Invesco

Global Fixed Income Strategy

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Invesco Fixed Income

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IN THIS ISSUE:

1. **Macro: China at a crossroads: On the verge of a downward spiral or a more forceful policy response?**
   Page 01
2. **Interest rate outlook**
   Page 04
3. **Currency outlook**
   Page 05
4. **Credit: Where we see relative value opportunity in credit**
   Page 06
5. **The bottom line: Where are we in the US high yield default cycle? And what could the next cycle look like?**
   Page 09

China at a crossroads: On the verge of a downward spiral or a more forceful policy response?

After abruptly ending its zero-COVID policy, China bounced back strongly in the first quarter. Economic forecasters promptly upgraded their growth forecasts beyond the government's moderate 5% target. Now, that positive sentiment has been replaced with doom and gloom. One weak data point after another has highlighted slowing domestic demand, a weakening currency, deflation and portfolio outflows. Reports of companies falling behind on debt payments have also weighed on sentiment. Add to this the weak policy response so far to stabilize the economy, and investors are questioning whether the government's growth target is in danger, and what would a sharp slowdown in China mean for the global economy and markets?

We think the answer lies somewhere between optimism and doom and gloom. We believe China is at a crossroads – and the economy's direction will likely depend on policies. We think 5% growth is still within reach and doom and gloom can be avoided. In our view, a revival in sequential growth is possible by the fourth quarter, but it would likely require a more rapid and forceful policy response than the trickle of announcements so far. Absent that response, we may enter an alternative universe not seen in China's recent history, with a downshift in economic activity potentially to the mid-3% to 4% range, further adjustments in asset prices and more concerns about balance sheets.

Recent developments have dampened growth

The fact that growth fizzled after the first quarter reflects the multi-faceted challenges China faces, many of which have their roots in the property sector. Official efforts begun in 2020 to reduce excesses in the property sector precipitated a vicious cycle, as leveraged property developers experienced financing problems and many committed, and mostly prepaid, housing projects stalled. Household confidence in housing investment sank, exacerbated by the COVID reopening when employment and income outlooks were uncertain. Widespread house price declines ensued, especially in lower-tier cities, where excess supply had been a concern well before COVID.

In addition, the authorities' crackdown on large platform industries, starting with Alibaba in 2020 and moving to the education sector, undermined confidence and dampened private capital investment and the employment outlook. This came on top of the emergence of COVID-related scars in the service sector, the largest source of employment. Despite efforts to push credit to the real economy, private investment has not bounced back sufficiently. Weaker global demand for goods hasn't helped investment in trade-dependent manufacturing and destocking is still the theme of the day, rather than rebuilding inventory or capacity.

The authorities' time-tested approach of using infrastructure and local government investment as a countercyclical fiscal policy tool to increase fixed capital

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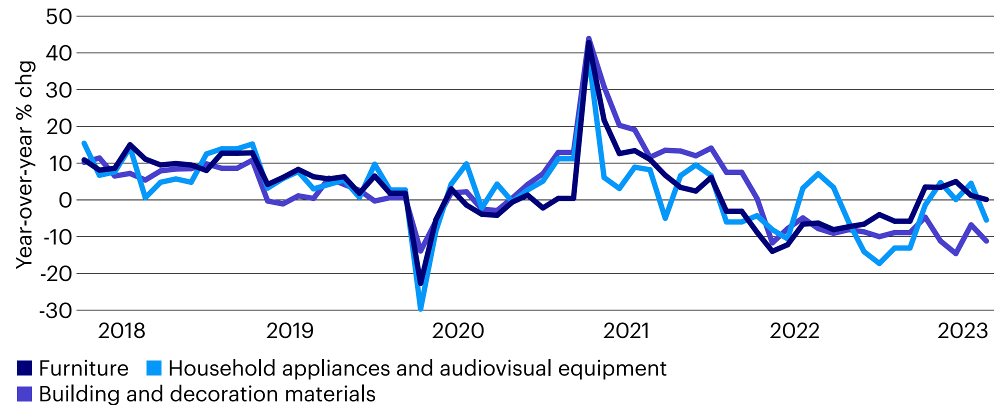
investment is also reaching its limits. Land sales represent an estimated 30% of local government revenues.[1] A stalled housing sector means stretched local government budgets, especially after the expensive enforcement of the zero-COVID policy and related health expenditures. If anything, total fiscal outlays shrank in the first half of this year, detracting from growth momentum.

