Invesco

Invesco Fixed Income
Multi-sector asset allocation outlook

Q4 2020

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Senior Editor

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IFI multi-sector asset allocation overview

- **Macro factor summary:** We have upgraded our growth expectations for the US and Europe and expect growth momentum to persist in 2021. We expect spare capacity to keep global inflation contained in the near term. Global financial conditions remain easy but appear to be factored in by markets.
- **Asset allocation summary:** Our macro factor framework suggests neutral positions in global duration and credit and an underweight position in the US dollar.
- **Risk position summary:** Underlying growth momentum is relatively supportive for risk taking, but valuations are tight, in our view. We prefer to stay neutral in risky assets, and use selloffs as an opportunity to buy risky markets that we believe will be supported by the fundamentals in the medium term.

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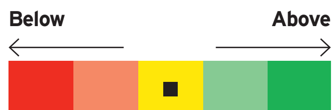
Factors vs. market expectations

IFI macro factor outlook (3-month outlook)

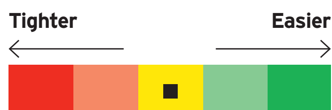
Global growth: Above expectations

The global growth bounce has been stronger than expected, and we have revised up the path for 2020 growth in the US and Europe. The US has outpaced Europe somewhat in the recovery. We expect growth momentum to persist into 2021, though there are some headwinds to growth from the US election and the lack of a phase four fiscal package in the US. Despite the continued spread of COVID-19 infections globally, individuals and businesses have learned to live with the risk of the virus, and policy makers have largely chosen to allow economies to reopen. We expect China to be the only large global economy to generate positive growth over the year 2020 as a whole. We believe a stronger than expected bounce in growth and continued growth momentum going forward are supportive of financial markets overall.



Global inflation: At expectations

Inflation has begun to recover from the downward adjustment related to the COVID-19 shock. We expect inflation to stabilize in the near term close to the prevailing trend before the COVID-19 shock. Large amounts of spare capacity in the economy and the labor market are likely to keep inflation contained in the near future. Further out, there is the possibility of upside pressure on inflation due to the aggressive monetary and fiscal policy implemented by the large developed market economies.



Global policy and financial conditions: At expectations

Financial conditions continue to be easy, but the impact of the current easy monetary policy appears to be factored in by markets. After announcing its new framework for monetary policy, the US Federal Reserve (Fed) seems to be taking a bit of a breather in terms of new policies, and has not committed to additional easing. Instead, the Fed has emphasized the need for more fiscal support, which appears unlikely as we write. The European Central Bank (ECB) announced an extension of the Pandemic Emergency Purchase Program (PEPP), which is very supportive of European markets and economies. The decline in the US dollar helps keep global financial conditions easy, but capital flows have been slow to return to emerging markets.

IFI 2020 macro outlook

	Growth (%)		Inflation (%)		Policy	
	IFI forecast	Consensus	IFI forecast	Consensus	Next move	Consensus
US	-3.9	-4.0	1.2	1.2	We expect policy rates of all three major central banks to remain at the effective lower bound until at least end-2023.	Consensus is broadly in line with our forecast
Europe	-7.4	-8.0	0.4	0.3		
China	1.8	1.8	1.0	2.8		
Japan	-5.5	-5.7	0.0	0.0		

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

IFI broad asset allocation (3-month outlook)

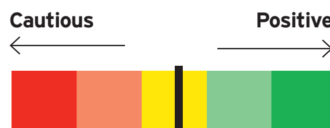
		Macro factor vs. market expectations			
		Growth: Above expectations	**Inflation: At expectations**	**Policy: At expectations**	**Asset allocation**
Market impact	**Global duration**	Neutral	Neutral	Neutral	Neutral
	US dollar	Neutral	Neutral	Negative	Underweight
	Global credit	Neutral	Neutral	Positive	Neutral

Global duration: Neutral
With a wide output gap across developed markets and a strong commitment from major central banks to keep interest rates low for a long period of time, nominal rates are unlikely to move significantly from here over the near-term horizon. Over the medium-term, we look for a continued decline in real rates in the US and inflation expectations to move toward 2%, with nominal bond yields remaining largely unchanged. Yield curves are also likely to steepen in the medium term as well.

