Invesco Insights

Invesco Broad Fixed Income | August 14, 2011

A Closer Look at Fixed Income

Assessing the effects of the downgrade on specific sectors

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Overview

Fixed income markets are dynamic and complex, and each fixed income asset class is unique in its level of exposure to the U.S. sovereign rating downgrade by Standard & Poor's (S&P). So, while I've taken a high-level view of the downgrade's effects so far, at this point, I think it would be helpful to drill a little deeper into these various asset classes.

Invesco Fixed Income believes the markets are best navigated by independent specialist decision-makers who are interconnected as a global team. In this piece, I've brought together five investment leaders from across Invesco Fixed Income to provide a deeper look into eight asset classes. They'll assess how these asset classes have been affected – or unaffected – by the downgrade that lowered long-term U.S. ratings from AAA to AA+ and subsequent downgrades on other U.S. bonds, and provide their outlook on what investors can look for next.

- Cash
- Municipals
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- High Yield
- Emerging-Market Debt
- Global Investment-Grade Credit
- Structured Securities
- Bank Loans

Lyman Missimer
Head of Global Cash Management
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Cash

Assessment: The cash management sector has been business as usual. The most important item for money market investors to know is that S&P affirmed the short-term rating of the U.S. at A-1+, which is S&P's highest rating for short-term sovereign debt. That means the downgrade of U.S. long-term debt has no material impact on Invesco's money market portfolios. After S&P affirmed that rating on Aug. 5, short-term markets remained well-functioning.

Outlook: Invesco's Global Cash Management team continues to monitor market developments, but at this time, we see no need to change our strategy, which seeks to preserve principal and liquidity by investing in high-credit-quality securities with shorter maturities.

Municipals

Assessment: Subsequent to downgrading U.S. long-term debt on Aug. 5, S&P lowered its ratings on thousands of U.S. government-backed municipal bonds from AAA to AA+ on Aug. 8. However, in the following days, the yields on these bonds remained largely unchanged, which we believe is an affirmation of the market's favorable view of U.S. creditworthiness.

When assessing their exposure to the U.S. sovereign downgrade, municipal bonds can be divided into three categories:

- **Directly linked.** S&P's municipal bond downgrade was limited to this category. It lowered its ratings on prerefunded bonds, which are backed by U.S. Treasuries, as well as bonds backed by the government-sponsored agencies Fannie Mae and Freddie Mac. Despite the one-notch downgrade, the prices of these bonds largely remained stable in the following days.

Simply put, the market has recognized that the rating change does not affect the issuers' ability to pay off debt. Prerefunded bonds make principal and interest payments from Treasuries that are held in escrow for that purpose and Treasuries have rallied post-downgrade, as of this writing. While some housing bonds are guaranteed by Fannie Mae and Freddie Mac, revenues are raised through mortgage payments. Also, housing bonds have collateral, reserve funds and, generally, additional backing from state housing agencies.

- **Indirectly linked.** These bonds have no explicit government guarantee, but are affected by the U.S.'s ratings as their issuers partially depend on federal backing. This includes state and local governments and other entities – for example, hospitals that receive Medicare and Medicaid payments.

As of this writing, no state or local governments have been downgraded as a result of the U.S. sovereign debt downgrade. S&P has indicated that the less federally dependent entities may be able to retain their AAA ratings. However, we recognize that the full effects of federal spending cuts and entitlement reforms on bond issuers will become clearer only over time.

- **Resilient.** These bonds have a low reliance on the U.S. government. They include higher education, utility and revenue bonds. We believe these bonds should not be directly affected by the U.S. long-term sovereign debt downgrade, and should see little impact from federal spending cuts, although any macroeconomic ripple effects may affect future credit quality.

Outlook: As a result of our investment strategies over the past few years, we continue to overweight revenue bonds and underweight state and local general-obligation (GO) bonds within our portfolios.

While Invesco's Municipal team believes the market will experience some volatility over the next few quarters, we do not see any increased risk of default for municipal bonds overall. Additionally, we expect the issuance of new municipal bonds to stay at historically low levels,[1] continuing the current supply/demand imbalance that has helped drive municipal yields significantly lower since the start of 2011.

Carolyn Gibbs
Co-Head of U.S. Taxable Fixed Income
and Global High Income

U.S. Investment Grade

Assessment: Concerns about another recession are rising as U.S. and global economic growth have shown signs of deteriorating:

- The U.S. Federal Reserve's (Fed) "mid-2013" policy commitment effectively caps short-term interest rates and likely pushes investors further out the maturity spectrum in search of yield.
- While corporate balance sheets look quite strong, policy uncertainty and signs of slower economic growth have hampered investor confidence and pushed risk tolerances lower:
  - Policy uncertainty has resulted in less clarity regarding future earnings and capital expenditures.
  - Government expenditure reductions have the potential to significantly influence the economy generally as well as specific sectors of the market, including health care and defense.
- European policy choices for the sovereign debt crisis are viewed as too limited in scope to eliminate the underlying problems.

