

# Global Fixed Income Views

Themes and implications from the Global Fixed Income, Currency & Commodities *Investment Quarterly*  
3Q 2021

AUTHOR

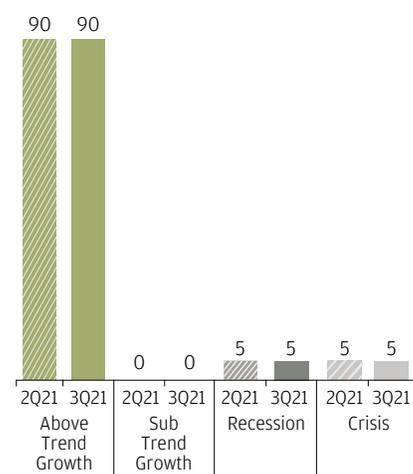


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**IN BRIEF**

- Above Trend Growth remains our base case at 90%, with central banks committed to over-accommodation and letting economies run hot. We left the probabilities of Recession and Crisis scenarios at 5%. We see only a very, very small risk that inflationary pressures build up enough to provoke an aggressive monetary response that could spur a global recession, or that virus variants trigger further lockdowns.
- The inflation story has become a complex and tangled web of considerations; in sum, as the structural factors supporting secular stagnation are challenged, we think the era of structurally low inflation *may* have passed.
- With the Federal Reserve (Fed) unwilling to change policy before year-end, the forward curve suggests a 10-year U.S. Treasury yield range of 1.5% to 2.0%. While negative real yields will be frustrating as growth and inflation spread, that is the hand the central banks are dealing.
- U.S. and European high yield, bank loans and bank capital notes are our best ideas. We also like lower-rated municipal bonds, securitized credit, and—if equity flows return to emerging markets—emerging market currencies. Treasuries and agency mortgage-backed securities were our least favorite ideas.

SCENARIO PROBABILITIES (%)



Source: J.P. Morgan Asset Management.  
Views are as of June 9, 2021.

TOO EASY

As we met for our June *Investment Quarterly (IQ)*, we were somewhat taken aback by how easy the last quarter had been. While our risk-on bias was rewarded, the truth is that pretty much everything in the bond market and across asset classes inflated in price over the last three months, including Treasuries, which drifted a little bit lower in yield. The powerful combination of ongoing fiscal stimulus and monetary accommodation was enhanced by a far more aggressive vaccine rollout than we expected in March. We believe that we are in the early stages of a broad-based global reopening that will last into 2022.

This, of course, raised the question “What on earth are the central banks thinking?” as broad measures of growth and inflation skyrocketed. As policymakers called these conditions transitory, it brought to mind for some of us the Federal Open Market Committees of the 1970s, and we wondered whether they had characterized oil price spikes then as “transitory,” too? In retrospect, the oil shocks were transient, but they sure triggered a repricing of bond markets along the way.

Much of our conversation centered on inflation. The inflation story has become far more complex than simply a view on whether it is transitory; instead, it is a tangled web of considerations about whether we are seeing the beginning of a new, reflationary era or are destined to return to secular stagnation. And while we all lamented the expensiveness of our favorite markets, we were not prepared to cash them in just yet.

MACRO BACKDROP

While global growth momentum may have peaked, we expect the U.S. output gap to close by midyear

and for U.S. GDP to clock 6.8% in 2021 and 5.1% in 2022. We expect global GDP to register 6.4% in 2021 and 4.8% in 2022. The wild cards that could change the vector of growth are the efficacy of the vaccines against new coronavirus variants (potential downward pressure) and the magnitude of fiscal stimulus coming out of Congress (upward pressure).

But the conversation on growth took a back seat to the debate over inflation. Trying to answer whether the surging inflation data will prove to be transient became a far more involved discussion. We accepted that there are supply constraints as durable goods demand blows through available inventory as employees gradually return to work. The situation has been exacerbated by a shortage of labor supply, driven by a combination of ill-timed factors.

While enhanced unemployment benefits have received much of the press, there are other considerations: childcare issues, the vaccine ramp-up and a simple speed limit on how quickly traditional businesses can reopen. At a pace of 500,000 job gains per month, it could take 15 months to get employment back to pre-pandemic levels. This all means that we have a lot more recovery in store, which should put consistent upward pressure on demand as the economy reopens; a surge in supply should *eventually* emerge to meet it. Indeed, most of the current inflationary pressures are in the harder-hit, reopening-sensitive parts of the economy (hotels, airfare and restaurants; used, new and rental cars ... ).

This led us to do a deep dive on the generally accepted inputs into the secular stagnation argument: **technology, globalization, demographics and inflation expectations**. Only technology appeared to be an ongoing driver of disinflation. Globalization has weakened over the last 10 years as global trade has stopped growing as a percentage of GDP. Further, inflation expectations on both a global and a developed market basis have begun to pick up. And the narrative on demographics seems to be pivoting. While it has been accepted that the aging global baby boomer population saves more and spends less, we are noticing a trending correlation of the global dependency ratio and annual world inflation. Simply put, fewer workers supporting a growing population of retirees will likely demand higher wages.

Lastly, we added the **debt overhang** to the conversation: Will the amount of global debt dampen world GDP as the burdens of servicing the overhang and paying it down overwhelm productive uses of capital? Given the low cost of financing, we did not believe it would serve as its own disinflationary headwind.

Long story short: The structural factors supporting secular stagnation are being challenged at a time when Modern Monetary Theory (MMT) has emerged as both an accepted and an effective tool for policymakers. The era of structurally low inflation *may* have passed.

