery in markets which might have otherwise entirely seized.

Figure 3.3
Use of credit portfolio trading (% citations, global)



Are you aware of credit portfolio trading and do you currently use it?

Sample size: Small = 38, Medium = 40, Large = 48

Innovations in algorithmic third-party pricing have also been pivotal in the development of credit portfolio trading, which has quickly found a role among fixed income investors. This is particularly the case among larger asset owners, with 42% of investors with assets of more than $50billion making use of this approach (**Figure 3.3**).

Buying and holding securities until maturity is another popular route to alleviate liquidity concerns, with 56% of investors using this strategy (**Figure 3.4**). This popularity can in part be linked to the additional returns on offer – liquidity premiums are seen as one of the key drivers of alpha within fixed income. However, this is not the only benefit, with fixed maturity strategies also valued for reducing costs, controlling interest rate risk and delivering predictable returns.

Figure 3.4
Use of fixed maturity strategies (% citations, global)

56%
Total

57%
DB Pension

72%
DC Pension

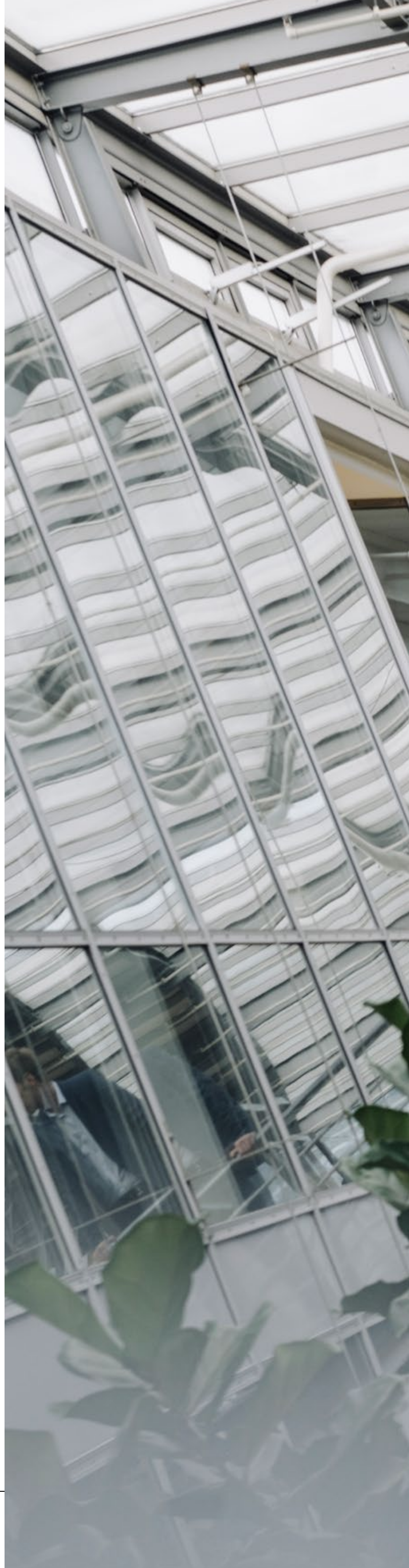
66%
Insurer

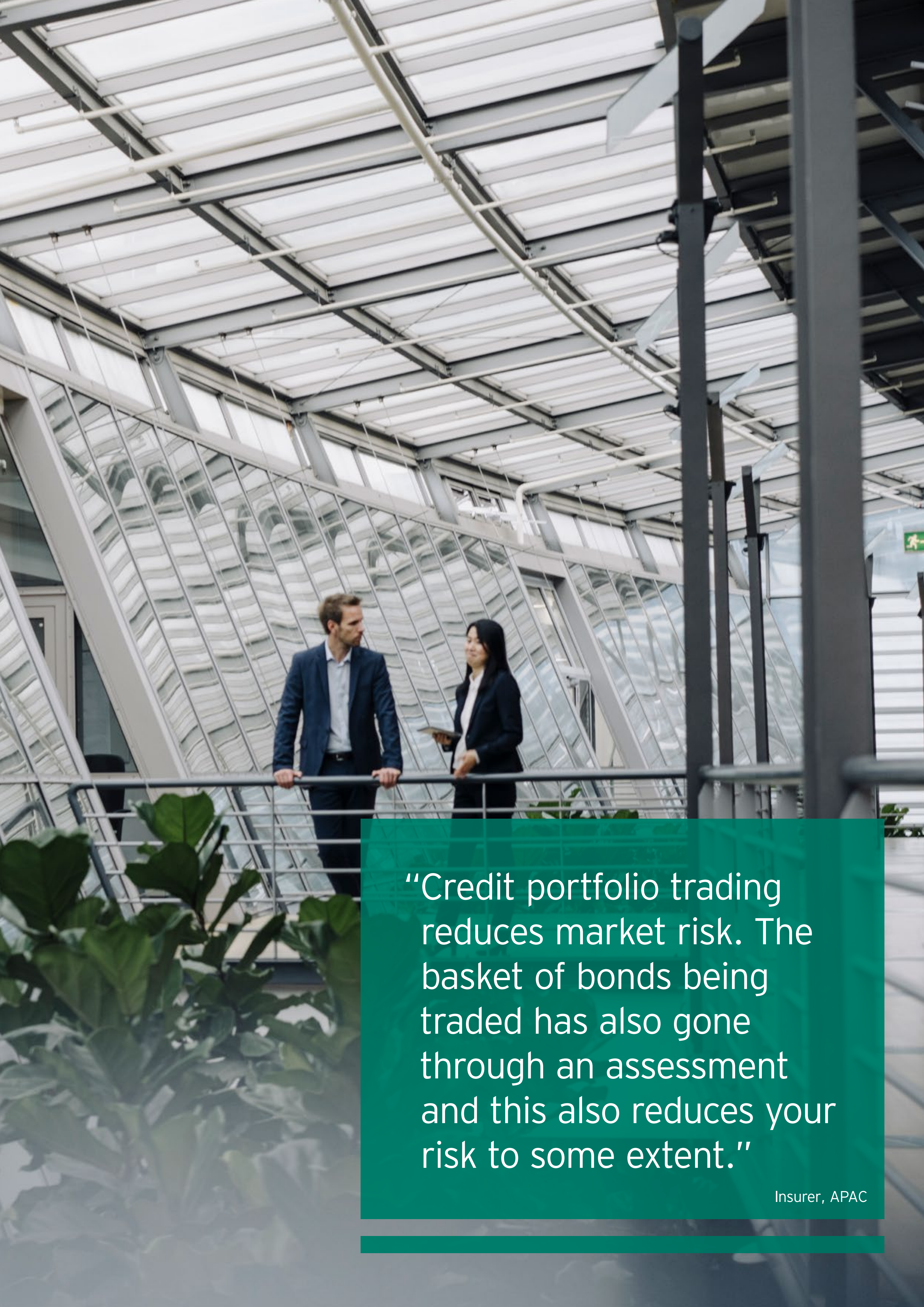
57%
Sovereign Wealth Fund

36%
Wholesale

Do you currently use Fixed Maturity/Buy and Maintain strategies?

Sample size: Total = 142, DB Pension = 35, DC Pension = 25, Insurer = 35, SWF = 7, Wholesale = 36





"Credit portfolio trading reduces market risk. The basket of bonds being traded has also gone through an assessment and this also reduces your risk to some extent."

Insurer, APAC

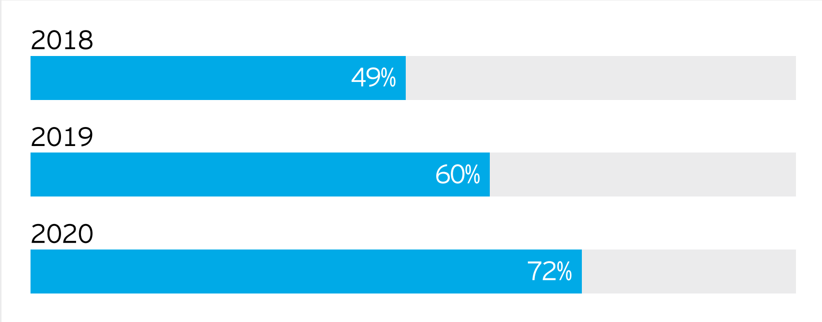
Theme 4

Being picky in emerging market debt – investors abandon broad mandates for country allocations

In theme four, we look at the continued rise in allocations to emerging market (EM) debt and the growing preference for country specific allocations.

