Global Fixed Income Strategy

MAY 2025

In this issue

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Global macro strategy

US fiscal policy and the sustainability of government debt

The US economy has benefited from a fiscal boost since the pandemic, but adjustments may be needed going forward to maintain fiscal sustainability. As in other countries, the US government supported household and business cash flows during the pandemic but the US government was more generous than most other countries, leading to a build-up of excess savings in the US. The US continued to support the economy after the pandemic with initiatives such as the Inflation Reduction Act of 2022, aimed at addressing climate change, and the CHIPS and Science Act of 2022, aimed at boosting the domestic semiconductor industry, strengthening the nation's technology ecosystem, and increasing the US share of global semiconductor manufacturing capacity.

The downside of these generous policies was the accumulation of government debt. The US Congressional Budget Office (CBO) estimates that the net government debt-to-GDP ratio was 98% at the end of 2024, while the gross debt-to-GDP ratio was 122%.[1] These metrics have increased significantly in recent decades and rank high relative to other developed countries.[2]

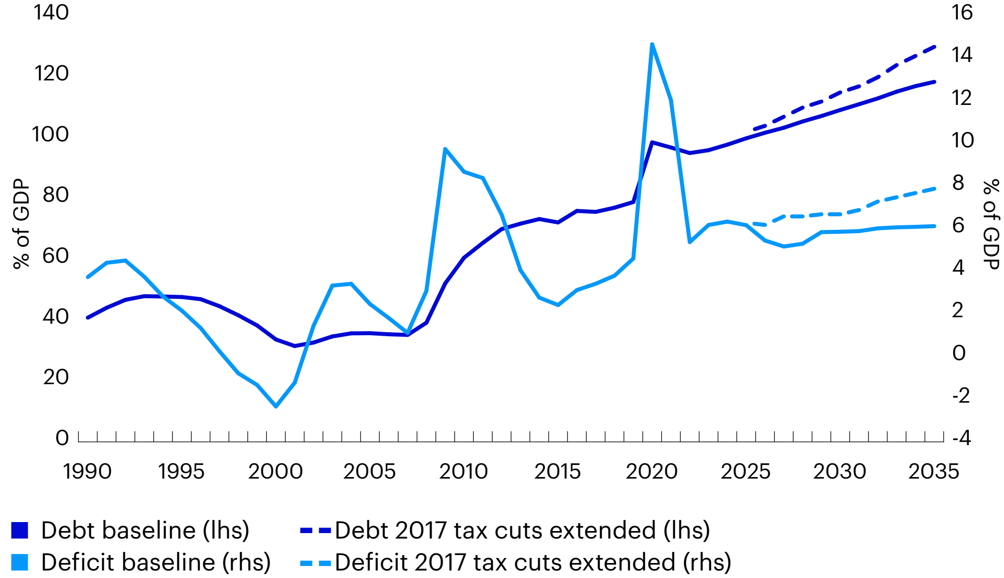
The extension of the Tax Cuts and Jobs Act (Trump 2017 tax cuts), and potential additional tax cuts currently being discussed by the US administration, are likely to put upward pressure on the US fiscal deficit, which is already at an uncomfortably large level. Such concerns were highlighted by Moody's' downgrade of the US's credit rating in May, citing large fiscal deficits and rising interest costs, and causing the US to lose its last triple-A rating.

In our view, Moody's' move is merely a symptom of a decline in the US's fiscal health over the past several years and does not offer markets new information. Other rating agencies, including Standard and Poor's in 2011, had already cut their US credit ratings to below triple-A. Consequently, the recent downgrade left little effect on markets after the initial shock value wore off. After the 2011 downgrade, most investment guidelines were rewritten to designate Treasuries as an eligible investment class generally, instead of specifically naming the triple A-rated bucket, meaning we would expect very limited forced selling as a result of Moody's' rating move. That being said, the reasons behind the downgrade – a large debt and debt service burden – are likely to be important going forward. Any news suggesting the need to increase Treasury issuance would likely drive Treasury yields higher and the yield curve steeper.

