
Invesco Fixed Income

Multi-sector asset allocation outlook
Q3 2023

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IFI multi- sector asset allocation overview

Macro factor summary

Slow, disinflationary growth is the current macro theme. The global economy continues to avoid recession and is realizing low, but positive, growth as underlying strength in the labor market and services consumption pushes economies along. As we have been expecting, inflation has been coming down quite quickly in recent months. The post-pandemic stimulus has worked its way through the economy and supply chain issues have been resolved, easing inflationary pressure. This positive macro backdrop is increasingly being acknowledged by the market and is a key reason that market performance has been so positive in recent months, in our view. It is becoming increasingly likely, however, that this good macro backdrop is being priced into markets.

The ongoing headwind for markets is the hawkish stance of most global central banks, who are still raising rates despite the good news on inflation. As inflation continues to decline and nominal growth comes down with inflation, high nominal interest rates are increasingly likely to have an impact on growth and markets. Said another way, as inflation comes down sharply real interest rates are rising. Risks for the economy and markets may develop if central banks overstay their welcome at higher levels of interest rates.

Asset allocation summary

We favor high quality credit assets in the current environment and being modestly overweight duration. The overall level of fixed income yields remains attractive, and despite tightening of valuations, we still believe technicals and fundamentals favor high quality credit. Investment grade bonds will likely gain some protection from embedded duration if a recession occurs. In the medium term, we favor longer maturity bonds in this disinflationary environment. In the shorter term, we are toward the top of our expected ranges for longer maturity bonds in the US and Europe.

Risk position summary

We are growing more cautious on risk taking. While the growth and inflation outlooks are positive for markets, the positive backdrop increasingly appears priced into markets. The risk of central banks keeping interest rates high despite progress on inflation is growing and this could turn into a headwind for economies and hence for markets. In our view, the key to risk positioning going forward will be central bank stance.

Senior Editor

Ann Ginsburg

Head of Thought Leadership
Fixed Income

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Factors vs. market expectations



IFI macro factor outlook (three-month outlook)

Global growth: Slightly below trend, but not recessionary

Global growth continues to show positive momentum, although Chinese growth recovery is disappointing and needs to be watched carefully. Growth is largely expected to be below potential, but positive. This is not a bad outcome for financial markets overall. The possibility of a recession continues to be a risk, but it is not in our base case.

Global inflation: Below expectations

Disinflation is well underway in the global economy. Most measures of headline, core and sticky core inflation are showing easing pressure, and we expect inflation to be in a range close to central bank targets by the end of next year. Inflation is absent in China, and while we expect policy easing to bolster growth and prevent deflation in China, this is a risk to watch.

Global policy and financial conditions: Hawkish

The US Federal Reserve (Fed) and the European Central Bank (ECB) both raised rates at their most recent policy meetings. Both central banks are providing little insight into their next moves and are emphasizing that they are data dependent. This means that future action should be in reaction to incoming inflation and growth data. We have little insight into their current reaction functions, but their messaging that they intend to keep rates high for longer should be a concern for markets. As inflation comes down, real interest rates will rise. Rising real interest rates and quantitative tightening may tighten financial conditions, which would likely be a headwind for markets.

IFI 2023 macro outlook

	Growth (%)		Inflation (%)		Policy	
	IFI Forecast	Consensus	IFI Forecast	Consensus	Next Move	Consensus
US	1.8	1.3	4.2	4.1	We expect the Fed to pause at the 5.25-5.50% range and stay there in 2023. Rate cuts will likely start in the first half of 2024. We expect a peak terminal rate of 3.75%. We expect monetary policy to remain loose. Targeted fiscal easing measures are expected in 2H23, but broad-based, grand-scale stimulus is less likely. We expect continued tweaks to the BoJ's YCC framework, leading to higher rates. A complete abandonment of YCC is possible later in the year, but such a change is not imminent in our base case.	We are close to market consensus. Though market pricing suggests some probability of cuts early in 2024. We are around the consensus. We are more conservative than the market on China's easing measures. We are close to consensus.
Europe	0.7	0.5	5.3	5.4		
China	5.0	5.5	0.5	1.1		
Japan	1.3	1.3	2.3	2.5		

Source: Invesco Fixed Income, Bloomberg L.P. Data as of July 15, 2023. IFI forecasts are six-month trends.

