MARKET INSIGHT SERIES

Themes in bond investing
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Bob Michele, the Global Chief Investment Officer for fixed income and currency at J.P. Morgan Asset Management, answers questions about the global economic climate, the recent spike in yields and the opportunities he is currently finding in bond markets.

Q. Although backward-looking economic data remains very bleak, forward-looking data seems to be pointing to a bottoming in the downturn. How do you see the outlook for the global economy?

Bob Michele: I believe we're in an L-shaped recovery, which will ultimately become a U. The freefall in the global economy, which lasted through most of the first quarter, seems to have come to an end and we're now seeing a period of stabilisation, albeit at much lower levels of activity than we're used to.

Q. Many people are worried that loose monetary policy may ultimately lead to high inflation. However, data is currently pointing to the opposite scenario. What is your view of the inflationary outlook?

Bob Michele: I think the inflation picture is going to be moderate in the near term. Inflation is currently at extremely low levels; indeed, in the eurozone, the May annual inflation reading came out at 0% – the lowest level since 1953. From here, I anticipate several quarters of deflation as the commodity price spike of 2008 fades from year-on-year data. Over the next 18 to 24 months, we're likely to see inflation of around zero. I believe that if central banks and governments want to reflate, they can, by printing money faster, so we will ultimately see reflation. However, I don't think it's a near-term concern.

Q. Bond yields have spiked 50 to 60 basis points higher than they were when the Federal Reserve and the Bank of England announced quantitative easing. How do you see them moving from here?

Bob Michele: I think the current situation reflects the age-old adage of "buy the rumour and sell the news." Markets anticipated that central banks would have to execute quantitative easing because of the amount of debt that governments were issuing and also the desire to push borrowing rates lower. In the US and UK in particular, markets seem to have anticipated quantitative easing quite well, and priced it in. Yields have risen as these expectations have been met. However, I believe this is only temporary.

We've reached a point at which the spike in yields is a cause of concern for governments, because it will inhibit growth and also because it defeats the purpose of quantitative easing, which is to bring all borrowing rates lower. Therefore, from now until the end of the year, I would expect ten-year government bond yields to drift lower as deflation becomes more widespread, economic activity remains muted and central banks continue to buy the ten-year part of the curve to push borrowing rates down and allow the system to refinance itself at a much more affordable level.

Q. We've seen huge demand for corporate bonds over the past few months. Is it the right time to look for yield in the corporate bond market, or still too early, or perhaps even too late?

Bob Michele: I think it's the right time to seek out value in the corporate bond markets. We've seen the most significant revaluation in the history of corporate bonds over the past 18 months: they've never gone from a more expensive level to a cheaper level when measured against risk-free securities. As a result, there is currently a lot of value in the market.

However, it's important to note that there's a lot of value because there's a lot of risk. Many bad loans were made in the easy credit conditions of the past few years and we therefore expect defaults to rise, particularly among the 'covenant light' issues that many investors appear to have forgotten about.

Therefore, the way to extract value from this market is through patient and disciplined analysis. In our own funds, our credit analysts are performing rigorous research on every potential investment with the aim of avoiding potential ratings downgrades or defaults. We are only interested in bonds at valuation levels we think are attractive for our portfolios. On a medium term (18 month) view I think this strategy should pay off handsomely.

Q. What are the key opportunities for investors in the current market?

Bob Michele: The number one opportunity at the moment has to be credit. Across the market, from investment grade to high yield and distressed securities, there is value to be found for those with the ability to look for it.

Secondly, investors should not be afraid of duration. The back up in yields is providing a good opportunity for us to add duration to our portfolios and enjoy some price appreciation as quantitative easing plus low growth and low inflation push yields lower.

Finally, mortgages are beginning to offer selected value once again. Agency mortgage-backed securities have done quite well already, but parts of the residential mortgage-backed security market, particularly those originated for prime borrowers, are now offering value.

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 New York and London fixed income investment teams. 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.