We discount hyperbolic comments about a US default, though there are refinancing risks looming – approximately USD8 trillion in Treasury notes and bonds are set to mature by the end of 2027.[3] Concerns that the Trump administration's fiscal framework could mean larger deficits raises fears around debt sustainability, which could put upward pressure on longer-term US Treasury yields. Tensions around raising the debt ceiling could also put pressure on US Treasuries during the period of negotiation. We have full confidence that the US debt limit will be raised, but the federal government's cash and extraordinary measures will likely be exhausted sometime in August and markets have already started to price US debt risks around that time.

1. Source: CBO. Data as of Dec. 31, 2024.
2. Source: OECD. Data as of Dec. 31, 2024.
3. Source: US Department of the Treasury. Data as of April 30, 2025.

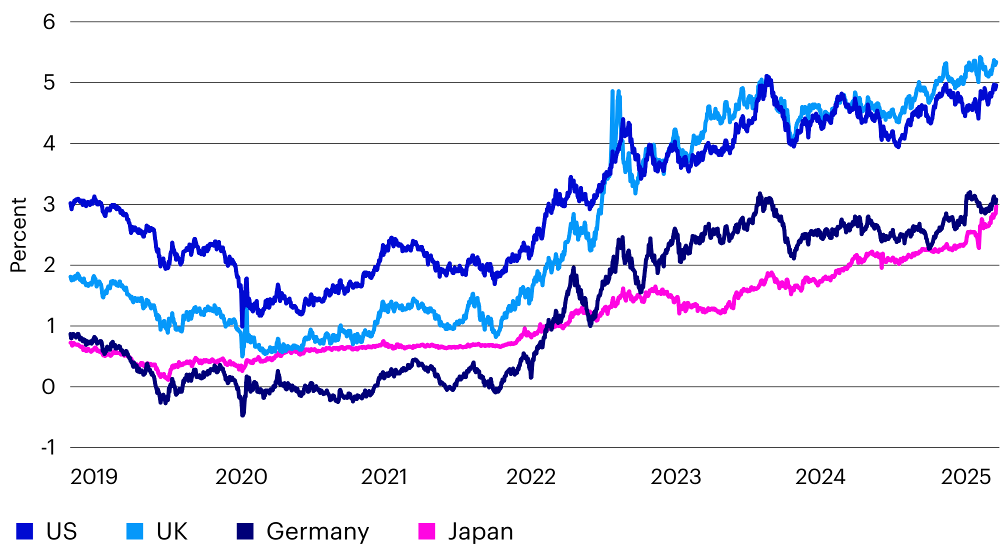
US federal deficit and debt estimates by CBO 1990-2035



Note: Annual data from 1990 to 2025, based on CBO (Congressional Budget Office) January 2025 estimates and supplementary estimates submitted to Congress in March 2025. Baseline estimates assume that the 2017 tax cuts are reversed in 2025 (as was originally planned). "tax cuts extended" variants assume those tax cuts are not reversed. "Deficit" is the total deficit and "debt" is net debt held by the public. Source: US Congressional Budget Office and Invesco Global Market Strategy Office.

This risk of larger US deficits going forward, and related worries about financing that deficit, come at a time when long-maturity government bonds have been generally performing poorly. Long maturity US yields have recently hit new highs, despite Fed rate cuts and the decline in shorter maturity bond yields. Global long-term bond yields have risen fairly steadily in the post-pandemic period. This upward momentum in long-maturity yields may be exacerbated by increased issuance needs in the US.

30-year government bond yields



Source: Macrobond. Data as of May 20, 2025.

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Interest rate outlook

US: Neutral

Earlier this year, we expected market participants to reduce their growth expectations due to growth-negative policies pursued by the Trump administration, such as tariffs and immigration measures. We believed these lower growth expectations would lead to lower long-term yields and increased expectations for Federal Reserve (Fed) rate cuts. However, Treasury risk premiums have risen for several reasons. These factors are varied and include the possibility of a larger budget deficit than previously expected and uncertainty about whether US domestic investors will step in to purchase US Treasuries, as foreign investors potentially reduce their demand. As a result, predicting the direction of the interest rate market has become significantly more challenging.

