Invesco

Invesco Fixed Income

Multi-sector asset allocation outlook
Q3 2021

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IFI multi-sector asset allocation overview

Macro factor summary
The global economy continues to grow at above-trend rates and we expect the current bout of inflation to be transitory. Global central banks have conveyed that they will remain easy much further into the recovery than they have in the past.

Asset allocation summary
We maintain our underweight positions in global duration and the US dollar. We maintain a neutral position in global credit.

Risk position summary
We maintain a neutral risk position. Solid economic growth and very easy monetary policy are supportive of risky assets, in our view, but tight valuations are a significant headwind.

Senior Editor

Ann Ginsburg
Head of Thought Leadership
Fixed Income

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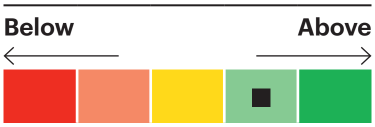
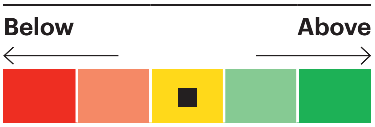
1

IFI macro factor outlook (three-month outlook)

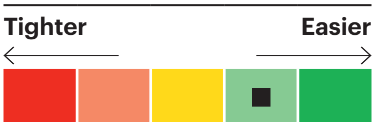
Factors vs. market expectations



Global growth: Above expectations
The global economy continues to grow at above-trend rates, as economies reopen after pandemic-related shutdowns and recovery powers ahead. The focus of growth is now moving toward Europe, where lockdowns ended after those in the US. US growth likely peaked (in quarter-on-quarter terms) in the second quarter of this year, but will likely continue to grow well above potential for the balance of this year. China, which was the first economy to reopen, is furthest along in the recovery and shows gently easing growth momentum.



Global inflation: At expectations
We believe the current bout of inflation will likely prove transitory. Inflation has been higher than expected so far in 2021 but has been related mostly to supply chain issues and pressures related to the reopening of economies. As the global economy returns to a more steady growth pattern, we believe the imbalances that have driven recent inflation prints will ease, and inflation will return to more sustainable levels, close to developed market central bank targets of around 2%. We will watch the labor market for signs of enduring wage inflation that may signal an upward move in longer-term inflation expectations.



Global policy and financial conditions: Easier than expectations
Global central banks continue to send the message that they will remain easy much further into the recovery than they have in the past. The US Federal Reserve (Fed) will likely keep interest rates at zero until unemployment is back to recent lows and inflation shows signs of persistently overshooting its 2% target. We believe the Fed will maintain its current pace of quantitative easing through the end of this year, and will not likely raise short-term interest rates until 2023.

IFI 2021 macro outlook

	Growth (%)		**Policy**	
	IFI Forecast	Consensus	Next Move	Consensus
US	7.1	6.6	We expect the Fed to taper asset purchases in early 2022 and hike once in 2023. We expect the ECB and BOJ to keep policy rates at the effective lower bound until at least end-2023. The PBoC's stance has tilted toward the tighter side, which is expected to continue in 3Q.	Consensus is broadly in line with our forecast.
Europe	5.0	4.5		
China	8.5	8.5		
Japan	2.6	2.6		

Sources: Invesco Fixed Income, Bloomberg L.P. Data as of July 15, 2021. IFI forecasts represent 6-month trends.

2

IFI broad asset allocation (three-month outlook)

Global duration: Underweight
Strong growth is likely to use up much of the spare capacity in the global economy, putting upward pressure on global bond yields over the coming year. This pressure is being offset by aggressive actions by global central banks, which is holding real yields at very negative levels. We expect yield curves to steepen, led by a rise in longer-term bond yields over the balance of this year.

US dollar: Underweight
As global growth broadens and improves relative to the US, we expect the US dollar to decline over the balance of the year. The Fed's commitment to keeping US interest rates low for an extended period of time, despite improving economic outcomes, should amplify downward pressure on the dollar.

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

3

IFI risk position (three-month outlook)

Solid economic growth and very easy monetary policy are supportive of risky assets, in our view, but tight valuations are a significant headwind. As the global economy transitions from the recovery phase of the economic cycle to a period of more stable growth, the pace of growth will likely slow, and this may be a mild headwind to overall risk taking. We expect market volatility may increase as a result, and overall market price action may become more two-way. We look to take advantage of corrections in the overall market to add risk back to portfolios that should be positioned neutral to credit and risky assets at the current time.

