THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

5 January 2023

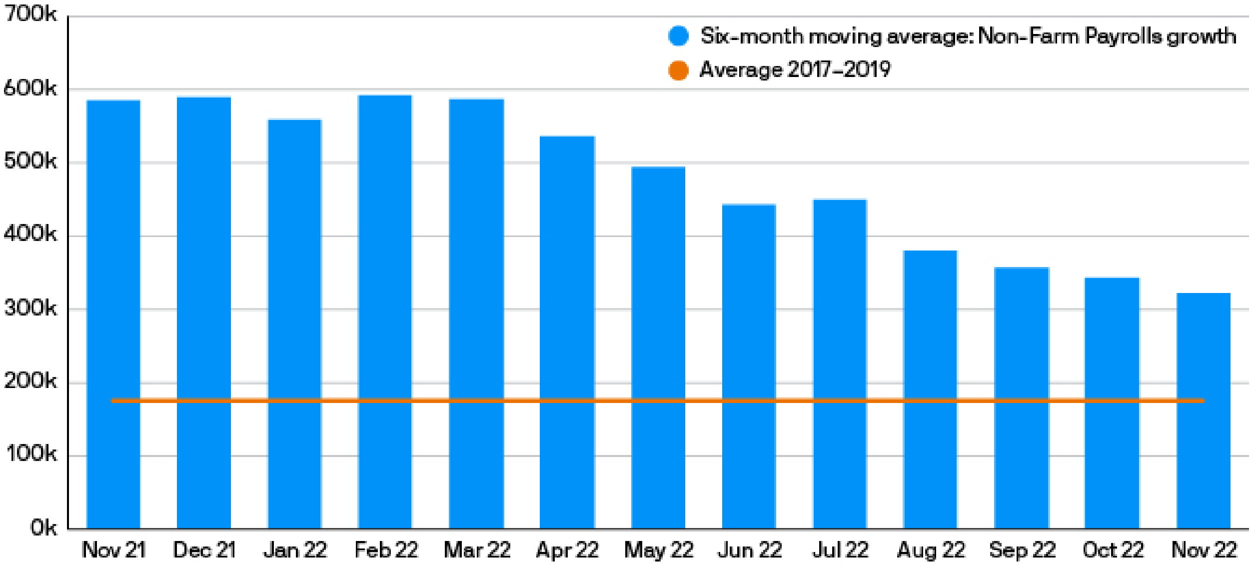
Three drivers to watch in 2023

The holiday period capped off a terrible year for fixed income investors with yields selling off globally in the last two weeks of the year. In the first bond bulletin of 2023, we focus on the three indicators that we expect will have a direct impact in the direction and magnitude of rate moves in the near term: US jobs, China reopening and the Bank of Japan (BoJ).

Fundamentals:

Attention has shifted to the US labour market, given that inflation has shown signs of rolling over. Although US Non-Farm Payrolls (NFP) has been decelerating, the pace has not been fast enough for the Federal Reserve (Fed) to stop its hiking cycle. That said, we expect payroll growth to continue to slow from its current pace of 275k-300k per month to close to zero over the next eight to twelve months as the lagged effects of tighter monetary policy flow through the economy. At that point, it may be a sign that the Fed has done enough and provide an opportunity to pivot policy. Outside the US jobs market, China's reopening and the BoJ are two recent topics which investors also need to consider. China's reopening is happening sooner than predicted. Although it appears reopening will be gradual, the impact on global inflation is unclear. Any fast or large resurgence in travel or other services could put upward pressure on inflation and in turn force global central banks to continue their hawkish policy. Finally, the BoJ surprised markets by letting long-term yields move 50 basis points (bps) either side of its 0% target, wider than the previous 25bps band. With a new governor due to be elected in April and a recent press leak stating that BoJ inflation forecasts for 2024 are being revised closer to their 2% target, it appears that the period of easy BoJ policy may be finally coming to an end.

US labour market should continue to soften as lagged effects of tighter monetary policy impact the economy



Source: J.P. Morgan Asset Management, Bloomberg as of 12 December 2022.

Quantitative valuations:

As a result of the BoJ policy tweak on 20 December 2022, 10 year Japanese Government Bonds (JGBs) briefly climbed to more than 0.43% intraday, a level last seen in 2015. Global bonds followed the sell off with the US 10-year Treasury yield rising by 26bps between 20 and 31 December 2022, finishing out the year at 3.84%. The BoJ can't take all the credit for the global sell-off; China reopening has also put upward pressure on yields as it is happening sooner than expected and is ultimately positive for global growth. Investors should keep in mind that if the BoJ's hawkish shift plays out and China reopening happens faster than expected, this could put further upward pressure on yields. Going forward, however, we believe a recession in 2023 is likely and although inflation is coming down, the labour market is still tight. The market is pricing in an additional 63bps of rate hikes for the Fed in 2023, ultimately reaching a terminal rate of 4.95% (as of 4 January 2023) which is slightly below the Fed's target terminal rate of 5.10%. If the deceleration of the US jobs market continues, market pricing may play out, with the Fed pausing later this year.

Technicals:

Demand for fixed income started to pick up in the second half of 2022 and the trend is continuing. The four-week rolling US bond demand, which includes the combination of retail flows, overseas flows, Fed custody holdings and bank holdings of bonds, was at -$12 billion on 21 December 2022, up from the recent trough of -$58 billion on 5 October 2022. We expect this trend to continue as valuations remain attractive and recession risks increase. In fact, recent investor positioning surveys showed market participants adding duration in December 2022. That said, investors remain underweight duration in Japan and China as further tweaks in BoJ policy and China reopening could push Japanese and Chinese government bonds higher.

What does this mean for fixed income investors?

Following our Investment Quarterly meeting on 14 December 2022, our near-term road map has played out thus far as yields sold off over the holiday period, creating an opportunity to add duration on the back-up in yields. Investors need to be aware, however, that in the near-term yields may be in a push-pull environment as the US jobs market, China reopening, and Bank of Japan policy tweaks may keep government bond yields range bound. That said, recession risks are rising. We are closely watching the labour market; any significant weakening may signal the end of the Fed's tightening cycle and provide an opportunity to move structurally long duration.

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

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