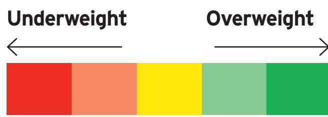
US dollar: Underweight
We continue to expect the dollar to decline in the coming months as US monetary policy remains very easy. Capital flows have been slow to return to emerging market currencies so their recovery has lagged somewhat.

Global credit: Neutral
The fundamentals associated with growth and policy are positive for credit, but valuations are not compelling, in our view. We believe the current risk-reward favors a more cautious stance on credit, and we are seeking to add value via security selection and buy into pullbacks.

IFI risk position (3-month outlook)

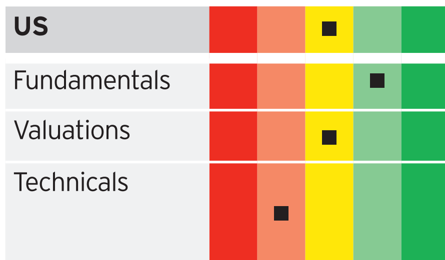


Underlying growth momentum is relatively supportive for risk taking, but valuations are tight, in our view. Monetary and fiscal policy have been supportive, but the pace of easing has slowed. Uncertainties around the US presidential election, including the potential for the result to be unclear for an extended period of time, will likely keep volatility high for the near term. We prefer to stay neutral in risky assets, and use selloffs as an opportunity to buy risky markets that we believe will be supported by the fundamentals in the medium term.

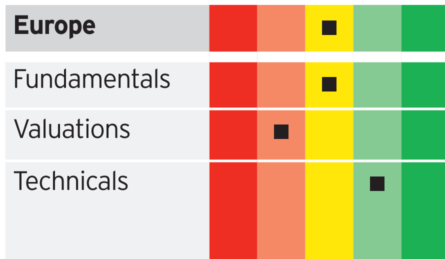


IFI multi-sector asset allocation (3-month outlook)

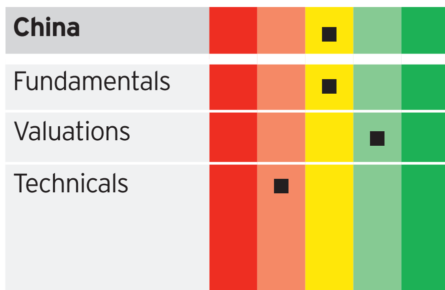
Long-term government interest rates



US Treasury yields offer little in the way of risk/reward as yields are likely to stay low for a significant length of time. 10-year US Treasuries are likely to trade below our fair value estimate (1%) while the economy remains in the slow growth/low inflation regime caused by the coronavirus. The Fed's policy is expected to remain accommodative for some time - it recently shifted toward an average inflation targeting regime and committed to the zero bound for interest rates until inflation is forecast to be moderately above its 2% target. This suggests that, while overall rates will remain low, real US interest rates may continue to rally. The Treasury curve may steepen, especially in the 30-year part of the curve as supply increases.



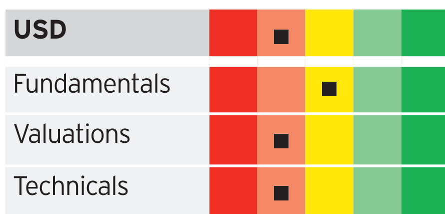
The European sovereign bond market remains in suspended animation despite the recent resurgence of COVID-19 in the region and the gradual but relentless return of lockdowns across many countries. Despite the expected impact on growth due to these measures and the resulting deterioration in sovereign balance sheets, the ECB has stood firm and promised to support the bond markets through an increased scope and scale of its bond purchase programs. Against this strong technical backdrop, sovereign bonds, including those of the mostly highly indebted countries, will likely continue to be well supported, despite high budget deficits and poor debt sustainability profiles.



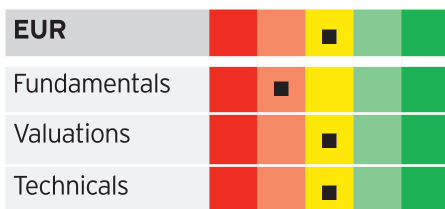
Onshore government bond moves have continued to be led by onshore equity market performance, supply pressure, interbank liquidity conditions and international investor demand. Monetary operations have shown some flexibility, but the year-end effect may still pressure front-end funding levels. Stock market performance and US-China news headlines may continue to drive near-term bond market performance. However, the upside to yields on rates bonds may be limited by strong buying interest from international investors when yields reach certain attractive levels.

