THE FUTURE OF FIXED INCOME

# Weekly Bond Bulletin

17 January 2019

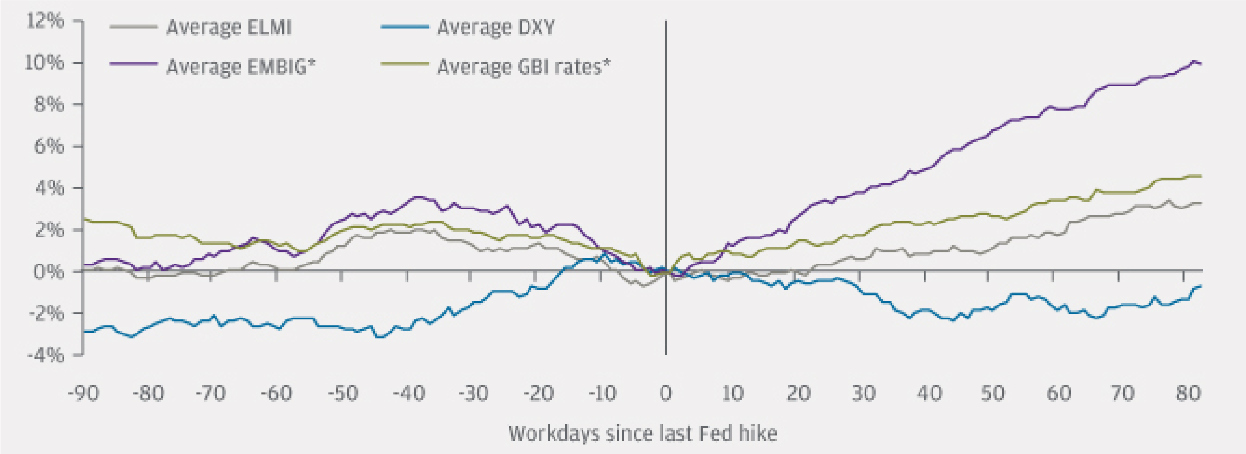
## Not all bad?

Weakening global growth data points to end-of-cycle dynamics. However, a pause in US rate hikes could be beneficial for emerging markets.

### Fundamentals:

2018 was largely a US exceptionalism story, with the economy enjoying above-trend growth even as recoveries elsewhere faded. The resultant dynamic of rising core rates, tighter financial conditions and dollar strength created an unfavourable environment for emerging markets. This year, slowing global growth poses new challenges, especially as business cycles are peaking. However, all is not gloomy for emerging markets. With US data having entered a prolonged patch of softness, an earlier-than-anticipated pause in the interest rate hiking cycle from the Federal Reserve (Fed) looks more likely. In the last five cycles, emerging market debt (EMD) has tended to rally after the last Fed interest rate hike of the cycle. Furthermore, even if financial conditions tighten further, EM countries such as Indonesia and South Africa have already made policy adjustments to address their external vulnerabilities. Meanwhile, signs from the US-China trade discussions look positive. With challenging structural issues such as intellectual property rights still to be addressed, we don't expect a quick resolution, but recent negotiations show willingness and may lead to a pause in escalation.

**EM debt has historically performed strongly following the end of the Fed hiking cycle**




**Source: Bloomberg, J.P. Morgan Asset Management; data as of 7 December 2018. Average returns of five previous cycles: 1994-1995, 1997, 2000, 2006, 2015-2016. *Returns may not be available for all cycles. ELMI = JPM ELMI Plus. EMBIG = JPM EMBI Global Diversified. GBI = JPM GBI-EM Global Diversified. DXY = US Dollar Index.**

## Quantitative valuations:

EMD valuations reflected negative fundamental developments in 2018, with all sub-indices—corporate, sovereign and local currency—posting negative returns for the year. Like other risk asset classes, EMD started 2019 on a positive note: as of 15 January, EM sovereigns and corporates have returned 1.92% and 1.23%, respectively. We believe EM sovereign spreads, at close to 400 basis points, look relatively attractive for long-term investors, especially given that the sector has never in its history since 2002 posted negative returns in the 12 months after reaching this level. Current spread levels suggest the market anticipates solvency issues, but that is not our base expectation. EM local currency bonds have fared even better than other sectors, returning 2.60% year to date and 9.51% since the low point in early September last year. Despite the extent of this rebound, we continue to see attractive value in selected EM local markets.

## Technicals:

Liquidity in EMD has improved significantly in the past few weeks compared to the fourth quarter of last year, and the supply and demand picture is looking more favourable. We expect net supply to be considerably lower in 2019 than in recent years, at around USD 13 billion for EM sovereigns and USD 22 billion for corporates. Demand is more difficult to predict, but we think it should also be more supportive given persistent outflows from EMD last year and anecdotal evidence of crossover and other investors holding significantly reduced allocations. Based on our internal retail fund flow monitor, we have already seen USD 2.4 billion of inflows in the first two weeks of 2019.

## What does this mean for fixed income investors?

Signs of a slowdown in US growth present both challenges and opportunities for emerging markets. On the one hand, slower global growth will feed into EM corporate earnings and the balance sheets of EM economies. On the other, a more dovish Fed and a pause in the tightening cycle should limit US dollar strength and the tightening of financial conditions, which would be favourable for emerging markets. With valuations having adjusted and technicals improved, we believe 2019 could be a better year for EMD, and see selective opportunities in fundamentally sound EM countries and corporates.

### About the Bond Bulletin

Each week J.P. Morgan Asset Management's **Global Fixed Income, Currency and Commodities** group reviews key issues for bond investors through the lens of its common Fundamental, Quantitative Valuation and Technical (FQT) research framework.

Our common research language based on **Fundamental, Quantitative Valuation and Technical** analysis provides a framework for comparing research across fixed income sectors and allows for the global integration of investment ideas.

**Fundamental factors** include macroeconomic data (such as growth and inflation) as well as corporate health figures (such as default rates, earnings and leverage metrics)

**Quantitative valuations** is a measure of the extent to which a sector or security is rich or cheap (on both an absolute basis as well as versus history and relative to other sectors)

**Technical** factors are primarily supply and demand dynamics (issuance and flows), as well as investor positioning and momentum

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