THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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Clash of dollar forces

The strength of the US economy is pushing rates higher, and the US dollar is following suit. But can this cyclical support for the currency continue, or will the structural headwinds prevail?

Fundamentals:

A slew of September data has confirmed the strong US economic environment we've seen for several months: the Institute for Supply Management's non-manufacturing index hit a new cycle high; the payrolls report showed a further decline in the unemployment rate to 3.7%—the lowest level since the late 1960s; and wage growth continued its solid run rate at 0.3% month on month. Importantly, the US picture isn't only strong on an absolute basis, but also relative to the rest of the world, with both manufacturing and services surveys in the US significantly outpacing the global prints. This backdrop may seem like a continuation of the recent status quo, but if so, why has it triggered a meaningful move in both rates and currency markets? According to our proprietary quantitative models, data in the US has continued to surprise to the upside—suggesting that positive economic momentum could persist.

Quantitative valuations:

The strong data momentum, combined with some hawkish rhetoric from central bankers, has driven US rates meaningfully higher. In the week to 9 October, 10-year yields climbed 15 basis points (bps) to 3.21%—the first time this level has been reached since 2011. While German yields have followed suit, with the 10-year rising from 0.42% to 0.55% over the week, the relative rate spread remains resoundingly in favour of the US dollar. This has played out in performance, with the US dollar index (a measure of the average exchange rate between the dollar and other major currencies) nearly 4% higher year to date and more than 1% higher in just the past three weeks (all data to 9 October). However, we believe the US dollar would be making new year-to-date highs if it weren't for the structural headwinds it faces—namely, with regards to the future of its status as a reserve currency.

Relative rate spread moves remain US dollar-supportive, despite ongoing structural concerns

Source: Bloomberg, J.P. Morgan Asset Management: data as of 9 October 2018.

Technicals:

With foreign exchange reserves standing at more than USD 11 trillion globally, the denomination of these reserves can have a significant impact on a currency's performance. The US dollar is clearly the world's primary reserve currency, and will be for the foreseeable future, but the premium that the dollar commands as a result of this status is being eroded by the US administration's policy actions. While this is only an initial observation, and perhaps not yet a trend, very tentative signs of a potential long-term structural shift are surfacing: the International Monetary Fund's most recent Composition of Foreign Exchange Reserves (COFER) data showed an uptick in the amount of holdings denominated in Chinese renminbi (albeit from a low starting point).

What does this mean for fixed income investors?

The currency tug of war that we've been pointing to for some time continues to play out. On the cyclical front, exceptional US data and the resulting rate spread differentials vs. the rest of the world make a strong case in favour of the dollar. However, the US economy is being propelled by substantial fiscal stimulus, pushing its twin deficit deeper into negative territory. So, from a structural perspective, the dollar looks vulnerable as the US administration's policies abuse its reserve currency status. In the near term, we believe the US dollar can move higher as the cyclical argument wins out, though structural challenges are likely to keep a cap on levels. Importantly, these structural headwinds also mean the US dollar could be vulnerable in the next downturn—a point we're keeping a close eye on.

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