Global Aggregate

Q3 Outlook 2024

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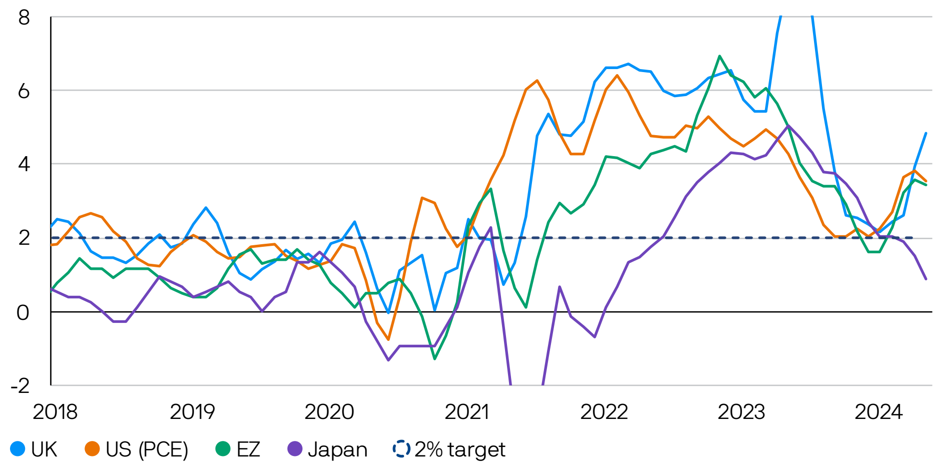
The economic expansion, which started with a very swift rebound from the pandemic recession in April 2020, has now entered its fifth year. Despite seeing the sharpest interest rates increase and the strongest inflation and wages increases in about 40 years, the most likely outlook is an economic soft landing: continued economic expansion against a backdrop of inflation declining to target and a gradual central bank rate cutting cycle.

Recent inflation data reinforces the soft landing outlook

The first quarter saw seasonally adjusted, annualised, three-month inflation accelerate, raising concerns that central banks would be unable to cut rates this year. Fortunately, US inflation data for April and May has come in much cooler, suggesting inflation remains on a downward trend towards central bank targets.

The First Quarter inflation acceleration appears to be more noise than signal

Core inflation seasonally adjusted annualized 3-month rate, %



Source : Bureau of Labour Statistics, Office for National Statistics (ONS), European Central Bank (ECB), MIAC, STCA. Data as of 28 June 2024.

The number of hot ticket inflation categories has also narrowed. In the US today, inflation excluding all housing and auto categories, is now back below its pre-Covid average level. Today's elevated inflation is largely due to actual and imputed rent inflation (owner's equivalent rent), which in itself is an echo from Covid as the average level of rent slowly catches up to the post-Covid sharp increase in market rents. Data from the Cleveland Fed paints a dovish outlook with new tenant market rental inflation below pre-Covid levels, suggesting that rental inflation for all tenants will follow suit, bringing US inflation towards it target level in the coming quarters.

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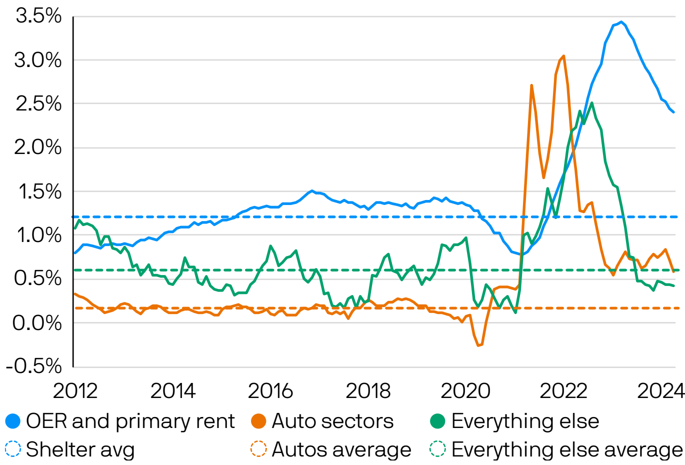
The US disinflation outlook is supported by leading indicators of rental inflation

