



Invesco Global Fixed Income Study 2019

Executive Summary



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For the second Invesco Global Fixed Income Study we interviewed some 145 fixed income specialists across pension funds (both defined benefit and defined contribution), sovereign wealth funds, insurers and wholesale investors (aggregated retail clients). Our respondents were typically Heads of Fixed Income, but also included CIOs and Heads of Investment Strategy, located across North America, Europe, and Asia-Pacific. The asset owners for whom they work represent portfolios totalling around US\$14 trillion in AUM (as at 30 June 2018).

Last year's relatively unified view of the "new normalization" scenario largely came to pass, with slow to moderate rates of economic growth along with gradual increases in interest rates by central banks and a flattening of yield curves. In contrast, this year's outlook for the global economy has become more uncertain and divergent, with no clear consensus on when the current cycle will come to an end.

Around half (49%) of the global respondents expect the economic cycle to last another 1-2 years (figure 1), playing out as a "soft-landing". North American fixed income investors were notably more conservative, with a strong tilt towards shorter time horizons of 6-12 months. Indicative of the late position in the cycle, we found that Investors across regions expect credit spreads to widen and yield curves to remain flat (figure 2) – but not to invert.

When asked what might trigger the next downturn, respondents were predominantly concerned with high levels of indebtedness. High levels of government debt incurred in the wake of the financial crisis and due to ongoing structural fiscal deficits are seen as the biggest risk, though there was also concern regarding high levels of corporate and consumer debt. A debt bubble in China, and geo-political risks (including trade wars) were also cited as potential triggers.

With respondents actively re-positioning fixed income portfolios to respond to the late stage of the cycle, the potential impacts of trade wars, and to manage a variety of potential market outcomes, a bias toward shortening duration in observed in 2017 has become more evenly split between those shortening and lengthening. However, the divergence in views among investors means that a wide variety of portfolio strategies is being considered – an observation reflected throughout the report by variations across and within regions and segments.

Fig 1. Expectations of time until end of the economic cycle (from Q4 2018), by region (%)
Wholesale investors

