J.P.Morgan
Asset Management

THE FUTURE OF FIXED INCOME

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Underneath the sea of stability

Fixed income investors have enjoyed plain sailing in 2017, buoyed by a healthy global economic picture. But with several idiosyncratic risks lurking beneath the surface, could it be time for investors to batten down the hatches?

Fundamentals:

Synchronised global growth and healthy corporate fundamentals are familiar stories this year. Eurozone consumer confidence continues to trend higher and unemployment is falling faster than any other G10 country. US business activity and new orders are strong, while third-quarter GDP growth was revised up to 3.3%. Central bank policies have remained accommodative on balance despite steady rate increases by the Federal Reserve. Finally, continued growth in emerging markets provides further evidence of a robust economy. The odd one out is inflation. Although US core inflation was relatively steady in November, rising 1.9% annualised over the past three months, inflation generally remains muted across the globe, particularly in the eurozone where the year-on-year rise in the core Harmonised Index of Consumer Prices was unchanged at a mere 0.9% in November.

Quantitative valuations:

Credit spreads have tightened steadily this year, with investment grade and high yield indices 28 basis points (bps) and 73bps tighter respectively. However, the tightening of spreads has been at the overall index level. Under the surface, there have been some considerable moves attributed to single stories. For instance, one European large capital structure credit with good fundamentals drove spreads wider by over 11bps in November, out of a total widening of 46bps in European high yield for the month, prompting fears of wider contagion despite no long-term cause for alarm. Emerging market local bond returns have proven positive but have been impacted by political events in Turkey and South Africa. Additionally, Venezuela’s debt crisis and uncertainty surrounding its default status has pre-occupied investors wary of pitfalls.

Credit spreads have steadily tightened in 2017, although index-level moves mask idiosyncratic volatility

Source: Barclays Live. Data from 31 December 2016 to 6 December 2017. Investment grade index: Barclays Global Aggregate Corporates. High yield index: Barclays Global High Yield. LHS = Left-hand side; RHS = Right-hand side.

Technicals:

Gross issuance has surprised to the upside in recent weeks, with EUR 2.8 billion of deals pricing in the European high yield market for the week of 27 November and a 7% increase in cumulative issuance vs. 2016 in the investment grade credit space for the first week of December. However, this activity is likely to precede a sharp slowdown as we move into the final days of 2017. Most of the issuance we have seen has been for refinancing purposes, meaning that net supply has not had a meaningful negative impact on technicals. There have also been strong flows into the broad fixed income market this year, with considerable support for aggregate and unconstrained strategies, which have received a combined USD 249.8 billion year to date (as of 1 December), accounting for 61% of all flows into fixed income strategies.

What does this mean for fixed income investors?

Although fixed income markets have appeared tranquil in 2017, several idiosyncratic stories have created volatility beneath the surface. Events in emerging markets show the political risks investors face, while recent moves in the high yield market highlight the value that can be added by experienced analysts. While these idiosyncratic stories weren't enough to disrupt the broader market in 2017, it is possible that they could have a more harmful influence in 2018—particularly as the backstop of accommodative central banks wanes. As such, credit selection is likely to become increasingly important, and we remain focused on avoiding the losers as much as picking the winners.

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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