THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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Coming off autopilot

With macroeconomic fears dominating the airwaves, the Federal Reserve (the Fed) may need to prepare to take a less predictable course.

Fundamentals:

Concerns around global growth appear to be driving financial markets. The recent softening in European data is well-documented, with several economies stagnant or contracting in the last quarter. Growth in the region is now only barely above trend, and negative data surprises continue—despite lower consensus forecasts. The outlook for China is also critical for the rest of the world, and we continue to see evidence of a slowdown despite the abundance of tools at the disposal of Chinese policymakers. Slower growth in China is likely to have widespread effects: for example, the country is the world's biggest car market, which means economies with large automotive sectors, such as Germany, would be impacted. To add to the risks around growth, trade tensions are likely to persist. Progress at last week's G20 summit came in the form of an agreement by both sides to a 90-day negotiation window and a pause in further tariffs. However, structural concerns will be harder to resolve in the long-run, primarily to do with cyber-security and China's approach to US intellectual property. These risks could feed back into the US economy, where growth remains above trend despite some signs of a slowdown in the housing market. In this context, the Fed may need to reassess its path of normalisation and take a more reactive approach to future rate hikes.

Despite a robust domestic outlook, a slowdown in other regions may bring the Fed off autopilot

Source: J.P. Morgan Asset Management; data as of 2 December 2018.

Quantitative valuations:

The 10-year US Treasury yield has fallen back below 3%, accompanied by significant underperformance by risk assets: since the 10-year yield reached the year-to-date high of 3.2% on 8 October, US equities have lost 6.1%, US high yield is down 1.8% and European high yield is down 3.4% (data as of 4 December 2018). Adding to investor nerves, headlines in the past week have focused on the inversion of the US two-to-five year yield curve, although more traditional recessionary indicators—such as the difference between two- and 10-year yields—remain positive. With such market moves following criticism by President Trump of the Fed's less accommodative stance, investors also now seem to be questioning the timing of the next Fed rate hike: with one increase fully priced in December, markets are only pricing one more full hike next year, which undershoots the Fed's own current projection of three.

Technicals:

Quantitative tightening continues at a steady pace, with the Fed expected to reduce its purchase of US Treasuries by around USD 250 billion in 2019. This reduction in demand will not be offset by lower supply, as an increase in issuance is forecast to fund a higher budget deficit. Normally, this environment should prove a technical headwind for US government bonds, but the fundamental concerns around the global economy have been encouraging investors into Treasuries at the expense of risk assets. The outflows here have been heavy: outflows from developed market credit and emerging market debt mutual funds this year have totalled over USD 80 billion, while inflows to US Treasuries and TIPS (Treasury inflation-protected securities) have totalled over USD 36 billion (data as of 4 December 2018).

What does this mean for fixed income investors?

Despite signs of a slowdown in global growth, and the persistence of structural trade concerns, the US economy remains in very good health from a fundamental standpoint. Additionally, recent re-pricing in risk assets could present attractive investment opportunities. However, the risk is that external factors feed back into the US economy, and at this point it will be incumbent on the Fed to reconsider its projections for 2019. For now, it does not look as though the hiking cycle—or indeed the economic cycle—are over. It may just be time for policymakers to switch off the autopilot.

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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