## SCENARIO EXPECTATIONS

**Above Trend Growth** remains our base case at **90%**. Central banks remain committed to over-accommodation, and the prospect of more fiscal stimulus out of the U.S. will only intensify the reopening of the economy. Government, business and household balance sheets have all been refreshed with low-cost borrowing and/or fiscal transfers.

We left the probabilities of **Recession** and **Crisis** at **5%** each. There is still some nonzero probability that inflationary pressures may build to a point that provokes an aggressive monetary response, throwing the global economy into recession as liquidity is aggressively drained from the system. And, of course, virus variants remain an ever-present threat that could trigger another global lockdown and crisis. But these each appear to be very, very small tail risks.

We left the probability of **Sub Trend Growth** at **0%**. Policymakers remain committed to letting economies run hot. Enough said.

## RISKS

The central banks have taken all of us on this magical journey/experiment with them. After decades of disinflation, they are willing to ignore the surge in growth and inflationary pressures, viewing them as transitory. What if they are wrong and cost pressures and pricing power have made a secular turn? Generations X and Y are becoming the dominant parts of the population, and their spending patterns have yet to fully emerge. With each passing month of central bank complacency, the risk increases that monetary policymakers will have to step in far more aggressively down the road to withdraw liquidity. The markets are not prepared for that.

We tried to construct alternate risks (virus variants, etc.) but felt that these risks would be met with more MMT and fiscal transfers.

## STRATEGY IMPLICATIONS

With the Fed unwilling to change policy before year-end, a look at the forward curve suggests that 1.5%-2.0% is a fair range for the 10-year U.S. Treasury. It will be frustrating to accept negative real yields as growth and inflation spread, but that is the hand the central banks are dealing us.

While we all would like to buy credit at cheaper levels, we're not likely to get them as credit fundamentals continue to improve. In fact, we expect EBITDA growth to involuntarily deleverage corporate America. Combine that with the tremendous pool of cash searching for yield and we view U.S. and European high yield, bank loans and bank capital notes as our best ideas. The lower rated part of the municipal market also garnered some attention, as municipal coffers have been replenished with tax receipts and

low-cost borrowing. Securitized credit also looks good to us, and if we see equity portfolio flows return to emerging markets, a basket of emerging market currencies would have a lot of upside.

The two assets we couldn't find any love for are, naturally, the two things the Fed is buying: Treasuries, with their negative real yield, and agency mortgages with their negative option-adjusted spreads. This view may put us in the uncomfortable position of fighting the Fed, but that could all change if the tapering discussion starts over the summer.

## CLOSING THOUGHTS

The coming quarter isn't likely to be as easy as last quarter. The recovery is going as well as had been hoped, and the central banks must invariably begin the process of telegraphing how they would begin to adjust policy. Our view is that this needs to start sooner rather than later or the potential for a more severe normalization process will grow and, with it, the possibility it impacts all markets.

## SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 3Q 2021

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	
	<b>ABOVE TREND</b> Global GDP growth >3.5% Inflation >2%	<b>SUB TREND</b> Global GDP growth 2%-3.5% Inflation 0%-2%	<b>RECESSION</b> Global GDP growth <2% Inflation <0%	<b>CRISIS</b> A disorderly movement in markets causes systemic impact and tail risk
<b>Probability</b>	90%	0%	5%	5%
<b>Change from last quarter</b>	Unchanged	Unchanged	Unchanged	Unchanged
<b>Drivers</b>	<ul style="list-style-type: none"> <li>Global growth momentum has peaked, but there is still enormous room for catch-up</li> <li>Vaccination progress drives growth variations across countries</li> <li>Supply constraints in global manufacturing and some labor markets likely weigh on growth and boost inflation for several quarters</li> </ul>	<ul style="list-style-type: none"> <li>We know we can survive a shutdown of the economy and work from home, so below-trend growth is off the table</li> <li>An issue with vaccines or a variant mutation is absorbed, and growth is still above trend</li> </ul>	<ul style="list-style-type: none"> <li>Inflation leads to much higher interest rates than expected</li> <li>Borrowing costs for governments, businesses and consumers materially increase</li> </ul>	<ul style="list-style-type: none"> <li>A sharp, sustained spike in inflation leads to much higher interest rates than expected</li> <li>Higher debt service costs in a levered economy lead to solvency concerns, and asset prices fall sharply</li> </ul>
<b>Monetary and fiscal environment</b>	<ul style="list-style-type: none"> <li>The unwelcome surprise in U.S. inflation lowers the bar for the Fed to taper</li> <li>Re-acceleration of the labor market pushes Treasuries to the top of the 1.5%-2% range by year-end</li> <li>Fiscal policy is less supportive, but the drag is manageable, with strong private sector balance sheets</li> </ul>		<ul style="list-style-type: none"> <li>Higher interest rates cause central banks to move their policy rates stance from easing to tightening</li> </ul>	<ul style="list-style-type: none"> <li>Higher interest rates cause central banks to move their policy rates stance from easing to tightening</li> <li>Recession occurs but inflation does not decrease (stagflation)</li> </ul>
<b>Market and positioning</b>	<ul style="list-style-type: none"> <li>Risk assets, especially high yield, bank capital and leveraged loans</li> <li>Remain short duration, as interest rates are expected to continue rising</li> <li>Avoid negative convexity, such as agency mortgage-backed securities</li> </ul>		<ul style="list-style-type: none"> <li>Developed market government bonds</li> <li>Agency mortgages</li> <li>Short, amortizing, high quality securitized credit</li> </ul>	<ul style="list-style-type: none"> <li>Real assets</li> <li>Reserve currencies – JPY and USD</li> </ul>

Source: J.P. Morgan Asset Management. Global Fixed Income Views are as of June 9, 2021.

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