Europe: Neutral

The risk for eurozone interest rates is skewed to the downside, in our view, reflecting the negative growth and inflation effects of global trade uncertainty and appreciation of the euro. In the short term, these factors should overwhelm the impact of German fiscal easing. The European Central Bank (ECB) is likely to cut its deposit rate by a further 25 basis points to 2% in June, but we expect the pace of cuts to slow thereafter. This reflects the resilience of near-term data, with Q1 GDP growth stronger than expected, moderating but not collapsing PMIs and stable employment. Also, a 2% policy rate represents a return to what many ECB policymakers perceive as neutral. Further easing would represent a shift from normalisation to outright accommodation. ECB hawks, such as Isobel Schnabel, have expressed some discomfort with such a move, given that inflation expectations are higher than previously, supply shocks could pressure inflation and the labour market remains tight. In this context, market pricing of 55 basis points of further cuts looks roughly fair, in our view.[4] While the front end of the yield curve remains anchored, with some downside potential for yields, rising bond supply, reduced hedging demand from Dutch pension funds and rising global term premia will likely support long-term yields, leading to a further steepening of the yield curve.

China: Neutral

China's April economic data showed resilience, despite the 145% tariff imposed by the US during the month. Short-term yields remain well anchored by the dovish stance of the central bank, which is demonstrated by the recent rate cuts. The performance of longer-term yields is expected to be influenced by the scale of China's potential fiscal easing and equity market sentiment, which, if stronger than expected, could lead to yield curve steepening.

4. Source: Bloomberg L.P. Data as of May 23, 2025.

Japan: Neutral

Strong inflation and wage data mean there is asymmetric upside to Japanese short-term yields, in our view. The market is only pricing around 30 basis points of Bank of Japan (BoJ) rate hikes over the next 18 months, but if the trade war ends, the BoJ could hike as soon as July. It is more likely in October, with a probable scenario being two 25 basis point hikes over 18 months. Longer maturity Japanese government bonds (JGB), however, have sold off significantly in the last month; 10-year and 30-year yields are up 20 basis points and 30 basis points, respectively, since the end of April.[5] The cause of the long end sell-off is hard to pinpoint. Life insurance demand has been lacklustre and heavy supply and BoJ quantitative tightening (QT) has led to an excess of long duration bonds. Concerns about fiscal stimulus heading into July's upper house elections have also been cited as a possible catalyst. The selloff may lead the Ministry of Finance (MoF) and BoJ to consider modifying their issuance and/or QT programs to reduce pressure on longer maturities, but the timing of such a move is uncertain. The markets will likely watch the BoJ's QT review in June and MoF consultation with the market. If the authorities succeed in moderating long end volatility, we would expect life insurance and pension demand to rise, as valuations now appear attractive relative to foreign assets and domestic equities, in our view.

UK: Overweight

UK 10-year gilt yields are 30 basis points higher since the end of April, and close to the highs hit in late March following the Budget.[6] Domestic data have been relatively mixed: Q1 GDP was stronger than expected and April's core inflation data surprised to the upside. However, in both cases, there are reasons to suspect that GDP and inflation should moderate from current levels. The spike in inflation was exacerbated by seasonality around Easter and the underlying rate of consumption remains soft. Employment is slowing and most wage indicators are decelerating. The Bank of England (BoE) delivered what can be described as a hawkish 25 basis point cut in May to 4.25%, with the deciding factor being the intensification of concerns about global trade. BoE messaging suggests there is a relatively high bar to accelerating the cutting cycle. The market is now pricing short-term rates to remain in what the BoE views as restrictive territory for the foreseeable future, despite weak growth and a BoE inflation projection that declines toward 2% in two years. The skew of the distribution of short-term rates is therefore toward the downside, in our view. The long end of the yield curve is more complicated by the rise in global term premia. However, 10-year 10-year forward gilt yields are now over 6% in nominal terms and over 3% in real terms, which is a relatively attractive valuation for longer term investors, in our view.[7] Long-end supply pressures are also moderating, as the Debt Management Office has become more active in cutting long-end issuance and the BoE will potentially end active QT sales later this year.

