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

This piece uses five charts from the *Guide to the Markets* to explain why, after a turbulent 18 months, we 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

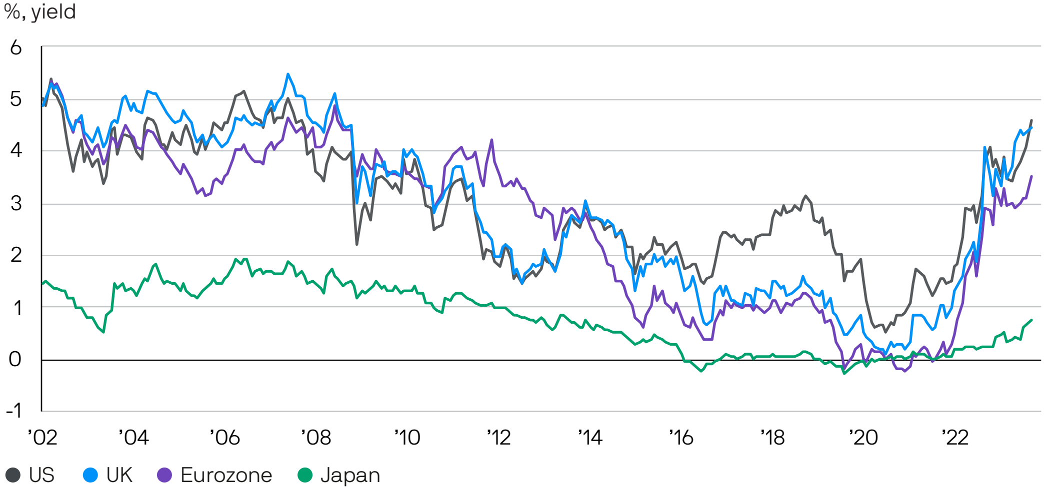
2) Diversification against riskier assets if the growth outlook deteriorates

For much of the past decade, the ability of bonds to offer either of these elements 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 over recent quarters are unprecedented. The global aggregate bond index fell by 16% in 2022, 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 this 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 broadly 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.

1 – Prior to 2022, low yields were an increasingly big problem

Nominal 10-year government bond yields



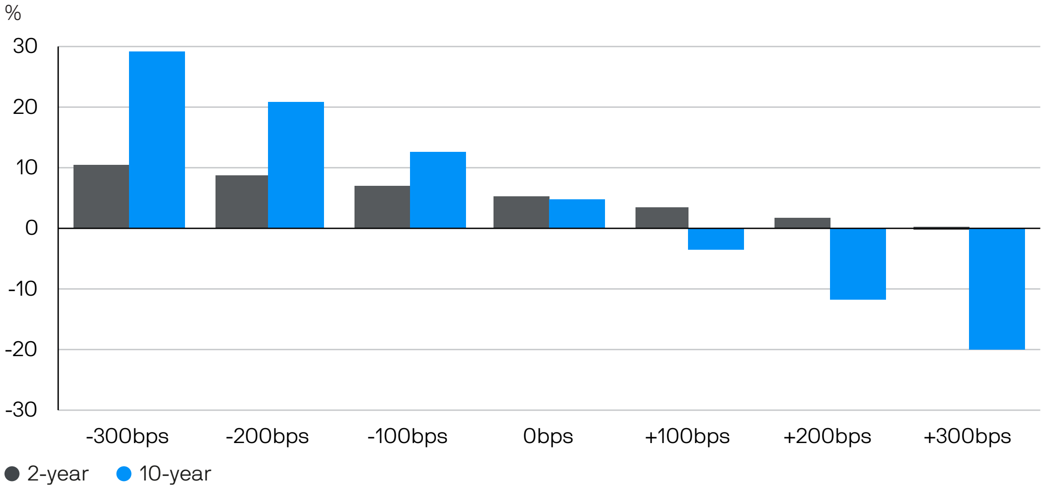
Our first chart focuses on government bond markets. Bond yields fell to record low levels over the last cycle as investors reacted to a combination of low inflation, sluggish growth, and central bank intervention. As a result, the low starting point for yields made it difficult for bonds to act as diversifiers when stocks were hit at the onset of Covid-19. The eurozone provided a clear 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 the desire to support growth. Given eurozone bond yields entered the pandemic at zero, there was little room for yields to fall further.

We believe that the sharp move higher in yields over the last 18 months has restored the ability of government bonds to diversify against a disinflationary shock to growth, vastly increasing the instruments on offer in a multi-asset toolkit for investors that are looking to build balanced portfolios.

