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THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

4 July 2019

Easing back

With the European Central Bank (ECB) almost certain to start quantitative easing again, what is the outlook for European credit?

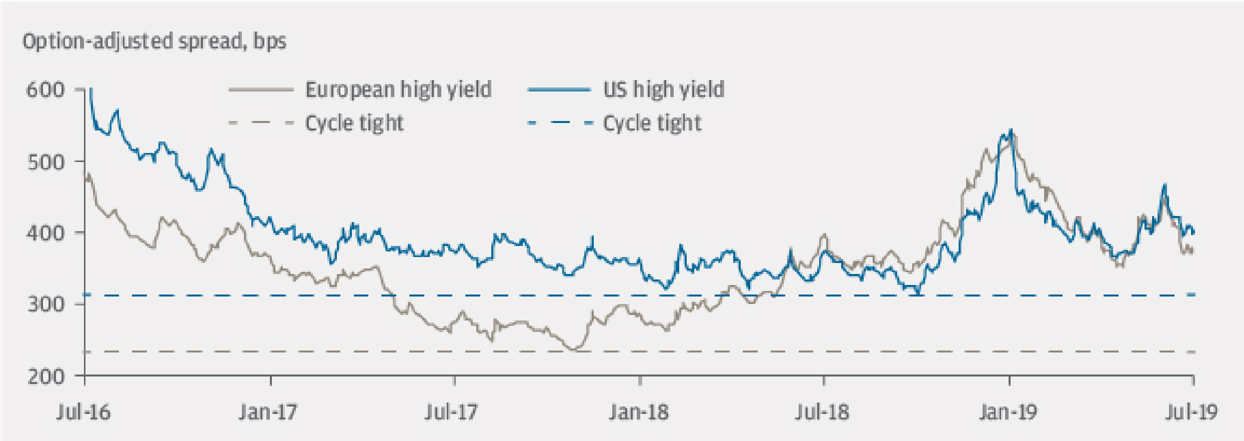
Fundamentals:

Christine Lagarde's nomination as the next president of the ECB is the latest development to confirm the direction of travel for central banks. The appointment of such a dovish figure could embolden the current president, Mario Draghi, to accelerate monetary easing sooner rather than later. However, it's important to note that more accommodative policy is here for a reason. Data has deteriorated, with the global manufacturing purchasing managers' index now in contractionary territory, compared to the highs of 54 at the end of 2017, when global growth was synchronised and above-trend. Lower growth and continued uncertainty over trade are unlikely to help company profit margins, which in turn means a higher risk of defaults. Therefore, this benign monetary policy environment will need to be navigated carefully.

Quantitative valuations:

Strong performance continued throughout June, with spread sectors leading the way: European high yield spreads have tightened by 81 basis points (bps) since the end of May – part of an emphatic move (183 bps) tighter from the wides seen at the start of the year. However, at 125 bps above their cycle tights, spreads still have room to grind tighter. With yields for almost a quarter of the Barclays global aggregate bond index now in negative territory, a grab for yield could prove a catalyst for further outperformance. However, tighter spreads will only be justified by robust fundamentals, and while certain areas of the market look like they have even further to run (CCC spreads have more room to tighten than higher quality names, for example), the current growth outlook makes higher risk credits less attractive. (All data as at 3 July 2019.)

Spreads are still some way off their cycle tights and could grind tighter



Source: Bloomberg; data as of 3 July 2019.

Technicals:

Technicals remain extremely supportive. There has been almost no new supply in European high yield year to date, with many companies having already refinanced at what looked like attractive levels last year. Investment grade demand – as measured by high grade fund flows – is high in Europe given the grab for yield. The prospect of corporate bond purchases by the ECB provides an additional layer of comfort for investment grade investors, although it remains to be seen whether the effect will be the same as in the last round of quantitative easing, given that the pool of bonds available is now larger, and the ECB will be committed to buying fewer bonds. We expect to see around EUR 3 billion per month of corporate bond purchases this time around, compared with the peak of around EUR 8 billion in 2016.

What does this mean for fixed income investors?

Markets are encouraged by the latest demonstration from central banks that they will do what is required to support the global economy. The grab for yield resulting from lower rates means that credit spreads could tighten – or at least remain stable – in the short term. However, growth continues to soften, and as such, investors need to be selective about the markets they enter, given that lower quality names will be more sensitive to weaker fundamentals. Noting this softer growth environment, a move up in quality is likely to reward investors, and it may now be prudent to sell into strength, rather than buy on dips.

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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