MARKET INSIGHTS

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Global bond outlook: Full circle, but which direction?

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Introduction

Low levels of economic growth and high levels of debt are creating significant opportunities in global bond markets. J.P. Morgan Asset Management's international chief investment officer for fixed income, Nick Gartside, explains how the global economy has come full circle and why global bonds may continue to provide investors with attractive returns in the coming years.

Global economic outlook – Japan provides a roadmap

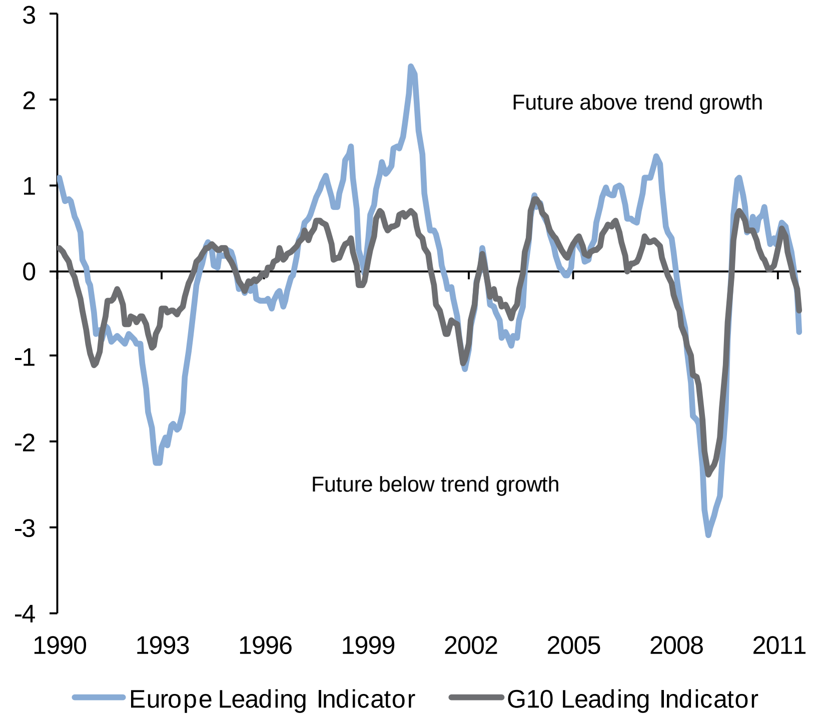
Global economic growth is below trend and the immediate outlook appears bleak. The reason why growth is so weak is that very high levels of public and private sector debt, particularly in the developed world, are set to continue to constrain government and consumer spending for some time to come. In this sense, the global economy has come full circle: economic weakness has led to increased government borrowing and high debt levels, while the austerity measures now being implemented to reduce these debts are only serving to further exacerbate economic weakness.

In the current economic environment, Japan may provide a roadmap for bond investors. Japanese growth collapsed in the late 1990s at the same time as government debt levels rose sharply. The Bank of Japan reacted by cutting interest rates to zero and by introducing several bouts of quantitative easing – the same policies now being pursued by western central banks.

The low growth, low interest rate environment was very supportive for Japanese bonds. In fact, not owning Japanese bonds was the graveyard of bond investors in the late 1990s and early 2000s. As in Japan, returns from western bond markets may also continue to surprise positively. Bonds have two traditional enemies: inflation and interest rate rises. On both fronts the outlook is now benign, with low growth and ongoing deleveraging suggesting that inflation will ease and interest rates will fall. The European Central Bank (ECB) and several emerging market central banks are likely to cut rates in the coming months, while the Bank of England and Federal Reserve are contemplating further quantitative easing (QE) measures.

Exhibit 1 – Future global growth is set to be below trend

Developed markets leading indicators



Source: J.P. Morgan Asset Management, Bloomberg. Data as at November 2011.

