

THE FUTURE OF FIXED INCOME

# Weekly Bond Bulletin

5 September 2019

## Forget the fundamentals?

A slew of fundamental developments over the week suggests the macroeconomic backdrop continues to deteriorate, and yet bond markets are still generating strong returns across not only safe havens but also risk assets. Can this momentum persist into September?



### Fundamentals:

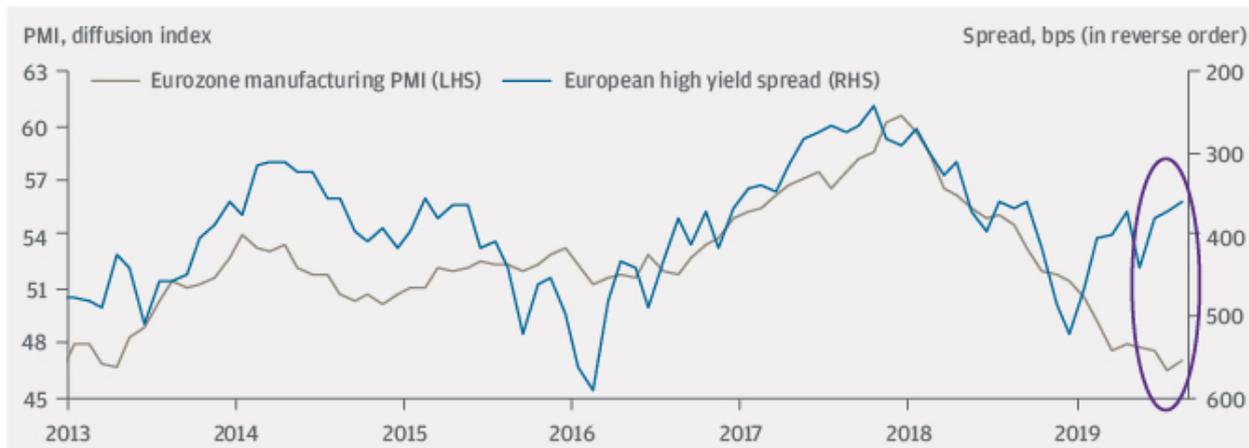
Purchasing managers indices (PMIs) in emerging markets continued to weaken in August, with only a third of PMIs signalling expansionary territory (a reading above 50). While the composition of US second-quarter GDP was better than expected (including strong domestic final demand), the ISM manufacturing index declined to below 50, with broad based weakness across components. Furthermore, inflation in Europe is going nowhere: core HICP (Harmonised Index of Consumer Prices) remained at a mere 0.9% year on year. On the political front, Italy has taken positive steps towards forming a new government, though it is a relatively fragile coalition and the potential for future volatility remains. Meanwhile, the UK backdrop is increasingly tenuous, resulting in heightened risks of both a no-deal Brexit and a general election.



### Quantitative valuations:

August proved to be a very strong month for fixed income markets as yields fell across all sectors, more than compensating for moderate spread widening (except in European high yield, where spreads actually tightened on the month). Demand for safe haven assets pushed the 10-year US Treasury yield 52 basis points (bps) lower, while even peripheral eurozone government bond markets experienced significant tightening, with Italian and Spanish 10-year yields falling by 54bps and 18bps, respectively. Spread sectors also posted robust total returns: US investment grade credit benefited the most from the duration rally with a 3.2% total return, and European high yield and emerging market hard currency sovereigns were both up 0.8% in August. It may be difficult to justify yields at current levels, although spreads could have scope to tighten further given that base rates in both the US and Europe are approximately 100bps lower than where they started the year. (All data to 31 August 2019).

### Bond markets continue to shrug off deteriorating fundamentals



Source: Bloomberg, Markit, Bank of America Merrill Lynch. European high yield spread = option-adjusted spread. Data as of 31 August 2019.



## Technical:

Powerful technicals have been the driving force pushing bond yields lower, as the search for any sort of positive yield dominates. The return of supply after the usual summer slowdown has the potential to weigh on bond markets, but initial indications show that new issuance is being digested well. In the US investment grade credit market, the day after Labor Day (3 September) proved to be the busiest day on record in terms of the number of issues: 21 borrowers came to market for a total of USD 26.7 billion in new supply. And yet this issuance was taken down well, as deals were more than three times oversubscribed on average. European investment grade credit has been similarly resilient to the recent deluge of supply. Of the approximately EUR 30 billion in new issuance received in August, EUR 15 billion came in the last week of the month, including a negative yielding multi-tranche deal from Siemens. The calendar has not been as aggressive from high yield issuers in Europe, though the resumption of the primary market thus far has been concentrated in existing issuers who will likely use proceeds to take down existing debt, so supply is not expected to weigh on the market.

## What does this mean for fixed income investors?

Strong performance across fixed income sectors in August has made investors wary of a potential consolidation in September. However, for the time being bond markets are ignoring the deteriorating macro fundamentals and instead trading on robust technical factors. Key to whether this trend can persist is the supply backdrop, so investors will need to watch for how well new issuance is digested. The upcoming European Central Bank meeting on 12 September could also provide direction, as details of any future quantitative easing may impact current supply/demand dynamics.

### 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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