Invesco

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What do strong growth, above-target inflation and central bank policy mean for interest rates?

Third quarter US GDP data surprised to the upside, and most US data point to a stronger than expected impetus to economic growth. Consumption continues to drive growth - the labor market is solid, and, as inflation has come down, real incomes have improved. These factors have supported US growth in the most recent quarter.

Slower growth from here should be positive for bonds

We do not expect this growth surge to continue, however, and we continue to expect a "bumpy landing" for the US economy. This view calls for slowing growth from here, as higher interest rates weigh on economic activity. We see few imbalances that would drive the economy dramatically lower and into recession, but if interest rates stay high, even as inflation comes down, the probability of a broader slowdown and potential recession grows.

In terms of markets, strong third quarter growth has clearly been partly behind the rerating of interest rates higher. If growth follows our expected slower, but still positive path, upward pressure on interest rates should ease, central banks should be able to stay on the sidelines, interest rate volatility should decline, and overall fixed income markets should perform relatively well. At the press conference after the November Federal Open Market Committee meeting, Chairman Powell acknowledged that progress had been made, policy is restrictive and risks are two-way. Continued disinflation should keep the Fed from raising rates again, and eventually get it to move off of a restrictive stance.

Inflation is slowing too

After a couple years of strong inflationary pressure, overall price levels remain elevated. However, inflation's developing trend is tracking close to our expectations: We believe we are in a disinflationary environment in which price pressures prevalent when the economy was boosted by post-pandemic reopening are easing, and overall levels of inflation are moderating toward lower long-term trends. Inflation has not yet returned to the level of central bank targets, and timing about when that might happen is very uncertain. This leaves room for market uncertainty, but the trend toward lower inflation seems clear.

Interest rates will likely be driven by growth

We contemplate two risk scenarios from here:

- If economic growth continues at an above-trend pace, upward pressure on interest rates will likely continue and the Fed will likely continue to raise rates. The level of GDP growth that the US economy experienced in the third quarter is inconsistent with the Fed achieving its inflation targets, and strong growth in the coming quarters would likely renew a series of rates hikes. This would likely be negative across all fixed income asset classes; bond yields would likely push higher and volatility would probably stay high.
- If the current high level of interest rates starts to weigh on the economy more broadly, inflation could decline toward

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central bank targets and central banks could fall behind the curve. In this scenario, central banks would purposely stick with their "higher for longer" strategies, even while inflation continues to ease and growth tips over. This would likely be a positive scenario for bond yields, as the overall level of yields would have room to rally. This would likely be negative for risky assets, though we would expect high quality assets to generate solid total returns due to the drop in yields and overall financing costs. This scenario would argue for favoring duration and high quality assets, in our view.

Our risk-taking stance

Our core view of slow growth and disinflation implies a positive backdrop for markets. Recent market volatility has been mainly driven by uncertainty around policy and central bank action. This uncertainty has kept interest rate volatility high and created a headwind for risky assets. If the disinflationary trend continues, central banks should be comfortable that inflation risks have receded, which should allow for a more dovish turn. This would be supportive of overall risky assets, in our view.

On the other hand, if central banks continue to keep rates high, prioritizing low inflation over all else, the risks of poor market outcomes rise. Market consensus is now looking for something close to a soft landing, and credit valuations seem to be priced for such an outcome. Overly hawkish central banks could lead to recessionary outcomes, however, and this does not appear to be priced into either bond yields or spreads.

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Interest rate outlook

US: Overweight. US Treasury yields have increased significantly over the past month, with the 10-year yield approaching the psychologically important 5% level. Current market dynamics have been influenced by technical factors and growing concerns about a potential acceleration in US economic growth. Despite these trends, our outlook anticipates a low-growth environment with inflation continuing to decline from high levels. Based on this outlook, we believe the Fed has likely finished its hiking cycle. This should constrain further yield increases and provide a favorable setting for positive Treasury performance. As a result, we favor maintaining an overweight position at current yield levels.

