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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 two years, we now see compelling opportunities across the fixed income landscape.

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

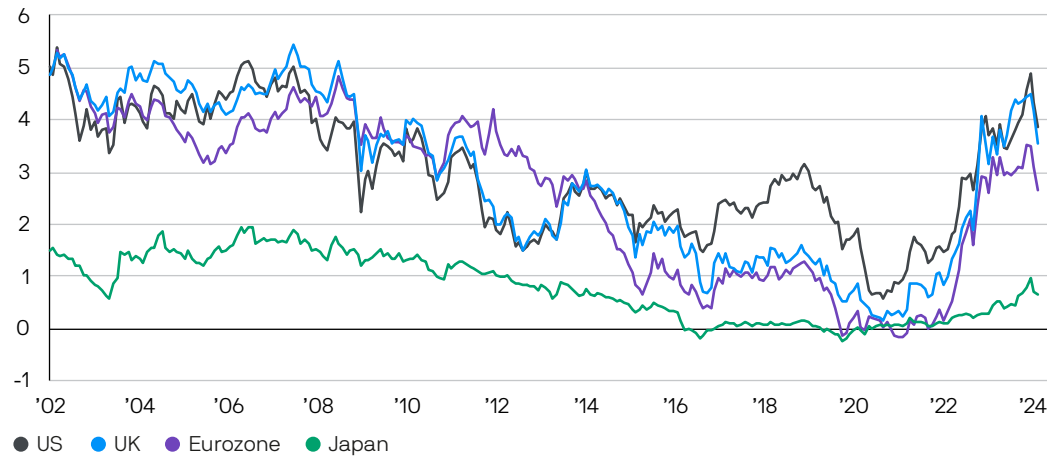
For much of the past decade, the ability of bonds to offer either of these elements was steadily diminishing. A long bull market compressed yields to record low levels, forcing investors to make an unenviable choice: accept paltry returns by investing in government bonds at ever lower yields, or chase 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 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. In 2023, 10-year government bond yields in many major markets ended the year roughly where they started. Yet this overlooks significant volatility, as the market swung sharply between over optimism and over pessimism on the economic outlook. While markets are likely to remain volatile for some time, 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

%, yield



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 31 December 2023.

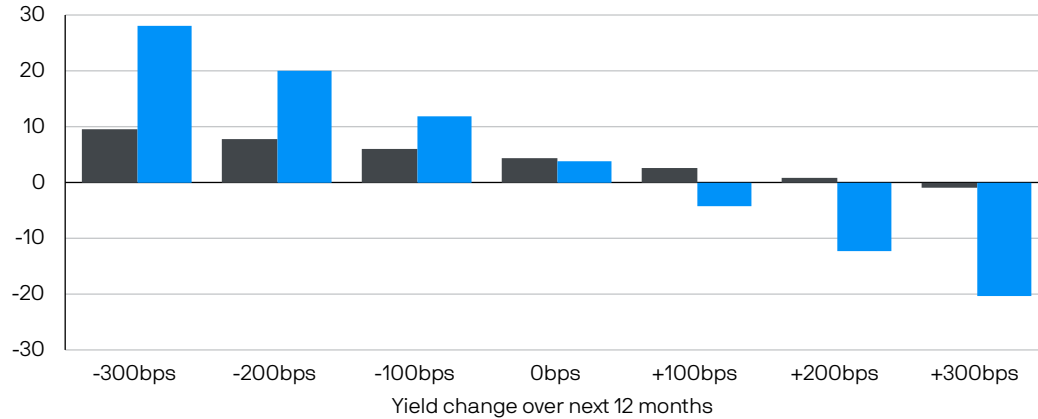
Our first chart focuses on government bond markets. Bond yields fell to record low levels over the last cycle as investors reacted to a combination of low inflation, sluggish growth, and central bank intervention. As a result, the low starting point for yields made it difficult for bonds to act as diversifiers 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 their 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 since the start of 2022 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.

2 – Diversification potential has improved

Total return scenarios for US Treasuries

%



● 2-year ● 10-year

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 31 December 2023.

