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# Invesco Fundamental Fixed Income

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Multi-sector asset allocation outlook  
Q2 2023

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## IFI multi- sector asset allocation overview

### Macro factor summary

We believe US and European growth will be slow, but positive, over the balance of this year. Growth momentum continues to surprise, and the outlook for the energy supply in Europe and the housing market in the US has improved. We also believe we are in a disinflationary period where the excesses introduced by pandemic stimulus are working their way out of the system and price pressures are easing. Core inflation has started to decline in the US, and we expect European inflation to follow. Supportive of this thesis, wage increases seem to be slowing. Despite this positive fundamental backdrop, central banks continue to run tight monetary policy. This is pressuring financial markets – failures of US regional banks are a great example – and will likely keep volatility elevated.

### Asset allocation summary

We favor high quality credit assets in the current environment. The overall level of fixed income yields remains attractive, valuations are close to medians for investment grade credit, and US corporate fundamentals look attractive. Investment grade bonds will likely gain some protection from embedded duration if a recession occurs. In the medium term, we favor fixed rate bonds, as current real yields are attractive versus historical levels, even if, in the shorter-term, we are toward the bottom of our expected near-term yield range.

### Risk position summary

We have a neutral risk positioning stance. The end of the central bank tightening cycle and better than feared news on economic growth point to a soft landing for the global economy and should provide a tailwind for risky assets. However, continued political and economic uncertainty argues for staying slightly cautious.

Senior Editor

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Head of Thought Leadership  
Fixed Income

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# 1

## Factors vs. market expectations



# IFI macro factor outlook (three-month outlook)

## Global growth: Neutral

Global growth continues to show positive momentum, and China's recovery following its COVID reopening continues. 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

Inflation has likely peaked. We expect inflation to decline through the balance of 2023 in the US and Europe, allowing the US and European central banks to stop hiking rates and contemplate cutting rates as 2023 evolves.

## Global policy and financial conditions: Neutral

The European Central Bank (ECB) will likely continue to tighten rates in the coming quarter, but the end of rate hikes is near. The US Federal Reserve (Fed) may have completed its rate hike cycle but is committed to keeping rates high for a considerable period of time. Central banks continue to be a negative factor in our outlook. Any signs toward a more dovish pivot by central banks would be a positive signal, in our view, and would likely improve the outlook for risky assets globally.

**IFI 2022 macro outlook**

	Growth (%)		Inflation (%)		Policy	
	IFI Forecast	Consensus	IFI Forecast	Consensus	Next Move	Consensus
<b>US</b>	1.4	1.1	4.3	4.2	We expect the Fed to pause at the current 5.00-5.25% range and stay there until early 2024.  In Europe, we expect a peak terminal rate of 3.75%.  In China, we don't expect aggressive easing measures in the near term.  In Japan, 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.	In the US, market consensus expects rate cut cycle to begin in November.  In Europe, we are slightly above consensus.  We are more conservative than the market on China's support measures.  In Japan, we are close to consensus.
<b>Europe</b>	0.9	0.6	5.7	5.6		
<b>China</b>	5.3	5.7	0.5	2.0		
<b>Japan</b>	1.0	1.0	2.2	2.4		

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

# 2

## IFI broad asset allocation (three-month outlook)

### Global duration: Overweight

In the medium term, we favor duration, but in the shorter term, bond yields are at the bottom of their likely ranges. Yield curves are very inverted, and the Fed is not expected to cut rates in the near future. This set-up will likely see bonds stuck in a range, with growth and inflation fundamentals favorable for bonds, but central banks using high interest rates to ensure that the inflation battle is won.

### US dollar: Neutral

Decent global growth and a near-term end to rate hikes in the US should support non-US currencies. It looks likely that the Fed will finish hiking rates before other major developed market central banks. That may be a headwind for the US dollar in the second half of 2023.

### Global credit: Slight overweight

Credit valuations have tightened in recent months, but the fundamentals of more favorable financial conditions, positive growth, and declining inflation are positive for credit. We favor high quality credit in investment grade corporate, municipal and securitized asset classes.

