

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

14 February 2019

Reading between the lines

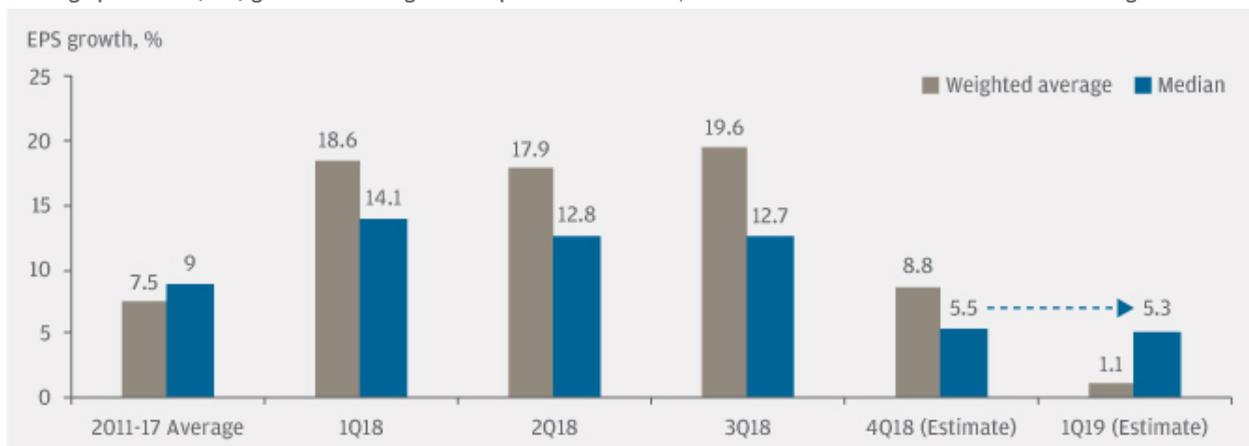
While weaker headline earnings growth in future quarters could unsettle investors, many underlying factors suggest corporate health remains strong. What is the full story for investment grade credit?



Fundamentals:

With around 80% of companies having reported, fourth-quarter results look good: revenue and earnings have grown at around 7% and 14% respectively. The key concern is how much longer such strong performance can continue given worries about the wider economy and the end of the credit cycle, with expectations suggesting both revenue and earnings growth will be markedly lower next quarter. However, index-level headline figures do not tell the whole story. The impact of last year's US fiscal boost on reported earnings to date is important: rather than reflecting a drastic change in corporate health, lower numbers next quarter are more likely to be the result of a drop from very high previous levels. Additionally, earnings are not the only indicator of corporate health. As well as boosting growth, last year's tax reforms had the effect of increasing corporate cash flow, which is a potential positive for bondholders. Furthermore, while earnings growth is likely to decelerate, the trend looks less stark when considering the median figures across the market instead of the broader weighted average, which is likely to be dragged lower by the larger technology, automotive and energy names.

Earnings-per-share (EPS) growth excluding tax is expected to decrease, but the median is less affected than the average



Source: Credit Suisse, Factset, J.P. Morgan Asset Management; data as of 8 February 2019.



Quantitative valuations:

US investment grade spreads have tightened around 30 basis points (bps) from the wides seen at the start of the year, to 124bps as of 13 February. As such, credit has posted total returns in the US of almost 2.5% year to date. Well-documented global headwinds mean that it is not clear how much further—if at all—spreads can tighten from current levels. With that said, certain parts of the market have lagged recently, and could catch up given the right conditions. The recovery in BBB credits has been less pronounced than in higher quality names, retracing less than half of the spread widening of the fourth quarter (single A rated credits have retraced over two thirds). Given that many issuers within the BBB market—especially those in the higher quality BBB+ area—are still exhibiting positive fundamentals, the cautiously selective investor could be rewarded.



Technical:

This year's rally has been aided by investors putting high cash levels to work after becoming overly bearish in the fourth quarter. Surveys now suggest much longer positions in credit than at the end of last year. While it is unlikely this pace can continue, demand remains healthy: US retail inflows have steadily accelerated this year, reversing the trend of heavy outflows late last year, with over USD 6.5 billion of inflows in the week ending 8 February 2019. Notably, demand has also picked up again recently from Asian investors. With supply meaningfully lower this year (cumulative issuance is down 16% year on year), technicals should not present a significant headwind in the near term.

What does this mean for fixed income investors?

Given the current global growth and political worries, weaker earnings headlines in the first quarter could cause concern in credit. However, broad-based index-level measures rarely tell the whole story. Softer earnings momentum should be taken in context, given last year's fiscal boost, and there will inevitably be sectors more susceptible than others to changes in global economic conditions. While it has become clear that the end of the credit cycle is moving closer, now is not the time to panic: a measured, selective approach to risk will continue to be crucial. We are methodically upgrading our portfolio, moving up in credit quality and the capital structure.

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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