

THE FUTURE OF FIXED INCOME

## Weekly Bond Bulletin

11 June 2020

### The risk rally rages on

With central bank liquidity continuing to drive a powerful risk rally in markets, can anything disrupt what is now one of the fastest retracements in fixed income history?



#### Fundamentals:

The Covid-19 economic shutdown has put the health of corporations in peril: balance sheets are more levered, the operating environment is more challenged and an increasing number of companies are likely to default on their debt. The pace of ratings downgrades has slowed since the peak of the crisis, with less than 0.5% of BB rated companies downgraded to a B rating in May, compared to more than 4% in March. However, downgrades could re-accelerate as the economic repercussions of the virus fully materialise. Nevertheless, the recent rise in asset prices has resulted in significantly fewer bonds trading at a spread of over 1,000 basis points (bps), meaning that even stressed names are more easily able to access funding. Looking ahead to the second-quarter earnings season, it's likely to be the guidance (or lack thereof) from companies that moves markets, rather than the earnings results themselves. In the meantime, investors remain firmly focused on the economy's direction of travel, rather than absolute levels, and recent data prints—such as the May US payrolls report—suggest that activity may have hit a bottom earlier than expected.



#### Quantitative valuations:

The risk rally has continued unabated, marking one of the fastest retracements in history. In the first seven trading days of June alone, global high yield spreads tightened by 85bps to 591bps, which represents a 70% retracement of the year-to-date spread widening in just two and a half months. More recently, the most beaten up credits and sectors have posted the largest comeback. In April, BB rated credits outperformed CCC rated names by 4%; since then, the lowest quality names have generated a 15% total return compared to less than 7% for BB rated issuers. At current spread levels, the market is pricing in a sharp economic rebound that doesn't reflect our expectation of higher defaults. (Data as of 9 June).



#### Technicals:

Technical factors, in particular the demand side of the equation, are overwhelmingly supportive. Central bank policy, including the European Central Bank's recently expanded Pandemic Emergency Purchase Programme, is flooding markets with liquidity and sparking the search for yield. Retail investors have flocked back to the high yield market: after more than USD 20 billion of outflows in the first quarter, US high yield funds have experienced USD 46 billion of inflows thus far in the second quarter. Although more muted, European high yield fund flows have followed the same trend. And with total assets in money market funds up USD 1.4 trillion on the year, there remains a wave of cash still to be put to work. (Data as of 8 June).

## The wave of cash still to be put to work could be supportive of credit markets



Source: J.P. Morgan Asset Management; data as of 8 June 2020.

### What does this mean for fixed income investors?

The speed and strength of the recovery in financial markets raises the question whether the rally has gone too far, too fast. As long as the technicals continue to dominate (and we don't envision a shift away from easy central bank policy anytime soon) then it is unlikely that outright valuation levels will deter investors. Instead, any potential catalyst that could disrupt this move tighter in spreads is likely to be fundamentally driven. A second wave of the virus, heightened US-China trade tensions, or a shift in the data such that economic prints begin surprising to the downside instead of the upside are all potential factors that we're monitoring. In the meantime, the central bank induced risk rally rages on.

#### 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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