Global Fixed Income Views

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

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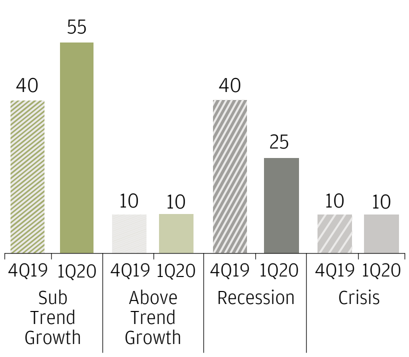
SCENARIO PROBABILITIES (%)



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

IN BRIEF

- After a thaw in the trade war and a year of three Federal Reserve rate cuts, along with easing by dozens of other central banks, we have lowered the probability of **Recession** to 25%.
- Lower interest rates freed up U.S. consumers to spend and save, while emerging market rate cuts limited trade war-induced damage; Europe and Japan, however, still struggle.
- **Sub Trend Growth** is our likeliest scenario (55% probability) as global growth bottoms, including in the emerging economies—but we can't see the next impulses that would ratchet growth higher.
- Among our top picks: Emerging market debt, focused on local currency; higher rated short-duration securitized credit, including non-agency CMBS; select investment grade credit and U.S. Treasuries, with yields expected to trade around current levels.

20/19 HINDSIGHT

In retrospect, it was all so clear. The Federal Reserve's (Fed's) pivot at the start of 2019 told us the central banks recognized they had little choice but to reverse their tightening policies of 2015-18 in an effort to offset the impact of the escalating trade war and tariffs. And that's exactly what they did. Throughout 2019, as tariffs were increased and trade tensions escalated, the Fed cut rates three times and soothed the markets. And it wasn't just the Fed. Globally, 40 other central banks cut rates a combined total of 63 times, for a cumulative 3,000-plus basis points (bps) in easing. They literally flooded the global markets and economy with liquidity. And then, like a holiday miracle, the U.S. and China sought to ease trade tensions by working toward a phase one deal. Suddenly, as we head into 2020, the combination of overwhelming central bank easing and the de-escalation in trade tensions has provided a powerful backdrop to the markets. For the participants at our December 11 *Investment Quarterly (IQ)* in New York, the big question was whether these factors were enough to turn the global economy upward, with the markets to follow.

MACRO BACKDROP

There was significant criticism at the start of the year that the central banks had very little firepower left to offset any slowdown. That proved to be a serious underestimation. In the U.S. alone, the 75bps in interest rate cuts led to a surge in home mortgage refinancing that freed up income for consumers to spend on housing and durable goods. Further, the reduced cost of debt servicing strengthened consumer balance sheets.

But perhaps the biggest economic surprise was in emerging market (EM) economies. As China struggled to manage its tariffs-induced economic slowdown, the other emerging economies were expected to get caught in its downdraft. This was true to some extent, but the tremendous amount of rate cutting (over 2,800bps in the emerging markets) and some fiscal stimulus out of China, Asia and Europe helped to limit the downside. This can be seen in the greater resilience of EM manufacturing purchasing managers' indices (PMIs) vs. those in the developed market (DM) economies.

Before we get too optimistic on the current state of play, though, let's not forget that Europe is still struggling and Japanese growth has been dragged down by the consumption tax hike. While it's nearly impossible to identify a European country with the ability and appetite for a fiscal spend, any fiscal package in Japan will result in only a small boost to growth.

Meanwhile, the central banks are tripping over one another to tell us that they are on hold and drawing a line under the amount of accommodation and number of unconventional tools they are willing to deploy. Both the Fed and the European Central Bank have made it clear that the politicians must step in and help. Will it be a trade compromise? Concerted borrowing and fiscal stimulus? Or some form of lasting structural reform?

SCENARIO EXPECTATIONS

The probability of **Recession** had to come down from 40% to 25% in acknowledgment of the quantity of global central bank ease and the bias for the U.S. and China to try to maintain some middle ground. We did not reduce it further because, one, those in the central banking community are telling us they are reluctant to ease further—they prefer help on the fiscal side or through structural reform—and, two, the devil will be in the details of any trade compromise.

We consequently increased the probability of **Sub Trend Growth** from 40% to 55%. We have to appreciate that after a two-year downdraft the global economy is bottoming. This is particularly true in the emerging economies, where the BRITs (I couldn't resist: not the UK after Brexit, but Brazil, Russia, India and Turkey) are contributing the most to the EM growth pickup.

