THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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How low can we go?

With the European Central Bank (ECB) set to resume quantitative easing, can European high yield spreads return to their lows of the last time around?

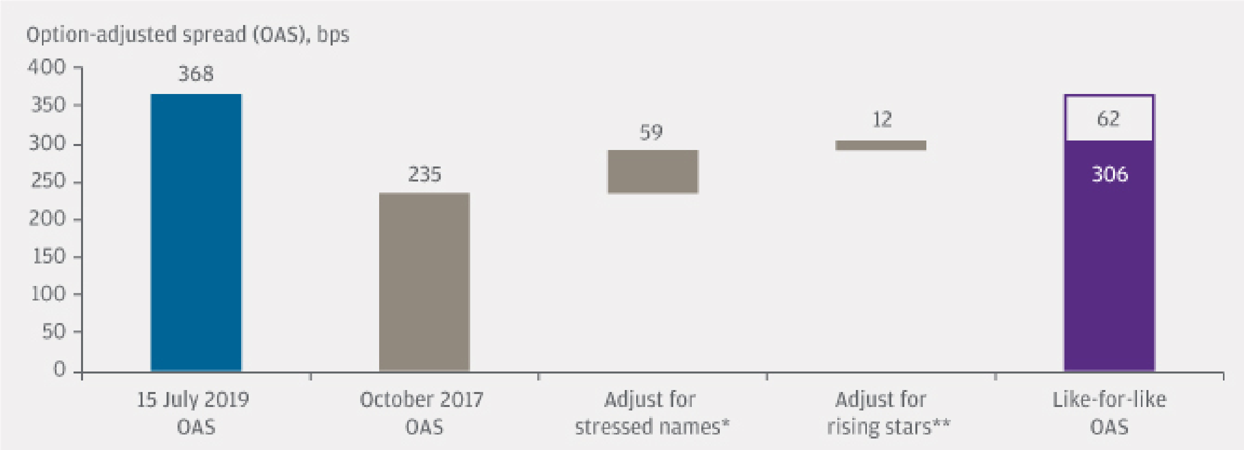
Fundamentals:

The fundamental position of high yield companies in Europe is mixed. While issuers are coming from a place of strength—interest coverage is at the top end of the past 10-year range and leverage still at the low end—we have concerns about the outlook for cyclical sectors. We expect second-quarter earnings to underwhelm in some of these sectors as trade war uncertainty weighs on the appetite of businesses to place new orders and invest in new projects. Profit warnings from some large cyclical names, such as BASF, Daimler and Lear, could be evidence of the start of this trend. One point to note: leverage appears to have ticked up across European high yield issuers in Q1 2019, but this is partly a reflection of a change in accounting standards, not solely a deterioration in credit metrics (operating leases now need to be shown on balance sheets, causing total debt to increase).

Quantitative valuations:

European high yield may not appear to offer obvious value at the headline level, with a yield to worst of 3.1% and approximately 20% of the market in negative yielding territory on the offer side. However, with the ECB expected to reinstate quantitative easing (QE) in the next few months, the key question is whether spreads can tighten from current levels of 368 basis points (bps). The low of 235 bps reached by spreads during the ECB's last round of QE would suggest that there's significant capacity for further outperformance. However, there are two important differences between then and now: first, the increase in names currently trading at stressed levels (defined as bonds with a cash price below 70); and second, the large number of rising stars over the past two years, without which there is less room for credit improvement. Adjusting for these differences suggests that spreads can tighten from current levels—to around 300 bps—but are unlikely to reach the tights seen during previous rounds of QE. (All data as of 15 July 2019.)

European high yield spreads have scope to move lower, but not as low as in October 2017



Source: Bloomberg, Bank of America Merrill Lynch, J.P. Morgan Asset Management; data as of 15 July 2019. *Stressed names: there were almost no stressed names (defined as bonds with a cash price below 70) in October 2017. **Rising stars: the European high yield index has lost approximately 10% of its market value to the investment grade market through rising stars over the past two years; these names traded well inside the index, at an average of 134 bps OAS, as of October 2017.

Technicals:

Robust technical factors continue to be the bright spot for European high yield. Flows are gathering pace, with five straight weeks of inflows (as at 16 July), and demand is now evidenced across both ETFs and mutual funds. The supply side of the equation is perhaps even more supportive. While new issuance has picked up, with five new deals in the week to 17 July, net supply remains elusive and is even running negative year to date. Furthermore, the supply that is coming to market continues to be high quality, with 66% of year-to-date new issuance coming from BB-rated companies and just 4% from CCC-rated names (as at 2 July).

What does this mean for fixed income investors?

The strong performance of European high yield looks set to continue given the supportive technical backdrop—though we're cognisant that technicals can change quickly. We expect the market, particularly BBs and defensive sectors, to continue to do well in the run-up to actual monetary policy easing (as opposed to just talk of easing) from the key central banks. Subsequent performance, however, will likely be driven by whether the growth picture turns out to be recessionary or simply a slowdown. If recession is looming, the expectation of higher default rates will hurt European high yield returns; if the economy is merely in a growth slowdown, accommodative central banks and the ensuing search for yield could propel the market further.

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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