THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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European credit ticks the boxes

An already accommodative European Central Bank (ECB) surprised markets with an even more dovish stance at its 7 March meeting—positive news for European credit.

Fundamentals:

While the measures announced by the ECB were broadly anticipated, the introduction of them now—and all at once—was unexpected. We view the ECB's decision to significantly downgrade inflation and growth forecasts, further push back rate guidance and introduce a third round of targeted longer-term refinancing operations (TLTRO) as a marking to market with the weak macro backdrop. The last measure, in particular, is supportive for European credit, as the TLTRO initiative lowers marginal funding costs for eurozone banks to incentivise them to lend to corporations. Our belief that the ECB will remain accommodative (we expect its next move to be further policy easing in some form), combined with signs that regional macro data has bottomed, creates a positive environment for credit. Furthermore, companies may experience a tailwind to Q1 2019 earnings as a result of the weaker euro (down 9% vs. the US dollar over the year to 12 March) and the downward trend in input prices. Mergers and acquisitions are also on the rise in European credit markets, particularly in the technology, media & telecom sector, which is positive for high yield (HY) given the resultant capital improvement for the companies being acquired. There are risks to be mindful of, though: if the US begins to target Europe with increased tariffs, this could certainly cause a risk-off move.

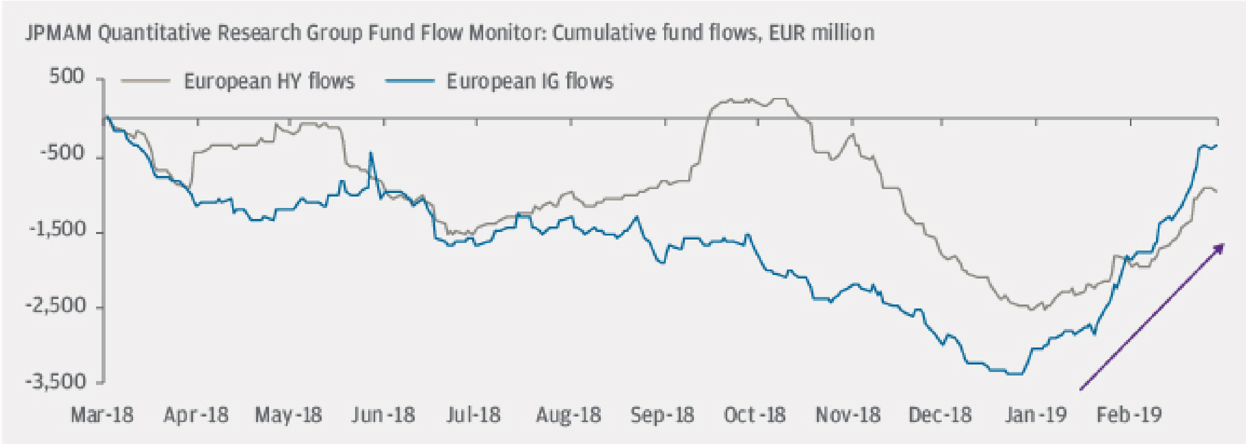
Quantitative valuations:

European investment grade (IG) credit still contends with low absolute yields, although valuations are increasingly attractive on a relative basis, given the supportive macro backdrop and the high quality nature of the sector as we shift to late cycle. With more than 30% of the European government bond market still trading with a negative yield, the 1% yield of European IG credit does not look as meagre. Moreover, hedged yields for Japanese investors have improved meaningfully in favour of the European market: European IG yields for the 5-7 year maturity bucket hedged to yen are 1.4%, compared with 0.8% for US IG yields hedged to yen. In the HY space, spreads continue to trade wider for Europe than for the US—despite the higher credit quality of the European market—suggesting that political risks are already priced in. (All data as at 12 March.)

Technicals:

Technical factors are a bright spot for both IG and HY credit in Europe. Demand has been strong across both sectors: IG recorded EUR 3.8 billion of inflows in the week to 6 March, the largest weekly inflow for the market in more than a year, and HY is on track for its third consecutive month of positive flows, with an increasing proportion coming from mutual funds vs. ETFs. In the IG market, supply has risen to meet this demand, with new issuance running more than 20% higher than this time last year, but new deals have been well absorbed by the market thus far. It's a different picture in European HY, where the primary market continues to be very subdued—only 11 new deals year to date, with a bias to higher-quality, BB-rated issuers.

After a year of mostly negative flows, demand has been strong across European IG and HY credit



Source: J.P. Morgan Asset Management; data as of 12 March 2019.

What does this mean for fixed income investors?

European credit looks attractive from both a macro and micro perspective: an accommodative central bank combined with slow but steady growth and still-decent earnings bodes well for the sector; relative valuations offer some yield and spread pickup in this carry environment; and constructive supply/demand dynamics should support further positive performance. In general, we are favouring higher quality credits for their longer duration and higher liquidity profile. That said, while we're cognisant that European HY has run a long way so far this year, it continues to look like an attractive carry opportunity.

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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