

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

29 August 2019

Quality leads the way

Investment grade credit has been a standout performer in 2019. Given the ongoing macro uncertainty and recent spread tightening, can the rally continue?



Fundamentals:

Trade wars continue to dominate markets: macroeconomic data has been deteriorating while uncertainty has been on the rise. Questions have intensified about the timing of the next recession, which is likely to prove especially negative for lower-rated parts of the credit markets. Nevertheless, there are reasons for some cautious optimism in investment grade (IG) credit. While leverage remains high compared to historical levels—a key concern for investors last year in particular—there are signs that companies have made concerted efforts to improve their balance sheets. In many BBB rated companies (the focus of investors' concerns), leverage has decreased in 2019, with median gross leverage stabilising at around 2.6x in recent months. At the same time, interest coverage ratios are very healthy at around 10x, with companies able to service their debt comfortably. This is encouraging: the last time the market saw similar leverage levels in 2001/02, interest coverage was significantly lower.



Quantitative valuations:

US IG credit has returned 14.2% so far this year (and is up 3.4% in August alone). Of this, the excess return—the return attributable to credit spreads—has been relatively small: 3.7% year to date, and negative (-1.0%) month to date. This relatively small excess return reflects the drastic fall in core rates. Investment grade credit has been a key beneficiary from the global duration rally, which has seen US 10-year yields fall by 120 basis points (bps) year to date. Should the uncertainty in the macro backdrop persist, rates could fall further, supporting high quality credit. Given such strong returns this year, investors may be questioning how much further the rally can continue. However, while spreads have tightened 33bps so far this year, they could have some room to grind tighter yet, having widened throughout August by 12bps (all data as at 28 August).

The rally in duration has benefitted investment grade credit in 2019



Source: J.P. Morgan Asset Management; data as of 28 August 2019.



Technical:

Lower rates have been pushing investors to look in all areas of the fixed income markets for yield. With an uncertain fundamental backdrop, this dynamic has been boosting demand for high quality credit. We have seen over USD 10 billion of inflows to high grade funds this year, reflecting strong demand, while net supply is lower by 18% year on year. On balance, we do expect higher supply in September given seasonal factors, and recent issues have not been especially well received: secondary market performance has been lacklustre following new deals, despite higher than usual premiums. Nevertheless, the global search for higher quality, positive yielding credit should prove supportive for now.

What does this mean for fixed income investors?

High quality fixed income remains well bid, given stable credit fundamentals and a reasonable yield pickup over government debt, where rates have been falling steadily. If the current environment persists—and we do not expect trade tensions to go away any time soon—rates can continue to fall, and the asset class should benefit from the duration component. In the event that we see a meaningful improvement in macroeconomic data (the catalyst for which is likely to be a sharp reversal in the trade war story), core rates could rise, which would reverse some of this performance—although excess returns are likely to remain positive. For now, selective investment grade credit offers a high quality alternative to government bonds.

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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