

Global Fixed Income Views

Themes and implications from the Global Fixed Income, Currency & Commodities *Investment Quarterly*
1Q 2021

AUTHOR



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IN BRIEF

- Above Trend Growth remains our base case as more countries gain control of the coronavirus and vaccine distribution begins (even if GDP in major economies may contract in Q1); we reduced the probabilities of Sub Trend Growth, Recession and Crisis, noting that potential vaccine problems and an early end to policy support are risks.
- We expect yields to grind slowly higher and central banks not to let bond yields rise too far, which would raise the cost of the recovery; by Q2, we expect 10-year U.S. Treasury yields at around 1.00%-1.25%.
- Inflation is a key risk, as global reopenings could create a demand surge, though we think this would be a short-term bounce amid longer-term disinflationary forces. We hope central banks will leave rates and balance sheets alone until 2025.
- Emerging market debt tops our list, especially local currency government bonds; we also favor investment grade credit bank securities, high yield credit and, while mindful of the challenges in real estate, single-A rated commercial mortgage-backed securities.

THE REOPENING

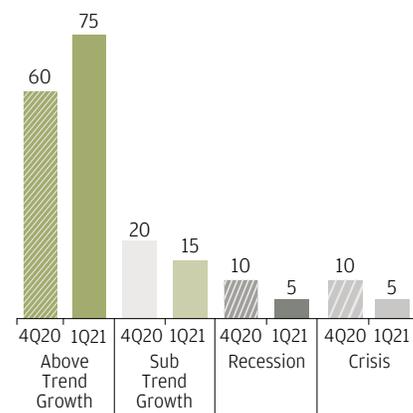
For the fourth consecutive meeting, our *Investment Quarterly (IQ)* on December 9 was held virtually. Similar to the last *IQ*, we spent a considerable amount of time gauging the impact of an economic reopening on inflation and central bank policy. But this time, the optimism was high about a broad reopening and return to something approximating what we remembered as normal. Since the last *IQ*, in September, uncertainty over the U.S. elections has passed, more of the world has returned to normal by controlling the coronavirus, and one highly effective vaccine is being distributed while additional ones are in the pipeline. Although a few harsh, dark winter months are ahead for Northern Hemisphere countries, there is light at the end of the tunnel.

Our challenge was to gauge the tempo of the reopening and its impact on growth and inflationary pressures. And then, to try to estimate how monetary and fiscal policies would evolve and, ultimately, the impact on the markets. However, since the markets have continued to perform well, there were very few pockets of obvious value. After much drilling down into regions and markets, we came up with a series of good investment ideas.

MACRO BACKDROP

As we head into year-end, we are forced to balance the near-term impact of rising infection rates and rolling regional shutdowns against the longer-term optimism about a vaccine-led reopening. It is very possible that the U.S. and Europe will post negative real GDP in the first quarter of 2021 and then significant above-trend growth during the rest of 2021. Our Corporate & Investment Bank forecasts U.S. GDP down 1% in Q1 and up 3.3% for all of 2021.

SCENARIO PROBABILITIES (%)



Source: J.P. Morgan Asset Management. Views are as of December 9, 2020.

To some extent, China serves as a road map for recovery. Its austere health care response has led to only a trace amount of infection in China. China's industrial production, fixed asset investment and exports are all above pre-COVID-19 levels, while retail sales are only very slightly below. Surprising to us, China's service sector is back to around pre-pandemic levels, and domestic airline flights are back to full capacity. These statistics demonstrate that economies are biased to return to where they were pre-pandemic. That's not to say there won't be some economic scarring in labor markets in the service sectors of the hardest-hit countries, but a fully distributed vaccine should lead to a recovery in those economies that some observers, in our view, may be underestimating. Bridging the gap from today until mid-2021 with adequate monetary and fiscal support will be critical to ensuring a speedier recovery.

Is it possible that a simultaneous global reopening could create a demand surge and push prices up, as the supply shock will take time to resolve? The surge in copper and iron ore prices that has coincided with the recovery in China is an ominous inflationary signal. Longer term in the U.S., the output gap¹ and substantial debt burden² should act as powerful disinflationary forces. But how will the central banks interpret an inflation spike in 2021? Can the Federal Reserve sit there and sanguinely argue that the inflationary pressures are transitory if GDP starts running well above its 1.5% trend and a number of inflation measures approach 3%? Will bond investors accept continued negative real yields, or will we see a return of the bond vigilantes? It is our hope that the central banks will remain patient and leave rates and balance sheets alone until 2025 ... but we believe the first significant challenge for them is only a couple quarters away.

SCENARIO EXPECTATIONS

Above Trend Growth remains our base case and has increased in probability by 15 percentage points (ppt), to a **75%** likelihood. Ongoing monetary and fiscal support, effective vaccines and lessons learned from China all point to a robust global economy in 2021.

Sub Trend Growth was reduced by 5ppt, to a **15%** probability. There is some chance that economies will struggle to reopen or that it may take longer than expected to distribute the vaccines. But the odds of economies operating below trend are small.

