

MARKET INSIGHTS

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Global fixed income – the seven-year workout



Bob Michele

Managing Director
Global CIO – Global Fixed
Income and Currency Group

Introduction

It's going to take at least seven years to work off enough consumer and government debt to close the output gap that opened in the recent recession and get the economy growing consistently at trend again, in our view. In the meantime, we believe the Federal Reserve and other major central banks will keep a lid on interest rates until economic growth is stimulated sufficiently to reduce private sector debt to a more manageable level. In this paper, we make the case that the resulting stable rate environment should bring comfort to bond investors in 2011. This is not the year to worry about your bond portfolio—unless you're looking for better than 8% returns. In that case, we argue, high yield and emerging market debt could provide opportunities.

The end of sovereign rule

Credit markets posted a second straight year of solid returns in 2010, notwithstanding occasional outbreaks of volatility. The year started out strong, but a period of weakness beginning in May put a significant strain on liquidity for most of the remainder of the year. Credit and equity markets managed to rally in the final two months, but developments in Europe underscored the added risk sovereigns have taken on by effectively moving the problem loans of their banking sectors onto their balance sheets. The failure of concerted intervention by the European Union, the European Central Bank and the International Monetary Fund to resolve the debt crisis in Greece and stop the contagion in its tracks illustrates the magnitude of the challenge. It remains to be seen whether European sovereigns and banks can manage another year of peripheral stress with an unproven temporary liquidity facility.

In any event, investors can no longer assume that any but the most solvent sovereigns will be able to roll over their obligations going forward. Even so, and despite a general erosion of confidence in sovereign debt, countries that are focused on reducing fiscal deficits should reward investors. Much of that opportunity is likely to come from the emerging markets, where we are finding very strong borrowers in the corporate as well as the government bond space.

Bond positive

With developed-world consumers fully extended and governments bringing so much private debt onto their books, the financial crisis has eroded credit's ability to fulfil its traditional role as economic stimulant after a downturn. In this environment, it will be tough to count on anything but a modest uptick in economic activity. Our economists' forecast for 2011 anticipates only a gradual acceleration in US growth and hiring, sustained low core inflation and a Federal Reserve that continues on the course of lower interest rates for longer. Politically, the recent tax compromise brightens recovery prospects somewhat for 2011, with our forecast of 3.1% GDP growth topping a projected 2.8% gain in 2010.

A muted recovery with inflationary pressures largely at bay should extend the credit market's bull run well into 2011. Our forecast doesn't anticipate central bank tightening this year. We expect US government bonds to remain between 2.25% and 3.50% in the ten-year sector, a positive backdrop for bonds that implies other interest rates will likely increase only marginally.

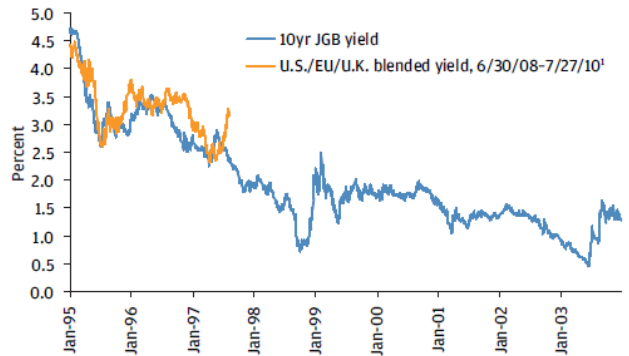
Of all the fixed income sectors, corporate bonds remain our favourite, thanks to strong fundamentals and the potential for further spread compression. Default rates among corporate borrowers are at multi-year lows as companies focus on maintaining strong balance sheets. There is no evidence they are doing the things that normally erode balance sheet strength, such as buying back shares, raising dividends or making acquisitions.

Steady Eddies

In an alternate scenario of a double-dip recession, rates could go a lot lower and bond prices rise, which is why we continue to view Treasuries as the ultimate safe haven against this still-possible scenario. In Japan, ten-year government bond yields fell to 0.40% in the wake of quantitative easing, a zero short-term interest-rate policy and bank bailouts (**Exhibit 1**). While that is not likely to be the case in the US, it does show that low interest rates can, in fact, go lower still.

