

THE FUTURE OF FIXED INCOME

# Weekly Bond Bulletin

20 September 2018

## A time to add risk?

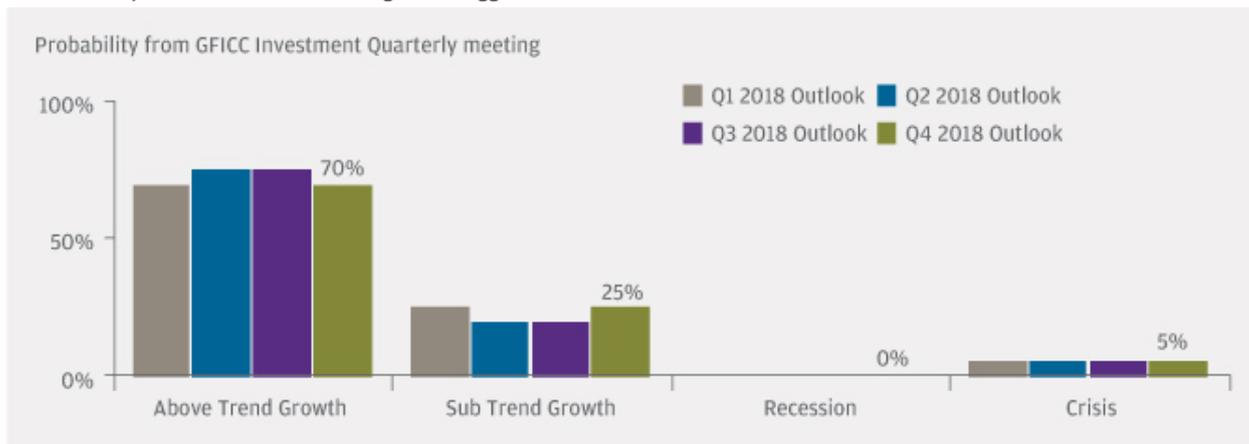
With strong global growth and a shift to tighter monetary policy continuing to make government duration look unattractive, is there value to be found in high yield, or even in emerging market debt?



### Fundamentals:

During our recent Investment Quarterly meeting, we reaffirmed “above-trend growth” as the most likely scenario in the coming months, although we have tempered our conviction given the risks posed by an escalation of trade tensions. The macroeconomic data supports a broadly optimistic view: all major developed economies are growing above potential and gradually rising wages warn against complacency on the low inflation narrative. We expect rising interest rates and tighter central bank policy, and as such, core government duration continues to look unattractive. Instead, we see opportunities in two other areas: high yield and emerging markets. First, high yield corporates are on solid footing, with leverage ticking down and interest coverage high, at a multiple of 4.6 in the US (second-quarter 2018 data). This suggests that the ability of companies to service their debt has improved, which should keep default rates low. We are more cautious in emerging markets, but there are tentative signs of stability. While growth is expected to slow, it remains elevated, and our base case is for only a modest impact on growth from a potential escalation of trade tensions. Furthermore, Turkey - one of the key idiosyncratic drivers of poor returns this year - has recently seen some reprieve, with the central bank raising interest rates last week to 24%, more than had been anticipated. While the situation remains fluid, we believe this is a step in the right direction.

Persistent expectations of above-trend growth suggest there is value to be found in fixed income



Source: J.P. Morgan Asset Management. Probabilities based on the views of senior fixed income investors at the Global Fixed Income, Currency and Commodities Investment Quarterly meeting, 13 September 2018. GFICC = Global Fixed Income, Currency and Commodities.



### Quantitative valuations:

The case for high yield – and in particular, European high yield – remains in place from a valuations point of view, with European high yield spreads continuing to trade wider than US spreads (by 27 basis points as of 19 September). History suggests that this situation will not persist for very long, so now could be an appropriate time to invest. Emerging market (EM) valuations are admittedly more challenging: despite a broad sell-off year-to-date, with local government bonds at an index level down 9.8%, and USD sovereigns down 4.4%, there remains significant dispersion across countries, making value harder to identify and necessitating differentiation. For example, the difference between EM investment grade and high yield sovereigns has touched new highs over the past few weeks, reaching 408 basis points on 4 September. In EM local markets, the index level yield now looks interesting, but this comes primarily from Turkey, where the investment case is not yet compelling. The conclusion seems to be that value lies in the higher yielding – and thus riskier – bonds.



### Technical:

Flows have improved in recent weeks. Developed market high yield outflows have ceased for now, with no significant moves in either direction since early July. In emerging markets, the picture is more mixed. While outflows continue for corporates and local bonds, sovereigns have seen marginal inflows (USD 182 million month to date, as of 19 September). EM sovereigns are also currently being helped by the supply picture, with no issuance so far in September. Back in developed markets, year-to-date gross high yield issuance is 20%-30% lower than last year depending on whether we look at Europe or the US.

### What does this mean for fixed income investors?

As rates continue to rise, positive fixed income returns remain a challenge. Value can be found in high yield – across both developing and emerging markets. European high yield is our top pick, given the positive macroeconomic backdrop and attractive relative valuations. Emerging markets is the runner up after a tough few months, and breaking the sector down further reveals some value in high yield external sovereign debt. EM local bonds could also look enticing—but for now, there is still considerable risk. Position sizing will therefore be crucial as investors start to dip their toes back in the water.

#### 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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