PORTFOLIO INSIGHTS

Global Fixed Income Views

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

4Q 2021

AUTHOR

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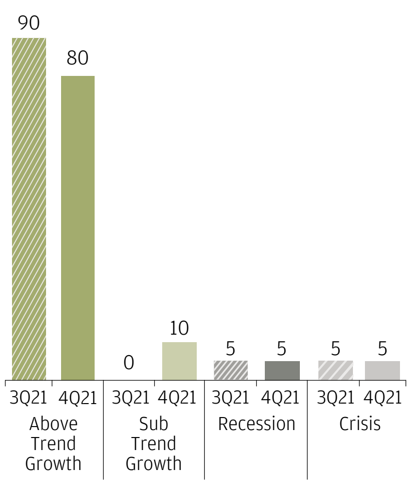
IN BRIEF

- Above Trend Growth is still our base case, but reduced to an 80% probability, given central bank normalization, the expiration of U.S. unemployment benefits and the persistence of COVID-19. We raised the probability of Sub Trend Growth to 10% from 0% because the growth peak has passed and downside risks have risen. The probabilities of Recession and Crisis remain at 5% each.
- The Fed is likely to wait a bit before making its first rate hike in mid-2023. The inflation trajectory over the next two years—and how far rates need to rise—may determine how disruptive this round of tightening will be.
- Though supply disruptions are pushing inflation higher for longer than expected, we expect them to fade. More persistent inflationary pressures are building up in some economies (U.S., UK); anecdotal evidence from companies suggests cost pressures have been passed through to the consumer, protecting corporate margins.
- Corporate credit remains our favorite sector. Our top picks are U.S. and euro high yield, leveraged loans and bank additional tier 1 (AT1) securities. We also like non-agency securitized credit.

SCENARIO PROBABILITIES (%)



Source: J.P. Morgan Asset Management.
Views are as of September 15, 2021.

DON'T OVERTHINK IT

Our September *Investment Quarterly (IQ)* came on the heels of another very good three-month period for markets. Nearly every asset class and market sector had appreciated in price, driven by the ongoing recovery, the relentlessness of central bank (over?) accommodation and the probability of further fiscal stimulus. Other than a bit of a misstep in local emerging market debt and currency, it was hard to find anything in the markets to be disappointed with.

This is not to say that everything has gone, and will continue to go, perfectly. Quite a number of issues and concerns are starting to accumulate. The reopening growth surge has appeared to peak, and there is some debate as to where U.S. and global GDP will settle. The Delta variant health care challenges have proven to be more material than originally hoped. Supply-side constraints are still evident and limiting growth. The U.S. is about to transition away from enhanced unemployment benefits, China is dealing with both lockdowns from its 0% infection rate policy and the impact of increased regulation, office tower occupancy rates in the U.S. hover around 20%, the Northern Hemisphere is about to roll into fall/winter with people moving back indoors, and the central banks are about to begin the normalization process by tapering their large-scale asset purchases.

As if that wasn't enough, we also had to assess the ongoing surge in inflation and the seemingly expensive valuation of markets—ours and others. It made for a spirited day, a willingness to not overthink things and a bias to ride the asset price momentum a bit longer.

MACRO BACKDROP

There is little doubt that the supply-side constraints and spread of the Delta variant have slowed U.S. GDP. We modestly lowered our 2021 forecast to 6% while forecasting a still buoyant 2022 outlook at 4.5%. This is still well in excess of the economy's long-term potential. We acknowledged that even with the infrastructure and reconciliation bills in the pipeline, U.S. fiscal policy will be materially less supportive in 2022. Consequently, the consumer must be ready to take the baton from the fiscal handoff. Our look at accumulated savings over the pandemic and current savings rates gave us confidence that the consumer is in a healthy position to do so.

Similarly to the last quarterly debate, we spent some time looking at inflation. While supply disruptions are pushing inflation higher for longer than expected, we expect them to eventually fade. More persistent inflationary pressures are building up in some economies (U.S., UK); anecdotal evidence from the companies we cover suggests cost pressures have been passed through to the consumer, thus protecting corporate margins. Labor shortages and the potential for durable wage increases present more upside risks: The Beveridge curve (job openings vs. the unemployment rate) reflects a challenging and potentially more persistent mismatch for employers looking to hire in record numbers but seemingly unable to do so. This context represents a novel challenge for the central banks in their path toward policy normalization.

The Federal Reserve (Fed) has already well telegraphed its intention to start tapering its large-scale asset purchases. Details are expected to be announced in November or December, with the taper starting in December or January. Consensus is that the Fed will reduce Treasuries by USD 10 billion/month and mortgages by USD 5 billion/month, resulting in a full exit from the USD 120 billion/month quantitative easing program within eight months. The Fed is then likely to wait a few quarters before the first rate hike, in mid-2023. Other than some modest upward pressure on bond yields, we expect this normalization path to be very palatable for markets. Importantly, the inflation trajectory over the next two years, and how far rates need to ultimately rise, will determine how disruptive this round of Fed monetary tightening will be.

