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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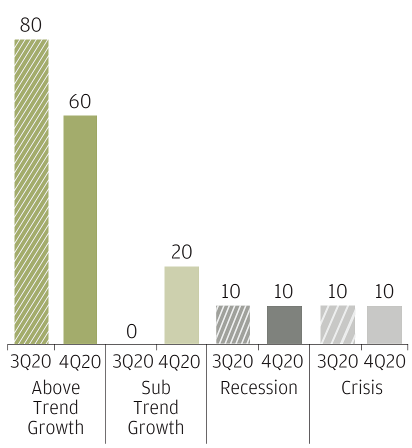
SCENARIO PROBABILITIES (%)



Source: J.P. Morgan Asset Management. Views are as of September 15, 2020.

IN BRIEF

- Above Trend Growth remains our base case despite the many challenges ahead; we reduced its probability to 60% from 80%.
- We increased the likelihood of Sub Trend Growth to 20% from 0%, as uncertainties surround the provision of additional fiscal stimulus, not only in the U.S. but in Brussels, Tokyo and Beijing. We left the probability of both Recession and Crisis at 10%.
- Key risks are two big unknowns: the timing of a vaccine's approval, manufacture and distribution and the outcome of the U.S. general elections.
- Higher beta U.S. corporates top our list; higher yielding municipal bonds also look attractive, and we find value in certain local emerging market debt and currencies.

HISTORIC STIMULUS ... NOW WHAT?

The setting for our September *Investment Quarterly (IQ)* was one to which we all are getting accustomed: virtual, with most participants Zooming from home and a few from a rather empty office building in a rather empty midtown Manhattan. Since the last *IQ,* in June, both the economy and markets have been very kind to us. The safety net of monetary and fiscal policies rolled out globally was effective, stabilizing the global economy and lifting asset prices.

While this also lifted everyone's spirits, the *IQ* participants recognized many challenges ahead. Fiscal support in the U.S. had largely expired at the end of July, the U.S. was headed into an election, and the timing of an effective COVID-19 vaccine was difficult to pin down. Overwhelmingly clear to us was that global monetary policy remained unprecedented in its stimulus. Arguably, the aggregate global availability and cost of money have never been easier or cheaper in the history of Earth.

MACRO BACKDROP

During the third quarter, global activity staged a strong but bifurcated recovery, largely due to unprecedented monetary and fiscal stimulus. While there has been some recovery in manufacturing, especially in China, and in retail sales, weakness remains in sectors constrained by social distancing, such as travel and leisure. Within the U.S., states and municipalities are gradually lifting lockdowns and there is some momentum to start the long journey back to normal. Clearly, consumers are consuming and availing themselves of the available fiscal support. It remains to be seen whether this is sustainable, given the slow reopening process and the lapse in fiscal support in the U.S.

Inflation was the focus of discussion for this *IQ,* as the Federal Reserve had recently released its new flexible average inflation targeting policy at Jackson Hole. While our group has largely believed that reaching sustained 2% inflation is quite aspirational for central banks, which have been trying to do so for the last 11 years, we also appreciated some of the impulses that could lead to a rise in inflation over the next 12 months. Globally, the volume of central bank accommodation should provide the backdrop for higher inflation, this time with a steady dose of fiscal stimulus driving a surge in money growth. Add the supply shock resulting from shutdowns, even as consumers continue to spend, and the ingredients for higher prices are there. In addition, many businesses are rethinking their supply chains and some market participants think that could lead to deglobalization—which would raise manufacturing costs. Finally, we looked at the handful of companies that have benefited from the stay-at-home environment. We wonder whether all that online purchasing has squeezed out the Main Street shop and allowed online retailers to begin raising prices.

Nonetheless, our bias is still to expect low inflation over the intermediate and longer term. The negative demand shock as fiscal support expires is starting to show up in data. Learning to live with COVID-19 while waiting for a vaccine means a less dynamic environment. And the trillions of dollars in debt being issued to fund a recovery will present long-term headwinds, as repaying it will likely absorb a lot of future economic output.

The two issues that will likely most impact the economy going forward are the most difficult to analyze. First is the timing and distribution of an effective vaccine. While expectations are high for a vaccine approval around year-end, how quickly it can be manufactured and distributed will directly impact the speed at which the economy may return to normal. The second is the U.S. elections. What Congress will look like and the next administration's ability to effect policy change are unknowns.

What is not in question is the support of the central banks, and that is what we felt we should focus on when looking at bond markets.

SCENARIO EXPECTATIONS

Above Trend Growth remains our base case but has been reduced to a **60%** probability from 80%. Macro policy remains broadly supportive of economic growth, but central banks have largely reached the limit on what they can realistically do from here. As reopenings accelerate globally, more economies will join China in beginning to close the output gap.