Outlook: The Fed is on hold, and we anticipate a low growth environment for an extended period. With short-term Treasury yields as low as they are, we anticipate investors seeking greater yield further out the curve. Nevertheless, in this volatile environment of risk on/risk off, we believe positioning for a yield-curve flattening presents a more attractive risk-reward tradeoff than an outright call on rate movements.

We have seen credit spreads widen in the face of concerns about slowing economic growth. Although signs of a possible U.S. recession have grown over the summer (sustained high unemployment, a depressed housing market and the lowest consumer sentiment in more than three decades[2]), we still don't believe recession is the most likely scenario. Barring an outright recession, in a slow growth environment, we feel companies should be able to adequately service their debt, so the upward pressure on spreads should be minimized. Nevertheless, some companies are bound to be more affected by upcoming cuts in government spending and a slowing economy than others; Invesco's team of credit analysts will continue to help us seek those companies that, in our opinion, are positioned to weather this environment best.

High Yield

Assessment: Fears of a renewed financial crisis and recession have dampened investors' appetite for risk.[3] We believe the investing public is experiencing low expectations that the government has the ability to stimulate growth, and that upward pressures on yields in the high-yield market have increased, not decreased. We see the Fed assurance of low short-term rates as intensifying the pressure for investors seeking yield to turn to higher yielding assets. Unless we experience dramatic economic weakness – i.e., a recession – we believe companies should be able to generate adequate cash flows to service their debt, thereby making a dramatic increase in defaults unlikely.

Outlook: Our view is that high-yield bonds don't require strong economic growth to perform, only the presence of growth. Ultimately, bonds are between companies and investors, so we believe it will take a recession to create meaningful realized losses in the high-yield bond arena, outside of individual issuer problems. We do believe we are likely to see volatility in high-yield bond prices as economic news supporting or refuting better growth is released.

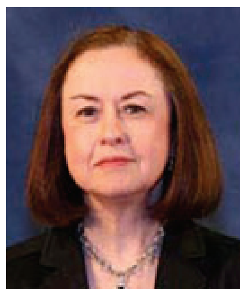
Our strategy of focusing on the credit cycle has our risk positioning in the middle of the high-yield credit spectrum. The market experienced a major down cycle in late 2008 and has had insufficient time since then to build up new excesses in terms of credit risk. Most activity since the last cycle bottom at the end of 2008 to early 2009 has been refinancing, not funding speculative ventures. The primary excess thus far has been in terms of weaker bond covenants, not increased leverage or speculative projects; we believe that leaves companies able to service their debt even in a weak growth environment.

Emerging-Market Debt

Assessment: We believe the S&P downgrade will have a greater effect on U.S.-dollar-denominated emerging-market (EM) bonds than local currency EM bonds, for several reasons:

- The downgrade prompted short-term risk aversion in the markets and a broad U.S. dollar rally, as there are few alternatives to the U.S. bond market that have the same depth of liquidity. However, we view this as a medium-term positive for EM currencies, as the elements that contributed to the downgrade (political concerns, need for a deeper fiscal adjustment) should be negative for the U.S. dollar relative to many EM currencies.
- Correlations between EM countries' local interest rates and U.S. Treasuries vary greatly. Countries with a higher economic link to the U.S. (such as Mexico) have historically tended to follow U.S. rates more closely than countries whose correlations are lower (such as Brazil and various Asian countries).[4] Those countries less linked to the U.S. are likely to be in a different part of the monetary cycle – e.g., raising interest rates because inflation is still a concern.
- Any further economic weakness in the U.S. raises the possibility of another round of monetary expansion (i.e., QE3). This could continue supporting EM currencies in general, unless commodity prices suffer a large price drop on back of the U.S. slowdown, in which case EM currencies could weaken.
- We believe the better fiscal position of many EM countries[5] also should prove to be an attractive investment for investors looking to diversify away from the ongoing fiscal and growth challenges in the U.S. and Europe.

Outlook: We believe the impact of a U.S. downgrade is manageable for the asset class as long as the world does not enter into another recession. Our feeling is that the near-term risks are concentrated in the developed markets, so we see opportunities in local currency emerging market bonds with attractive yields. For example, we believe there are opportunities in some Latin American countries (e.g., Brazil) where we feel central banks are done raising interest rates. We also favor certain currencies in Asia where we believe valuations remain attractive.



