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Five charts to explain why fixed income deserves its place in a multi-asset portfolio

Following a sharp sell-off in bonds over the course of 2022, this piece uses five charts from the *Guide to the Markets* to explain why we now see some of the most exciting opportunities in fixed income in over a decade.

Fixed income has historically provided two key characteristics in a multi-asset portfolio:

1) A steady stream of income

2) Diversification against riskier assets if the growth outlook deteriorates

For much of the past decade, the ability of bonds to offer either of these was steadily diminishing. A long bull market compressed yields to record low levels, forcing investors to make an unenviable choice: accept paltry returns by investing in government bonds at ever lower yields, or chase higher yields in lower quality parts of the fixed income universe and take on much more risk as a result?

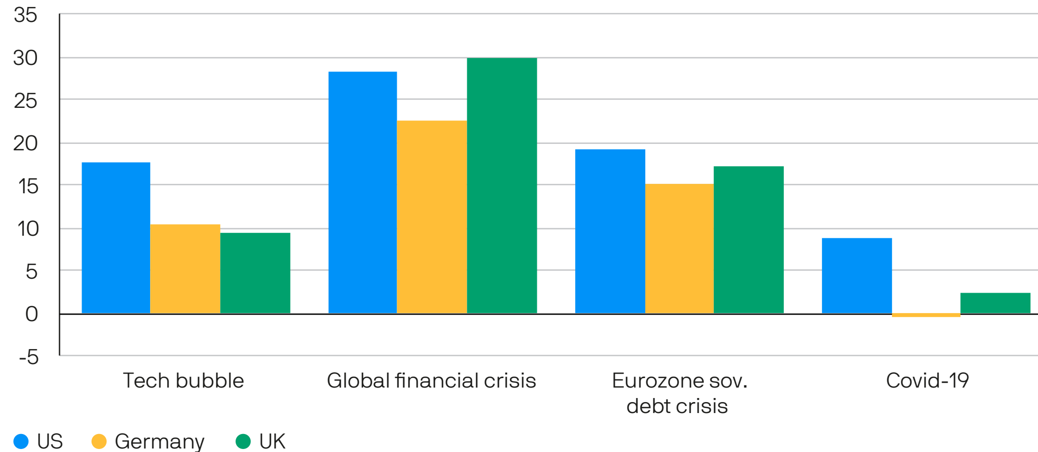
The declines witnessed in fixed income markets in 2022 were unprecedented. The global aggregate bond index fell by 16%, the worst annual decline since the index began in 1990 and more than three times as bad as the second worst year on record. Yet while last year's correction was extremely painful, it was also necessary as central banks realised it was no longer appropriate to be running the ultra-loose monetary policies that had prevailed for much of the previous decade. We believe that the fixed income reset is now complete and that the role of bonds in a balanced portfolio has been restored, both in terms of income and diversification against a recession that pushes inflation lower.

J.P.Morgan ASSET MANAGEMENT

1 – Prior to the reset, low yields were a big problem

Historical returns from 10-year govt. bonds during shocks

%, total return over the period when stocks were falling



Source: Refinitiv Datastream, J.P. Morgan Asset Management. Returns are shown over the period when MSCI World was falling in local currency terms. Tech bubble: 24 Mar '00 to 21 Sep '01; Global financial crisis: 13 Jul '07 to 9 Mar '09; Eurozone sovereign debt crisis: 18 Feb '11 to 3 Oct '11; Covid-19: 19 Feb '20 to 23 Mar '20. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 30 June 2023.

Our first chart considers the challenges that low yields have created for investors looking for diversification over recent years. In the first three recessions of our sample, 10-year government bonds generated healthy double digit returns during the periods when equity markets were declining. Yields were forced lower during each episode as investors anticipated interest rate cuts being required to support economic growth.