4

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

Underweight ←				→ **Overweight**
🟥	🟧	🟨	🟩	🟩

Long-term government interest rates

US		■			
Fundamentals		■			
Valuations		■			
Technicals			■		

Fundamentals still support an underweight in the US rates market, in our view. While the COVID-19 Delta variant could threaten our baseline view, we do not yet see data to support a change in our view, which is robust growth and elevated, noisy inflationary pressures. Therefore, we expect the economic recovery to continue at a broad level in the US. Inflation data continue to show signs of strength, with COVID-related sectors getting hit with pricing pressures. We believe the Fed is willing to be patient in the wake of improving growth and a messy inflation picture given its Average Inflation Target mandate. We are likely to see rates pressured higher as a result, particularly at the long end of the yield curve. Recent declines in Treasury yields seem to be related to positioning unwinds and concerns about the Delta variant. We expect upward pressure on US yields due to fundamentals to reassert itself in the coming period.

Europe		■			
Fundamentals		■			
Valuations		■			
Technicals				■	

As the European economy opens further and optimism and growth have rebounded, surprisingly, European bond yields have fallen back to levels last seen during the winter COVID wave. While this dynamic can be partly attributed to the spread of the Delta variant in the region and a potentially a slower reopening for some countries, the fact that the European Central Bank will likely mop up all net supply for the remainder of the year is a powerful driver of bond prices. While our analysis indicates that bond yields should be higher in the second half of the year given the robust recovery, we suspect that, absent a rise in global bond yields, European bonds may struggle to sell off.

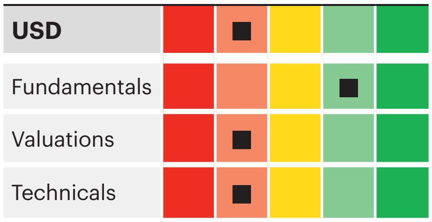
China			■		
Fundamentals				■	
Valuations			■		
Technicals		■			

We continue to be neutral on Chinese onshore government bonds. China's economic growth momentum, as we have expected since late last year, has come in weaker than market expectations. Interbank liquidity has been relatively stable and the central bank (PBoC) has managed market expectations well through open market operations. At the current juncture, we are not convinced that the recent cut in the reserve requirement ratio (RRR) is the start of an easing cycle. As mentioned by the PBoC, the liquidity released from the latest RRR cut was to mitigate the liquidity drainage from the medium-term lending facility (MLF) and tax payment. There is a sizable maturity wall of MLF and we expect relatively heavier rates bond supply pressure in the second half of 2021. We will be watching how the central bank manages the MLF maturities in the third quarter before reassessing our investment view.

Japan		■			
Fundamentals			■		
Valuations		■			
Technicals		■			

10-year Japanese government bond (JGB) yields have fallen to their lowest level this year, largely in response to the global decline in yields led by long-term US Treasuries. However, with yields now at two basis points, there is limited scope for a further decline, in our view. Banks are unlikely to buy 10-year JGBs below 0% when they can receive 0% from the Bank of Japan (BoJ) on their excess reserves. In addition, the BoJ again cut the size of its quantitative easing (QE) operations for the July – September period. If the current pace of QE operations is maintained for the next 12 months, it should result in an increase in gross JGB supply, net of QE, with the majority of the increased supply in the 6 to 10-year and 11 to 20-year maturity buckets. If the global recovery persists, it is also likely that foreign central banks will start to increase interest rates, incentivising Japanese investors to seek higher yields abroad.

Currencies

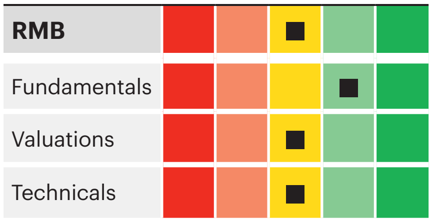


USD		■			
Fundamentals				■	
Valuations		■			
Technicals		■			

The US dollar has seen support following the June Fed meeting and more recently due to developing concerns about the Delta variant. Recent inflation data have revealed that COVID-related sectors continue to be the most impacted — consistent with our view that these pressures are transitory, which should allow the Fed to be patient in its policy stance. Therefore, over the longer term, we expect the Fed to continue to be one of the more accommodative central banks globally, pressuring the dollar lower as investors seek higher yields elsewhere. That said, the direction of the US dollar in the near term could be less clear than expected. While we see no reason to change our baseline view that the US re-opening will continue, we could see a global impact on the recovery if the Delta variant gains momentum, particularly in areas where vaccine distribution has been less successful. This could provide safe-haven support to the dollar, as investors grow concerned about the global impact. We are watching this closely.