Overall, the proportion of investors allocating to EM debt has risen rapidly and very substantially, from 49% in our 2018 Study to 72% in 2020 (**Figure 4.1**). APAC and EMEA investors have been leading the charge while their North American counterparts, able to rely on better domestic yields, have also been increasing allocations but at a more measured pace.

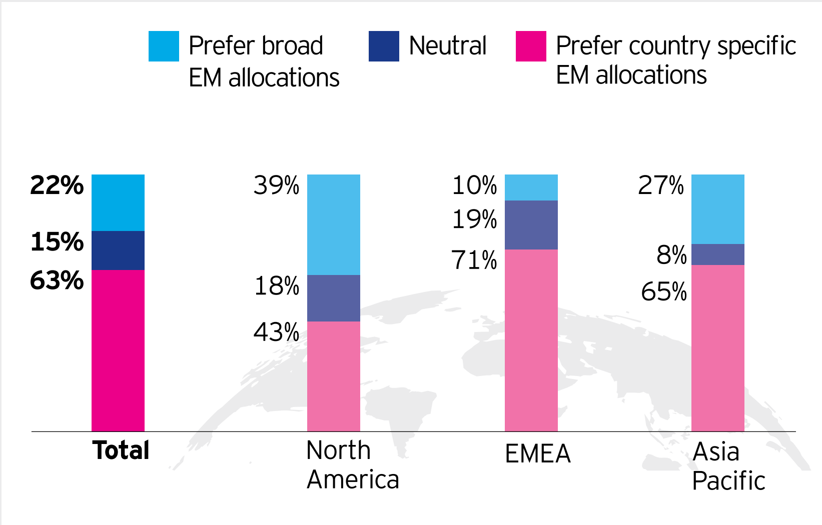
Figure 4.1
Investors with allocations to EM debt (% citations, global)



Do you have exposure to EM debt within your fixed income portfolio?

Sample size: 2018 Study = 79, 2019 Study = 85, 2020 Study = 156

Figure 4.2
Country allocation preference (% citations, EM debt investors)



It's now preferable to take individual country allocations rather than broader EM allocations

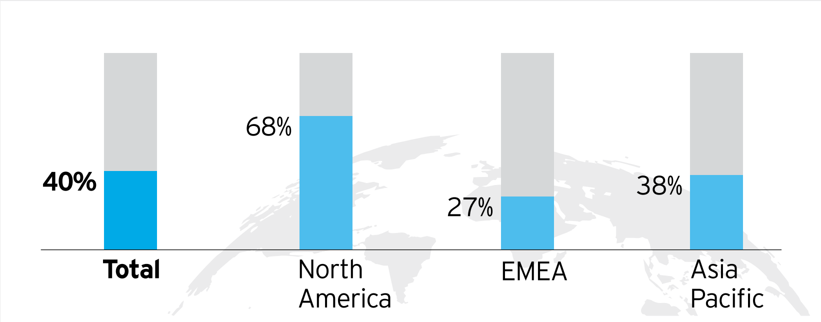
Sample size: Total = 97, North America = 23 EMEA = 48, Asia Pacific = 26

The average allocation thus varies by region, with EM debt accounting for an average of 7.2% of portfolios for investors in Asia Pacific, 6.5% for those in EMEA and 3.6% for those in North America. For many, part of the appeal of EM debt is the potential to utilise specific knowledge advantages in individual markets (**Figure 4.2**). This has spurred a move to country-specific allocations and away from broad regional mandates, with 41% of investors believing that EM markets are increasingly disconnected.