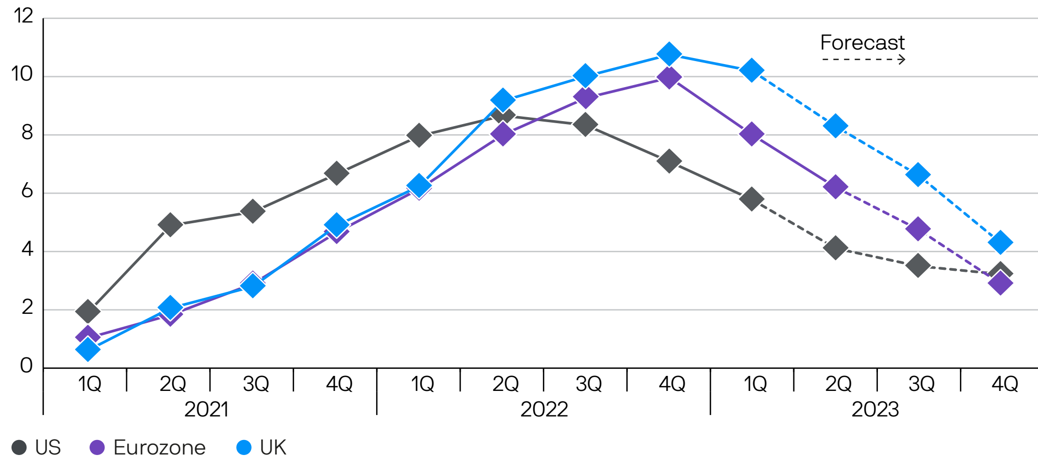
After a decade long bull market in fixed income, government bonds failed to provide the same diversification benefit when stocks were hit at the onset of Covid-19. German government bonds were the clearest example – with interest rates in the eurozone already at -0.5% at the start of the pandemic, the European Central Bank decided against taking rates even lower despite their desire to support growth. With German bond yields also entering the pandemic already in negative territory, there was little room for yields to fall further.

We believe that the sharp move higher in yields over the course of 2022 has restored the ability of government bonds to diversify against risks to the growth outlook, vastly increasing the instruments on offer in a multi-asset toolkit for investors that are looking to build balanced portfolios.

2 – Inflation should continue to moderate in 2023

Median of economists' forecasts for headline CPI

% change year on year, quarterly average



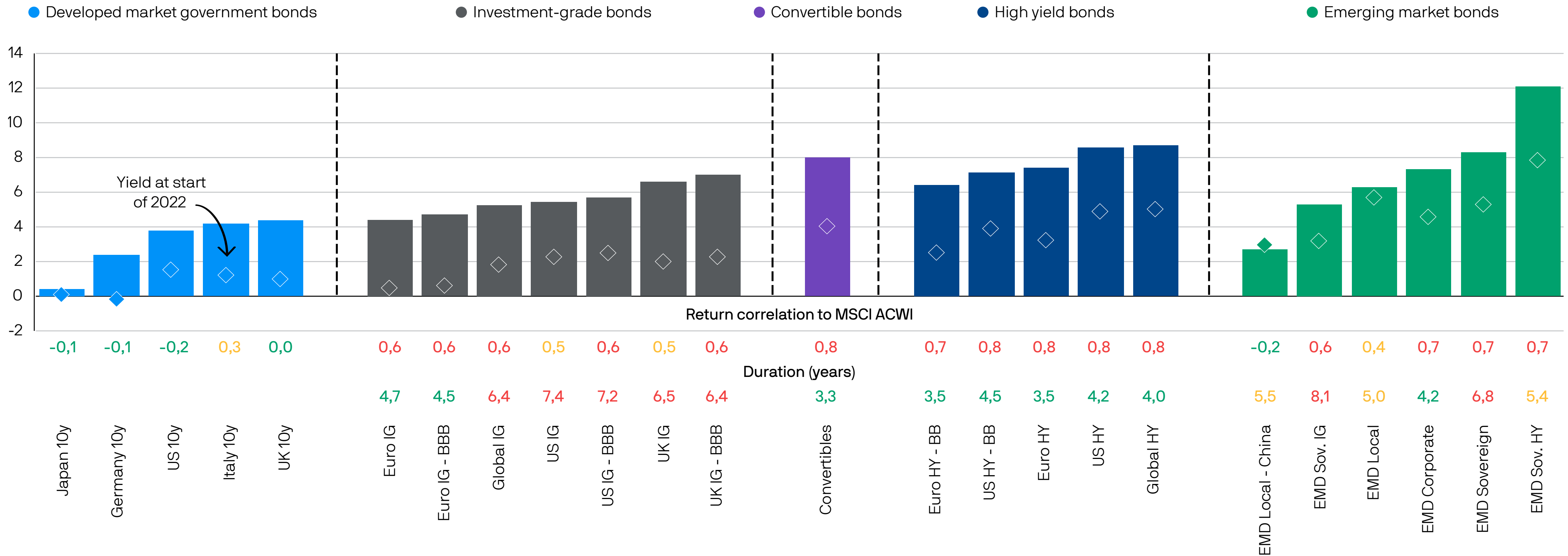
Source: Bloomberg, BLS, Eurostat, ONS, J.P. Morgan Asset Management. CPI is consumer price index. *Guide to the Markets - Europe*. Data as of 30 June 2023.