Europe: Overweight. We remain positive on European duration despite recent volatility. European rates have been driven higher by US bond yields over the past month and while that dynamic may continue in the short term, longer-term valuations are compelling, in our view. The European Central Bank (ECB) has most likely reached a peak in its current rate hiking cycle and, although inflation remains above target, we expect it to fall over the coming months, allowing the ECB to reduce rates in the first half of 2024. Economic growth in the euro area has slowed sharply against a backdrop of higher borrowing costs and weaker consumer confidence, and we expect those headwinds to persist. We are also mindful that, as we approach winter, energy supplies will likely be vulnerable to supply shocks. Amid so much uncertainly, the ECB will likely be cautious in the coming quarters, talking about "higher-for-longer" but ultimately cutting as inflation falls back to target.

China: Overweight. We expect China government bonds to outperform global peers thanks to the different phase of the economic cycle that China is in compared to the US and Europe. Although China's fiscal easing measures are likely to become more proactive, as shown by the recently announced expanded fiscal budget deficit, we expect monetary policy to remain relatively steady to keep local liquidity sufficient and funding conditions stable. Recent interbank market volatility, especially at the front-end of the yield curve, is likely to have shaken some investors' positions, which we think has provided some good entry points. We expect the Chinese central bank to show more flexibility toward loosening in the fourth quarter, as the Fed is getting close to the end of its rate hiking cycle.

Japan: Underweight. The Bank of Japan (BoJ) effectively scrapped its yield curve targeting regime at the October meeting by shifting from a regime in which it committed to capping 10-year yields at 1%, to one in which it would conduct operations "nimbly" to offset speculative moves in yields. The change in policy reflects progress toward achieving the inflation target, with the BoJ now forecasting core inflation (ex-fresh food and energy) at 3.8% in FY2023 and 1.9% in FY2024 and FY2025. Given these forecasts' proximity to the 2% target, any further upward inflation surprises, which are likely given the higher than expected October Tokyo inflation data, will likely result in increased speculation about a possible move to end negative interest rates. This could happen as soon as the January meeting, but more likely once annual wage negotiations are close to completion in April. BoJ governor Ueda has drawn particular attention to the role of higher wages in generating a sustainable inflation impulse. It is therefore significant that Japan's largest union, Rengo, has started negotiations with a 5% wage demand. Furthermore, continued yen depreciation will likely increase the pressure on the BoJ to normalize policy in the future, placing further upward pressure on bond yields.

UK: Overweight. Gilts have outperformed US Treasuries over the last month, but they have not been immune to the global duration selloff. The recent move higher in yields has been driven by higher longer-term rates, with 2-year yields essentially unchanged over the last month. Although the inflation outlook remains uncertain, recent data have shown a moderating trend and the labor market is showing signs of loosening, which should feed into slower wage growth going forward. The Bank of England's (BoE) decision to pause at its September meeting suggests that the bar for near-term rate hikes is relatively high. Short-term rates should, therefore, remain capped in the context of relatively weak macro fundamentals and tighter financial conditions. However, heavy supply and the lack of liability-driven investment demand continues to put upward pressure on term premia, driving the yield curve steeper. We expect the pace of steepening to slow, as long-term gilt forwards are now over 5.5%, which should generate some seasonal demand toward year-end.[1]

1. Source: Bloomberg L.P. Data as of Oct. 19, 2023.

Australia: Overweight. 10-year Australian government bond yields have risen by over 50 basis points in the last month, largely tracking the bear steepening of the US Treasury curve.[2] In the context of a relatively lackluster domestic economy and moderating inflation, valuations for long-term securities now look attractive, in our view, with 5-year/5-year forward rates now well above 5%.[2] Any rally will likely be led by the long end, given that short-term rates in Australia are starting from a lower level than global peers and the Reserve Bank of Australia (RBA) retains a hiking bias, which leaves a relatively low bar to future hikes if inflation or growth exceeds expectations. The fact that Australia's yield curve is starting from a steeper level than the US's or European peers', and there is no expected increase in local bond supply, should limit the extent the Australian curve can bear steepen.

