Invesco

Global Fixed Income Strategy

Monthly report

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Global macro strategy

Is Europe's neutral rate rising?

The US labour market has dominated headlines in recent months, but a significant shift in the eurozone deserves attention. Over the past year, the European Central Bank (ECB) has started to remove policy restriction, navigating signs of disinflation while grappling with, what now appears to be, exaggerated fears of a wage-price spiral. Thus far, growth has remained resilient, allowing the ECB to adopt a cautious approach to cutting interest rates. However, recent data suggest a downward trend in growth, with indicators pointing to likely below-potential performance in the second half of 2024. Simultaneously, inflation metrics have disappointed, further diminishing concerns about a wage-price spiral. In light of these developments, it seems prudent for the ECB to accelerate its policy adjustments. We now anticipate a 25-basis point cut at each meeting until it reaches a "neutral" stance. Given the ECB's inflation-focused mandate, we believe it is unlikely to implement more aggressive 50-basis point cuts.

As the journey toward lower rates begins, a critical question has arisen: What is the ultimate destination? This uncertainty has sparked discussions among economists about the elusive concept of the "neutral interest rate" - an unobservable rate that achieves both target inflation and potential growth. Unlike the US Federal Reserve (Fed), which updates its neutral rate estimate quarterly in its Summary of Economic Projections, the ECB does not regularly revise its figure. However, a working paper released earlier this year suggested that the neutral rate in real terms is estimated to be around 0%-0.5%, or 2%-2.5% in nominal terms.[1]

Is the neutral rate higher than it was before?

There has been speculation that a combination of aggressive fiscal policy and a strong post-COVID recovery has pushed the neutral rate higher. While this may hold true for the US, we urge caution in applying these assumptions to the eurozone for three key reasons.

First, we consider the growth outlook. The eurozone is gradually recovering from the depressed levels of 2023. However, restrictive monetary policy remains a significant barrier, hindering a robust recovery. If we assume potential growth is around 1.25%, the region has not recorded above-potential growth since the third quarter of 2022. This suggests that policy is indeed restrictive, challenging the notion that the neutral rate has risen in the eurozone.

1. Source: ECB, Working Paper Series, "Monetary policy and the drifting natural rate of interest", Revised Sept. 2024.

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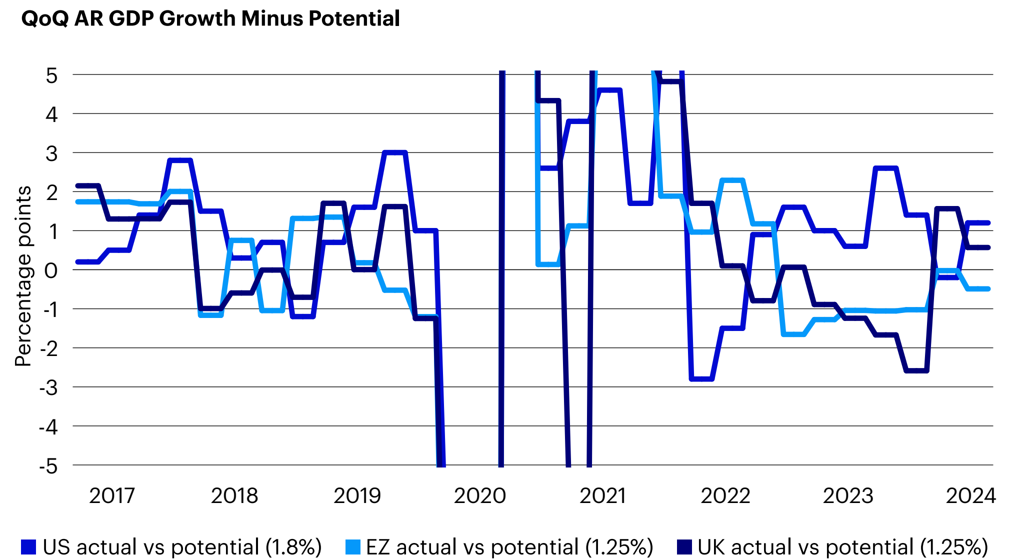
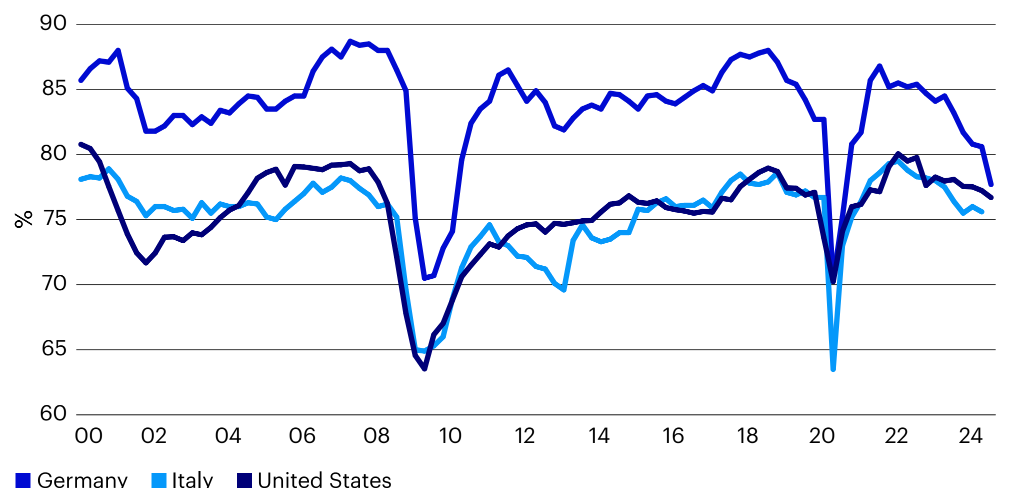
Figure 1: Gap between actual and potential GDP growth



