PORTFOLIO INSIGHTS

# 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

- Our fears about a trade war have become reality; **Sub Trend Growth** is now our base-case scenario, with a 45% probability.
- We have raised the probability of **Recession** to 20% from 10%, as the fatal erosion of consumer and corporate confidence has begun, and give **Crisis** a 10% probability, recognizing how rapidly things might unravel in an all-out trade war.
- We expect the Federal Reserve (Fed) to begin cutting rates in July and China's central bank to respond with its own tools to try to stabilize the global economy. Our base case is a 10-year U.S. Treasury yield of 1.75%–2.25%.
- Among our top picks: high quality duration such as three- to five-year corporates, long government bonds, AAA asset-backed securities and certain mortgage-backed securities, and research-driven yield (including short securitized credit and emerging market debt).

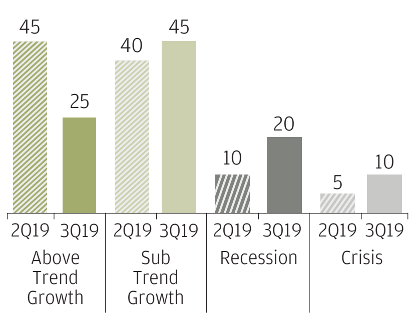
## TRADE MAY-HEM

It was all going so well. The Fed had decided early in the year to end three years of tightening and take pressure off the markets. Other major central banks validated this by tilting dovishly. The markets rejoiced by drifting higher: Yields went lower, credit spreads narrowed, and other asset classes drafted off the stability in the bond market and central banking. Throughout all of this (and for the last 18 months), our primary concerns were the trade negotiations between the U.S. and China and then between the U.S. and the rest of the world. Quite simply, we feared tariff escalation would reduce trade, which would lead to less GDP and, ultimately, bring forward the probability of recession. In May, our fears became reality and forced us to make a call on what is effectively a binary outcome: trade compromise and the extension of a recovery or trade war and a step closer to recession. Such was the backdrop for our June 12 *Investment Quarterly (IQ),* held in Columbus, Ohio.

## MACRO BACKDROP

The optimists in the room could find plenty of economic positives to focus on. Globally, labor markets were tight, wages were going up, the consumer looked strong, and the U.S., Europe and Japan were all growing just above trend. But we also saw economic data beginning to roll over. Escalating trade tensions had begun to hit consumer and corporate confidence, which should continue to erode. We believed that it was only a matter of time before a retrenchment in corporate spending would hit the labor market and lead to higher unemployment. The time when many anticipated a bounce in the second half of 2019 now looked a distant memory.

SCENARIO PROBABILITIES (%)




Source: J.P. Morgan Asset Management.
Views are as of June 12, 2019.

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Our discussion on trade centered on three themes:

1. We expect a prolonged trade disruption, mainly because of the **strategic nature** of the U.S.-China rivalry. Where previously the view held that both sides were incented to compromise, it now appears that both sides believe it may be in their own self-interest to escalate.

2. As trade and manufacturing weaken, we felt there would be an **acceleration in the slowdown** across the broader economy—enough to push global growth below trend. The recent negotiations with Mexico were highlighted. It has become incredibly hard for companies to know where to spend on capex if they don't know the outcome of any trade agreements and if there's a chance those agreements may simply get revised or ignored. Most importantly, the group felt that the damage had been done. Regardless of the outcome on trade, credibility and confidence have been meaningfully eroded.

3. The one bright spot was the Fed's acknowledgment that it was monitoring the trade front and was ready to respond. A meaningful, coordinated central bank response would certainly cushion a trade-induced slowdown. But could the Fed ever do enough, from these levels, to avert a recession?

The group also spent time talking through the absence of inflation. Other than in wages, it was difficult to find any. Certainly, inflation has been too low for too long and is now undercutting central bank credibility. The usual reasons were given: the impact of technological disruption, the secular move toward globalization and trends in labor participation. Without question, the trade battles and tariffs look set to challenge the globalization of the last few decades and could potentially roll it back.

In short, the group was not optimistic that a trade compromise would be reached at the June 28–29 G20 summit and saw the trade battle escalating. Expectations were that U.S. GDP would slow down to below trend and China's GDP would settle in the 5.8%–6.2% range. Much of this is predicated on the expectation that the Fed will begin cutting rates in July and the People's Bank of China (PBoC) will respond with an array of its own tools. It appears the central banks have already crossed the divide, from focusing on ways to normalize policy over the last few years to accepting that it is again time to try to stabilize the global economy and create higher inflation expectations. We think the 10-year U.S. Treasury yield will settle in a range of 1.75%-2.25% as our base case.