2. Source: Bloomberg L.P. Data as of Oct. 19, 2023.

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Currency outlook

USD: Neutral. The recent strength in the US dollar appears to be waning. The tailwinds of growth outperformance and higher interest rates have had a diminishing influence on the greenback over the past month. The lack of the dollar's follow-through is a concern, especially if the economy begins to slow into 2024, as we expect. While our outlook for the dollar currently remains balanced, headwinds are gathering.

EUR: Neutral. We have moved to a neutral stance on the euro after the recent period of weakness. Despite the continued outperformance of the US economy, the euro has barely moved. European growth, while subdued, appears to have at least stabilized for the time being, while we expect the US economy to slow from a stellar third quarter. As such, we believe downward pressure on the euro has abated, leading to our move to neutral.

RMB: Neutral. We think the main driver of the USD/RMB exchange rate's performance continues to be the US dollar's strength against the major currencies. Although China's growth trajectory and interest rate differential have weighed on the renminbi's performance, recent rhetoric from policymakers and a series of fixing deviations showed a tendency to contain USD/RMB moves when seen as excessive. We think the purpose of policymakers' recent actions has been to contain the acceleration of speculative positioning, rather than reversing a trend. We note that the renminbi appreciated against the basket of currencies after the central bank used various tools to stem its weakness against the US dollar during the dollar's recent strengthening moves.

JPY: Neutral. Despite the jump in Japanese government bond yields after the BoJ's decision to loosen its Yield Curve Control framework, the yen has continued to depreciate against the US dollar and euro, breaking the psychologically important 150 level immediately after the BoJ meeting. The insensitivity of the yen to BoJ policy changes can be explained by the fact that short-term interest rate differentials are still very wide, particularly in real terms. Until the BoJ hikes rates, and probably more importantly, the Fed and ECB cut rates, we will not likely see substantial yen appreciation. The recent string of stronger than expected US data is making the prospect of near-term Fed cuts unlikely. In fact, there is some potential for the Fed to keep hiking. Consequently, the scope for yen appreciation against the US dollar appears relatively limited. However, signs of economic weakness in Europe and Asia might lead to more scope for the yen to appreciate against currencies from these regions, where the negative carry of holding long yen positions is less punitive.

GBP: Underweight. Weak growth and a more dovish BoE reaction function are likely to continue to weigh on the British pound in the future. Unless UK and global growth expectations pick up, it is hard to see a sustained appreciation of the pound. It is possible that merger and acquisition-related equity inflows and a short squeeze might lead to some retracement, but the general structural dynamic remains bearish for sterling, in our view.

AUD: Neutral. Negative interest rate differentials with the US and fragile global risk sentiment continue to weigh on the Australian dollar, even though Chinese growth expectations may be bottoming, and the RBA recently sounded more hawkish than other central banks. A combination of RBA hikes, Fed dovishness and better than expected global growth are probably necessary to drive a sustained Australian dollar appreciation against the US dollar. It is possible that better Australian growth and scope for interest rates hikes in Australia might lead the Australian dollar to outperform the New Zealand dollar and European currencies, especially in the latter case if commodity prices continue to accelerate.

