Global Fixed Income Views

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

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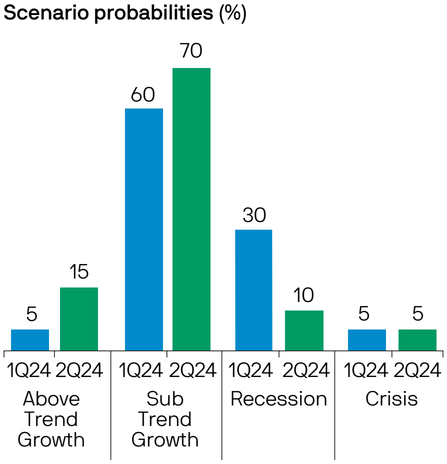
In brief

- With evidence of a soft landing all around us, and amid a widening economic expansion, Sub Trend Growth is our base case and grows more entrenched with a 70% probability.
- We raised the probability of Above Trend Growth to 15% from 5%, appreciating that significantly looser financial conditions are supportive of growth.
- Our Recession expectation declines to 10% from 30%; we leave the likelihood of Crisis unchanged at 5%.
- The biggest risk is persistent inflation prompting further central bank rate hikes. Election-related volatility could also pick up this summer.
- Credit has become the dominant focus of our risk budget. Our preferences include high yield bonds, leveraged loans, hybrid bank and industrial debt and intermediate investment grade corporates. We also see improved outlooks for some emerging market sovereign and corporate bonds.

Our March *Investment Quarterly (IQ)* was held in New York the day after Federal Reserve (Fed) Chair Jay Powell continued to surprise the market (as he did in December) with a dovish message. We believe that this is a Fed chair looking for the opportunity to cut rates and willing to look past resilient growth and sticky inflation. While it is true that there were some signs that the labor market continued to rebalance and that longer-term disinflationary trends were still in place, the fact that core inflation rates continued to hover above the 2% target, coupled with low unemployment, suggested that any easing of policy in the near term would be premature. While the market continues to price in three rate cuts this year, the market was initially braced for a more hawkish tone.

Scenario probabilities (%)



Source: J.P. Morgan Asset Management.
Views are as of March 21, 2024.

They did it

The *IQ* group did its best to challenge the soft-landing narrative but saw only further evidence of it practically everywhere we looked. To their credit, **the Fed did it. They engineered the aspirational soft-landing ... at least for now.** The challenge became where to find value across markets. Government bond yields had already priced in a considerable amount of rate cuts and credit spreads had narrowed to the tighter end of their historical ranges. While bond market returns and alpha have generally been good so far this year, it would be tricky to find ways to maintain that momentum over the balance of 2024.

Macro backdrop

This is not to say the economy has all smooth sailing ahead. Despite 27 consecutive months with unemployment at or below 4%, the group did appreciate the number of signals that the labor market was indeed moderating. The quits rate tracked by the U.S. Department of Labor's Job Openings and Labor Turnover Survey (JOLTS) has fallen to a post-pandemic low, and according to the National Federation of Independent Businesses, hiring plans have fallen below pre-pandemic levels. The Beveridge curve shows that job openings have plummeted as labor supply (immigration and participation) has risen but a higher unemployment rate could be just around the corner. More slack in the labor market will help to contain inflation, but too much slack raises the probability of recession. Unemployment rates and wage gains will certainly be a Fed focus over the coming quarters.

For now, those concerns are being outweighed by a widening economic expansion. Strong private sector balance sheets, a rebound of real incomes in Europe and Chinese stimulus have helped to sustain growth. As businesses and households continue to absorb the global rate shock, we expect consumption in travel and leisure to remain firm, home sales to pick up and manufacturing to bounce.

The last couple years are a reminder that significant central bank tightening does not automatically lead to recession. It does however create a frailty across the markets and economy that leaves them vulnerable to shocks. A couple shocks have occurred over the last two years but the policy response has been swift, sizeable and effective. After eight months at the peak policy rate, the ongoing moderation in growth and inflation should allow the Fed to cut rates around the middle of the year.

