Invesco Fixed Income
2020 outlook

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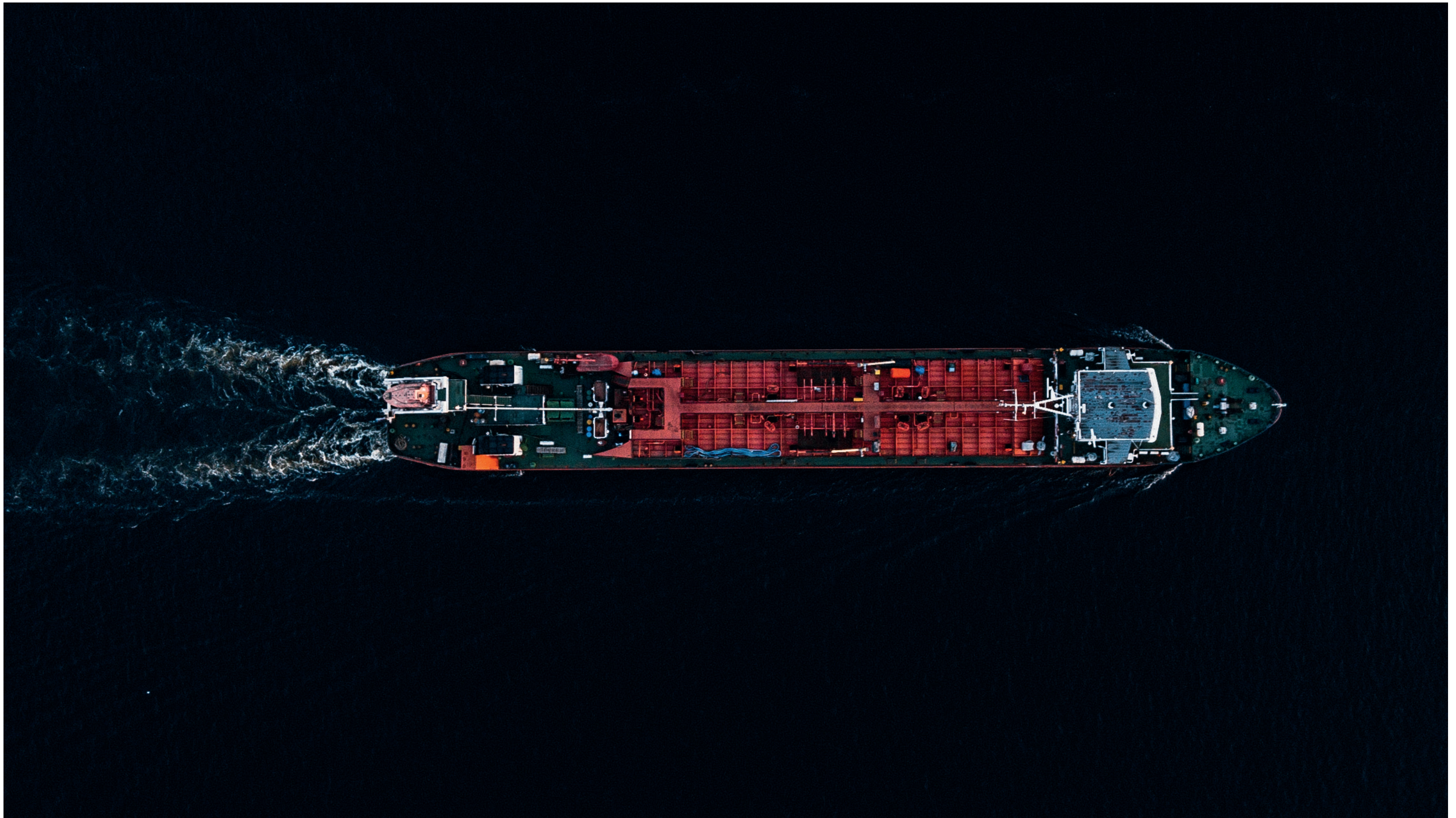

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Key takeaways

- Despite the rally in credit-related assets in 2019, we enter 2020 with a positive backdrop for investment grade bonds.
- In our view, strong market technicals, coupled with favorable demographic trends, mean high yield bonds will likely remain attractive in 2020.
- Chinese growth has shown signs of bottoming, and we believe the credit metrics of Chinese issuers will remain largely resilient and corporate default risk will remain low.

"Despite uncertainty, in our view, fundamentals remain solid in many fixed income markets."