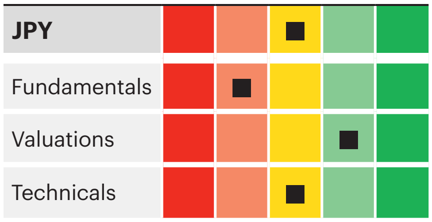
EUR		■			
Fundamentals			■		
Valuations			■		
Technicals			■		

With the US economy powering ahead and the European Union contemplating the response to the Delta variant and implications of easing restrictions, we remain cautious on the euro, especially versus the US dollar. The uncertain implications of the Delta variant may provide the ECB with the cover to maintain very easy accommodative policies well beyond the September meeting. The ECB recently announced an updated framework for monetary policy, suggesting that it would tolerate above-target inflation. Simply put, rates are going nowhere, and the euro is unlikely to appreciate much in that environment.



RMB			■		
Fundamentals				■	
Valuations			■		
Technicals			■		

We expect the renminbi to consolidate in the near term on the back of the US dollar's strength against major currencies. However, we continue to be positive on the renminbi's performance against the US dollar in the medium term. This is due to favorable fundamental and policy factors, which could support the renminbi's appreciation momentum. In addition to strong export data, which have continued in recent months, the softening of US-China trade tensions in the past few years could provide a catalyst for the renminbi's performance. We expect a relatively limited impact on net capital flows from China's upcoming measures to open more channels for capital outflows.

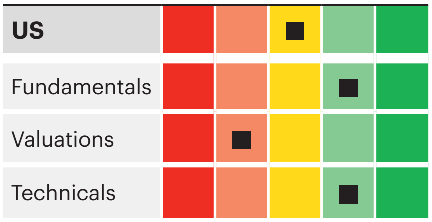


JPY			■		
Fundamentals		■			
Valuations				■	
Technicals			■		

The Japanese yen has been relatively stable versus the US dollar over the last month, but has outperformed the euro and higher beta currencies, such as the Australian dollar. The move probably reflects weaker risk sentiment, lower international bond yields and a reduction in short yen positioning. Although, the recent spread of the Delta variant might weigh on risk sentiment, potentially supporting flows into the yen as a safe haven, in the medium term, the prospect of higher yields internationally, higher commodity prices and increased merger and acquisition flows should all weigh on the yen.

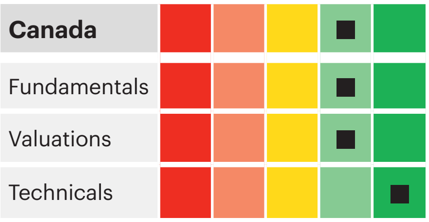
Credit

Investment grade



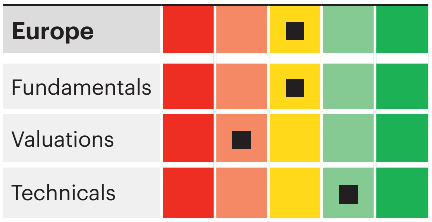
US			■		
Fundamentals				■	
Valuations		■			
Technicals				■	

Corporate fundamentals continue to improve as growth and earnings, especially in the US, have shown remarkable resilience over the last year. We anticipate continued deleveraging in the second half of 2021, but may see further merger and acquisition activity, given the highly conducive environment. Foreign demand continues to be strong as developed market investors seek yield in US debt markets while benefiting from reduced currency hedging costs, which continue to trade near cycle lows. Liquidity remains robust as central banks continue quantitative easing and hold short-term rates near the zero bound, despite surging inflationary pressures. We remain constructive on the investment grade asset class due to the improving economic environment, but valuations may limit appreciation given the tightest investment grade spread levels in decades on an absolute and duration-adjusted basis.