"Emerging markets are a lot less correlated than they used to be as they have become better developed.

DB Pension Plan, EMEA

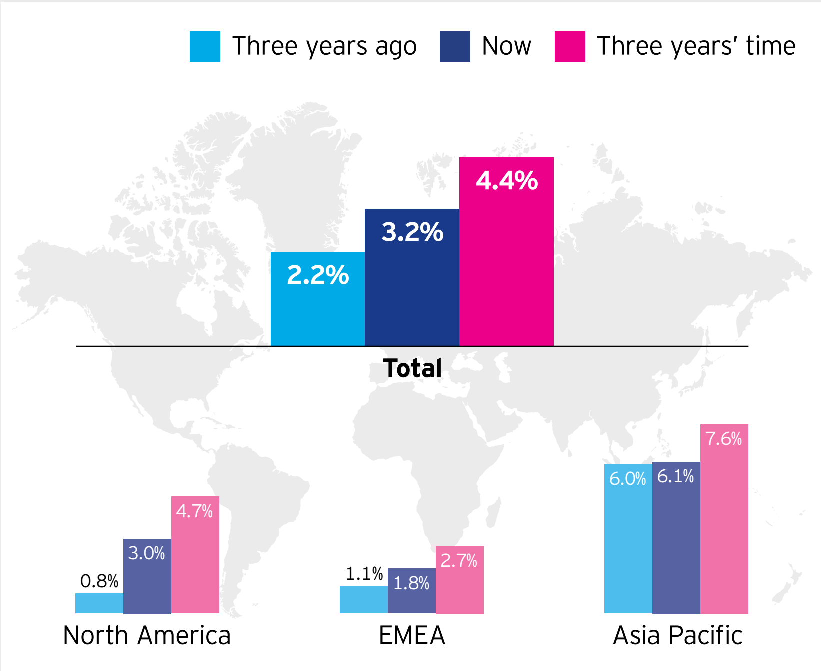
Figure 4.3
EMD considered part of core fixed income (% citations, EMD investors)



Do you see EM debt as part of your core fixed income portfolio or your alternative fixed income portfolio?

Sample size: Total = 107, North America = 25
EMEA = 48; Asia Pacific = 34

Figure 4.4
Average allocation to China (%, investors in China)



What % of your fixed income portfolio was/ invested in China three years ago? What % of your fixed income portfolio is currently invested in China? What % of your fixed income portfolio do you expect to be invested in China in three years' time?

Sample size: Total = 43, North America = 13, EMEA = 20, Asia Pacific = 10

Investors in EMEA and APAC are more likely to cite return as the main driver of their EM debt allocations, while a majority in North America are motivated by diversification. Some 68% of North American investors in EM debt view these allocations as core investments, rather than satellite, suggesting that they fulfil long-term stable objectives (**Figure 4.3**).