Source: BEA, ONS, Eurostat and OECD. Data from Jan. 1, 2017 to June 1, 2024. Note: Potential growth is shown in parentheses.

Second, there's the issue of investment. Higher levels of investment for given levels of savings and interest rates could imply that the neutral interest rate is rising. But investment levels in the eurozone have not risen materially. In terms of private investment, the eurozone is not a leader in technology or artificial intelligence—sectors that are attracting a disproportionate amount of investment. Instead, investment flows are primarily to older, established industries that face intense competition from lower-cost rivals, like China. In Germany, for example, the manufacturing capacity utilization rate is at levels typically associated with recessions. According to the European Commission's business survey, many firms are maintaining rather than expanding their structures, such as buildings and factories, with fewer investing to "extend" facilities and more focusing on "replacing" or "rationalizing" them. Clearly, this is not a strong backdrop for capital investment. If private companies aren't investing, the neutral rate is unlikely to be rising.

Figure 2: Eurozone manufacturing capacity utilisation



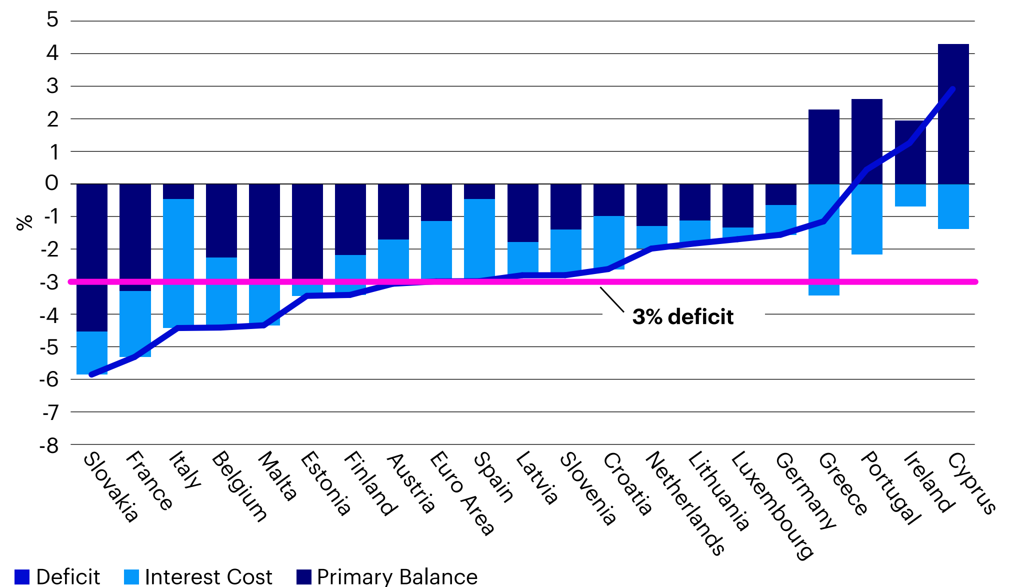
Source: US Federal Reserve, Istat, Destatis, Banque de France. Data from Jan. 1, 2000 to July 1, 2024.