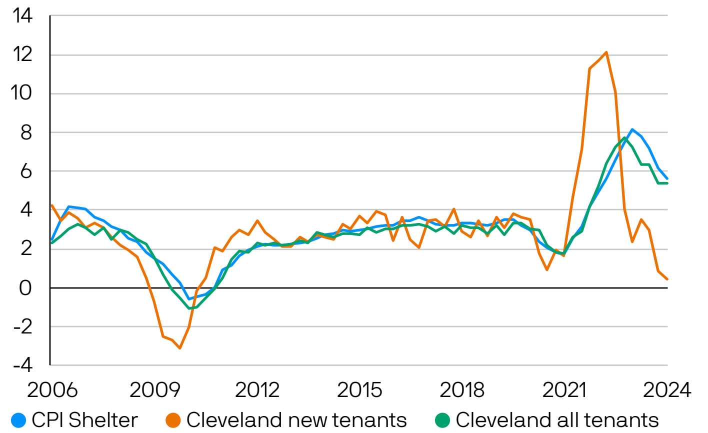
US core inflation is narrowly based

Contribution to year-on-year, Core CPI, pre-covid averages in dotted lines



New rent's inflation leads CPI inflation

Year-on-year

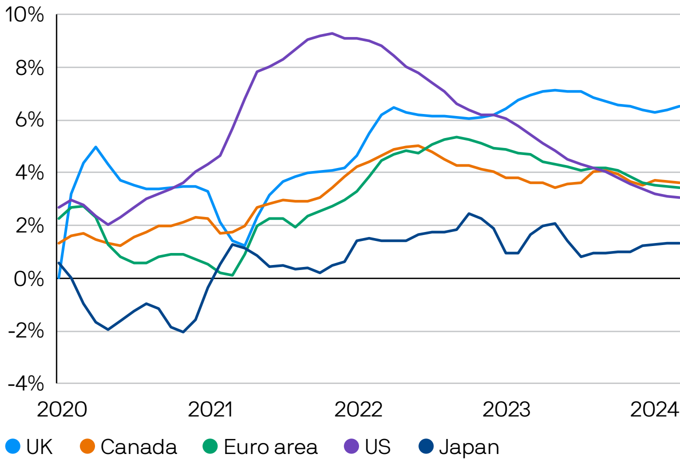


Source: Bureau of Labour Statistics (BLS), BEA, Bloomberg, JP Morgan Asset management, Apartment List, Cleveland Fed. LHS data as of 31 May 2024. RHS data as of 30 June 2024. * Owner's Equivalent Rent (OER) and primary rents 42.6% weight. Auto sectors represent New Vehicles(4.5%), Used Cars and Trucks(2.4%), Rental(0.2%), Insurance(3.7%), Maintenance(1.6%)

Inflation outside the US also surprised to the upside in Q1. While Q2 data is not as encouraging as in the US, the data does show inflationary pressures narrowing. Together with business surveys, which show moderating inflationary pressures, and labour market data, which shows slowing demand, European inflation also appears to be on a downward path.

Wage inflation is moderating globally

3 month moving average year-on-year



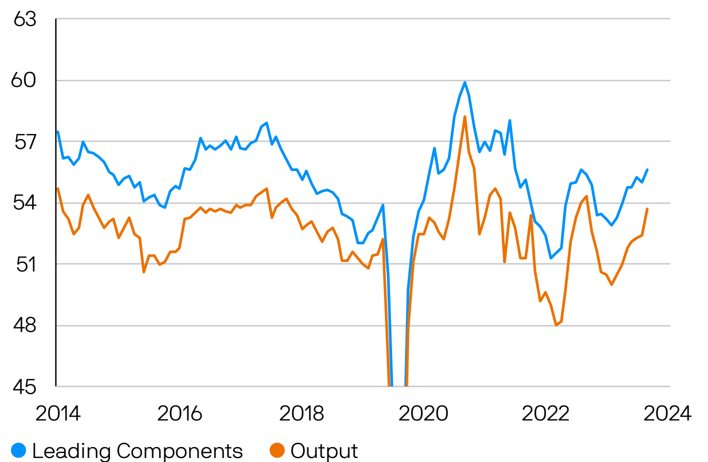
Source: Bureau of Labour Statistics (BLS), Atlanta Fed, Indeed, DMP, European Central Bank (ECB), J.P Morgan Asset Management, Bloomberg, Eurostat, Office for National Statistics (ONS), Jolts. Data as of 31 May 2024.

Economic activity data signals continued expansion but at a moderating pace

Economic growth remains resilient. US GDP slowed to 1.2% in Q1 2024 but much of this is due to inventory and net exports. Final domestic sales, GDP less inventory and net exports, was 2.5% in Q1, down from an average rate of 3.2% in 2023 but in line with the 2018–2019 average. The outlook for continued expansion is supported by broadly stable business surveys and healthy corporate fundamentals.