Touching bottom? Interest rates have tumbled, but as Japan's 1990s experience shows, they could fall further

Exhibit 1 – G3 rates (July 2008 – 2010) versus Japan ten-year (1995 – 2003)



¹ Blended at J.P. Morgan World Government Bond Index weights. Source: Bloomberg, December 2010

Mortgages also remain attractive as a source of stable returns. We expect a modest tightening relative to interest rate swaps and US Treasuries in 2011, but also recognise that mortgages will face considerable headwinds not only from falling home prices but also from rising supply, namely about USD 195 billion of agency fixed-rate MBS. Liquidated agency and non-agency loans should also find their way back into the market, backing new securities, and runoff from the Fed portfolio could exceed the magnitude of organic supply.

The Fed will be especially careful how it manages its mortgage holdings as any abrupt reduction could be interpreted as a shift toward tighter monetary policy. More likely, it will allow mortgage prepayments to reduce its holdings, which will create limited impact in the market. With money managers likely to serve as the primary source of demand in 2011, it may prove difficult for mortgages to tighten to fundamentally rich levels.

Still, current coupons for mortgages are about 4%, not bad for an asset with an effective government guarantee. People who have the economic ability to refinance—they have equity in their home and can get into a rate that makes more sense for them—simply can't do so because the banks won't lend. And due to home price depreciation in a wide swath of major markets, many others are servicing mortgages with loan-to-value ratios of 100% and higher, creating a huge drag on refinancing activity. With prepayments likely to remain stable as a result, mortgage debt is attractive. As long as homeowners who are not able to refinance for whatever reason continue to make their monthly payments, as is happening now, prepayments will be largely unchanged, creating an odd stability in agency mortgage debt.

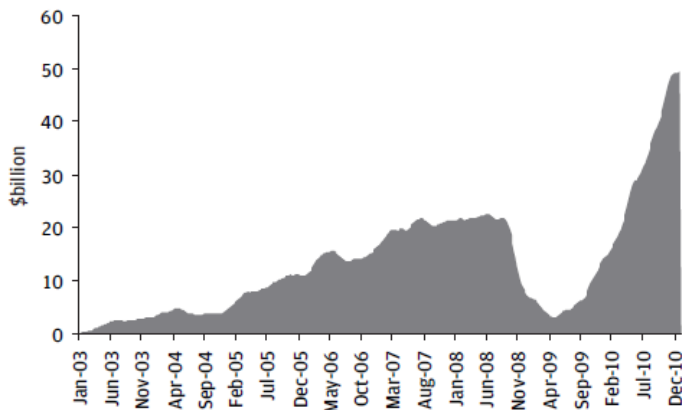
Although many institutional investors are still targeting 8% returns, it will be difficult to reach that mark without taking some additional credit risk. For the coming year, emerging market (EM) and high yield debt appear poised to fill that role. Even in peripheral Europe, where we are likely to see sovereign debt restructuring in the coming years, there should be many corporate issuers with strong franchises or global reach fully able to service their debt.

High return candidates

Inflows into EM fixed income were a dominant story in 2010 and will remain a key driver in 2011. We forecast 2011 EM fixed income inflows in the range of USD 70 billion to USD 75 billion (**Exhibit 2**). With so much money pouring into Latin America and Asia, the credit quality of local borrowers may be expected to improve. We expect the EM corporate default rate, for instance, to fall to 0.8% this year.

EM appetite unsated: Record emerging market capital inflows are not expected to abate in 2011

Exhibit 2 – Emerging market debt inflows



Source: ICI Investment Company Institute, J.P. Morgan Asset Management.