Third, if the private sector isn't investing, what about the public sector? Several factors suggest that public sector investment is also subdued, and likely to remain so, contradicting the idea that the neutral rate is rising. A year ago, there was widespread discussion about increasing structural spending to enhance Europe's defence capabilities and shift its energy mix away from reliance on Russian gas. While this remains a priority, the urgency appears to be waning, and fiscal conservatism is reemerging. New fiscal rules do allow for some country-specific flexibility, but they are still centred around a conservative 3% deficit and 60% debt target.[2] Later this year, as these rules take effect, five countries—representing about 40% of the eurozone's GDP — will enter excessive deficit procedures.[3]

Depending on their adjustment programs, these nations will likely need to tighten fiscal policy over several years, albeit Next Generation EU (NGEU) grants should soften the impact over the short term.[4] Additionally, Germany, which accounts for another 29% of eurozone GDP, will also likely tighten its fiscal stance as it re-establishes its debt brake.

Politics may also hold back public sector investment. Populist parties are gaining traction across the eurozone, complicating efforts to implement vital reforms in areas like pensions and social spending, which consume an increasing share of government budgets. Without these reforms, governments' ability to invest is further diminished.

Figure 3: 2024 deficits as a percent of GDP



Source: Eurostat. Data as of Oct. 17, 2024.

Conclusion

At this stage, we hesitate to be overly pessimistic on the eurozone's growth outlook. Several supportive factors—such as lower inflation, rising real incomes, and a gradual rebound in loan growth—that drove growth in the first half of 2024 are still in place. However, to sustain any recovery, we believe that monetary restrictions should be promptly eased. Moreover, the combination of subdued growth and fiscal conservatism raises questions about the case for a higher neutral interest rate. The ECB estimates the neutral rate to be approximately 0%-0.5% in real terms, and considering the points made above, we believe we are likely closer to the lower end of that range.

2. Source: Bruegel, Policy Brief, "The implications of the European Union's new fiscal rules", June 20, 2024.
3. Source: European Union, Invesco. Data as of Oct. 21, 2024.
4. Source: Invesco. Data as of Oct. 21, 2024.

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Interest rate outlook

US: Neutral. We favor a neutral position in US Treasuries. While growth and inflation have slowed from high levels, employment and inflation data have recently shown resilience. We believe it is likely that the market will overreact to these data in the near term. We look for a favorable valuation and technical environment to add to US Treasury risk.

Europe: Overweight. We are positive on European rates, despite the recent back-up in yields. The region's economy remains challenged, especially for those countries reliant on manufacturing, a dynamic that is likely to persist for some time. At the same time, inflation is falling back toward target, although the ECB remains concerned about the lagged impact of previous periods of inflation and has been slow to lower rates. Interest rates are far too high for the region's economy, in our view, and we believe the ECB will be forced to cut rates sharply next year, as it becomes apparent that inflation is heading below target and the economy is struggling to escape a recession.

China: Neutral. We expect the Chinese onshore interest rate environment to remain accommodative in the near and medium term, and should see curve steepening, as short-term rates should outperform long-term rates. Various easing measures in the coming months may bring periodic volatility to the onshore rates market. We expect more proactive guidance from the central bank through its open market operations and window guidance for the long-term segment of the bond market. Rate cuts in the front end coupled with fiscal easing and ultra-long special government bond issuance in the long end are likely to be the main themes in the near and medium term.

Japan: Underweight. Japanese government bond (JGB) yields have pushed higher, in line with US Treasuries. However, the market is still pricing only a modest increase in rates over the next 12 months. Although Bank of Japan (BoJ) Governor Ueda has downplayed the likelihood of a policy move in December, the BoJ appears increasingly confident that underlying inflation pressures are picking up, as wage growth accelerates and growth recovers to an above-trend pace. Recent data have shown a sharp reacceleration of core inflation momentum. If price increases continue, further interest rate normalization beyond current market pricing is likely. The timing of the next rate hike is probably in January, with the BoJ keen to see the impact of annual rises in services prices in October and the outcome of Liberal Democratic Party elections.