Australia: Overweight

The Reserve Bank of Australia (RBA) made its second 25 basis point cut this cycle in May, taking the overnight cash rate to 3.85%. However, unlike the February cut, the RBA's forecast revisions and Governor Bullock's press conference struck a dovish tone. She stated that the cut was justified based on softer domestic inflation and consumption data alone, even before taking into account recent developments around the trade war, suggesting faster and deeper easing may be possible if the tariff war escalates. The RBA sees the trade war as having a net deflationary impact on Australia, potentially justifying further cuts. The RBA's shift in reaction function, despite resilient domestic labour market data, is noteworthy. Further cuts toward 3% now look likely. The Australian yield curve has followed the global steepening trend, though its starting point as one of the steepest yield curves among core developed markets should limit how much long-term yields can rise. Long-term forwards are now trading over 5%, which represents reasonable value, in our view, given Australia's subdued inflation and growth picture.[8]

5. Source for all Japan market data: Bloomberg L.P. Data as of May 23, 2025
6. Source: Bloomberg L.P. Data as of May 23, 2025
7. Source: Bloomberg L.P. Data as of May 23, 2025
8. Source: Bloomberg L.P. Data as of May 23, 2025.

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Currency outlook

USD: Underweight

The US dollar broadly depreciated in May, despite reduced trade-related uncertainty after the US and China reduced bilateral tariffs for 90 days and nominal interest rate differentials widened in favor of the US dollar. Although the US dollar has changed little against haven currencies, such as the Swiss franc, yen and euro, it has weakened against lower volatility Asian currencies, such as the Taiwan dollar and Korean won. This dynamic may reflect an increased repatriation of US dollar balances by Taiwanese and Korean companies and increased currency hedging by local life insurance companies in anticipation of pressure from the US to weaken the dollar. There may also be less willingness to hold US dollar assets in the face of policy-driven uncertainty. These dynamics may continue to weigh on the US dollar, given the US administration's seeming desire to include currency valuations in trade negotiations and the overweight US dollar position of many overseas asset holders.

EUR: Overweight

The euro is little changed versus the US dollar since the end of April, but we believe there is potential for further appreciation. We expect growth and interest rate differentials to narrow as the impact of policy uncertainty hits the US harder than Europe. This narrowing should incentivise funds to flow into the eurozone, as investors look for large liquid alternatives to US assets. However, the euro might have less appreciation potential on a trade weighted basis since, in our view, it is already relatively richly valued, especially relative to Asian currencies, such as the yen and renminbi. The euro offers little carry relative to these currencies, and a further downside shock could cause it to underperform the yen in particular.

RMB: Overweight

In the medium term, uncertainty over US policies and the reserve currency status of the US dollar are likely to cause the major non-US dollar currencies to outperform. Although the renminbi is less likely to outperform the euro or yen in the near-to-medium term under this scenario, we expect it to perform strongly against the US dollar.

JPY: Overweight

The yen has underperformed over the last month, as fears of a tariff driven recession have receded and global yields and equity prices have rebounded. However, risk markets are now pricing little risk premium for a recession, potentially reducing the scope for this factor to drive yen depreciation. Furthermore, the yen's correlation with US interest rates has fallen lately, potentially hinting at reduced foreign demand for US assets and/or an increase in currency hedging by Japanese investors. The combination of downside risk to global growth, which would likely lead to a narrowing of US and European interest rate differentials with Japan, and a potential for increased currency hedging or repatriation demand from Japanese investors, should support the yen.

GBP: Underweight

Our underweight position reflects our view that the British pound will likely underperform on a trade-weighted basis versus a conviction that it will depreciate against the US dollar. Our main justification is that interest rate differentials versus the eurozone and Japan are likely to narrow going forward, reducing the carry advantage enjoyed by the pound, pressuring the euro/pound exchange rate higher and the pound/yen exchange rate lower. The market is currently pricing virtually no narrowing in the interest rate differential between the UK and eurozone in the next 18-months. However, current interest rate differentials are historically wide, having been exceeded only in late 2004-2005 and 1999. The risk seems skewed to a narrowing as the more negative fiscal impulse in the UK weighs on growth in 2026 and UK inflation decelerates toward eurozone levels. The outlook for the pound is less certain against the US dollar. The pound might benefit from a reallocation of capital out of the US and the change in the interest rate differential is likely to be smaller than with the eurozone or Japan. Furthermore, it is worth noting that the UK, like the US, runs a current account deficit. It is therefore less likely to benefit from repatriation flows, compared to surplus currencies in Europe and Asia.