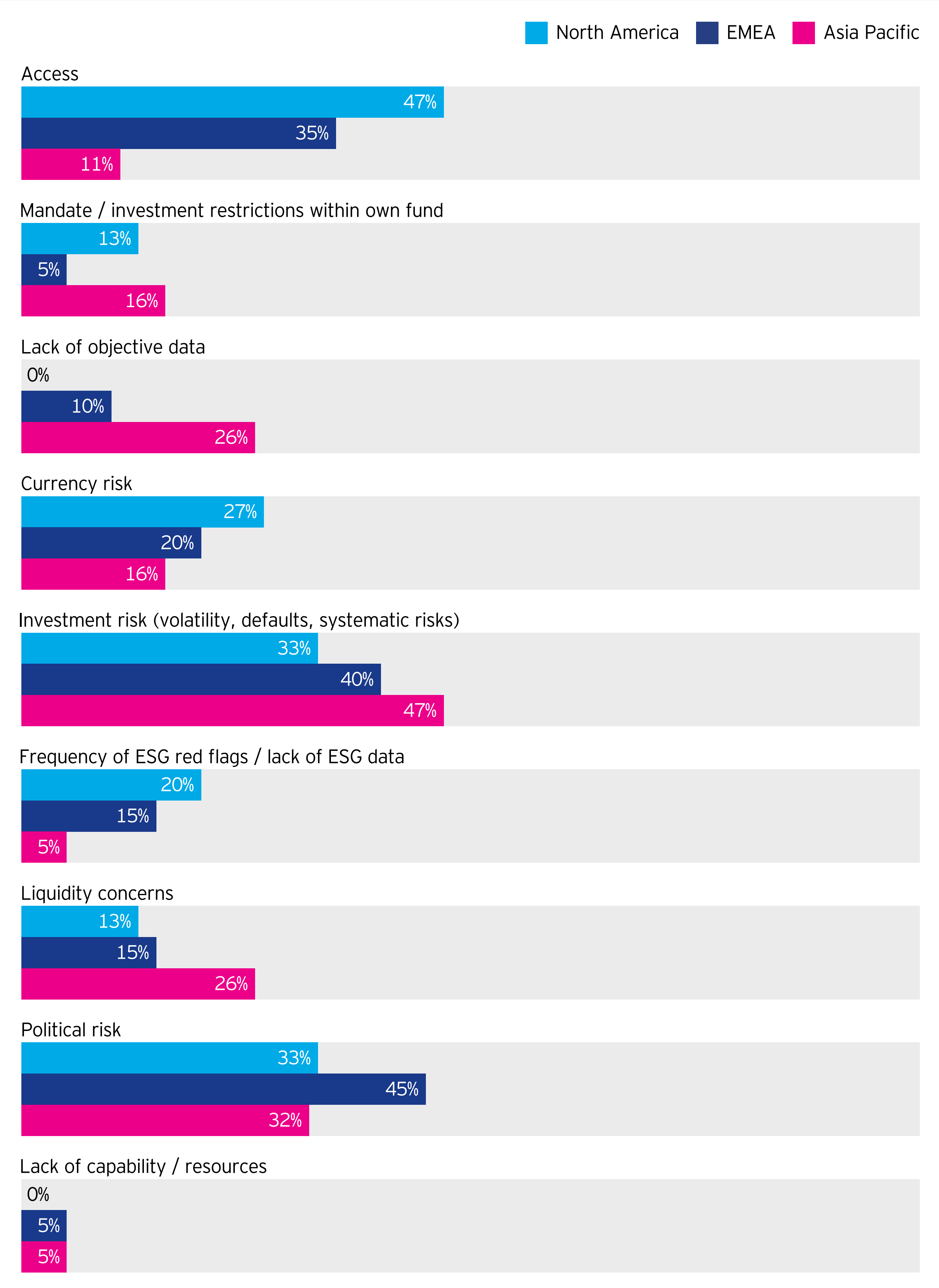
This year's Study also shows continued growth in allocations to China. In the past three years EMEA allocations have grown 68% from 1.1% to 1.8%, while in North America allocations have grown to from 0.8% to 3% (**Figure 4.4**). Chinese corporates are the most popular category of bond, with access opening up since 2016 and facilitating a rapid uptake. Nearly three-quarters of investors now have at least some exposure.

Almost half of EM debt investors believe that the Chinese economy and political system offer unique diversification benefits, although 40% of China investors cited investment risk as a concern (**Figure 4.5**). Market access was still a worry for a third. However, this challenge is decreasing rapidly with 62% of investors perceiving access to be a less significant obstacle than two years ago.

In past editions of the survey, we have noticed a strong preference for offshore access to Chinese investment. However, this is changing: more than half of investors have some onshore experience, and 44% in this year's Study expressed a preference for onshore over offshore. Onshore investment is supported by low correlations with core fixed income instruments along with higher yields and a broader range of issuers. Meanwhile, for 70% of those investors still favouring offshore, the ease of investment was a major factor alongside liquidity (52%) and currency (57%) advantages.

Some 68% of North American investors in EM debt view these allocations as core investments, rather than satellite, suggesting that they fulfil long-term stable objectives.

