

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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Is credit clear for take off?

US investment grade yields are at an eight-year high, after considerable moves higher year-to-date. With midterm election uncertainty in the rear view mirror, could now be an opportune time to add some exposure?



Fundamentals:

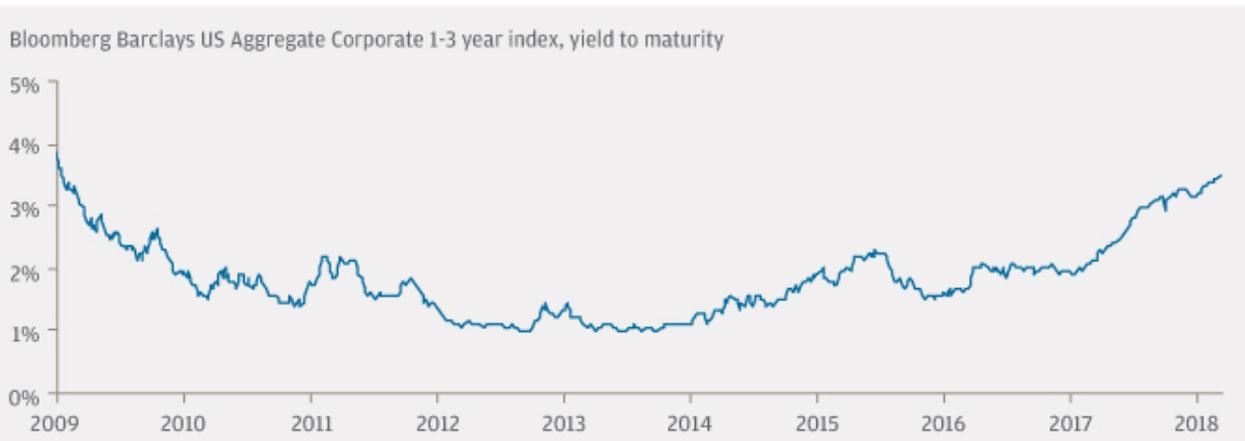
Growth is continuing at pace, especially in the US, where employment growth has surprised to the upside, wage growth is accelerating and non-manufacturing survey data remains at high levels. Softer data in Europe suggests divergence in global growth, but for now, most economies in the region are still expanding. On the political front, the US midterm election passed without incident and was consistent with expectations. The focus should now return to credit fundamentals, which look robust for now: third-quarter earnings seem healthy, as shown by growth in earnings per share of 27% among S&P 500 companies, and revenue growth of 9%. In Europe, the picture is less robust, but still positive: 10% and 6% in earnings and revenue growth respectively. Caution is required, however, as there is a growing belief that US earnings may have peaked, under pressure from a stronger dollar, rising rates and higher wages. Trade tariffs and legislation have also put pressure on some sectors, such as the automotive sector. With that said, the near-term outlook for credit is generally good, especially given increasingly compelling valuations.



Quantitative valuations:

US investment grade corporate bond yields now look attractive relative to history, reaching an eight-year high this month at 4.3% on a broad index level. In Europe, yields of 1.1% are the highest since March 2016. Spreads have also backed up this year, despite rising core rates, with both US and European markets widening by 22 basis points (bps) and 40bps respectively. Given that fundamentals appear to be stable, this could represent an opportune time to invest. Following completion of recent bank stress tests, which did not highlight anything concerning, European bank capital is one area where valuations look attractive: Contingent convertible (CoCo) spreads have widened by 85bps year-to-date, to 3.91% (data as of 6 November).

Corporate front-end yields are now at levels not seen since 2009



Source: Barclays live; data as of 6 November 2018.



Technical:

On the one hand, supply dynamics are favourable. This year, we have seen USD 1.1 trillion of new issuance in the US, down around 10% on last year's figure—a trend that is expected to continue. Estimates are beginning to form for lower expected net supply of up to -20% year over year, given higher maturities and a lower expected level of merger & acquisition related issuance. This drop in supply should provide support to the market. On the other hand, demand is also lower: according to our own fund flow monitor, the US investment grade sector has seen almost USD 5 billion in high grade mutual fund outflows year to date, in addition to reduced demand from foreign investors given the elevated cost of hedging USD-denominated assets. In Europe (ex-UK), investment grade mutual fund outflows have totalled EUR 4.9 billion, given broad-based underperformance thus far (data as of 5 November).

What does this mean for fixed income investors?

A market-friendly US election outcome and solid macro data is likely to reassure investors spooked by recent market volatility, and investment grade credit may be a place to add some near-term risk. Value is likely to be found in both the US and European markets, with higher all-in yields looking enticing. This, along with a supportive supply calendar into year-end and 2019, could act as a tailwind. With flows the key missing element, a pickup in demand could propel the asset class to end the year on a high.

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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