Daniel Phillips
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Head of Emerging Market Credit

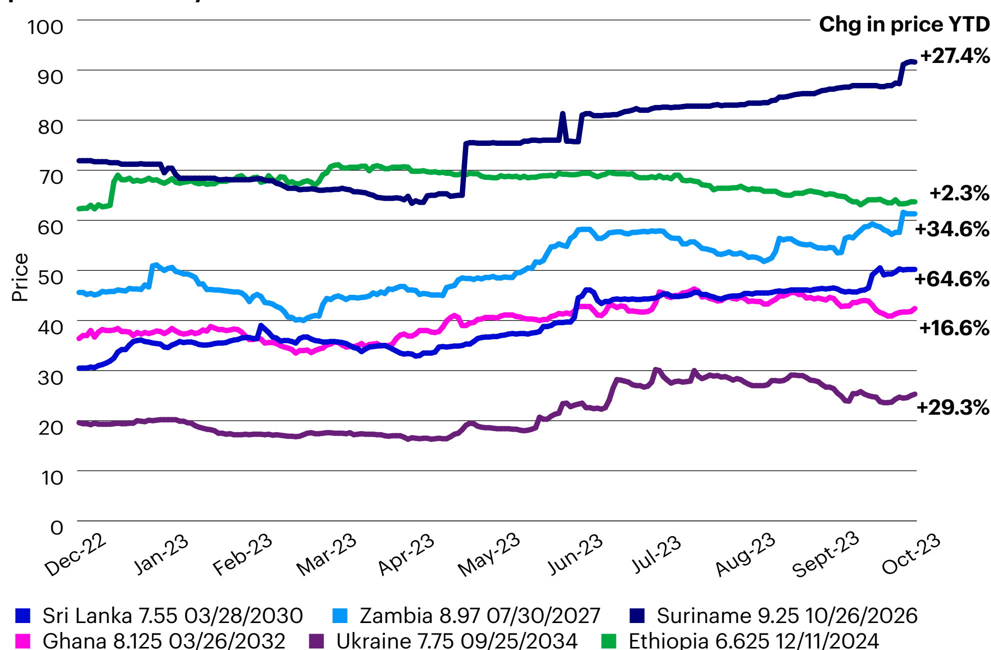
This section highlights the views of Invesco Fixed Income's credit analysts across a broad range of fixed income assets managed by Invesco.

China's role as EM creditor evolves

The June 2023 agreement between Zambia and its creditors on a comprehensive debt restructuring marked a turning point for emerging market (EM) sovereign debt. It solidified a trend that breaks an impasse between various lenders, such as China, the European Union, the US, international bondholders, and debtor countries that borrowed heavily from China over the last ten years. While by no means a panacea, the restructuring of Zambia's Chinese debt – with Sri Lanka soon following suit – is an important development for the portion of JP Morgan's Emerging Market Bond Index (EMBI) consisting of low-income countries indebted to China and with limited ability to access financial markets.

Zambia's agreement with official creditors has already borne fruit by paving the way for a subsequent deal with commercial creditors – including holders of Zambia's eurobonds. At the end of October, Zambia reached an agreement in principle to restructure these bonds, in a deal that came faster than expected. Notably, Zambia and Sri Lanka's eurobonds have outperformed their defaulted EMBI peers year-to-date (Figure 1). Below, we discuss the developments leading up to the recent breakthrough and prospects for a more favorable EM debt restructuring landscape going forward.

Figure 1: Defaulted EMBI countries that have resolved debt issues with China have performed best year-to-date



Source: Bloomberg L.P. Data from Dec. 30, 2022 to Oct. 31, 2023.

Zambia's deal: an EM debt restructuring turning point

In 2000, an initiative to alleviate the long-time debt burdens of highly indebted poor countries (HIPC) resulted in a 63% net present value reduction in Zambia's external debt owed to rich countries, or around USD3 billion in cash flow relief. After a period of strong growth and low debt, the country began to borrow again, gradually at first and then at a more worrying pace. From 2011-2019, Chinese loans grew from under USD1 billion to almost USD6 billion. Even after Zambia's bonds reached distressed price levels (signaling market fears of a default), the Chinese continued to disburse loans and sign new commitments. In the wake of the COVID pandemic, Zambia eventually breached the International Monetary Fund's (IMF) debt sustainability limits and was unable to pay its external debt obligations. This mattered because the IMF's determination that Zambia's debt was unsustainable meant that any emergency IMF funding would require a full debt restructuring, including the restructuring of Zambia's eurobonds.