UK: Overweight. We have turned broadly positive on UK rates at current levels, with a view that the Bank of England will likely lower rates further in 2025 than the market anticipates. Recent inflation data have surprised to the downside and some members of the Bank's Monetary Policy Committee, including the governor, have suggested that rates may need to be lowered more quickly than they anticipated earlier in the year. UK rates have underperformed both US and European rates in recent months as the market awaits the first budget of the new Labour administration, with some speculation that a commitment to an increase in public service expenditure may result in a much higher level of bond issuance. However, valuations look attractive, in our view, and once the budget is out of the way, we expect UK rates to perform well into year-end.

Australia: Neutral. Australian bond yields pushed higher over the last month, in line with global rate markets and Australian bonds have been a relative outperformer in the selloff. The Reserve Bank of Australia (RBA) is lagging other central banks in reducing policy rates, given the relative resilience of the domestic economy, and have pushed back on expectations of rate cuts this year. In the big picture, Australia has lacklustre growth and relatively benign wage movements. Ultimately the RBA will likely join in rate cuts, but, for now, we are neutral.

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Currency outlook

USD: Neutral. We are broadly neutral on the US dollar. The performance of the US economy remains impressive, despite high interest rates and a slowing labor market. That said, the US election will likely be pivotal to the future direction of the greenback. The opinion polls have begun to move in President Trump's favour and the dollar has rallied in response. A Trump victory and the associated policies of trade tariffs, tax cuts and high deficits will likely provide a floor for the dollar in the short term. Longer term, however, the picture is less clear.

EUR: Underweight. We are underweight the euro, as we believe the currency faces a number of headwinds: weak growth, political turmoil and a central bank behind the curve, to name a few. As the ECB lowers rates to below 2% next year and growth remains anaemic, investors will likely be reluctant to own euros, especially against currencies with higher carry and countries with better growth prospects.

RMB: Overweight. We remain overweight the renminbi, as we expect it to be resilient relative to peers amid market volatility. Despite market concerns of potential trade tariffs under a new US administration, we expect the RMB to deliver a relatively strong performance against peers, partly helped by stimulus, higher export receipt conversion to renminbi, as already seen in September, and potentially higher inflows to onshore capital markets. We acknowledge that some international investors remain skeptical about potential policy effectiveness and current renminbi positions are relatively light.

JPY: Overweight. We have used the sharp selloff in the yen to add exposure. While interest rate differentials may be a headwind in the short term, the yen is fundamentally undervalued on many metrics, in our view. We believe Japanese rates are likely to head higher in the next 12 months, driven by broadening domestic inflationary pressure. The yen is approaching valuation levels where we expect policy intervention to resume.

GBP: Neutral. The recent stellar performance of sterling has begun to wane as markets digest lower than expected UK inflation data and signs that the Bank of England will likely cut rates further than previously anticipated. That said, we expect the pound to hold its ground versus the euro, which faces myriad headwinds. On the other hand, we expect the pound to struggle versus currencies of economies with better growth outlooks, such as the US and Japan.

AUD: Neutral. Relative interest rate expectations were supportive of the Australian dollar, but as this differential has narrowed, the Australian dollar has come under meaningful selling pressure versus the US dollar. We see potential cross currents - Chinese easing should support sentiment toward the Australian dollar, but a strong US dollar post the US elections should cause higher beta currencies, such as the Australian dollar, to underperform.