Canada				■	
Fundamentals				■	
Valuations				■	
Technicals					■

The pace of vaccinations has accelerated across Canada, leading to economic re-opening and stronger domestic demand, which should persist for the remainder of 2021. The Bank of Canada will likely continue its moderate path of bond tapering given how well markets are functioning on their own, but we don't expect this to impact credit markets. Valuations remain attractive, in our view, given the high all-in yields and additional compensation from corporate bond allocations, given the strong economy and still loose policies. Relative valuations have become even more compelling, in our view, for outperformance into year end.



Europe			■		
Fundamentals			■		
Valuations		■			
Technicals				■	

In Europe, we maintain a neutral allocation to European investment grade credit. A strong spread performance year-to-date has taken valuations to relatively rich levels, but this has been compensated by an improving macroeconomic outlook, which has reversed the rating agency risk in our view. Although the European vaccine rollout will likely lag other regions, year-over-year economic comparisons are favorable and there is likely to be pent-up demand supporting some sectors that were disproportionately impacted in 2020. The technical picture remains supportive with the acceleration of the ECB's bond purchasing program (PEPP) likely to support spreads, especially if issuance follows its usual seasonal pattern of being modest over the summer. While this could allow modest spread compression, we expect carry to be the predominant driver of excess returns from here.

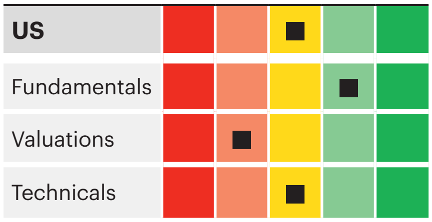
UK			■		
Fundamentals			■		
Valuations		■			
Technicals			■		

A rapid vaccination rollout in the UK and the removal of the "no deal" Brexit overhang is improving the fundamental outlook after an extremely challenging 2020. Although company management teams are still adopting a conservative approach to their balance sheets, we are starting to see "event risk" emerge as private equity sponsors look for undervalued assets. Nevertheless, we continue to see strong demand for sterling credit from pension schemes, which remains a strong driver of technicals. This has helped remove what had been a persistent "sterling credit market premium." We also believe the Bank of England would rapidly resume its bond buying scheme if financial market conditions deteriorated.

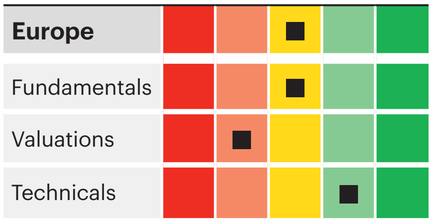
Asia			■		
Fundamentals			■		
Valuations				■	
Technicals			■		

The market appears to expect growth to accelerate across the Asian region helped by a faster pace of vaccinations, which is positive for Asian investment grade issuer credit fundamentals. However, idiosyncratic risks are the dominant theme for certain sectors. Valuations of Chinese and Indonesian credits remain relatively attractive, in our view, but onshore Chinese credit events and potential changes in US policy could weigh on sentiment toward Asian IG credits in general. We expect ongoing credit differentiation in Chinese state-owned enterprise/local government financing vehicle (SOE/LGFV) bonds and we believe credit selection remains critical.

High yield



US			■		
Fundamentals				■	
Valuations		■			
Technicals			■		



Europe			■		
Fundamentals			■		
Valuations		■			
Technicals				■	

The high yield market is benefitting from strong fundamental tailwinds, offset by valuations that limit the total return potential for the asset class, in our view. The economic backdrop provides a sweet spot for high yield: US growth is strong bolstered by a recovering global economy. This is leading to steadily improving credit fundamentals and rapidly declining default rates. The outlook for defaults is exceptionally low. Meanwhile, some uncertainty over the recovery is keeping the Fed accommodative, in spite of clear inflationary pressures, which tends to benefit risk assets, including high yield. Although valuations are tight by historical measures, we believe spreads more than sufficiently cover the near-term default outlook and appear even better on a quality and duration-adjusted basis. The high yield market is currently of higher quality and shorter duration (limiting rate sensitivity) than usual. Issuers of debt have exhibited reasonable constraint in recent quarters, leading to far less aggressive issuance than we would normally see at this stage of the cycle and given these relatively low yields. In this environment, our portfolio focus is on 1) lowering interest rate sensitivity, 2) avoiding highly leveraged, lower rated bonds with insufficient yields to compensate for such risk, 3) investing in improving credits that may benefit from rating upgrades and 4) a modest overweight to targeted energy issuers and other recovering situations where we believe we are paid for incremental risk.