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IFI broad asset allocation (three-month outlook)

Global duration: Overweight

Major market bond yields are close to the top of our expected near-term ranges, and also close to their longer-term highs. We favor modest duration exposure here, both in our base case, and also in the risk case that growth and/or market dislocations build, in response to tightening financial conditions.

US dollar: Neutral

The US dollar has revalued lower in the recent period as markets have priced in the possibility of soft landings in the US and global economies. At current levels, US dollar risk appears more balanced, although we believe opportunities exist in certain emerging market and developed market currencies.

Global credit: Slight overweight

Credit valuations have tightened in recent months limiting their potential upside. We still believe fundamentals and technicals are positive for credit. We favor high quality credit in investment grade corporate, municipal and securitized asset classes.

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IFI risk position (three-month outlook)

We are neutral on risk taking. While the current trend in growth and inflation continues to be positive for risk taking, more hawkish than expected central banks or weaker than currently expected growth could create headwinds for asset markets, keeping us somewhat cautious. Valuations have steadily tightened in recent months, which also limits the potential upside in some risky asset classes and increases the potential for losses if the risk taking environment deteriorates. To get more constructive on risk taking, we would want to see central banks acknowledge the recent progress on inflation and provide some indication of a less hawkish stance as a result.

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

US	Red	Orange	Yellow	Light Green	Dark Green
Fundamentals	Red	Orange	Yellow	Light Green	Dark Green
Technicals	Red	Orange	Yellow	Light Green	Dark Green
Valuations	Red	Orange	Yellow	Light Green	Dark Green

Long-term government interest rates

US

US bond yields are caught between two countervailing forces: A slow growth, disinflationary environment should normally allow yields to decline, but an aggressive Fed that is driving the yield curve to be deeply inverted is pushing yields higher. We expect 10-year US Treasuries to stay in a 3.5% to 4.0% range, bound by the interplay of these two forces. We are currently near the top of the range and favor an overweight stance to US duration. With the Fed close to the end of its rate hiking cycle, yields may decline through the bottom of our range if disinflationary conditions persist in the coming quarter.

Europe	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

China	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

Japan	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

USD	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

EUR	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

Europe

We are positive on European rates, despite the ECB's continued hawkishness. Recent economic data in the region point to a deteriorating economic landscape, which should reduce inflationary pressures in the coming months and quarters. However, the ECB seems determined to continue hiking, irrespective of the data, and our analysis indicates that it will have to start cutting rates sooner than the market anticipates.

China

We see room for Chinese government bond yields to decline with the potential for the yield curve to steepen. Investor positioning has been relatively crowded after the onshore bond market rally in 2Q 2023 and the weaker-than-expected economic growth report. However, the growth trajectory, household risk appetite, and our expectation of relatively moderate easing measures point to potential further yield declines, especially at the front end. We expect monetary policy to remain accommodative, with sufficient liquidity in the interbank market. Yield spikes on the back of unexpected policy easing measures may present potential buying opportunities. As longer-term yields approach historically low levels, additional yield moves through key levels may face resistance.

Japan

Japanese government bond (JGB) yields jumped after the Bank of Japan (BoJ) announced it would raise the 10-year yield level at which it would carry out unlimited fixed rate purchase operations from 0.5% to 1.0%. Although the BoJ maintains that 2% inflation has yet to be reached on a sustainable basis and that it will retain discretion to intervene in the market below 1% yields, there is no doubt that this is a gradual exit from the Yield Curve Control policy. JGB yields will likely now be more responsive to macro factors, as the BoJ will probably be less present in the market. As a result, rising Japanese inflation and wages, combined with resilient local and global growth, will likely push yields higher.

Currencies

USD

As the Fed approaches the end of its current rate hiking cycle, we believe the outlook for the US dollar is finely balanced. If the Fed can engineer a soft landing while global growth improves, then the gradual decline in the US dollar since last year is likely to continue, especially versus emerging markets. However, we remain cautious, as we are concerned that the cumulative impact of such an aggressive rate hiking cycle could begin to weigh on the US economy in the second half of the year, generating more market volatility and potentially providing some short-term support to the dollar.