AUD: Overweight

The Australian dollar (AUD) has lagged other developed market currencies. However, the shift to a more Asia-led US dollar depreciation might cause the Australian dollar to play catch up going forward, especially if this is combined with Chinese stimulus that lifts commodity prices. The Australian dollar already looks undervalued relative to terms of trade and interest rate dynamics, in our view. The Australian dollar has room to outperform against non-USD currencies like the New Zealand dollar and euro, in our view, as it offers better carry and, in the case of the European currencies, less direct exposure to tariff risks. Also, Australia's large retirement or "Superannuation" schemes may raise their currency hedge ratios or sell foreign assets. Hedge ratios have been low, due to the Australian dollar's positive correlation with risk assets. However, if the currency diverges from US risk assets in particular, Super funds may move to hedge more of their currency risk.

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

Global credit strategy

We see value in the structured space

Each month the Invesco Fixed Income Team assesses relative value across global fixed income markets. This month, our Structured Credit Team sees value in the four major structured debt asset classes highlighted below.

Agency MBS

We favor being modestly overweight agency mortgage-backed securities (MBS). With slowing economic growth and potential Fed rate cuts, we believe agency mortgages are favorably positioned relative to corporate credit. Spread tightening in MBS has lagged the performance of corporates over the last month and valuations appear attractive relative to historical levels of MBS spreads. Mortgage index option-adjusted spreads are currently near the wide end of their range over the past decade. Progress on US trade negotiations reduces tail risks for growth and inflation, narrowing the range of economic outcomes, which may result in lower interest rate volatility. Lower volatility could benefit agency MBS spreads.

RMBS

We are positive on non-agency residential mortgage-backed securities (RMBS). Select profiles within non-agency RMBS provide an opportunity to earn higher yields relative to core fixed income. They also offer potential diversification from fundamental risks associated with tariffs and broader policy uncertainty. Though home price gains are likely to slow as the economy cools and inventory builds, we expect significant homeowner equity and conservative underwriting to limit borrower defaults and loan losses. We see the best relative value at the top of the capital structure, where securities have more structural protections to help insulate bondholders from losses if there is an economic downturn. Bonds backed by closed-end second lien loans (CES) and home equity lines of credit (HELOCs) are particularly compelling, in our view, given sound fundamentals, attractive carry and short duration profiles. Borrowers of CES and HELOCs have demonstrated pristine performance and prepayment behavior that is less sensitive to changes in interest rates compared to other mortgage securities. We also like AAA rated bonds backed by prime jumbo and non-qualified mortgages. While prepayment speeds of these mortgages are more sensitive to interest rate movements, we think these bonds still look attractive on an option-adjusted basis relative to similar duration investment grade corporate bonds.

