

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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Quality bias in emerging markets

Investment grade and high yield credit in emerging markets have delivered divergent performance over the summer. Could this trend reverse, or is investor caution warranted in the high yield space?



Fundamentals:

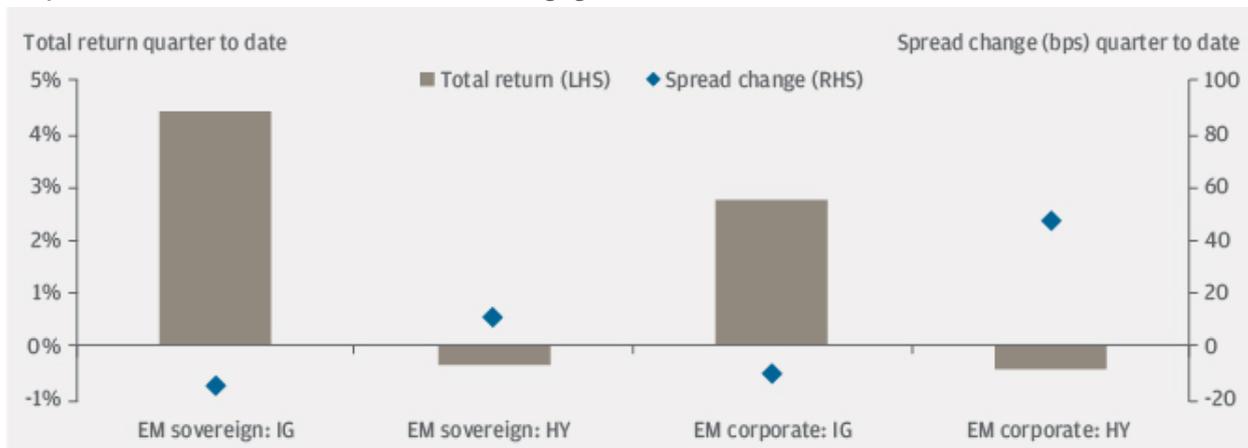
Emerging markets are being steered by the same macroeconomic factors driving global markets—namely, the headwind of trade war escalation vs. the tailwind of dovish monetary policy—rather than by idiosyncratic factors. Despite a continued slowdown in China, where we expect growth to fall to sub 6% in 2020, growth across the emerging market (EM) complex is expected to rise to 4.4% in 2020 given recoveries in Latin America and EMEA (Europe, the Middle East and Africa). August purchasing managers' indices in emerging markets were mixed: while they were more resilient than developed market prints, which continued to deteriorate, they look vulnerable to a spillover.



Quantitative valuations:

Although EM bonds have been driven by the same global trends as their developed market counterparts, performance has been notably different. In developed markets, investment grade (IG) and high yield (HY) credit have generated solid and comparable returns over the summer months (global IG credit is up 1.1% quarter to date, while global HY is up 1.2%). However, there has been a stark quality bias in the EM space, with IG outperforming: quarter to date, EM sovereign IG has generated total returns of 4.4%, with 15 basis points (bps) of spread tightening, compared to EM sovereign HY's return of -0.3%, with 12 bps of spread widening. The same pattern is evident in EM corporates. While the most obvious value is now clearly in the EM high yield space, where spreads are well north of 500 bps for both sovereigns and corporates, the uncertain macroeconomic backdrop means caution is needed when venturing down in the quality spectrum. (All data to 10 September 2019).

The performance differential between IG and HY in emerging markets is stark



Source: J.P. Morgan, J.P. Morgan Asset Management. Quarter to date: 30 June 2019 to 10 September 2019.



Technical:

Technical factors are broadly supportive across the EM space. Issuance should remain manageable for the rest of the year, with net supply flat in sovereigns and net new issuance negative in corporates. Flows into both sectors have been positive throughout the year, though they have tapered off more recently. This pause, combined with the fact that market beta is relatively close to 1, suggests that investor positioning is not overextended.

What does this mean for fixed income investors?

What could cause the IG outperformance/HY underperformance trend to reverse in emerging markets? In the near term, a more aggressively dovish position from Federal Reserve chair Jerome Powell could propel risk assets higher in price, bringing EM HY along for the ride. However, for a more strategic recovery, we believe we would need to see a significant improvement in the trade rhetoric, which is not our base case. Despite the strong performance of EM IG both year to date and quarter to date, we think the market can continue to generate positive returns given the powerful search for yield. Although IG yields may not appear obviously attractive on an absolute basis, on a relative basis their level above 3% looks compelling in the persistently negative yield environment.

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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