Source: LSEG Datastream, J.P. Morgan Asset Management. Eurozone is a GDP-weighted average of the French, German, Italian and Spanish 10-year government bond yields. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 30 September 2023.

2 – Diversification potential has improved

Total return scenarios for US Treasuries



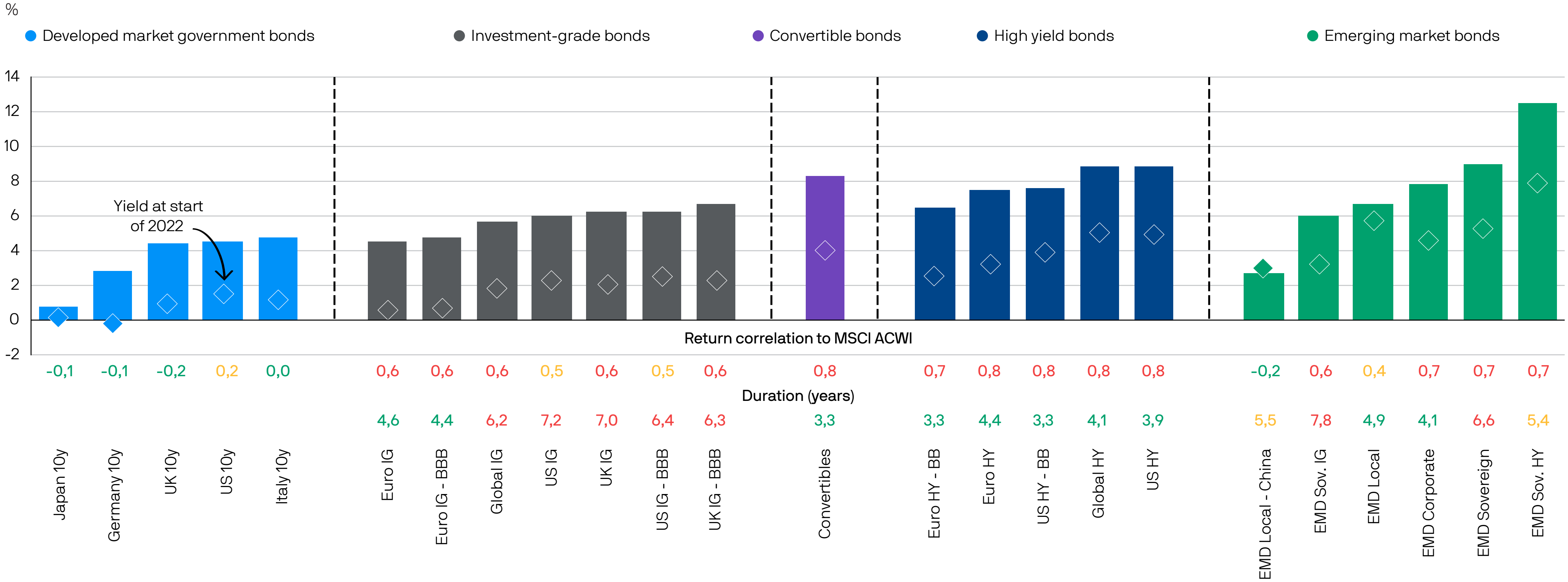
Our second chart considers the total return that investors would receive from US Treasuries depending on how yields move over the next 12 months. If the economic outlook deteriorates over the coming months, the market's focus would likely flip quickly from worrying about high inflation to worrying about weak growth. In this scenario, bond yields now 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. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 30 September 2023.

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 at the start of the fourth quarter of 2023, and the small squares show where they stood at the start of 2022. As the chart highlights, yields all across the fixed income spectrum have increased significantly over recent quarters. 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. If it's diversification rather than income that investors are looking for, government bonds have the biggest role to play given their typically low or negative correlation to stocks.