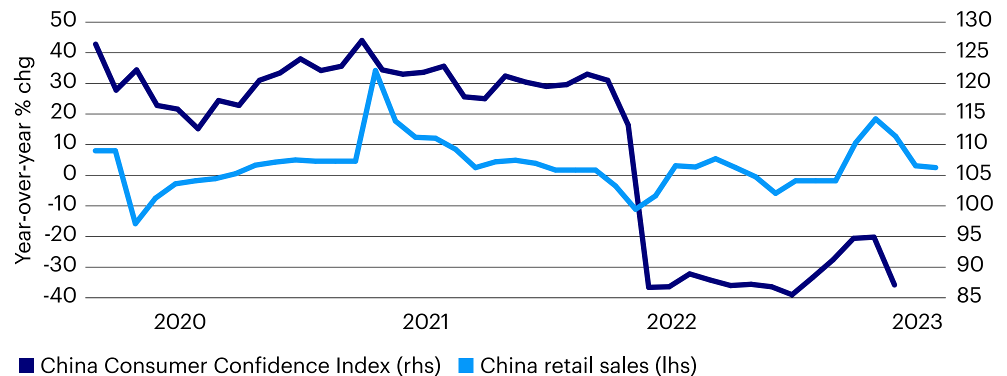
Amid a deteriorating employment and income outlook, households have pulled back from the housing market and housing-related consumption, such as appliances and furnishings, which are estimated to be about 8-10% of total consumption.[2] Other big-ticket purchases, such as automobiles and communication equipment, are also slowing. As a result, retail consumption growth remains below 2019 levels.

Figure 1: Real estate-related consumption has slumped



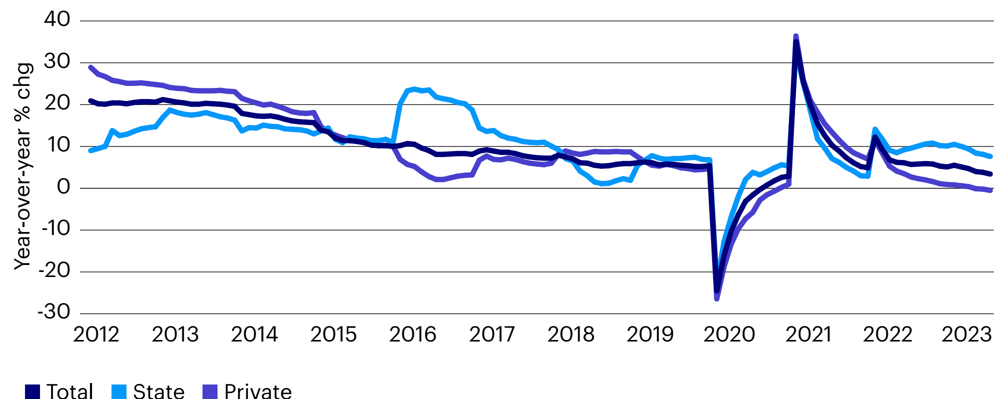
Source: Macrobond. Data from March 1, 2018 to July 1, 2023.

Figure 2: Retail sales are sluggish amid a sharp drop in consumer confidence



Source: Macrobond. Data from Jan. 1, 2020 to July 1, 2023.

Figure 3: Fixed investment is slowing



Source: Macrobond. Data from March 1, 2012 to July 1, 2023.

1. Source: Tianlei Huang (PIIE) Working Papers 23-5 June 2023, Why China's housing policies have failed.
2. Source: Macrobond. Data as of Dec. 31, 2019.

Recently each new data point on real economic activity has surprised to the downside, spurring a policy response from the authorities in July on the heels of the politburo meeting. These measures were focused on household consumption along with housing and private business sentiment but policymakers refrained from deploying the type of largescale stimulus that was deployed after the global financial crisis.[3] In our view, this reflects a recognition of the structural issues facing China's economy, which can no longer be addressed by creating excessive leverage in the system.

So far, the policy measures appear to be too modest and too late to stabilize market sentiment, especially in the housing sector, as they lack national coverage or are yet to be rolled out in a significant way. More recently, the government response has shifted from more targeted sector-specific policies to national monetary policy, with cuts to various policy tools, including the loan prime rate, but these measures also underwhelmed the market.

Why are we optimistic about a modest sequential growth rebound in Q4?

First, we think there is more policy response to come. In the latest State Council Meeting in August, the authorities implicitly acknowledged that the 5% growth target could be at risk if they do not "optimize their policies". We expect the next move to be a cut in the reserve requirement that allows banks to lower mortgage rates on outstanding mortgages to alleviate the household debt burden. In addition, we expect more widespread easing of home purchase restrictions, including in first tier cities. However, these measures will likely not lead to a housing boom or reversal of fortunes for property developers. The housing sector has been designated as overleveraged and we are about halfway through the authorities' traditional four to five-year window for restructuring a sector. Although the housing market's final form remains uncertain, we expect a more consolidated property sector in the next two to three years and a more sustainable outlook.

Second, local governments have been asked to fulfill their remaining bond financing quotas before September and to deploy bond proceeds to local infrastructure spending in the fourth quarter. Even if the level of spending is not as high as it was before, it should put a floor under public investment growth and "crowd-in" other related private sector investment.

Third, as we have seen in the rest of the world, the Chinese economy's post-COVID re-opening and recovery is likely to be a longer process than a one or two quarter-long rebound. We expect sustained tailwinds to emerge over the next three to six quarters from the service sector and general pent-up demand. Already, the service sector, which accounts for more than 63% of the economy, has recovered sharply following the lifting of the zero-COVID policy.[4] Although households remain cautious in their spending, including in the "revenge sectors" of tourism and travel, we believe there is more room for organic recovery in services consumption in the second half of the year.