Figure 2: Zambia public debt as of December 2021 (USD million)

Total Debt	**32,466**
External Debt	15,442
Multilateral	2,655
IMF	-
WB	1,405
Other	1,250
Bilateral	7,952
Paris Club	1,332
Non-Paris Club	6,620
China	5,935
India	685
Commercial	4,835
Eurobonds	3,280
Other	1,555
Various Arrears	1,231
Domestic Debt	17,024

Source: IMF. Data as of Dec. 31, 2021.

Following the default, bilateral creditors struggled to jointly determine how to restructure their loans in the context of the IMF's assessment of how much debt Zambia could sustain going forward. This group of bilateral creditors was split into two. On one side was the Paris Club (PC), made up of wealthy developed countries, who were historically the only significant bilateral lenders to developing countries.[3] On the other side, was a relative newcomer to bilateral lending – China.

The process was long and contentious, but this summer's deal finally broke a two-and-a-half-year impasse. China ultimately conceded some important points: It implicitly dropped its demands to negotiate with the Zambian government one-on-one, clarified the status of each Chinese lending entity in a way the PC found acceptable and dropped its demand that multilateral lending institutions, like the World Bank, take haircuts (the forgiveness of some or all of the debt's principal). However, China won some concessions, including a cap on foreign participation in Zambia's local debt market and a commitment from multilaterals that, rather than merely rolling over their existing debt, they would try to contribute net new money to plug Zambia's financing gaps.

What has been the market reaction?

The market reaction to this development has been subdued. However, in our view, this newfound procedural clarity is a meaningful turning point for countries that owe significant amounts of money to China and may need to restructure. Many factors weighed on high yield EM sovereign debt earlier this year, such as volatile US interest rates, geopolitics and countries' internal political dynamics. But uncertainty over Chinese lenders' alignment with existing sovereign debt restructuring precedents and norms also played a significant role. We believe developments in Sri Lanka and Zambia constitute a trend toward smoother and more predictable EM debt restructurings.

Roughly a quarter of the EMBI comprises frontier markets with outstanding debt to China, a history of uneven repayment, and limited institutional capacity to manage their debt, much less a complex restructuring. Of the 15% of the EMBI trading at distressed levels (yields above 10%), the majority have borrowed from China at some point in the recent past. We believe the progress achieved on these individual debt restructurings should, over time, lower the overall risk premium implied in this distressed segment of the EMBI.

3. The Paris Club members include Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, the Netherlands, Norway, Russia, South Korea, Spain, Sweden, Switzerland, the United Kingdom and the United States.

The historical sovereign restructuring process

Sovereign debt restructuring is nothing new. Though the process has changed considerably over the decades, by the 2000's the world had a rough but identifiable system for restructuring a sovereign's debt – including its eurobonds.

A country in default on its external debt almost always owed money to three distinct types of entities, and a general system of precedent and norms governed their interplay. Countries owed money to multilateral lending institutions like the IMF and the World Bank, other countries ("bilateral" debt), which was almost always owed to members of the PC, and "the market", which includes eurobonds and syndicated loans. The debt restructuring process typically moved from one creditor class to the next, in the order listed above.

If a country entered a crisis, it would eventually turn to the IMF and World Bank for help. These multilaterals are considered senior to other creditors and never took write-downs so they could maintain their low cost of capital and continue vital lending at concessional rates to countries in crisis. The IMF and World Bank would traditionally design a bailout program that offered the final word on the size and scope of any debt relief a country might need post-crisis, plus the mix of macroeconomic and monetary policies the country should implement in exchange for debt forgiveness. The PC would follow the IMF's recommendation and offer the borrower government "financing assurances" that would involve some combination of principal losses (haircuts), maturity extensions and interest rate reductions, or new loans. With this new map of future interest and principal payments, the IMF could feel confident in their long-term plan for the economy and have a sense of how much money was left to pay holders of commercial debt. Finally, the banks and bondholders would receive "comparable treatment" to the PC (though this term was never formally defined). Bondholders would typically receive a deal that provided the country with breathing room without being overly generous. This arrangement was favored by the IMF and the PC who wanted these countries to eventually support themselves through international capital markets by issuing bonds at some point in the future.