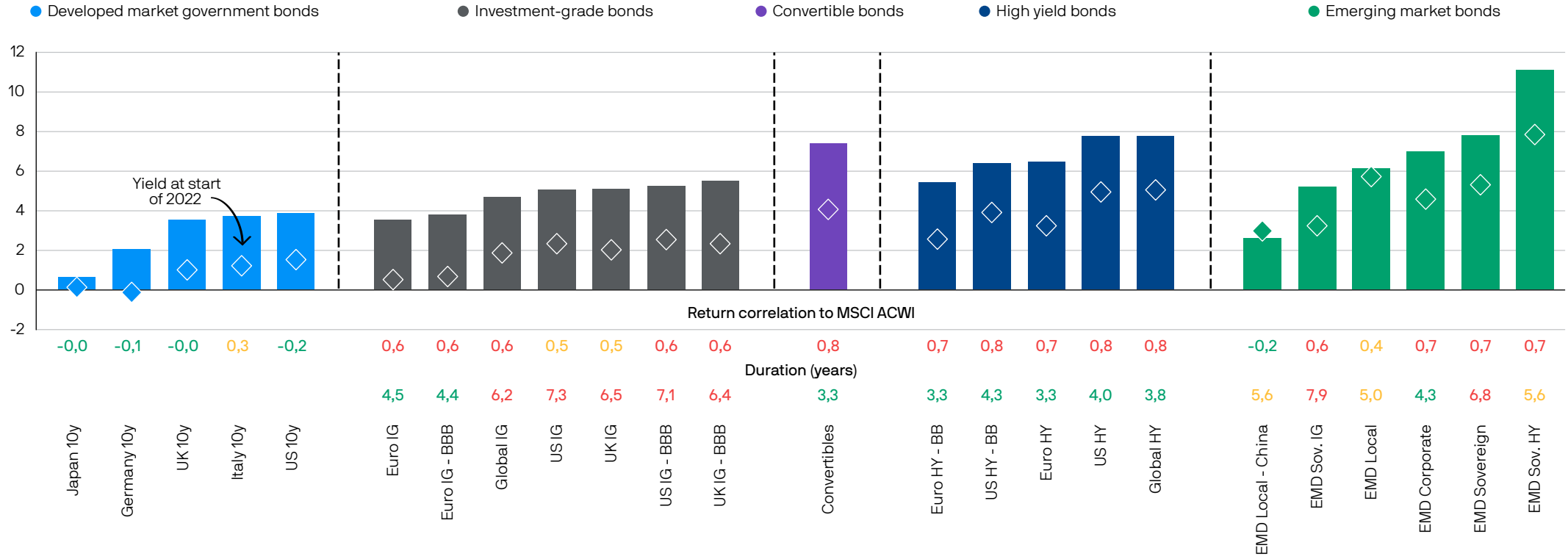
Our second chart considers the total return that investors would receive from US Treasuries depending on how yields move over the next 12 months. If the economic outlook deteriorates over the coming months, the pressure on central banks to cut interest rates will only intensify. In this scenario, bond yields still have significant room to fall from current levels, even after a strong rally in the fourth quarter of 2023. In the event that 10-year US Treasury yields fell by 100 basis points over the next 12 months, 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.

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 2024, and the small squares show where yields stood at the start of 2022. As the chart highlights, yields all across the fixed income spectrum have increased significantly over the past two years. 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