Surging inflation was at the root of the bond market's troubles in 2022. When Russia invaded Ukraine, the spike in energy prices forced inflation sharply higher. With Western labour markets already tight, central banks saw a significant risk that a one-time cost shock would become embedded as workers battled for real pay rises. Policymakers had little choice but to lean against the inflationary impulse.

Looking forward, the chart shows how inflation is expected to come down across developed economies over the coming quarters as the impulse of food and energy prices fades and the global economy weakens. As a result, we expect central banks in major developed economies to be able to pause their rate hiking cycles. This should help to stabilise bond markets. However, investors should remain selective. In the UK, structural labour market shortages are likely to keep inflation higher for longer, putting more pressure on the Bank of England to deliver further rate hikes. We also anticipate an end to the Bank of Japan's yield curve control policy, which has the potential to generate significant volatility in the Japanese bond market. This highlights the importance of an active approach within a global opportunity set when considering fixed income allocations.

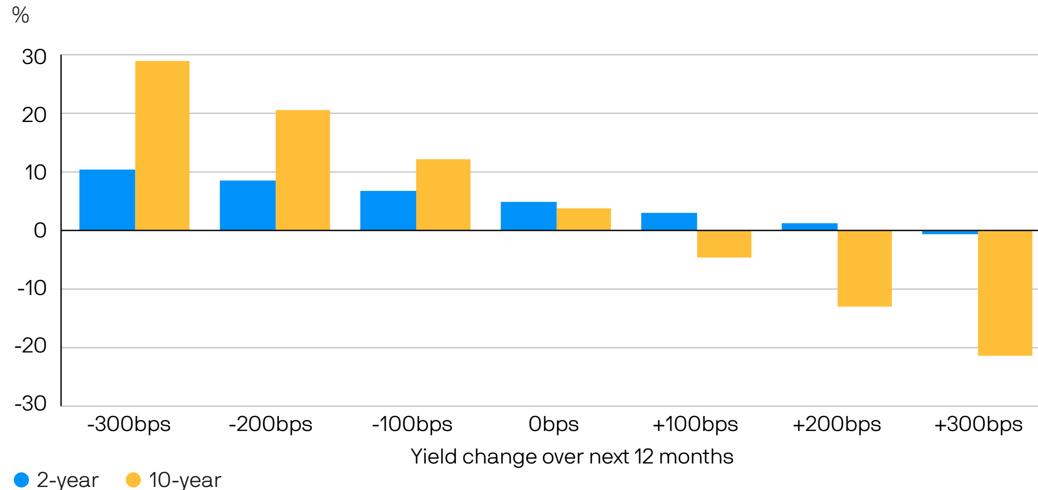
3 – Yields have moved higher across the fixed income spectrum

Our third chart considers the 'menu of options' across the fixed income universe. The bars show yields in at the start of 3Q 2023, and the diamonds show where they stood at the start of 2022. As the chart highlights, yields across the fixed income spectrum have moved significantly higher over the past 18 months. This is positive for two key reasons: it improves the income available, and it also creates room for yields to fall again in the event of a shock to the growth outlook. Higher yields are available in riskier categories such as emerging market bonds and high yield corporate bonds, but investors should pay attention to how the correlation to equities increases as you move from left to right on this chart. For diversification against recession risk, government bonds have the biggest role to play given their typically low or negative correlation to stocks.



Source: Bloomberg, Bloomberg Barclays, ICE BofA, J.P. Morgan Economic Research, Refinitiv Datastream, J.P. Morgan Asset Management. Return correlation to MSCI All-Country World Index is calculated using monthly total returns since 2008. Indices used are as follows: Euro IG: Bloomberg Barclays Euro-Aggregate – Corporate; Global IG: Bloomberg Barclays Global Aggregate – Corporate; UK IG: Bloomberg Barclays Sterling Aggregate – Corporate; US IG: Bloomberg Barclays US Aggregate – Corporate; Convertible bonds: Bloomberg Barclays Global Convertible Rate Sensitive hedged to USD; Euro HY: ICE BofA Euro Developed Markets Non-Financial High Yield Constrained Index; Global HY: ICE BofA Global High Yield Index; US HY: ICE BofA US High Yield Constrained Index; EMD corporate: CEMBI Broad Diversified; EMD local: GBI-EM Global Diversified; EMD local – China: JP Morgan GBI-EM Broad Diversified China; EMD sovereign: EMBI Global Diversified; EMD sov. IG: EMBI Global Diversified IG; EMD sov. HY: EMBI Global Diversified HY. Past performance is not a reliable indicator of current and future results.
Guide to the Markets - Europe. Data as of 30 June 2023.

