Fixed income investing in 2020

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IN BRIEF

- While easier monetary policy helped investors in 2019, it sets up a challenging investment environment for 2020. Historically, an investor's starting yields tends to be a reliable indicator for subsequent five year returns.
- If this precedent holds with a lack of yield curve steepness, investors will likely be tempted to shorten duration and take a lower quality focus to maintain the status quo of their historical fixed income returns.
- At this late stage in the cycle, investors should focus on higher quality areas of the fixed income market. Areas of opportunity include long duration U.S. Treasuries as well as mortgage-backed securities and asset-backed securities, which benefit from their exposure to the sturdy U.S. consumer.
- While intermediate-term bond styles have historically been considered a safe haven asset class, often ticking most boxes in the above mentioned point, stringent manager due diligence should not be neglected.

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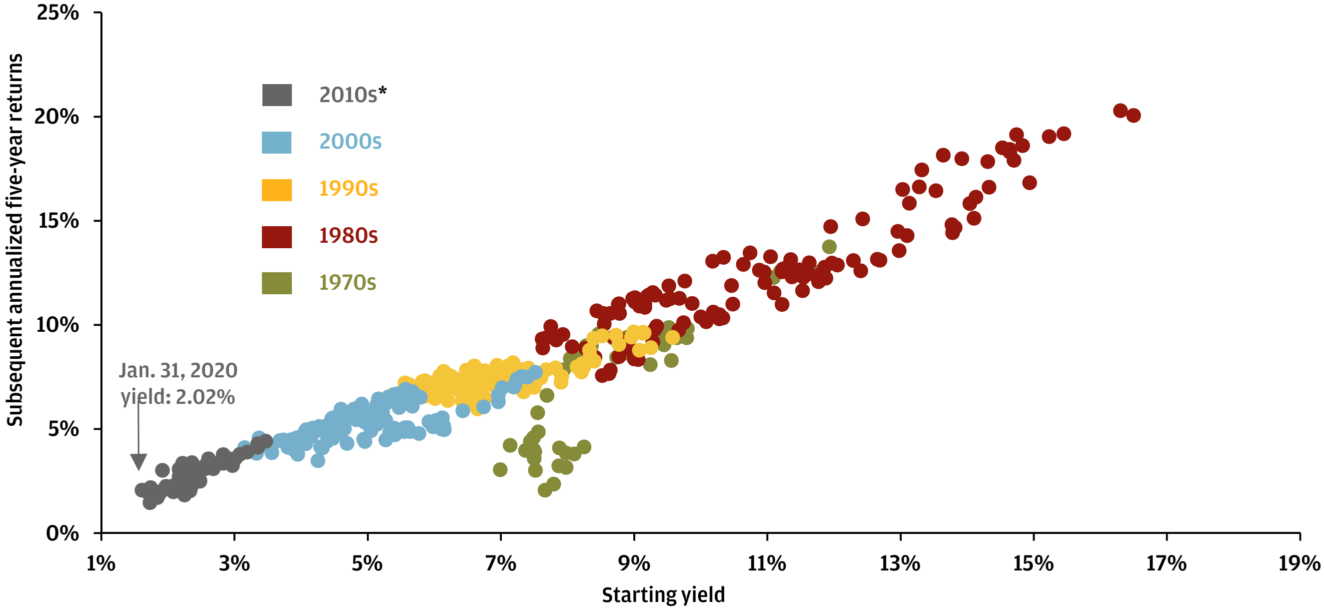
2020 investment outlook: Low yields, low returns

After a challenging 2018, fixed income investors caught a break in 2019 with the U.S. Barclays Aggregate returning 8.7%, its best year since 2002. Easy monetary policy from the global central banks also helped boost returns last year as 41 central banks cut interest rates 66 times between them. While this has helped stabilize economic growth and boost fixed income returns in 2019, it creates a low-yielding environment for fixed income investors in 2020.

As we highlight in **Exhibit 1**, historically, investors' starting yield explains a significant proportion of investors' subsequent five-year returns. Should this relationship hold going forward, today's starting yield implies a subsequent return of 2-3% per year for the next five years. This is considerably below what investors have received from their U.S. fixed income holdings in recent years. The U.S. Barclays Aggregate has returned 4% per year since 2009.

While past performance is not indicative of future results, loose monetary policy and subsequently low yields within fixed income creates a difficult investment environment for fixed income in 2020.