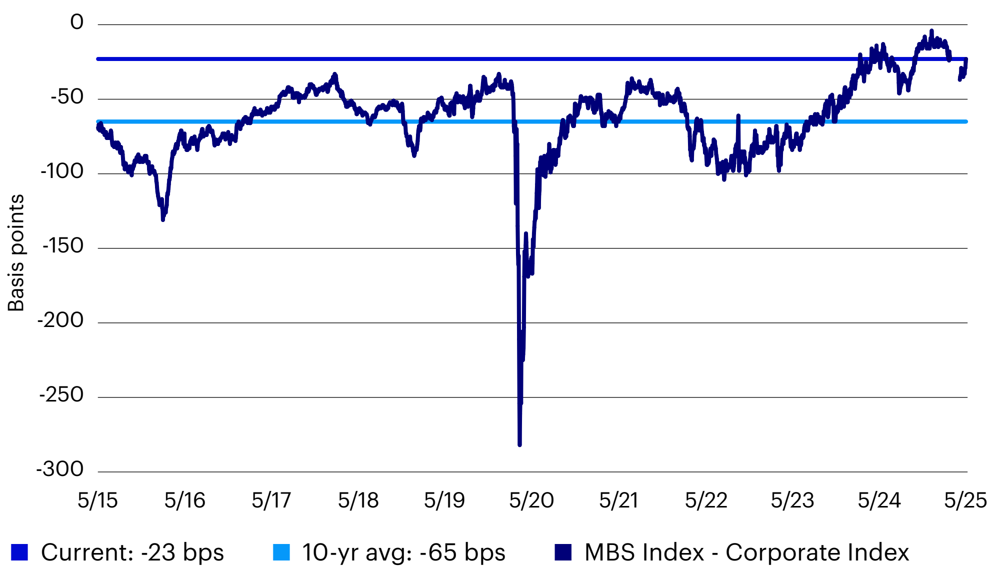
CMBS

While commercial mortgage-backed security (CMBS) spreads screen rich versus corporate bonds, we think certain positions look attractive. CMBS credit spreads have largely retraced their initial Liberation Day related widening, as investor primary and secondary market demand is returning. As a result, we remain somewhat cautious on multi-borrower conduit subordinate credit, as uncertainty around economic growth, increased market volatility and higher real interest rates create headwinds for near-term credit spread tightening. However, we think select senior and mezzanine CMBS positions look attractive as they're more insulated from fundamental deterioration due to their substantial subordination and low effective loan-to-value ratios and offer attractive carry. We're particularly focused on short-duration CMBS backed by properties with resilient cash flows and believe the single asset/single borrower sector provides the best way to capture value via targeted property exposure. At the property level, we favor an overweight in multi-family properties and we're generally positive on industrial warehouse, self-storage, and select office properties. In contrast, we are more selective in shopping centers due to lowered expectations for landlord pricing power and the rising potential for increased bankruptcies and store closures, as tariffs and slower consumer spending may impact retailer margins. We also believe that hotel asset selection has become increasingly important as the risk of recession rises. We are focusing on luxury hotels that benefit from leisure travel located in gateway cities, as we believe they would be less sensitive to a broader macro-economic downturn.

ABS

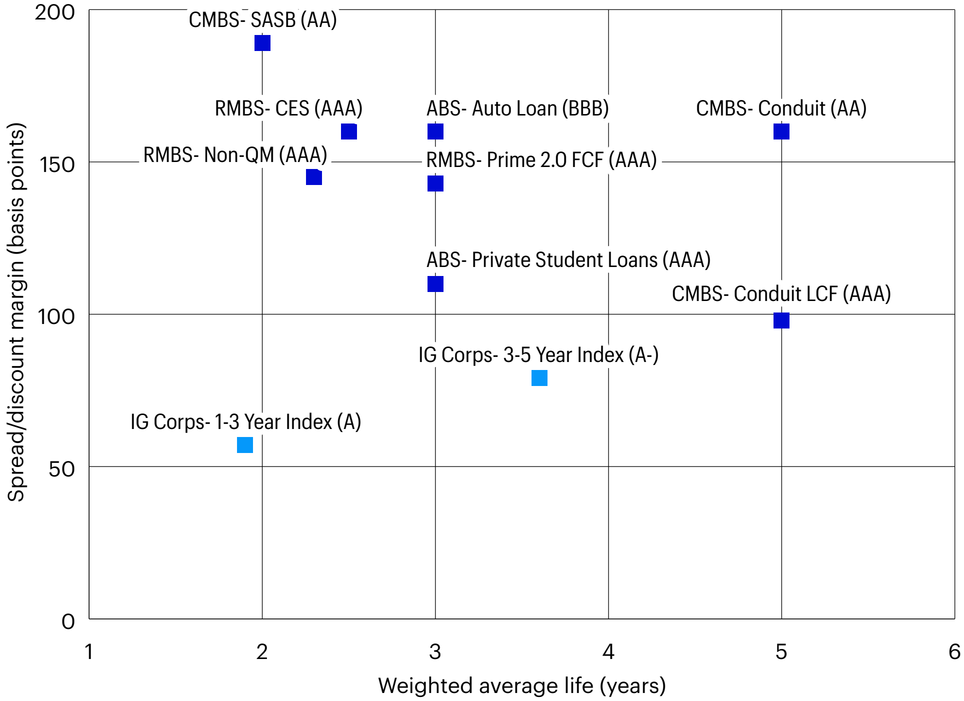
We see value across the asset-backed security (ABS) market, with value especially compelling in the private student loan and subordinate auto loan markets. We believe the refinance private student loan sector offers good value, given the stringent underwriting and fundamental strength of the borrower base, and fundamentals that are potentially insulated from a moderate slowdown in the economic cycle. Private refinance student loan borrowers typically have some form of graduate school degree in a field that would be considered lucrative by mean income standards. Specifically, we tend to see a large percentage of borrowers with masters of business, law, or medical doctor degrees. As such, the typical borrower tends to exhibit exceedingly high post-debt service free cash flow. On the opposite side of the credit spectrum, the auto loan market has shown resilience, as delinquencies are generally within historical ranges, though moderating from post-COVID lows, and used vehicle prices remain well anchored, thus supporting recovery rates. We believe the combination of ongoing consumer strength and used vehicle valuations provides for a compelling opportunity to add exposure across the credit spectrum in subordinated auto loan ABS, as the sector continues to offer a compelling relative value proposition, in our view, in a short duration, amortizing structure that has seen rating upgrades.