Figure 4.5
Perceived obstacles to investment in China (% citations, investors in China)



What do you see as the top challenges when investing in China? (Select top two)

Sample size: Asia pacific = 19 EMEA = 20; North America = 15

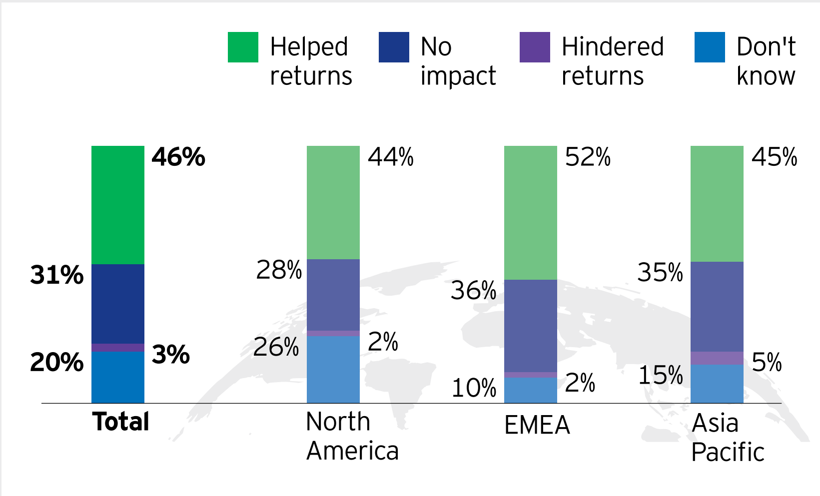
Theme 5

ESG widely seen as beneficial to returns, as focus turns to shortage of product and implementation

We conclude with a focus on ESG, which is now extensively adopted within fixed income portfolios, and widely seen as beneficial to returns.

In our 2019 Study, many investors asserted that they were not willing to sacrifice returns to integrate ESG considerations. However, the debate has shifted rapidly and a year later most investors believe ESG enhances, or at least has no impact, on returns (**Figure 5.1**).

Figure 5.1
ESG impact on performance (% citations, ESG investors)



Has embedding ESG principles into your fixed income portfolio had any impact on returns?

Sample size: Total = 112, North America = 43 EMEA = 48, Asia Pacific = 21

The debate has shifted rapidly and now most investors believe ESG enhances, or at least has no impact, on returns.

Indeed, half of investors that have adopted ESG within their fixed income portfolios cite return enhancement as a key driver (**Figure 5.2**). Investors also increasingly recognise ESG as a valuable risk-management tool, given the connection between credit impairment, and risks associated with issuers that can be highlighted by a robust ESG process. However, other drivers remain more prominent, with social responsibility (75%), stakeholder demands (67%) and a desire to align with beneficiary beliefs (60%) the most important motivating factors.

APAC has witnessed the most significant uptick in ESG adoption over the past two years, with investors in that region overtaking their North American peers and catching up on EMEA (**Figure 5.3**).

Figure 5.2

Motivations for incorporating ESG factors within fixed income (% citations, ESG investors)

