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The case for constructive credit

The JPMorgan Global Strategic Bond Fund leverages its strong research base to provide investors access to the asset manager's best ideas in global fixed income.

In his fourth quarter update to investors, J.P. Morgan Asset Management chief investment officer and head of the global fixed income, currency and commodities group (GFICC), Robert Michele[01] wrote about a sea of macroeconomic divergences investors are grappling with.

Economic growth, interest rates, trade, monetary policy and politics are several forces that are challenging the way investors allocate capital, he says.

But what's different this time around, Michele adds, is that investors will have to forge ahead without the backstop of the central banks.

"Quantitative easing (QE) is evolving into quantitative tightening (QT), so that sea of cash that indiscriminately supported all asset prices will not be there to cover up 'mistakes' going forward," he says.

"This doesn't mean that there won't be opportunity. It just means that investors will have to once again roll up their sleeves, do the detailed research and uncover the treasures from the trash."

Outside of the tariffs scuffle between the US and China, the good news is the global economy is in very good shape.

Almost all regions across the globe are growing above trend and central banks are reluctant to normalise policy at a meaningful pace.

Michele raises the probability of sub-trend growth from 20% to 25% to acknowledge the potential impact of broad tariffs.

He appreciates the People's Bank of China easing and a weaker currency could offset most of the initial impact of tariffs. But it might be too much for the Chinese economy to absorb tariffs on the entire – about US$500 billion of exports or tariff rates rising from 10% to 25%.

Pointing to a potential worst-case scenario, Michele says Chinese gross domestic product could potentially fall to 4.5%. There would also be a broader knock-on effect to the rest of the emerging markets.

Pleasingly for investors, Michele notes the probability of a recession at 0%.

"Fiscal stimulus in the US, a well-capitalised global banking system, strong US consumer balance sheets and central banks that are overly cautious in restoring normality to the system are on the growing laundry list of reasons not to expect a recession any time soon," he explains.

However, there has been a lot of noise about the flattening US yield curve – which historically has been a reasonable indicator of a pending recession.

On this note, Michele comments that the monetary distortions present in this current cycle were a meaningful difference accentuating the curve flattening.

"We'll see how the next couple quarters play out for the curve as QE gives way to QT and the tax reform incentive for US plans to contribute to their pension funds ends," he adds.

This is not to say that a potential trade war, QT, rising interest rates and geopolitics should not be so quickly dismissed, Michele points out.

"It's too early to worry that the next crisis is in the offing, but all these issues bear keeping a watchful eye on," Michele says.

Access to the best ideas

So where are the best investment opportunities? Michele and the GFICC team continue to carry credit.

They believe that zero/negative real yields of developed market government bonds are a reflection of the ongoing distortions created by global central banks.

And as for their preferred investments over the next three to six month?

High yield, short-duration securitised credit and emerging market debt, Michele says.

"We like U.S. and European high yield, as well as leveraged loans. Companies continue to enjoy top line growth, cost discipline and accelerating earnings."

This is the first time since the global financial crisis that the market felt normal.

Meanwhile, short duration, yield and credit enhancement are an "irresistible combination," while US consumers are enjoying their strongest balance sheets in over 40 years.

Emerging markets is the one sector that's gone through a painful correction, Michele says.

He adds that the market seems to have fully priced in potential trade wars and a strong US dollar. "It's time to scale in," he says.

The JPMorgan Global Strategic Bond Fund is an investment vehicle open to Australian investors and one which can access all these credit positions and the asset manager's best ideas in fixed income.

The high-conviction, unconstrained bond fund aims to deliver returns of 3% over cash over a market cycle, with a focus on mitigating downside risk.

It also targets volatility of 1.5-5% over that cycle. The fund's investment flexibility is underpinned by the group's top-down and bottom-up approach.

The quote

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Three dedicated unconstrained portfolio managers are able to tap into the best ideas generated by a team of more than 250 investment professionals globally.

The portfolio managers focus on making these top-down decisions. This includes factures such as sector allocation, duration management and currency exposure – while sector specialists perform the bottom-up security selection.

Allowing portfolio managers and analysts to specialise in particular sectors of the fixed income market means they are better able to identify and exploit the opportunities that offer the best return potential, JPMAM says.

Dedicated risk management

Although the investment team doesn't have a stringent benchmark, their best ideas are based on extensive market and risk analysis.

Portfolio manager Iain Stealey says the GFICC group has developed its own proprietary risk analysis tools specific to the JPMorgan Global Strategic Bond Fund.

These risk tools help understand how several elements (think sectors and factors) of the fund interact with one another.

For example, the volatility tool not only identifies sources of volatility in fixed income but plays out several scenarios including the impact on diversification and if market correlations increased.

The correlation and beta tool then gets to work, measuring the portfolio against market and economic indicators such as US Treasuries, equity markets, oil, gold and the US dollar.

It allows the fund to invest in "desired sensitivities" at any point in time, Stealey says.

Finally a duration tool looks at "adjusted empirical duration," using historical data to calculate the yield beta of every security to both the 10-year US Treasury and 10-year German Bund, using these as proxies for interest rates. It helps to more accurately understand how the portfolio will react to changes in interest rates, JPMAM says.

It's not an exact science but the asset manager's Fixed Income Risk Management (FIRM) team runs the proprietary tools over different time periods and frequencies to better understand what happens in the market cycle.

The asset manager's view is this global presence and expertise across all sectors of fixed income affords them an important "informational advantage." FS

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