## SCENARIO EXPECTATIONS

After several years of **Above Trend Growth** as our base-case scenario, we chopped it from a 45% to a 25% probability.

Everything we feared about the prospect of a trade war has slowly become reality over the last 18 months. **Sub Trend Growth** has now become our base-case scenario at a 45% probability, up from 40%. There is some confidence that the tailwind of a coordinated central bank response will somewhat offset the headwind of a trade war.

Worryingly, the biggest increase in probability went to **Recession** at 20%, up from 10%. We are seeing too broad-based a slowdown—and the fatal erosion of consumer and corporate confidence has begun. Spoiler alert: If there is no trade compromise before our next quarterly, Recession probability will go up. We raised the probability of **Crisis,** from 5% to 10%. The use of tariffs not just to normalize a structural trade disadvantage but to achieve policies and agreements is worrisome. A 10% probability is a warning shot for us all to recognize how rapidly things might unravel in an all-out trade war.

## RISKS

The primary risk is that U.S. trade and tariffs are broadened to include other regions and countries, possibly Europe.

Another risk is that the central banks are slow to respond with easing. They may consider that they are better off waiting to see how things play out in geopolitics and then responding more aggressively (50 basis point cuts?). In central banking, like in investing, being late is being wrong.

## STRATEGY IMPLICATIONS

While we see some storm clouds gathering, the combination of Above Trend and Sub Trend Growth totals 70%. We need to be careful not to get so conservative about a 30% probability of Recession/Crisis that we miss opportunities. Still, the definite bias was to add high quality duration on any backup in yields. Here are a few of our top picks:

*High quality duration*: three- to five-year corporates; long government bond duration; 10-year Spanish bonds; AAA asset-backed securities; moderate prepay-protected agency mortgage-backed securities (MBS); agency commercial MBS (CMBS).

*Research-driven yield*: short securitized credit; local emerging market (EM) debt (currency hedged); external EM debt.

## CLOSING THOUGHTS

It may be true that expansions don't die of old age, but they sure are vulnerable to policy shifts. The binary outcome of the trade conflict is almost impossible for markets to accurately price. We believe it's time to be less complacent, get closer to neutral and tilt portfolios more conservatively. Let's see how things play out over the summer and let the central banks get in there and do our bidding to cushion the economy and the markets.

## SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 3Q19

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**<br>Global GDP growth<br>>3.5%<br>Inflation<br>>2% | **SUB TREND**<br>Global GDP growth<br>2%–3.5%<br>Inflation<br>0%–2% | **RECESSION**<br>Global GDP growth<br><2%<br>Inflation<br><0% | **CRISIS**<br>A disorderly movement in markets causes systemic impact and tail risk |
| **Probability** | 25% | 45% | 20% | 10% |
| **Change from last quarter** | -20 percentage points | +5 percentage points | +10 percentage points | +5 percentage points |
| **Drivers** | • De-escalation of trade tensions<br>• Global dose of monetary and fiscal stimulus recharges the market | • Odds of prolonged trade war with China move from tail risk to base case<br>- Acknowledgment this is a strategic conflict<br>- Both sides feel little incentive at present to compromise<br>• Global growth forecasts have been trending down; trade escalations should continue this trend<br>- Manufacturing weakness becomes more broad-based<br>- Uncertainty tempers animal spirits | • Trade escalates beyond tariffs; financial conditions tighten materially<br>• Confidence channels fade<br>• Business and consumer spending drop off<br>• Central banks ease too late or moves are ineffective | • Geopolitical risks rise sharply<br>• Unexpected turn on trade policy |
| **Monetary environment** | • Global economic growth outlook improves<br>• Recession probabilities recede<br>• Animal spirits revive | • Global central banks look to provide accommodation as an offset<br>- Fed has more levers to pull; expectation is two to three cuts in 2019<br>- Central banks have consistently undershot on inflation, impacting credibility<br>- Efficacy of further rate cuts called into question<br>• Political events in UK (Brexit) and Italy (debt, budget) remain contained locally | | |
| **Market and positioning** | • Short-duration securitized credit provides yield and lower duration<br>• Emerging market debt provides attractive carry; favor external credit, local duration<br>• U.S. high yield | • Stable fundamentals, positive flows, a healthy U.S. consumer offer support; migrate up in quality<br>- Short-duration securitized credit—stay up in the capital structure<br>- High quality corporate credit—less cyclical sectors<br>• Own government duration (agency CMBS, long government bonds) | • Own developed market (DM) government bonds<br>• Short credit default swaps | • Own DM government bonds<br>• Short credit default swaps<br>• Own DM government bonds |

Source: J.P. Morgan Asset Management. Views are as of June 12, 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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*FX: foreign exchange; MBS: mortgage-backed securities; IG: investment grade; DM: developed market.



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