Figure 3: Relative value in Agency MBS looks attractive (MBS index spread - IG corporate index spread)



Source: Invesco, JPM DataQuery. Data as of May 13, 2025. Agency MBS Index is JP Morgan Research MBS Index. Investment Grade Corporate Index is JP Morgan US Liquid Index–IG Dollar denominated US corporate Bond Market.

Figure 4: Securitized credit relative value comparison



Source: For securitized spreads: Bank of America, Bloomberg, Deutsche Bank, JP Morgan, Wells Fargo. Bloomberg US Corporate 1-3 Yr Index is being used as a proxy for A rated fixed rate investment grade corporates. Bloomberg US Corporate 3-5 Yr Index is being used as a proxy for A minus rated fixed rate investment grade corporates. Data as of May 23, 2025.

Note: SASB is single asset single borrower. Non-QM is non-qualified mortgage. CES is closed-end second mortgage. FCF is front cash flow. LCF is last cash flow.

Panelists

Wim Vandenhoeck
Co-Head of Emerging Market Debt

Jason Trujillo
Head of Emerging Market Credit and Strategy

The bottom line

IFI's unified EM platform enhances EM investment capability and client experience

Invesco Fixed Income has recently made changes to its emerging market (EM) debt platform. Members of the EM Debt Team to walk us through these changes.

Q: Can you provide the history of IFI's EM debt capability?

Wim: Since the 2019 acquisition and integration of OppenheimerFunds, our EM local debt team, which focuses on investments denominated in EM currencies, such as the Brazilian real and South African rand, has been part of the Global Debt Team. While our EM credit team, which focuses on US dollar-denominated investments, has been part of the broader, public credit investment team, which includes US investment grade and high yield.

With this change, we have combined these two investment teams – EM local debt and EM hard currency credit – into one unified EM debt team.

Jason: In addition, we have moved our EM focused research personnel under this combined EM debt platform. Overall, this change gives us a fully consolidated EM debt platform that allows us to ensure a consistency of process and output, and aligns everyone behind a common purpose.

Q: This sounds compelling. What was the impetus behind this change?

Jason: Both teams have worked well together over the past five years, effectively sharing resources and ideas. We believed we could achieve even more synergies by bringing the teams together. We felt this formal combination was a logical evolution after years of informal collaboration and a way to enhance our already strong capability in EM debt.

Wim: There are a couple of facets to this. The first is that it is simply more effective from an investment and business standpoint to have our EM investment professionals united under one umbrella and focused on a common goal.

Second, it is better for our clients to be able to interact with one team on the full suite of EM debt capabilities.

And last, we see blended (a combination of hard and local currency) EM debt strategies as a key part of the future of this business. This combined platform enhances our ability to deliver on such strategies.

Q: Has there been any change in who is leading portfolio decision making?

Wim: This is an important question, as this combination only works if we are able maintain investment leadership continuity. From that standpoint, there is essentially no change. Jason Trujillo will continue to drive portfolio decisions for the hard currency portfolios, and I will do so for the local portfolios.

Jason: From a portfolio management standpoint, the main change is that we are now interacting on a daily basis, which I view as a benefit across all our EM strategies.

Fortunately, this has been a very smooth process. All of the individuals involved in the integration have been working together formally and informally for some time now. So, we had already established a high level of familiarity and trust, which has made the formal integration easy. Ultimately, our investment team is quite happy to have all the investment strategies that they have been supporting united under one platform.

Q: Do you think this change comes at an opportune time?

Wim: In our view, the investment opportunity in EM debt is as attractive as it has been in the past decade. We have the combination of compelling valuations across the asset class, in our view, and a macro environment that we believe is looking increasingly supportive of EM fundamentals. As such, we believe this is the ideal time to enhance our EM platform as we position ourselves to take advantage of this opportunity and deliver value for our clients.

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Non-investment grade bonds, also called high yield bonds or junk bonds, pay higher yields but also carry more risk and a lower credit rating than an investment grade bond.

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.

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