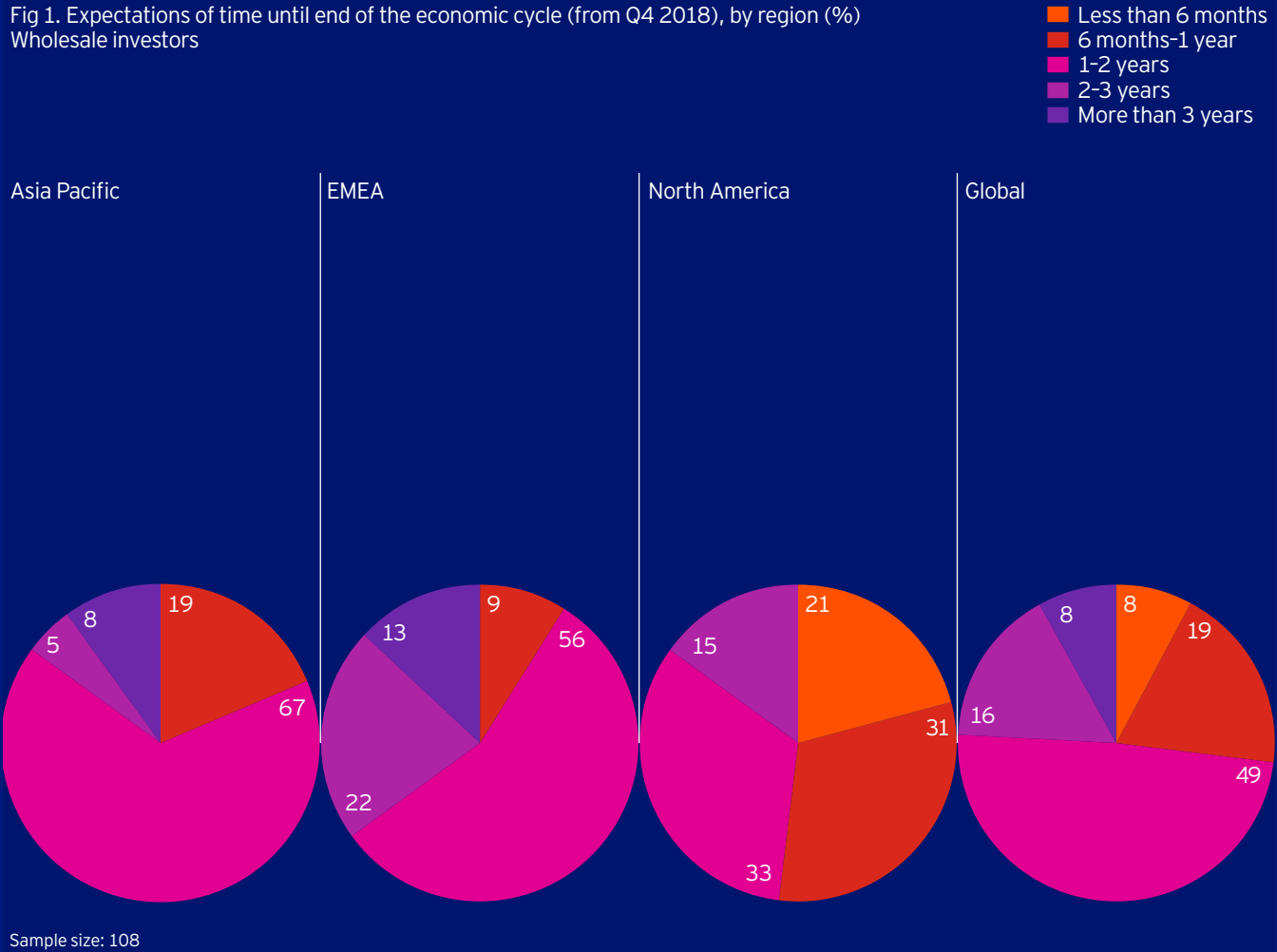


Fig 2. Perspectives on state of the economic cycle (%)



In our second theme we focus on how the search for new fixed income securities and strategies has combined with improved access and transparency to increase interest in and allocations to the Chinese fixed income market.

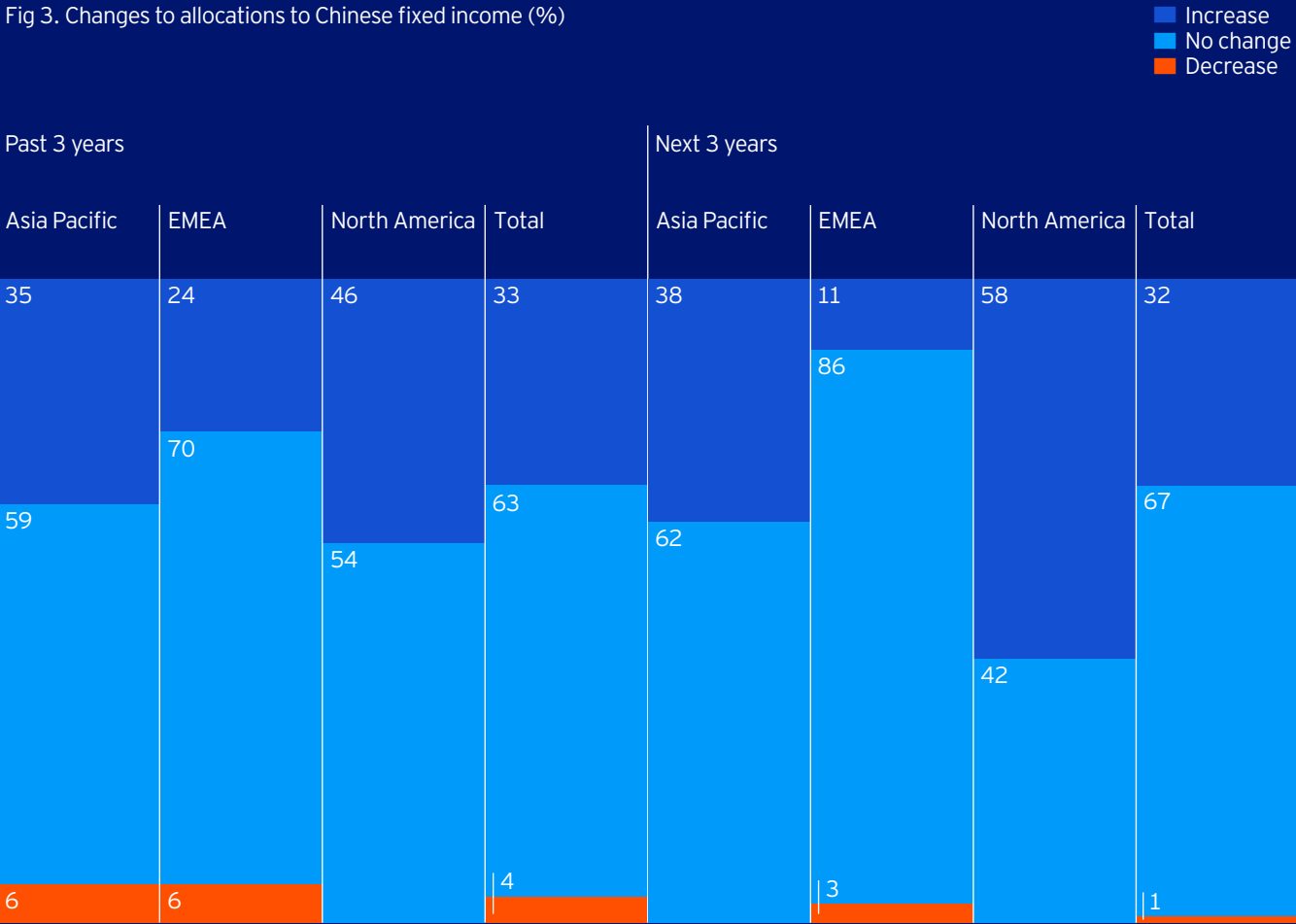
We found that around half of investors already have allocations to China - more than might be aware of that fact - and with the structural tailwind of higher future weightings in fixed income indices, allocations are set to rise further. Figure 3 shows that over the past three years around a third of investors have increased allocations to China, while just a handful decreased. Most intend to maintain positions over the next three years, but a third intend to increase allocations. In the full report we discuss significant regional variations in this trend, with North American investors leading in terms of allocation increases both over the past three years and the next three years - despite the threat of a US-China trade war.