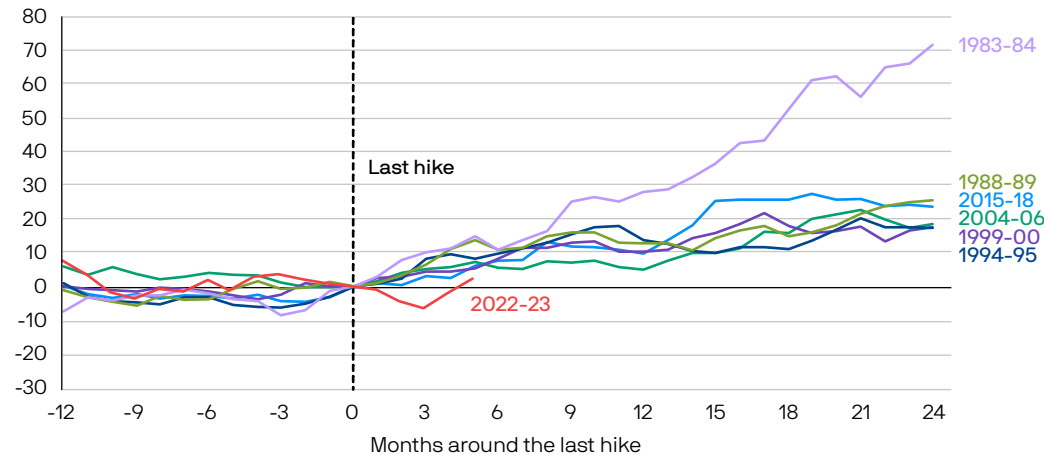
%



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 31 December 2023.

4 – The end of central bank hiking cycles has historically been good for bonds

US 10-year Treasury returns at the end of a Federal Reserve hiking cycle
%, total return, indexed to zero at the last hike



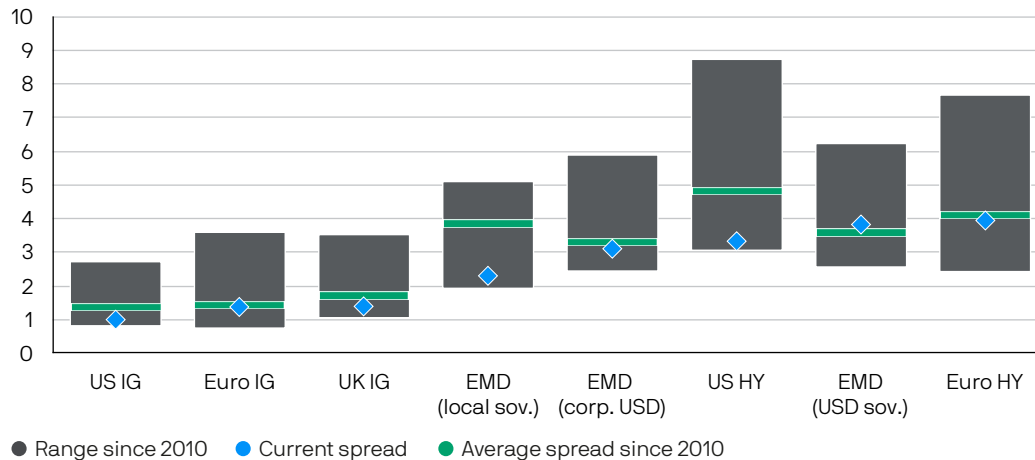
Source: Federal Reserve, LSEG Datastream, S&P Global, J.P. Morgan Asset Management. The 2022-2023 cycle assumes that the last hike of the cycle was in July 2023. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 31 December 2023.

The Federal Reserve has now kept interest rates on hold since July 2023, and we expect the next move in rates to be a cut, rather than a hike. While significant uncertainty remains about how quickly interest rates will fall, history indicates that the two years after the end of a hiking cycle have historically been a positive environment for high-quality fixed income, as highlighted by our fourth chart.

If the economy slows sharply and rates fall quickly, this could result in significant capital appreciation. But even in scenarios such as the mid-1990s, when the US economy made a 'soft landing' and rapid rate cuts were not required, bond returns post the end of a hiking cycle were still solid.

5 – Be selective in lower quality parts of the market

Fixed income spreads
%, option-adjusted spread



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 31 December 2023.

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, which has helped to keep near-term refinancing needs in check. Yet even when factoring in solid fundamentals, credit markets do not appear to be pricing in much risk of a major slowdown in the economy ahead, particularly in lower quality parts of the market such as high yield. As a result, we believe that a selective approach within credit markets remains prudent in the current environment.

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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