Global Fixed Income Views

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

2Q 2021

AUTHOR

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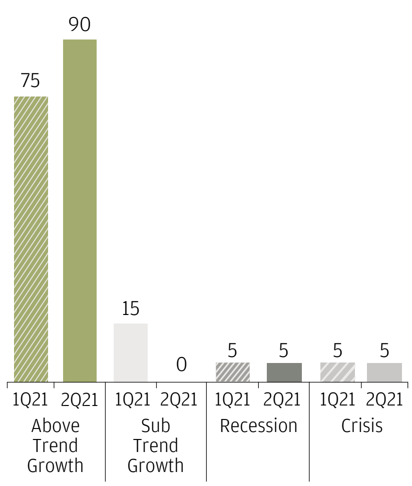
IN BRIEF

- Above Trend Growth remains our base case, raised to 90%, with monetary and fiscal stimulus in the pipeline, vaccinations accelerating and our 2021 U.S. real GDP forecast raised to a 38-year high. We cut the probability of Sub Trend Growth to zero and left at 5% the probabilities of Recession (in the event that virus variants slow reopening) and Crisis (due to financial panic).
- We believe central banks will keep their word and not raise rates until around the end of 2023, and expect the Federal Reserve to control the normalization of 10-year Treasury yields toward 0% real yield; we also think bond investors would accept a rise to around 2% without fleeing the asset class if the rise stretches out over the next few quarters.
- Regarding inflation risk, we expect prices to rise more than 2% year-over-year—potentially higher, depending on consumer spending and a U.S. infrastructure spending bill—but think the structural factors that have dampened inflation for years remain.
- High yield bonds and leveraged loans top our picks for returns; our other best ideas are European bank capital notes, securitized credit, pro-cyclical currencies and emerging market sovereign debt.

SCENARIO PROBABILITIES (%)



Source: J.P. Morgan Asset Management.
Views are as of March 10, 2021.

ECONOMIC AND MARKET PEDs (PERFORMANCE-ENHANCING DRUGS)

Is it possible? Could there really be a global economic environment with no downside risk? And if so, did it take a global pandemic to achieve this? These were a few of the questions we looked to answer during our March *Investment Quarterly (IQ)*. As the U.S. accelerates toward a full-blown reopening, the pandemic has elevated Modern Monetary Theory (MMT) to the generally accepted policy response, whereby fiscal authorities borrow and spend while monetary authorities print money and purchase the debt. As governments wrestle with domestic virus containment, fiscal relief and vaccinations, cross-border trade conflicts are largely absent. It appears that layers and layers of safety nets are in place to ensure recovery only advances. But zero probability of any downside? We debated this in earnest.

Throughout the day, we were reminded that our role is not to predict the direction of the economy but rather that of the fixed income and currency markets. A considerable amount of good economic news is already priced into the markets, so our mission was to roll up our sleeves, dig through the markets and find reasonable value. Inflation trends, central banks' reaction functions and historical comparisons were among the many topics we waded through. We found that the opportunities are more nuanced than last quarter, but they are still there.

MACRO BACKDROP

January 5 was the key date for the *IQ*. That was the day the Georgia runoff elections awarded the Democratic Party a slim majority in the Senate and, hence, a tenuously unified government. Suddenly, potential obstructions—congressional gridlock, no additional fiscal stimulus and a slow recovery—were in the rearview mirror. With the central banks enabling MMT, the Democratic-led government (armed with two budget reconciliation processes in 2021) was set to become the Fed's primary customer. On the heels of a USD 900 billion stimulus package passed at year-end, President Joe Biden has signed a USD 1.9 trillion stimulus bill into law, and there is already talk of the next one, centered on infrastructure spending, before 2021 is through.

Consequently, we have raised our full-year 2021 U.S. real GDP forecast to just over 7%, which, if achieved, would bring the pace of economic growth amazingly close to the high of 7.9% reached in 1983. It's possible that an acceleration in global vaccinations and an early agreement on a U.S. infrastructure spending bill could push 2021 U.S. GDP over 8%—there are already a number of 8% forecasts in the market. A key uncertainty is how much of their vast pool of excess savings consumers will spend. We estimate that consumers spending 20% of the accumulated excess savings would translate to a further 2% boost to GDP growth. Such is the impact of a consumer-led economy.

Once again, much of our discussion centered on inflation. Before we meet again in June, the impact of low base effects will have created year-over-year inflation data well in excess of 2%. Stronger reopening growth, a weaker dollar and higher commodity prices have also boosted the inflation outlook. The growth handoff from goods to services should become visible in inflation, with some services' prices mirroring the pandemic surge in goods prices. Federal Reserve (Fed) Chair Jerome Powell is saying the Fed expects brisk spending as the economy reopens, which will lead to higher inflation. He acknowledges that market participants will be watching to see how the Fed reacts. For now, he says, the Fed will be patient. Maybe.

Our base case remains that the structural factors that have held inflation down for years have not gone away. They include low and sticky inflation expectations, flat Phillips curves, demographics and technology. We believe that it would take persistent fiscal easing to shift inflation onto a materially higher path. Consequently, we expect the major central banks to stay true to their word and keep policy accommodative for the foreseeable future … essentially, weathering the short-term inflation storm. The Fed will likely begin tapering its large-scale asset purchases at the start of 2022 and begin to raise rates toward the end of 2023.