While China has offered relatively attractive yields compared to developed market peers, allocations are also being driven by continued liberalisation of China's capital markets. China is seen by respondents as seeking to attract foreign capital to support its ambitions for the renminbi as a global reserve currency. Exposure decisions are also driven by the inclusion of Chinese securities in major bond indices, and the potential for index providers to progressively increase weighting over time (reflecting that China is one of the world's largest bond markets).

Amongst the half of our study respondents who do not yet invest in Chinese fixed income, the concerns cited revolves around government intervention and potential restrictions on capital, as well as the general risk of the asset class (figure 4).

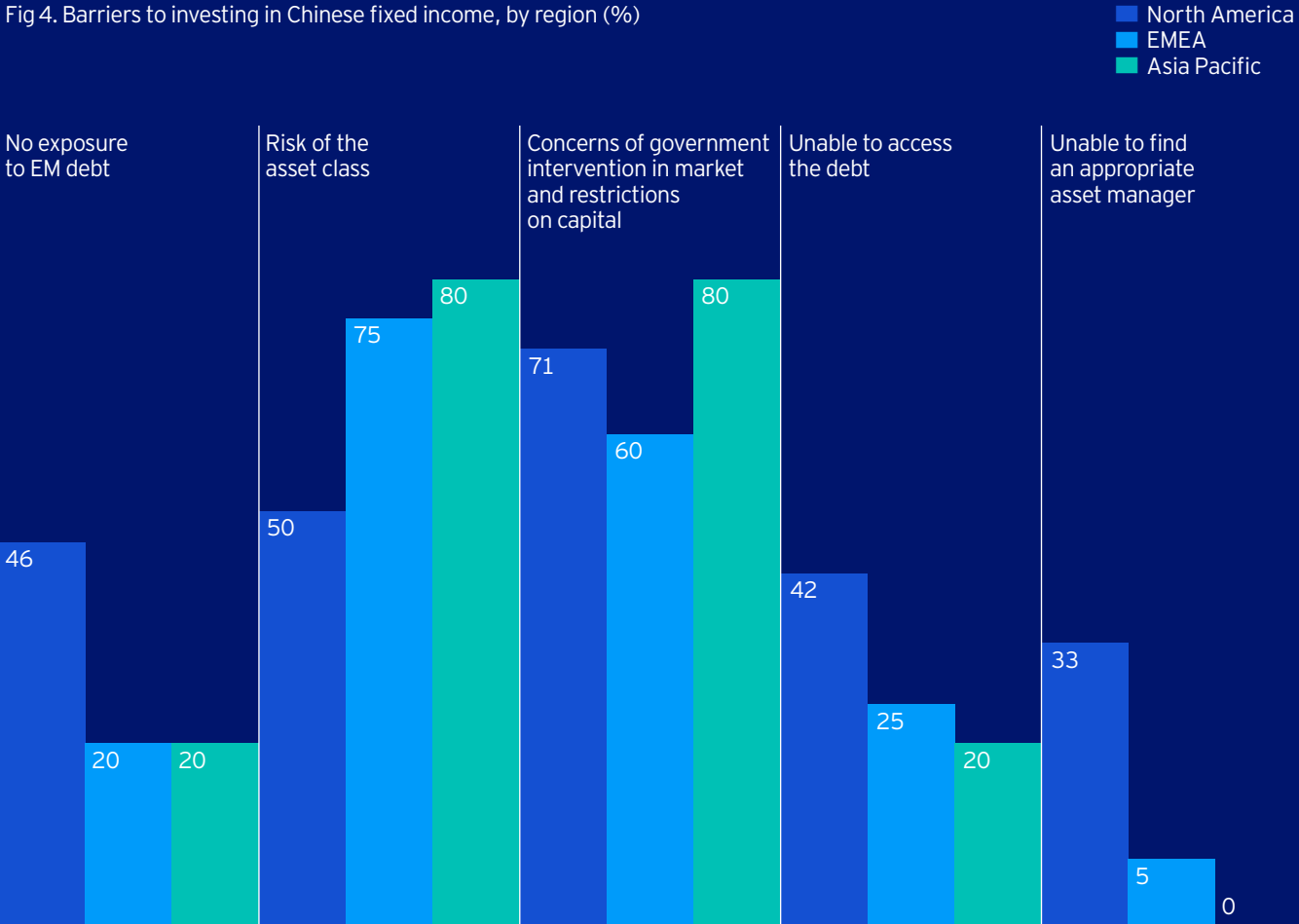
We found concerns about potential government intervention were relatively even across regions, while North American investors were relatively less concerned about asset class riskiness, and more concerned about structural barriers such as strategic portfolio allocations, accessibility, and the commercial challenge of finding a good asset manager. However, in general barriers are coming down; gaining access to the market, once considered a major challenge, is now a secondary issue.

