THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

25 October 2018

European credit watch

Mounting political tensions in Europe have been negative for risk assets in October, particularly equities. European credit has so far escaped relatively unscathed, but how long can this resilience persist?

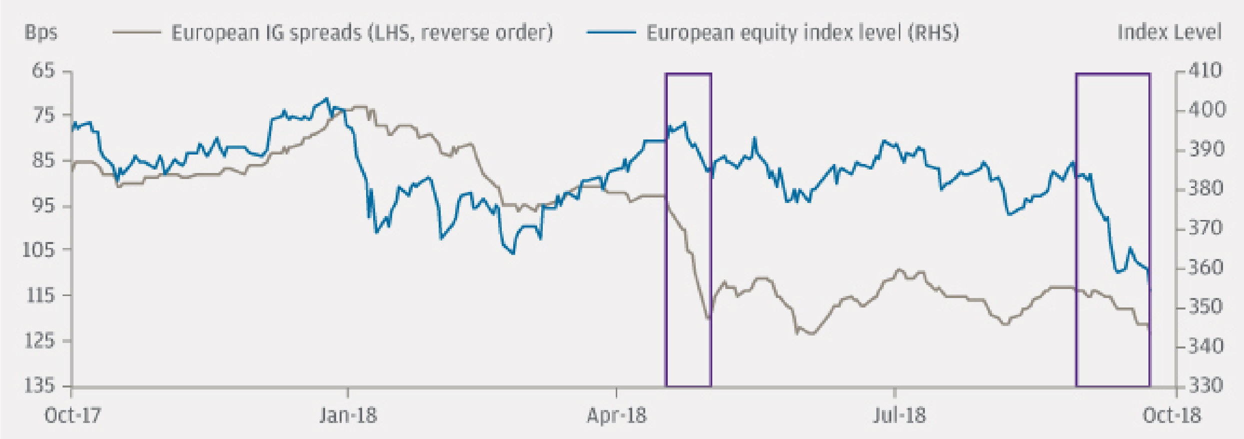
Fundamentals:

European macro data prints continue to paint a picture of an economy growing above trend, but at a meaningfully slower pace than last year. This trajectory was further confirmed by the October flash purchasing managers' indices, with the eurozone composite falling to 52.7—still in expansionary territory, but well below the 56 reached a year ago and lower than long-term averages. However, corporate earnings are not reflecting these macro concerns and 2018 earnings-per-share growth estimates are stable at 6% (although it is still early days in the reporting period). The strength in underlying fundamentals is also evident in credit ratings, as the slow but steady growth environment has enabled European high yield companies to strengthen their balance sheets. So far in 2018, rising stars (companies upgraded from high yield to an investment grade rating) have accounted for EUR 16.4 billion of bonds transitioning from the European high yield market, compared to just EUR 2.7 billion of fallen angels (companies downgraded from investment grade to a high yield rating). This is the largest differential of rising stars to fallen angels based on data that goes back to 2001, and it has provided strong support for the market.

Quantitative valuations:

October has proven to be a difficult month for risk assets, with European equities experiencing a correction of nearly 10% since their peak in September, on a par with the sell-off experienced in February. Meanwhile, European credit has been fairly resilient: spreads have widened by 10 basis points (bps) in the investment grade space and by 44 bps in the high yield market over the same period (27 September to 23 October). While these moves are not inconsequential, they are also not nearly as dire as the reactions to the last iteration of major European political risk in May of this year. In particular, European contingent convertibles—which exhibit a higher beta and tend to trade in line with broad risk sentiment—even tightened in spread over the past week amid the heightened market volatility.

European equity markets have caught up with credit markets, which suffered in May



Source: Bloomberg, Barclays Live, Bank of America Merrill Lynch. Data as of 23 October 2018. IG: Investment Grade

Technicals:

Technical factors pose a risk to European credit markets. Demand has waned, particularly for European investment grade funds, which have suffered 11 consecutive weeks of outflows. The week to 17 October saw outflows reach more than EUR 4 billion. High yield has fared better, although the return of inflows several weeks ago has tapered off and flows are currently neutral. Flows into unconstrained bond funds have just turned negative on the year, suggesting that an indirect support for credit markets is also diminishing—at a time when central bank buying is also on the decline. The key question is whether these flows are a coincident indicator, and reflective of risk-off performance, or a leading indicator, and suggestive of a further downturn in credit performance? One mitigating factor to bear in mind is the supportive supply backdrop, as we are not expecting much new issuance through the end of the year in either investment grade or high yield.

What does this mean for fixed income investors?

European credit has not been as negatively impacted by the risk-off sentiment as the equity market. This can partially be explained by the fact that credit markets suffered more earlier this year. However, volatility—which is still low overall—has room to increase. We remain constructive on European credit because of strong corporate fundamentals, though we have reduced risk at the margin: partially to take profit on positions that have performed well in a challenging year for bond markets, and partially to increase the liquidity profile of portfolios as we recognise we're nearing late cycle.

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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