EUR

The outlook for the European economy has deteriorated over the past few months as the impact of the ECB's aggressive rate hiking cycle has begun to weigh on it. Against that backdrop, the euro has retreated from its recent high while the market assesses the magnitude and duration of the slowdown. We expect the euro to trade in a range versus the US dollar until we get a clearer understanding of whether the Fed has reached a peak in rates. Ultimately the euro/US dollar exchange rate will likely be driven by the broad US dollar beta.

RMB	Red	Light Red	Yellow	Light Green	Green
Fundamentals	Red	Light Red	Yellow	Light Green	Green
Technicals	Red	Light Red	Yellow	Light Green	Green
Valuations	Red	Light Red	Yellow	Light Green	Green

JPY	Red	Light Red	Yellow	Light Green	Green
Fundamentals	Red	Light Red	Yellow	Light Green	Green
Technicals	Red	Light Red	Yellow	Light Green	Green
Valuations	Red	Light Red	Yellow	Light Green	Green

US	Red	Light Red	Yellow	Light Green	Green
Fundamentals	Red	Light Red	Yellow	Light Green	Green
Technicals	Red	Light Red	Yellow	Light Green	Green
Valuations	Red	Light Red	Yellow	Light Green	Green

Europe	Red	Light Red	Yellow	Light Green	Green
Fundamentals	Red	Light Red	Yellow	Light Green	Green
Technicals	Red	Light Red	Yellow	Light Green	Green
Valuations	Red	Light Red	Yellow	Light Green	Green

RMB

We think the main driver of the USD/RMB exchange rate's performance continues to be the US dollar strength against major currencies. Although China's growth trajectory and rate differential have weighed on the renminbi's performance in the first half of this year, recent rhetoric from policy makers and a series of fixing deviations showed a tendency to contain USD/RMB moves when seen as excessive. We believe 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, versus the basket.

JPY

The BoJ's decision to adjust its Yield Curve Control policy in July will likely put upward pressure on JGB yields, helping to narrow the interest rate differential with the US and Europe at longer-term maturities. This should help support the yen, in addition to Japan's better terms of trade relative to 2022, due to lower energy prices. However, Japanese short-term rates remain fixed at low levels with no imminent change likely, and resilient global growth is supporting short-term rates in the US and Europe, making yen long trades very negative carry. The yen will probably not appreciate meaningfully until recessionary dynamics in the rest of the world lead to interest rate cuts, compressing the short-term yield differential with Japan.

Credit

Investment grade

US

We have a neutral outlook on investment grade credit. All-in yields are attractive and demand for the asset class remains strong, but this is balanced by some high-level deterioration in fundamentals and average credit spreads. Yields remain at multi-year highs driven primarily by rates. While credit spreads in aggregate are in line with longer term averages, valuations are bifurcated, with industrials trading rich to historical levels and financials trading wide. Financials have recently outperformed on the back of a solid start to bank earnings season, but we still see value in the sector. We expect some erosion of fundamentals overall but from a strong starting point. Earnings are likely to trough in Q3 but could end the year around the same level where they entered. Higher interest rates are taking their toll gradually, but investors increasingly see a path toward a soft landing rather than a more severe recession. Technicals have improved as new issue supply in the asset class tends to be front-loaded and is therefore expected to be muted in the second half of the year. Demand also remains strong as investors extend duration as the Fed winds down its hiking cycle.

Europe

Spread widening at the end of Q1 driven by bank solvency concerns (originating in the US, but eventually leading to the bailout of Credit Suisse) proved relatively short-lived, but this has been replaced by fears that central banks will have to tighten financial conditions further to control inflation. This has created a more uncertain macroeconomic outlook in Europe, and elevated levels of spread volatility in European credit markets.

However, we take comfort that the Credit Suisse bailout proved to be idiosyncratic. In our view, this means that the spread widening in the financials sector is offering an attractive relative value opportunity. We are seeing early signs of weakness in segments of the industrial sector, but these look relatively contained rather than indicative of a prolonged recession. Spreads are relatively wide, but all-in yields are at levels not seen since the 2011 sovereign crisis. We have a neutral view on European investment grade credit, but we could see a more supportive backdrop in the second half of 2023, if we see the peak in central bank rate hikes.