Fig 3. Changes to allocations to Chinese fixed income (%)



Sample Size: 75

Fig 4. Barriers to investing in Chinese fixed income, by region (%)



Sample size: 49

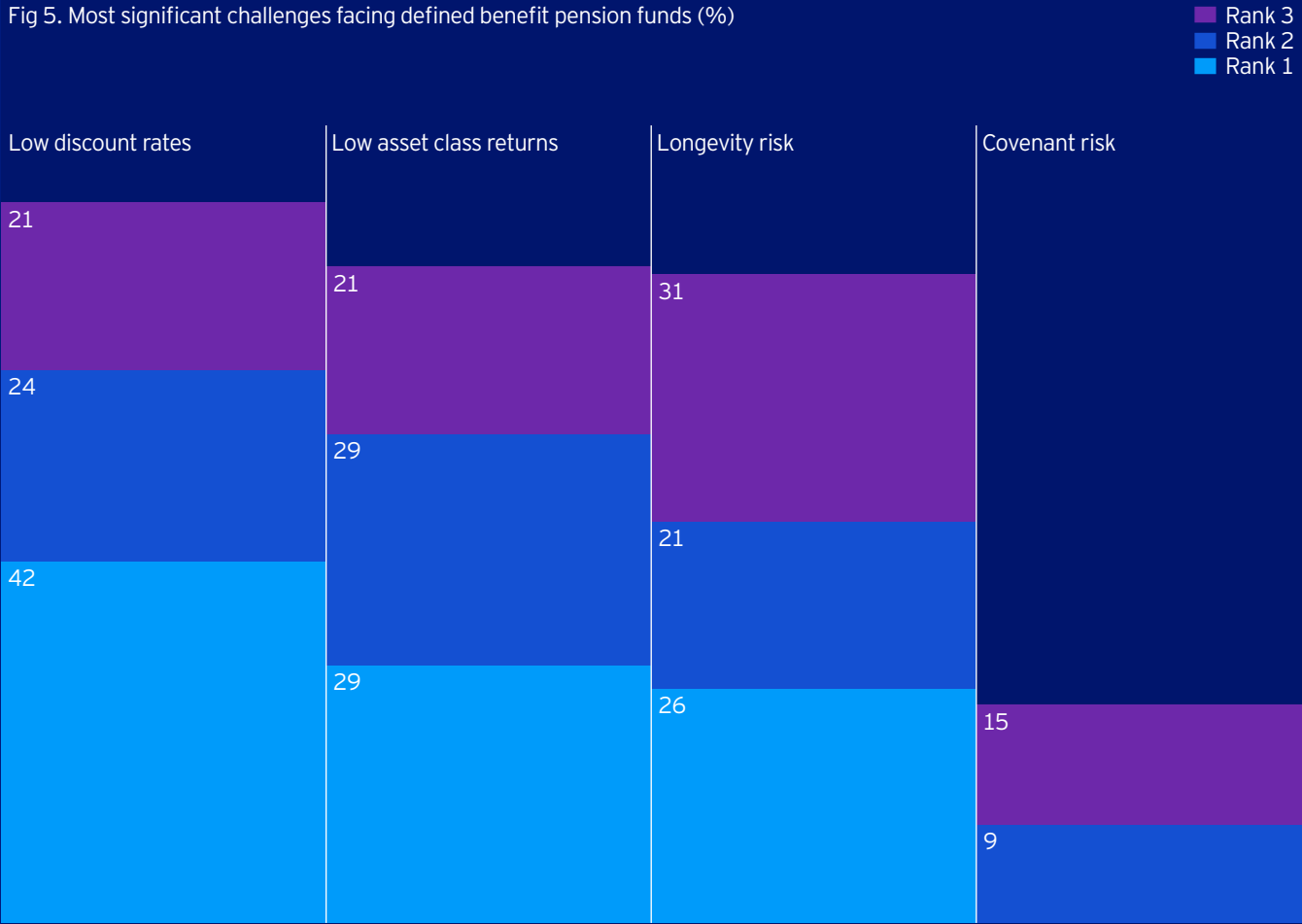
In our third theme we look at the growing role of liability-driven investing (LDI) and nascent growth of cashflow-driven investing within defined benefit (DB) pension funds. Figure 5 indicates that addressing the long-term issues of DB pensions including the low yield environment and ageing populations remains a significant concern, but volatility in equity markets in late 2018, coupled with the start of quantitative tapering, has highlighted the ongoing challenge of funding level volatility.

Improved funding levels in recent years has increased the emphasis on locking in gains and de-risking through liability hedging strategies. We found significant regional divergence in the use of LDI strategies, with EMEA investors at the forefront, in part due to the better funded nature of DB pension schemes and regulatory frameworks that encourage matching and mark-to-market valuations to reduce short term volatility.

