THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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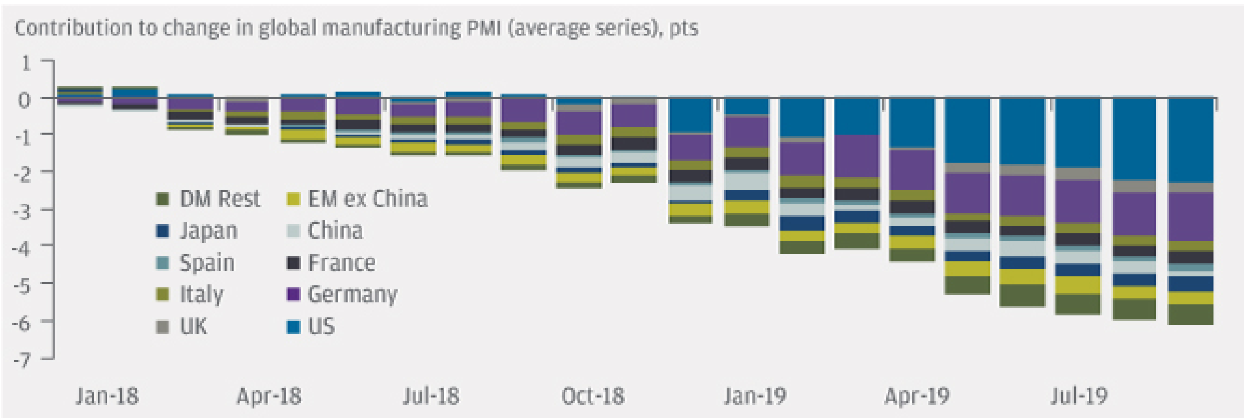
A matter of time

As demand for duration sends US Treasury yields down towards 1.50%, we look at the factors that could potentially push rates through this key psychological level.

Fundamentals:

With manufacturing driving most of the recent slowdown in global growth, the latest US data has added to concerns as September's Institute for Supply Management (ISM) manufacturing index recorded a bigger-than-expected fall to its lowest level in a decade. The US and Germany have contributed most to the change in global manufacturing purchasing managers' indices (PMIs) this year, most likely a direct result of trade wars. However, the rot no longer stops with manufacturing, with the ISM non-manufacturing index falling to 52.6 last month compared to expectations for 55.0—the biggest miss and lowest level since August 2016. Although labour market data held up relatively well, the more forward-looking ISM data proved unsettling for markets. Risk assets have also been weighed down by trade rhetoric, with few signs of optimism ahead of the thirteenth iteration of US-China negotiations. The US recently moved to "blacklist" key Chinese technology and artificial intelligence companies, and has placed visa bans on Chinese officials linked to human rights abuses. China's crackdown on protestors in Hong Kong is helping to crystallise bipartisan support in the US for a robust stance, arguably making de-escalation a less likely path. As the evidence mounts that the trade war is holding back growth, markets are understandably cautious.

The US and Germany have driven negative changes in global PMIs this year



Source: Markit, Bloomberg, J.P. Morgan Asset Management. Constructed PMI using an average of multiple US and China surveys. Data as of 30 September 2019.

Quantitative valuations:

US Treasury yields, despite a sharp sell-off in early September as trade rhetoric momentarily improved, have continued their march downwards. Ten-year yields now hover at 1.58%, almost 1.7 percentage points lower than at this point a year ago and approaching a psychologically significant resistance level of 1.50%. In Europe, 10-year Bund yields remain well in negative territory at -0.54%. (Yields as of 10 October 2019). While core rates are already close to record lows, there is no obvious catalyst to push them higher. Markets have already priced in further rate cuts by central banks, but persistent trade tensions could cause expectations for lower rates to intensify.

Technicals:

Global uncertainty is driving demand for high quality duration, particularly government bonds with positive yields, such as US Treasuries. Over USD 15 billion of retail money has flowed into US government bonds this year, with almost USD 80 billion into high quality alternatives, such as municipals or mortgage-backed securities (as of 10 October 2019). The demand picture is likely to also be supported if central banks migrate monetary policy from rate cuts to other measures. The European Central Bank has announced the resumption of its asset purchase programme and, while the Federal Reserve (the Fed) is not yet ready to introduce further quantitative easing measures, chairman Jerome Powell nevertheless recently announced that the Fed would organically grow its balance sheet over the coming months by conducting repurchase operations.

What does this mean for fixed income investors?

Unless there is a steadfast commitment from both sides to roll back trade tariffs and adopt a conciliatory tone, trade wars will continue to feed into macroeconomic data. It is only a matter of time before corporate earnings are impacted, as well as consumer health, which until now has remained relatively stable. In this environment, risk assets are likely to remain vulnerable. Therefore, despite ever lower yields, government duration could still play an increasingly important role as a defensive allocation within investors' portfolios.