**IN BRIEF**

- We have doubled our probability of Recession from 20% to 40%, reducing Above Trend Growth from 25% to 10% and Sub Trend Growth from 45% to 40%. We now see Recession and Sub Trend Growth as equally likely.
- The threat of increasing trade tensions and tariffs is playing out, and governments appear unwilling or unable to provide fiscal stimulus, leaving the central banks to keep a potential recession at bay. Investors should not be surprised by how low rates can go or how creative monetary policy can be.
- Our strategy bias is to become more defensive, and we have turned cautious on credit.
- Among our best ideas: U.S. government bonds with 10- and 30-year maturities, short- and intermediate-maturity investment grade corporate bonds and selected areas within securitized markets.

**NO BUSKING**

The market doesn’t need to beg for further monetary accommodation—it’s going to get it. Once again, it’s the central banks that must try to hold off a potential recession. With the U.S. and China embroiled in a trade war that is dragging down global manufacturing, and little hope of rescue by fiscal stimulus, all eyes are on the central banks and their willingness to offset the global downturn by returning to the aggressive policy tools seen early in the post-financial crisis world. Certainly, the rally across all markets since our last Investment Quarterly (IQ), on June 12, suggests that investors are confident that the central banks will be successful. We’re not so sure. Such were the crosscurrents during our September 11 IQ, held in London—the home of yet another controversy (Brexit)!

**MACRO BACKDROP**

For sure, the trade war has created a downturn in global trade and manufacturing. The weakness in PMIs is compelling, as is the anecdotal evidence from corporate managements. With little expectation that the U.S. and China will find a compromise that would roll back the tariffs, we focused on when, and if, the services sector and the consumer would be impacted. Globally, unemployment is very low, wages have been ticking up, and consumer confidence is high. If central banks cut rates aggressively and expand balance sheets once more, we anticipate the consumer balance sheet will further improve. Already, mortgage refinancing in the U.S. and the surge in asset prices have been generating a wealth effect across savers, but we worry that the growing impact of tariffs may cause companies to cut their labor forces to shed expenses.

While monetary policy will act to cushion the downside, we are not so convinced that it can avert recession on its own. This late into an expansion, the central bankers need the politicians to help with some form of fiscal stimulus. But where is the ability and courage to embark on a fiscal spend? A split U.S.
Congress means that President Trump is powerless. Japan is facing a consumption tax hike that will become a headwind for growth. And most of Europe is facing enormous levels of debt-to-GDP ... except for Germany. Over the last 10 years, debt-to-GDP in Germany has fallen from ~80% to ~60%. Germany can certainly spend up to 3% of GDP, but self-imposed deficit rules limit it to only ~0.5% at the federal level. Pity. At a time when the bond markets are inviting governments to expand deficits, they cannot.

So where do we think monetary policy will go? Is there a limit to the measures the central banks will employ? And what is the purpose if the efficacy is difficult to measure? We believe that the central banks will have little choice but to respond and to tempt governments into fiscal expansion with easy money. We can see the Federal Reserve getting to 0% and growing its balance sheet by USD 1 trillion per annum, if needed. The European Central Bank (ECB) could go to -1% and expand its balance sheet by EUR 1.5 trillion before it runs out of government bonds to buy ... and then what? Presumably, it must buy other assets and extend the duration of easing. And the Bank of Japan will likely leave rates at -0.10% and manage its balance sheet growth within its current targets. The unspoken intent (?) of such aggressive monetary easing is that it will create competitive currency devaluation. But from a global perspective that may have a zero-sum net impact.

Should the central banks do anything at all? Our simple response is, “Why not?” Surging inflation is not their problem; an approaching global recession is. Why keep any powder dry and take the risk?

SCENARIO EXPECTATIONS

Our base-case scenario is now evenly split between Sub Trend Growth and Recession, at 40% each (previously 45% and 20%, respectively). Since 2018, we have highlighted increasing trade tensions and tariffs as the biggest threat to the global economy. Now that it’s happening, we can’t ignore it. We hope the policy response by the central banks will be sufficient to engineer a soft landing, but we’re not entirely convinced.

We put the tail probabilities of Above Trend Growth and Crisis at 10% each (previously 25% and 10%, respectively). An immediate resolution to the U.S.-China trade conflict, including the rollback of tariffs, looks unlikely. Even if it occurs, we expect companies will remain cautious about increasing spending until after the 2020 election. Crisis seems difficult to envision with the central banks so willing to cushion downside risk.

RISKS

We believe the biggest risk is that the central banks are slow to respond. They may believe that monetary policy is accommodative enough and that it’s time for the politicians to contribute with fiscal policy. We would view that as a major policy error. Of course, another risk is that the trade war expands as the U.S. broadens tariffs to include Europe.