EXHIBIT 1: Bloomberg Barclays U.S. Aggregate index
Relationship between bond yields and subsequent five-year returns



Source: Bloomberg Barclays, FactSet, J.P. Morgan Asset Management. Period is from January 1976 to January 2020. *2010s is periods from January 2010 through January 2015. Past performance is not indicative of comparable future results. Data are as of February 17, 2020.

Be wary of reaching for yield/know what you own

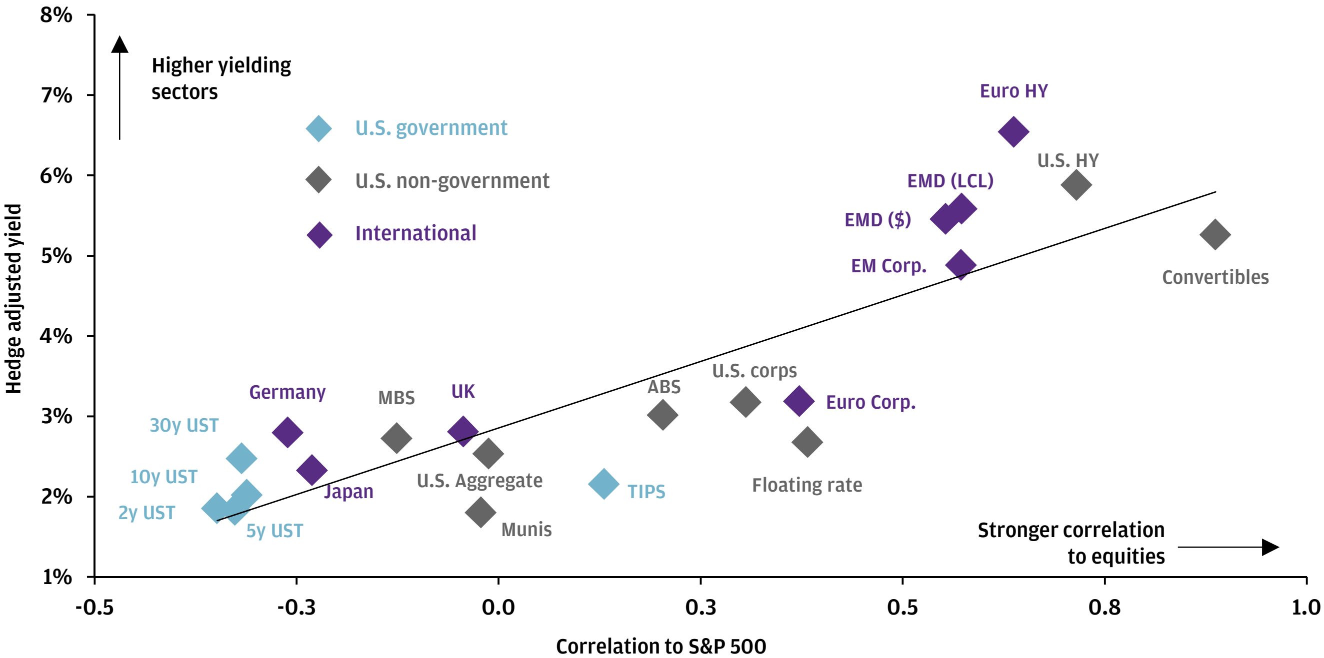
An initial solution to this low-yielding conundrum, is for investors to go hunting for yield in riskier areas of the fixed income markets. At this point in the economic cycle, investors would be wise to remember the diversification benefits core fixed income can provide to a portfolio, the below chart highlights this concept. **Exhibit 2**, essentially shows that higher yielding, riskier asset classes, such as high yield, may offer higher yields but this comes with stronger correlations to the S&P 500. This means that if equities fall sharply, riskier fixed income sectors will not provide investors with much protection. In short, higher yield equals higher risk.

Instead, investors should focus on quality within their fixed income portfolios. U.S. Treasuries, while low-yielding, provide protection for the portfolio as a whole. In addition, mortgage-backed securities (MBS) and asset-backed securities (ABS) help leverage the financial strength and resilience of the U.S. consumer. U.S. municipal debt has historically provided protection with reasonable yields.

By way of our Portfolio Insights team analyzing thousands of portfolios throughout 2019, we've seen investors, somewhat risk averse, have shifted toward higher quality and slightly longer duration categories. Dedicated high yield, for instance, consistently ticked down and ended 2019 at its lowest allocation of the year. Similarly, short duration styles have come down significantly from their highest allocations in the first half of 2019. While some have reallocated to more flexible managers, a vast majority trended toward the intermediate core and intermediate core-plus categories, in an attempt to insulate the portfolio.

