FOR INSTITUTIONAL / WHOLESALE / PROFESSIONAL CLIENTS AND QUALIFIED INVESTORS ONLY – NOT FOR RETAIL USE OR DISTRIBUTION

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

30 April 2020

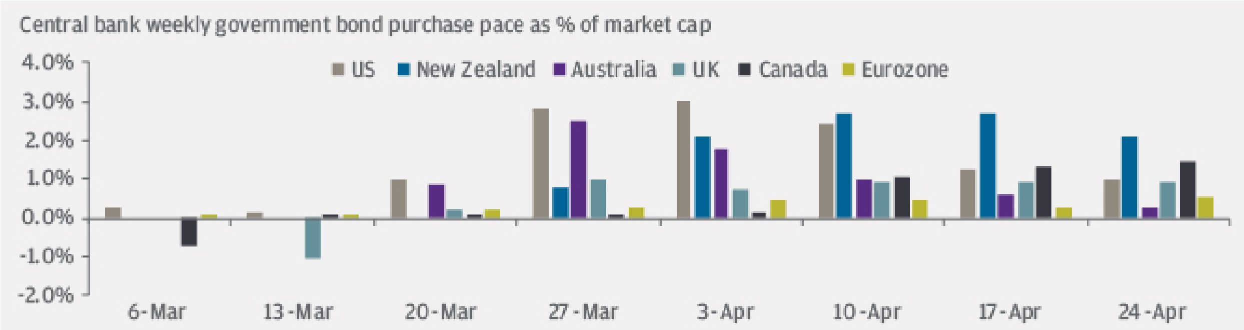
European periphery on the brink

Although markets generally have enjoyed a relief rally over the past six weeks, certain parts of the European bond market have had a much bumpier ride. What's driving this divergence, and what are the implications for bond investors?

Fundamentals:

Our framework for assessing the status of the present crisis focuses on monitoring the policy response and the virus response. On the former, it has become clear that countries are providing varying levels of support to their economies. From a monetary policy perspective, the Federal Reserve, which has purchased close to USD 1.5 trillion of Treasuries in the past month (7% of GDP), and the Reserve Bank of New Zealand, which has purchased more than 10% of its total market, stand out. The European Central Bank (ECB), on the other hand, has been a notable laggard. Although large in absolute terms and relative to past stimulus measures, the ECB's EUR 750 billion Pandemic Emergency Purchase Programme (PEPP) has proven insufficient given the scope of the current economic drawdown. European leaders have also fallen behind the curve on fiscal measures, though they are taking steps towards setting up a recovery fund. In terms of the virus response, certain regions are beginning to relax restrictions, although the high frequency data that tracks transit and retail mobility has shown only tentative signs that individuals are resuming activity. It's still too early to draw concrete conclusions, but this data does suggest that the re-opening of economies is likely to be slow.

Central banks are providing varying levels of support to their economies



Source: Federal Reserve, European Central Bank, Bank of England, Bank of Canada, Reserve Bank of Australia, Reserve Bank of New Zealand. All weekly purchase pace as of week-end, except for US (mid-week to mid-week). Eurozone gov't purchases proxied by Public Sector Purchase Programme + PEPP net holding increase pace; UK and Canada purchase pace implied by gov't bond net holding increase pace. As of 24 April 2020.

Quantitative valuations:

Risk assets have been buoyed by the substantial policy stimulus, with high yield and investment grade credit spreads 100 basis points (bps) and 58bps tighter on the month, respectively. It has not, however, been such a smooth ride for European peripheral government bonds. Italian 10-year yields started April by selling off nearly 65bps, to 2.16% on 21 April, not far off the peak in yields reached in mid-March (2.43% on 18 March). Spanish government bonds have moved in sympathy, with the 10-year yield rising from 0.68% at the end of March to 1.14% on 22 April. European markets rebounded in the final stretch of April, re-tracing nearly two-thirds of their earlier sell-off on hopes of an increase in PEPP purchases.

Technicals:

In addition to the monetary and fiscal policy shortcomings in Europe, peripheral sovereign bonds have been weighed down by immense levels of new issuance. Italian government bond supply was north of EUR 35 billion for the past month, far surpassing any previous monthly run rate (based on data back to 1999), and eurozone government bond supply was more than EUR 125 billion over the past four weeks. While flows into fixed income broadly have been strong—US aggregate funds saw over USD 11 billion of inflows in the week to 28 April, for instance—insufficient demand from the ECB's quantitative easing measures has left the European periphery on the brink.

What does this mean for fixed income investors?

We continue to favour assets that are being back-stopped by central banks. While the European peripheral sovereign market falls in scope for this strategy, the aggregate monetary and fiscal policy response in the region, up until the time of writing, has not been adequate. Until this is addressed, we remain cautious on the European periphery. Looking forward, spread widening driven by heightened supply may present attractive tactical opportunities, though we are also cautious of a potential ratings downgrade cycle for European sovereigns in the second half of this year.

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

LET'S SOLVE IT.SM

0903c02a828ae1f4