Finally, as happened with the abrupt removal of the zero-COVID policy, when economic hardship hits a severe pain threshold, we have seen the authorities change their response very quickly. We think we are fast approaching that threshold.

3. The measures focused on household consumption promoted big-ticket, service, rural, digital and green spending. In the housing sector, several local authorities relaxed house purchase restrictions, including lowering loan-to-value ratios and new mortgage rates. Measures to promote private business sentiment focused on five major areas: fair treatment in market access and government procurement, cost reductions for business operations, transparent legal protections, improved regulatory and financial services for private businesses and the restriction of online criticism of private entrepreneurs. The new guidelines also encourage private participation in certain high-tech areas and grant eligible companies the ability to compensate employees according to their expertise level, a privilege previously reserved for state-owned enterprises.
4. Source: Government announcements, July-August 2023.

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Interest rate outlook

US: Overweight. We have broken through the 4.0% top of our previous expected range for the US 10-year Treasury note. Concerns about the persistent strength of US growth have driven increases in real yields, and have pushed expectations for Federal Reserve (Fed) easing further out in time. While some growth data have shown surprising strength, we expect growth to remain slow. We expect increasing headwinds through the balance of the year, as interest rates stay high, even while nominal growth slows. We have revised our expected range for near-term Treasury yields higher but still believe we are close to the top of the range and favor a modest overweight.

Europe: Overweight. We are positive on European interest rates against a backdrop of deteriorating economic activity in the region. The European Central Bank's (ECB) aggressive rate hiking cycle is beginning to weigh on the service sector, which has slowed significantly in recent months. That said, the ECB is determined to maintain its hawkish stance, despite the deteriorating outlook and, as such, rates are likely to remain volatile. We see any rise in yields as an opportunity to add duration on a medium-term view. Central banks have been embarrassed by the rise in inflation and are likely to maintain overly tight monetary policies for too long to compensate. Inflation is likely to fall sharply over the coming months, leaving interest rates too high for the prevailing level of economic activity, opening the door to aggressive rate cuts in early 2024.

China: Overweight. We continue to see lower yields on Chinese government bonds, especially at the front end. Hence, we continue to see the potential for the yield curve to steepen. Recent 1H23 earnings results of Chinese banks showed net interest margin pressure faced by the banking sector and hence the impact on capital ratios. To further lower funding costs for the economy and enable banks to extend loans on a sustainable basis, one of the least resistant paths is to sharply lower front-end rates and hence reduce banks' funding costs in both the deposit and wholesale markets. We recognize that positioning may have become relatively crowded and the market may react to fiscal measures, if any, to be announced by policymakers. Still, we think the Chinese central bank's monetary actions are the most important factor to consider for onshore bond market positioning and performance.

Japan: Underweight. Japanese government bond (JGB) yields moved higher after the Bank of Japan raised the upper limit on the 10-year bond's yield range from 50 basis points to 1%. Domestic growth and inflation data remain relatively strong, adding impetus to the rise in yields. However, the international environment is becoming more mixed, with growth disappointments in China and the eurozone creating a potential headwind for a further substantial move up in JGB yields.

UK: Overweight. Persistently high wage and services inflation make it likely that the Bank of England (BOE) will hike by another 25 basis points at its September meeting to 5.50%. However, the recent jump in unemployment has made further tightening more questionable, limiting the upside for short-term gilt yields. Longer maturities might still face upward pressure as the BOE will likely announce an acceleration in the pace of quantitative tightening in September and economic weakness will likely place further stress on public finances.

Australia: Overweight. Disappointing domestic and Chinese growth data, and signs that inflation pressures are moderating, have increased the probability that the Reserve Bank of Australia (RBA) has completed its hiking cycle. The current valuation of Australian government 10-year bonds looks relatively fair in this light. However, the recent outperformance versus US Treasuries probably has little room to run further, as it is hard to see the RBA cutting ahead of the Fed. Long maturity Australian government bonds will likely face less supply pressure than US Treasuries, potentially allowing for some relative curve flattening versus the US yield curve.

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Currency outlook

USD: Neutral. Despite a neutral position overall, we are positive on the US dollar against most developed market currencies in the short term. The US "economic exceptionalism" phenomenon is likely to support the US dollar, while other developed market economies deteriorate under the weight of recent rate hikes, a fate that, so far, seems to have eluded the US economy. In the longer-term, however, our analysis indicates that the US economy will likely slow toward the end of the year, placing downward pressure on the US dollar. Until that occurs, we maintain our positive outlook.

EUR: Negative. With the European economy slowing and the US surprising to the upside, we are somewhat negative on the euro, given the growth differentials. The hawkish bias of the ECB, which has supported the euro in recent months, may wane if the European economy deteriorates further and the ECB moves to a more neutral stance.

