THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

13 December 2018

A year of transition

2018 has been a challenging year for market returns across the board. What has driven the uncertainty, and will volatility persist in 2019?

Fundamentals:

Negative sentiment in 2018 has been widely attributed to political turmoil—particularly trade war worries—as well as recessionary fears. While these factors are no doubt having an impact, we believe another drag on markets has been the undercurrent of reduced liquidity in the system, as central banks, particularly the Federal Reserve (Fed), have shifted to more restrictive policy stances. The move away from ultra-accommodative monetary policy is likely to persist in 2019, though we expect the pace of change to slow as we approach the end of the economic cycle. Peak global growth for this cycle is likely behind us, given fading momentum in the US, as tariffs, weaker global growth and reduced fiscal support take their toll. Market pricing of central bank actions next year is reflecting this outlook, with only 15 basis points (bps) of hikes from the Fed and just 8 bps from the European Central Bank (ECB) priced in. It's important to keep in mind, though, that while financial conditions have tightened this year, they remain more favourable than at the recent peak in 2016, suggesting that this market pricing may be more dovish than is warranted.

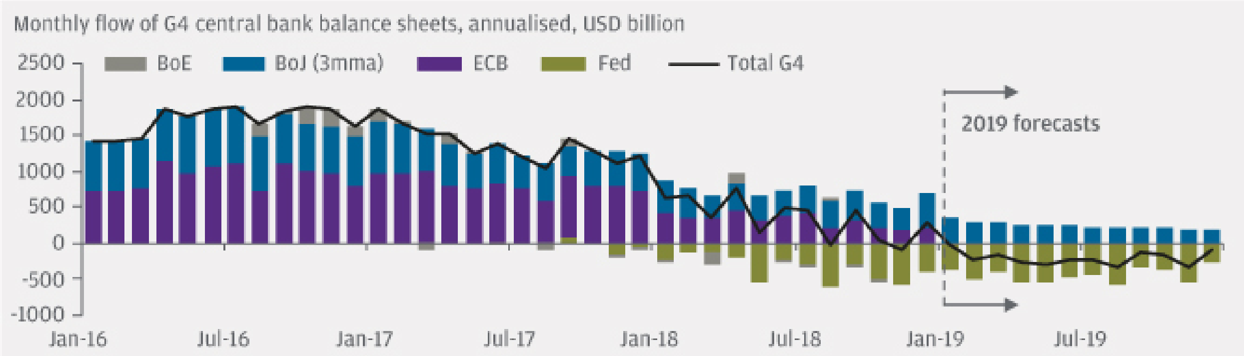
Quantitative valuations:

The increase in volatility (which could be seen merely as a return to more normal levels of volatility) has resulted in negative returns broadly across financial markets. Fixed income spread sectors have endured a meaningful move wider year to date: global high yield spreads are nearly 140 bps higher, global investment grade more than 50 bps higher, and emerging market sovereign spreads more than 100 bps higher. This risk-off sentiment is also evident in equity markets, where Europe, Asia and certain sectors of the US market have struggled significantly. The government bond market has been more nuanced, with dispersion in rate moves across regions. After rising more than 80 bps to peak at 3.24% on 8 November, the 10-year US Treasury yield has subsequently retraced nearly half of that move, to current levels below 3%. Meanwhile, just when investors thought German yields couldn't go any lower, they have: 10-year Bund yields have fallen 20 bps this year, from 0.43% to 0.23% currently—the lowest level all year. (All data to 11 December.)

Technicals:

The liquidity drain—that is, the shift from quantitative easing to quantitative tightening—was well telegraphed. However, the impact that it would have on markets was less certain, due to the unprecedented nature of the policies themselves. As we move into next year, we can add another central bank to the list of those no longer actively buying bonds in the market, as the ECB winds down its public and corporate sector purchase programmes. While the ECB's policy will remain in expansionary territory as it continues to reinvest the proceeds of its existing holdings, that still leaves the Bank of Japan as the only major central bank actively expanding its balance sheet. The net result? An environment of shrinking central bank balance sheets, and likely ongoing volatility for financial markets.

Entering a world of shrinking central bank balance sheets



Source: Federal Reserve, ECB, Bank of Japan (BoJ), Bank of England (BoE) and J.P. Morgan Asset Management forecasts; data as of December 2018. 3mma: three-month moving average. Opinions, estimates, forecasts, projections and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

What does this mean for fixed income investors?

2018 has been a transition year: to a higher volatility regime, to the late stages of the economic cycle, and to a world of quantitative tightening. As we look ahead to 2019, uncertainty is likely to persist, given question marks over the potential for global growth convergence, the direction of trade wars, and the ability of central banks to normalise policy before the next recession. For bond investors, this clouded global picture poses two key questions: Will duration be friend, or foe? And are spread assets signalling a value opportunity, or a value trap?

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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