Although LDI has become widely utilised, the goal of stabilising funding levels does not necessarily guarantee that DB pension funds will achieve their cashflow requirements. Traditional methods of meeting cashflow requirements from contributions and income are becoming less viable as schemes close to new members and yields on traditional income generating assets fall below target levels. When asked about their ability to meet cashflow requirements Figure 6 reveals that confidence levels among DB pensions funds are not high, especially for funds with lower than 100% funding levels.

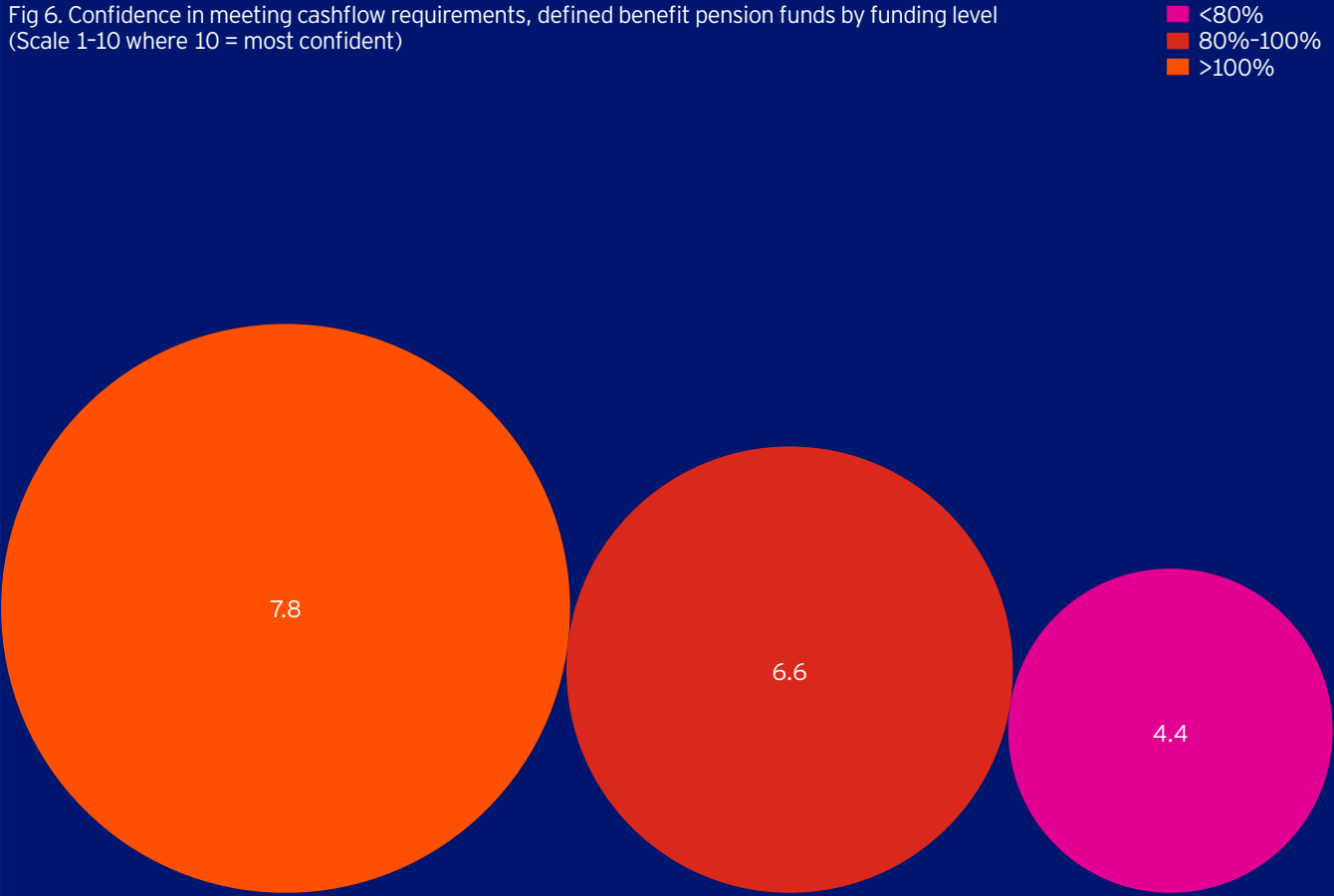
Respondents acknowledge that it is not straightforward to add a third sub-portfolio to existing mixes of LDI and the return-seeking portfolio, and the uptake of an additional cashflow-driven investing (CDI) strategy to date has been relatively slow to date. However, it is also clear that DB pension funds are now turning their attention to this challenge, with over half of study respondents that do not currently utilise a CDI strategy intending to introduce one as funding levels tick upwards and they become more comfortable with their LDI portfolios.

