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THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

1 November 2018

Magic seven

With data coming in much stronger in the US than in the rest of the developed markets, does recent spread widening for US high yield present an entry point?

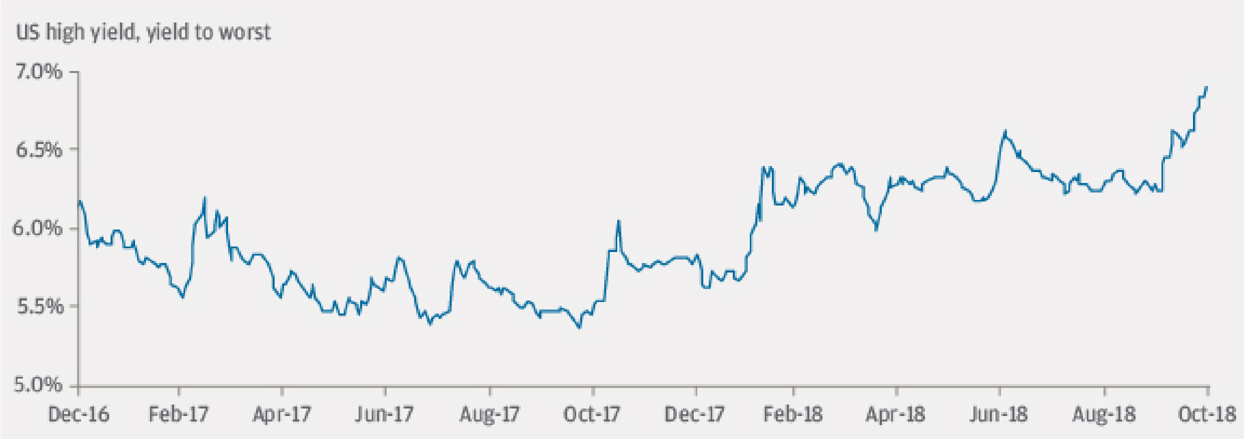
Fundamentals:

The growth divergence story is back: US macroeconomic data remains upbeat, while in emerging markets and Europe we are seeing signs of a slowdown. Third-quarter GDP numbers confirmed this trend: growth in the US surprised to the upside at 3.5% quarter on quarter, while in the eurozone, momentum faded, with growth falling to 0.2%. US consumption also remained strong, and purchasing managers' indices rebounded, with only the housing market showing signs of softness. Third-quarter earnings have attracted headlines due to weakness in a few individual names and slightly less optimistic guidance, but results in the US remain broadly on a strong footing, supporting the improving picture for credit fundamentals. Furthermore, there is upside risk for the upcoming midterm elections in the US: the market is pricing in a gridlock outcome, so a Republican hold of Congress could herald a rally in risk assets in anticipation of further fiscal stimulus.

Quantitative valuations:

Although fixed income overall has been relatively resilient during the recent equity sell-off in the US and Europe, the change in risk sentiment has taken its toll on high yield. Investment grade (IG) credit spreads widened only marginally in October—12 basis points (bps) for US IG and 14bps for European. However, spread moves were more pronounced in the riskier part of the credit market, with the US high yield (HY) index widening by 53bps and EUR HY by 58bps over the same period. These moves took spreads in both markets to their widest levels of the year, with the yield on the US HY index trading just short of the 7% threshold, at 6.89%, at the end of the month—a level last seen in 2016.

The yield on the US HY index is nearing a key threshold of 7%



Source: Bank of America Merrill Lynch, Bloomberg, J.P. Morgan Asset Management; data as of 30 October 2018. ICE BofAML US High Yield Constrained Index.

Technicals:

Fund flows into developed market credit turned negative in October. Our in-house fund flow monitor registered an outflow of around USD 5.4 billion from US HY over the month, the largest monthly outflow since February this year. However, we find anecdotal evidence of investors looking to add back to US HY with the index yield nearing the 7% level. Meanwhile, supply remains supportive: year-to-date gross issuance stood at USD 168 billion at the end of September, compared to USD 256 billion for the same period last year, representing a year-on-year decline of around 35%. Lower dealer inventories are also a positive technical for the market, suggesting that dealers are able to absorb increased selling or supply.

What does this mean for fixed income investors?

We believe the jitters in the US and European HY markets that resulted from the recent equity sell-off have provided an opportunity to add to fundamentally sound names that have been indiscriminately punished by weak risk sentiment. Particularly in the US, the macroeconomic backdrop remains very strong and earnings show little sign of weakness, meaning a yield of almost 7% looks attractive. In addition, HY's shorter duration profile and higher spreads relative to other sectors provide investors with a larger cushion against rising core rates.

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