We have increased the likelihood of **Sub Trend Growth** to **20%** from 0%. While the intent of all policy is to generate a meaningful economic restart, the political uncertainties around additional fiscal stimulus have grown. At some point, economies will need to operate without fiscal transfers. The growing debt burden resulting from fiscal support is effectively mortgaging the future. Creating a longer but affordable bridge to the other side of the pandemic will be an ongoing challenge for Brussels, Washington, Tokyo and Beijing. If monetary policy becomes the only source of further support, muddling along is a realistic scenario.

Recession and **Crisis** remain at a **10%** probability each. The downside to an engineered recovery has not disappeared. Any policy misstep or resurgence in the virus could trigger a contraction. However, the odds are low, since such a downturn would likely trigger further fiscal and monetary responses.

RISKS

The U.S. general election is a looming risk. A Biden victory would likely lead to more regulation and, depending on the composition of Congress, could lead to higher taxes. A Trump victory might trigger more tariffs and more confrontation with China. The development of a vaccine is also a significant risk. A delay in finding and distributing an effective vaccine would likely delay a return to normal. Yet, conversely, an effective vaccine that is quickly distributed would trigger a strong tailwind to growth that might cause central banks to reconsider the amount of accommodation they are providing.

STRATEGY IMPLICATIONS

Our base case scenario looks for a continuing economic recovery supported by both policy and the potential for a vaccine. The broadly supportive environment encourages us to continue to maintain risk while adding to it selectively.

Higher beta U.S. corporates top our list. Most companies have taken steps to improve their liquidity and maturity profiles. While leverage has risen, record low interest rates have made that debt affordable.

Higher yielding (BBB rated) municipal bonds also look attractive. A Democratic sweep in the general election might lead to badly needed funding for state and local governments.

Finally, we like local emerging market (EM) debt and currencies. Yields remain high, and EM central banks have embarked on programs of rate reductions and large-scale asset purchases. Additionally, the USD's yield advantage and exceptionalism have faded, providing a tailwind to EM currencies.

CLOSING THOUGHTS

The beta trade of the last six months has come and gone. The markets convulsed and then rebounded as policy responses exceeded expectations. Now is the challenging time in markets to do the research and find opportunities that are undervalued on a relative basis. The key is not to get too greedy and accept that returns in fixed income are likely to equal the yield of the market one is investing in, plus a bit in capital appreciation as yields drift lower. When we meet again in mid-December, the market landscape will surely have changed in the wake of the elections and progress on a vaccine.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 4Q20

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%–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	60%	20%	10%	10%
Change from last quarter	-20 percentage points (ppt)	+20 ppt	Unchanged	Unchanged
Drivers	• Economies continue growth recovery, reopening, increasing economic activity and lowering unemployment • Governments avoid further shutdowns and widespread quarantines in addressing COVID-19 crisis, potentially helped by a vaccine	• Moderate global growth rebounds as businesses resume operations at lower activity levels • Less appetite for fiscal assistance as economy and markets rebound and deficit concerns grow	• Resurgence of COVID-19 infections causes second wave of shutdowns and/or rising trade tensions, or another exogenous shock disrupts recovery and roils markets	• Economic activity remains depressed: – Second wave of infections creates drag – Consumption falls amid higher unemployment and uncertainty – Businesses continue to be challenged at lower activity levels
Monetary and fiscal environment	• Policy actions serve as a backstop for risk assets: – Additional fiscal assistance continues to support businesses and consumers – Central banks continue asset purchases, keeping interest rates low – Robust corporate credit supply continues	• Global central banks remain accommodative, keeping rates unchanged near lower bounds • Corporates continue balance sheet repair and defense	• Inadequate fiscal and monetary response fails to restore investor confidence • Small and medium-sized enterprises begin to run out of operating cash; unemployment rate increases • Elevated corporate leverage leads to waves of downgrades and restructurings • Stresses in credit and liquidity markets cause funding pressures, disorderly market behavior	• Geopolitical risks: – U.S.-China trade tensions rise – U.S. elections create policy uncertainty • Central banks, with policy rates at lower bound, pass baton to fiscal policy • Fiscal policy response insufficient to create expansion
Market and positioning	• Higher beta investment grade (IG) corporate credit • High yield municipal debt • Emerging market local currency debt and FX	• IG corporate credit • Agency mortgages	• 30-year Treasuries • Favor reserve currencies: JPY, USD	• Developed market government bonds

Source: J.P. Morgan Asset Management. Views are as of September 15, 2020.

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NEXT STEPS

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