Lu Ann Katz
Head of Global Investment-Grade Credit

Global Investment-Grade Credit

Assessment: The market dislocation post-downgrade is material for financial markets and warrants serious review as volatility is often self-perpetuating. Global investment-grade credit spreads are widening, but not due to deterioration of corporate credit quality. Investors are buying sovereign bonds in what we consider to be a typical risk-aversion manner, despite those very sovereigns being the cause of concern.

The most significant triggers of latest risk aversion appear to be:

The uncertainty caused by the U.S. long-term sovereign credit downgrade by S&P and the possible ramifications for France if its credit rating is also downgraded.

Weaker economic data highlighting the potential for a double-dip recession.

Invesco's Global Investment-Grade Credit team doesn't perceive the S&P downgrade as a particularly big market-moving event in this sector. Although it is a symbolic move in financial markets, we believe the broad effects on global investment-grade credit markets should be limited for several reasons:

- **Two-way dependency.** Although the U.S. is reliant on foreign capital to fund its current account deficit, the U.S. dollar's reserve currency status and the depth and size of the U.S. Treasury market make this a two-way dependency with foreign investors. The rating downgrade of one notch will not change this dynamic.
- **Continued creditworthiness.** We simply don't perceive the creditworthiness of the U.S. at AA+ by S&P to be a concern for investors, as proven by the rally in U.S. Treasuries on the risk aversion produced by U.S. downgrade fears.
- **"Debt trap" avoidance.** An important metric for creditworthiness of a sovereign is the level of nominal GDP minus the long-term borrowing rate (with a balanced

budget). If the result is negative, the sovereign must borrow just to cover its borrowing costs, an unsustainable equilibrium. We believe low borrowing costs should enable the U.S. to avoid this debt trap in a low GDP world.

France and QE3. The three major ratings agencies – Standard & Poor's, Moody's Investors Service and Fitch Ratings - affirmed a AAA credit rating for France's sovereign debt last week. In the near term, we see weak growth globally, but not a global recession if policymakers inject liquidity via quantitative easing (so-called QE3, in various forms, including purchasing sovereign debt); we believe that would lift asset prices. So the impact of the triggers mentioned above - uncertainty caused by the S&P downgrade of U.S. long-term sovereign credit, the impact if France received the same treatment and weaker economic data pointing to a possible recession – should begin to fade.

Outlook: The perceived risk of non-government debt is measured by the additional yield the issuer has to pay, or "spread" over sovereign debt to attract investors. When investors want additional yield to hold corporate debt, those spreads increase, or "widen" and so spread levels in corporate debt are indicators of investors' risk appetite (with price movement in the opposite direction). Recently some credit spreads have widened to levels not seen since the fallout of Lehman Brothers in 2008, when corporate risk, especially in financials, was seen as very high, and investors only wanted to hold government debt. We believe the current widening of credit spreads offers investment opportunity, as the underlying credit fundamentals are strong compared to 2008 due to bank capital strengthening and corporate balance sheet clean-up since then. Still, liquidity is comparatively poor, and the modest amount of new issues recently launched required considerable price concessions in the secondary market.

As we have seen this past week from the European Central Bank purchase of government bonds, a marked deterioration in sentiment could force a more coherent and unified policy response. The subsiding of fear should create a retracement as spreads tighten in European credit. This is not as clear in the U.S., as spreads are at lower levels versus Europe and have not adjusted as much. Whether or not credit will retrace back to its tightest point of 2011 will depend on the effectiveness of policy measures, but our current view is that global investment-grade credit investors can benefit from spread tightening in Europe.

Rich King
Co-Head of U.S. Taxable Fixed Income
and Global High Income

Structured Securities

Assessment: With the U.S. sovereign downgrade from AAA to AA+, securitized assets like commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) still offer an opportunity to own AAA/Aaa-rated investment options. The AAA/Aaa ratings on these bonds stem from the fact that the loans backing these securities must become severely impaired before investors suffer any losses on those loans, and this status should bode well for demand going forward. Rigorous underwriting standards mean these bonds can withstand the stresses of weak economic growth or further drops in real estate prices. And low financing rates through mid-2013 can help boost investor demand for assets that provide yield in the current environment.

Structured securities investors likely include hedge funds, REITs (real-estate investment trusts) and banks, all of whom can benefit from low borrowing costs. Public-Private Investment Program (PPIP) investors[6] have roughly $7 billion in purchasing power to employ according to the Treasury Department's June 30, 2011, report on PPIP investments. From a demand standpoint, this "dry powder" could support security valuations.