Glenn Bowling
Head of ABS Credit

Global credit strategy

Using asset-backed securities to enhance fixed income portfolios

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

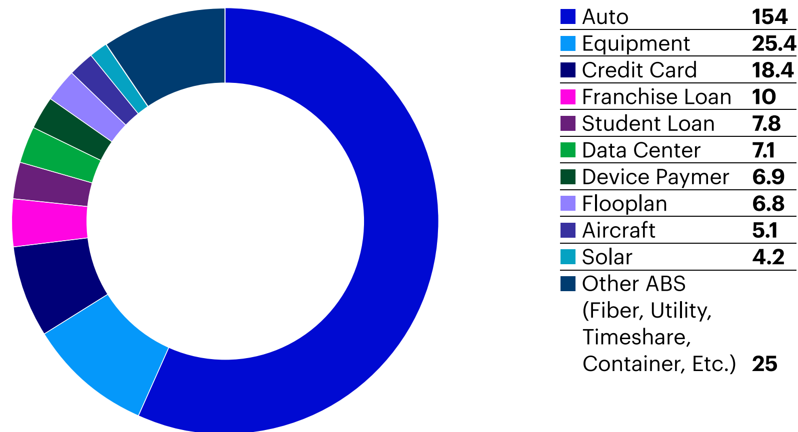
ABS opportunities

Asset-backed securities (ABS) are an attractive investment alternative to US Treasuries and agencies, and investment grade corporate securities. With a significant number of issuers and collateral types available, plus structures with various risk tolerances, investing in ABS can offer incremental income and credit diversification that can potentially contribute positively to portfolio risk and return objectives.

The ABS market is well diversified across consumer and commercial asset types. Consumer ABS include assets such as autos, credit cards, and student loans. Commercial ABS include assets such as equipment and transportation loans or leases. An emerging asset class is digital infrastructure ABS, which includes fiber-to-the-home as well as data centers. These smaller sectors continue to expand and can offer additional spread over benchmark ABS.

The significant number of asset-backed securities issued year-to-date in the primary market include more than 25 unique asset types.

Figure 1: 2024 ABS gross supply (USD 287 billion YTD)



Source: Invesco, J.P. Morgan, Data as of Oct. 22, 2024.

ABS benefits include the ability to invest in higher-quality assets, which have historically experienced favorable liquidity, lower spread volatility and ratings stability relative to other fixed income securities. ABS has also proven to be a relatively stable flight-to-quality investment during times of broader market uncertainty. Given the near-term uncertain impact of the US elections and Fed policy decisions, and potentially weaker-than-expected economic data, adding ABS can potentially be a sound investment strategy.

Some considerations and risks for ABS would be a meaningful increase in US household debt or weakening labor market conditions, prolonged pressure from inflation and higher interest rates on the consumer, as discussed below.

Fundamentals and technicals are supportive

In general, we are neutral on consumer fundamentals based on relatively strong household balance sheets and current labor market conditions, as layoffs are projected to remain low in the near term. Underlying collateral supporting most ABS asset classes is performing in line with our original expectations and continues to normalize along typical seasonal patterns as we head into year-end. Given previous tightening in credit standards and a resilient consumer, we expect collateral performance to deteriorate only moderately, and in some cases, stabilize over the near term under our current baseline soft-landing risk scenario.

Higher interest rates and inflation have negatively impacted lower-income households to a greater degree, and this segment is the most sensitive to any weakening in labor market conditions. A greater-than-expected increase in layoffs or consumer debt levels could become a headwind. However, downside risks are limited by embedded structural credit enhancement and conservative loss coverage multiples required by the rating agencies, which protect against various stressed economic conditions.

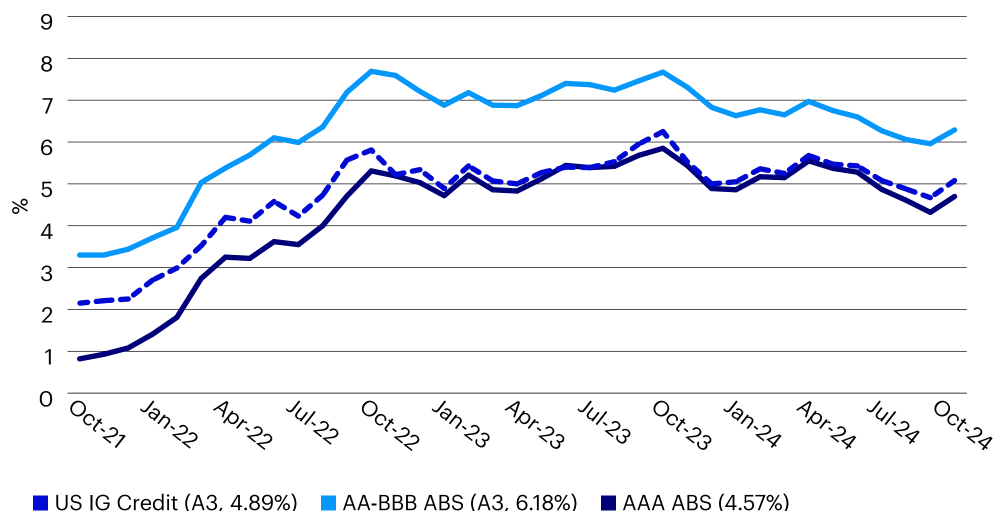
Positive technical trends also support adding ABS. While gross new supply in the primary market has set record-highs and secondary trading activity remains elevated this year, investor demand remains strong across most ABS sectors on relatively attractive valuations and normalizing fundamentals.

