LIQUIDITY INSIGHTS

Focus on short-term fixed income

Q1 2019 in review: From risk-off to risk-on

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IN BRIEF

- The market mood shifted from risk-off in late 2018 to risk-on in response to the Federal Reserve pausing rate hikes in January. Recession fears returned in March.
- In the eurozone, the downward trend in economic data plateaued and then resumed. The European Central Bank (ECB) announced in March that it will support bank refinancing sooner than expected, which led bond markets to slump. Pricing suggests the market expects no ECB rate hike for about 18 months.
- In the UK, everything still hinges on ongoing Brexit negotiations. The Bank of England said it would tighten gradually assuming a smooth Brexit scenario while market pricing suggests no rate rise for nearly five years. We think a Brexit deal will be reached.
- Our portfolios tilt to higher quality, with relatively short duration as a hedge.

MARKET REVIEW

The new year brought a new mindset to global markets. The risk-off attitude of Q4 2018 flipped to risk-on after more conciliatory headlines around global trade wars and, more importantly, dovish noises from the Federal Reserve (Fed) as economic data appeared to stabilize. But late in Q1, anxiety rose again.

A major driver behind the dramatic plunge in investor sentiment in Q4 was the then-stubborn stance of the Fed on ever-higher rates; dot plots pointed to further tightening, and Chair Jerome Powell stated that even after nine increases, the Fed funds rate was below what he would view as neutral. Market participants feared that overly aggressive monetary policy could push the economy into recession.

The market spoke, and the Fed listened: In January, the Fed dropped its hiking bias, fuelling a risk-on rally in global markets. Bond and equity markets alike retraced most of their fourth quarter losses on expectations that the Fed's less hawkish stance would extend an already long period of economic growth. In March, the Fed again surprised the market, indicating that it no longer foresaw any rate hikes this year. This shift was so marked that it spooked the markets, and concerns about economic growth took hold.

U.S. data will be closely followed in Q2 for signs of whether economic fundamentals are deteriorating enough to justify Fed easing. In early April, the market was pricing in a greater chance of a Fed rate cut from summer onwards. The market seems to believe that interest rates have reached their peak for this economic cycle.

The UK offered no silver lining to the clouds gathering in the U.S. The Brexit story continues to play out in Parliament, with repeated "No" votes on proposed exit deals. We are reluctant to say much, since the situation may reverse tomorrow.

At its March meeting, the Bank of England (BoE) Monetary Policy Committee (MPC) stuck to its view that it would be appropriate to tighten monetary policy gradually and to a limited extent, if the economy develops in line with its February projections—which were based on a smooth transition to a new trading relationship with the European Union. This could change substantially if the transition ends up being rocky.

The market has currently priced out a BoE policy rate increase until 2024. This could change quickly, depending on the outcome of the Brexit negotiations. Our view remains that a Brexit deal will be reached and that the MPC's next move will be to raise rates but the dovish biases of the Fed and ECB may constrain the BoE's ability to tighten.

In Europe, risk sentiment improved in response to the Fed's less hawkish turn and stimulus in China. Also cheering the market were signs early in the year suggesting that a relentless run of weak eurozone data had found a bottom. But at its March meeting, the ECB, like the Fed, surprised the market with downward revisions to its growth and inflation projections, dashing hopes that the economic slowdown had bottomed. The ECB's shift reflected surprisingly weak recent data from Europe, particularly the manufacturing Purchasing Managers' Indices (PMIs) in Germany and France. The ECB's governing council extended its forward guidance until the end of the year and also announced targeted longer-term refinancing operations (TLTRO) support for banks at a much earlier point than the market was forecasting. The news hit the markets hard, forcing the German 10-year Bund down into negative territory and about 25 basis points (bps) lower than where it started the year.

Current market pricing points to expectations of a first ECB rate increase of 10bps around September 2020, and policy rates remaining below zero until late 2022. We are losing faith that the ECB will have a window to raise rates at all, given the looming US recession. The market is now focused on the ECB's lack of policy options to counter the next downturn, when it occurs.

