THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

25 April 2019

Time for a breather?

Credit markets have enjoyed a strong march upwards, supported by robust technicals and a broadly positive fundamental backdrop. With issuance set to pick up, could now be the time to take some chips off the table?

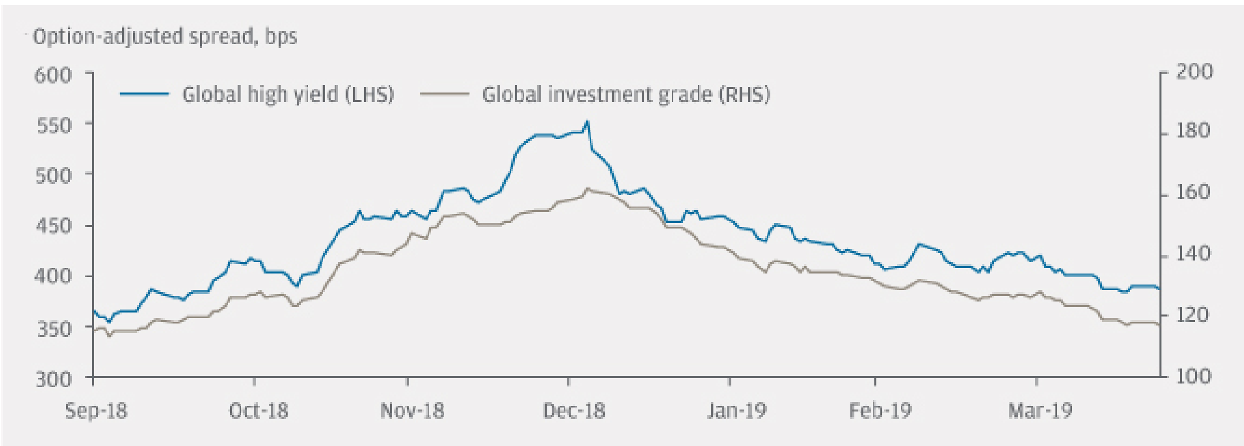
Fundamentals:

The latest data releases have reaffirmed the picture of low inflation and muted growth. US core CPI came in below expectations at a lacklustre 2% year on year in March. Australian CPI fell significantly short of estimates, resulting in the market now pricing in two rate cuts this year, while inflation remains soft in Europe and Japan. On the manufacturing front, the latest US purchasing managers' index steadied at lower levels, while the eurozone also seems to have stabilised, but shows little sign of a more convincing recovery. On a positive note, the first-quarter earnings season is off to a strong start and, with a substantial portion of US corporates having reported, there have been no significant negative surprises so far among the large investment grade issuers. On the whole, growth is far from recessionary, but is not strong enough to warrant a hawkish stance from central banks.

Quantitative valuations:

Against this relatively benign backdrop, credit markets are enjoying a strong run. Global investment grade and high yield markets have already achieved year-to-date returns of 4.5% and 7.99%, respectively. Spreads are almost back to the levels seen at the end of September last year, before risk markets sold off in the fourth quarter. Looking at high yield specifically, if we strip out the laggards from the recent rally—namely the distressed portion of the market (with a price below 70), to which investors have been unwilling to commit—the market's current spread of 388 basis points (bps) reduces to 353bps. (All data as of 23 April.)

Credit market valuations are almost back to their levels of the end of September 2018



Source: ICE BofAML Global High Yield Index (HW00), ICE BofAML Global Corporate Index (G0BC); data as of 23 April 2019.

Technicals:

Supportive technical conditions have been a significant driver of the upward march of credit. On the demand side, US investment grade funds saw their largest weekly inflow since 2015 in the week to 12 April, according to EPFR. In Europe, high yield funds have witnessed inflows nearly every day this month, while investment grade funds have enjoyed seven straight weeks of inflows since the end of February. At the same time, supply has tracked well below last year's levels for credit markets globally, with the exception of European investment grade, where new issuance has been well digested. However, the European high yield market alone announced seven deals in the week beginning 22 April. For the most part, these have been to refinance existing debt, and therefore net supply is not too much of a worry. But the primary market for investment grade looks set to pick up substantially once earnings blackout periods are behind us. In the short term, this could cause some indigestion, unless demand remains elevated.

What does this mean for fixed income investors?

Overall, the backdrop provides a positive environment for fixed income. Low growth and inflation should result in a sustained accommodative stance from central banks, while ensuring that corporates remain focused on balance sheet health, which keeps us constructive on the medium- to long-term outlook. However, we acknowledge that volatility is close to historical lows again. As such, we think it would be sensible to reduce risk at the margin before the spring supply surge takes its effect on the market. As and when bouts of volatility do resurface, we would be inclined to see them as buying opportunities.

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