Debt is dominating the economic landscape

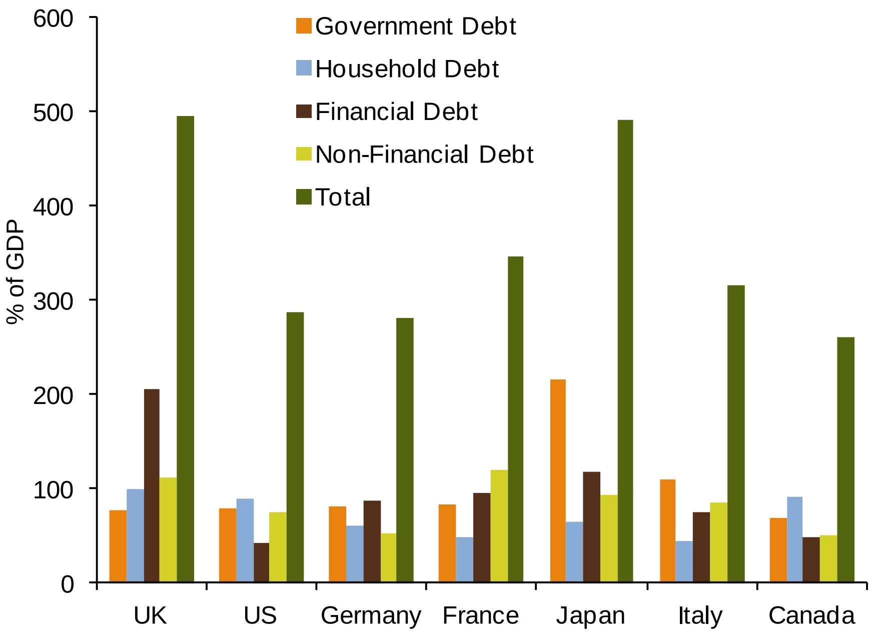
Most major developed economies have too much debt, running total debt burdens of between 200% and 500% of GDP. Worries over the sustainability of these debts are leading to credit downgrades in the developed world: the US has lost its AAA rating and other top-rated countries now look vulnerable, particularly France and the UK.

The reason credit ratings are coming under pressure is that the low growth environment is making it much harder for governments to bring their debts under control. Deleveraging cycles have historically taken between five and ten years to complete. Given that we are no more than a few years into the current cycle, and given the high levels of debt and low levels of growth, the current deleveraging cycle is likely to be more like ten years than five years.

The corollary of this long deleveraging cycle is that economic growth will remain lower for longer than previously expected. If deleveraging takes ten years, global economic activity may be anaemic for several more years to come.

Exhibit 2 – The developed world has too much debt

World Debt



Source: J.P. Morgan Asset Management, McKinsey. Latest available data.

Eurozone questions remain unanswered

At the moment, the region facing the biggest challenge managing its debt burden is the eurozone, where several peripheral countries have borrowed too much and are now struggling to repay lenders. Despite its many complexities, the eurozone sovereign debt crisis comes down to two fundamental questions:

1. Who will suffer writedowns?

2. Who is injecting new capital to help indebted countries?

Both of these questions remain unanswered. Investors do not know who will suffer writedowns on their peripheral eurozone bond holdings and they have no idea how much debt will ultimately have to be written off to return the region to a path of debt sustainability. This uncertainty is creating nervousness in the European banking system due to its large exposure to peripheral eurozone bonds, which in turn is having a detrimental impact on bank lending and economic growth.

Meanwhile, it is clear that investors are reluctant to inject new capital into the eurozone without greater guarantees that they will get their money back. This means the attempt to leverage the eurozone's bailout fund, the European Financial Stability Facility (EFSF), is a non starter. Many investors would like to see the ECB step in and support eurozone peripheral debt using quantitative easing before they commit any money.

Any injection of capital from the EFSF or the ECB (or a combination of the two) would help aid the deleveraging process and alleviate the crisis in the short term, but even that would not provide a long-term comprehensive solution. To avoid a future crisis, wide-reaching and fundamental reform is needed to address the serious structural imbalances that exist within the eurozone, in particular the lack of competitiveness of the region's periphery. Either way, the eurozone debt crisis has no quick-fix solutions.

Finding value in today's bond markets

In this deflationary, low growth environment, fixed income returns are likely to continue to provide positive surprises. Anaemic growth and record-low interest rates will also place an increased emphasis on the search for securities that offer attractive yields. As already mentioned, Japan may provide a roadmap for investors. The Japanese experience suggests that reducing exposure to global bond markets in the current environment could be costly.