Fig 5. Most significant challenges facing defined benefit pension funds (%)



Sample size: 34¹

Fig 6. Confidence in meeting cashflow requirements, defined benefit pension funds by funding level (Scale 1-10 where 10 = most confident)



Sample size: 33

¹Other and Currency Risk were omitted from the chart due to low response rates (small sample)

We conclude the report by looking at the ongoing integration of Environmental, Social and Governance (ESG) into fixed income. Figure 7 shows that the implementation of ESG within to fixed income has lagged to date, with only two-fifths of respondents considering ESG factors for their fixed income portfolio. This compares with 62% of respondents that have implemented some form of ESG strategy for their overall organisation.

Figure 8 indicates that the primary driver of ESG within fixed income has been a transmission effect from firm-wide adoption of ESG policies. Other factors influencing uptake include the perceived benefits relating to risk management, enhanced return potential, and pressure from stakeholders.

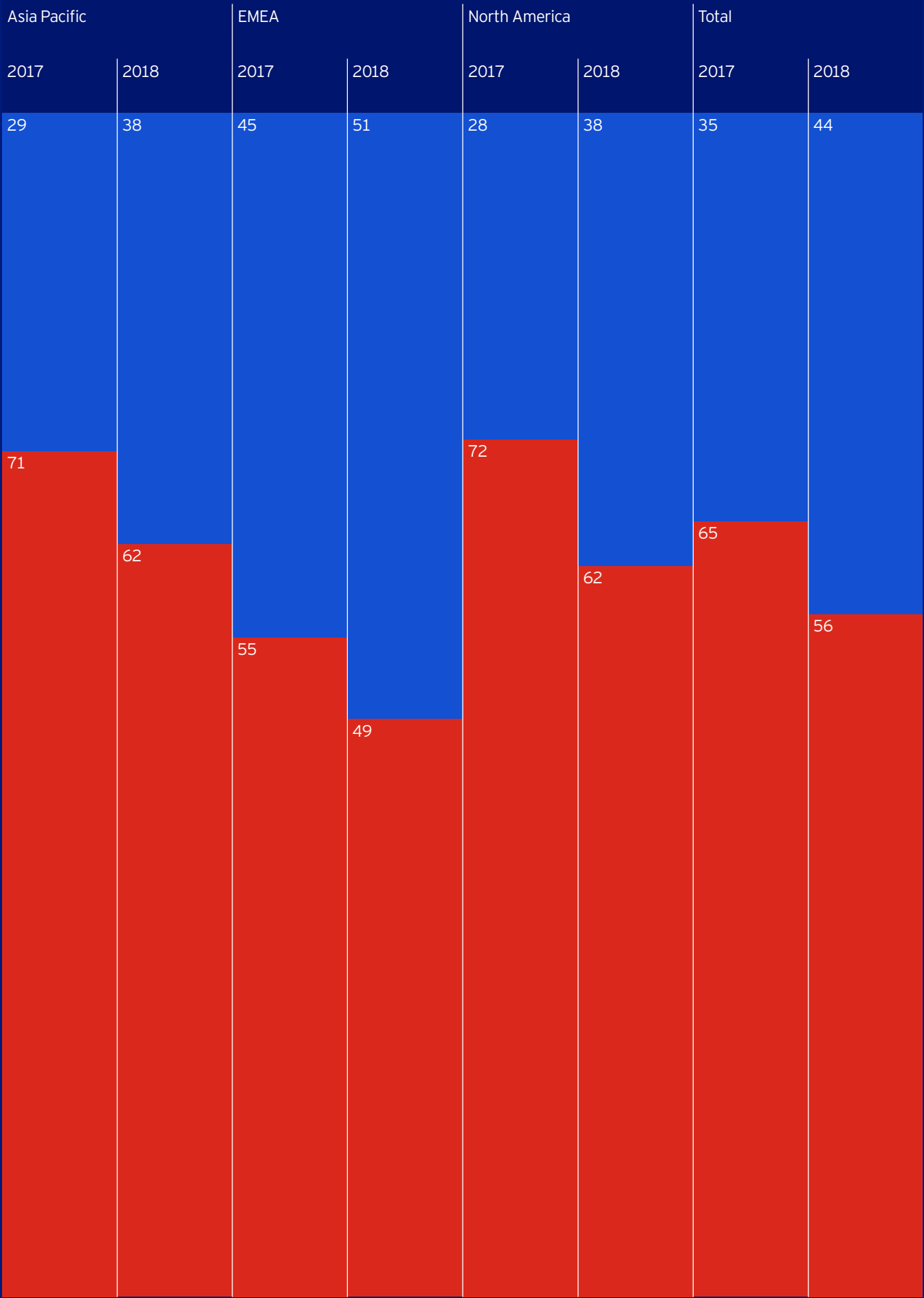
Figure 8 also shows that the principle drivers of ESG adoption vary significantly across regions. EMEA and APAC investors are the most active in implementing stakeholder ESG preferences and are more likely to have engagement with regulators and governments in relation to fiduciary standards. Meanwhile, North American fixed income investors that have adopted ESG were likely to be at least partly motivated by the prospect of enhanced return potential (particularly DB pension funds with a need to close deficits), with this often a requisite for investment committee members in this region to adopt and integrate ESG considerations into their fixed income investment processes.