Business surveys point to resilient growth

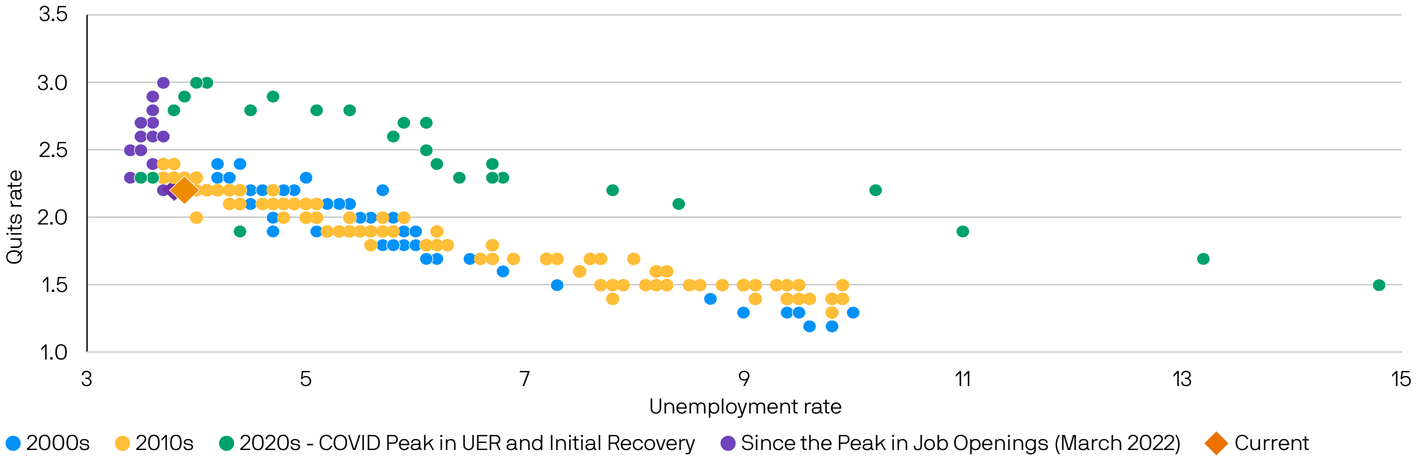
Global PMIs



Source: S&P Global, Institute for Supply Management (ISM), Bureau of Economic Analysis (BEA), Bloomberg, J.P Morgan Asset Management. Data as of 31 May 2024.

Labour markets continue to rebalance but paint a more mixed picture on the outlook. While US payroll growth remains strong, unemployment is slowly increasing. History would suggest that a further cooling of labour demand, as proxied by US quit rate, would be associated with a sharper increase in unemployment. In contrast, weekly US initial unemployment claims, are tracking trends seen in 2019, 2022 and 2023, suggesting that we are simply witnessing a rebalancing of the labour market which is reducing the excess demand in the labour market. Incoming labour market data, particularly US payrolls, will be key to understanding US recession risks.

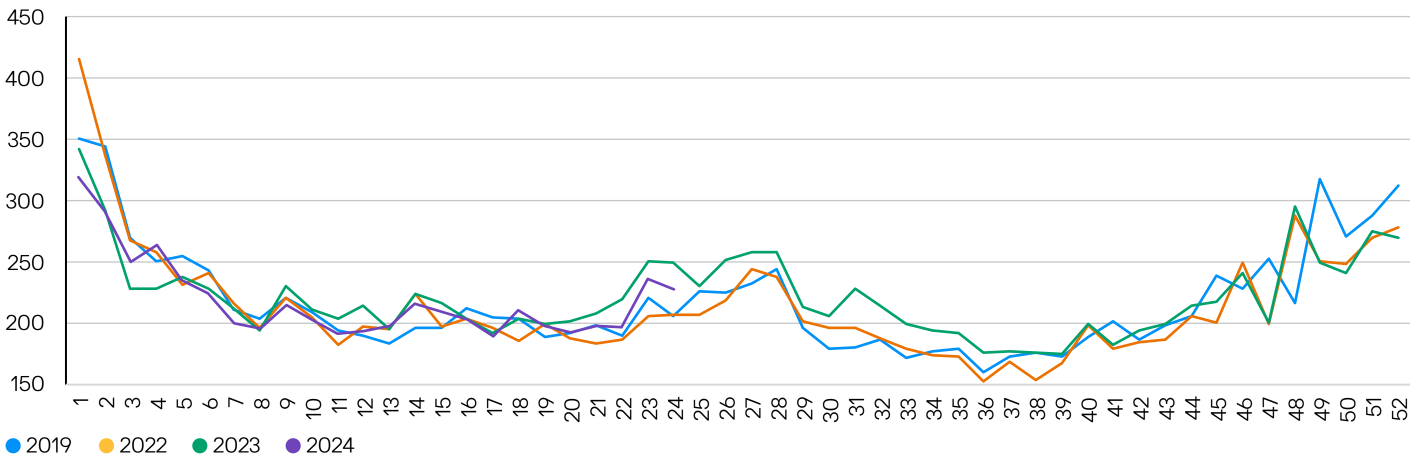
Glass half empty – history suggests further labour market loosening will see unemployment increase sharply