But where should bond investors be looking to put their money? At the moment, attractive fixed income opportunities can be found in selected sovereigns (particularly Australia) and corporate credit (particularly high yield). The US mortgage market provides a further good source of value for investors in both agency and select non-agency securities. We also continue to like emerging market debt and emerging market currencies, particularly on a long-term basis, although short-term dynamics are less supportive.

Government bonds

The weak global growth outlook is supportive for government bonds. However, given the deteriorating credit outlook in several large sovereign markets, we would suggest that investors focus on attractively valued bonds offering competitive yields that are backed by a high and stable credit rating.

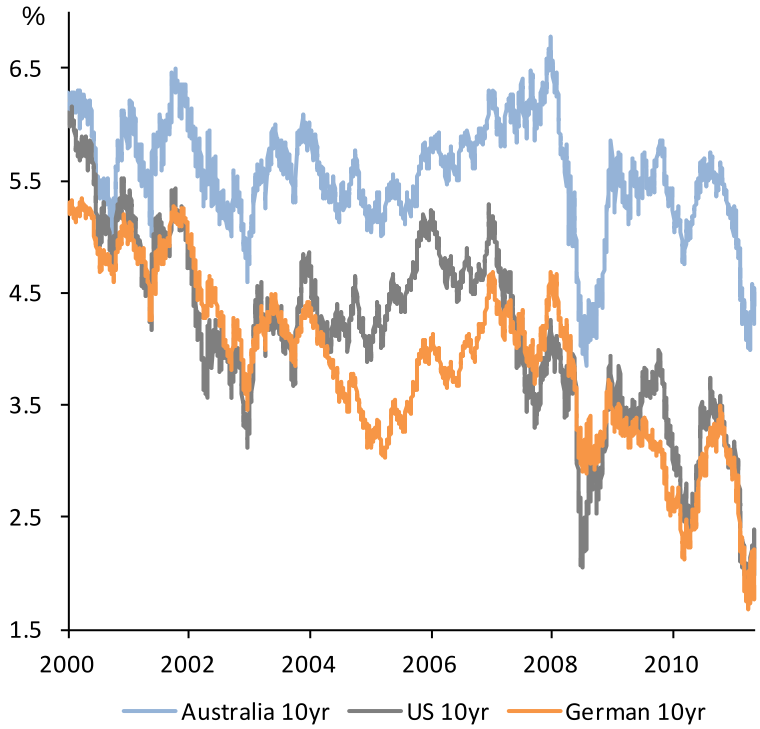
On a valuation basis, Australia stands out at the moment. Australian bonds benefit from the backing of strong public finances (the country has a low debt-to-GDP level and only a modest budget deficit), yet they offer a much higher yield than UK Gilts, US Treasuries and German Bunds. Australia is also expected to continue to cut interest rates fairly aggressively given a weakening trend in domestic consumer data and concerns over Chinese demand for commodities.

Corporate bonds

Following a recent widening in spreads over Treasuries, opportunities can be found in the investment grade and high yield bond markets. High yield offers particularly good value, from both a fundamental and a valuation viewpoint.

Exhibit 3 – Australia stands out among sovereign issuers

Envious of Australia: an attractive real AAA



Source: Bloomberg, 3 November 2011.

High yield fundamentals are strong, with companies generating high levels of cash and benefiting from low levels of leverage on their balance sheets. Fundamentals are therefore radically different from those of 2008, prior to the global financial crisis, when borrowing was high and cash flows were low. Therefore, companies are much better positioned to withstand any renewed economic slowdown. Furthermore, refinancing needs are relatively manageable for the next few years.

