

Global Fixed Income Views

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

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In brief

- The Federal Reserve's dovish pivot has tipped the odds away from recession and toward a soft landing. Sub Trend Growth is now our base case probability at 60%, and we've dropped the likelihood of Recession to 30%. We raised the probabilities of Above Trend Growth and Crisis from 0% to 5%.
- In both our Sub Trend Growth and Recession scenarios, the Treasury-risk asset correlation should return to its normal negative relationship and work as a hedge to riskier assets.
- The primary risk is a reacceleration of inflation that causes central banks to return to tightening.
- We favor the higher yielding credit sectors of the bond market: corporate bonds and securitized bonds, including agency pass-throughs, non-agency commercial mortgage-backed securities and short-duration securitized credit. Emerging markets also present opportunities, with high real yields and cutting cycles already on the way.

In cash, left out

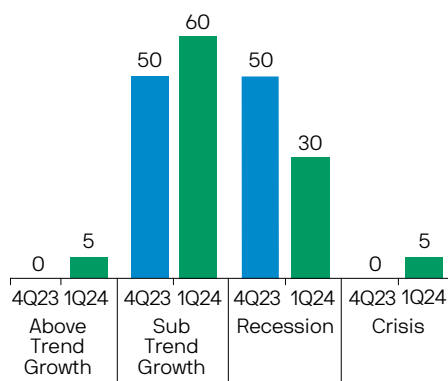
Our December *Investment Quarterly* (IQ) was held in New York the day after Federal Reserve (Fed) Chair Jay Powell and the Federal Open Market Committee (FOMC) stunned the markets with an unambiguously dovish message. After almost two years of relentless monetary tightening, policymakers acknowledged that they had seen enough improvement in inflation to call a truce, and they even opened the door to rate cuts in 2024. Expecting a hawkish bias from the Fed, the markets were caught off-guard, and an impressive rally began across all asset classes. Those investors sitting in cash are bound to feel left out, wondering "What next?"

For our part, the group had been increasingly embracing the markets in recent months and using every backup to add bonds to portfolios. Our discussions about what to do next were mostly around where the best value was, how to access it and what valuation metrics to focus on to identify whether markets were getting ahead of themselves. Although the long and variable lags in monetary policy may eventually hit the economy with more force, this was not the time to worry about them.

Macro backdrop

In truth, there were plenty of signs showing a widespread slowdown in growth and inflation well before the December 13 FOMC meeting. The U.S. labor market had cooled off, with the six-month rolling average of nonfarm private payroll growth at 130,000, down from the pre-pandemic (2017–19) average of 164,000. More

Scenario probabilities (%)



Source: J.P. Morgan Asset Management. Views are as of December 14, 2023.

importantly, inflation had fallen surprisingly close to the Fed's 2% target: The important core Personal Consumption Expenditures index was registering 2.4% on a three-month annualized rate (down from a high of 6.6% in 2021), and the year-over-year core producer price index was at 2.0%.

While the slowdown was evident, recession looked increasingly remote. Unemployment had remained at or below 4% for 24 consecutive months, corporate earnings looked solid, and there appeared to be little stress in the funding markets. In short, the Fed was entitled to congratulate itself on a job well done.

Outside the U.S., the picture was less rosy. Europe faced an imminent recession, and the UK was battling sticky inflation. And for the first time in a generation, the Bank of Japan appeared ready to hike rates and exit negative interest rate policy. In emerging markets, the group acknowledged the fiscal and monetary discipline but worried about China's ability to provide sufficient stimulus.

Overall, the combination of moderate growth, continued disinflation and central bank bias toward easing created a very different macro backdrop from what we had seen in recent years – and, in our view, a powerful tailwind to the bond markets.

Scenario expectations

Sub Trend Growth/Soft Landing (raised from 50% to **60%**) became our base case probability, at a 2-to-1 weighting over **Recession** (lowered from 50% to **30%**). We came into the fourth quarter believing that the central banks were key to determining whether the economy would wind up in recession or enjoy a soft landing. Our concern was that policymakers might keep rates high until inflation was consistently at their 2% target – and then the long and variable lags would hit. We had recession vs. soft landing as a 50-50 toss-up. Clearly, the Fed's dovish pivot has tipped the odds in favor of a soft landing. In both the Sub Trend Growth and Recession scenarios, the Treasury-risk asset correlation should return to its normal negative relationship and work as a hedge to riskier assets.