The tail probabilities of **Above Trend Growth** and **Crisis** remain just that at 10% each. Significant global fiscal stimulus seems as unlikely as the central banks withdrawing all their monetary accommodation.

RISKS

The biggest risk remains on the trade front. If China and the U.S. cannot agree to a status quo with modest de-escalation, and/or the U.S. looks at putting tariffs on Europe or Latin America, the global economy would invariably shift downward.

As we roll into 2020, the U.S. general election will take center stage, with the campaigning and rhetoric commencing in earnest. An early look suggests that it will be difficult to find a moderate who can win.

STRATEGY IMPLICATIONS

What a difference a quarter makes—or, more to the point, my goodness, how the combination of dramatic central bank ease combined with positive trade rhetoric can alter one's views. Our bias has shifted from defensive to more focused risk seeking.

Emerging market debt surfaced as our top choice. We favor segments of the market that lagged the rally in corporate bonds; for example, emerging market currencies look convincingly left behind. Local emerging market debt (Russia, Mexico, Peru and Indonesia) and currencies were our top pick. Not far behind were the securitized markets (structured credit and commercial mortgage-backed securities [CMBS]), and then investment grade (IG) corporate bonds and taxable municipals, as foreign investors look for incremental quality yield over U.S. Treasury debt. This is not to say we were particularly bearish on interest rates. Rather, we believe that with the central banks on hold, rates will remain anchored around current levels (U.S. 10-year: 1.5%-2.0%).

CLOSING THOUGHTS

After the last *IQ,* we positioned portfolios up in quality given prevailing risks and valuations. While risks have diminished, valuations are priced for more than our 55% probability of "Goldilocks." We will add some risk on the margin in the sectors noted but are aware that it is late cycle and valuations are higher ... and that the central bank "put" may not be as powerful if there is another downturn.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 1Q20

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	
	SUB TREND Global GDP growth 2%–3.5% Inflation 0%–2%	**ABOVE TREND** Global GDP growth >3.5% Inflation >2%	**RECESSION** Global GDP growth <2% Inflation <0%	**CRISIS** A disorderly movement in markets causes systemic impact and tail risk
Probability	55%	10%	25%	10%
Change from last quarter	+15 percentage points	Unchanged	-15 percentage points	Unchanged
Drivers	• Global growth bottoming after thaw in the trade war and a year of monetary easing – Exports rising from low levels, feeding through to manufacturing PMIs – Recovering business confidence keeps employment growth stable at high levels – Diminished prospects of a disorderly Brexit ease euro-area growth concerns • Leverage for IG and HY corporates has deteriorated, impacted by slowing EBITDA growth	• Significant de-escalation of trade tensions, with a major rollback of tariffs • Wage growth continues to drive consumer and business confidence, prompting further demand growth	• Trade war escalates beyond tariffs to impact sectors such as tech and cyclicals • Financial conditions tighten materially • Consumer and corporate confidence erode; employment indicators deteriorate significantly • China growth falls below 5%; oil prices fall below $50/bbl for sustained period	• Geopolitical risks rise sharply
Monetary environment	• DM rate cuts on hold; more EM rate cuts likely – Fed considers its current stance appropriate to support sustained expansion – Muted inflation pressures, falling unemployment, strong wage growth give central banks options in event of trade-related growth downdraft • Interest rates remain anchored • Little meaningful fiscal easing • Higher-yielding external EM debt provides attractive carry; local EM duration takes advantge of policy easing	• Global economic growth outlook improves as recession probabilities recede further • Ongoing global monetary and further fiscal stimulus through infrastructure/green projects	• Global central bank policy rate easing ineffective as policy rates approach the zero bound	• Central banks stop providing accommodation, including actively shrinking balance sheets • Restrictive fiscal policy to rein in debt levels
Market and positioning	• Higher-yielding external EM debt provides attractive carry; local EM duration takes advantge of policy easing • Short-duration securitized credit and higher rated nonagency CMBS tranches • Intermediate BBB, B corporate credit, select 30-year IG corporates • U.S. Treasury duration at higher rates in range-bound environment	• Favor local EM duration, select EM currencies against DM and commodity currencies • U.S., HY; higher yielding EM countries and corporates.	• Own high quality duration • Own DM government bonds • Long-duration agency mortgages	• Own DM government bonds • JPY and USD

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