Global Fixed Income Views

Themes and implications from the Global Fixed Income, Currency & Commodities *Investment Quarterly*

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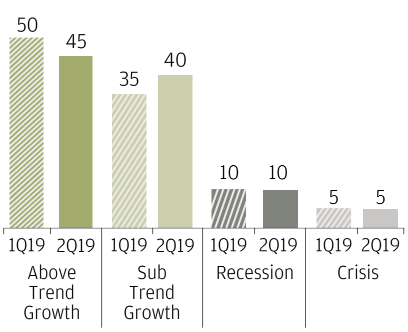
IN BRIEF

- We lowered slightly our base-case scenario, Above Trend Growth, from a 50% probability to 45% and slightly raised the probability of Sub Trend Growth from 35% to 40%. A soft landing, with growth roughly at trend, appears likely for the global economy.
- U.S.-China trade negotiations still top our list of concerns; if the trade battle escalates, the impact on business spending and consumer sentiment will be globally significant.
- We don't see recession in 2019 or early 2020—we believe the Federal Reserve (Fed) unambiguously ending three years of tightening, and other central banks' dovish tilts, have extended the cycle. We left the probability of Recession unchanged at 10%, although even a minor policy error could raise that.
- We are encouraged to fully embrace the bond market again and want to be buyers of every backup in yields or widening in credit spreads. Among our top picks: external and local emerging market (EM) debt and currency, BBB corporates, high yield credit and loans, and short-term securitized credit.

MARCH MADNESS

Anyone in the U.S., or passing through this time of year, knows all too well about the collegiate basketball spectacle known as March Madness.[1] This year, the Federal Reserve one-upped the ballers by unleashing its own version of March Madness the day before the official start of the tournament. The Fed's unambiguously ending three years of monetary policy tightening not only left policy rates where they are but also included a surprisingly detailed plan for concluding the balance sheet runoff. It confirmed the dovish tilt of the last several months and validated the dovish posture adopted by a growing number of other central banks, which toppled like dominoes once the Fed made that first move. What more could a fixed income investor ask for? But now the hard work begins. Does one chase the bond market here, with its flat yield curves and narrower credit spreads? Or does one try to wait for a consolidation and hope to get in ahead of the loads of cash sitting on the sidelines—before investors get over the sticker shock and cash starts piling in again? Such was the backdrop for our March 21 *Investment Quarterly* (IQ), held in New York.

SCENARIO PROBABILITIES (%)



Source: J.P. Morgan Asset Management.
Views are as of March 21, 2019.

MACRO BACKDROP

The problem with a global growth slowdown is the unknown of whether it ends in a soft landing or recession. With the central banks signaling their unwillingness to risk a monetary policy-led recession, the odds of a soft landing have clearly increased and the late-cycle recovery should extend. Although the data has softened, the U.S. economy is far from recession. The consumer, two-thirds of the U.S. economy, is in fantastic shape—enjoying a strong balance sheet, full employment and wage growth.

[1] National Collegiate Athletic Association Division I college basketball national championship.

Any de-escalation of trade tensions between the U.S. and China will only increase business confidence and spending. And what's not to like about China? A combination of fiscal and monetary stimulus seems to have stabilized the economy and helped to counter the drag resulting from trade pressures. We expect China's growth to be supported at around 6.3%–6.4% in 2019, as opposed to the 5.9% we feared three months ago. Last, despite concerns on Brexit, Italian deficits and trade, the eurozone looks reasonably stable. The combination of the European Central Bank on hold for the foreseeable future and fiscal austerity giving way to fiscal stimulus in France and Italy should be supportive of the broader economy. While we are certainly not expecting the array of global policy stimulus to lead to a GDP surge reminiscent of 2017 and 2018, we also cannot see the onset of recession. The central banks can comfortably sit with rates and balance sheets where they are—under cover of inflation that remains stubbornly below their targets.

Scenario expectations

We reduced the probability of our base-case scenario of **Above Trend Growth** to 45% from 50%. We consequently raised the probability of **Sub Trend Growth** to 40% from 35%. It does appear as though the global economy will glide toward a soft landing with growth roughly at trend, perhaps a little bit above or below. The outcome of the U.S.-China trade negotiations and Brexit will surely be important in determining which side of trend growth we will see.

We kept the probability of **Recession** unchanged at 10%. We do believe that the central banks have extended the cycle, and we don't see recession as a 2019 or early 2020 event. The Fed's preference for looking at average inflation through a cycle suggests that it is trying to protect against prematurely tightening, or over-tightening, monetary policy. But we are late cycle, and a policy error, however minor, might be enough to bring forward that probability.

Finally, we kept the probability of **Crisis** at 5%. Geopolitics are a constant concern but, for now, cooler heads and rational thinking seem to be prevailing.

Risks

U.S.-China trade negotiations remain at the top of our list of concerns. If the trade battle escalates, the impact on business spending and consumer sentiment will be globally significant, with the potential to lead to a dangerous stagflationary spiral.

