Global Fixed Income Views

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

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AUTHOR

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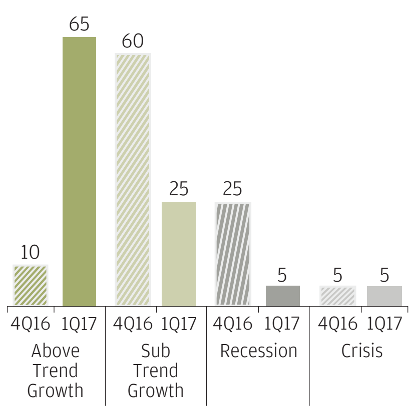
IN BRIEF

- Since the Republican sweep of U.S. elections, expectations for higher growth and inflation have driven bond yields and equity prices to recent highs.
- The change in sentiment portends a new trajectory for corporate investment and growth. The way has been paved for a raft of policy initiatives we expect to be implemented in short order.
- We view the probability of Above Trend Growth as much higher than we did last quarter, supported by meaningful U.S. fiscal stimulus, and tax and regulatory reform; strong growth in two-thirds of the world's economies; and an end to the deflationary effects of lower oil prices.
- Our best ideas for the quarter: U.S. high yield, U.S. leveraged loans and shorter-duration securitized credit.

SCENARIO PROBABILITIES (%)



Source: J.P. Morgan Asset Management.
Views are as of December 2016.

WHAT A DIFFERENCE A DAY MAKES

Since 2010, for all but one quarter, our base case has been that the world's economies were mired in sub-trend growth and inflation. More recently, we expected that the outcome of the U.S. elections would mean more of the same, with gridlock in Washington and little compromise available to change the existing trajectory. A Republican sweep changed all that. Outside of a nanosecond of risk-off market reaction, expectations for higher growth and inflation have driven both bond yields and equity prices to recent highs. Has the potential for growth really changed? Are even higher rates to come? And if so, are there opportunities left in the bond market? These are the questions we asked during our recent IQ (*Investment Quarterly*), held in December in New York.

We think the answer to all three is yes. Two-thirds of the world's economies—including Europe, China, Japan and the U.S.—were already growing above trend before the U.S. elections. Inflation was also ticking up, as the base effects of lower oil prices rolled off. The sustainability of that growth was a question, however, given poor demographics and declining productivity in much of the developed world. Now, with no opposition party in the U.S. government, the way has been paved for meaningful fiscal stimulus and both tax and regulatory reform. The change in sentiment portends a new trajectory for corporate investment and sustainable growth.

During our meeting, we engaged in a healthy debate about the near-term potential for Above Trend Growth, particularly as nothing has actually been enacted yet. Our job, however, is not to determine the exact path of growth, but instead to consider what will be priced in over the next three to six months. And the markets are clearly pricing in expectations of higher growth and higher inflation. Furthermore, we expect a raft of policy initiatives to be implemented in short order, for reasons not the least of which is that Congress will want to go into the mid-term elections in 2018 with a strong tailwind. As a result, we made the largest shift in our probabilities since we began quantifying them six years ago: We raised the probability of Above Trend Growth to 65% from 10%, and we lowered the probability of Sub Trend Growth to 25% from 60%.

We also reduced the probability of Recession (to 5% from 25%) and kept the probability of Crisis unchanged at 5%. Longer term, if stimulus does not lead to productivity growth, we will be faced with a traditional recession. But we believe that the potential for a slowdown has been pushed out for several years. In the near term, the consumer is in good shape; the business cycle is not about to end.

Risks

There are many risks out there, not the least of which are the elections across Europe. China remains a risk, but we are comfortable that this risk is not imminent. China has been aggressively spending to keep growth above 6%, and it's hard to see a slowdown before the next Party Congress in the fall of 2017. Protectionist policies emanating from Washington could put the brakes on global growth, as could intra-party gridlock. As always, an unforeseen political misstep is a small, but not impossible, risk.

