

# On the minds of investors

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## Investing in fixed income when rates are falling

Market expectations are building that the U.S. Federal Reserve (Fed) will cut interest rates in months ahead. At this juncture it is worth taking stock of the rationales and considerations when investing in fixed income.

We see fixed income as a crucial component in portfolio construction for two reasons. First, its volatility is lower than equities, which helps to reduce overall portfolio volatility (you can see this on P.54 of *Guide to the Markets, Asia*). Some fixed income sectors, such as development market government bonds, have a negative correlation with equities. This means the value of these bonds would rise as equities fall. Second, fixed income provides a better risk-reward balance than cash. Our analysis of the last two equity bear markets (the dot-com bust and Global Financial Crisis) shows U.S. aggregate bonds consistently outperformed cash (P. 57 of *Guide to the Markets, Asia*). This is due to the rise in bond prices as bond yield falls.

To answer the question of which fixed income asset class investors in Asia should consider, we propose the following framework. The chart on the next page breaks down three sources of bond return, namely Treasury base rate return (A), or sensitivity towards Treasury bond movements; credit spread (B) and coupon (C).

Coupon (C) is relatively straight forward since this is known at the time of investing. Corporate high yield bonds and emerging market (EM) debt typically offer a higher coupon compared to development governments or investment grade corporates because investors are exposed to higher risks, such as credit risk or market risk.

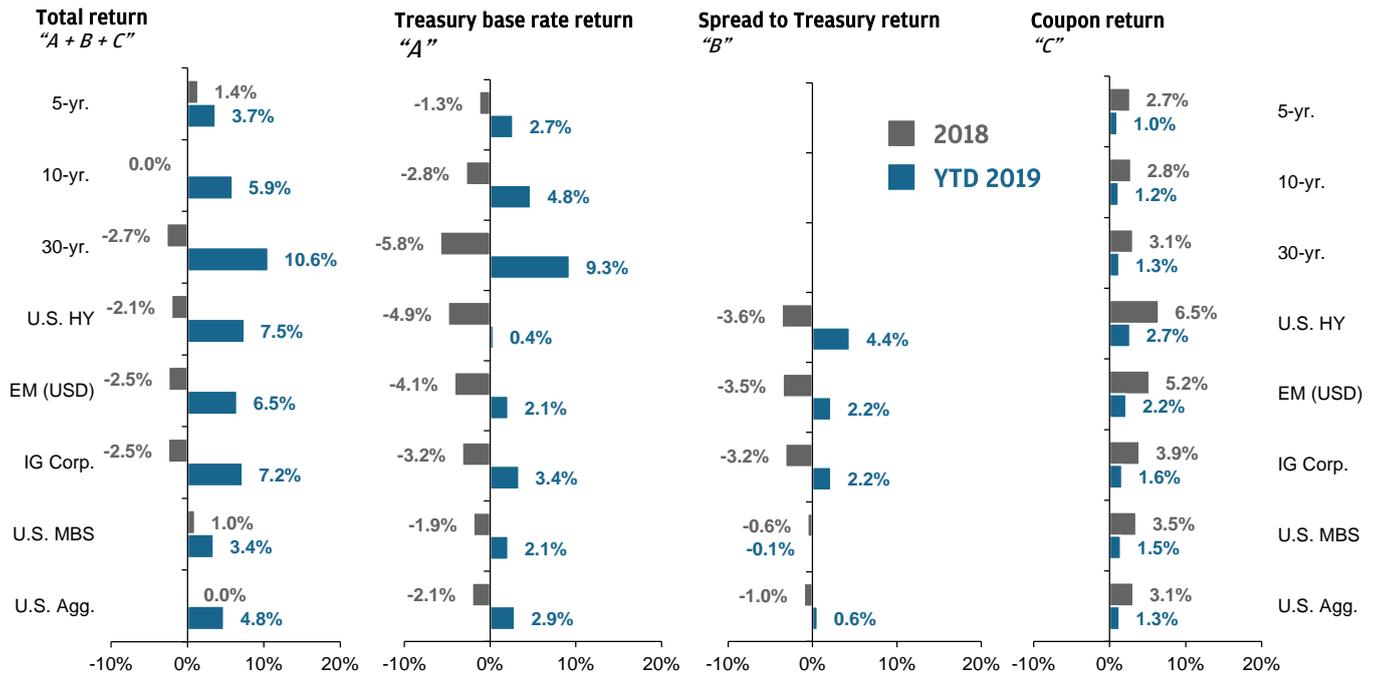
The Treasury base rate return (A) would depend on the movements of U.S. Treasury yields. Falling yields imply a positive return. The magnitude of this return would depend on the sensitivity of different types of bonds to changes in interest rates, or duration. Historically, Treasury yields continued to fall after the Fed rate cut cycle has started, so this component continues to contribute to total return.

The credit spread (B) is probably the trickiest of the three sources of return. A deterioration in economic performance raise the risk of default, causing spreads to widen for corporate debt, and bond prices to fall. High yield debt is particularly sensitive to this development. EM debt would also depend on the U.S. dollar exchange rate, since a strong U.S. dollar could lead to more capital outflow.



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EXHIBIT 1: UNITED STATES: SOURCES OF BOND RETURNS



Source: Barclays, Bloomberg, Federal Reserve, J.P. Morgan Asset Management. All returns reflect year-to-date returns. Treasury base, spread and coupon returns based on Barclays and J.P. Morgan Asset Management estimates. The sum of charts A and B equate to price return for each sector and the sum of charts A, B and C do not add up to the total return due to rounding. Indices used include Barclays U.S. Treasury Bellwethers (10Y), Barclays U.S. Aggregate, Barclays U.S. Aggregate Credit - Corporate Investment Grade, Barclays U.S. Aggregate Credit - Corporate High Yield, Barclays U.S. MBS Index, Barclays Floating Rate Index and Barclays Emerging Markets USD. Data reflect most recently available as of 31/05/19.

Investment implications

Taking these three sources of return into consideration. We believe that a falling yield environment should continue to benefit U.S. Treasuries, with longer duration bonds seeing greater potential upside. This advantage would continue to appeal to investors despite their low yields. For corporate debt, the fear of weaker growth may lure investors to the relatively higher quality investment grade bonds. It is important to recognize that a growing share of investment grade universe is BBB and vulnerable to downgrade to high yield. Hence, active management is needed to understand the financial fundamentals of these companies.

That said, since we don't think a recession is imminent, we still believe investors can benefit from corporate high yield bonds and EM debt. Corporate high yield debt should continue to enjoy low default rate. A very expensive U.S. dollar, implying limited upside potential, should benefit EM debt. They would also satisfy global investors' search of income. Securitized assets, such as mortgage-backed securities, also offer an alternative to investors who wants to generate income and manage portfolio volatility.

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