THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

28 February 2019

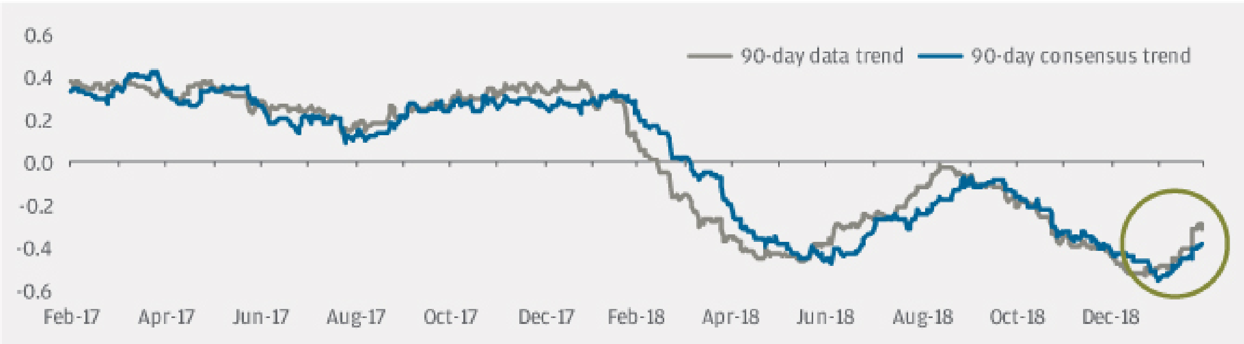
On the rebound?

The year started with global macro data and quantitative valuations moving in opposite directions. Can this trend continue, or will one side give way?

Fundamentals:

While the data out of the US has been marginally weaker this week, with the Philadelphia Fed Manufacturing Index ticking lower, the US economy remains in a healthy state. Europe, on the other hand, may be showing early signs of a rebound after experiencing a prolonged period of weak macroeconomic momentum since early last year. While the eurozone manufacturing Purchasing Managers' Index (PMI) has surprised to the downside, the services PMI has actually improved from 51.2 in January to 52.3 in February. In Germany, the Ifo Business climate index fell from 99.3 last month to 98.5 in February, the lowest level since December 2014. However, the manufacturing export expectations component has stabilised, suggesting that the outlook for Europe's largest export economy may not be so bleak after all. Moreover, continued positive headlines surrounding trade talks between the US and China, even on the more contentious topics, present some favourable news for Europe's auto companies and other goods exporters. Combined with other data in the region, Europe's negative data trend appears to have bottomed out at the end of January 2019 and has been recovering since then. Our in-house trend indicators also show positive macro surprises in emerging markets, particularly in Asia and CEEMEA (central and eastern Europe, the Middle East and Africa).

Eurozone data has bounced back since the end of January 2019



Source: J.P. Morgan Asset Management; data as of 26 February 2019.

Quantitative valuations:

Since the beginning of the year valuations across both government bonds and risk asset classes have rewarded investors despite the worsening global economic data. While the January rally could have been seen as a rebound from the December sell-off, developed market and emerging market credit valuations have continued to gradually grind tighter in February. Investment grade corporates in Europe and the US returned positive month-to-date numbers, while the performance of the high yield segment was even stronger, with US high yield and Europe high yield delivering returns of 1.51% and 1.60% respectively (as of 26 February). Emerging market sovereigns and corporates also continued their strong year-to-date momentum, with returns of 0.89% and 1.02% respectively. Although more dovish global central banks have helped to fuel this stronger sentiment, we believe we will need to see further signs of improving global growth if this positive momentum is to continue.

Technicals:

One of the key drivers for positive performance in January and February was the technical backdrop. Investors who sold holdings in emerging market debt, developed market high yield and investment grade credit late last year have been rebuilding their exposure. This strong demand is confirmed by our fund flow monitor, which shows that all these asset classes received significant inflows in February. Surveys are suggesting heavier positioning across asset classes, leaving us to believe that the near-term upside should be somewhat limited. The supply side remains more mixed—we continue to see barely any new primary deals in the European high yield space and there were only a few larger new issues in the emerging market sovereign space, but supply is expected to pick up for US investment grade and emerging market corporates.

What does this mean for fixed income investors?

The decoupling of global macroeconomic data and market sentiment has been one of the main worries this year. Strong market rallies, such as the one witnessed in January, are often followed by corrections and periods of weakness, but signs of a turnaround in macroeconomic data in Europe and emerging markets suggest that the market may have been more forward-looking and has already priced in these improvements. We believe that we could be back in a "muddle through" growth scenario, where economies avoid overheating or rapid slowdowns. Such an environment should be favourable for fixed income spread products and bond investors generally.

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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