Global Fixed Income Views

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

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In brief

- Given the strength in the economy, was a larger-than-expected rate cut too much, too soon? Or is the slowing of labor market an indication it is already too late?
- Amid the debate, central bankers' ability to maintain the U.S. economy's current balance will be key to ensuring the first soft landing since 1995.
- We believe the Fed can bring rates down to 2.75%–3.75%. The wide forecast range reflects the uncertainty around the speed of the economy's response to current and future policy easing.
- Most bond markets have risen significantly since last quarter and we expect similar moves over the next three to six months. As returns on cash sink, the ABCs for investing during this part of the cycle are "Anything But Cash."
- Our best ideas include high yield credit, bank loans, convertibles, additional tier 1 (AT1) securities, securitized credit, and emerging market debt.

The ABCs of easing cycles: Anything But Cash

Our September *Investment Quarterly (IQ)* was held in London a day after the Federal Reserve (Fed) cut rates for the first time since March 2020. The Fed beginning its rate cutting cycle was not particularly surprising. What was surprising were the press reports a week earlier, during the Fed's blackout period (when members cannot speak to the media), that had the effect of guiding the markets to expect what would be the eventual 50 basis points (bps) reduction—as opposed to 25bps, which had looked carved in stone.

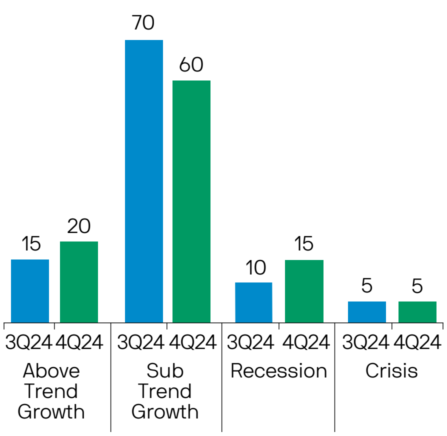
While Fed Chair Jerome Powell's press conference remarks gave a very balanced view of the rationale for the 50bps rate cut, the markets will continue to debate in the weeks ahead whether something more significant is occurring or if this is really a simple, in the Chair's words, "recalibration."

The *IQ* participants spent much of the day poring through data and identifying what had changed to justify the Fed's larger rate cut, and whether the U.S. economy was as well balanced as Chair Powell portrayed. Certainly, inflation and the labor market had moderated further in recent months, but broad measures of economic activity continue to remain healthy.

Had the Fed waited too long to reduce some of the funding pressure on businesses and households? Or was there enough underlying strength in the U.S. economy that an aggressive easing cycle would lead to a resurgence in growth and inflation? Complicating the picture were a range of policy divergences globally. China and Europe were struggling with weak growth, while the UK was still battling sticky inflation and Japan was in the midst of a hiking cycle.

The one thing the group did not want to lose sight of is that the beginnings of Fed rate-cutting cycles are always met with market euphoria—no matter

Scenario probabilities (%)



Source: J.P. Morgan Asset Management. Views are as of September 19, 2024.

where markets land in the end. Since our June *IQ,* most bond markets had risen by 4%–6%, and we expected something similar over the next three to six months. As returns on cash sink, the ABCs for investing during this part of the cycle are "Anything But Cash."

Macro backdrop

The Fed has done very well in cooling off a supercharged economy following the COVID stimulus bills, and in bringing the economy back in line with their dual mandate of price stability and full employment. By the time of the rate cut, their preferred measure for inflation, core personal consumption expenditures (PCE), had declined to a three-month annualized run rate of 1.7%, down substantially from 6.6% in 2021. The labor market had also cooled off, as unemployment had risen from a low of 3.4% to a recent high of 4.3%, and payrolls growth had slowed from above 200,000 a quarter ago to a three-month moving average of 116,000, as of the August report.

The only problem was that while inflation and the labor market were now in good balance, the fed funds rate was still at a highly restrictive level and a far distance from around 2.9%, which both the Fed and the markets assume to be the neutral rate. Perhaps the Fed had waited too long to ease, and the pressure on businesses and households would continue at a pace that would lead both to pull back on spending and, eventually, to recession? There is ample evidence that the housing market was weak and small businesses were suffering—both signs of high funding costs. Perhaps it was the rapid rise in unemployment triggering the Sahm rule[1] that led Chair Powell to unexpectedly shift from a 25bps to a 50bps rate cut.

On the other hand, the *IQ* group was also concerned that the underlying strength in the economy was still evident and 50bps in rate cuts may have been too much, too soon. The Atlanta Fed GDP tracker was indicating that 3Q GDP would come in at 2.9%. We continue to see money from the full range of COVID stimulus bills (American Rescue Plan, Infrastructure & Jobs Act, Inflation Reduction Act, CHIPS and Science Act) being distributed. And a look at corporate earnings and consumer loan payments suggested that while some pressure was there, nothing particularly troublesome was evident. Also, absent were any potential crises in the emerging markets or U.S. municipalities—traditionally soft spots following aggressive Fed hiking cycles. The balance sheets for businesses, households and state and local governments seem to be in good shape, with only sovereign balance sheets looking overleveraged (but does that matter anymore?).