We raised the probability of the tail risks, **Above Trend Growth** and **Crisis**, from 0% to **5%**. We have to appreciate that inflection points in monetary policy come with considerable volatility and risk, and we will only know with hindsight whether central bankers changed direction too soon or too late. Certainly, with the U.S. economy operating at full employment, any pickup in China and the tailwind of lower policy rates could lead to a meaningful reacceleration in growth to Above Trend. Conversely, an extended period of high real yields at a time of two wars and U.S. general elections contains the ingredients for a possible Crisis.

Risks

The primary risk is a reacceleration of inflation that causes central banks to return to tightening. As each quarter passes, businesses and households are progressively adjusting to the higher cost of financing any expenditures. A global shortage in housing stock and low unemployment may mean that delayed consumption starts up again at a time when inflation is still above most central bank targets.

Also on the horizon in 2024 are the U.S. presidential election and elections in 39 other countries, including the UK, Taiwan, Mexico, Indonesia, Venezuela and Pakistan. The potential for geopolitical tensions to escalate remains high and is not priced into bond markets.

Interestingly, some of the old favorite concerns – such as problems with the U.S. regional banking system and vacant office properties in central business districts – didn't resonate this quarter.

Strategy implications

A dovish pivot by the Fed is essentially a “full speed ahead” signal for the bond market. The former narratives of potential additional tightening or “higher for longer” can be retired. This was reflected in our best ideas, which were split among the higher yielding credit sectors of the bond market.

Corporate bonds were the marginal favorite. We appreciated that public corporate borrowers had termed out their debt in a far lower interest rate environment and were enjoying a prolonged period of solid earnings growth. Default expectations remained very low, and the group was receptive to U.S. and European investment grade and high yield issuers. There was some bias toward European bank additional Tier 1 (AT1) securities and U.S. leveraged loans, but the bottom line was to get in while spreads were still reasonable relative to the overall level of interest rates.

Securitized bonds were the next favorite. Again, the interest was broad-based, encompassing agency pass-throughs, non-agency commercial mortgage-backed securities and short-duration securitized credit. The group found limited stress outside the lowest quality borrowers in consumer loans, and many sectors seemed to be performing well. When we couple sound fundamentals with reduced volatility, securitized assets look to be one of the cheaper remaining sectors of the market.

Lastly, emerging market debt gained quite a number of supporters after several quarters in exile. The group appreciated the high real yields in local bond markets and that several emerging market central banks had already embarked on their rate-cutting cycle. Most also wanted to

take the local currency as well, believing that the U.S. dollar was topping out.

Closing thoughts

A Fed on the verge of easing does not lead to a bond bear market. Quite the contrary: Any sell-off should be bought, and total yield is valuable. Once the Fed starts cutting rates, it can cut several hundred basis points regardless of soft landing or recession. As other developed market central banks either lead or join the Fed, the sea of money sitting on deposit and in money market funds will grudgingly come into the market. We're not intending to hold cash and be left out of this rally.

Scenario probabilities and investment implications: 1Q 2024

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 day-long discussions, we reviewed 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 ~2%	Recession Global GDP growth <2%	Crisis A disorderly movement in markets causes systemic impact and tail risk
Probability	5%	60%	30%	5%
Change from last quarter	+5%	+10%	-20%	+5%
Drivers	Financial conditions ease and growth reaccelerates	The cumulative and lagged effects of central bank tightening slow inflation and growth; strong consumer, corporate and municipal balance sheets extend the economic expansion Ample liquidity and falling inflation forestall a recession	Consumers deplete savings and increase their revolving credit; cumulative and lagged effects of monetary tightening challenge both consumers and corporations Job creation stalls and unemployment rises Corporate spreads widen, consistent with historical recessionary periods	U.S. political rhetoric escalates with elections War impacts widen; geopolitical risks proliferate Consumer savings and municipal rainy-day funds fall below pre-pandemic levels Corporations roll maturities at punitive rates, exposing fragilities and causing risk assets to plunge in price
Monetary and fiscal environment	Central banks back away from rate cuts as growth reacceleration risks reversing disinflation progress Continued fiscal impulse	Central banks show willingness to be more forward looking and cut rates proactively before inflation reaches target	Weakening growth and falling inflation induce aggressive central bank easing, resulting in lower government bond yields	Central bank easing is too little and too late because policy was too restrictive
Market and positioning	Risk assets, especially high yield, lower rated investment grade credit and lower quality EM debt, outperform	High quality corporates and securitized outperform, especially interest rate-sensitive sectors Select local EM rates outperform	Government curves dis-invert and steepen High quality core fixed income – agency MBS, developed market government bonds and securitized credit – outperform	U.S. rates fall sharply Reserve currencies and cash outperform

Source: J.P. Morgan Asset Management. Views are as of December 14, 2023. MBS: mortgage-backed securities.

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Next steps

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