THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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Balancing dollar bearishness

We may not be outright US dollar bulls, but fundamentals and quantitative valuation factors both suggest that investors are currently too negative on the currency.

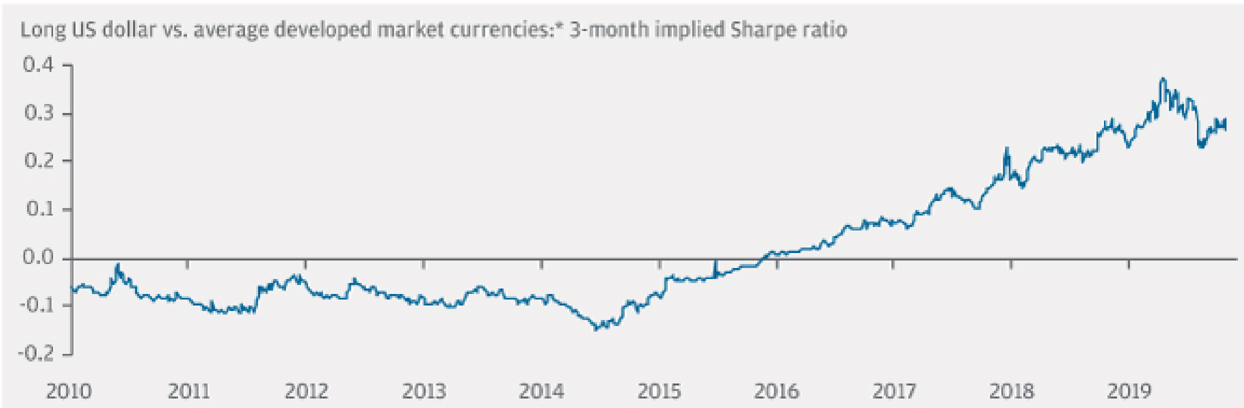
Fundamentals:

In line with the recent uptick in global economic releases, US data has shown signs of improvement. The October labour market report was unambiguously strong, showing robust job creation in the month and positive revisions to the previous two months. Survey data also points to a rosier outlook, with better non-manufacturing surveys and a sharp bounce in leading components on the manufacturing side. While this does not represent US exceptionalism, these improvements should nevertheless be constructive for the currency. Furthermore, the development of the shale oil & gas sector in the US has led to a structural shift in the country's energy trade balance, from net importer to net exporter status. This is supportive for the US current account balance and should have a positive impact on the US dollar—something that, as yet, appears underappreciated by currency markets.

Quantitative valuations:

The real value of the US dollar is close to the strongest it's been in the past 50 years, leading many currency strategists to believe it will depreciate from here. We believe the outlook is more nuanced than this analysis suggests. In addition to the fundamental reasons not to be bearish on the dollar, the currency maintains an attractive yield advantage over its developed market peers. Not only does this mean the US dollar offers a compelling carry profile, particularly in a muddle-through economic environment, it also makes it an expensive currency to short.

The US dollar maintains an attractive yield advantage over other currencies



Source: Bloomberg, J.P. Morgan Asset Management; data as of 4 November 2019. *Developed market currencies: EUR, GBP, CHF, AUD, NZD, CAD, JPY.

Technicals:

Investor positioning in the US dollar has been long for much of the past two years, but has recently shifted towards neutral as market participants have become more bearish. On the demand front, with relative rate spreads still firmly in favour of the US dollar (10-year US Treasuries out-yield the equivalent German Bunds by more than 2% as at 12 November), foreign investors are likely to continue to favour US dollar-denominated assets. It is important to keep in mind, however, that flow trends can be fickle and the most recent release of our proprietary fund flow monitor actually indicates a preference for euro-denominated assets in the week to 4 November.

What does this mean for fixed income investors?

The premise that real effective exchange rates are stable over long time periods is leading many investors to consider moving short US dollar, in anticipation of a meaningful sell-off in the currency. We believe both structural and short-term factors could prevent this move from materialising. The US's new status as an energy exporter, combined with improved domestic economic data and a still meaningfully positive rate spread differential, suggests that it may not yet be time to turn bearish on the US dollar.

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