Recession and **Crisis** were each reduced by 5ppt, to **5%**. While improbable, they are not zero-probability scenarios. Near-term risks could include problems with the vaccines or a policy error leading to the premature withdrawal of monetary and fiscal support.

RISKS

The biggest risk to our expectations has to be a problem with the efficacy or distribution efficiency of the vaccines. That would extend the harsh winter and perhaps trigger a double-dip recession. In the event of such a delayed reopening, it would be essential for monetary and fiscal policies to remain highly accommodative. Ongoing fiscal support is something that can no longer be taken for granted.

STRATEGY IMPLICATIONS

Given our base-case expectation, the group unanimously held a risk-on view. We were worried about a sharper rise in government bond yields that could go beyond our base case of a slow grind higher.

It's unlikely that the central banks will let bond yields rise too far, raising the cost of the recovery, as they have all the tools to "fix" yields whenever they like. We expect the 10-year U.S. Treasury to be around 1.00%-1.25% by sometime in the spring or later in the second quarter of 2021.

Emerging market debt was at the top of our list of ideas, especially local market government bonds. High real yields, accommodative central banks and a global reopening should benefit both the bonds and currencies. Further, a Biden administration is likely to dial down the rhetoric with emerging market trade partners. This should encourage more crossover buyer flows into those markets after years of absence.

Bank hybrid securities (AT1s)³ were also toward the top of our list. Their yield spread tightening has lagged other sectors of the investment grade (IG) bond market, although banks seem to have come through this crisis in very good shape. The bonds also benefit from continued demand as European Central Bank actions push European investors toward the highest yielding parts of their market. High yield corporates also garnered some support, as history tells us that spread tightening after crises runs for years, not months.

Finally, the group believed there was value in sorting through the securitized markets. Despite the known challenges with commercial real estate, single-A rated commercial mortgage-backed securities (CMBS) offer a way to invest in the reopening story, with a fair amount of return potential for a moderate amount of risk through credit enhancement.

¹ We estimate the U.S. output gap doesn't close until the middle of the decade.

² USD 7.7 trillion in global debt expansion since December 2019 based on Bloomberg Barclays data.

³ Additional Tier 1 bonds are a special category of bonds issued by financial institutions. They are perpetual/callable and are designed to absorb losses if capital dips below a certain threshold, in which case they can convert to equities or be written down fully.

CLOSING THOUGHTS

We are mindful that we want to be in the consensus as it is building. Only after a consensus has fully formed will these trades be crowded. As reopening is on the horizon and the recovery should accelerate,

we believe that the consensus and cash will continue to coalesce around the reflation trades that have lagged the last few months. There are enough markets and ideas for us to tilt our portfolios toward higher returns and get off to a good start in 2021.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 1Q21

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.

	75%	15%	5%	5%
	+15ppt	-5ppt	-5ppt	-5ppt
	<ul style="list-style-type: none"> Economic activity should continue to grow globally, reducing the global output gap and lowering unemployment as a vaccine-led reopening is on the horizon China’s experience serves as a road map for a robust global economy in 2021 	<ul style="list-style-type: none"> Awaiting vaccine distribution, shelter in place could continue Moderating global growth rebound as resumption of business activity lags amid rising COVID-19 cases Inflation expectations remain low with elevated slack in economy 	<ul style="list-style-type: none"> Challenges with vaccine efficacy or distribution lead to further shutdowns, spike in cases 	<ul style="list-style-type: none"> Challenges with vaccine efficacy or distribution leads to further shutdowns and spike in cases
	<ul style="list-style-type: none"> Policy actions serve as a backstop for risk assets: <ul style="list-style-type: none"> Additional fiscal assistance continues to support businesses, consumers Central banks continue with asset purchases, keeping interest rates low Despite potential for short-term bounce in inflation, structural headwinds create a disinflationary environment in the longer term 	<ul style="list-style-type: none"> Global central banks remain accommodative, keep rates unchanged near lower bound Fiscal policy response is muted and reactive Corporations continue balance sheet repair and defense 	<ul style="list-style-type: none"> Economic activity remains depressed: <ul style="list-style-type: none"> New wave of infections creates economic drag, leading to double-dip recession Consumption falls on higher unemployment and uncertainty Businesses continue to be challenged at lower levels of activity Central banks, having cut rates to lower bound, pass baton to fiscal Fiscal policy response fails to create expansion 	<ul style="list-style-type: none"> Fiscal and monetary responses fail to restore investor confidence Small and medium-sized enterprises run out of cash, and unemployment rates increase sharply Elevated corporate leverage leads to mass downgrades, restructurings Stresses in credit and liquidity markets cause funding pressures and disorderly markets
	<ul style="list-style-type: none"> Corporate credit: investment grade bank hybrid securities (AT1s) and high yield Emerging market local currency debt (rates + FX unhedged) Single-A rated CMBS 	<ul style="list-style-type: none"> IG corporate credit Emerging market hard currency debt Securitized credit 	<ul style="list-style-type: none"> Developed market government bonds Agency mortgages Short, amortizing, high quality securitized credit 	<ul style="list-style-type: none"> 30-year Treasuries Favor reserve currencies - JPY and USD

Source: J.P. Morgan Asset Management. Views are as of December 9, 2020.

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