Global Fixed Income Views

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

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AUTHOR

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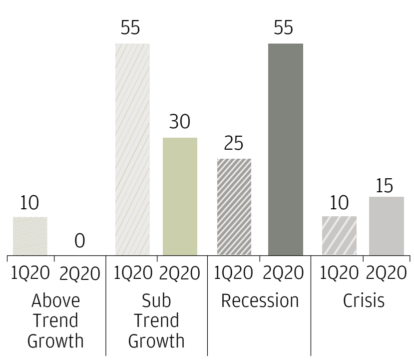
IN BRIEF

- A supply shock as China shut down in response to COVID-19, a demand shock as quarantining began in Europe and oil prices' collapse—all amid market and official policy volatility—have led us to raise the probability of Recession to 55% from 25%; it is our base case.
- A coordinated and powerful global policy response is quickly and desperately needed on health care, and on monetary and fiscal policy fronts. This includes cutting official rates to structural lower bounds, rate tiering, more large-scale asset purchases and getting cash to small and medium-sized enterprises to create broader spend.
- We raised the probability of Crisis to 15% and lowered the probability of Sub Trend Growth to 30%, as there is some hope of avoiding recession if we get a substantial step-up in policy response from Europe and the U.S.
- We do not believe that the leverage in the system that existed in 2008 is present today, and the probability of financial crisis remains very low. However, Dodd-Frank regulations make the dealer community unable to provide meaningful liquidity in times of stress.
- In our portfolios, we are de-risking and adding very high quality duration; we anticipate default rates rising and credit markets further cheapening. Reserve currencies should all do well. Emerging market debt is alluring, but we need to see the risk unwind further.

SHOCK, SHOCK, SHOCK, SHOCK

It was all going so well headed into the fourth quarter of 2018. The Federal Reserve (Fed) was gradually normalizing monetary policy, and global economies were doing well. Then Shock I hit: a trade war between the U.S. and China. When it looked like the resulting global manufacturing recession would spill over into the services economy, a Phase One trade deal was agreed to. It seemed like recovery was on the horizon. Suddenly, Shock II: a supply shock out of China as it shut down in response to COVID-19. Then came Shock III: a demand shock across Europe as COVID-19 led to quarantining millions of people in Italy. Quickly following this, Shock IV: Oil prices collapsed as OPEC+ fell apart. Such was the backdrop for the March 11 *Investment Quarterly (IQ),* held for the first time as a virtual meeting. Investors video-conferenced in from New York (the *IQ's* official host), Columbus, London, Indianapolis and an assortment of personal residences.

SCENARIO PROBABILITIES (%)



Source: J.P. Morgan Asset Management.
Views are as of March 11, 2020.

MACRO BACKDROP

As the COVID-19 experience evolves, it is becoming clear that the most effective health care response is social distancing and quarantining. While these policies are necessary for public health, they are bad for the economy. They result in an instantaneous shutting down of economic activity and a dramatic increase in the probability of recession. As that mindset ripples through markets, they are reacting violently. It should not be lost on everyone that a fair percentage of people in the investment community were not in the markets when the last recession hit almost 12 years ago, and dealer desks are strained as people increasingly work from home. These add another degree of tension and anxiety to what is unfolding.

What is desperately needed is a coordinated global policy response on three fronts:

1. The health care policy response needs to build confidence that these measures are both comprehensive and effective at limiting infection and mortality rates. There needs to be progress on a vaccine so that fears of a "second wave" are diminished.
2. The monetary policy response needs to be powerful and quick. Cutting official rates to structural lower bounds, rate tiering, more large-scale asset purchases (increasing in size and expanding to new asset classes) and targeted long-term repo operations are all tools that need to be fully deployed. Surely, the plunges in energy prices and inflation indicators give the central banks little reason to be concerned about stoking longer-term inflation expectations.
3. Fiscal policy needs to be focused on where the greatest damage is occurring—to businesses of all sizes but especially small and medium-sized enterprises (SMEs). As demand shocks cascade globally, SMEs are expected to run out of operating cash in one to two months. It will only be a matter of time before they are forced to lay off employees.

China, the first to come through the COVID-19 cycle (we hope), shows us that a compelling series of policy responses can be effective. Now we need to see Europe and the U.S. respond more fully. The European Central Bank (ECB) and the Federal Reserve can no longer carry the global economy on their own. They need the politicians to come together and pass legislation that gets cash to small businesses and creates a broader spend for the economy to bounce back once we get through COVID-19.

SCENARIO EXPECTATIONS

We raised the probability of **Recession** to **55%** from 25%. The February jobs report of a 273,000 increase in nonfarm payrolls was small solace to us and our formerly low probability of recession. Everything has changed, led by quarantining and social distancing. Economies are shutting down, and the demand shock is real. Combine that with a collapse in oil prices and suddenly the energy industry looks precarious. With insufficient monetary and fiscal policy arising, recession has become our base case.