UK					
Fundamentals					
Technicals					
Valuations					

Asia					
Fundamentals					
Technicals					
Valuations					

US					
Fundamentals					
Technicals					
Valuations					

Europe					
Fundamentals					
Technicals					
Valuations					

Asia					
Fundamentals					
Technicals					
Valuations					

UK

Sterling investment grade credit spreads rallied in Q2 as bank solvency concerns proved to be relatively contained. We believe that valuations are compelling, and we think that current yields are attractive for pension schemes to de-risk. The Pension Protection Fund 7800 Index reported a record aggregate surplus for UK pension schemes at the end of May 2023 and, now that the Bank of England has disposed of its Asset Purchase Facility holdings, we believe the technical picture is improving. Unfortunately, the UK hiking cycle is not yet finished, which is creating some short-term spread volatility. We could become more constructive if we see evidence of a less hawkish approach.

Asia

We maintain our constructive view toward Asia investment grade in the medium term. We believe macro uncertainties and external factors should subside in the latter part of Q3. Lower US rate volatility should benefit high quality investments and help the Asia investment grade outlook. However, we expect market participants to remain relatively conservative in positioning due to overall tight valuations and lingering uncertainties. Credit differentiation will likely become more important as we progress through 2023.

High yield

US and Europe

We remain cautiously optimistic about high yield. The current positive backdrop combines fundamentals that are starting from a strong position and high yield levels. We believe the carry from going down in quality is likely to generate positive outcomes for investors, but we are wary of lowest quality risk ahead of a softer economic backdrop and the higher cost of debt. Hence, we favor the yield offered by higher quality high yield, but don't like the risk of extending into triple-C and speculative situations, absent idiosyncratic compelling value propositions. Odds are increasing that we enter a slow growth, no recession outcome, which supports credit but raises the specter of rates remaining higher for longer. We view leveraged companies as more vulnerable in a "new regime" of more permanent higher capital costs and are avoiding lower quality issuers that require cheap financing to survive. We also see compelling opportunities in short-dated high yield, as the yield curve remains negatively sloped. Meanwhile, hedged yields can offer improved yields within the same credit. We have added euro denominated bonds of the same issuer where we've held the US dollar denominated issue and added upwards of 150 basis points in yield by hedging back to US dollars. This helps add yield without adding credit risk to our portfolios. Broadly speaking, greater uncertainty tends to lead to fear and broad-based selling. We like to buy from forced sellers and/or fear-driven activity. We expect such events to increase as we enter the later stages of the cycle. Historically, these opportunities have benefited high yield investors and the longer-term returns of the asset class.

Asia

We expect Asian high yield fundamentals to stay largely stable, except in China's property sector. Some high yield bonds, especially in China's non-property sector, have started to show attractive valuations, following a recent sell-off. Various Southeast Asian high yield issuers should be able to refinance domestically and we expect technical support to remain in place due to a lack of supply, especially among commodity exporters. We are cautious on the Chinese high yield property sector due to the slowdown in sales recovery and highly technical trading momentum in the bonds.

Sovereign	Red	Light Red	Yellow	Light Green	Green
Fundamentals	Red	Light Red	Yellow	Light Green	Green
Technicals	Red	Light Red	Yellow	Light Green	Green
Valuations	Red	Light Red	Yellow	Light Green	Green
Corporate	Red	Light Red	Yellow	Light Green	Green
Fundamentals	Red	Light Red	Yellow	Light Green	Green
Technicals	Red	Light Red	Yellow	Light Green	Green
Valuations	Red	Light Red	Yellow	Light Green	Green

IG	Red	Light Red	Yellow	Light Green	Green
Fundamentals	Red	Light Red	Yellow	Light Green	Green
Technicals	Red	Light Red	Yellow	Light Green	Green
Valuations	Red	Light Red	Yellow	Light Green	Green
HY	Red	Light Red	Yellow	Light Green	Green
Fundamentals	Red	Light Red	Yellow	Light Green	Green
Technicals	Red	Light Red	Yellow	Light Green	Green
Valuations	Red	Light Red	Yellow	Light Green	Green