Macro

We believe global growth will exceed current expectations. The growth slowdown in Europe and China may have troughed and US growth, while weak, has been supported by Fed policy. We expect the US to return to its level of potential growth at around 2% sometime next year.

Inflation is likely to be volatile in 2020. As tariffs on consumer goods rise, inflation readings at the beginning of the year may be significantly higher than during previous periods of the recovery. If there are no further tariff increases, we would expect inflation to stabilize toward the end of 2020.

Global policymakers have eased significantly in recent months. The Fed has cut interest rates three times since July and may ease further if data continue to weaken. It has also begun increasing the size of its balance sheet for technical reasons to support the short-term funding market. The ECB is also loosening and has resumed its quantitative easing (QE) program. China has eased fiscal policy, but monetary stimulus has been more restrained. We believe the US Federal Reserve (Fed) must continue to take appropriate easing measures to counteract weakness driven by slower global growth to prevent drops in financial markets that could sap confidence. It may further increase the size of its balance sheet to stabilize volatility in the market for repurchase agreements.

We expect global core interest rates to rise back toward fair value levels. We do not expect interest rates to sell off beyond fair value unless there is a significant increase in inflation, which we believe is unlikely. We expect the US dollar to weaken as global growth bottoms and monetary policy eases in the US. Resolution of trade tensions may also result in downward pressure on the US dollar, although uncertainty remains. We expect appreciation of most developed market and emerging market currencies versus the US dollar.

Global liquidity

Global interest rates are lower and developed market central banks have cut rates and eased financial conditions to support the current economic expansion and reduce the risk of recession. However, uncertainty remains for global liquidity markets, which are highly correlated with monetary policy regimes. For example, many market observers consider the US to be late in the business cycle.

We believe a couple of things are certain, however. First, the Fed has already reversed course and cut rates, and the European Central Bank (ECB) has pushed rates further into negative territory. Second, we expect the Fed to "do what is needed" to keep the current expansion in place, including the potential for additional rate cuts plus the use of its balance sheet to support liquidity and financial conditions. The Fed used its balance sheet capacity in 2019 to alleviate potential stress in the funding markets and support liquidity at the front end of the market. We expect the Fed to continue to be vigilant on this front with the potential for more permanent operations. The Fed may also use its balance sheet to contain longer-term rates and promote easier financial conditions by expanding outright largescale asset purchases (LSAP).

The US investment grade financials sector, primarily banks, has remained a solid credit story, being at cycle highs in terms of quantity and quality of capitalization (low leverage). However, in non-financial credit sectors, leverage metrics (i.e., gross debt/EBITDA or net debt/EBITDA) are at cycle highs, and we may see more pressure for companies to deleverage, which would be positive for relative valuations. Nevertheless, we may see corporate CFOs take advantage of renewed low rates in order to tender/refinance existing debt or for equity buybacks. From a technical perspective, strong demand for US spread may offset elevated issuance due to low interest rates. Similarly, persistent supply of US Treasury bills and US Treasury notes/bonds is likely to continue unabated, also impacting technical factors in money markets and at the very short end of the yield curve.

Asset flows to money market funds increased significantly in 2019, which may suggest investor fatigue and concern about longer-term markets. Money markets have recently provided a competitive yield for the first time in many years, but if the Fed continues to cut rates, the possibility of a positively sloped yield curve could incentivize investors out of cash and into opportunities further out the yield curve. However, even though the Fed has reversed course and lower rates may again be the norm, money markets maintain their perception as a dependable asset class that seeks to offer liquidity and capital preservation.

Typical at this late stage are a flat/inverted yield curve and tight credit valuations, which may be reflective of the current subdued inflation environment and potential lower global growth expectations balanced by demand for US fixed income assets.

Emerging markets

Heading into 2020, we see cross currents at play in emerging markets (EM) debt. Tailwinds for the asset class include looser financial conditions in developed and emerging markets and the continued global hunt for yield. Challenges to the asset class are due primarily to trade uncertainty, which has already had an impact – and which we expect to continue to weigh on global business sentiment, capital expenditure and growth. The optimistic expectation would be that healthier balance sheets and the benefits to consumers of wealth affects could support large EM economies. A gradual organic recovery could take hold, especially if supported by fiscal policies. The main risk to our outlook is a continuation of trade tensions and a sharper-than-expected slowdown in China.