And, lastly, Brexit looms as a risk for all broad markets, not just the UK, if Boris Johnson wins the election on the horizon.

STRATEGY IMPLICATIONS

Similar to last quarter, our bias is to become more defensive. We like high quality duration in the current market climate. Either the global economy tips into recession, causing the central banks to respond with dramatic policy, or recession is averted because they have already cut rates and expanded balance sheets. The U.S. government bond market stands out to us as a high yielding market, especially 10- and 30-year maturities.

Other forms of high quality duration include short- and intermediate-maturity investment grade (IG) corporate bonds and parts of the securitized markets.

Overall, we have turned cautious on credit and worry about the prospect of rising default rates in the high yield market, the viability of additional tier-1 (AT1) bank bonds in a negative yield environment and the lack of defensive sectors in the U.S. corporate bond market.

CLOSING THOUGHTS

We’re not supposed to be here. The world was supposed to reflate, and central banks were meant to normalize monetary policy. In fact, the September meeting was meant to see the ECB’s first rate hike since 2008. It has all gone the other way. We can fret about how distorted the bond markets are, but what’s the point? The markets are no more distorted now than they were in the early 1980s, when the central banks were combating oil shocks. Every central bank must deal with the issues in front of it as it sees fit. We believe they are doing so today. All investors need to accept this and be open-minded about how low interest rates can eventually go and how creative monetary policy can become.

With stocks near their highs and credit spreads near their tights, we believe that risks are asymmetric, even as probabilities are symmetric. Therefore, the team’s best ideas generally favor moving up in quality.
SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 4Q19

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.

<table>
<thead>
<tr>
<th>Probabilities and Investment Implications</th>
<th>EXPANSION</th>
<th>CONTRACTION</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SUB TREND</strong> Global GDP growth 2%-3.5%</td>
<td><strong>ABOVE TREND</strong> Global GDP growth &gt;3.5%</td>
<td><strong>RECESSION</strong> Global GDP growth &lt;2%</td>
</tr>
<tr>
<td>Inflation 0%-2%</td>
<td>Inflation &gt;2%</td>
<td>Inflation &lt;0%</td>
</tr>
<tr>
<td>Probability</td>
<td>40%</td>
<td>10%</td>
</tr>
<tr>
<td>Change from last quarter</td>
<td>-5 percentage points</td>
<td>-15 percentage points</td>
</tr>
<tr>
<td><strong>Drivers</strong></td>
<td>• A number of late-cycle indicators are flashing orange and red</td>
<td>• De-escalation of trade tensions</td>
</tr>
<tr>
<td></td>
<td>• The downturn in global trade and manufacturing shows little sign of abating</td>
<td>• Global dose of monetary and fiscal stimulus recharges the market</td>
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<td>• Weakening business confidence is starting to feed into the labor market</td>
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<td></td>
<td>• Continued escalation of a prolonged trade war with China is the most likely path</td>
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<tr>
<td></td>
<td>• Expect China growth to slow to 5.7% in 2020 from 6.1% in 2019</td>
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<td></td>
<td>• Corporate credit leverage has been increasing since the last quarter</td>
<td></td>
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<tr>
<td><strong>Monetary environment</strong></td>
<td>• Expect Fed to cut rates at next 3 meetings and ECB to announce QE</td>
<td>• Global economic growth outlook improves and recession probabilities recede</td>
</tr>
<tr>
<td></td>
<td>• Central banks are not ahead of the curve—not done enough to bolster inflation</td>
<td>• Revival of “animal spirits”</td>
</tr>
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<td></td>
<td>• Efficacy of further rate cuts called into question</td>
<td></td>
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<td></td>
<td>• In Europe, negative rates are not a temporary phenomenon</td>
<td></td>
</tr>
<tr>
<td><strong>Market and positioning</strong></td>
<td>• Short-duration securitized credit; stay up in the capital structure</td>
<td>• Short-duration securitized credit provides yield and lower duration</td>
</tr>
<tr>
<td></td>
<td>• High quality corporate IG credit (short to intermediate maturities); defensive sectors</td>
<td>• Emerging market debt provides attractive carry; favor external credit and local duration</td>
</tr>
<tr>
<td></td>
<td>• Own government duration—(i.e., long government bonds, 10- or 30-year UST), agency commercial mortgage-backed securities (CMBS)</td>
<td>• U.S. and European high yield</td>
</tr>
</tbody>
</table>

Source: J.P. Morgan Asset Management. Views are as of September 11, 2019.

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