After selling off in September amid heavy supply, Japanese government bond (JGB) yields have stabilized in October, outperforming US Treasuries but underperforming German bunds. The Bank of Japan's reluctance to increase its quantitative easing operations has limited the scope for lower yields in the face of relatively heavy supply, in our view. However, lower yields, especially in Europe, are making JGBs look relatively attractive to domestic investors and foreigners who have increased currency-hedged purchases. We expect these off-setting forces to keep yields relatively rangebound going forward.

Currencies



We expect the US dollar to depreciate broadly versus other currencies. We expect US monetary policy to reduce US real yields below levels experienced in other countries over the long term. The Fed's new average inflation regime is aimed at keeping rates lower for longer until the economy is strong enough to support an average inflation rate of 2%. The Fed has committed to keeping interest rates at the zero bound until inflation is forecast to be moderately above 2%. Lower US yields will likely encourage investors to look elsewhere, ultimately reducing demand for the US dollar and causing it to depreciate.



The outlook for the euro is dependent on that of the US dollar, in our view. The recent appreciation of the euro stumbled against a recovery in the US dollar and, while we expect the fundamentals in the euro area economy to remain under pressure well into 2021, we believe the euro would benefit from a more broad US dollar decline.

RMB			■		
Fundamentals				■	
Valuations				■	
Technicals			■		

We continue to see a favorable fundamental backdrop for the renminbi but think the USD/RMB exchange rate may consolidate at the current level for a period of time, especially during the US presidential election. Both China's current account and portfolio flows have been supportive of renminbi performance. As China has swiftly contained the coronavirus outbreak and the economy has strongly rebounded, we see room for Chinese assets, including the renminbi, to continue to outperform in the medium term.

JPY				■	
Fundamentals		■			
Valuations				■	
Technicals				■	

The Japanese yen has been relatively rangebound versus both the US dollar and the euro in October, despite strong risk sentiment and higher US Treasury yields, both of which tend to correlate with yen weakness. The relative resilience of the yen might reflect a more favorable flow dynamic, as Japanese portfolio outflows have slowed and the current account surplus has increased, and as exports recover from their slump.

Credit

Investment grade (IG)

US			■		
Fundamentals		■			
Valuations				■	
Technicals			■		

Sentiment in corporate credit markets has been positive since early June, due partly to the Fed's willingness to do whatever it takes to stabilize functioning debt markets. From a valuation perspective, credit spreads recovered dramatically in Q2 and Q3, having retraced a significant amount of the Q1 spread widening. The primary market remains robust; the ability to raise cash offsets some of the uncertainty about corporate earnings in the short term. With the Fed continuing to support the corporate credit market and interest rates potentially remaining near zero for an extended period, we remain constructive on the asset class, although valuations likely limit further significant appreciation.

Canada			■		
Fundamentals			■		
Valuations			■		
Technicals				■	

Fiscal stimulus continues to support the Canadian economy through the pandemic recovery, and corporate earnings have held up better than previously anticipated. Easier financial conditions and an evolving work environment have provided a significant boost to residential housing markets in the largest cities. But the recovery is expected to remain uneven as job losses are set to continue, especially in some of the service sectors of the economy. Valuations have become far less attractive, in our view, as the year has progressed, partly due to historically low all-in yields. Demand for new bond issuance continues to remain strong as supply is expected to materially slow into the final quarter of the year. We move to a more neutral view at current spread levels.

Europe				■	
Fundamentals			■		
Valuations				■	
Technicals					■

European IG markets have retraced most of their COVID-19 spread widening but still offer attractive relative value opportunities, in our view. We remain cautious on sectors with significant pandemic exposure (cyclical firms and travel and leisure industries) given lingering demand concerns that could be exacerbated by a possible second virus wave. However, we see attractive pockets of value in the more resilient sectors, especially in the subordinated bond space. We expect market technicals to continue to drive spreads in European credit markets. Although the PEPP has not yet been directed at the corporate space, the ECB is still buying around €10 billion of corporate bonds per month through other programs (equating to just over 1% of the eligible index).[1] Inflows into the asset class remain positive as investors "follow the central banks," and supply should slow down, providing ongoing tightening support. We are seeing increased evidence of large benchmark issuers adopting "early credit cycle" behavior (issuing equity to protect balance sheets), and pressure from regulators has largely prevented financial companies from making shareholder returns, supporting capital positions.