While the surface of the water appears calm in the trend toward higher quality and longer duration categories, undercurrents insinuate investment selection will be imperative. Take a well-documented phenomenon of the growing and potentially risky BBB market.

EXHIBIT 2: Correlation of fixed income sector vs. S&P 500 and yields

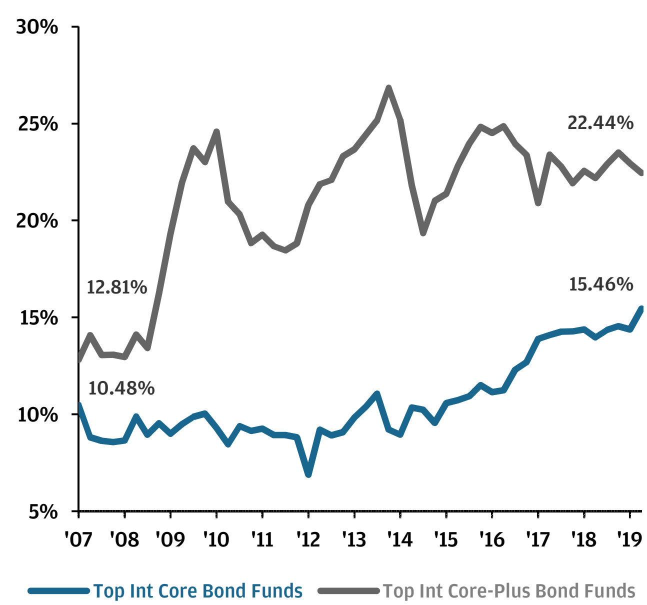


Source: Bloomberg, FactSet, ICE, J.P. Morgan Asset Management. Sectors shown above are represented by Bloomberg indices except for EMD and ABS – U.S. Aggregate; MBS: U.S. Aggregate Securitized - MBS; U.S. corps: U.S. Corporates; Munis: Muni Bond 10-year; U.S. HY: Corporate High Yield; TIPS: Treasury Inflation-Protected Securities (TIPS); Floating Rate: U.S. Floating Rate; Convertibles: U.S. Convertibles Composite; ABS: J.P. Morgan ABS Index; EMD ($): J.P. Morgan EMBIG Diversified Index; EMD (LCL): J.P. Morgan GBI EM Global Diversified Index; EM Corp: J.P. Morgan CEMBI Broad Diversified Index; Euro Corp.: Euro Aggregate Corporate Index; Euro HY: Pan-European High Yield Index. Convertibles yield is based on the U.S. portion of the Bloomberg Barclays Global Convertibles. Country yields are represented by the global aggregate for each country. Yield and return information based on bellwethers for Treasury securities. Correlations are based on 15-years of monthly returns for all sectors. International fixed income sector correlations are in hedged U.S. dollar returns except EMD local index. Yields for all indices are hedged using three-month LIBOR rates between the U.S. and international LIBOR and are a 12-month average. *Guide to the Markets – U.S.* Data are as of February 17, 2020.

In reviewing **Exhibit 3**, data suggests many intermediate core and core-plus bond funds are following suit with the structural market changes and/or consciously taking on more risk over time. When assessing your high quality core fixed income investments, it would behoove investors to look beyond common high level metrics such as categorization and trailing performance when seeking diversification to equity oriented risks. A handful of data points we encourage using include standard deviation, correlation to equities and performance during our stress test periods*. With returns likely more sparse and volatility likely more frequent, knowing what you own will prove paramount with regard to portfolio construction.

**Please reach out to your JPMorgan representative to find out how to stress test your portfolio*

EXHIBIT 3: BBB rated bond holdings by category
As a percentage of portfolios



Source: Morningstar, J.P. Morgan Asset Management. Data are as of February 17, 2020.

Investment implications

- After another round of monetary policy easing in 2019, the low bond yields on offer today are likely to hamper investor's long-term returns in fixed income.
- Investors should be cautious about reaching for yield late in the economic cycle. A focus on lower-yielding but higher quality areas of the fixed income may add some important protection to portfolios.
- Investors utilizing what has traditionally been considered high quality fixed income categories should proceed with a trust but confirm mindset. If the role in portfolio is to provide protection during turbulence, now is an optimal time to ensure the instrument is positioned to fulfill that role.

PI-MI-FI-Fixed income investing in 2020

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