Taxable	Red	Light Red	Yellow	Light Green	Green
Fundamentals	Red	Light Red	Yellow	Light Green	Green
Technicals	Red	Light Red	Yellow	Light Green	Green
Valuations	Red	Light Red	Yellow	Light Green	Green

Emerging markets (USD)

For the most part, major emerging market economies remain strong and growing, although the pace of growth has slowed since the initial COVID rebound. Exports have stabilized after a steep fall last year and current account balances remain at modest deficits. Disinflation has stalled and core inflation remains quite persistent. While current fundamentals may be reassuring, markets seem unwilling to accept that the worst is basically over. There is uncertainty around the trajectory of valuations driven by the uncertainty in China and major developing markets, which could pose downside risks to growth in the coming years.

Portfolio outflow pressures in emerging markets have abated somewhat as global inflation concerns cool, but year-to-date flows remain negative. Emerging market investors continue to prefer local currency bonds, targeting countries that are near the end of their hiking cycles. While little new money is coming into the asset class, there is also a dearth of issuance, providing the index with some technical support.

Municipals

Tax-exempt municipals

We have a positive outlook on tax-exempt municipals. Fundamentals are constructive and technicals have been positive, with limited supply and a slowdown in the outflows that characterized 2022. The liquidation of the Silicon Valley Bank and Signature Bank portfolios has been an overhang for the market, but liquidations have been accomplished in the secondary market without significant repricing. Valuations continue to be neutral, with yield ratios versus US Treasuries and spreads in the middle of historical ranges. We expect subdued high yield municipal supply, as some issuers were able to refinance last year. We see few large projects that need financing, and though we expect high yield issuance to fall short of last year's, we expect it to pick up in the second half of this year.

Taxable municipals

We are positive on taxable municipals as overall valuations are fair, in our view, with pockets of potential opportunity in A rated and healthcare securities. Technicals remain favorable with muted supply and strong demand. Year-to-date supply is USD18 billion, representing a 52% decline compared to last year.¹ While higher hedging costs are a headwind, attractive relative valuations have helped both new issues and the significant secondary market selling of Silicon Valley Bank's tax-exempt portfolio by the US Federal Deposit Insurance Corporation to perform in an orderly manner.

1. Source: JP Morgan. Data as of June 30, 2023.

Agency MBS	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

RMBS	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

CMBS	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

ABS	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

Structured*

Agency MBS

There is a significant valuation difference between the overall MBS index, which is near fair value, in our view, and current coupon MBS, which are attractive relative to their historical spread levels and corporate bonds. This sharp differential is being driven by tight spreads on low coupon Agency MBS, which are the coupons most owned by the Fed. Realized and implied interest rate volatility is still elevated but trending lower. As we near the end of the Fed's rate hiking cycle, volatility should recede further, which should be a positive support for Agency MBS performance, especially securities with higher coupons. The prepayment outlook for Agency MBS continues to be driven by the large amount of deep discount bonds in the market. The amount of MBS with coupons 300-400 basis points below the prevailing mortgage refinance rate is keeping negative convexity near an all-time low.

RMBS

Non-agency residential MBS have settled in at slightly cheap to fair value, in our view, versus corporate bonds at the end of Q2. While each of the non-agency subsectors has its own technical nuances, the moderating US housing market provides a stable backdrop for bonds across most sectors of this asset class. Low secondary home supply, positive demographic trends and shifts in housing preferences in favor of single-family properties are some crucial tailwinds for the residential market. We are finding more value higher in the capital structure, generally speaking, across government sponsored entity credit risk transfer securities and single-family rental bonds.

CMBS

Parts of the CMBS market, especially many office properties, continue to face headwinds from stalled return-to-office trends and increased sublease activity. Property values across several CMBS subsectors are declining, creating uncertainty. Increased borrowing costs and tighter mortgage lending standards have created refinancing challenges for loans coming due in 2023. As a result, particularly in the office sector, loan servicers are receiving more borrower requests for maturity extensions or other relief from high coupons that await them upon loan maturity. On the positive side, technical conditions are fairly positive in the CMBS market and maturities coming due this year are lower than in recent years. Valuations appear attractive relative to corporate bonds, in our view, but we believe careful selection is required, given the headwinds specific to commercial real estate.