The probability of **Crisis** was raised to **15%** from 10%. Given the scale of the dislocations that are occurring, this may appear decorative. However, we acknowledged that the Phase One trade deal occurred after our last *IQ* and likely would have changed the probability to 5% ... so this is effectively a 10% increase from our average view last quarter. Crisis is all about disorderly markets and policy errors. Enough said.

We lowered the probability of **Sub Trend Growth** to **30%** from 55%. There is some hope of avoiding recession if we get a substantial step-up in policy response. In addition to cutting rates to zero, the Federal Reserve needs to expand large-scale asset purchases and support corporate bonds. (Note: This was partially delivered since the *IQ*.) This crisis will be focused on corporate balance sheets, and the Fed needs to help backstop the market. Under exigent circumstances, the Fed will either need to buy corporate bonds outright or provide attractive financing against corporate bond portfolios. The ECB needs to cut rates, raise the multiple on rate tiering and increase the size of quantitative easing (QE) to further support the European government bond market. Further, ECB President Christine Lagarde needs to immediately backtrack on her comment that the central bank is "not here to close spreads" between peripheral countries' government bonds and those of Europe's larger economies. The remark created an irresponsible and unnecessary tightening in financial conditions (Note: The ECB has provided some clarification since the *IQ*.) On the fiscal side, both Brussels and Washington need to avail themselves of ultra-low funding rates, put politics aside and pass countercyclical spending measures. A world devoid of aggregate final demand will need help to recover.

We dropped the probability of **Above Trend Growth** to **0%** from 10%. The damage has been done to the economy and markets, so we shouldn't spend a lot of time fantasizing.

RISKS

The biggest risk is that the economic and market crisis becomes a financial crisis. A negative feedback loop from Main Street to Wall Street to Main Street must be avoided. We do not believe that the leverage in the system that existed in 2008 is present today, and the probability of financial crisis remains very low.

STRATEGY IMPLICATIONS

We are focused on de-risking and adding very high quality duration to our portfolios. As the U.S. enters recession, default rates will go up and the credit markets will have to further cheapen. This is especially true of lower rated corporate credit and less so in the securitized market. Reserve currencies such as the Swiss franc, Japanese yen, U.S. dollar and euro should all do well. While emerging market debt is alluring at these new yield levels, we need to see the risk unwind go further before we step in.

CLOSING THOUGHTS

It's been 12 years since the last recession, and market participants need to hold their nerve. Opportunities will be created, but patience may be better rewarded. The length and depth of the recession have yet to be determined, and the damage created by the market dislocation is not fully in evidence. Our experience with recessions teaches us that there will be time to pick through the markets and their cheaper valuation. In the meantime, we will look to preserve capital.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 2Q20

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	0%	30%	55%	15%
Change from last quarter	-10 percentage points (ppt)	-25 ppt	+30 ppt	+5 ppt
Drivers	• Rate of new infections falls rapidly, allowing policymakers to lift social distancing measures and restore economic activity	• Quarantine measures and warmer weather successfully slow the spread of new COVID-19 cases • Rebound in global growth over the summer – Chinese businesses resume normal operations by April – U.S. and Europe follow shortly thereafter • Supply cuts stemming from Saudi-Russian agreement, together with renewed global demand, push oil prices above $45/bbl	• Shutdowns, quarantines, travel restrictions hinder economic activity and growth – Shocks to demand and supply sides – Global GDP slows in Q1 and Q2 before rebounding over Q3 and Q4 2020 • Small and medium-sized enterprises (SMEs) run out of operating cash in 1–2 months • Part-time and low wage workers struggle to replace lost income	• Acceleration of spread of COVID-19 and fears of second wave of infections • Oil prices fall below $30/bbl on prolonged standoff among OPEC+
Monetary environment	• Governments announce overwhelming stimulus plans	• Central banks act aggressively to ease – Fed cuts rates to zero, supports corporate bond market – ECB cuts rates further, raises multiple on bank tiering • Targeted fiscal policy lends support to businesses and consumers in need • Market volatility subsides	• Global central banks exhaust remaining capacity to lower policy rates, focus on balance sheet expansion • Tight financial conditions and elevated corporate leverage lead to waves of downgrades and restructurings	• Inadequate fiscal and monetary responses fail to restore investor confidence – Central banks pass the baton – Politicians cannot come together to pass effective legislation • Stresses in credit and liquidity markets cause funding pressures and disorderly market behavior
Market and positioning	• U.S. and European high yield • Higher yielding external EM debt	• A and BBB rated corporate credit • High quality securitized credit • Higher yielding external EM debt provides attractive carry; local EM duration takes advantage of policy easing	• Own very high quality duration: DM government bonds and agency mortgages • Short, amortizing, high quality consumer ABS • Favor reserve currencies – JPY, CHF, EUR, USD	• Own DM government bonds • Favor reserve currencies – JPY, CHF, EUR, USD

Source: J.P. Morgan Asset Management. Views are as of March 11, 2020.

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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