Against this backdrop, we favor EM interest rates, as central banks still have room to cut, especially amid looser global monetary policy. EM real yield differentials versus developed market yields are close to 12-year highs. We believe the US dollar will slowly decline, possibly more quickly in 2020 if the global growth differential versus the US widens. We maintain our view that the medium-term trend is for a lower US dollar, continuing the decline that started in 2015 and was only interrupted in 2018 by the large US fiscal stimulus. We expect EM currencies to benefit from carry in 2020.

In sovereign and corporate credit, we favor high yield issuers with solid fundamentals, and we focus on idiosyncratic dynamics at the country level, screening for names with strong reform anchors and improving macro dynamics. We see some tentative green shoots in Latin America, where we expect Brazil and Mexico to emerge from below-average economic growth trends. Growth in the Gulf Cooperation Council and sub-Saharan African regions should also benefit as they recover from a low base.

Global investment grade

Developed market economic growth, which has trended lower since 2017, is expected to stabilize at low, yet positive, levels in 2020. Global central banks have stepped in with interest rate reductions and promises to expand balance sheets to prevent low growth from becoming an economic stall, while extending the cycle. Declining yields globally have caused a renewed search for yield, resulting in tighter valuations and concerns about the benefits of negative interest rate policies.

Despite the rally in credit-related assets in 2019, we enter 2020 with a positive backdrop for investment grade bonds. A combination of demand from high quality and international buyers, corporate deleveraging, and the potential crowding out of investors by central banks has resulted in technical strength for investment grade credit. We believe euro-denominated investment grade credit will benefit from the ECB's renewed bond purchases. We expect US dollar-denominated assets to be positively impacted to a lesser extent and may further benefit from global demand due to lower currency hedging costs if the Fed continues to reduce rates.

From a fundamental standpoint, we are seeing a willingness of corporate borrowers to deleverage. This began in the second half of 2018 following years of shareholder-friendly activity such as share buybacks, increased dividends, and merger and acquisition activity.

We are positive on corporate credit from a fundamental standpoint and expect central bank liquidity to benefit credit markets. We also expect corporate credit to outperform comparable sovereign debt.[1] We continue to believe sector allocation and security selection resulting from a sound credit process will be critical in 2020 as the business cycle ages.

"We are positive on corporate credit from a fundamental standpoint and expect central bank liquidity to benefit credit markets."

European fixed income

We expect the eurozone economy to see its growth rate halve from 1.9% to around 1% in 2019. The threat of trade tensions – from an escalating US-China trade war to "no-deal" Brexit risk to possible US tariffs on European car imports – has been the main driver behind weaker trade and tumbling industrial confidence.

In 2020, we are concerned this vicious circle of lower trade and heightened business uncertainty could spread to the still-buoyant labor market and the so far resilient consumer and services sectors. We expect another below-trend gross domestic product (GDP) growth result of around 1% next year.

While helpful, the new large-scale easing measures from the ECB will not likely be enough to have a significant bearing on the economic cycle and restore investment confidence amid trade and Brexit uncertainties and worrisome politics – both domestically and globally – all of which could easily persist into 2020.

We expect next year's focus to shift away from monetary policy toward fiscal easing and structural reform. However, large scale reforms on the structural or fiscal front will likely be difficult for the eurozone to achieve in the absence of a crisis, in our view.

We believe the December 12 election will be polarizing and difficult to predict. A no-deal exit is not a foregone conclusion, even in the event of a Conservative victory. Although we may see substantial volatility, we believe the balance of risk points to some upside for sterling, gilt yields, and UK credit relative to other markets heading into 2020.

Overall, barring an extreme escalation in trade tensions or a no-deal Brexit surprise, we expect the eurozone economy to grow at a steady pace of around 1% next year. The economy should continue to benefit from an accommodative ECB and the currently benign employment and inflation outlook, while the industrial sector will likely continue to be a drag. We expect that any positive Brexit developments or reduction in global trade uncertainty would largely benefit the manufacturing sector and tremendously improve business sentiment and investments. As it stands, we believe these positive developments are unlikely to happen soon, but potentially later in 2020.

Global high yield

With trade tensions resulting in an uncertain global growth environment, some companies have reduced business investment, leading to lower GDP forecasts in the US, eurozone, and Asia. Despite market fears of slowing economic growth, high yield has historically fared well in moderate growth environments. While there is some fear in the marketplace that corporate earnings have hit a near-term peak, we believe fundamentals overall are sufficiently robust for companies to generate free cash flow and reduce leverage.

