Global Fixed Income Views

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

3Q 2020

AUTHOR

Bob Michele
Global Head of Fixed Income, Currency & Commodities and co-head of the Asset Management Investment Committee

IN BRIEF

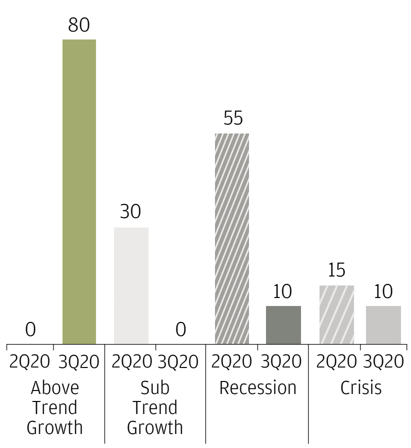
- After a historic quarter of global pandemic, economic shutdowns, ballooning government fiscal support and breathtaking central bank lending, Above Trend Growth has become our base case at 80% probability; we believe GDP bottomed in Q2.
- We expect current policy responses to spark U.S. double-digit GDP growth in 2H20 and 3%–5% growth in 2021; we expect a robust bounce back in Europe and the emerging markets and for central banks to keep rates at their lower bound for years.
- We cut the probability of Crisis from 15% to 10% and recession from 55% to 10%; any weakness should be met with additional policy response in an election year, however we forecast double-digit U.S. unemployment into 2021.
- We are diversifying our up-in-quality bias and extending further out the credit spectrum, and rotating into certain sectors, including bank capital (additional tier 1 and preferred securities). We continue to like high quality securitized credit, and our interest is returning to emerging market local and external debt.

RETURN OF THE ZOMBIE

I could scarcely believe what I was seeing. When we last held our *Investment Quarterly (IQ),* on March 11, the 10-year U.S. Treasury was yielding 0.82%. Then at our June 10 *IQ,* the 10-year was still yielding 0.82%—as though nothing had happened for three months. In fact, a historic period had passed. In reaction to the pandemic, the first response was for politicians globally to shut down their economies. As the economic damage became evident, the next policy response was a coordinated effort by governments to fill the hole of lost income with fiscal assistance. Central banks helped to underwrite this ballooning debt burden with a breathtaking array of lender-of-last-resort policies. As the global economy staggered through the shutdown, markets quickly recovered half or more of their sell-offs.

Such was the backdrop for our most recent *IQ,* held virtually from our home offices. Questions we knew we would have to answer concerned the expected shape of the recovery and whether asset prices could—or should—be supported by the combination of economic fundamentals and evolving policy responses. Most importantly for us was this: Had the central banks created a bond market without volatility—effectively, a zombie bond market?

SCENARIO PROBABILITIES (%)



Source: J.P. Morgan Asset Management.
Views are as of June 10, 2020.

MACRO BACKDROP

We estimate that USD 17.1 trillion in global policy response has been committed (not yet all spent): USD 6.2 trillion in quantitative ease, USD 3.5 trillion in direct fiscal stimulus (grants) and USD 7.4 trillion in indirect fiscal stimulus (loans). What impressed the *IQ* participants was that these policy responses were created and deployed in a matter of weeks, whereas the entirety of the global financial crisis policy response took years to deploy and was about one-third the size. Nonetheless, we could not bring ourselves to believe in a V-shaped recovery. While annualizing quarterly GDP might look V-shaped, we believe GDP should be viewed relative to its long-term potential. We estimate it could take as long as 10 years in the U.S. to again reach this potential.

A tremendous amount of damage has been done globally. Many parts of the economy will need to rethink their business models, including anything that involves large gatherings of people. Sporting events will proceed without fans, businesses will return to offices with only a fraction of their staffs and the knock-on effect on businesses that are reliant on a full reopening will be severe. We expect a persistent social distancing drag, and considerable scarring, from the sudden stop in activity.

Certainly, the future of fiscal stimulus will be important in determining the recovery's path. We are concerned about approaching fiscal cliffs in the U.S. as support packages lapse. We are eyeing whether a new round of layoffs could ensue if business owners need to resize their workforces for diminished consumer activity. And what if reinfection rates start to rise and a vaccine and/or treatment are still far off?

This is no time for policymakers to rest on their laurels. They must agree to the next round of fiscal support, and the central banks need to be committed to maintaining enormous levels of accommodation. There are encouraging signs in both the U.S. and Europe as Congress looks to another CARES package and Europe launches its Recovery Fund … while both the Federal Reserve and European Central Bank point to years of ultra-low rates and large-scale asset purchases.

SCENARIO EXPECTATIONS

Above Trend Growth has become our base case, rising to **80%** probability from 0%. The bottom in GDP appears to be this quarter's, with the U.S. expected to register below -30% annualized growth. But the current policy responses should lead to double-digit GDP growth in the 2H20 and 3%–5% growth in 2021. We also expect Europe and the emerging markets, led by China, to ride their policy responses to a robust GDP bounce back. Yet it will still take years for the output gap to be closed and for a return to full employment. We forecast double-digit unemployment in the U.S. into 2021.

We lowered the probability of **Crisis** from 15% to **10%**. It's less likely, but not impossible, that another shock could hit the system as the frail recovery is underway, but the odds of any shock overwhelming the current and future policy responses are remote.

