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THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

18 October 2018

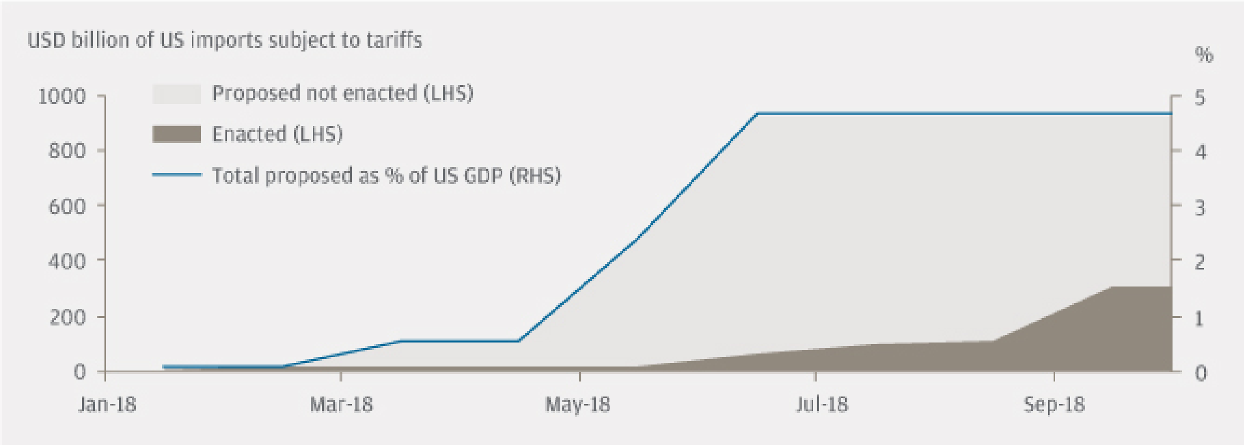
A postcard from Bali

Idiosyncratic stories in emerging markets are showing signs of improvement. Are tactical opportunities opening up, and what is the fundamental outlook for the sector as a whole?

Fundamentals:

Caution was the theme at this month's meetings of the International Monetary Fund and the World Bank Group in Bali. Amid US dollar strength and rising rates, a key risk remains the escalation of US-China trade tensions, with more tariffs proposed than currently enacted. Chinese growth expectations have been reduced, which is likely to affect other emerging markets: for example, China accounts for around half of all global copper and iron ore imports, and a slowdown could affect key exporters such as Chile and Peru. However, China has shown readiness to take measures to prevent a severe downturn, announcing counter-cyclical measures such as spending increases in local government infrastructure projects and tax changes to boost consumption. Our base case is that growth in China will not drop below 6% in 2019, even with continued trade escalation. Another theme to emerge from Bali was one of tactical opportunities as idiosyncratic stories have shown improvement. While the questions around trade and Chinese growth play out, investors might be rewarded in the shorter term for considering countries such as Turkey, where tensions with the US have eased following the release of the imprisoned American pastor Andrew Brunson, or in Brazil, where we see less uncertainty around the upcoming presidential elections.

With more tariffs proposed than enacted, trade tensions could still escalate



Source: J.P. Morgan Asset Management; data as of 16 October 2018.

Quantitative valuations:

Emerging market (EM) turbulence this year has been well documented, and overall returns have proven elusive: EM corporates are down 2%, with EM local government bonds down almost 8% at an index level, in USD terms. However, this masks the differentiation under the surface: in local bonds, Turkey and Argentina have overwhelmingly driven poor performance (down 42% and 52%, respectively), whereas other countries have held up well: Mexico has returned 8% year-to-date. Now may be the time to look at the underperformers: from a year-to-date high of 25%, Argentina government bond yields have recently fallen to around 22%, still markedly higher than 16% at the start of the year. If fundamentals continue to improve, this might represent something closer to good value (all data as at 16 October 2018).

Technicals:

Technicals pose a near-term headwind: liquidity remains poor given recent market turbulence, and supply looks set to increase over the coming weeks, with a heavy new issue pipeline. However, recent new issues have been relatively well received: strong demand recently prompted Turkey to issue USD 2 billion of new debt instead of USD 1 billion. Indeed, demand has shown signs of improvement with outflows tempering: EM aggregate strategies have seen net outflows of USD 1.3 billion in September and October combined, compared to USD 4.1 billion in August alone (as at 12 October). This reduction in outflows could reflect cleaner positioning, with cross-over investors remaining under-allocated.

What does this mean for fixed income investors?

EM valuations are more attractive than they were earlier in the year, and technicals suggest that there are investors on the sidelines who may wish to take advantage. However, a closer look at the fundamentals reveals the need for caution. Investors may need to be wary of the potential drag on growth posed by trade wars, and position themselves accordingly. Tactical opportunities should be the current focus: countries like Brazil, Argentina and Turkey now warrant consideration.

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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