J.P.Morgan Asset Management

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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Can it carry on?

The 2019 rally is underpinned by progress on the fundamental issues that rattled markets at the back end of last year. But given the strength of the rebound, how much longer can it continue?

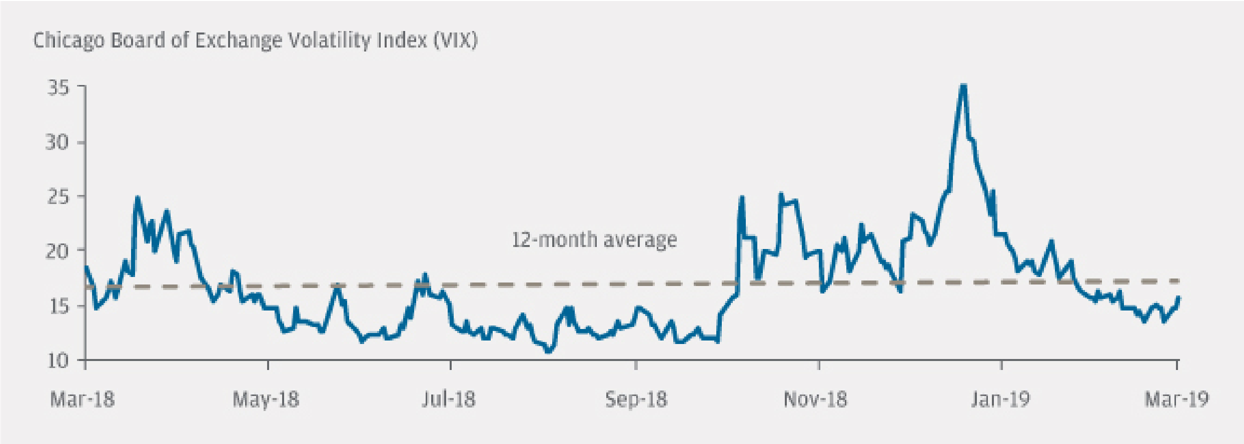
Fundamentals:

Four key themes combined to weigh on markets in Q4: China's slowdown, compounded by trade wars; political discord; weak economic data; and the threat of over-tightening by central banks. Broadly speaking, there has been progress on all fronts. US-China trade talks seem to be making headway, while Beijing's stimulus measures are starting to take effect. The political climate in Europe has been more muted, and there are signs of improvement in the regional data, with a tentative tick up in consumer and services confidence providing a potential early sign of stabilisation. Finally, in the wake of the Federal Reserve's (Fed's) more dovish stance, Canada has become the latest central bank to step back from its tightening bias. These factors have led investor sentiment to shift emphatically: over 80% of the panic indicators that we monitor now demonstrate a risk-on bias. The question is whether this can persist.

Quantitative valuations:

The bounce back in risk assets has been hard and fast, delivering a 5.5% total return for high yield so far this year. Moreover, the rally has been relatively plain sailing, with volatility remaining low, as seen by the steady drop in the VIX to below the trailing 12-month average for the last 12 months. Caution is warranted: low volatility now means there is scope for an increase if the positive macro backdrop turns around. Furthermore, there are signs that the rally could be in its late stages. In European high yield, for example, lower quality bonds have begun to outperform, with CCCs returning 3.55% since the end of January, vs. 2.27% for the broad index, suggesting investors are willing to look to less attractive areas of the market in the search for yield. Nevertheless, while valuations generally look less compelling than they did at the start of the year, all-in yields remain higher than levels seen in early 2018. Providing the macro fundamentals hold steady, we could see a grind tighter in risk assets—or at least an attractive carry trade. (All data as of 6 March.)

Volatility has moved meaningfully lower as markets have rallied



Source: Bloomberg; data as of 6 March 2019.

Technicals:

Technicals are proving benign, and the more dovish Fed should continue to provide a tailwind. For risk assets, low supply is further propelling returns as risk sentiment improves. In high yield, for example, the volume of US new issuance is 12.7% lower than at this point last year, while Europe has seen only nine new deals this year. There has been a meaningful pickup in investment grade supply over the past few weeks, but this has been offset by very healthy demand, particularly from investors in Asia. With only a couple of exceptions, flows have been positive year to date in all fixed income sectors (as of 6 March), confirming the change in sentiment.

What does this mean for fixed income investors?

Improved fundamentals make an extension to the economic cycle more likely, and risk assets are very much on the rebound. However, valuations are becoming stretched, and a grind tighter looks the most likely scenario from here. The risks will need to be monitored carefully, as a change in any of the macroeconomic factors driving sentiment—deteriorating data in Europe, for example, or a trade setback—is likely to prompt investors to revisit the questions they were asking in Q4 about the global growth environment. For now, we think the vigilant investor should be rewarded with attractive carry and the prospect of continued near-term positive returns for risk assets.

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