THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

20 February 2020

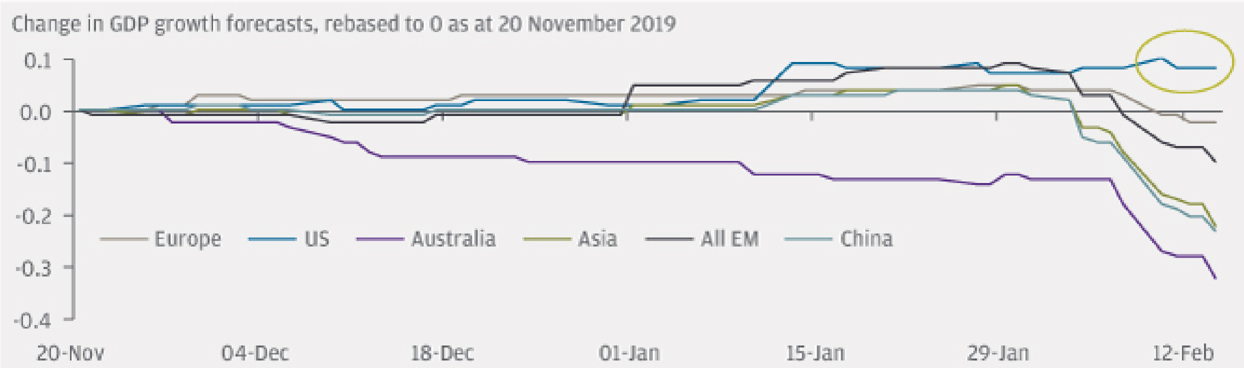
Carrying on with EM currencies

The expected implications of coronavirus for short-term growth are creating challenges for emerging market currencies vs. the dollar. While there are a lot of unknowns, we still see opportunities.

Fundamentals:

The full economic impact of the coronavirus outbreak is still uncertain, as many workers in China have yet to return to work. High frequency indicators, such as highway use and coal consumption, continue to indicate reduced levels of activity. Some international companies are expecting to feel the pain from the outbreak. For example, Apple – a heavy consumer of components made in Asia – announced a downgrade this week to its forward earnings guidance. Globally, some regions are likely to be hit more than others: consensus forecasts for growth in Australia and Europe, in particular, have been revised downwards. The US, by contrast, looks resilient at the time of writing (20 February). The news from Apple aside, indicators of growth are broadly positive: the empire manufacturing print rose to 12.9 vs. 5.0 expected – the highest reading since May 2019. If US data releases continue to show strength, we may see a period of US exceptionalism, which typically means a stronger dollar.

Growth forecasts have been downgraded in recent weeks, with the US a notable exception



Source: J.P. Morgan Asset Management Quantitative Research Group; data as at 14 February 2020.

Quantitative valuations:

The majority of emerging market (EM) currencies have underperformed vs. the dollar year to date, with the FX component of the GBI EM index down 3.3% and some currencies having underperformed significantly, including the Brazilian real (-7.9%), South African rand (-7.2%) and Chilean peso (-5.9%). With the virus impact likely to hamper EM growth relative to the US in the near term, the case for immediate EM currency appreciation has become challenged. We do still see select opportunities in fundamentally strong countries with high real yields, including Indonesia (3.8%), Mexico (3.6%) and Russia (3.4%). (All data as of 19 February 2020.)

Technicals:

Demand dynamics continue to favour fixed income, in particular US dollar-denominated assets. Our proprietary tracker has observed more than USD 65 billion into US retail funds, including US aggregate, investment grade and high yield year to date, whereas euro aggregate, EM Asia and EM local currency bonds have all seen negative flows. The picture is further supported by demand for foreign fixed income from Japan: more than JPY 3 trillion of foreign bonds have been purchased since the beginning of the year. Although our technical indicator suggests that the US dollar looks overbought, such flows signal healthy demand, which should support dollar strength. (All data as of 19 February 2020.)

What does this mean for fixed income investors?

Given the underperformance so far, there is still a case for EM currencies to bounce back at some point, once the impact from the coronavirus outbreak is clear and economy activity returns to normal levels. In the short term, however, the uncertainty around EM growth is likely to keep EM currencies anchored, especially relative to the dollar. Patient investors looking to benefit from attractive carry in the near term could still be rewarded – although it may be prudent to diversify funding for such trades via short positions in other developed market currencies where the growth outlook is less robust.

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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