

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

13 June 2019

The story so far

As we hold our latest Investment Quarterly meeting, we take a look at how 2019 has played out so far. Dovish central bank policy has propelled markets to strong returns, but trade remains a key risk.



Fundamentals:

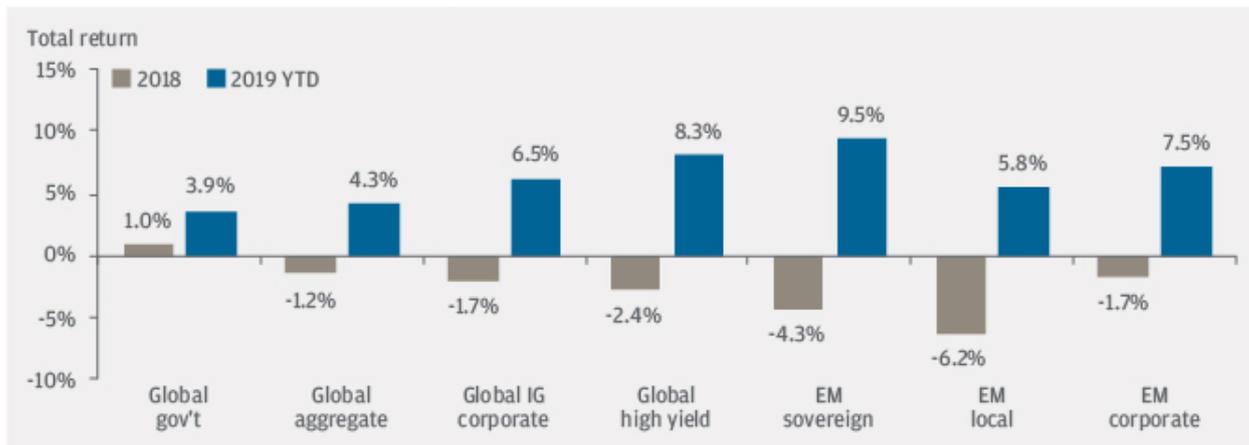
Having lifted rates four times in 2018, the Federal Reserve (the Fed), along with most other developed market central banks, has shifted emphatically to a dovish stance in 2019—thus extending the cycle and driving positive returns across asset classes. Central banks have responded to two main factors. First, economic activity has been lower in general, led by manufacturing, while the US labour market has recently shown signs of slowing, with the non-farm payrolls report undershooting expectations last week. Second, the Fed's reaction function has placed an increased focus on inflation expectations, which has lowered the bar for future rate cuts if the economy continues to weaken. Away from central banks, worries over an escalation in trade tensions have played out, with markets proving especially sensitive to the further deterioration in the trade relationship between the US and China. While some positive developments in US-Mexico relations have been welcome in the last week, the US-China dispute shows few signs of resolution in the near term. As such, trade risk looks set to continue to unsettle investors.



Quantitative valuations:

Returns have been very strong year to date, with markets buoyed by the possibility of an extended cycle thanks to the dovish shift from central banks. All fixed income sectors have performed well, especially risk assets, with emerging market hard currency sovereign bonds, for example, having delivered a return of 9.5% since the beginning of the year. With that said, such strong performance now makes valuations look stretched. In high yield, spreads have tightened by 124 basis points (bps) in the US and by 132 bps in Europe from their wides on 3 January this year. With growth now markedly weaker, capital gains at the same pace look less likely going forward (all data as of 12 June).

All fixed income sectors have performed strongly in 2019, in sharp contrast to last year



Source: Bloomberg, Barclays, JPMorgan Chase & Co. Data as of 12 June 2019. Returns are unhedged. IG = investment grade. EM = emerging market.



Technical:

Most fixed income sectors have recorded inflows so far this year, with unconstrained and US aggregate inflows totalling over USD 100 billion. Demand for government bonds has been strong, with over USD 14 billion flowing into US government bond mutual funds. Investment grade credit has also enjoyed strong demand, while in high yield, lower net supply relative to 2018 has supported European markets. In the US, demand has more than offset marginally higher net supply, with flows coming from coupon reinvestments as well as from the need to reinvest principal in the markets as rising stars have left the index.

What does this mean for fixed income investors?

Monetary policy is now moving into easing territory, and our base case is for rate cuts in 2019 in several developed markets as central banks respond to the weakening macroeconomic backdrop. Combined with less attractive valuations, particularly in risk assets, the outlook for fixed income has changed notably from the start of this year. Sectors that offer high quality carry are now expected to offer the best risk-adjusted returns. High quality duration, whether it be corporates, governments or securitised, all stand to benefit most from the expected continuation of the move lower in rates. These were the top ideas from our Investment Quarterly meeting. We are wary that the risk of recession has increased as central banks can only extend the cycle for so long, and ultimately the negative impact of trade will likely bring on the end of the economic cycle. In the near term, technical factors, such as supply and demand, will be key to watch given that they have helped to support the year-to-date rally amid a mixed economic backdrop.

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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