RMB: Neutral. We think the main driver of the USD/RMB exchange rate's performance continues to be the US dollar's strength against major currencies. Although China's growth trajectory and rate differential have weighed on the renminbi's performance, recent rhetoric from policymakers and a series of fixing deviations showed a tendency to contain USD/RMB moves when seen as excessive. We think the purpose of policymakers' recent actions is to contain the acceleration of speculative positioning, rather than reversing a trend. The valuation of the renminbi against the basket of currencies has started to return to a more neutral range, from a historical context, and has already corrected a substantial amount of the overvaluation accumulated in 2022, from the basket perspective.

JPY: Neutral. The BoJ's policy change has not been enough to stop the yen's depreciation against the US dollar and the euro. This underlines the powerful role monetary policy in the US and Europe will likely play in determining the direction of yen crosses. As long as the Fed and ECB appear far away from easing, thereby reducing the yen's yield disadvantage, it appears hard to see a meaningful appreciation of the yen.

GBP: Underweight. Signs that the UK economy is starting to slow, as monetary policy tightens, is limiting the scope for higher interest rates to support British pound valuations. High inflation and slowing growth will likely start to weigh on the pound going forward. Positioning also appears more balanced than it has for a long time, posing less risk for short pound positions.

AUD: Neutral. Weak Chinese data and a negative yield differential versus the US continue to weigh on the Australian dollar. Valuations are becoming more attractive but it is hard to see a catalyst for Australian dollar outperformance unless sentiment around Chinese growth and commodities picks up, which appears unlikely in the near term. Although the Australian dollar might struggle against the US dollar, it could outperform European currencies, which have similar yields but arguably worse growth prospects.

Author

Bixby Stewart
Senior Analyst

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

Where we see relative value opportunity in credit

Invesco Fixed Income's globally integrated and collaborative investment process includes monthly in-depth relative valuation discussions among credit analysts and portfolio managers across our global platform. We implement a proprietary valuation and credit ranking process to identify investment ideas across Invesco's global credit teams to find the best risk-adjusted investment opportunities for our clients. In August, we reaffirmed several of the teams' positive views on global credit - although credit spreads have largely tightened in recent months, global credit yields remain historically high and attractive, in our view.

Relative value analysis implies modest richness in some higher beta asset classes...

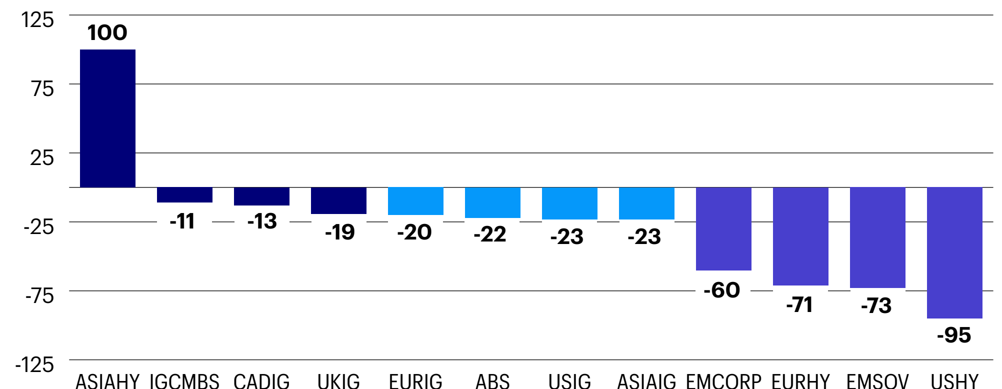
Invesco Fixed Income uses a regression-driven relative value framework to assess sectors' relative attractiveness compared to US investment grade. US investment grade is one of the largest and most liquid credit classes in the world, and we think it serves as an appropriate market to anchor our relative value analysis. This valuation analysis is the starting point for more in-depth asset class level views that each credit team drills into as part of our investment discussions.

In our August discussions, we came away with several interesting conclusions. While regression-implied valuation dispersion and dislocation across global investment grade remained relatively low, emerging market credit, Asia investment grade and US high yield screened rich in the context of US investment grade's current valuation.

Why might this be? An analysis of relative performance partially explains the apparent richness of emerging markets and US high yield. Looking back three months, US investment grade credit spreads tightened by 23 basis points, compared to 60 basis points of tightening for emerging market corporate credit, 73 basis points for emerging market sovereign credit and an impressive 95 basis points for US high yield. Given the strength of these credit classes over the past three months, it is not surprising that they would screen rich against US investment grade.