Perhaps Chair Powell is correct, and the U.S. economy is about as well balanced as it can be at this stage of the cycle. What is clear to us is that the Fed and the other central banks, and the extent to which they can maintain the current balance, are the keys to ensuring the first soft landing since 1995.

We believe the Fed can bring rates down to a range of 2.75%–3.75%. That, admittedly, is quite a wide range, but the terminal fed funds rate will be dependent on the pace at which they cut rates, and the extent to which the economy responds to that policy action. The other important consideration would be any policy actions following the U.S. general elections that altered the current trajectory.

Scenario expectations

Like the Fed, the group had to acknowledge that the labor market had weakened more than expected. We also had to balance that with the 50bps rate cut in response. After much discussion, we lowered the probability of **Sub Trend Growth/Soft Landing** by 10%, to **60%**, and increased by 5% both **Above Trend Growth** (to **20%**) and **Recession** (to **15%**). While **Soft Landing** remains our base case, we appreciate that a fast moving Fed is a sign that policymakers may have either waited too long to cut rates or are cutting too aggressively. We will have time, over the next couple of quarters, to see the speed of the transmission from monetary policy to business and household behavior.

While it was tempting to reduce **Crisis** to zero, the U.S. elections loom large, so we kept the probability unchanged at **5%**. Policies resulting from either party sweeping the presidency and Congress could be aggressive. Additionally, the assassination attempts are a threat to stability.

Risks

The risk to our soft landing expectation is a sharp reacceleration in growth and inflation that would cause the Fed to under-deliver in this easing cycle and reverse course. A unified Congress under either a Harris presidency or a Trump presidency would come with promised tax cuts and increased spending. It's as though the level of sovereign debt is no longer an obstacle to fiscal stimulus in the eyes of politicians, regardless of party.

[1] The Sahm Recession Indicator, named for economist Claudia Sahm, signals a recession when the three-month moving average of the national unemployment rate rises 0.50 percentage points (or more) relative to the minimum of the previous 12 months' three-month averages.

Despite the softening in the labor market, we are less concerned about the risk of recession. We know the Fed and other central banks have a lot of tools at their disposal to reinvigorate growth.

Strategy implications

The *IQ* group was overwhelmingly biased toward ideas that would benefit from proactive central bank easing. Carry-oriented ideas and yield curve steepeners dominated our best ideas. High yield, especially CCC rated credits, were a favorite, as were bank loans, convertible bonds and additional tier 1 (AT1) securities. Stable and still relatively high margins, and the potential for renewed top line growth, should be very supportive to corporate credit.

Given the record high in money market fund assets, they also gravitated to a market that has gone largely unnoticed over the last couple of years: emerging market debt. There was a belief that money would search not only for yield but also markets that had lagged or been left behind. Local emerging market debt, emerging market currencies and emerging market corporates all received considerable support from the group. High real yields, an overvalued USD and stable economies make the asset class compelling. Securitized credit also remains a staple in our portfolios. Consumer loan performance looks fine and Fed rate cuts will be a nice tailwind to the consumer.

Closing thoughts

Until the week before the Federal Open Market Committee meeting, we didn't think we would see a 50bps rate cut. But here we are, and now all those with cash on the sidelines will face major FOMO (fear of missing out). Historically, once the Fed starts cutting, cash is liquidated in earnest and flows into all markets ... but mostly into fixed income. We still see plenty of value across a lot of markets, so **Anything But Cash** is our mantra into the elections and year-end.

	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	20%	60%	15%	5%
Change from last quarter	+5%	-10%	+5%	Unchanged
Drivers	Economic resilience is supported by strong corporate fundamentals, continued investment in infrastructure Proactive monetary policy support allows housing market to reaccelerate and labor market deterioration to reverse	Cumulative and lagged effects of central bank tightening continue to slow inflation while growth remains resilient Strong private sector and municipal balance sheets extend the economic expansion Labor market cooling remains gradual, layoffs remain low	Job creation stalls, the unemployment rate rises further, and consumer spending slows Cumulative and lagged effects of monetary tightening hit the economy, leading to wider credit spreads	Financial market instability stems from lagged impacts of policy and a liquidity crunch as quantitative tightening continues U.S. elections result in elevated political uncertainty
Monetary and fiscal environment	Central banks promote accommodative financial conditions and stimulus from fiscal policy lingers. However, central banks do not ultimately have to deliver as much easing as currently priced	Central banks continue to show willingness to be forward-looking and cut rates proactively	Fed policy shifts from recalibration to emergency easing, resulting in lower government bond yields as the market prices a terminal rate well below neutral	Central banks are likely to remain pro-active and swift in providing support, but insufficient to forestall a systemic impact
Market and positioning	Risk assets—especially high yield, lower-rated investment grade credit and lower quality emerging market (EM) debt—outperform	Corporates and securitized outperform, especially interest rate-sensitive sectors Local EM rates outperform Curve steepens modestly	Government curves steepen aggressively High quality core fixed income—agency MBS, developed market government bonds and high-quality securitized credit—outperform	U.S. rates fall sharply Reserve currencies and cash outperform

Source: GFICC Investment Quarterly; as of September 19, 2024. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections and other forward statements, actual events, results or performance may differ materially from those reflected or contemplated.

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