We are keeping a close eye on several key data points and events in 2019.

PORTFOLIO COMMENTARY

Sterling Managed Reserves Strategies

We extended duration from 0.24 years to 0.29 years through the quarter. The GBP ETF's portfolio duration was also extended from 0.39 years to 0.58 years. We opportunistically increased our duration positioning as a hedge against the potential scenario of a hard Brexit through selectively adding to our credit exposure as dovish central bank language led to a strong technical bid for risk assets. Although supply was extremely limited, we looked to participate in cheaper new issues. Strategically, we maintained our up-in-quality bias and exploited opportunities through cross-currency trades and hedging back into GBP.

KEY ECONOMIC INDICATORS

Indicator	31 Mar 19	28 Feb 19	31 Dec 18
United Kingdom			
Consumer Price Index (%, y/y)	1.90%	1.80%	2.10%
Markit UK Composite PMI (SA)	50.0	51.5	51.4
Unemployment Rate (%, SA)	3.90%	4.00%	4.00%
UK 2-year Gilts (%)	0.64%	0.83%	0.75%
Sonia (%, Sterling OverNight Index Average)	0.70%	0.71%	0.70%
GBP/USD Spot Rate	1.3035	1.3263	1.2754
Continental Europe			
Consumer Price Index (%, y/y)	1.40%	1.50%	1.50%
Markit Eurozone Composite PMI (SA)	51.6	51.9	51.1
Unemployment Rate (%)	7.93%	8.03%	7.93%
German 2-year Bund (%)	-0.61%	-0.53%	-0.62%
Eonia (%, Euro OverNight Index Average)	-0.36%	-0.37%	-0.36%
EUR/USD Spot Rate	1.1218	1.1371	1.1467

Source: Bloomberg, as at 31 March 2019.

Currently showing the most recent published number as per date in column heading. SA: seasonally adjusted.

Euro Managed Reserves Strategies

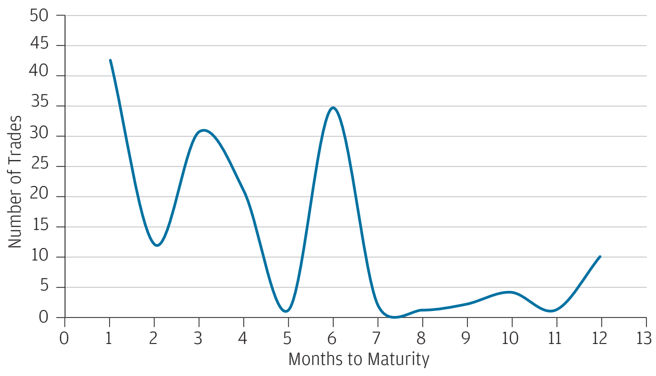
We slightly extended the Euro ETF duration position from 0.45 years to 0.48 years. Credit markets were in risk-on mode, although rates in the front end were flat over the quarter. Being late cycle, we continued with our up-in-quality bias, while strategically adding risk after the dovish central bank language led to strong a technical bid in credit markets. We also looked to shorten our cyclical credit exposures across the strategy, and exploited opportunities through cross- currency trades and hedging back into EUR. The ETF spread duration ended the quarter at 1.08 years.

Sterling Liquidity Strategies

J.P. Morgan Asset Management's early adoption of European Money Market Fund Reform (EMMFR) allowed us to complete our first full quarter managing the Sterling strategies under the new rules. Sterling investments covered the entire spectrum of the short-term money market curve, with the largest concentration of purchases in the one month, three month and 6 month periods (see graph below). Given the softening of some UK data, combined with a dovish Fed in the US and continued uncertainty around BREXIT, the market has pushed out expectations of a UK rate hike resulting in us targeting a weighted average maturity (WAM) in the 50 to 55 day range. Spreads narrowed in the 1 year floating rate note (FRN) space during the quarter, however these instruments still provide good value when compared to equivalent fixed rate paper and give the strategy some hedge should the Bank of England raise rates, on the back of an orderly BREXIT and improved UK data.

