J.P.Morgan Asset Management

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THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

23 May 2019

Will rate cuts follow the sun?

The Reserve Bank of New Zealand has led the way with its recent interest rate cut. As we head towards the end of the cycle, other developed market central banks could be expected to follow.

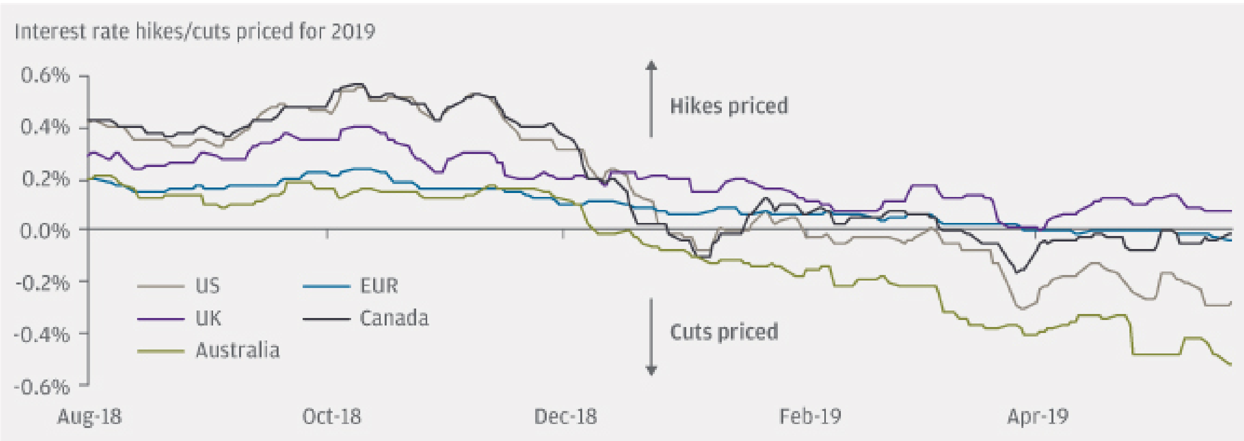
Fundamentals:

Acting on a combination of low inflation and weaker economic growth, the Reserve Bank of New Zealand earlier this month became the first developed market central bank in the last few years to cut interest rates. The Reserve Bank of Australia looks set to follow, having signalled this week that it would "consider the case for lower interest rates" at its next policy meeting in June. A cut would be a reasonable response to persistent weakness in the Australian housing market and recent softer labour market data, with unemployment rising to 5.2% in April. The immediate trajectory and timing for other regions is less clear—particularly in the US, where low inflation is likely to prevent further rate increases, but growth remains robust enough to prevent immediate cuts (for example, US consumer confidence reached cycle highs in April). On balance, therefore, while the Federal Reserve (the Fed) is likely to remain on hold for the time being, it is clear that other central banks are shifting towards easier policy.

Quantitative valuations:

Market expectations have shifted considerably over the past six months, from a tightening bias to anticipation of looser monetary policy. Markets have priced in a full 25 basis point rate cut for the Fed this year, with another priced for 2020. Given that growth in the US is yet to meaningfully slow down, and the Fed looks comfortable with rates where they are, we're sceptical about the chances of a full rate cut in the second half of this year. With that said, growth concerns and headline risk elsewhere around the globe could mean that two full cuts is a realistic expectation between now and the end of 2020, with the specific timing yet to be established. Regardless, current market expectations serve as a useful barometer for global sentiment, and may pre-empt the general direction of central bank policy in the coming months.

Expectations of rate hikes have disappeared, with cuts priced in for most central banks in 2019



Source: Bloomberg; data as of 21 May 2019.

Technicals:

Demand for fixed income in general looks robust, as positive performance this year has led to strong inflows across asset classes. US aggregate bond funds in particular have seen strong flows—over USD 64 billion year to date. These inflows, along with coupon and principal repayments, have required investors to grapple with high cash balances. As such, the grab for yield continues. With recent central bank actions also meaning that the fear of higher yields (which characterised most of 2018) has subsided for now, this should be a favourable environment for fixed income.

What does this mean for fixed income investors?

New Zealand has led the way in cutting rates. As we near the end of the cycle, opportunities to add government bond duration across the globe should begin to increase. Australia is a current case in point. Other regions are not quite there yet, with the growth picture in the US, for example, remaining broadly supportive of fixed income risk assets. Nevertheless, it now looks increasingly clear that, on balance, central bank policy is more likely than not to be accommodative for the rest of this cycle.

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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