

Global Fixed Income Views

Themes and implications from the Global Fixed Income, Currency & Commodities *Investment Quarterly* 4Q 2020

AUTHOR



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

IN BRIEF

- Above Trend Growth remains our base case despite the many challenges ahead; we reduced its probability to 60% from 80%.
- We increased the likelihood of Sub Trend Growth to 20% from 0%, as uncertainties surround the provision of additional fiscal stimulus, not only in the U.S. but in Brussels, Tokyo and Beijing. We left the probability of both Recession and Crisis at 10%.
- Key risks are two big unknowns: the timing of a vaccine’s approval, manufacture and distribution and the outcome of the U.S. general elections.
- Higher beta U.S. corporates top our list; higher yielding municipal bonds also look attractive, and we find value in certain local emerging market debt and currencies.

HISTORIC STIMULUS ... NOW WHAT?

The setting for our September *Investment Quarterly (IQ)* was one to which we all are getting accustomed: virtual, with most participants Zooming from home and a few from a rather empty office building in a rather empty midtown Manhattan. Since the last *IQ*, in June, both the economy and markets have been very kind to us. The safety net of monetary and fiscal policies rolled out globally was effective, stabilizing the global economy and lifting asset prices.

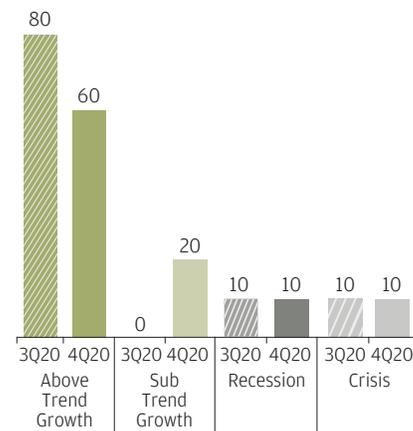
While this also lifted everyone’s spirits, the *IQ* participants recognized many challenges ahead. Fiscal support in the U.S. had largely expired at the end of July, the U.S. was headed into an election, and the timing of an effective COVID-19 vaccine was difficult to pin down. Overwhelmingly clear to us was that global monetary policy remained unprecedented in its stimulus. Arguably, the aggregate global availability and cost of money have never been easier or cheaper in the history of Earth.

MACRO BACKDROP

During the third quarter, global activity staged a strong but bifurcated recovery, largely due to unprecedented monetary and fiscal stimulus. While there has been some recovery in manufacturing, especially in China, and in retail sales, weakness remains in sectors constrained by social distancing, such as travel and leisure. Within the U.S., states and municipalities are gradually lifting lockdowns and there is some momentum to start the long journey back to normal. Clearly, consumers are consuming and availing themselves of the available fiscal support. It remains to be seen whether this is sustainable, given the slow reopening process and the lapse in fiscal support in the U.S.

Inflation was the focus of discussion for this *IQ*, as the Federal Reserve had recently released its new flexible average inflation targeting policy at Jackson Hole. While our group has largely believed that reaching sustained 2% inflation is quite aspirational for central banks, which have been trying to do so for the last 11 years, we also appreciated some of the impulses that could lead to a rise in inflation over the next 12 months. Globally, the volume of central bank accommodation should provide the

SCENARIO PROBABILITIES (%)



Source: J.P. Morgan Asset Management. Views are as of September 15, 2020.

backdrop for higher inflation, this time with a steady dose of fiscal stimulus driving a surge in money growth. Add the supply shock resulting from shutdowns, even as consumers continue to spend, and the ingredients for higher prices are there. In addition, many businesses are rethinking their supply chains and some market participants think that could lead to deglobalization—which would raise manufacturing costs. Finally, we looked at the handful of companies that have benefited from the stay-at-home environment. We wonder whether all that online purchasing has squeezed out the Main Street shop and allowed online retailers to begin raising prices.