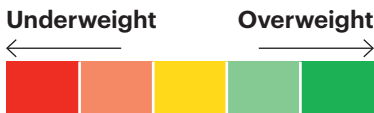
# 3



## IFI risk position (three-month outlook)

We are neutral on risk taking. While the macro backdrop is increasingly supportive of global markets, there are still significant uncertainties, and markets are priced for an orderly transition from central bank tightening to easing later this year. More hawkish than expected central banks or weaker than currently expected growth could create headwinds for asset markets and keep us somewhat cautious. We also highlight the potential risks of a US government default, as the path to an increase in the US debt limit is not clear in the current political landscape. A default, or near-term risk of default by the US government, would likely lead to underperformance of risky assets globally.

# 4



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

<b>US</b>					
Fundamentals					
Technicals					
Valuations					

### Long-term government interest rates

#### US

Slowing inflation and low growth argue for lower yields across the yield curve. But a very hawkish Fed is keeping short-term rates high, and limiting the downside for yields, given the very inverted yield curve. We continue to look for US 10-year Treasuries to be in a 3.0% to 4.0% range. At current levels, we are in the middle of this range and favor a neutral stance on duration.

<b>Europe</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

<b>China</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

<b>Japan</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

<b>USD</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

<b>EUR</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

## Europe

Our outlook for the European bond market is positive, despite the recent back-up in yields and continued hawkish rhetoric by most ECB members. While inflation remains well above the ECB's target of 2% and the service sector continues to prove resilient, forward looking indicators such as credit demand and growth have turned down. The cumulative impact of the rate hikes so far have yet to be fully felt by households and companies and, as they filter through in the coming months, our analysis indicates that the European economy will likely begin to slow, forcing the ECB to reappraise its tightening bias. With the market now pricing in a peak in rates of around 4%, we believe that rates will begin to fall as we move into the second half of the year.<sup>1</sup>

## China

Despite the international community's expectations of positive growth for China and a potentially high GDP number on the back of base effects, onshore investors have appeared more conservative. This has been reinforced by the government's relatively modest GDP growth target for 2023 and reflected in limited expectations for substantial easing efforts on the monetary and fiscal sides. Although yields have declined since mid-April, investor positioning might not be heavy at this stage. This could provide room for a potential further dip in bond yields, although there could be some consolidation at current levels.

## Japan

New Bank of Japan (BoJ) Governor Ueda's reluctance to signal an imminent end to Yield Curve Control at his first meeting has resulted in a sharp move lower in 10-year Japanese government bond yields over the past month, primarily driven by short covering. However, higher than expected growth and inflation data point toward the ultimate unsustainability of the BoJ's current policy stance. Although the BoJ only revised its forecast in April, recent releases make a further upward move at the July meeting likely. In addition, optimism on the sustainability of the inflation process should be reinforced by higher than expected annual wage negotiations. Aside from positioning, the fall in yields over the last month might stem from the market misinterpreting the launch of a 12 to 18 month review of policy by Ueda as effectively ruling out any near-term policy adjustments. However, he has said that the review would not prohibit a policy adjustment if inflation were sustainably above target. We believe the market will need to reflect more risk premium for an upcoming change in policy, pushing JGB yields higher.

## Currencies

### USD

We believe the near-term outlook for the US dollar is positive, given its recent underperformance, improvement in economic data and a rise in bond yields in the US. The resilience of the economy has surprised us so far but we expect the cumulative impact of the rate hiking cycle and the tightening of credit conditions following the SVB collapse will begin to weigh on the real economy. In that environment, the US dollar downtrend could continue to reassert itself, but only once we have navigated the debt ceiling challenges successfully.

### EUR

The recent move higher in the euro has stalled in recent weeks as rates in the US have moved sharply higher and fears of market disruptions driven by a debt ceiling impasse have supported the US dollar. While those dynamics are likely to drive the broad dollar mood in the near term, we are positive on the euro over the medium term and expect the currency to appreciate.

1. Source: Bloomberg L.P. Data as of May 24, 2023.

<b>RMB</b>	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

<b>JPY</b>	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

<b>US</b>	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

<b>Europe</b>	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

Although the USD/RMB exchange rate was led higher by US dollar strength in early May, we expect China's solid external sector fundamentals to support renminbi performance in the medium term. The Chinese central bank's statement May 19 showed its commitment to curbing one-way speculative moves of the currency. From a seasonality perspective, corporate dividend payments in the next two months could create corporate demand for dollars, but exporters' dollar supply could be a mitigating effect.