SCENARIO EXPECTATIONS

Above Trend Growth remains our base case and was raised from 75% to 90%. Frankly, an excess of caution was the only thing that kept us from going to 100%. (With so much monetary and fiscal stimulus in the pipeline as vaccinations are accelerating, we gave some thought to creating an Above Above Trend Growth category.) The concern is that in running an economy hot, the potential exists for a more severe inflationary environment than anticipated. Instead, we incorporated stagflationary risks into our crisis scenario.

Sub Trend Growth was reduced from 15% to 0%. It is simply not realistic for the economy to settle into a 0%–1.5% range given policymakers' commitment to generate a full recovery with steady 2% inflation.

Recession and **Crisis** both remain 5% probabilities. The only known unknown is whether a variant of the virus triggers a meaningful setback to the reopening.

RISKS

Inflation has moved to the front of the queue of potential risks. Milton Friedman famously said that "inflation is always and everywhere a monetary phenomenon." Well, we certainly have an overabundance of money. Further, this crisis features MMT as the appropriate policy response, whereas the global financial crisis (GFC) response focused on austerity. The torrent of fiscal stimulus and its various multiplier impacts have yet to be fully understood. The demographic trend has also moved on. The peak population cohort in the U.S. is 1991 births; they were 17 years old at the onset of the GFC. Today, they are 30 years old and about to become the dominant earners, spenders and savers. Lastly, commodity prices are rising ominously.

The inflation risk is not of a short-term spike that the central banks manage through. The risk is that persistently rising inflation becomes a great challenge for the central banks and the Fed's long-term federal funds policy rate projection, the dot plot, has to migrate from 2.5% to 4%-plus. The markets are simply not prepared for monetary tightening of that magnitude.

STRATEGY IMPLICATIONS

We expect the Fed to control the normalization of 10-year U.S. Treasury yields toward a 0% real yield. A range of 1.875%–2.125% would be palatable to bond investors if stretched out over the next few quarters. For now, yields should consolidate the recent rise as overseas money comes into the U.S. market.

High yield bonds and leveraged loans were our top picks for returns. We noted that credit spreads don't tend to widen when default rates are declining, and we expect default rates to halve from current levels.

Other best ideas included European bank capital notes, securitized credit, pro-cyclical currencies and higher yielding sovereign emerging market debt (EMD).

Notably absent were local EMD and emerging market currencies (EMFX). While the group still generally likes local EMD and EMFX, we felt that the opportunity was dependent on evidence that a strong recovery in the U.S. was bringing along the emerging economies levered to U.S. growth.

CLOSING THOUGHTS

Jeopardy! category: Finance for $1,000. Answer: MMT. Question: During the pandemic crisis, what was the economic and financial market equivalent to the banned performance-enhancing drugs used by some athletes and bodybuilders?

We are living in a policy-juiced world. How it is all resolved, and what the payback will be, are important questions but distant ones. For now, we prefer to enjoy the ride and not fight the reflation trades within our portfolios.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 2Q 2021

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	90%	0%	5%	5%
Change from last quarter	+15ppt	-15ppt	Unchanged	Unchanged
Drivers	• Economic activity continues to grow globally, led by vaccines' rollout, fiscal spending and consumers spending excess savings • Despite the potential for a pickup in inflation, structural headwinds likely keep interest rates and inflation in check	• Issues with vaccines' rollout or a virus variant are absorbed more readily than last year • Corporations continue balance sheet repair	• COVID-19 cases spike globally as vaccine-resistant variants spread • Official lockdown measures and unofficial self-quarantining derail the service sector recovery • Uncertainty causes consumers and businesses to continue to hoard excess savings	• Strong consumer demand and supply-chain disruptions lead to high inflation • International and domestic bond investors dump holdings while central banks are unable to control long-dated interest rates • Volatility and solvency concerns cause risk asset prices to fall • Economic weakness and rising inflation lead to stagflation
Monetary and fiscal environment	• Additional fiscal stimulus and ongoing central bank asset purchases backstop risk assets by supporting businesses, consumers and municipalities • Monetary policy remains accommodative, given a lack of sustained inflation pressure and high government debt burdens	• Fiscal policy response is muted and reactive • Global central banks remain accommodative and keep rates unchanged near their lower bound		
Market and positioning	• Risk assets, especially high yield credit • Remain short duration, as interest rates are expected to continue rising • Avoid negative convexity, such as low coupon agency mortgage-backed securities	• Investment grade bonds, especially BBB rated • Emerging market debt • Asset-backed securities (auto, credit cards, multi-family and other sectors tied to the consumer)	• Developed market government bonds • Low coupon agency mortgages • Short, amortizing, high quality securitized credit	• Short-dated high quality securitized and government bonds • Favor reserve currencies—JPY and USD

Source: J.P. Morgan Asset Management. Global Fixed Income Views are as of March 10, 2021.

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.

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NEXT STEPS

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