UK				■	
Fundamentals			■		
Valuations				■	
Technicals				■	

The Bank of England's decision to pause its own bond-buying scheme has diminished some of the technical support in the sterling market. However, we are still seeing strong demand for sterling credit from pension schemes, which is currently the main driver of technicals in the sterling market. Spreads are close to average levels over the past five years, which seems relatively attractive, in our view, given the general low yield environment. We believe that Bank of England buying would quickly resume if market conditions were to deteriorate, which is helping to underpin a market facing the dual fundamental challenges of COVID-19 and Brexit.

Asia			■		
Fundamentals			■		
Valuations			■		
Technicals			■		

Earnings of Asian IG issuers were announced with few negative surprises. We believe Asian IG issuers, in general, have sufficient buffers to guard against downgrades. We do not see a deterioration in credit fundamentals among Chinese issuers resulting from US-China tensions and the new entity list issued by the US government. However, uncertainty surrounding long-term US Treasury yields could impact the demand for long-term Asian IG bonds, and new issue pressure is expected to mount.

High yield (HY)

US			■		
Fundamentals		■			
Valuations			■		
Technicals				■	

Europe			■		
Fundamentals		■			
Valuations			■		
Technicals				■	

Though we acknowledge the substantial uncertainty surrounding the near-term path of the global economy, we expect increasing revenues to help improve earnings profiles for many companies. In our view, improved earnings may lead to tighter credit spreads as default risks fade from the elevated levels seen earlier this year. Many companies continue to access the primary market to push out near term maturities with new 8- and 10-year bonds. This type of refinancing behavior is positive for credits and improves near-term balance sheet liquidity. While we expect to see more distressed companies restructure their balance sheets, much of this activity is already priced into the market. Given the large spread compression over the last six months, we expect near-term market gains to be more limited, but still attractive, given the overall risk backdrop.

Asia			■		
Fundamentals		■			
Valuations			■		
Technicals			■		

Earnings figures of Chinese property issuers have generally been positive on the back of the robust economic recovery in China. However, the continued spread of the coronavirus in the rest of developing Asia has continued to put pressure on issuers in those countries. Technical support is still strong with major central banks implementing easy monetary policies, but recent equity market volatility could hamper investor appetite for Asian HY bonds in the near term.

Emerging markets (USD)

Sovereign				■	
Fundamentals		■			
Valuations				■	
Technicals				■	

Easing in the core markets, together with low emerging market (EM) inflation and much improved external balance sheets over the past five years, has allowed EM central banks to aggressively cut policy rates and ease fiscal policy. Scope for further recovery remains a function of cyclical factors, such as the easing of mobility restrictions, oil prices, exposure to tourism and remittances. Structural factors will likely play a role, such as the growth picture, trade structure, fiscal space, debt levels and external balances. The International Monetary Fund will likely be ready to help more challenged countries, as long as domestic politics permit. EM recovery overall remains hostage to the developed market outlook, with a number of big countries vulnerable on macro and COVID-related weaknesses. Market technicals are supportive, with inflows returning to the hard currency market amid the perpetual global hunt for yield. EM valuations have tightened, but spreads are still wide to historical levels and, in our view, offer select relative value versus developed markets.

Municipals

IG			■		
Fundamentals		■			
Valuations			■		
Technicals			■		

HY			■		
Fundamentals		■			
Valuations			■		
Technicals			■		

If there is a flight to quality due to a delay in determining the US election results, we believe that high-quality tax-exempt municipals would generally follow US Treasury moves – i.e., falling tax-exempt yields and increasing municipal-to-US Treasury yield ratios. In this case, we would expect taxable and tax-exempt credit spreads to widen. For these reasons, plus the impacts of COVID-19 and the lack of additional fiscal stimulus to states, we maintain a neutral overall grade for both investment grade and high yield municipals. Market technicals, though stable, have weakened since the third quarter and hence our shift to neutral. Regarding valuations, investors appear reluctant to put money to work given the many uncertainties in the months ahead (COVID, US election, China-US relations, etc). Ratios look favorable from a historical perspective, in our view, but concerns regarding Q4 supply and the slowing of fund flows appear to be causing investors to be cautious.