## JPY

The yen has depreciated by almost 3% against the US dollar over the last month, due to a combination of strong risk sentiment, higher US yields, positioning and disappointment that the BoJ did not signal an imminent shift in policy at its April meeting. However, looking forward, a number of factors should support the yen: Global growth sentiment is starting to wane, as Chinese data have disappointed expectations recently. Commodity prices have fallen sharply, supporting Japan's terms of trade. US debt ceiling related volatility could lead to a safe haven bid for the yen, as investors seek diversification and Japanese investors repatriate funds. Positioning is now also cleaner, after yen positions have stopped out over the last month.

## Credit

### Investment grade

#### US

We maintain a neutral outlook on investment grade after a volatile first quarter. Spreads ended Q1 just wide of where they started the year, after regulators stepped in to contain a potential banking sector crisis. Valuations are now bifurcated, with industrials trading rich to historical levels and financials trading wide of medium-term averages. Fundamentals remain neutral with a gradually weakening trend. Higher interest rates are leading to slower loan growth for banks and limit scope for further deleveraging in the industrial sector. Technicals have improved with new issue supply down compared to a year ago and positive flows into the asset class from both retail and institutional investors. Investors are moving out of cash to lock in yields for longer, as they anticipate the end of the Fed rate hiking cycle. Investors expecting a recession are also reducing equity allocations and moving into relatively safer fixed income. We expect US investment grade inflows – and investment performance - to benefit from this dynamic, as well as from a disinflationary environment for the rest of 2023 and into next year.

#### Europe

After tightening in early 2023, European credit spreads widened in March – mainly in the financials space - as bank solvency concerns originating in the US shifted to Europe and led to the bailout of Credit Suisse. While the macroeconomic outlook had improved somewhat at the start of the year, as energy concerns abated and geopolitical risk failed to proliferate, we are concerned that tightening financial conditions could weigh on the outlook for the second half of 2023.

That said, we believe that near-term credit fundamental deterioration should be minimal within the investment grade universe. Ongoing rate increases and the pursuit of quantitative tightening by the ECB have created meaningful headwinds, but we believe that overall valuations compensate for these risks with all-in yields at levels last seen during the 2011 sovereign crisis. As such, we maintain a neutral view on European investment grade credit, although we envisage a more supportive backdrop as we move through 2023, especially if risks around the banking sector continue to abate and we reach the peak in central bank rate hikes, helping to reduce interest rate volatility.

<b>UK</b>	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

<b>Asia</b>	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

<b>US</b>	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

<b>Europe</b>	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

<b>Asia</b>	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

## UK

We have a neutral outlook on sterling investment grade credit. Although spreads rallied in Q1, we still believe that valuations are compelling and we think current yields are attractive for pension schemes looking to de-risk. Given the index's heavy exposure to financials, sterling credit was especially impacted by concerns relating to financial solvency in the US and Europe, but our expectation is that this should prove relatively short-lived and contained. The Bank of England is still grappling with elevated inflation, which creates a headwind, but the reduction of the Asset Purchase Facility has proceeded more smoothly than feared, suggesting a good level of underlying demand for sterling credit. We would likely become more constructive once we are convinced that the hiking cycle is complete, but maintain a neutral stance ahead of this.

## Asia

We believe Asia's investment grade market will enter a period of consolidation, as valuations are not cheap versus their historical averages, in our view, or relative to their developed market peers. We believe the market needs to see solid fundamental improvements in Chinese and Asian macro data or company earnings to support further spread tightening. Nonetheless, we maintain our medium-term constructive view toward Asian investment grade. We believe Asia's fundamentals will continue to improve and support the asset class, as China's recovery progresses.

