J.P.Morgan Asset Management

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

27 June 2019

An ounce of prevention?

Another week of dovish central bank rhetoric suggests that rate cuts are a near certainty in the US and Europe. Will easier monetary policy fulfil its objective of preventing recession, and what will be the implications for currency markets?

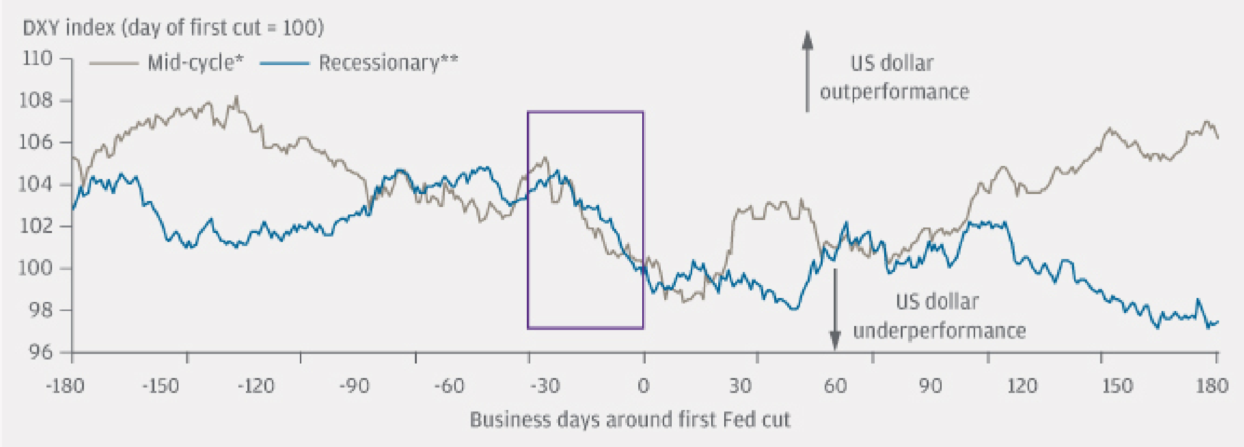
Fundamentals:

The reaction function of the major central banks has shifted, and it's now evident that policymakers are aiming to be ahead of the curve. This was corroborated on 19 June, when Federal Reserve (Fed) chairman Jerome Powell quoted the axiom "an ounce of prevention is worth a pound of cure" in reference to his current monetary policy mindset. Recent US data prints have been mixed to negative—though, importantly, central bankers have indicated that they will ease policy even against a stable data backdrop, given the trade-related uncertainty. The Philadelphia Fed manufacturing survey fell to a four-month low in June, and signs of weakness emerged on the consumer front, with consumer confidence deteriorating and the labour market differential (an assessment of whether survey respondents think jobs are "plentiful" or "hard to get") appearing to have topped out. It therefore appears likely that the sustained period of US economic and monetary policy divergence vs. the rest of the world is coming to an end.

Quantitative valuations:

The US dollar has broadly benefited from the rate spread differential between the US and the rest of the world, with the US dollar index appreciating by more than 4% in 2018 as the Fed continued to diverge from other global central banks, with a more hawkish approach. Dollar strength continued into 2019, with the index up 2% from the start of the year to 30 May. More recently, though, the currency has suffered from the increasingly dovish Fed, completely erasing year-to-date gains between 30 May and 25 June. The key question is how the US dollar will react to the shift to a rate cutting cycle. Historically, the US dollar has weakened in the lead up to the first cut of the cycle, which is in line with current performance. However, the path of the currency thereafter has depended on the growth response to policy easing: when the rate cut has proven to be mid-cycle and preventative, the US dollar has strengthened; when the growth backdrop has subsequently deteriorated and become recessionary, the currency has weakened further.

The reaction of the US dollar to Fed rate cuts has historically depended on the growth response



Source: Bloomberg, J.P. Morgan Asset Management. DXY Index = US dollar Index, a measure of average exchange rates between the US dollar and major world currencies. *Mid-cycle: 1995 and 1998 rate cut cycles. **Recessionary: 2001 and 2007 rate cut cycles.

Technicals:

Technical factors, particularly on the demand front, continue to be very supportive of bond markets. The likelihood of persistently negative yields is driving the bid for high-quality duration, while the prospect of quantitative easing in Europe is driving demand for lower-quality, relatively higher-yielding assets. This demand is broad-based not only from a sector perspective, but also from a regional perspective, suggesting that the flows will not necessarily favour the performance of one currency over another. In the week to 24 June, for example, US credit (high yield and investment grade) funds experienced inflows of USD 6.2 billion, European credit funds received USD 2.2 billion, and emerging markets debt funds saw USD 1.8 billion. Surprisingly, investor positioning surveys continue to indicate a consensus long US dollar position, which could further contribute to dollar weakness over the next few weeks, in the lead up to the Fed meeting in July.

What does this mean for fixed income investors?

In our view, the shift in central bank reaction functions is momentous, and it's currently proving supportive for both risk assets and safe havens in fixed income. However, the US dollar has reacted negatively. Whether this currency performance will persist or reverse is not likely to become clear until after the much-anticipated Fed rate cut in July. As the jury is still out, we think a tactical approach is warranted, and favour a short US dollar bias for now, with the first rate cut representing a potential window for profit taking.

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

LET'S SOLVE IT.SM