A hard Brexit would also be a challenge for the eurozone and global economy to absorb. Perhaps it is already being somewhat mitigated, as many companies are already executing on their new location strategies.

Further out, we have the U.S. 2020 general election. As 2019 progresses, we are likely to hear from a growing chorus of campaigners with less market-friendly views … think an array of higher taxes and greater regulation.

STRATEGY IMPLICATIONS

A soft landing, dovish central banks and the promise of compromise between the U.S. and China and the UK and the eurozone encourage us to fully embrace the bond market again. We want to be buyers of every backup in yields or widening in credit spreads. There is potentially a significant pool of money sitting in cash equivalents looking to enter this market, with investors who once believed that they would get a much better entry point.

Here are a few of our top picks:

Emerging market debt. External, local market and EM FX all look appealing. They have lagged the other markets and stand to benefit the most from a complacent Fed and a U.S.-China trade resolution.

BBB rated corporates. In our view, the market became heavily oversold as concerns over leverage and recession built. With some deleveraging underway and a stable economic backdrop, the growing overseas demand for investment grade credit should find its way into this market.

High yield credit and loans. Everyone wants to buy it cheaper, but it never seems to get there. Expected low default rates and recession risks beyond the horizon should continue to generate inflows into this market.

Short-term securitized credit. Keep riding the winner. Strong consumer balance sheets should continue to be a tailwind for this market.

CLOSING THOUGHTS

The market expected the Fed to keep raising rates well into 2019 and even into 2020. That, combined with the balance sheet run-off and hawkish rhetoric from many other central banks, suggested that yields would be moving higher and credit spreads would be widening. Money poured into liquidity, short duration and absolute return bond funds as investors prudently waited out the expected carnage. The abrupt pivot by the Fed and other central banks caught the market flat-footed. While money already in bonds has covered shorts, the cash sitting on the sidelines has yet to enter in earnest. At some point, there should be a grudging acceptance of the new reality: It's time to embrace your bond portfolio manager again. Welcome to March Madness.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 2Q19

Every quarter, lead portfolio managers and sector specialists from across J.P. Morgan's Global Fixed Income, Currency & Commodities platform gather to formulate our consensus view on the near-term course (next three to six months) of the fixed income markets. In daylong discussions, we review the macroeconomic environment and sector-by-sector analyses based on three key research inputs: fundamentals, quantitative valuations and supply and demand technicals (FQTs). The table below summarizes our outlook over a range of potential scenarios, our assessment of the likelihood of each and their broad macro, financial and market implications.

	EXPANSION		CONTRACTION	
	ABOVE TREND Global GDP growth >3.5% Inflation >2%	**SUB TREND** Global GDP growth 2%-3.5% Inflation 0%-2%	**RECESSION** Global GDP growth <2% Inflation <0%	**CRISIS** A disorderly movement in markets causes systemic impact and tail risk
Probability	45%	40%	10%	5%
Change from last quarter	-5 percentage points	+5 percentage points	Unchanged	Unchanged
Drivers	• Despite signs of slowing, global growth remains at or near trend across developed and emerging markets • U.S. is growing above trend—albeit with a lower trajectory—while Europe, Japan and China continue growing at or just below trend • China growth expected to reaccelerate amid fiscal stimulus, which should drive EM growth higher	• Fiscal stimulus in the U.S. wanes; lagged impact of Fed tightening hits • Chinese stimulus supports local but not global production • Profit margin compression continues as companies can't pass on rising wage costs • Capex falls as companies focus on balance sheet repair	• Central banks tighten policy aggressively	• Geopolitical risks rise sharply
Monetary environment	• More accommodative central banks • Fed pauses hiking but retains optionality; expectations lowered to one hike in 2019 • Fed will tolerate higher levels of inflation, only acting if inflation expectations move sharply • Political events in the UK (Brexit) and Italy (debt, budget) remain volatile but relatively localized; Europe has moved from fiscal austerity to fiscal stimulus • EM economies start to see benefits of stimulus coming through in the economy			
Market and positioning	• Emerging markets should be supported by stability in China and globally accommodative central banks; EM local currency bonds and currencies look attractive • BBB corporate credit spreads have lagged and look attractive given Fed pause and overseas buying • Securitized credit should benefit from stable housing market and strong U.S. consumer	• Own higher quality duration in spread assets • Loans not a systematic risk; position up in quality for attractive risk-adjusted carry	• Own developed market (ex-Japan) government bonds	• Own developed market (ex-Japan) government bonds

Source: J.P. Morgan Asset Management. Views are as of March 21, 2019.

Opinions, estimates, forecasts, projections and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

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NEXT STEPS

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Investments in bonds and other debt securities will change in value based on changes in interest rates. If rates rise, the value of these investments generally drops. Securities with greater interest rate sensitivity and longer maturities tend to produce higher yields, but are subject to greater fluctuations in value. Usually, the changes in the value of fixed income securities will not affect cash income generated, but may affect the value of your investment. Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Such default could result in losses to an investment in your portfolio.

*FX: foreign exchange; MBS: mortgage-backed securities; IG: investment grade; DM: developed market.

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