## High yield

### US and Europe

We remain cautiously optimistic about high yield. The positive backdrop includes yields that are high and underlying fundamentals that are in a fairly strong position. We believe the carry from going down in quality is likely to generate positive outcomes for investors, but we are wary of the lowest quality risk ahead of possible consumer retrenchment due to inflationary pressures and a less certain employment outlook. Hence, we like the carry offered by higher quality high yield, but we don't like the risk of extending into triple-C and speculative situations, absent idiosyncratic compelling value propositions. We also see compelling opportunities in short-dated high yield as the yield curve remains negatively sloped. Meanwhile, long-dated lower dollar bonds with improving credit fundamentals are also attractive, in our view, since most are higher quality, which offers better downside risk while offering upside price potential. While uncertainty tends to lead to fear and broad-based selling, we often find opportunities among forced sellers and/or fear-driven activity. Recently we added high quality positions in the banking sector and are actively looking for similar situations as we enter the latter stages of the cycle. Historically, these opportunities have benefitted high yield investors and longer-term returns.

### Asia

China's macro policies continue to support the property sector. Other Chinese high yield bonds should benefit from China's increasing domestic consumption, overall economic recovery, fiscal stimulus, and easier financial conditions. We believe negative headlines in the non-China Asian high yield space were idiosyncratic and that the financial health of most major bond issuers has been improving. Asian high yield is still trading wider than historical spread levels. We see the bonds as attractive from a risk-adjusted reward perspective, considering their short duration, high carry, improving fundamentals and benign market technicals.



<b>Sovereign</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green
<b>Corporate</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

<b>IG</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

<b>HY</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

<b>Taxable</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

## Emerging markets (USD)

We expect the environment to remain challenging for emerging market credit. The reduced likelihood of an economic soft-landing and persistent geopolitical risk, combined with somewhat tight spreads in the higher quality and more liquid areas of the market, continue to leave us cautious. However, this is tempered by historically attractive yields and decent fundamentals across the asset class, as well as significantly wider spreads in high yield. On balance, we are neutral on emerging market credit but with an increasingly positive orientation as valuations have begun to more fully reflect the macro headwinds cited above. If some macro uncertainty dissipates or valuations improve further, we would shift to a more positive stance on risk within the asset class. However, with overall yields at attractive levels, a moderately defensive position still allows us to benefit from the substantial carry offered by the asset class until more asymmetric opportunities arrive.

## Municipals

### Tax-exempt municipals

We maintain a positive outlook on tax-exempt municipals, and expect to see strong performance into the summer months. Credit fundamentals remain strong, as they were during the 2022 selloff, with upgrades continuing to outpace downgrades. The healthcare sector has some fundamental challenges that we are monitoring, but valuations have cheapened accordingly and provided some good idiosyncratic opportunities for hospital systems that we believe will outperform.

Technicals have been a positive driver of performance, given limited supply, and, going forward, we expect tax-exempt investors to return to the municipal market as interest rate volatility abates. The selloff of 2022 made tax-exempt municipal yields more compelling, and the asset class should be an area of refuge if bank related volatility continues to impact the broader markets heading into the summer.

One risk to our view would be forced selling of bank municipal portfolios if needed to meet redemptions, but we believe the market can handle such an event in an orderly manner, and could present medium to long-term buying opportunities.

### Taxable municipals

We are selectively positive on the taxable municipal market. Fundamentals remain strong and overall valuations appear fair relative to history, in our view. We are finding pockets of value, particularly in the healthcare industry and new issue market. Although the new issue calendar has been light, taxable new issues have generally done well as a broad range of investors have participated. These buyers have turned to the taxable municipal market seeking higher quality, longer duration, and/or diversified exposure. Hedging costs for foreign buyers remain elevated but have stabilized somewhat. Looking forward, we expect supply to remain muted but expect demand to remain elevated, and are, therefore, more positive on the technical outlook for taxable municipals.

<b>Agency MBS</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

<b>RMBS</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

<b>CMBS</b>	Red	Orange	Yellow	Green	Green
Fundamentals	Red	Orange	Yellow	Green	Green
Technicals	Red	Orange	Yellow	Green	Green
Valuations	Red	Orange	Yellow	Green	Green

<b>ABS</b>	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

Agency MBS delivered a positive return to begin the first quarter of 2023, but underperformed similar duration US Treasuries. Interest rate volatility remained at very elevated levels during the first quarter, which typically hinders MBS performance. Agency MBS now look attractively priced to us on both a nominal and option-adjusted spread basis. When interest rate volatility eventually normalizes, we expect higher coupon Agency MBS to perform the best. The prepayment outlook for Agency MBS is generally benign, given the large allocation to discount MBS. The net supply of Agency MBS should remain low in the first half of 2023, although there is the prospect of additional secondary market selling from the portfolios of SVB and Signature bank. The Federal Deposit Insurance Corporation intends to wind down the MBS portfolios of these two failed banks in a gradual and orderly fashion.