Source: Bureau of Labour Statistics (BLS), JOLTS, J.P Morgan Asset Management, Bloomberg, Institute for Supply Management (ISM). Data as of 31 May 2024.

Glass half full – weekly unemployment claims consistent with continued economic expansion

Initial claims NSA by Week of the Year



Source: Bloomberg, J. P. Morgan Asset Management. Data as on 26 June 2024

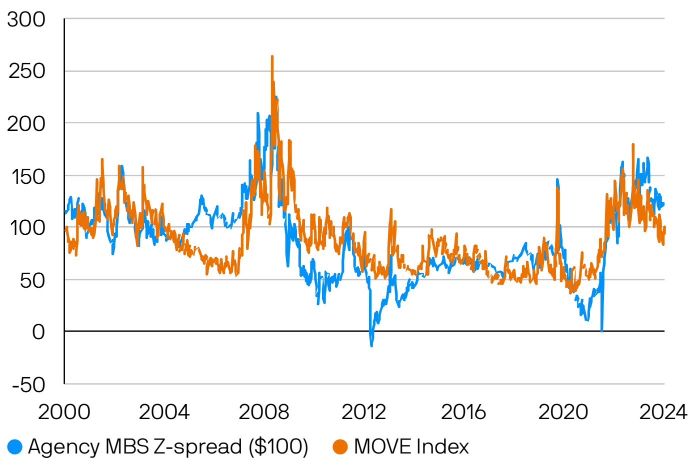
What does this mean for your bond portfolio?

A soft landing would be good for credit and spread assets more broadly. Global investment grade corporate fundamentals continue to exhibit resilience at this stage of the economic cycle. Continued economic expansion would keep the corporate default rate low while lower interest rates would ease the cost of debt for the more leveraged parts of the credit market.

Global corporate spreads are at the lower end of their historical range, suggesting that the additional spread or income, rather than capital gain from spreads tightening, will drive much of the excess return. The low level and volatility of spreads at the index level, make bottom-up security and sector allocation a more important part of the investment strategy. Within credit, bank valuations are relatively attractive to non-banks, having cheapened up on the back of heavier supply.

The relatively low level of corporate spreads makes diversification more important for portfolio construction. High quality assets, such as US Agency Mortgage-Backed securities (MBS) and euro-denominated covered bonds look particularly attractive. These bonds are less exposed to the economic cycle and driven more by technical factors. Agency MBS have cheapened over the last few years as interest rate volatility increased on the back of higher inflation and Fed hikes. With interest rate volatility back at pre-2007 levels, this sector now looks attractive compared to other spread assets.