Spread and yield contribution

Spreads tightened for most ABS during the first half of the year to their lowest levels in nearly 24-months. Since early August, however, spreads have widened on broader market concerns, driven by weaker-than-expected labor market conditions and uncertain Fed rate policy. However, ABS has lagged the recent spread tightening in investment grade corporate credit and, we believe, has the potential to outperform over the near-term.

Yields currently range between 4.5% to 6.5% and, while down from their recent peak in the second quarter, levels are relatively attractive, in our view, and can provide additional income over similarly rated investment grade corporate securities (Figure 2). We expect this favorable yield contribution to contribute to continued strong investor demand for ABS over the near-term.

Figure 2: ABS and US corporate yield comparison



Source: Invesco, Bank of America. Bloomberg L.P. Data from Oct. 31, 2021 to Oct. 29, 2024. Note: Parentheses show average composite rating and current yield of each index.

Panelists

Daniel Phillips
Senior Emerging Market Strategist

The bottom line: Taxes, corruption and elections: A path to better EM fiscal health?

Today, we estimate that emerging market (EM) countries are missing out on some USD1.5 trillion in tax revenue, owing partly to distrust in governments viewed as corrupt. But recent youth-driven elections of anti-corruption candidates could help unlock that uncollected revenue, a potential source of funding for further development and growth. We speak with EM strategist, Daniel Phillips about how changing politics could be the first step in unleashing this needed funding.

Q: Low tax collection can constrain a country's growth and threaten its creditworthiness. What is the magnitude of the tax revenue shortfall in EMs?

Daniel: When it comes to collecting taxes, it is widely accepted that a government should aim for a minimum tax revenue-to-GDP ratio of around 15% - and higher is generally better.[1] The International Monetary Fund (IMF) found that the rate of tax collection in low income countries is around 13% today, but could potentially reach 22% of GDP if the total amount owed were collected and if tax collection capacity were improved.[2] If each country in the JP Morgan EMBI Global Diversified Index (EMBIGD) brought tax collection to that level, we estimate that governments would take in an additional USD1.5 trillion in tax revenues annually, money that could help fund needed development.[2]

Q: Why do many EM countries collect so little in taxes?

Daniel: EMs typically have limited legitimacy to ask their populations for greater tax contributions, due to perceptions of corruption among the governing elite. The relationship between a corrupt government and a citizenry's willingness to pay taxes is intuitive, and the data support the connection. In a study on tax compliance in developing countries, the IMF identified five variables most predictive of a country's tax revenue-to-GDP: public sector corruption, government effectiveness, the size of agriculture in the economy, openness to trade and overall wealth.[3] The first two are directly related to corruption.

Q: Additional studies have shown that endemic corruption is especially unpopular among the younger portions of the electorate. What effect does this have?

Daniel: Anti-corruption sentiment has made young voters in EM increasingly skeptical of their democratic systems of government. They judge their governments on their observable merits rather than in comparison to a past era they never experienced. In other words, young voters in EM today no longer compare their corrupt governments to the dictator or colonial government from 25 or 60 years ago. Instead, they compare their government with an ideal government or a government in a less corrupt country. According to a 2024 African Youth Survey, 83% of respondents said they are concerned about corruption in their country, and 62% believe the government is failing to address it.[4] A full 58% say they are "very likely" or "somewhat likely" to emigrate to another, less corrupt country in the next three years.

The opinions of this younger cohort matter greatly in the EM world, given these countries' young demographics. The younger an EMBIGD country is, the smaller is its tax base – meaning there are several countries with a low standard of living, collecting very little in taxes, with a young population that is unsatisfied with this arrangement. While leaving the country altogether or rejecting democracy outright are two options to address the issue, the most obvious and popular method for fighting corruption remains voting.

Q: What does this growing concern about corruption among EMs younger voters mean for elections going forward?