Nonetheless, our bias is still to expect low inflation over the intermediate and longer term. The negative demand shock as fiscal support expires is starting to show up in data. Learning to live with COVID-19 while waiting for a vaccine means a less dynamic environment. And the trillions of dollars in debt being issued to fund a recovery will present long-term headwinds, as repaying it will likely absorb a lot of future economic output.

The two issues that will likely most impact the economy going forward are the most difficult to analyze. First is the timing and distribution of an effective vaccine. While expectations are high for a vaccine approval around year-end, how quickly it can be manufactured and distributed will directly impact the speed at which the economy may return to normal. The second is the U.S. elections. What Congress will look like and the next administration's ability to effect policy change are unknowns.

What is not in question is the support of the central banks, and that is what we felt we should focus on when looking at bond markets.

SCENARIO EXPECTATIONS

Above Trend Growth remains our base case but has been reduced to a **60%** probability from 80%. Macro policy remains broadly supportive of economic growth, but central banks have largely reached the limit on what they can realistically do from here. As reopenings accelerate globally, more economies will join China in beginning to close the output gap.

We have increased the likelihood of **Sub Trend Growth** to **20%** from 0%. While the intent of all policy is to generate a meaningful economic restart, the political uncertainties around additional fiscal stimulus have grown. At some point, economies will need to operate without fiscal transfers. The growing debt burden resulting from fiscal support is effectively mortgaging the future. Creating a longer but affordable bridge to the other side of the pandemic will be an ongoing challenge for Brussels, Washington, Tokyo and Beijing. If monetary policy becomes the only source of further support, muddling along is a realistic scenario.

Recession and **Crisis** remain at a **10%** probability each. The downside to an engineered recovery has not disappeared. Any policy misstep or resurgence in the virus could trigger a contraction. However, the odds are low, since such a downturn would likely trigger further fiscal and monetary responses.

RISKS

The U.S. general election is a looming risk. A Biden victory would likely lead to more regulation and, depending on the composition of Congress, could lead to higher taxes. A Trump victory might trigger more tariffs and more confrontation with China. The development of a vaccine is also a significant risk. A delay in finding and distributing an effective vaccine would likely delay a return to normal. Yet, conversely, an effective vaccine that is quickly distributed would trigger a strong tailwind to growth that might cause central banks to reconsider the amount of accommodation they are providing.

STRATEGY IMPLICATIONS

Our base case scenario looks for a continuing economic recovery supported by both policy and the potential for a vaccine. The broadly supportive environment encourages us to continue to maintain risk while adding to it selectively.

Higher beta U.S. corporates top our list. Most companies have taken steps to improve their liquidity and maturity profiles. While leverage has risen, record low interest rates have made that debt affordable.

Higher yielding (BBB rated) municipal bonds also look attractive. A Democratic sweep in the general election might lead to badly needed funding for state and local governments.

Finally, we like local emerging market (EM) debt and currencies. Yields remain high, and EM central banks have embarked on programs of rate reductions and large-scale asset purchases. Additionally, the USD's yield advantage and exceptionalism have faded, providing a tailwind to EM currencies.

CLOSING THOUGHTS

The beta trade of the last six months has come and gone. The markets convulsed and then rebounded as policy responses exceeded expectations. Now is the challenging time in markets to do the research and find opportunities that are undervalued on a relative basis. The key is not to get too greedy and accept that returns in fixed income are likely to equal the yield of the market one is investing in, plus a bit in capital appreciation as yields drift lower. When we meet again in mid-December, the market landscape will surely have changed in the wake of the elections and progress on a vaccine.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 4Q20

