THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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A crude awakening

Oil prices have fallen sharply as investors assess the economic impact of the coronavirus. Could this present a buying opportunity in energy-linked fixed income sectors?

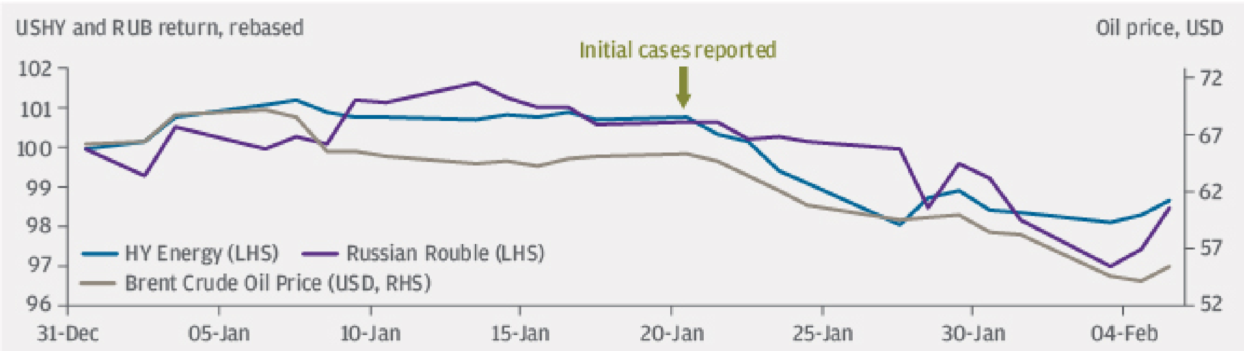
Fundamentals:

The recent coronavirus outbreak is affecting Chinese economic activity. In response to the threat, 14 provinces and cities have asked businesses not to operate until at least 10 February. Measures such as these will impact growth, with 69% of China's GDP, 78% of exports and 63% of power demand expected to be disrupted. Another key casualty has been oil, with Bloomberg reporting that demand in China has dropped by as much as 3 million barrels per day – representing 3% of global demand. The subsequent effect on oil prices is putting assets with a high beta to oil under pressure. With that said, market sentiment appears to be improving, with a feeling that the virus outbreak should be limited from persisting beyond the first quarter. The Chinese authorities have reacted swiftly to contain the virus and monetary policy has been adjusted to combat some of the negative impact. Furthermore, the Organization of the Petroleum Exporting Countries (OPEC) is likely to act to support oil prices from falling too far – possibly by restricting production – having commenced discussions in response to the outbreak.

Quantitative valuations:

After rising briefly in the wake of the tensions between Iran and the US, oil prices are now at their lowest since December 2018, at USD 55 per barrel. This represents a year-to-date fall of 16%. At the same time, sectors with higher beta exposure to oil have underperformed: US high yield energy credit spreads, for example, have widened by 58 basis points (bps) so far this year to 731bps, leading to a total return of -1.75%. Emerging market currencies have also underperformed: the Russian rouble, a currency strongly linked to oil, is down 1.3% year to date, while Asian currencies are feeling the effects of the outbreak, with the Singapore dollar and Korean won down 1.9% and 2.7% respectively. As long as the virus outbreak is contained, some of these moves could present a buying opportunity (data as of 5 February 2019).

Assets with a high beta to oil have underperformed since the coronavirus outbreak



Source: Bloomberg. USHY (US high yield): ICE BofA Merrill Lynch US High Yield Constrained Index (HUCO). RUB (Russian rouble) returns use spot prices. Data as of 5 February 2020.

Technicals:

Despite recent volatility, demand for fixed income in general remains robust, providing a solid technical backdrop. Issuance is higher than last year, but supply is being well received. Flows into high grade bonds remain strong, and the European Central Bank's corporate purchasing programme continues to soak up new issuance. After the initial reaction to the coronavirus outbreak, there also now appears to be cleaner positioning in emerging markets, where investors appear less long than they were several weeks ago.

What does this mean for fixed income investors?

With central banks continuing to provide policy support and growth likely to be impacted, at least in the short term, by the coronavirus outbreak, core duration and high quality credit will continue to play a key role in portfolios. Provided the virus is contained in good time, there could also be some scope to add risk. While not all sectors pose an obvious opportunity (US high yield energy, for example, still accounts for a substantial portion of the overall market's defaults), other sectors with a high beta to oil could be attractive, such as investment grade energy names and some emerging market currencies.

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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