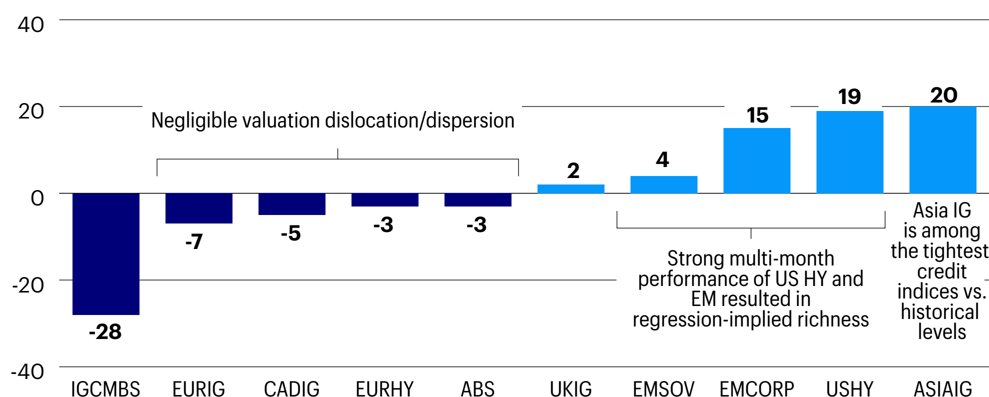
When evaluating standalone historical percentile rankings for each credit class we analyze, Asia investment grade is now trading at the tightest level of all evaluated credit classes, on a one-year and five-year basis (the Asia investment grade credit index is now trading in the second percentile over one year, and at its tightest level (zero percentile) over five years). Asia investment grade is also currently trading at the tightest spread differential versus US investment grade of any other evaluated credit class in the last five years (third percentile over five years). While regression analysis underlines the relative tightness of Asia investment grade spreads versus US investment grade, and these historical percentile rankings support this regression-implied relative richness, we also believe one driver of this optical spread tightness is more nuanced and likely a partial function of some survivorship bias within this particular credit index.

Figure 1: Three-month index spread change (basis points)



Source: Invesco, Bloomberg L.P. Data as of August 15, 2023.

Figure 2: Regression-implied fair value vs. current value (basis points)



Source: Invesco, Bloomberg L.P. Data as of August 15, 2023.

Note: Regression outputs reflect R-squared weighted index fair value indications, derived using regressions for each respective index against the USIG credit index over 3-month, 1-year, 2-year, 3-year and 5-year timeframes. Implied index fair values are weighted by regression correlations across each timeframe to arrive at the "regression-implied fair value vs. current value" shown in Figure 2.

...but global credit views remain positive overall

Given this valuation backdrop in August, it was not surprising that many asset classes across the globe retained their neutral to fairly constructive allocation ratings. Ratings on several asset classes remained unchanged at positive or neutral, compared to the previous month. This positive stance reflected the credit team's broadly constructive view of market fundamentals, historically high yields and generally favorable technicals, as the risks of global recession and accelerating inflation show signs of moderating. Though fundamentals generally remained firm (albeit modestly weaker off of a historically high baseline) and the technical backdrop for global credit was generally positive, these factors were offset somewhat by richening credit spread valuations, as spreads tightened. Invesco's Emerging Market Sovereign team downgraded its overall allocation rating and valuation rating to negative, which made sense given the degree of strength in this particular asset class over the previous month. The Commercial Mortgage-backed Securities (CMBS) Team downgraded its asset class rating to negative overall, a function of weakening technicals and a less attractive valuation backdrop (both technicals and valuations were downgraded to neutral in August). The negative fundamental rating on CMBS remained unchanged compared to the previous month.

Credit valuation analysis extends to the sector level across geographies and credit ratings

Invesco Fixed Income's relative value discussions don't stop at the asset class level, but continue to the sector level. Each month, global sector teams present thematic, fundamental and valuation analysis on sectors across geographies and credit risk levels. Participation across the platform encourages in-depth discussion and debate to identify the most attractive investment themes and ideas across global industry sectors.

In August, the Global Industrials Sector Team discussed thematic investment narratives around utilities, aviation supply chains and global chemicals trends. This sector team comprises analysts in the US, Europe and Asia, covering investment grade, high yield and emerging market credits. The team highlighted its cautious stance on chemicals credit due to significant year-over-year earnings pressure, although, despite weakening credit fundamentals, this dynamic has not yet resulted in a balance sheet-oriented capital allocation pivot. In other words, despite a weakening credit backdrop (lower earnings and higher leverage), capital allocation policies among chemical companies have generally remained equity-oriented. In other words, excess cash is predominantly being used for buybacks and dividends, rather than for debt reduction, a negative consideration, given that leverage is creeping higher as earnings move lower.

The team was more constructive on air lessors and long-dated utility bonds. Fewer supply disruptions at aircraft manufacturers and the normalization of air traffic are expected to support corporate fundamentals for lessors. In utilities, relative underperformance in long-dated utility bonds has positioned the sector as attractive from a valuation standpoint, in our view. We believe this is especially true given utilities' solid fundamentals, with many utilities operating with credit metrics below rating agency downgrade thresholds, which is a positive consideration for utility credit investors.

