

THE FUTURE OF FIXED INCOME

# Weekly Bond Bulletin

11 April 2019

## Laggard of the bunch

An improved macroeconomic backdrop continues to support hard currency emerging market (EM) debt, which has outperformed local currency EM debt this year. However, is there now room for EM currencies to take off?



### Fundamentals:

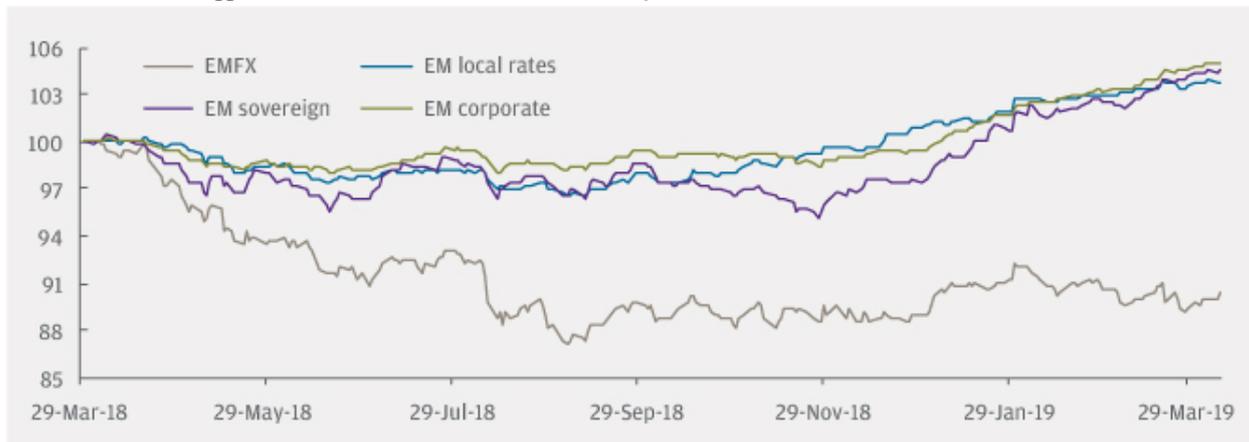
Global growth continues to show tentative signs of a recovery, with J.P. Morgan's March global composite purchasing managers' index, European hard data and US first-quarter GDP expectations all improving in recent weeks. While this rebound in developed markets, especially in Europe, is still to be confirmed by additional data releases, our outlook on emerging markets is increasingly positive. Our internal economic surprise indicators are pointing to a steep improvement in EM data and market expectations since March, while our leading economic indicator index is also showing a noticeable uptick after a prolonged period of weakness. The newly released International Monetary Fund World Economic Outlook has largely confirmed our expectations that the growth differential between emerging markets and developed markets is set to rise this year, and even more so in 2020, creating a positive environment for EM debt. The backdrop for EM currencies to perform is also there, especially as US dollar strength should be limited by a dovish Federal Reserve and the US economy is looking unlikely to grow as fast as last year.



### Quantitative valuations:

Hard currency EM debt has performed strongly since the start of the year. EM sovereigns and corporates have returned 7.30% and 5.57%, respectively. Although spreads have moved by 75 basis points (bps) for sovereigns and by 50bps for corporates year-to-date, both asset classes continue to offer an attractive carry given the current improved environment. The real conundrum for EM investors has been EM currency performance. After underperforming substantially in early 2018, EM foreign exchange (EMFX) has rebounded by 3.66% since the low point in September last year. However, performance has lagged in the past few months with EMFX appreciating only by 1.42% against the US dollar year to date. This leaves the EM currency index still down 7.81% since the beginning of 2018. Historically, EM currencies have appreciated when the Fed has finished its hiking cycle, but we are not seeing this playing out to the same extent as in the past. (All data to 9 April).

EM currencies have lagged other EM asset classes in the recent rally



Source: J.P. Morgan Asset Management; data as of 9 April 2019.



## Technical:

Although fund flows were very supportive in the first quarter, early April data has been more mixed. Our in-house fund flow monitor recorded inflows of almost \$23 billion into EM debt funds over the first quarter, while we have seen an outflow of around \$1.1 billion so far this month (as of 9 April) possibly driven by cautious profit taking. While investors may be inclined to believe that there is limited room for further inflows, it's worth noting that even with year-to-date fund flows, we are still below where we were in April last year. Furthermore, the recent Saudi Aramco multi-tranche international bond debut that had an order book of over \$100 billion shows how much money there is still at play waiting to be invested in strong credits. Given that EM sovereign supply remains subdued and only the EM corporate pipeline looks reasonably busy, we may see part of that capital invested through the secondary market. On the EMFX front, a number of surveys are flagging that investors have reduced their long positions, potentially providing room for a near-term rally if we get more positive news.

## What does this mean for fixed income investors?

With the macroeconomic backdrop turning supportive for risk assets this year, investors with exposure to EM debt and other higher yielding fixed income classes enjoyed a sizeable rally in the first quarter. With the environment remaining positive and demand for credit still strong, we are looking to capture attractive carry opportunities in hard currency EM sovereigns and corporates. We are more constructive on duration and therefore aren't shying away from moving into higher quality longer maturity credits. At the same time, investors looking for higher potential returns may find selective EM local currency exposure attractive given improved technicals and supportive fundamentals.

### 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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