Asia			■		
Fundamentals			■		
Valuations				■	
Technicals			■		

Chinese property developer sales have been resilient year-to-date, despite policy tightening. We expect further divergence within the Chinese property sector, depending on the execution of sales and refinancing conditions. We expect weak sentiment to persist in the near-term amid shaky confidence in the Chinese high yield property space. Rising commodity prices should benefit Indonesian high yield issuers. Credit differentiation is crucial and some short-dated single-B bonds could provide good carry, in our view.

Emerging markets (USD)

Sovereign			■		
Fundamentals			■		
Valuations			■		
Technicals				■	

Corporate			■		
Fundamentals				■	
Valuations		■			
Technicals				■	

We have moved to a neutral stance on emerging market hard currency debt (from modestly positive). The primary reason for the shift is a somewhat weaker technical outlook. Uncertainty about US real interest rates prevails, reducing return expectations for EM hard currency debt. We also expect somewhat less favorable supply/demand conditions, though global liquidity remains very supportive. One area of improvement has been corporate fundamentals. First quarter earnings beat expectations and we expect trailing twelve-month earnings to peak by the fourth quarter. Growth will likely be led by commodities, industrials and real estate. We also expect net leverage and default rates to continue to decline. Our view on sovereign fundamentals remains neutral. An improved cyclical outlook and positive terms of trade shock for commodity exporters provides support against deteriorated fiscal positions as a result of the pandemic. Valuations are a mixed bag, in our view. Spreads are tight relative to history for the highly rated credits but we believe they offer value in high yield and select triple-B names.

Municipals

IG			■		
Fundamentals				■	
Valuations		■			
Technicals					■

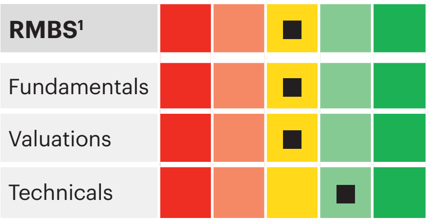
HY			■		
Fundamentals			■		
Valuations		■			
Technicals					■

The municipal market remained strong in the second quarter, as the US was back open for business and flows into the asset class were consistently positive amid the prospect for higher tax rates and the relative appeal of municipal returns. Along with an improving economic backdrop, market technicals have also been strong with record inflows against manageable issuance thus far in 2021 and expectations for net negative issuance in the third quarter. We saw more spread compression in the second quarter amid the technical strength, which has supported high yield and investment grade performance. Valuations are tight, in our view, with municipal to US Treasury ratios hitting, and floating around, record highs, while credit spreads are at or near pre-pandemic levels. Although valuations are tight, we expect continued positive flows and solid demand, creating strong technicals and a market supportive of positive, albeit limited, upside as we look toward the third quarter.

Structured

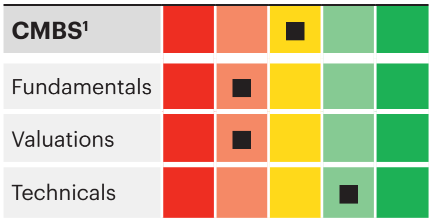
Agency MBS[1]		■			
Fundamentals			■		
Valuations		■			
Technicals			■		

Agency MBS underperformed US Treasuries in the second quarter as spreads widened in light of eventual Fed tapering and extremely rich starting valuations. We still expect the Fed to support Agency MBS for many years to come as tapering is expected to be gradually reduced and paydowns will likely be reinvested for a number of years, assuming past episodes of quantitative easing are a reasonable guide to the current experience. Prepayment risk is moderating as many borrowers have already refinanced their mortgages, given how long interest rates have remained low. Implied volatility of interest rates remains elevated, however, increasing the risk of owning Agency MBS. On the technical front, net supply should remain very high in 2021. Domestic bank demand has remained strong and non-US buyers have stepped up the pace of purchases versus earlier this year. Within TBA mortgages, our favorite coupons are 2.5% and 3.0%.