Global collaboration and knowledge-sharing drive value creation for our clients

The relative value discussions highlighted above are a key component of Invesco Fixed Income's globally integrated investment process. Through regular in-depth and collaborative valuation discussions, portfolio managers across the globe gain insight into credit market drivers, helping managers allocate capital to the best risk-adjusted opportunities. We believe Invesco Fixed Income's global knowledge base and our consistent asset class valuation and ranking framework combine to create a key platform differentiator, as we seek to deliver results for our clients.

Panelists

Niklas Nordenfelt
Head of High Yield

Philip Susser
Senior Portfolio Manager

The bottom line: Where are we in the US high yield default cycle? And what could the next cycle look like?

The Invesco High Yield Team believes US high yield is well positioned for the next default cycle and expects losses to be less severe than during prior cycles. We speak with Niklas Nordenfelt, Head of High Yield, and Senior Portfolio Manager, Philip Susser, about how US high yield has fared in the last three major recessions and how this time might be different.

Q: With the US unemployment rate at 3.6% and GDP growing, why are you concerned about a recession and rise in corporate defaults?

Philip: As high yield managers, we are always cognizant of downside protection, whether our concerns surround a company's individual competitive dynamics, or a broader pull-back in consumer and business spending that could impact the companies we invest in. Even though the odds of a recession have receded in recent months and a soft landing is increasingly possible, our bias is toward managing downside scenarios.

Four key indicators have recently caused us to be more vigilant since they all have good track records of predicting recessions in the short-to-medium term: the inverted US Treasury yield curve, tougher lending standards according to the US Federal Reserve's Senior Loan Officer Opinion Survey, a weak and falling Leading Economic Index and falling money supply.

Q. Has the default cycle started, or is it still in the distant future?

Niklas: We believe the default cycle has already begun, and default rates have been inching higher for the past few months. Higher financing costs are starting to weigh on companies with overleveraged balance sheets and more challenged business outlooks. However, the pace of rising defaults has been slow, and is consistent with our view that the cycle may be more prolonged but less painful than in the past, with a lower peak and lower level of cumulative defaults among high yield bond issuers.

Q: How did high yield fare in previous default cycles?

Philip: In each of the last three modern credit cycles (1989-1991, 2000-2002 and 2007-2009), the cumulative three-year default rate reached about 15% of aggregate US corporate debt across investment grade, high yield, and bank loans (this excludes the brief COVID recession of 2020).[1] Historically, high yield bore the brunt of these losses. Cumulative three-year high yield default rates peaked at 40% in the early 1990s, 55% in the early 2000s, and 30% during the global financial crisis (GFC).[2]

In the 14 years after the GFC, the cumulative three-year US corporate credit default rate did not exceed 5%.[3] Ultra-easy monetary policies around the world have undoubtedly played a key role in moderating recessions since the GFC. However, with the post-pandemic bout of inflation, monetary authorities need to be more constrained and balanced than they have been in recent downturns. Monetary easing to preempt a potential surge in defaults must now be weighed against the impact of easing on inflation.

Q: Do you think the next default cycle will look similar to previous ones, or different?

Niklas: We think high yield is currently better positioned for the next downturn because of its recent default history and, importantly, its current makeup. High yield's history of cyclical challenges and, recently, its higher exposure to energy bonds that led to a disproportionate number of defaults in 2015-2016, made high yield a less favored asset class. As a result, investors have demanded higher yields in the past five-to-ten years to underwrite the same risks when compared to other leveraged asset classes, such as private credit and bank loans. Issuers choose where they borrow, and in recent years they have chosen the bank loan or private credit markets over high yield for their easier and cheaper terms.

This can be seen in the relative growth of these asset classes in the last several years. According to JP Morgan, the total US leveraged finance market (high yield, syndicated loans and private debt) has grown to USD3.4 trillion.[4] Since 2001, the high yield bond market has approximately doubled in size from USD657 billion to USD1.4 trillion.[5] But the syndicated loan market has grown from less than USD200 million to nearly USD1.5 trillion, and private debt has grown from a negligible amount to over USD600 billion today, with a significant amount of the growth occurring during the period of depressed bond yields due to extremely accommodative central banks.[6]

A positive by-product of high yield's slower growth is a better cohort of issuers

1. Source: Bank of America Global Research. May 12, 2023.
2. Source: Bank of America Global Research. May 12, 2023.
3. Source: Bank of America Global Research. May 12, 2023. Refers to 14 years through July 31, 2023.
4. Source: JP Morgan. Data as of May 24, 2023. This does not include committed but uninvested capital, referred to as "dry powder".
5. Source: JP Morgan. Data as of May 24, 2023. This does not include committed but uninvested capital, referred to as "dry powder".
6. Source: JP Morgan. Data as of May 24, 2023. This does not include committed but uninvested capital, referred to as "dry powder".

going into a possible downturn, compared to the past. This gives us comfort that the high yield default rate will be potentially lower and recovery rates will be potentially higher than in previous cycles.

To illustrate, several market-wide metrics reflect high yield's overall improvement:

- **High yield leverage** is near the lowest levels seen since 2013 and interest coverage levels are higher, though they have fallen with the rise in interest rates (Figures 1 and 2).

