THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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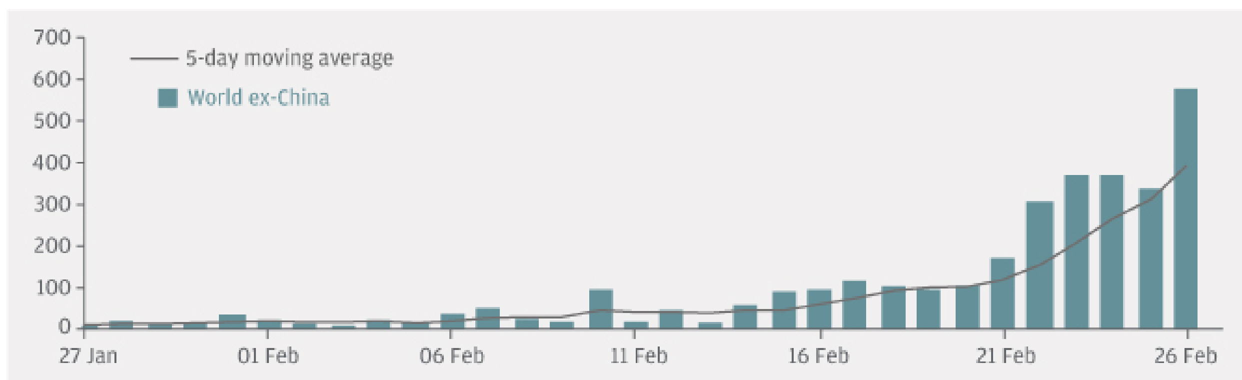
Coronavirus takes hold

Risk markets have taken a turn for the worse as coronavirus spreads outside of China. Valuations are lower, but do they compensate investors for the increased risks to global growth and corporate fundamentals?

Fundamentals:

The spread of coronavirus has caused growth forecasts and corporate earnings expectations to be revised down globally. Although the rate of daily reported cases has subsided in China, economic activity remains well down on previous years. At the same time, the five-day average increase in the number of cases reported outside of China is 4x higher than a week ago, largely driven by Italy, Korea and Japan. With the daily increase now close to 400 cases, the threat of a global pandemic is rising. It is likely that Italy and Japan are already in technical recession, and the impact of the virus on global growth will only make things worse. Early signs from February's leading indicators have revealed a slowdown in manufacturing and a larger-than expected decline in the services sector. In terms of corporate fundamentals, we will need to wait for the first-quarter reporting period to see how hard earnings have been hit, but management teams have already started to guide expectations lower. (All data as of 26 February 2020.)

Coronavirus infections have accelerated outside of China



Source: John Hopkins CSSE, J.P. Morgan Asset Management; data as of 26 February 2020.

Quantitative valuations:

Safe haven assets have benefited from the market sell-off, with the yield on the benchmark 10-year US Treasury note closing at an all-time low of 1.35%. The recent spread widening has left US and European high yield spreads 58 basis points (bps) and 46bps higher respectively than at the start of the year. Global investment grade spreads have widened by a more modest 8bps. Sectors with a higher risk of credit deterioration have suffered the most. For instance, the energy sector has led the US high yield market down, dropping 2.17% over the past week, and transportation has been the worst performing sector in European high yield, falling 1.64%. Neither look attractive enough to compensate investors for the increased risk. Defensive sector positioning is starting to pay off and we believe credit selection will continue to be a key determinant of future returns. (All data as of 25 February 2020.)

Technicals:

Technical support has subsided along with investor sentiment, with retail demand for risk assets turning particularly negative. Notably, the high yield market's largest exchange-traded fund (ETF), the iShares iBoxx High Yield Corporate Bond ETF, witnessed its largest ever one-day decrease in assets ($1.57 billion), which capped its fifth straight day of outflows and resulted in a 17% decline in assets over the period. Investment grade and high yield supply has also dropped significantly in the recent rout. Companies that have needed to access capital markets have been punished by wider spreads. (All data as of 24 February 2020.)

What does this mean for fixed income investors?

For the time being, we are monitoring news flow and constantly re-evaluating the economic toll of the virus, which should only become clearer once corporates start to report results for the first quarter and as macro data is released. Uncertainties from the outbreak are expected to reinforce the dovish bias for central banks, especially the People's Bank of China. Monetary stimulus should support government bonds and selected Asian and Chinese high grade corporate credits. While the situation remains fluid, we continue to advocate defensive positioning within credit markets while utilising a rigorous fundamental credit selection process.

About the Bond Bulletin

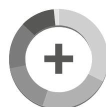
Each week J.P. Morgan Asset Management's **Global Fixed Income, Currency and Commodities** group reviews key issues for bond investors through the lens of its common Fundamental, Quantitative Valuation and Technical (FQT) research framework.

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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