US Agency MBS valuations attractive due to elevated volatility

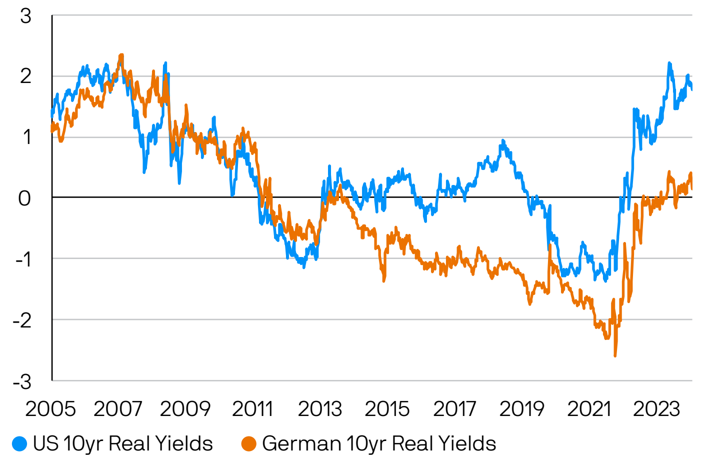


Source: Bloomberg, J. P. Morgan Asset Management.
Data as on 26 June 2024

Two key risks hang over the soft landing portfolio

Bond valuations have cheapened significantly over the past few years, with the real yield, after expected inflation, increasing from around -1% to about +2% on 10-year US Treasuries. The market is expecting rate cuts, with the Fed expected to cut rates in the third quarter, and then at a quarterly pace thereafter. This looks reasonable for a soft-landing outlook.

Bond valuations have fallen significantly



Source: Bloomberg, J. P. Morgan Asset Management. Data as on 26 June 2024

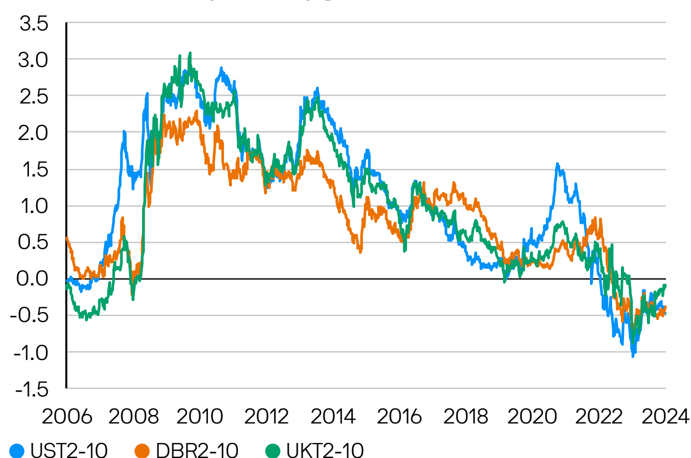
While the ECB cut rates in June, the persistence of inflation in the first quarter has generally delayed the global central bank rate cutting cycle. This creates the risk that central banks leave it too late and that the lags of monetary policy create an economic downturn. Wider credit spreads in this scenario would not be good for carry orientated scenario. But this recession scenario would be consistent with a faster pace of rate cuts, a steeper yield curve and lower 10 year government bond yields.

In contrast, the US general election may result in one party obtaining a sweep of the presidency and both chambers of Congress. Markets need to price in the possibility that an election sweep, by either party, could result in more fiscal stimulus. This would be positive for growth but would probably increase interest rates in anticipation of higher government bond supply and fewer anticipated rate cuts. Hedging credit risk by being overweight interest rate risk would backfire in this scenario.

Yield curve strategies are better protection for portfolios positioned for soft-landing

The market prices yield curves to dis-invert as central banks cut rates. But the level of curvature is still relatively low with the market pricing the 2-10 US Treasury yield curve only slightly above zero in 2 years' time. Should the recession risk-scenario unfold, we would expect the Fed to cut rates rapidly, leading to lower interest rates across the curve and a steepening of the 2-10 curve by 100-200 basis points (bps), consistent with past cycles.

Yield curve to steepen sharply if recession unfolds



Source: Bloomberg, J.P. Morgan Asset Management.
Data as on 26 June 2024.

In contrast, the US election clean sweep/fiscal stimulus risk scenario would likely drive yields higher but have a more modest impact on yield curve. Higher inflation and term premia could offset expectations for fewer Fed cuts. While yield curves could be broadly unchanged, the yield curve steepener would suffer slightly from the negative carry priced in today's market, representing a low-cost strategy that protects carry orientated portfolios from recession risk.

Build your portfolio around soft landing with an eagle eye on payrolls and politics

The macro data has strengthened the outlook for soft landing and the expected return from portfolios orientated around carry strategies. With many spreads sectors at the lower end of historical valuations, diversification is important as is focusing on bottom-up alpha opportunities. Valuations for high quality sectors, such as US Agency MBS look particularly attractive. Portfolio construction needs to focus on the tail risks to the base case soft landing outlook. While interest rate valuations are compelling and support against the risk of a recession, bond yields would rise if the US election produced a clean sweep. We think it is better to protect carry orientated portfolios from recession risk with yield curve steepeners.

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LV-JPM55257 | 07/24 | 09qn240807095233

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