High yield credit metrics - Strong balance sheets, modest deterioration, significant cushion

Figure 1: High yield net leverage ratio

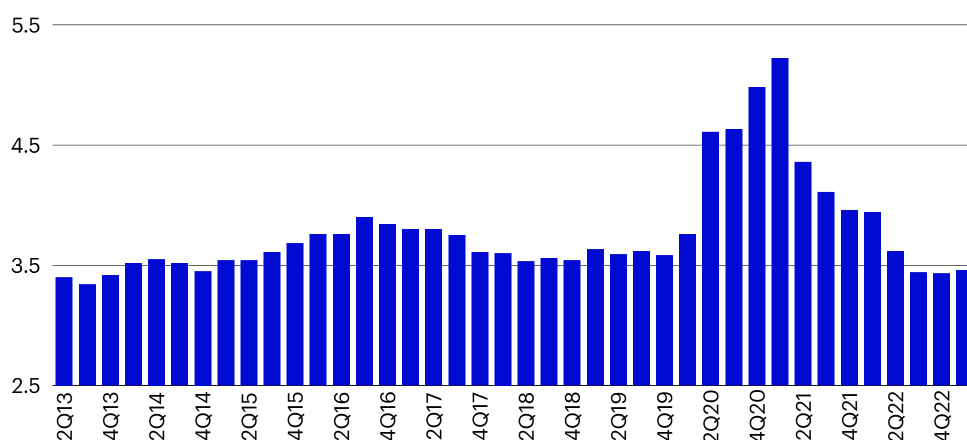
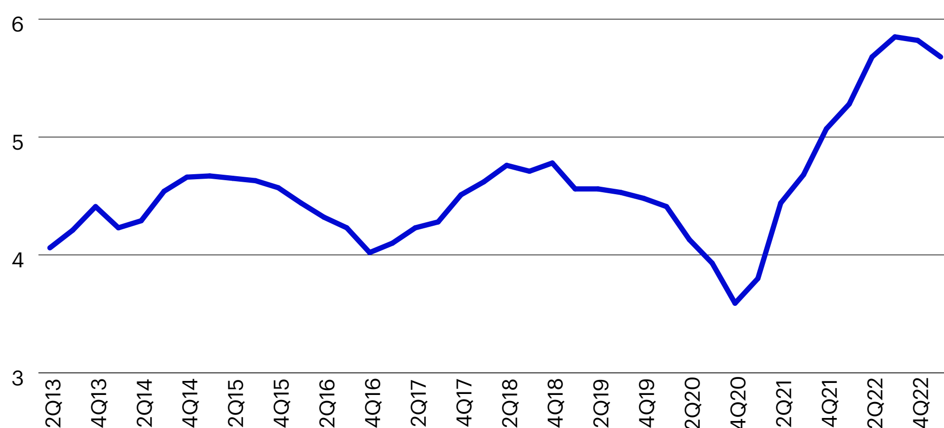


Figure 2: High yield interest coverage ratio



Source: JP Morgan, Capital IQ. Data as of March 31, 2023.

- The percentage of the high yield market rated BB is near a record high, and the percentage rated CCC is significantly below historical levels (Figure 3).
- The percentage of the market that consists of secured bonds is at a record high, representing 29% of the US high yield market by par, as of March 31, 2023 (Figure 4).
- The high yield market currently does not suffer from sector concentration, unlike in past downturns when peak default rates were skewed by high default rates within the largest sectors of the high yield market (Figure 5).
- High yield issuers have grown in size, leading to potentially improved credit prospects. The average EBITDA of high yield issuers grew

from around USD500 million in 2011 to over USD1 billion today, as private credit and loan markets lured smaller issuers away with better terms.[7] We believe larger companies have several advantages, such as more diversified businesses, often with multiple business lines that can allow one business to offset weakness in another division, and more opportunities to cut costs to weather downturns. As a result, all things being equal, we believe larger companies tend to be better credits than smaller credits, and the current high yield market is skewed toward larger credits.

High yield composition - Composition changes have improved the credit quality of the asset class