Daniel: By the end of 2024, 4.2 billion people around the world will have voted in an election, and EMs will make up a large portion of those voters.[5] Even in imperfect democracies, a surge of young citizens – typically less loyal to established political parties or focused on traditional political fault lines – will have a chance to voice their opinions. These young voters, angry with corruption, are increasingly finding an electoral outlet with candidates committed to fighting a corrupt "establishment."

Typically, these movements are labelled populist, as they are a mass movement, cutting across political structures and aimed at dethroning an elite that is suppressing common citizens. While populism can be used as pejorative, in many instances in EM, there actually is a ruling elite conspiring to exploit the population.

Not surprisingly then, populism is surging in EM. An IPSOS poll on populist attitudes around the world showed that EM voters

1. Source: IMF, "Tax Capacity and Growth: Is there a Tipping Point?", Nov. 2016. The optimal number is 13%, but 15% is the recommended goal, given revenue volatility. Fifteen percent should, therefore, be considered a floor for countries in the investable world of publicly traded EM sovereign debt (i.e., countries with bonds in the JP EMBIGD Index).
2. Source: JP Morgan as of Sept. 2024; "World Economic Outlook" IMF, April 2024. This Invesco calculation took IMF WEO revenue as percentage of nominal GDP, imputed the uncollected percentage for every country that was collecting less than 22.2%, then summed those amounts across each country.
3. Source: IMF, "Building Tax Capacity in Developing Countries", Sept. 2023.
4. Source: Ichikowitz Family Foundation, "The African Youth Survey 2024", 2024.
5. Source: World Economic Forum, "4.2 Billion People at the Ballot Box", Jan. 19, 2024.

were 17% more likely than voters in advanced economies to agree with the statement that “traditional parties and politicians don’t care about people like me” and 12% more are likely to agree that “the economy is rigged to advantage the rich and powerful”.[6]

Q: Could a tilt toward anti-corruption politicians in EM lead to better tax collection?

Daniel: Guatemala and Senegal are two recent examples that highlight the potential for a link between faith in government and tax compliance. Events in these two countries do not make a trend, and even they may not end up advancing government transparency and tax-raising capacity. But they may provide templates that show insurgent candidates taking power, driven by the youth vote, and pledging cleaner and more representative government.

In August 2023, Guatemalans voted an anti-corruption outsider and underdog, Bernardo Arévalo, into the presidency by a 20-point margin. In a report on the election’s outcome, the United States Institute of Peace said, “it’s clear that youth participation — both on the campaign trail and at the polls — was a critical component [of victory]”.[7] Arevalo ran on a campaign focused on faster and more inclusive economic development and fighting corruption. On the economic front, the IMF has made clear that, “Guatemala needs more tax collection to continue advancing on its path to development … tax revenues are still among the lowest in the world, making it difficult to address the country’s pressing needs (e.g., infrastructure, education, health, and malnutrition) without increasing the sovereign debt substantially.” It recommends a reform agenda underpinned by a national anti-corruption plan.

A similar story is unfolding across the Atlantic in Senegal. The young duo of Bassirou Diomaye Diakhar Faye and Ousmane Sonko who ran for President and Prime Minister earlier this year and won, are former tax collectors who ran on promises to combat corruption – both in the form of outright graft and bloated and politicized public spending. While the actual data on youth support is scarce, the journalists on the ground around election time confirmed the youthful nature of these candidates’ crowds and volunteers.[8] The IMF recommends raising additional revenue by broadening the tax base and increasing the tax collection ratio to 20% of GDP.

Greater government transparency and respect is necessary but not sufficient for EM governments to raise more taxes for badly needed productive investment. Indeed, people do not like paying taxes. But it is clear that greater compliance is conditioned on a government’s perceived legitimacy. While Guatemala and Senegal are not far enough along in their efforts to constitute durable success stories, they represent a potential blueprint for an ideal outcome, based on a common set of features often found in EM countries: a low tax base, a young population and a newly elected and popular government promising to fight corruption.

6. Source: IPSOS, “Populism in 2024”, Feb. 2024.
7. U.S. Institute of Peace, “Youth Mobilization Sparks Hope for Guatemala’s Democratic Future”, Aug. 28, 2023.
8. Source: Christian Science Monitor, “Uncertain but undeterred: Young Senegalese prepare to vote”, March 1, 2024.

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