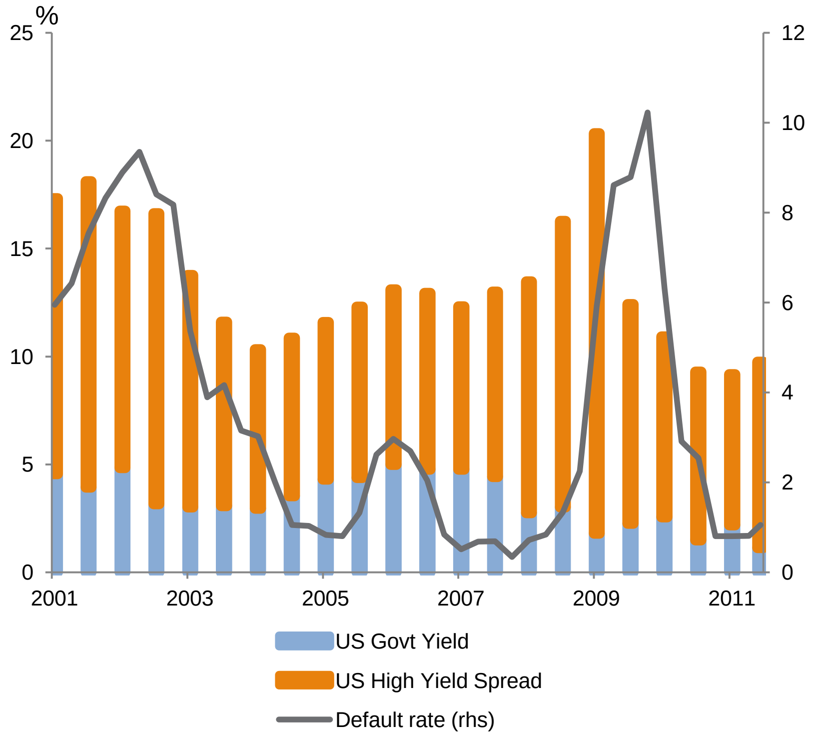
From a valuation perspective, the current 9% yield offered by the high yield market is favourable compared to the negative real return available from cash and the low yield offered by other bond sectors. Current valuations also imply that default rates will rise significantly. With default rates at just 1% it is inevitable that they will rise at some stage, but we do not expect this to be dramatic and expect defaults to remain below the long-term average of 4%, again indicating current valuations are attractive.

Mortgage-backed securities

Agency debt (mortgage bonds backed by US government-sponsored agencies such as Fannie Mae and Freddie Mac) offer yields that are around 1.5-2% higher than is available from US Treasuries, despite being implicitly backed by the US government. As a result agency mortgage securities provide attractive value for investors.

Exhibit 4 – High yield valuations are attractive

High yield yields and defaults



Source: J.P. Morgan. Data as of 30 September 2011. For illustrative purposes only.

Non-agency mortgage bonds offer selected opportunities depending on structure and maturity, so individual security analysis is vital. The highest rated bonds that originated before the peak of the US housing bubble (pre-2006) can offer value. These bonds typically have a short average life of around a year, while yields are very attractive, at between about 6% and 9%.

Emerging market debt

Emerging market bonds are supported by falling inflation at the headline level and interest rates are likely to be cut by emerging market central banks as global economic growth continues to slow. Structurally, emerging market debt is also supported in the long term by strong government finances, low levels of public sector debt and healthy economic growth rates.

However, in the short term, the stress in western financial systems has translated into some fairly significant volatility in the emerging bond markets. Emerging markets have not decoupled in any meaningful sense, and therefore investors should remain cautious over emerging market debt, at least until credit conditions in the developed world stabilise and global risk appetite improves.

Strategic bond investing – seeking out the value in global bond markets

In the current environment it is perhaps more important than ever that bond investors are able to invest flexibly and strategically across global bond markets. Strategic bond funds can take a global view in search of the most attractive markets and securities, irrespective of any benchmark, adapting their fixed income allocations and duration exposures for the prevailing economic and market environment.

This ability to adapt to changing conditions can prove vital for returns. Investors only have to look back at the volatility of the last 12 months to see the potential pitfalls of being stuck in a single-country or single-sector bond fund. Instead, investors need to be able to change their allocations and portfolio positioning in order to try and limit losses and seek out the most attractive valuations. With global bond market returns likely to continue to surprise in 2012 and beyond, such a flexible approach could help investors to navigate these complex markets.

Nicholas J. Gartside, *managing director*, is the International Chief Investment Officer, within J.P. Morgan Asset Management's Global Fixed Income and Currency Group. He is responsible for leading and overseeing the activities of our international fixed income teams, as well as being the co-manager of our multi-sector fixed income products and serves on the Currency Investment Policy Committee. Prior to this, Nick was at Schroder Investment Management for eight years, most recently serving as the Head of Global Fixed Income. Nick earned a B.A. in History and Politics from Durham University and an M.Phil. in International Relations from Cambridge University. Nick is a CFA charterholder and holds the Investment Management Certificate from the UK Society of Investment Professionals.

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