Reduced leverage generally means lower default risks, which can lead to tighter credit spreads. Negative returns in high yield are typically driven by recessions, as company earnings decline and defaults increase. We do not believe we are in that environment today, as the Fed and the ECB have elongated the business cycle. Their actions have benefited credit markets and afforded many companies the opportunity to reduce leverage. The prevalence of low interest rates around the globe, even negative in some cases, has caused some investors to shift their investments from low/negative rate instruments to higher yielding instruments, like high yield bonds. The majority of high yield bonds offer fixed coupons and multi-year call protection, allowing investors to better forecast interest income and possibly benefit from the effects of duration.

While history demonstrates that recessions are negative for high yield, we do not see an immediate cause for concern given the overall health of the global economy, supportive roles by the Fed and the ECB, and still-healthy fundamentals among many high yield issuers. In our view, strong market technicals, coupled with favorable demographic trends (an aging population's need for income), mean high yield bonds will likely remain an active and attractive relative value proposition for retail and institutional investors in 2020.

Structured securities

Agency mortgage-backed securities (MBS)

In our view, the agency MBS sector should benefit from attractive valuations in 2020, relative to both historical averages and investment grade alternatives, while negative supply technicals and a challenging fundamental outlook will likely continue to limit outperformance. Lower mortgage rates should pressure valuations as supply remains elevated, while a sustained increase in interest rate and mortgage spread volatility will likely limit demand. We expect commercial banks and overseas investors to remain consistent buyers, while a potentially slowing economy will likely result in crossover buyers of agency MBS emerging from investment grade alternatives. We anticipate the emergence of these crossover buyers to be the primary determinant of agency MBS performance for the year.

Residential mortgage-backed securities

We expect consumer and housing fundamentals to remain supportive of residential MBS in 2020, absent a substantial spike in mortgage rates. Housing should prove resilient in the next recession, in our view, given stark fundamental differences versus the end of the previous cycle. The sector also offers a measure of diversification away from risks inherent in corporate credit, and a domestic focus that can reduce investors' exposure to slowing global growth. We believe that shifting supply technicals will continue to drive relative value in highly rated securities collateralized by non-qualified mortgages. In comparison, we anticipate more stable issuance dynamics and fewer dislocations in the Government Sponsored Enterprise (GSE) credit risk transfer market. While we are closely following GSE reform efforts, given their potential to dramatically impact the sector, meaningful change is relatively unlikely in the near term.

Asset-backed securities (ABS)

We expect ABS spreads to remain range-bound in 2020 with supportive fundamentals helping to mitigate any broader macro uncertainty surrounding rates, tariffs, or other potential headlines. Supply should continue to be met with ample demand, and any potential spread widening would likely be driven by rates rather than credit concerns. Although the relative value of ABS compared to corporates is near historically tight levels, we still find value in shorter maturities that can provide better liquidity and mitigation against uncertainty. However, while select esoteric sectors may appear cheap, we believe they could be biased wider as they are more directly linked to macro growth, which has been decelerating.

Commercial mortgage-backed securities

We expect commercial real estate rent growth and property price appreciation to continue, although at a slower pace, as new supply dampens space absorption. Lending conditions remain accommodative across property markets, and the recent decline in US interest rates should incrementally lower borrowing costs for property owners. Accommodative monetary policy and lower sovereign bond yields are also likely to be positive tailwinds for commercial real estate valuations. As property prices appreciate, we expect loan-to-value ratios of underlying mortgages to decline. As a result, we expect debt secured by well-performing commercial real estate properties to offer attractive carry.

"We believe the tax changes made under the Tax Cuts and Jobs Act (TCJA) of 2017 will be a key driver of municipal demand in 2020."

2020 US municipal outlook

We believe the tax changes made under the Tax Cuts and Jobs Act (TCJA) of 2017 will be a key driver of municipal demand in 2020. The law's US$10,000 cap on state and local tax deductions, the so-called "SALT cap," has resulted in surprisingly larger individual tax bills for people in high state income tax states (especially Democratic-leaning states like California, New York and New Jersey). Although the TCJA went into effect on Jan. 1, 2018, investors did not fully understand the impact until they filed their tax returns later that year. This has led to record inflows into municipal mutual funds in 2019. As of Oct. 2, 2019, municipal funds reported net inflows of US$69.5 billion, marking the 39th week of consecutive net inflows, and the largest year-to-date inflow the market has experienced since the tracking of this data began in 1992.[2]

