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THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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The credit party isn't over yet

European high yield has started the year in good spirits, supported by attractive valuations, robust credit quality and positive technicals. But with global growth momentum slowing, will the credit party continue?

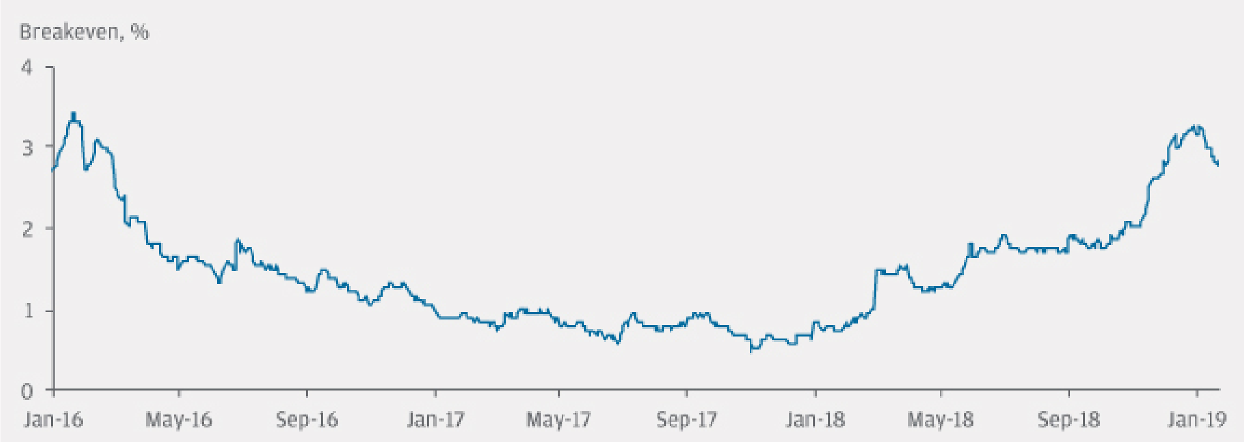
Fundamentals:

The earnings season has yet to begin in earnest and the impact of trade tensions on companies remains to be seen, but European high yield credit quality looks sufficiently robust to weather any fourth-quarter earnings disappointment. Slowing global growth remains a headwind to Europe's export-driven economy, but we still expect growth to remain above trend in 2019 and thereby avoid a recession. Furthermore, we expect that the fall in commodity prices late in the second half of last year will boost European corporate earnings over subsequent quarters. Investment grade corporate bond quality seems to be one of the primary concerns in credit markets at the moment, with the growth of the BBB market (around 50% of all investment-grade companies are now rated BBB) prompting fears of a flood of fallen angels entering the euro high yield market. While at a headline level, the surge in BBB credits might be cause for alarm, it is worth noting that a large proportion of this recent growth is the result of rising stars from the high yield market, as opposed to companies downgraded from higher ratings. In the last year alone, more than EUR 20 billion of high yield bonds was upgraded to BBB. Moreover, the share of Baa3-rated debt (the lowest investment grade rating) within the BBB market has actually declined in the past five years, from a peak of 23% to 18.6% now.

Quantitative valuations:

European high yield has started 2019 well, returning 1.64% month to date and reversing almost half of last year's losses. While this trails the US high yield market so far this year, the European market did not suffer the sharp energy-led downturn experienced by US high yield bonds in December. As a result, the performance of both markets since the end of November is more similar. Despite having a higher average credit quality, European high yield spreads still trade 41 basis points wider than US spreads. This discount has largely persisted since last summer and reflects general malaise around European growth prospects. Spreads should remain attractive for some time, leading to a positive carry environment. The short duration component of the European high yield index looks particularly compelling from a breakeven standpoint: with 1.2 years of duration and a yield of 3.4%, overall yields would need to increase by over 2.8% to produce a negative total return (all data as of 23 January).

Breakeven levels in short duration European high yield are near the highest in three years



Source: Bloomberg, J.P. Morgan Asset Management; data as of 23 January 2019.

Technicals:

A lack of new issuance in recent months has resulted in very low liquidity in the primary market. Just as a lack of bids propelled much of the underperformance in December, a lack of offers is now driving market performance. The risk that these less volatile markets will prompt a rush of new supply, and thus pressure secondary spreads, is offset by two main factors. First, new deals will provide fresh investment opportunities and thereby ease liquidity conditions in the secondary market. Second, demand looks healthy as weekly fund flows into European high yield have turned positive for the first time since October and the initial wave of new supply could provide attractive risk premiums for investors.

What does this mean for fixed income investors?

Fundamentally, lower European growth has prompted issuers to manage their balance sheets prudently and default rates are expected to remain below average. 2018's sell-off has resulted in compelling valuations, especially relative to US high yield. We are cautiously optimistic that, providing an increase in issuance does not upset the supportive technical backdrop, this market can at least provide an attractive environment for carry. We remain conscious of the persistent global macroeconomic risks and are therefore looking selectively at defensive sectors that can withstand a slowdown in global growth momentum.

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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