Figure 3: High yield ratings composition

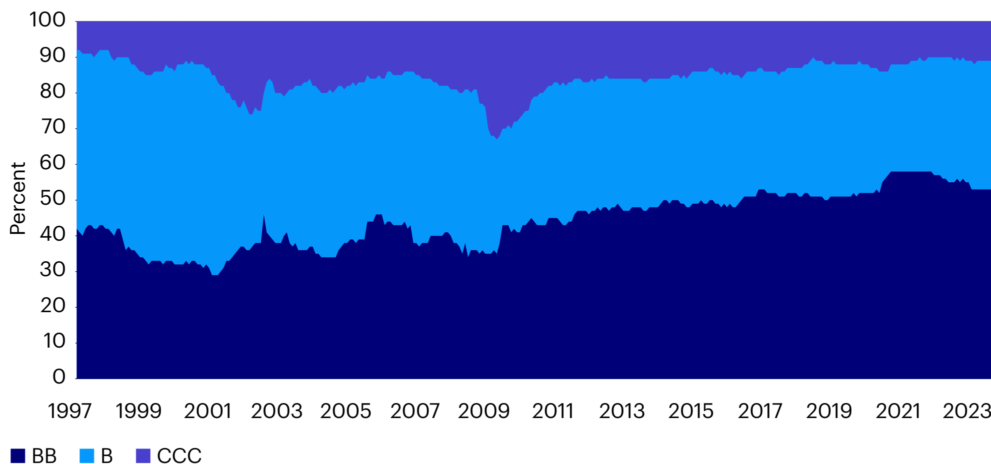


Figure 4: High yield seniority composition

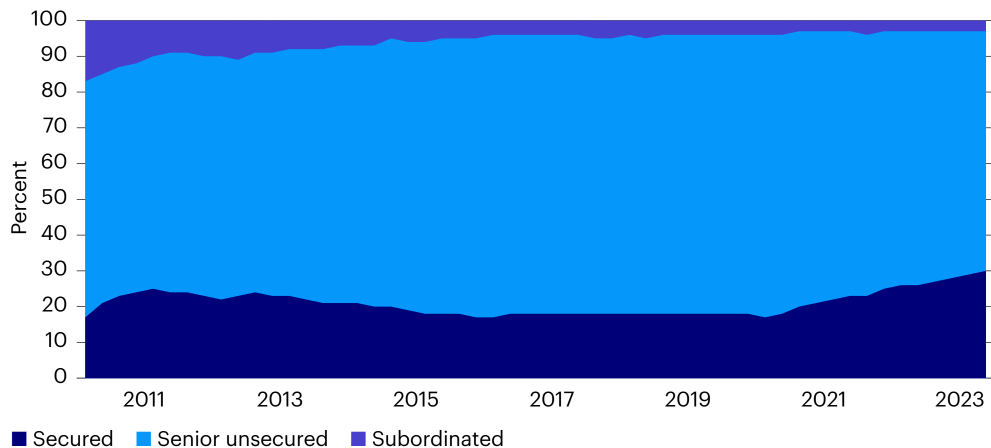
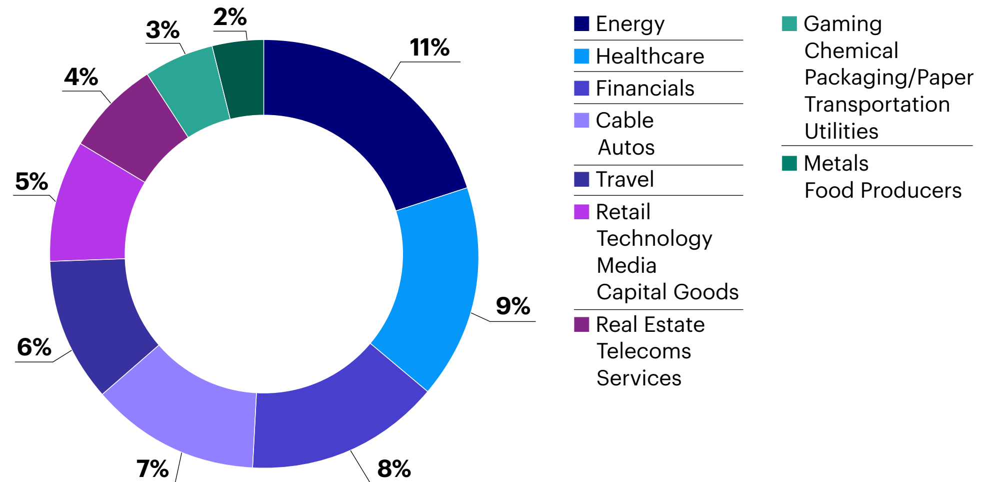


Figure 5: High yield sector composition



Source: BofA Global Research, ICE Data Indices LLC. Data as of June 30, 2023.

In summary, we think the high yield market is currently well positioned to post a lower cumulative default rate, a lower peak rate and a modestly higher recovery rate than in previous default cycles.

Q. How does Invesco's High Yield Team handle company defaults?

Philip: Our process is designed to select companies with lower probabilities of default by focusing on asset coverage, competitive positions and business momentum. We focus much of our attention on downside protection. Our long-term approach targets companies with assets and businesses that we believe are worth more than the market values of their debt. Given this approach, we often prefer to allow our original theses to play out, believing that, over time, a company's performance will prove to the market that our original valuation was correct. As a result, we tend to prefer to hold our positions through bankruptcy. There are, of course, times when events lead us to change our thesis, in which case, we would sell down our position.

When a position becomes distressed, we follow a team-based approach to working it out, led by the high yield analyst with coverage of the company. The team includes portfolio managers, back-office employees and Invesco's deep legal team. Our high yield team would join creditor committees where appropriate. In the end, our process, like all of our processes, is designed to maximize value for our clients, whether that means selling our bonds upon bankruptcy or working with other creditors to maximize bondholder recoveries.

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