The strategies were liquid throughout the quarter, remaining above the minimum requirement of 30% in the weekly liquidity bucket. Assets under management (AUM) ranged between GBP9.3 billion and GBP12.7 billion in the Low Volatility Net Asset Value (LVNAV) strategies, and between GBP784 million and GBP931 million in the Variable Net Asset Value (VNAV) strategies. The yields for the strategies were competitive throughout the quarter.

STERLING MATURITY PROFILE



Source: Cortex, the J.P. Morgan trading system; data as of 31 March 2019.

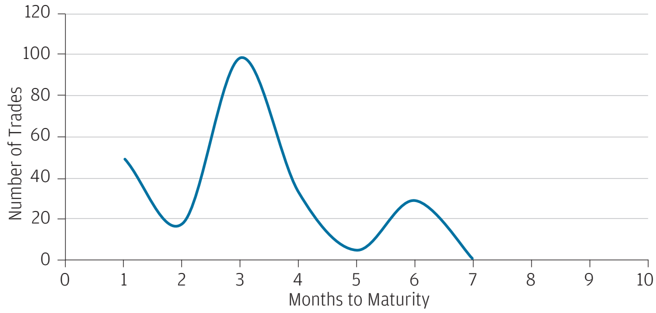
Euro Liquidity Strategies

Early adoption of European Money Market Reform has meant that we have completed our first full quarter of managing the Euro strategies under the new rules. Investments during Q1 2019 were range bound between one and seven months, with particular emphasis on the three- and six month-periods (see graph below). We continued to find value in European agency paper, purchasing maturities that also supported our weekly liquidity metrics. Investments in one- to three-month maturities included asset-backed commercial paper, and corporates' and financials' paper.

At the start of the year, the ECB ceased new purchases for its Asset Purchase Program but continues to re-invest maturities. Hence, the eurozone excess cash level has remained constant at around EUR1.85 trillion, meaning that money market rates are staying close to the ECB deposit rate at -40bps.

The average WAM for the strategies was around 50 days during the quarter. AUM ranged between EUR11.7 billion and EUR15 billion for LVNAV, and between EUR1.3 billion and EUR1.6 billion for VNAV. Both Euro strategies remain well diversified and extremely liquid, with more than 40% in weekly liquidity, well above the 30% minimum required. Yields have remained consistently competitive.

EURO MATURITY PROFILE



Source: Cortex, the J.P. Morgan trading system; data as of 31 March, 2019.

OUTLOOK

With Brexit fast approaching a deadline, the negotiating committees appear to be as far apart as ever. Neither the market's fear of a no-deal scenario, nor a general election, can be discounted, which quite rightly will keep many investors on the sidelines or cautious on UK risk. The uncertainty premium on UK trading is currently just too large. Sterling remains volatile, moving on Brexit-related headlines. In terms of economic outlook and subsequent rates policy, these Brexit uncertainties are limiting the ability to look further ahead than the next few weeks. Keeping our rates strategy shorter feels appropriate at this juncture, until we have more concrete information. What we do know is that with the bank rate at 75bps, the MPC has three cuts worth of ammunition in a no-deal scenario (if it actually cuts at all). On a softer Brexit outcome, we believe the market may still price in a steeper yield curve with a faster-tightening cycle forecast.

The broad themes remain largely unchanged. We are increasingly concerned that the run of disappointing macro data will continue and force the ECB to further push out its guidance on rates. Such a scenario may introduce the risk that the ECB will not be able to raise rates at all. With late-cycle risks circling, we feel an active, fundamentally focused approach to credit—with unwavering focus on market liquidity—is appropriate. Global liquidity strategies, including our Managed Reserves suite, are particularly well equipped to provide solutions at this stage of the market cycle.

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