Then along came China – a creditor difficult to categorize. At first, increased Chinese lending to developing governments – largely through the Belt and Road Initiative (BRI) – was welcomed by all, especially borrower governments who loved the low-reform or no-reform conditionality in the loans – compared IMF or World Bank loans – and the speed with which China could disburse money. China liked aiding in global development, using the loans to finance projects that meant more business for Chinese engineering and construction firms, and the prestige and influence of being a significant bilateral lender.

Over time, closer scrutiny of Chinese loans revealed problematic ambiguities that would arise if a country entered distress or default. The loans were difficult to categorize; they were made by many Chinese entities including the Chinese government itself, government-owned banks at concessional rates, government-owned banks at market rates, private banks, insurance companies, etc. – and nobody knew quite where they would all fit in a potential restructuring. Were they bilateral or commercial or a new category? When it became clear that China's role straddled multiple different interest groups, the second step in the traditional debt restructuring process stalled. As it stalled, eurobonds were left in default and waiting for a resolution.

Being unable to proceed past the multilateral stage delayed the rest of the process, making the final approval of an IMF program take about five times longer than usual. A Reuters analysis of IMF programs signed in the last ten years measured the time between a staff-level agreement (when IMF technicians negotiate a workable agreement with a debtor country) and board approval (when IMF member countries approve the program developed by the staff and disburse emergency funds). The key component allowing the process to move from staff to board approval is the "financing assurances" step.

Figure 3: Days from IMF staff approval to board approval

Chad	317
Suriname	237
Zambia	271
Sri Lanka	200
Average	256
Median 2013-2023	55

Source: Reuters, IMF. Data as of March 31, 2023.

In some cases, in which China was a major creditor, they were able to act quickly. However, in most cases, it proved more difficult. In four complex debt restructurings involving China – Chad, Suriname, Zambia and Sri Lanka – the average time from staff to board approval was 256 days, versus the median of 55 days in all other instances, according to Reuters' analysis (Figure 3).

Without the other creditors sorted and an IMF program on-track, eurobonds typically cannot be restructured. An analysis by Morgan Stanley in October 2022 found that since 1999, the average eurobond restructuring typically takes 18 months from the announcement of a default to a full restructuring. Most instances involving China have – or are expected to – run longer (Figure 4).

Figure 4: Months from default to final restructuring agreement

		Default
Zambia (ongoing)	35	Nov-20
Sri Lanka (ongoing)	18	Apr-22
Suriname	25	Apr-21
Average	26	
Average 1999-Present	18	
Median 1999-Present	10	

Source: Morgan Stanley. Data as of October 31, 2022.

The time without repayment negatively impacts cash flows to existing investors and leaves these countries and their companies with a higher cost of capital. Equally important, long periods without payment also dissuade so-called "cross-over" investors (investors with global mandates versus dedicated EM investors) from considering EM as a potential allocation, all of which makes capital scarcer for EM issuers.

Market implications

With Zambia's and Sri Lanka's official debt restructuring processes settled, the emergence of a rough template for restructuring sovereign bonds has replaced a system that seemed broken. This newfound clarity should help distressed sovereign bonds in two ways: First, improved dedicated EM investor engagement and comfort with this distressed segment should promote better liquidity and improve price efficiency, which we believe should generate a virtuous cycle. Second, with a greater ability to assess the timing and terms of the debt restructuring process, sophisticated non-dedicated EM investors should be able to engage in the space with greater confidence.

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