The report identifies that embedding ESG factors in fixed income carries its own set of unique challenges, including how to engage with issuers, ongoing debate surrounding the role ESG plays in credit ratings, and the scarcity of credible index options in comparison to equities. Respondents also commented on the dearth of ESG-focused products that are of sufficient quality to bring to their board or investment committee (figure 9).

These concerns are reflected in the muted level of enthusiasm we found for green and social bonds. Although investors already holding these ESG-specific securities generally said they found value and intended to increase their allocation, others were concerned about having appropriate resources to monitor such investments and had reservations relating to a lack of market depth.

Fig 7. Level of Inclusion in fixed income portfolio 2017-18 (%)

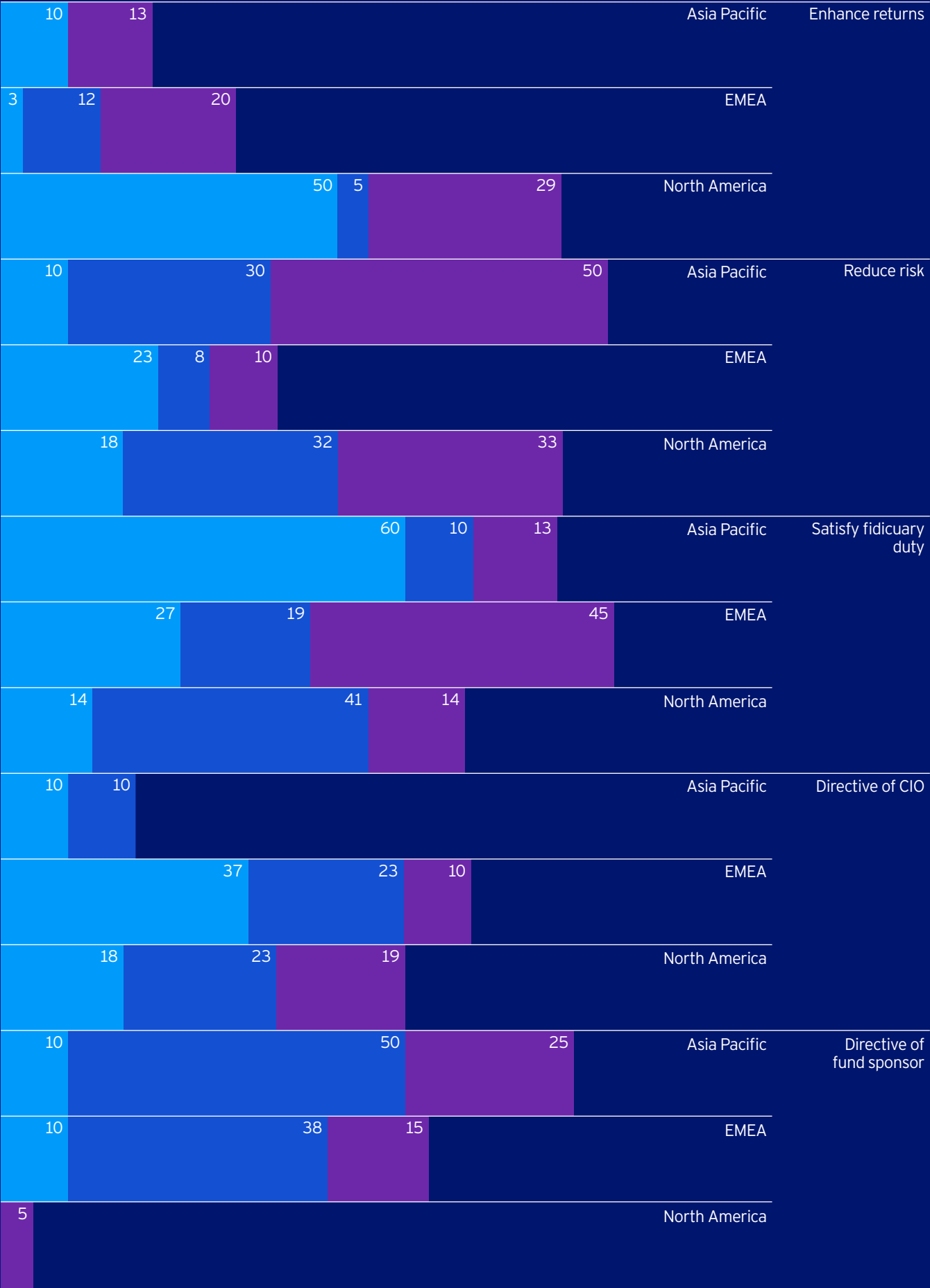
Yes
No



Sample size: 108

Fig 8. Reasons for including ESG in fixed income portfolio (%)