The Bank of England also looks set to end its quantitative easing program by year-end, with a first rate hike in 2Q 2022. The European Central Bank should end its Pandemic Emergency Purchase Program (PEPP) in March 2022, but maintain market support through the general Asset Purchase Program (APP), with no rate hikes on the horizon. Lastly, the Reserve Bank of Australia has indicated further taper in February 2022, with the bond-buying program to end by 3Q 2022 and a first rate hike in 2024.

Overall, the aggregate monetary, fiscal and health care response of the last 18 months has been effective and has led to a broad-based recovery. The economic trajectory going forward may not be perfect, but with inflationary risks building, it's time for central banks to begin removing some of their emergency policies and begin the long journey to a more "normal" policy environment.

SCENARIO EXPECTATIONS

Above Trend Growth remains our base case but has been reduced from a 90% probability to **80%**. Growth is still there, but so is the growing list of issues. At the top of the list are the central bank policy normalization, the expiration of U.S. enhanced unemployment benefits and the persistence of the virus. Nonetheless, policymakers are likely to ensure that monetary and fiscal support remain a tailwind, albeit somewhat less intense.

We raised the probability of **Sub Trend Growth** to **10%** from 0%. We acknowledge that the growth peak has passed and that risks to the downside have risen. In addition, supply disruptions and inflationary pressures could have a greater impact than we are anticipating.

We left the probabilities of **Recession** and **Crisis** at **5% each**. Policy error and the potential aggressive, premature withdrawal of monetary and/or fiscal support are key risks … but tail risks at best.

RISKS

The biggest risk to our outlook remains a non-transitory surge of inflation: Input cost pressures could get pushed through to the price of finished goods and services, and wage pressures could become more persistent. We are reminded of Milton Friedman famously saying that "inflation is always and everywhere a monetary phenomenon." The cash resulting from monetary policy is still very much present.

STRATEGY IMPLICATIONS

Until the central banks are well into the tapering process, yields are unlikely to move materially higher. We expect 10-year U.S. Treasury yields to drift up to 1.875%, but not much higher.

Corporate credit remains our favorite sector. Corporate profitability looks terrific, and default rates continue to evaporate. U.S. and Euro high yield, leveraged loans and bank additional tier 1 (AT1) securities are our top picks.

We also like non-agency securitized credit, as the consumer balance sheet looks very strong.

Emerging market debt was noticeably absent from our top picks this quarter. Concerns on the efficacy of the health care response to COVID-19 and the slowdown in China weighed on the participants.

CLOSING THOUGHTS

From an economic perspective, growth has crested and the path forward is a bit bumpier but still above trend.

From a central bank perspective, the field has long been tilted in favor of the borrower at the expense of the saver, although central banks are about to embark on a multi-year rebalancing of that dynamic.

From a markets perspective, everything looks expensive, but the past buildup of liquidity is looking for an entry point.

From our perspective, keep an open mind, but don't overthink it. The recovery continues, driven by the abundance of policy support … and that is asset price friendly.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 4Q 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	
	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	80%	10%	5%	5%
Change from last quarter	-10%	+10%	Unchanged	Unchanged
Drivers	• Global growth momentum has decelerated due to the Delta variant spread, supply chain bottlenecks and Chinese regulatory reforms. We expect these factors to prove temporary • Services could be a catalyst for growth, given high potential to catch up to pre-pandemic levels • Vaccination progress contributes to the continued reopening of many developed economies	• Colder weather in Northern Hemisphere could increase COVID-19 spread and augment likelihood of curbs on economic activity. Booster jabs could alleviate this risk • Service sector recovery takes longer to occur, while durable goods spending continues to be constrained by a lack of supply	• The risk to our forecast is a sustained/non-transitory move higher in inflation, leading to central banks tightening policy faster than expected. Yield curves flatten • Handover from fiscal stimulus to private consumption does not happen	• New vaccine-resistant, highly contagious COVID-19 strain takes hold • Chinese idiosyncratic risks become systemic and reverberate into a global growth shock
Monetary and fiscal environment	• Fiscal and monetary support, while slowing, is historically high, and private sector balance sheets are strong • Inflation set to fall next year, but shelter/wage dynamics indicate no reversion to a disinflationary trend • Growth acceleration could push USTs toward the higher part of the 1.25%–1.875% range	• Chinese regulatory reforms could affect growth and risk-taking sentiment	• Borrowing costs for businesses and consumers materially increase	• Higher debt service costs in a levered economy lead to solvency concerns, and asset prices fall sharply
Market and positioning	• Risk assets, especially non-agency securitized credit, high yield, leveraged loans, bank capital • Remain short duration, as interest rates will continue rising • Avoid negative convexity products, such as agency MBS	• Corporate credit should continue to perform well • Developed market government yields to remain low	• Long-dated developed market government bonds • Agency mortgages	• Developed market government bonds • Favor reserve currencies—JPY and USD

Source: J.P. Morgan Asset Management. Global Fixed Income Views are as of September 15, 2021.
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