Scenario expectations

Sub Trend Growth/Soft Landing (which we raised from 60% to **70%**) became more entrenched as our base case. Almost all economic data is pointing to the global economy closing in on trend growth and 2% inflation, and the willingness of G10 central banks to start cutting rates by the summer is reminiscent of the 1995 soft landing experience. Trend growth of around 2% and near target inflation appear inevitable in the U.S.

We raised **Above Trend Growth** to **15%** from 5%. We have to appreciate that the significant loosening of financial conditions has become supportive of growth. As corporate profits firm and a fully employed consumer keeps spending, any additional impulse coming out of China or from a resurgence in housing or manufacturing will push growth above its trend line and inflation well above 2%.

The downside probability has an equal weight to the 15% upside one. We lowered **Recession** to **10%** from 30% and left **Crisis** unchanged at **5%**. A delay in central bank rate cuts may allow the long and variable lags of the tightening cycle to ultimately catch up with the economy and tip it into recession. Higher funding costs are still putting downward pressure on the system making it more vulnerable to shocks.

Risk

Persistent inflation that leads to further central bank rate hikes is the biggest risk. In that case, financial conditions would tighten and asset prices would crumble. Market participants are dismissing the recent set of higher than expected inflation prints for now but if inflation proves to be stickier and reinvigorates fears of a wage-price spiral, the central banks would have no choice but to respond aggressively.

The U.S. general election looms large at the end of the year. It's too early to tell whether Congress will be split or what policies may come out of each candidate's administration but market volatility is sure to pick up over the summer.

Lastly, we are watching the Fed's balance sheet. A drop in reserves and the continued drain of the Fed's Overnight Reverse Repo (RRP) Facility could be a headwind to risk assets. We have noticed a relationship between reserves held at the Fed and asset prices more broadly.

Strategy implications

As the group has embraced the soft landing, credit has become the dominant focus of our risk budget. We noted that although credit spreads were toward the narrower end of their historical ranges, they could still tighten further and stay there for years. During 2004–2007, investment grade corporates traded in a range of 80–100 basis points (bps) over comparable Treasuries. U.S. high yield traded at either side of 300 bps, with the narrowest spread below 250 bps.

Further, the growth of the private credit markets seems to have created a buffer to the public credit markets. Many marginal borrowers are flocking to private credit, leaving the public markets "cleaner" than in the past.

Among our favorite ideas were high yield bonds, leveraged loans, hybrid bank and industrial debt and intermediate investment grade corporates that would favorably roll down an eventually steeper yield curve.

Emerging markets were also popular as disinflation and central bank easing is well underway in these regions. Although China still looks to be struggling, we expect ratings upgrades are coming to a number of sovereigns (Turkey, Indonesia and Costa Rica—just to name a few), and see tailwinds for larger economies including India and Mexico, as well. Corporate balance sheets look strong across most of the emerging markets and provide a crossover opportunity to developed market credit.

As for interest rate exposure, we're buyers of back-ups in yields and will keep a slight tilt toward longer duration with a bias toward steepeners as a hedge against tail risks. But a lot of the expected central bank rate cuts appear to be priced into markets.

Closing thoughts

An economic soft landing with rate cuts on the horizon are excellent ingredients for rallies in asset prices. While some of the appreciation has occurred, cash has built up in money market funds, suggesting that the rally can go considerably further once the Fed begins to cut rates. Soft landings are incredibly difficult for central banks to engineer, but for now, **they did it** and the markets will continue to be a major beneficiary.

	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	15%	70%	10%	5%
Change from last quarter	+10%	+10%	-20%	Unchanged
Drivers	The U.S. housing market reaccelerates on pent-up demand Aggressive pre-emptive central bank rate cuts lower borrowing costs, ease financial conditions and fuel growth	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 Ample liquidity, higher labor supply 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	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 high-quality securitized credit—outperform	U.S. rates fall sharply Reserve currencies and cash outperform

Source: J.P. Morgan Asset Management. Views are as of March 21, 2024. MBS: mortgage-backed securities.

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