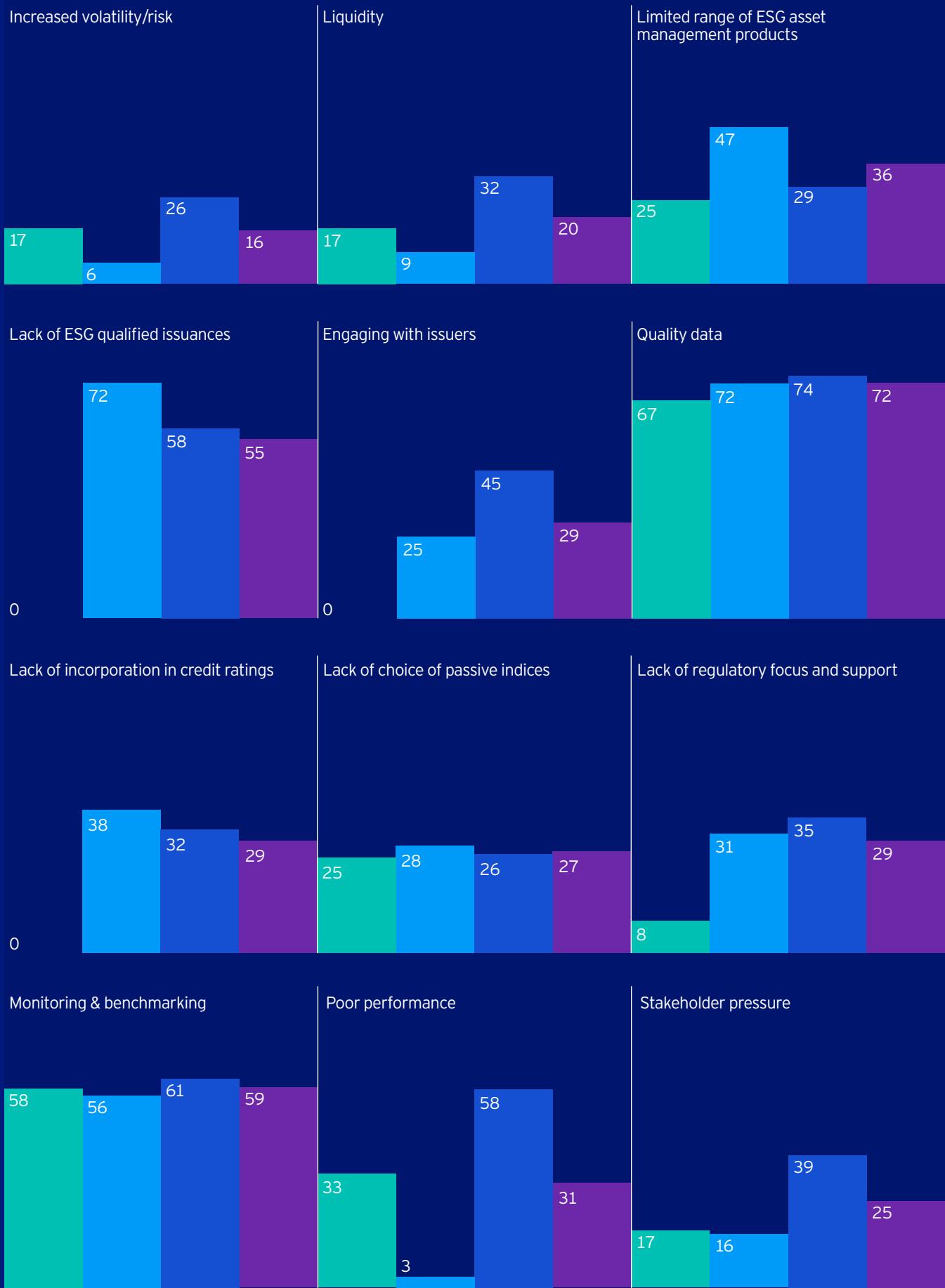
Rank 1
Rank 2
Rank 3



Sample size: 62

Fig 9. Challenges for incorporating ESG in fixed income (%)

Asia Pacific
EMEA
North America
Total



Sample size: 75

Sample and methodology

Survey participants' experience may not be representative of others, nor does it guarantee the future performance or success of any product. The opinions expressed are those of NMG and are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals. There may be material differences in the investment goals, liquidity needs, and investment horizons of individual and institutional investors. Invesco is not affiliated with NMG, an independent full-service market research provider, specializing in wealth management and financial services market research and consulting. The fieldwork for this study was conducted by NMG's strategy consulting practice. Invesco chose to engage a specialist independent firm to ensure high quality objective results. Key components of the methodology include:

- A focus on the key fixed income decision makers within institutional investors and wholesale investors (including private banks, diversified fund managers, multi-managers and model builders), conducting interviews using experienced consultants and offering market insights rather than financial incentives
- In-depth (typically 1-hour) face-to-face interviews using a structured questionnaire to ensure quantitative as well as qualitative analytics were collected
- Analysis capturing investment preferences as well as actual investment allocations with a bias toward actual allocations over stated preferences
- Results interpreted by NMG's strategy team with relevant consulting experience in the global asset management sector

In 2019, we conducted interviews with 145 different insurers, defined benefit and contribution pension funds, sovereign investors and private banks across Asia Pacific, EMEA and North America. The breakdown of the 2019 interview sample by investor segment and geographic region is displayed in the main study.

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