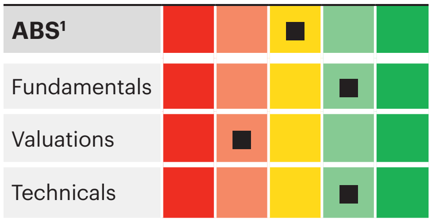
RMBS[1]			■		
Fundamentals			■		
Valuations			■		
Technicals				■	

Home prices continue their ascent, with low mortgage rates and strong demographic trends providing strong demand amid limited supply. Higher home prices are pressuring affordability and we expect some moderating of recent double-digit home price gains. Fundamentals continue to be a distinct positive in this sector with strong equity positions, tight underwriting and strong housing technicals providing an exit for homeowners needing to sell. Spreads have firmed after cheapening earlier this spring and are now near the tighter end of their range. We currently favor higher quality bonds for carry and expect range-bound spreads near current tight levels.



CMBS[1]			■		
Fundamentals		■			
Valuations		■			
Technicals				■	

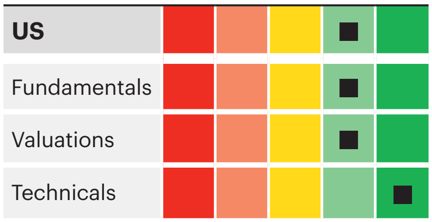
Fundamental trends in CMBS property markets remain generally challenging. However, as vaccinations rates in the US rise and re-opening continues in the leisure travel sector, we are seeing meaningful improvements in lodging and retail. Property prices have held up better than expected, with pockets of expected weakness in regional malls, in particular. Valuations further down the capital structure in conduit CMBS continue to look less attractive, in our view, and we prefer to focus on opportunities in single-asset single-borrower (SASB) exposure in certain property types such as warehouses, medical/life science, data centers and senior housing, to name a few.



ABS[1]			■		
Fundamentals				■	
Valuations		■			
Technicals				■	

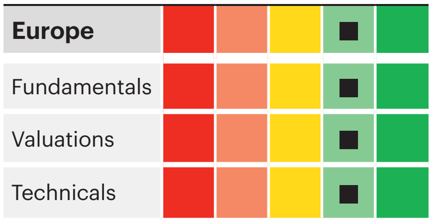
Fiscal stimulus and tax returns have been positive for the US consumer. Delinquencies and losses remain below pre-pandemic levels for many consumer-related ABS. Additionally, projections of strong future growth support several commercial and selected esoteric ABS sectors, while risks remain for emerging market aircraft. Investor demand has remained quite strong for ABS, with dealer inventories low and new issue demand high. Senior ABS valuations appear full, with limited tightening potential, in our view. Spreads in certain esoteric ABS sectors that we favor, such as container and whole business securitizations, are still wider than pre-pandemic levels and offer opportunities to outperform, in our view, as fundamentals continue to improve.

Bank loans



US				■	
Fundamentals				■	
Valuations				■	
Technicals					■

With reopening well underway and aggregate demand improving with it, corporate credit fundamentals continue to strengthen. A broadening earnings recovery and abundant liquidity (both on issuers' balance sheets and in capital markets) contribute to vanishingly low levels of distress in the loan market and to rapidly falling near-term default expectations. Market technicals, meanwhile, remain highly supportive of loan prices, stemming from robust collateralized loan obligation (CLO) origination activity and consistent inflows from retail and institutional accounts. Recently updated policy rate guidance from the Fed, which pulled forward rate hike expectations, adds to the loan-friendly macro backdrop. These dynamics — strong demand and constructive fundamentals — together have resulted in a buoyant loan price environment that has encompassed the entire risk spectrum.



Europe				■	
Fundamentals				■	
Valuations				■	
Technicals				■	

The COVID vaccine roll-out across Europe, cautious ECB policy coupled with recovery aid, and improved consumer sentiment will likely be positive for European loans in the third quarter. Macro indicators, such as purchasing manager surveys, imply a strong economic rebound in the second half of 2021. Leveraged buyout and CLO activity should provide technical momentum, partly offsetting refinancing transactions (at a lower margin). We believe defaults will remain low in the upcoming quarters, especially as the number of distressed credits — loans trading at deep discounts below par — remain low.

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

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. Past performance is not a guide to future returns.

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.

Important information

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