J.P.Morgan Asset Management

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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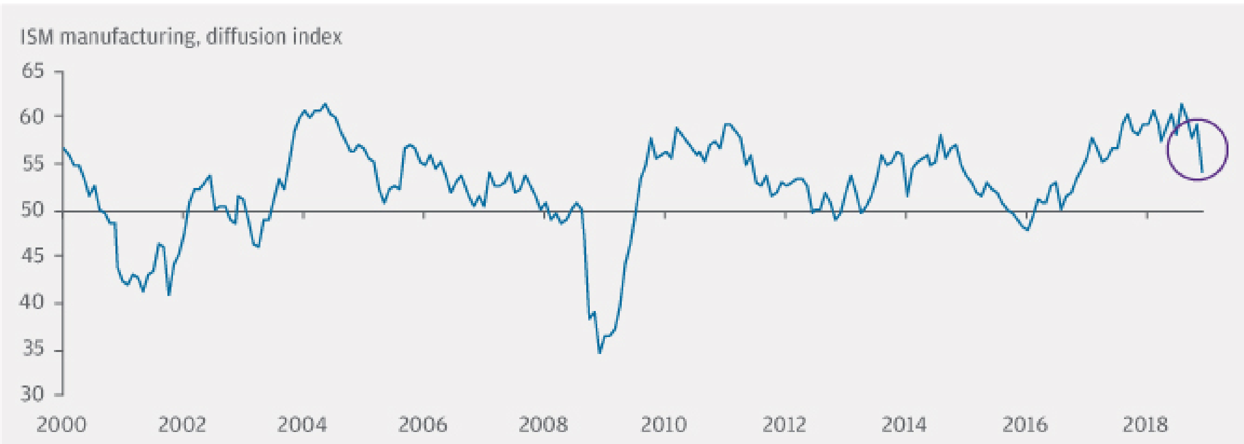
A watchlist for 2019

After a difficult period for returns in 2018, we are watching five issues that could shape markets in another potentially volatile year.

Fundamentals:

One key question for investors in 2019 is whether the Federal Reserve (Fed) will make a policy mistake. Although December's US rate hike—the fourth in 2018—was consistent with both forward guidance and market expectations, global markets reacted negatively, suggesting investors are now concerned with the threat of over-tightening. With the right conditions, we think the Fed will find capacity to hike twice more in 2019, although our conviction in this view is lower than before and the timing is uncertain. The path of the federal funds rate is one of the five factors we think will shape markets this year, and itself depends on the other four—namely, the outcome of US/China trade discussions, which are dragging on global activity; the strength of demand for oil; political developments, including Italy, Brexit and the US Congress stand-off; and the impact of reduced fiscal stimulus in the US as a result of congressional gridlock. We can be reasonably confident that a lack of resolution to ongoing uncertainties will be bad for markets, and will hold the Fed back from any further tightening. What remains unclear is the probability of positive outcomes, and the extent to which they could boost the global economy, thus allowing the Fed to exercise its mandate.

ISM manufacturing PMI reflects widespread concerns around trade



Source: Institute for Supply Management, data as of 31 December 2018. PMI: purchasing managers' index.

Quantitative valuations:

Fed chair Jerome Powell's reassuring comments at the beginning of this month were key to reversing much of December's underperformance. As of 9 January, risk assets were sharply up, with US high yield up 3.14% year to date, reversing its losses in December. Accordingly, Treasury yields have climbed again, from the low of 2.56% on 3 December 2018 to 2.71% on 9 January. Rate expectations have also moved dramatically. On 3 January, the market was pricing in 44 basis points (bps) of rate cuts between now and the end of 2020; as at 9 January, the market expects 12 bps of cuts—though we think this underestimates the likelihood of further hikes this year, pending positive outcomes to the conditions outlined above.

Technicals:

A key technical in bond markets is the supply and demand dynamics for US Treasuries. On the supply front, a wave of issuance is expected, to fund a higher US budget deficit. However, this potential headwind is already well understood by markets, and the outcome of last year's mid-term elections makes the prospect of further supply from fiscal stimulus highly unlikely. On the demand side, the Federal Reserve has ended quantitative easing and is actively shrinking its balance sheet. However, the impact may be softened by Powell's recent indication that the Fed is prepared to pause its balance sheet runoff should conditions warrant it.

What does this mean for fixed income investors?

It is too early to see the New Year rally as a harbinger of strong returns in 2019, given the obstacles that lie ahead. We acknowledge some optimism, but maintain a cautious note. Market observers will be watching the outcome of trade wars, political worries and reduced US fiscal stimulus carefully. Not least among such observers will be the Fed, which has come off autopilot and gone to some lengths to demonstrate the patience and flexibility required to navigate the uncertain economic environment.