Structured

Agency MBS[2]				■	
Fundamentals				■	
Valuations			■		
Technicals				■	

Nominal and option-adjusted spreads, while tighter now than at mid-year, continue to look attractive in agency MBS relative to prior periods of Fed support, in our view. Additional Fed purchases and strong bank demand continue to provide significant support to absorb a high level of mortgage production spurred by low interest rates. Dollar roll markets are expected to remain special for key coupons that the Fed is buying, adding significantly to the attractiveness of owning TBA (to be announced) mortgages in an environment of high prepayment rates.

RMBS[2]				■	
Fundamentals			■		
Valuations			■		
Technicals				■	

Delinquencies have declined somewhat from their mid-summer peaks, and foreclosures have remained muted, as forbearance programs continue to push out, and hopefully substantially reduce, ultimate defaults as the US economy continues to heal from COVID-19 job losses. Additional fiscal support from the federal government will likely be an important determinant of future delinquencies, as some homeowners have relied on additional unemployment assistance. Low interest rates have been very positive for housing overall as the crisis abates. With lower-rated bonds having tightened significantly, our favored allocations are toward investment grade rated credit risk transfer and non-qualified mortgage AAA-rated bonds. We have seen new issue activity met with strong investor demand.

CMBS[2]			■		
Fundamentals		■			
Valuations				■	
Technicals				■	

COVID-19 has caused an abrupt decline in property revenue and an anticipated decline in property valuations. Loan delinquencies are significantly elevated, although plateauing recently. Lending remains available for high-quality assets. Investor demand for bonds has increased notably in the past few months. Additionally, large pools of capital have been raised to invest in dislocated commercial real estate as eventual defaults and sales begin occurring. We believe senior bonds in CMBS offer attractive value, noting that subordinated credit requires careful navigation.

ABS[2]			■		
Fundamentals		■			
Valuations			■		
Technicals				■	

While many sectors in ABS are facing fundamental challenges, we believe robust credit enhancement and structures can withstand a deep recessionary experience. AAA-rated generic ABS (credit cards and prime autos) have tightened back to, or in some cases through, pre-COVID-19 levels. Investor interest has migrated to lower-rated bonds where spreads are still wider than pre-pandemic levels. Supply and investor demand have been very strong, and low dealer inventories round out a strong technical picture for most ABS transactions. Certain ABS sectors remain exposed to the risk that federal government support may wane. We are neutral benchmark ABS and are finding some opportunities in non-benchmark sectors.

Bank loans

US			■		
Fundamentals			■		
Valuations			■		
Technicals				■	

Credit fundamentals have gradually improved in most sectors. The easing of restrictions continues to unfold as local conditions permit, facilitating a recovery in economic activity. The ever-shifting location of COVID-19 hotspots has precluded earnings recovery in some sectors that have been stuck at or close to a full stop, while other sectors have been able to resume business as usual, more quickly. As a result, earnings will likely show broad sequential improvement in Q3 but be uneven across sectors. Default rates have stayed relatively low so far but should rise during the rest of the year. Meanwhile, the policy backdrop is broadly supportive, although the Fed's targeted lending programs have provided only modest direct benefit to loan market issuers. The absence of additional fiscal stimulus could be a headwind to issuers reliant on assistance if Congress fails to pass new support measures soon. Market technicals have supported a recovery in asset prices as steadily rising demand from collateralized loan obligations (CLOs), and limited new loan supply have kept the market tight. Issuance will likely remain muted ahead of the US election as deal makers await the results. Resolution of election uncertainty and the approval of a COVID-19 vaccine stand out as the likeliest positive catalysts in the near term.

Europe			■		
Fundamentals			■		
Valuations				■	
Technicals			■		

Market techincals are supportive and will likely remain so during Q4. Loan demand from the reopening of the bona fide CLO market is likely to provide a constant bid for loans and easily absorb modest new deal issuance. While we expect the pipeline of deals to increase, we think the technical balance will favor demand, given the likely continued tightening of CLO AAA demand (deep bid for this paper) and CLO equity returns in the mid-to-high teens. From a fundamental perspective, we see risk-on at the back end of the quarter as key themes are settled (Brexit, US election, vaccine development) and investors turn their attention and positioning to the expected economic rebound in 2021. We expect governments to be more balanced between public safety and economic impacts when implementing social distancing measures and expect any severe restrictions to be cushioned with government support.

1 Sources: ECB, Invesco, data as of Oct. 15, 2020.
2 MBS is mortgage-backed securities. RMBS is residential mortgage-backed securities. CMBS is commercial mortgage-backed securities. ABS is asset-backed securities.

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