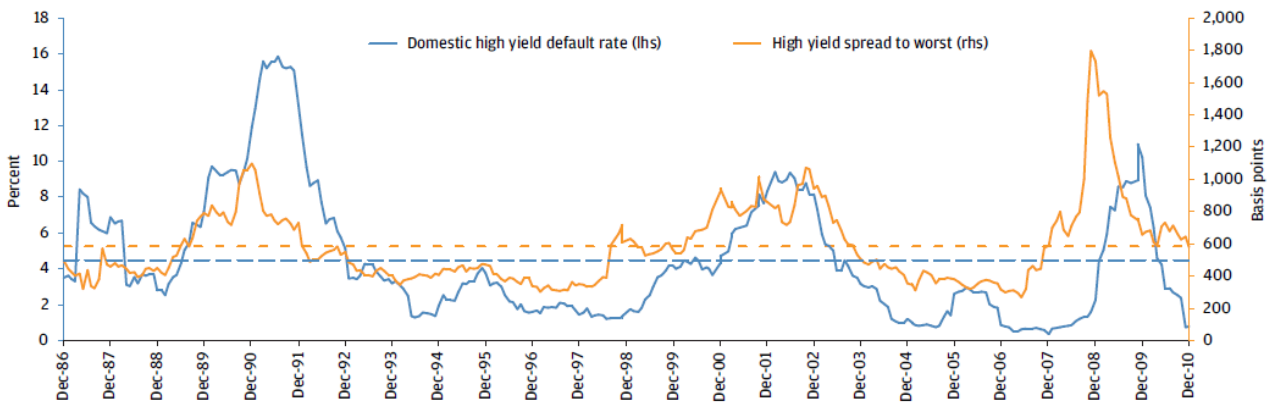


On top of positive EM corporate fundamentals, EM currencies should continue to revalue in 2011. Despite the inflows – or maybe because of them – a number of investors still think of emerging economies as prone to boom-and-bust cycles. Yet many emerging economies have fully emerged. They have working political and economic infrastructures and an established middle class that is earning and spending and increasing domestic consumption. Asia has built very strong financial systems with central banks and monetary authorities that manage their country's finances and their reserves quite well. Commodity-rich Latin America is benefiting from soaring commodity prices. And the EMs as a whole will gain from rapid urbanisation. The debt markets still haven't fully reflected these developments, in our view.

High yield is another sector we like for 2011, thanks to improving credit quality. High yield default rates remain very low – below 1% – and we can expect to see credit spreads narrow even further, probably by another 200 basis points at least (**Exhibit 3**). Credit spread narrowing could work out to about 10% in price appreciation relative to US Treasuries. Adding in yields of 6% to 8% on the bonds that we're buying, and assuming US Treasury yields do not change appreciably, a 17% total return for high yield in 2011 is possible, an inviting return indeed in a world of zero short-term rates.

Room for improvement: High yield spreads have only fallen to long-term average, even though the default rate hovers near an all-time low

Exhibit 3 – High yield spread default rate



Source: J.P. Morgan.

Solid returns for shaky times

With lukewarm global economic growth expected to persist in the foreseeable future, the risks for inflation lie very much to the downside. The private sector's deleveraging has made government pump priming necessary to keep economies from slipping back into recession. But even governments have to retrench at some point, and the prospect of tax increases and spending cuts after conditions improve should act as a brake on growth. Fiscal policies have helped stabilise developed markets, but they are not going to be the drivers going forward. That will fall to emerging markets, which should deliver just enough demand to sustain a tentative recovery in the US and Europe. All in all, the environment favours fixed income assets. Deleveraging, by definition, means that borrowers are focused on paying back what they owe, and that's what we all want.



Bob Michele, *managing director*, is the Global Chief Investment Officer within J.P. Morgan Asset Management's Global Fixed Income and Currency Group. In this role, he is responsible for overseeing the activities of our fixed income and currency investment teams based in the United States (New York), Europe and Asia. Prior to joining the firm in 2008, Bob was at Schroder Investment Management for ten years, most recently serving as the global head of fixed income. He also previously served as the head of Schroder's US Fixed Income Group, based in New York. Bob was at BlackRock from 1995 to 1998, responsible for managing core bond portfolios and developing credit strategies across all client mandates. Prior to that, Bob spent five years at FirstBoston Asset Management as head of their domestic fixed income desk. Before that, he was at Brown Brothers Harriman for eight years managing taxable, total return portfolios for non-US institutions. Bob began his career at Bankers Trust, working as an investment analyst and portfolio manager. He holds a BA in classics from the University of Pennsylvania, is a CFA charterholder and has the Investment Management Certificate of the UK Society of Investment Professionals.

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