We dropped the probability of **Recession** from 55% to **10%**. The global economy is emerging from recession now and is not likely to double-dip. We also consider it very unlikely that Congress would leave the U.S. consumer in limbo during an election year; any risk of recession should be immediately met with fiscal stimulus.

Sub Trend Growth has dropped from 30% to **0%**. The willingness and ability of policymakers to deploy monetary and fiscal stimulus means an all-or-none economy. Muddling along just isn't realistic.

RISKS

While all seem to be committed to the long road to recovery ahead, we do see three potential risks:

1) **COVID-19.** A second wave of infections may cause a return to shutdowns, or governments may turn to deficit reduction rather than focus on an adequate health care response.
2) **The U.S. general election.** This may boil down to Donald Trump and a return to tariffs or Joe Biden and increases in regulation and taxes. Either would be difficult for markets to deal with.
3) **U.S.-China relations.** There is a lot to worry about. Both are so critical to the health of the global economy. Another trade war, or the U.S. looking to decrease its dependence on foreign suppliers, are ongoing concerns. The bigger concern would be a Cold War reminiscent of that between the U.S. and the Soviet Union.

STRATEGY IMPLICATIONS

Our probable recovery path suggests central banks at their lower bound for years, little inflationary pressure and bond yields in another lower-for-longer environment. Against this steady backdrop, we are diversifying our up-in-quality bias and extending further out on the credit spectrum. This means handing off our government bonds to the central banks to hold and rotating from liquid, investment grade (IG) corporate names to specific sectors like bank capital—both additional tier 1 (AT1) and preferred securities. We also continue to like the securitized credit market. Short, amortizing, high quality consumer loan securitizations have the credit enhancement and structuring to withstand a slow recovery. Finally, our interest is returning to the emerging markets. Local sovereign debt and FX have plenty of room yet to rally, and the external debt market offers value through sub-Saharan Africa.

CLOSING THOUGHTS

We believe we are seeing the deepest and shortest recession that anyone has experienced. Lawmakers' willingness to work with central bankers to engineer a recovery is, perhaps, something that could only be born out of crisis. It could very well mean that central banks are implicitly fixing the rate of funding for all levels of government, businesses and households. While I don't relish the thought of zombie bond markets, the global financial crisis taught us that there will be occasional bouts of market volatility on the way to normal. But this is not the time to fight the aggregate might of joint fiscal and monetary stimulus.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 3Q20

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 >3.5% 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	80%	0%	10%	10%
Change from last quarter	+80 percentage points (ppt)	-30 ppt	-45 ppt	-5 ppt
Drivers	• Economies continue to reopen, economic activity rises, and unemployment falls • Governments avoid further shutdowns, widespread quarantines, as they address COVID-19 crisis • Corporate credit supply continues to be robust	• Moderate rebound in global growth as businesses resume operations at lower levels of activity	• Economic activity remains depressed: – Social distancing, fear of pandemic second wave create drag – High unemployment and uncertainty cause consumers to save rather than spend – Businesses remain challenged at lower levels of activity • Geopolitical risks weigh on economy: – Further U.S.-China trade tensions – November U.S. presidential election creates policy uncertainty	• Resurgence of COVID-19 infections causes second wave of shutdowns and/or another exogenous shock impacts markets during frail recovery • 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
Monetary and fiscal environment	• Policy actions backstop risk assets: – Additional fiscal assistance continues to support businesses and consumers – Central banks continue with asset purchases, keeping interest rates low	• Less appetite for fiscal assistance as economy and markets rebound and deficit concerns grow • Global central banks remain accommodative, keep rates unchanged near lower bounds	• Central banks, having decreased policy rates to their lower bound, pass baton to fiscal • Fiscal policy responds, but not enough to create expansion	• Inadequate fiscal and monetary response fails to restore investor confidence – Central banks pass the baton – Concerns over deficit spending and/or political gridlock mute fiscal response
Market and positioning	• IG corporate credit (bank capital–AT1 and preferred) • Short, amortizing, high quality securitized credit • Emerging market debt	• IG corporate credit (bank capital–AT1 and preferred) • Agency mortgages • Short, amortizing, high quality securitized credit	• Developed market (DM) government bonds • Agency mortgages • Short, amortizing, high quality securitized credit	• DM government bonds • Favor reserve currencies–JPY and USD

Source: J.P. Morgan Asset Management. Views are as of June 10, 2020.

Opinions, estimates, forecasts, projections and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

BUILD STRONGER FIXED INCOME PORTFOLIOS WITH J.P. MORGAN

We have built and evolved our fixed income capabilities with just one aim: to build stronger portfolios that solve our clients' needs. Today we are one of the top fixed income managers in the world.

Diverse perspectives, integrated solutions:

- Access the power of a globally integrated team of investment professionals and our **proprietary research**, encompassing fundamental, quantitative and technical analysis.
- Benefit from **actionable insights** designed to help you invest with conviction, from our regular macro and market views to our fixed income portfolio construction tools.
- Choose from a wide variety of **outcome-oriented** solutions designed to address all your fixed income needs.
- Tap into the **proven success** of one of the world's largest fixed income managers, with broad experience gained across regions and market cycles.

NEXT STEPS

For more information, contact your J.P. Morgan representative.

PI-GFIV_3Q20 | 0903c02a81d2d0a6