Fixed income yields

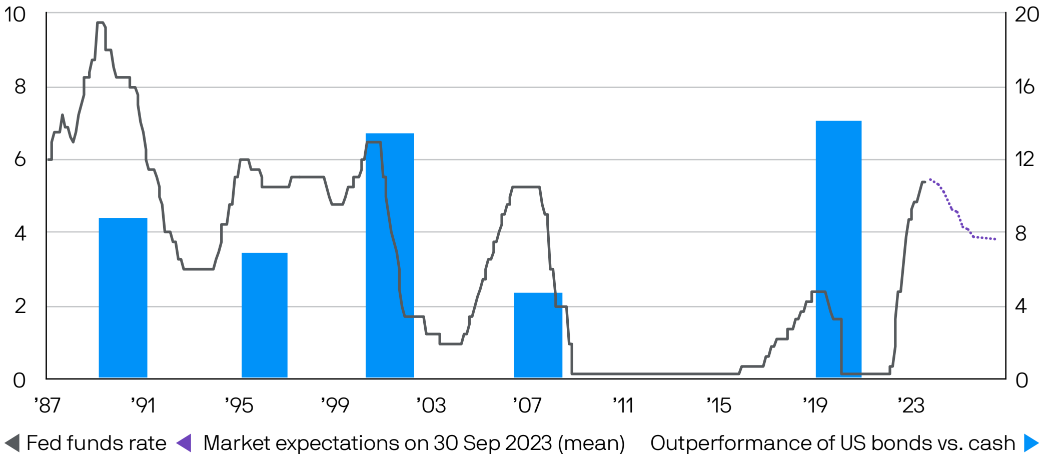


Source: Bloomberg, Bloomberg Barclays, ICE BofA, J.P. Morgan Economic Research, Refinitiv Datastream, J.P. Morgan Asset Management. Return correlation to MSCI All-Country World Index is calculated using monthly total returns since 2008. Indices used are as follows: Euro IG: Bloomberg Barclays Euro-Aggregate – 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 September 2023.

4 – Bonds typically outperform cash after the peak in interest rates

Relative performance of US bonds vs. cash after interest rate peaks

% (LHS): % points, two-year relative performance of US Aggregate bonds vs. cash (RHS)



Our fourth chart considers the relative attractiveness of cash versus fixed income today. Risk-free cash rates above 5% look appealing to many investors, with the negative returns from both stocks and bonds in 2022 still fresh in the memory. However, history shows that hiding out in cash at the end of a hiking cycle is rarely the right option.

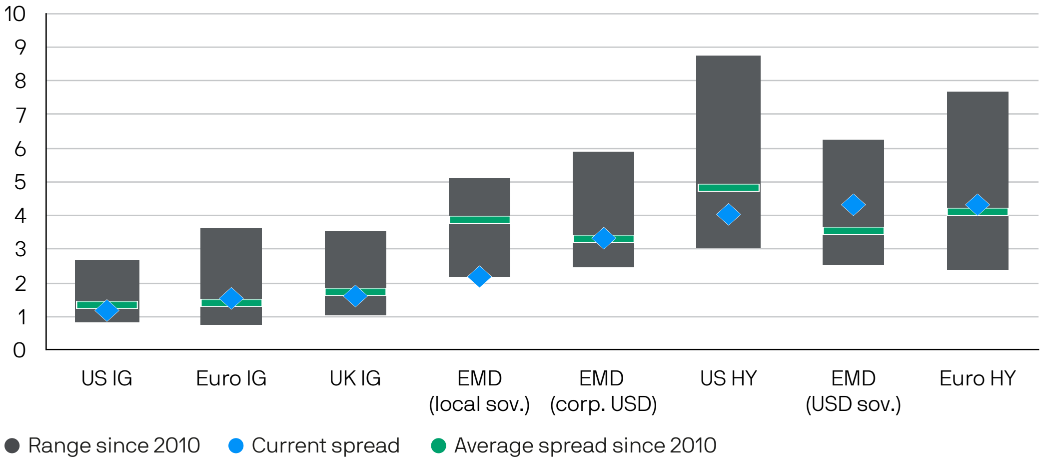
In the two years after a pause in Fed rate hikes, core US fixed income has outperformed cash in every example since the mid-1980s, as shown by the bars in our chart. Although it can take some time, tighter monetary policy typically induces a slowdown in the economy, which in turn often creates a better environment for longer-dated bonds.

Source: Bloomberg, Bloomberg Barclays, Federal Reserve, ICE BofA, J.P. Morgan Asset Management. Market expectations are calculated using OIS forwards. Cash: ICE BofA 3 Month Treasury Bill Index; US bonds: Bloomberg Barclays US Aggregate Index. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 30 September 2023.

5 – Favour higher quality credit over lower quality counterparts

Fixed income spreads

%, option-adjusted spread



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. Corporate fundamentals across much of the global economy appear to be in decent shape. 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. Yet even when factoring in solid fundamentals, credit markets do not appear to be pricing in much risk of a slowdown in the economy ahead, particularly in lower quality parts of the market such as high yield. 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 September 2023.

Conclusion

Recent times have been difficult 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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