THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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What's the alternative?

Yield in Europe is increasingly hard to come by, but with the European Central Bank (ECB) expected to ease monetary policy, should investors maintain their fixed income positioning?

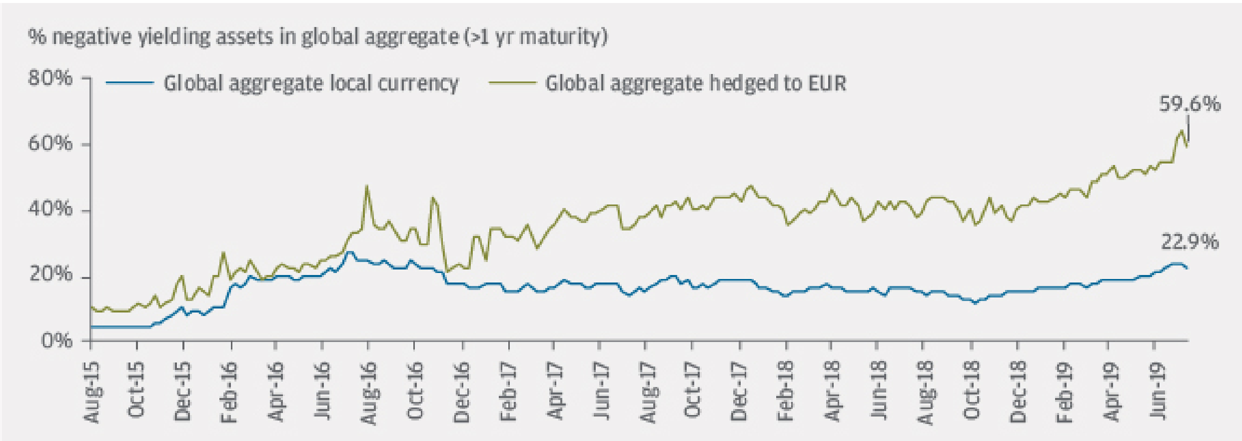
Fundamentals:

Mario Draghi's press conference following the latest ECB policy meeting was eagerly anticipated against a backdrop of disappointing macro data. The German manufacturing purchasing managers' index has weakened, with new export orders hitting new cycle lows, while long-term inflation expectations have continued to drift lower according to the ECB's professional forecasters' survey. Draghi was dovish on inflation and balanced on growth, but details of the ECB's stimulus package were largely omitted, so the market's knee-jerk reaction was negative. However, while the press conference disappointed market expectations, the ECB's post-meeting statement included explicit reference to a range of monetary policy tools, including new asset purchases. Our outlook for the ECB has not changed, with a rate cut and quantitative easing (QE) expected to be announced at the September meeting. Whatever the ECB delivers in September, however, its most important task will be to convince the markets that it is not out of ammunition and that further easing could be sanctioned if needed.

Quantitative valuations:

Given that expectations for looser monetary policy and renewed QE remain apparent, bond yields in Europe have edged relentlessly lower. It is no surprise that investors are questioning whether valuations are still attractive, with more than 20% of the global bond market now negative yielding. US dollar assets may appear to have more positive yields, but from a European investor's perspective, once the cost of hedging is taken into consideration the attraction is all but lost. It's even hard to find attractive yields among European high yield corporate bonds, where almost half of the market is offered at a yield of less than 1% and less than 15% of the market trades with a yield above 5% (all data as of 30 July 2019).

Negative yielding assets continue to grow, especially for EUR investors



Source: Bloomberg; data as of 15 July 2019. Hedged yield calculated with 12-month forwards.

Technicals:

The absence of a rosy fundamental picture has increased expectations that the ECB will introduce more QE later this year. Further central bank buying could enable the already strong technical backdrop to continue to drive the market higher. Demand for quality yield has been consistently strong in recent months. According to EPFR, as of 24 July, European investment grade funds had witnessed 21 weeks of inflows in a row. So long as valuations remain tight and investors continue to search for yield, demand should continue to outstrip supply, especially with issuance seasonally low at this time of year.

What does this mean for fixed income investors?

Negative yields are by no means a new phenomenon in Europe, but it looks like they are here to stay, making valuations look ever more unappealing. Nevertheless, in a world where central banks are expected to bolster technical conditions, unloved valuations may continue to grind tighter. We expect investors to continue buying bonds for some time yet given the lack of an alternative.

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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