ABS

Asset-backed securities markets have been resilient through the recent bouts of broader market volatility experienced in Q2, due to both regional bank stress and the federal debt negotiations. Attractive valuations, favorable technical trends and manageable near-term fundamentals remain supportive for many subsectors of the ABS universe. Many ABS securities are short maturity instruments that can deliver attractive yield potential, given high interest rates at the front end of the inverted yield curve. Employment conditions are also still favorable for most ABS asset classes. While we expect employment to eventually weaken, it has been surprisingly robust so far, which has been beneficial to ABS. We expect fundamentals to weaken going forward under pressure from high inflation and interest rates, but strong structures continue to support projected collateral loss expectations.

US	Red	Light Red	Yellow	Light Green	Dark Green
Fundamentals	Red	Light Red	Yellow	Light Green	Dark Green
Technicals	Red	Light Red	Yellow	Light Green	Dark Green
Valuations	Red	Light Red	Yellow	Light Green	Dark Green

Europe	Red	Light Red	Yellow	Light Green	Dark Green
Fundamentals	Red	Light Red	Yellow	Light Green	Dark Green
Technicals	Red	Light Red	Yellow	Light Green	Dark Green
Valuations	Red	Light Red	Yellow	Light Green	Dark Green

CLOs	Red	Light Red	Yellow	Light Green	Dark Green
Fundamentals	Red	Light Red	Yellow	Light Green	Dark Green
Technicals	Red	Light Red	Yellow	Light Green	Dark Green
Valuations	Red	Light Red	Yellow	Light Green	Dark Green

Bank loans

US

Robust economic data and moderating (but still high) core inflation have resulted in higher-for-longer rates expectations. This may place incremental pressure on issuers with limited levered free cash flow, but the extent to which this creates distress depends more on the earnings environment. Distress levels are fairly benign at the moment, signaling that those concerns are contained. Meanwhile, loan investors continue to reap the benefits of interest rates at 20-plus year highs via floating rate coupons. Technical dynamics remain supportive with very sparse new primary issuance and steady (but potentially fading) collateralized loan obligation (CLO) origination.

Europe

While inflationary pressures have recently moderated, especially due to lower energy and food prices, expectations remain above target and the ECB will likely maintain its hawkish policy bias. Geopolitical concerns remain ever-present, leading to periods of volatility on unexpected developments. Overall, loan issuers have articulated constructive inflationary pass-through initiatives and maintain healthy liquidity profiles and debt service coverage ratios. However, these ratios are gradually decreasing as interest rates rise. Distress levels remain muted and loan defaults remain low. The primary pipeline is light with deal flow dominated by maturity extension transactions (at market yields, thus to the benefit of loan investors). A lack of new paper will likely continue to support secondary loan prices. CLO arbitrage continues to be tight, although creation remains steady, providing additional upward technical pressure on asset/loan prices.

CLOs**

The issuance of collateralized loan obligations (CLO) slowed in the second quarter compared to a strong first quarter. Decreased issuance was primarily driven by a rally in loan assets. Increased loan prices resulted in less favorable economics for investors seeking to take advantage of the spread between CLO assets (bank loans) and CLO liabilities (CLO debt), also known as equity arbitrage, leading to weaker CLO issuance.

Within existing CLO structures, the quality of the collateral continued to show signs of weakening. The portion of lower-rated loans (CCC buckets) and the credit quality of the collateral (Weighted Average Rating Factor scores) have increased, while the overcollateralization protection against potential losses for investors (junior overcollateralization cushions) has declined. However, this deterioration is still manageable, in our view, and well below levels seen during the height of the COVID-19 pandemic in 2020.

We believe valuations remain attractive, as modest technical tailwinds, such as continued CLO issuance from manager-controlled equity profiles that are less limited by the equity arbitrage constraints mentioned above, and minimal loan issuance, keep primary CLO spreads wide relative to historic levels.

*MBS is mortgage-backed securities. RMBS is residential mortgage-backed securities. CMBS is commercial mortgage-backed securities. ABS is asset-backed securities. **CLOs are collateralized loan obligations.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

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

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

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

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

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

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