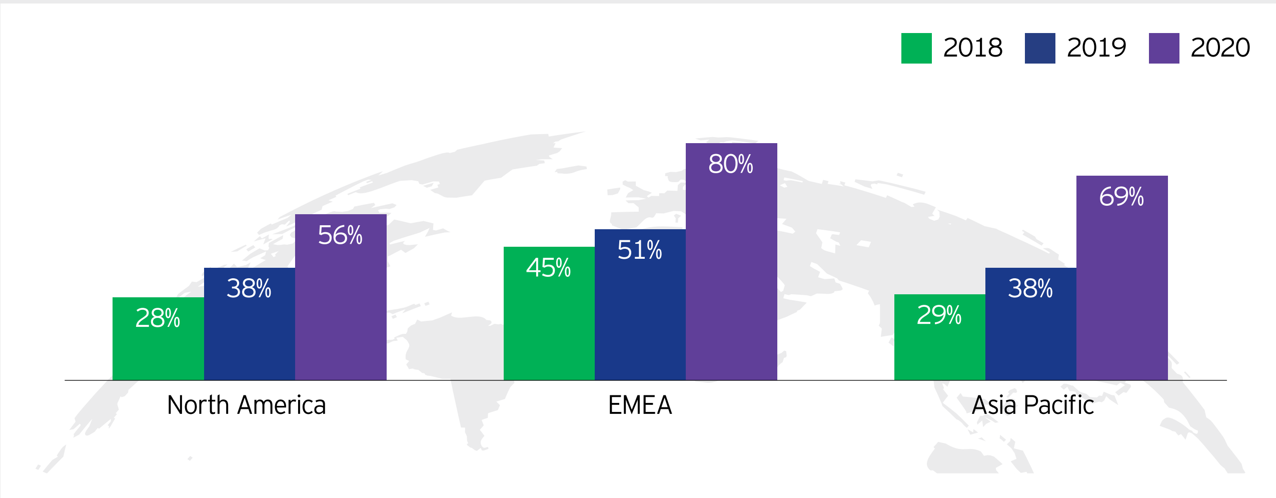
75% Social responsibility	**67%** Stakeholder wishes	**60%** Alignment with beneficiary beliefs
57% Alignment with fund / investment objective	**55%** Senior management decision	**50%** Return enhancement
44% Generate income	**44%** Credit risk management/ downside protection	**37%** Fiduciary responsibility
30% Altruistic reasons	**25%** Regulation	

What was your main motivation for considering ESG factors within your fixed income portfolios?

Sample size: 100

Figure 5.3

Incorporate ESG in fixed income (% citations, global)



Do you currently incorporate ESG within your fixed income portfolio?

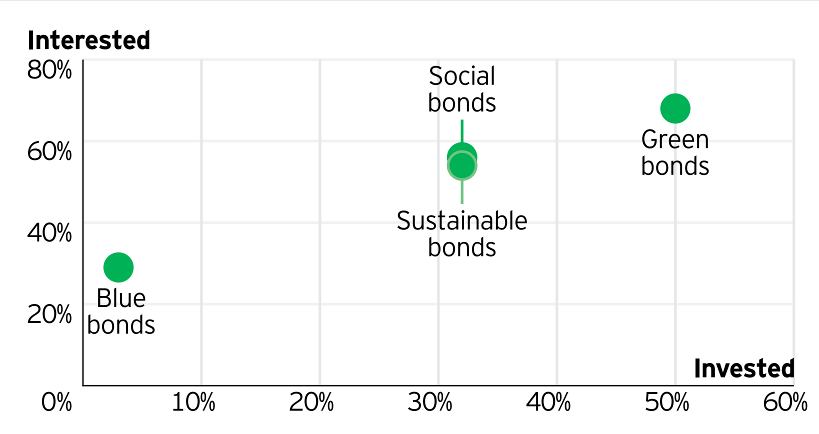
Sample size: 2018 = 79, 2019 = 107, 2020 = 147

In 2019, our Study found most investors chose not to purchase ESG-specific products whereas today half own them and 80% are anticipating making new/additional investments in the future. While green bonds are the most common, interest has also expanded across the full range of offerings with a third of investors having bought social and sustainable bonds (**Figure 5.4**).

However, adoption continues to be stifled by the perceived absence of suitable instruments – more than half of investors believe there is a lack of suitable product in the market and interest in ESG-specific bonds currently exceeds supply.

Figure 5.4

Investment and interest in ESG bonds (% citations, global)



Do you invest in any of the following types of ESG bonds? Which of these would you be interested in investing in the future (either additional or new investments)?

Sample size: 159

Faced with a lack of supply of specialised ESG securities, investors are often looking to compensate by incorporating ESG in a structured way throughout their fixed income portfolios, with 62% of investors incorporating ESG into their financial/ credit models and 55% requiring external asset managers to integrate their ESG policies within customised mandates.

More than half of investors believe there is a lack of suitable product in the market and interest in ESG-specific bonds currently exceeds supply.

"It's even more important for a fixed income investor to consider ESG than an equity investor."

Wholesale, US

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GL411 (18 May 2020)

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