In spite of a sharp move lower in rates, limited mortgage origination capacity may limit refinancing activity versus historical periods with similar rates. From an investor standpoint, we believe muted refinancing activity should limit the need to reinvest cash flows in lower-yielding securities.

Outlook: Securitized assets are currently providing attractive yields.[7] In such a low-yield environment overall, we find this yield advantage quite appealing. While investor risk tolerances appear to have decreased, we feel an income advantage like that offered by securitized assets could serve risk-tolerant investors well over the long term.

Greg Stoeckle
Head of Senior Secured Bank Loans

Bank Loans

Assessment: Although bank loans have no direct exposure to U.S. Treasuries, this market has been affected by the volatility of equities and the broad sell-off of credit following sentiment attached to the S&P downgrade. Bank loans, as represented by the S&P/LSTA Leveraged Loan Index, opened Aug. 11 at $0.9111, down $.0243 points for the week and $.0373 points since concerns about Europe and economic growth started roiling markets on July 22.

There are a few key factors investors will want to consider:

- **Trading volumes.** Trading volumes for the week of Aug. 8 have been slightly above normal levels, but activity has been orderly, in our view. This is in stark contrast to the market sell-off after Lehman Brothers' bankruptcy in September 2008, when systemic deleveraging and forced selling dominated the landscape and drove prices to all-time lows. Today's market is also clearly differentiating risk, with higher-quality BB-rated issues showing the best relative performance, and lower-quality CCC-rated issues showing the widest price declines. We view this as both rational and orderly.

- **Demand.** Demand is strongest for higher-quality BB issues and, somewhat paradoxically, for "stressed" names that are trading at or below a price of $0.85. We believe this indicates a "barbell" market. The stressed bid has remained fairly steady at the $0.85 price, which, in our opinion, implies a general support level for the overall market and underscores investors' confidence in the long-term prospects for bank loans.

- **Default rate.** Aside from investor sentiment, we have yet to see tangible, fundamental factors affect credit performance. We see corporate earnings as one of the few remaining bright spots in the economy, with second-quarter earnings up an average of 17% for the S&P 500 Index companies that have reported so far.[8] This leaves the annualized default rate for the bank loan market at 0.77% as of July 31, 2011, which is meaningfully below the historic average of 3.6%.

Outlook: To be clear, we face a number of well-enumerated economic headwinds, and these are likely to continue weighing on investor sentiment and to eventually lead to weaker fundamental performance. That said, we believe this risk is covered with bank loan yields at 6.50% over the U.S. dollar London Interbank Offered Rate (Libor).9 We also point out that the market-specific systemic risks of 2008 are not present in the current environment. In fact, based on consensus default forecasts of 1% to 1.5% for the next 12 months, the market is offering an excess credit spread of 6.75%, which is 3.75% wide of historical norms.[10]

We continue to like bank loans but acknowledge near-term volatility risks against the headlines. We will also be keenly focused on retail flows, as this could add technical pressure to the market following the first weekly outflow after 56 consecutive weekly in-flows. At issue here is that the daily segment of the retail market has grown over $45 billion from $24 billion, or 5% of the market at the beginning of 2010, to $69 billion, or 14% of the market today.[11]

We see bank loans remaining vulnerable to sentiment across the overall markets, but we do not see market-specific systemic concerns driving a "2008" scenario. Also, we like the longer-term risk-reward profile relative to other credit-driven or duration-based assets, as bank loans are generally secured by collateral and have a relatively short duration.

Sources:

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3. "Analysis – Slow growth, sovereign downgrades sour junk bonds," Reuters UK Edition. Aug. 12, 2011. http://uk.reuters.com/article/2011/08/10/uk-investment-junk-idUKTRE7792IA20110810
4. Zephyr
5. JP Morgan

[6] PPIP: The program launched March 23, 2009, that was designed to provide liquidity for so-called toxic assets on the balance sheets of financial institutions in 2009 by allowing private investors to partner with the government to purchase such assets. Source: U.S. Treasury; http://www.treasury.gov/initiatives/financial-stability/programs/Credit%20Market%20Programs/ppip/Pages/publicprivatefund.aspx PPIP is available to US investors only. Invesco Ltd. was chosen as one of the fund managers to raise capital.

[7] Barclay's Capital Management Inc.

[8] Bloomberg, S&P/LCD, as of July 31, 2011

[9] S&P/LSTA Leveraged Loan Index

[10] S&P/LCD market poll; Invesco

[11] S&P/LCD

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