

THE FUTURE OF FIXED INCOME

## Weekly Bond Bulletin

17 December 2020

### Questioning the consensus

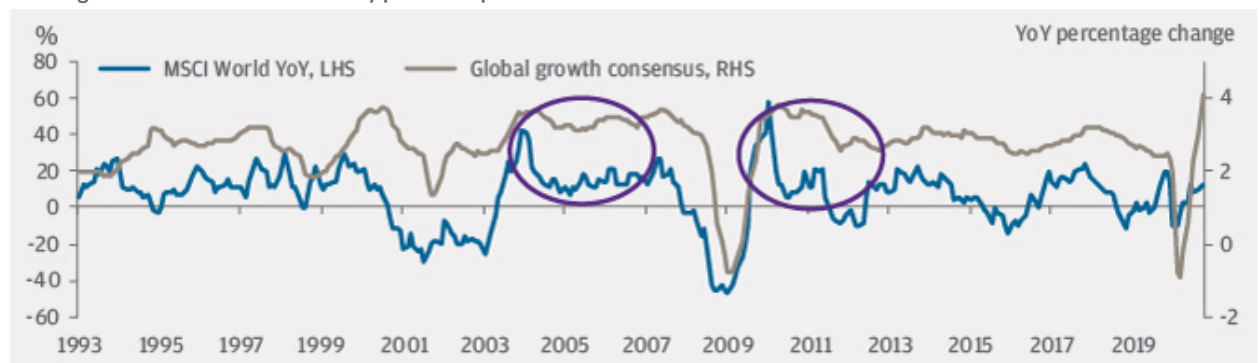
While investors can never get too comfortable, given the unpredictable nature of the past few years, the market consensus is very much risk-on as we head towards the end of a tumultuous year.



#### Fundamentals:

With the vaccine rollout underway, the outlook for the global economy is brighter. With global manufacturing purchasing managers' indices already having recovered, services should be next up—particularly in-person services in the US, which have lagged the wider economy. In China, the growth story remains strong, with a broad GDP rebound across sectors, and services production now back above pre-Covid levels. All of this points to a positive environment for risk. The global economy is likely to be weak going into 2021, but the market is now clearly expecting much stronger growth as economies reopen in first and second quarters. While it is prudent to ask if this optimism is warranted, on balance we agree with the consensus view. Previous recoveries have seen strong risk performance for sustained periods of time as the consensus has peaked. While there could be near-term upsets (obstacles to the vaccine rollout, a temporary bounce in inflation, or some currently unknown factor) we think we will see above-trend growth for the next three to six months, primarily because the vaccine is such a game changer. Put another way, the consensus optimism reflects the fact that the path to recovery seems to be so clearly mapped out.

A strong consensus doesn't necessarily precede a pullback in risk



Source: J.P. Morgan Asset Management, Bloomberg; data as of 4 December 2020. YoY = year on year.



#### Quantitative valuations:

With such a clear market consensus, it is more important than ever to discriminate when it comes to valuations. Spreads across the board are tight: investment grade spreads have retraced 97% from their wides to 104 basis points (bps). High yield spreads at the index level (423bps) look relatively attractive, but further spread tightening is likely to be driven by riskier, Covid-stricken names, as higher quality names with stronger fundamental outlooks are closer to pre-crisis tights. With that said, spreads in certain subordinated areas of the credit markets still have plenty of room to compress (with AT1 spreads still 109bps above their pre-crisis tights), while select unhedged emerging market local bonds offer attractive all-in yields: the average yield among four of our top picks—Indonesia, Russia, Mexico and South Africa—is 6.7%.



## Technical:

Wherever you look, investors seem to be long risk. The Bank of America Global Fund Manager Survey highlights that the majority of managers see the current environment as being early cycle, rather than recessionary. Our own indicators suggest that emerging markets are the top trade as an expression of that view. Investors are positioned long emerging market currencies, while around a third of the USD 17.6 billion that has flowed into fixed income markets in December so far has gone into emerging market debt funds. Although the consensus trade is something to be conscious of, the current strong momentum should continue in the absence of a significant shock to the vaccine and recovery narrative, especially given the amount of cash on the sidelines (money market fund assets under management are still up over USD 1.4 trillion year to date).

## What does this mean for fixed income investors?

Vaccine developments are such a game changer that it is possible to see through near-term concerns around virus growth, and any bounce in inflation is likely to be short lived. The consensus is therefore skewed towards owning risk, and probably for good reasons. We see a 75% probability of above-trend growth over the next three to six months and we think that as long as investors are discerning and focused on identifying the remaining pockets of value, the upwards market momentum could continue for some time to come.

### 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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