THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

30 August 2018

Stepping up a notch?

With the summer lull coming to an end, will volatility remain subdued or will it pick up? What events in the coming months have the potential to disrupt fixed income markets?

Fundamentals:

With the exception of a few hiccups, the summer has been relatively calm for fixed income investors. Macroeconomic data in the US has remained strong, while Europe has seen improvement as confirmed by this week's higher German Ifo business expectations reading. Trade tensions are lighter as the US and Mexico begin to agree on contentious Nafta issues, providing some relief in emerging markets and helping US equities to record highs. However, significant political risks lie ahead. The upcoming US mid-term elections in November could dramatically affect the US president's political leverage, forcing markets to react, whatever the outcome. Emerging market (EM) hotspots, such as Turkey and Argentina, are likely to continue to present challenges. To add to this, uncertainties over Brazil's presidential elections this year and South Africa's own political challenges are likely to create further worries. Meanwhile, continued monetary policy tightening from the central banks will reduce excess liquidity, potentially leading to volatility levels not seen since the first quarter.

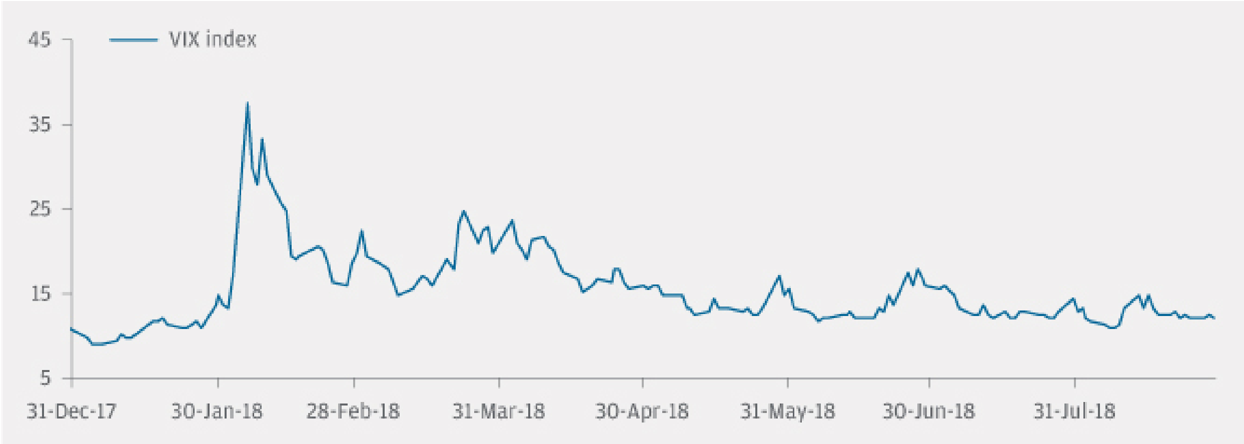
Quantitative valuations:

The potential for volatility is clear, and we have already seen a wide dispersion in returns this year, notably in emerging markets, where local currencies of the weakest EM countries—Argentina and Turkey—have lost 40.8% and 39.5% against the US dollar this year. At the same time, the Mexican peso has appreciated 3.0% against the US dollar as the Mexican presidential election did not present large shifts in policy making and trade risks have also faded. In the eurozone, a market that typically exhibits far lower volatility than emerging markets, Germany's government bond index has returned a positive 1.24% year-to-date, while Italy's index is down 5.76% (performance to 28 August 2018). As we move away from the summer lull, idiosyncratic events and tightening financial conditions are as likely, as ever, to lead to increased volatility.

Technicals:

Very light issuance across fixed income markets has favoured investors this summer. However, the primary market is set to pick up: we expect US investment grade new issue supply to increase from around $85 billion expected in August to around $120 billion in September. This increase may be even more pronounced in the EM corporate market, where new issuance has been very calm until now thanks to seasonality and weaker risk sentiment. Increased supply, a busy event calendar and tighter financial conditions over the coming months could push volatility back up from its lower recent levels (see chart). Central banks should be mindful of such risks and are therefore less likely to blindly pursue tightening without properly assessing market conditions. Chinese policymakers are already reverting some of their tightening efforts and have also recently started pursuing a "counter-cyclical factor" method to stabilise the country's currency. Similarly, we expect the Federal Reserve to take a pause from rate hikes from mid 2019 to reassess the market and economic conditions.

After a volatile few months earlier this year, volatility has remained subdued through the summer



Source: J.P. Morgan Asset Management; data as of 28 August 2018.

What does this mean for fixed income investors?

Event risk and a heavy supply calendar is likely to present fresh challenges for fixed income investors as we head into the fourth quarter. However, this should also bring opportunities as dispersion in returns grows further and investors are rewarded for making distinctions within asset classes. We would expect central banks, which have kept a steady grip so far this year, to continue to guide markets through uncertain waters as volatility threatens to pick up.

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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