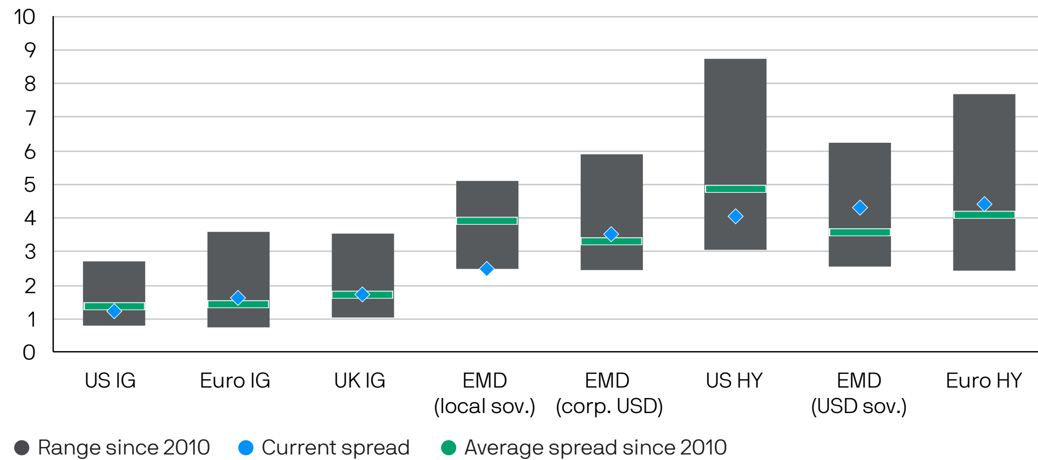
4 – Diversification potential has also improved



In addition to the improvement in income on offer, we believe the ability of bonds to diversify against recession risk – rising in price when equity prices are falling – is now also much stronger. Our fourth chart considers the total return that investors would receive from US Treasuries depending on how yields move over the next 12 months. While we still expect the slowdown ahead to be relatively mild, if the global economy did fall into a much deeper recession, the market's focus would likely flip quickly from worrying about above-target inflation to worrying about weak growth. In this scenario, bond yields would have significant room to fall from current levels. In the event that 10-year US Treasury yields fell by 100 basis points, this would deliver a return of more than 10%. This is the kind of meaningful diversification against equity losses that multi-asset investors rely on when constructing balanced portfolios, and has not been available for several years given the very low level of yields.

Source: Bloomberg, J.P. Morgan Asset Management. Chart indicates the calculated total return achieved by purchasing US Treasuries at the current yield and selling in 12 months' time given various changes in yield. For illustrative purposes only *Guide to the Markets - Europe*. Data as of 30 June 2023.

5 – Favour higher quality credit over lower quality counterparts



Our final chart considers credit spreads, or the extra compensation that investors are paid for investing in riskier corporate bonds and emerging market debt over core government bonds. Despite the deteriorating economic outlook, corporate fundamentals across much of the global economy remain robust. In recent years we have seen a clear trend of companies reducing their leverage levels and extending the maturity profile of outstanding debt, reducing near-term refinancing needs. These solid fundamentals should limit the amount that spreads widen if we do see a recession this year, although spreads on lower quality, high yield companies would likely move much higher than spreads on higher quality segments in this scenario. As a result, we believe that an "up-in-quality" approach remains prudent in the current environment.

Source: Bloomberg, Bloomberg Barclays, ICE BofA, J.P. Morgan Economic Research, Refinitiv Datastream, J.P. Morgan Asset Management. Euro IG: Bloomberg Barclays Euro Agg. – Corporate; US HY: ICE BofA US High Yield Constrained; EM Debt: J.P. Morgan EMBI Global Diversified; Euro HY: ICE BofA Euro Developed Markets Non-Financial High Yield Constrained; US IG: Bloomberg Barclays US Agg. Corporate – Investment Grade; UK IG: Bloomberg Barclays Sterling Agg.– Corporates; EMD local: J.P. Morgan GBI-EM Global Diversified; EMD corporate: J.P. Morgan CEMBI Broad Diversified. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 30 June 2023.

Conclusion

2022 was a historically difficult year for bond investors but the opportunities available in fixed income are now the most compelling in over a decade. Whether for income or diversification against recession risk, bonds deserve their place in a balanced portfolio once again, even though an element of selectivity will still be required.

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