J.P.Morgan Asset Management

THE FUTURE OF FIXED INCOME

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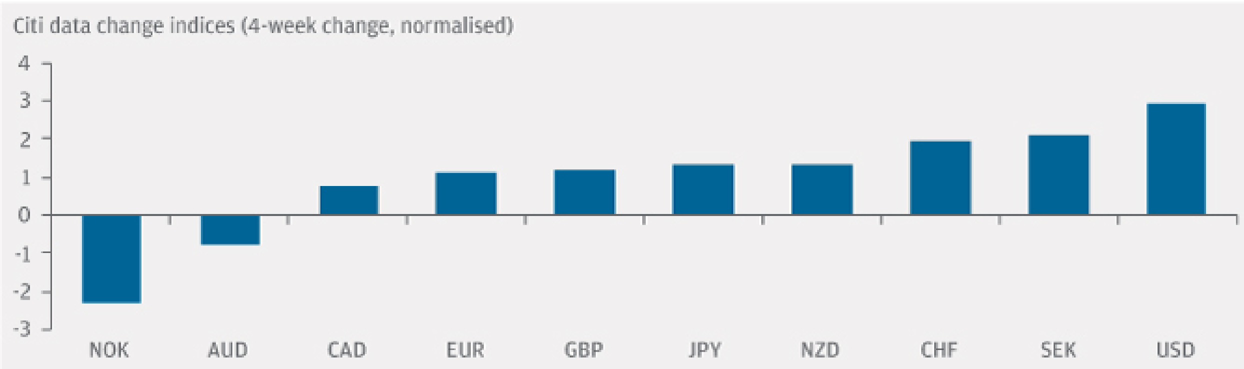
Searching for the euro floor

US exceptionalism shows signs of re-emerging, adding to the pressure on the euro. Could this cause the currency to break out of its recent range?

Fundamentals:

Recent US data prints have been strong—particularly the monthly labour market report, which showed a reacceleration in employment growth and a new cycle high for the employment-to-population ratio of prime age workers. The Institute for Supply Management's non-manufacturing index also improved in January, with a strong bounce in the business activity component. In contrast, European data has disappointed of late: industrial production data for December surprised significantly to the downside in Germany, Italy and France, and there is likely to be renewed weakness in the next round of business surveys as a result of coronavirus-related disruptions. While the coronavirus outbreak has shown tentative signs of stabilisation, we believe it is still too early to make broad conclusions on its economic impact. However, any drag to Chinese growth will have more material repercussions for European activity, given the region's export-oriented economy, than for the US.

US data momentum is the strongest in the G10



Source: Bloomberg, Citi, J.P. Morgan Asset Management; data as of February 2020.

Quantitative valuations:

The euro continues to be one of the lowest-yielding currencies, as the European Central Bank (ECB) maintains a firmly negative deposit rate. The likelihood of this dynamic changing any time soon is low, with the ECB showing little inclination to shift away from its dovish stance even before the recent batch of weak data. As a result of its low-yield status, the euro is a cheap currency to short, and there is evidence that foreign investors are increasingly using it to fund long positions in other currencies.

Technicals:

The interest rate differential between the US and Europe has contributed to a rise in reverse Yankee issuance (issuance of euro-denominated debt by US companies). From a currency perspective, this issuance pattern is putting downside pressure on the euro against the dollar (EURUSD), as corporations often then convert the proceeds back to US dollars. Equity flows are also in favour of a weaker EURUSD: month-to-date, US equity funds have experienced over USD 3.4 billion of inflows, vs. outflows of over USD 700 million for European equity funds. It will be important to look out for any reversal of investor positioning in this carry trade. Were a catalyst for a stronger euro to materialise—such as a renewed easing cycle in the US, a substantial growth pickup in Europe, or an unexpectedly dollar-negative reaction to the US presidential election—there could be a painful squeeze on euro-funded carry positions. (All data to 10 February 2020.)

What does this mean for fixed income investors?

Having weakened more than 2.5% vs. the US dollar year to date, the euro is now trading at the low end of its recent range—and we believe there are more risks to the downside. Data trends, fund flows and relative valuations in the US compared to Europe all point to the possibility of further euro weakness vs. the US dollar, though we must be mindful of the risk of a positioning unwind.

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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