Credit fundamentals have been supportive of municipal bond market performance in 2019. and we expect fundamentals to remain stable in 2020. This stability has been influenced by ongoing economic recovery across many parts of the US. Further boosting state fundamentals was the US Supreme Court's decision in June 2018 to overturn a decades-old ban on state tax collection from online sellers. The 5-4 decision did away with the notion that governments can only collect sales taxes on purchases made from retailers with a physical presence in their state. Additionally, states across the country have begun levying "sin" taxes on industries like recreational marijuana and sports betting. As these industries grow, states are poised to reap the benefits from a tax collection perspective. In general, we expect the growth of state and local property tax collections to remain healthy in 2020. Politics could create volatility in 2020 if there is uncertainty over government policy leading up to and following the US presidential race. Another round of income tax reform, for example, could be especially impactful to the US municipal bond market.

Infrastructure spending, one of the only areas with bipartisan support, may see a boost in 2020, although we view this as unlikely since Democrats will likely wait to pursue infrastructure as part of their 2020 campaign, with potential implementation in 2021 or 2022. Once decisions are made on infrastructure, new projects will likely be financed via the municipal market. When this day arrives, we believe the pace of issuance will be measured. Finally, we expect further clarity in 2020 regarding several Puerto Rico-related credits, which we believe will be welcomed by the high yield municipal investing community.

Asian fixed income

We are constructive on Asian fixed income in 2020 and expect lower interest rates globally and dovish tones adopted by Asian central banks to cushion downside risks. Despite rising geopolitical risks and slowing economic growth around the world, we believe monetary and fiscal easing measures implemented by Asian policymakers will help local issuers, whose fundamentals remain solid, and offset external headwinds. Asian credits still provide attractive yield pick-up over US and European credits, in our view, and the "home bias" for Asian US dollar-denominated bonds has been strong. With investors hunting for yield outside of Europe and Japan's expanding negative-yielding territory, we believe the Asian credit market will see continued technical support.

Chinese growth has shown signs of slowing amid trade uncertainty, but we believe it is bottoming. We believe the credit metrics of Chinese issuers will remain largely resilient and corporate default risk will remain low. Inflationary pressure related to last year's breakout of swine flu leading to higher pork prices will likely be short-lived, and we believe China can ease policy further to stimulate economic growth. We also expect China to accelerate structural reforms and further open its financial market. We are, therefore, constructive on the Chinese onshore bond market, especially given prospects for further index inclusion. We expect Chinese offshore credits to remain stable and spreads to tighten from current levels, especially as high-quality Chinese credits are becoming scarcer after the Chinese authorities tightened quotas for offshore issuance by Chinese issuers.

Outside of China, we are positive on issuers in Vietnam, Thailand, Malaysia, Indonesia, and India, which will likely benefit from the relocation of global supply chains from China, steady progress in domestic reform and more transparent government policies. We favor currencies from countries that are likely to enjoy continued capital inflows, like Thailand and Vietnam. In 2020, we will closely watch developments in US-China trade talks, political headlines as we approach US elections, and the oil price, given the heightened situation in Middle East.

Indian fixed income

Headline inflation has moved markedly lower to around 3% compared to a target neutral level of 4%. This prompted the Reserve Bank of India to cut its policy rate by over 100 basis points cumulatively from February 2019 until the end of September 2019. The stage appears set for multiple rounds of additional rate cuts amid slowing growth and low inflation. The decline in the repo rate is expected to reduce borrowing costs for sovereign and high-credit-quality entities and to percolate through to all credits over time.

On the fiscal side, the 2019 cut in the corporate tax rate to 22% from 30% has been cheered by many investors and may boost India's manufacturing competitiveness relative to China, amid a potential exodus of companies leaving China to avoid tariffs.

The Indian rupee is expected to perform well as the inflation differential between India and its trading partners declines and its ability to attract portfolio and foreign direct investment inflows (highest recipient in the world) increases along with remittances from non-resident Indians.

Inclusion in global indices is expected to increase foreign investors' exposure to Indian financial markets over time. Current low foreign ownership, however, has contributed to the Indian bond market's low correlation to other global asset classes and hence may provide a hedge, along with potentially higher yield, to a global portfolio.

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[1] There is no guarantee these views will come to pass.

[2] Source: Lipper US Fund Flows, Jan. 1, 1992.

Diversification does not guarantee a profit or eliminate the risk of loss.

Risk warnings

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.

The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

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.

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.

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