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%-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	60%	20%	10%	10%
Change from last quarter	-20 percentage points (ppt)	+20 ppt	Unchanged	Unchanged
Drivers	<ul style="list-style-type: none"> Economies continue growth recovery, reopening, increasing economic activity and lowering unemployment Governments avoid further shutdowns and widespread quarantines in addressing COVID-19 crisis, potentially helped by a vaccine 	<ul style="list-style-type: none"> Moderate global growth rebounds as businesses resume operations at lower activity levels Less appetite for fiscal assistance as economy and markets rebound and deficit concerns grow 	<ul style="list-style-type: none"> Resurgence of COVID-19 infections causes second wave of shutdowns and/or rising trade tensions, or another exogenous shock disrupts recovery and roils markets 	<ul style="list-style-type: none"> Economic activity remains depressed: <ul style="list-style-type: none"> – Second wave of infections creates drag – Consumption falls amid higher unemployment and uncertainty – Businesses continue to be challenged at lower activity levels
Monetary and fiscal environment	<ul style="list-style-type: none"> Policy actions serve as a backstop for risk assets: <ul style="list-style-type: none"> – Additional fiscal assistance continues to support businesses and consumers – Central banks continue asset purchases, keeping interest rates low – Robust corporate credit supply continues 	<ul style="list-style-type: none"> Global central banks remain accommodative, keeping rates unchanged near lower bounds Corporates continue balance sheet repair and defense 	<ul style="list-style-type: none"> Inadequate fiscal and monetary response fails to restore investor confidence 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 	<ul style="list-style-type: none"> Geopolitical risks: <ul style="list-style-type: none"> – U.S.-China trade tensions rise – U.S. elections create policy uncertainty Central banks, with policy rates at lower bound, pass baton to fiscal policy Fiscal policy response insufficient to create expansion
Market and positioning	<ul style="list-style-type: none"> Higher beta investment grade (IG) corporate credit High yield municipal debt Emerging market local currency debt and FX 	<ul style="list-style-type: none"> IG corporate credit Agency mortgages 	<ul style="list-style-type: none"> 30-year Treasuries Favor reserve currencies: JPY, USD 	<ul style="list-style-type: none"> Developed market government bonds

Source: J.P. Morgan Asset Management. Views are as of September 15, 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.

For the purposes of MiFID II, the JPM Market Insights and Portfolio Insights programs are marketing communications and are not in scope for any MiFID II / MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programs, as non-independent research, have not been prepared in accordance with legal requirements designed to promote the independence of investment research, nor are they subject to any prohibition on dealing ahead of the dissemination of investment research.

This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be taken as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit, and accounting implications and determine, together with their own financial professionals, if any investment mentioned herein is believed to be appropriate to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yields are not reliable indicators of current and future results.

J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide.

To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our privacy policies at <https://am.jpmorgan.com/global/privacy>.

This communication is issued by the following entities:

In the United States, by J.P. Morgan Investment Management Inc. or J.P. Morgan Alternative Asset Management, Inc., both regulated by the Securities and Exchange Commission; in Latin America, for intended recipients' use only, by local J.P. Morgan entities, as the case may be.; in Canada, for institutional clients' use only, by JPMorgan Asset Management (Canada) Inc., which is a registered Portfolio Manager and Exempt Market Dealer in all Canadian provinces and territories except the Yukon and is also registered as an Investment Fund Manager in British Columbia, Ontario, Quebec and Newfoundland and Labrador. In the United Kingdom, by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions, by JPMorgan Asset Management (Europe) S.à r.l. In Asia Pacific ("APAC"), by the following issuing entities and in the respective jurisdictions in which they are primarily regulated: JPMorgan Asset Management (Asia Pacific) Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited, each of which is regulated by the Securities and Futures Commission of Hong Kong; JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601586K), which this advertisement or publication has not been reviewed by the Monetary Authority of Singapore; JPMorgan Asset Management (Taiwan) Limited; JPMorgan Asset Management (Japan) Limited, which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Australia, to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Commonwealth), by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919). For all other markets in APAC, to intended recipients only.

For U.S. only: If you are a person with a disability and need additional support in viewing the material, please call us at 1-800-343-1113 for assistance.

Copyright 2020 JPMorgan Chase & Co. All rights reserved.

PI-GFIV_4Q20 | 0903c02a81d2d0a6