### RMBS

National home prices fell in the second half of 2022, but the pace of price decline has moderated as mortgage rates have stabilized. Low housing supply, positive demographic trends and shifts in housing preferences in favor of single-family properties are lending crucial support to the market. We expect loan losses to remain contained given strong underwriting, high levels of borrower equity and increased reliance on forbearance and modification for borrowers in distress. New issue demand was very strong to start the year, but has cooled on tighter spreads and as higher rates took hold later in the first quarter of 2023. Issuance is set to decline significantly versus last year on lower origination activity. Relative value across most RMBS subsectors has normalized, in our view, from ultra-cheap levels in early November.

### CMBS

Fundamental improvement has halted, as lending conditions have tightened. Valuations on commercial properties are declining as financing costs are higher than capitalization rates, given elevated borrowing costs. Servicers are beginning to receive borrower requests for maturity extensions or other relief from high coupons that await them upon loan maturity. Technical conditions for CMBS have improved significantly since 2022, given slower new issuance and modest dealer inventories. We favor targeted senior single-asset single-borrower (SASB) exposure collateralized by property types that are positioned to outperform in the post-pandemic environment.

### ABS

While employment conditions are still favorable for many ABS assets, we expect weakening trends to materialize. We are closely monitoring growth in revolving debt and lower personal savings rates. Technical conditions are weaker in the ABS market, as new issue markets are unsettled with bouts of spread widening needed to clear some deals. Higher yields at the front of the yield curve continue to provide support for ABS spreads, however. We believe ABS spreads are generally attractive relative to corporate bonds.

\*MBS is mortgage-backed securities. RMBS is residential mortgage-backed securities. CMBS is commercial mortgage-backed securities. ABS is asset-backed securities.

<b>US</b>	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

<b>Europe</b>	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

<b>CLOs</b>	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

## Bank loans

### US

Moderating inflation and wages have provided improved visibility regarding the end of the Fed's rate hiking cycle, especially given the recent shock to lending activity resulting from banking sector stress. This moderating outlook should lessen the risk of incremental cash flow pressure on issuers from even higher interest rates. Meanwhile, loan investors continue to reap the benefit of interest rates at 15-year highs via coupon income, although macro headwinds to demand make for a more challenging corporate earnings environment in 2023. While defaults are expected to rise from historic lows, we expect the increase to be manageable. Given the choppy capital market environment, 2023 issuance remains sparse while collateralized loan obligation (CLO) origination has so far been a supportive market technical.

### Europe

Energy concerns (and prices) continue to fade, reflected in improving purchasing manager index and confidence surveys, although geopolitical risks remain, with no near-term resolution evident. While bank stress came to the fore in recent weeks, the ECB continued to raise deposit rates – and remained sanguine on the European banking sector - with further hikes expected in the medium term, as core inflation remains sticky. In general, loan issuers have reported constructive inflationary pass-through actions, cash balances, debt service coverage ratios, and have shown a degree of de-leveraging. Loan defaults remain muted. The primary pipeline remains thin with deal flow (at attractive levels) occurring during periods of lower market volatility. The lack of new paper should continue to support secondary loan prices. CLO arbitrage continues to be tight.

### CLOs\*\*

On the back of strong first quarter CLO issuance, CLO creations are set to potentially slow into the second quarter of 2023. Lack of loan issuance has forced managers issuing CLOs in the first quarter to look to the secondary market to build portfolios, supporting loan prices. With the expectation that loan issuance will likely remain anemic in 2Q 2023, the arbitrage to creating a CLO remains challenged. Demand remains strong for investment grade tranches as international bank, insurance, and money manager accounts look to capitalize on attractive valuations created by continued macro volatility. The demand for sub-investment grade has remained firm for longer, cleaner new issue portfolios, although concerns remain regarding how junior-most tranches will handle increased loan downgrades, particularly the CCC rated tranches, and increased loan defaults off historic lows.

\*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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