U.S. rate expectations

Expectations for stronger growth and higher inflation are reflected in the recent move to higher rates. This should provide support for the Federal Reserve (Fed) to dial down its accommodative stance, as it began to do at its December meeting. Replacing monetary policy, there's a new "backstop" in town: Any hint of a slowdown will be met with more stimulative fiscal policies. We expect the Fed to raise rates another three to four times in 2017, and while a near-term rally is a possibility, we anticipate a continued move to higher rates in 2017, with the 10-year Treasury at 3.00–3.5% by year-end. We also anticipate that the U.S. dollar has room to move higher, supported by both higher rates and a transfer of corporate cash from offshore.

STRATEGY IMPLICATIONS

In the face of rising rates and diminishing central bank support, low yielding duration looks mispriced. Outright shorts in U.S. Treasuries, German Bunds and U.S. agency mortgages are all ways to hedge against rising rates.

Opportunities also exist in areas that benefit from the prospects for higher growth:

- **Our best idea is once again U.S. high yield**. Improving growth and higher commodity prices should strengthen fundamentals; we expect a decline in default rates as we move through 2017. The carry provided by the sector remains attractive, and spreads should absorb much of the increase in rates. Technicals also remain constructive, particularly as investors rotate out of more interest rate-sensitive sectors.
- **U.S. leveraged loans**, like their fixed rate counterparts, also benefit from the positive tailwind to credit. Carry is attractive, particularly on a duration-adjusted basis. Flows are positive, and every rise in LIBOR is accretive to yield. In portfolios where we have the flexibility, we like the option of owning high yield bonds, while swapping out of the duration, creating synthetic leveraged loans.
- **Shorter-duration securitized credit** has been a favorite asset class for some time, but an environment of rising rates makes the duration-adjusted spread and rapid amortization that much more attractive. Furthermore, fiscal stimulus could further benefit already strong consumer balance sheets.

Our best idea from last quarter—emerging market local currency bonds—still offers opportunities, if implemented on a tactical basis, but with the currency exposure funded not by the U.S. dollar, but by a basket of low yielding, weaker developed market currencies.

CLOSING THOUGHTS

Having been longtime advocates of the financial repression, secular stagnation and lower-for-longer arguments, we find ourselves in a curious position of leading the charge toward pro-growth, rising inflation and higher bond yields across the board. We accept that monetary policy is no longer the only tool that can be deployed. Fiscal stimulus and structural reform are on the way and the markets have yet to fully appreciate how the central banks will react to their impact and what normalized bond markets will look like. We don't want to waste one second trying to defend how portfolios were positioned pre-election.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 1Q17

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 >3½% Inflation >2%	**SUB TREND** Global GDP growth 2-3½% Inflation 0-2%	**RECESSION** Global GDP <2% Inflation <0%	**CRISIS** A disorderly movement in markets causes systemic impact and tail risk
Probability	65%	25%	5%	5%
Change from last quarter	+55%	-35%	-20%	Unchanged
Drivers	• Republican sweep in U.S. leads to fiscal stimulus, tax and regulatory reform • Two thirds of world economies growing above trend • China and commodities stabilize • Headline U.S. inflation moving toward 2.5% • Higher developed market government bond yields • Strengthening USD	• Fiscal Stimulus fails to deliver in the U.S. and developed markets	• U.S. protectionist policies implemented • Washington gridlock prevents meaningful fiscal stimulus	• Further EU departures • China hard landing • Political misstep
Monetary environment	• Fed may be forced to accelerate tightening	• Central banks continue monetary policy support	• Central bank policies lose effectiveness	
Market and positioning	• Own credit – U.S. high yield – Shorter duration securitized credit – U.S. leveraged loans • Outright shorts in low-yielding duration – U.S. Treasuries – German Bunds – U.S. agency mortgages	• Environment positive for all asset classes • Own credit for carry – U.S. high yield, Euro high yield, bank capital • Own unhedged local EM debt	• Reduce EM debt • Add high quality government debt • Cut credit exposure	• Own U.S. rates and gold

Source: J.P. Morgan Asset Management. Views are as of December 8, 2016.

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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Investments in bonds and other debt securities will change in value based on changes in interest rates. If rates rise, the value of these investments generally drops. Securities with greater interest rate sensitivity and longer maturities tend to produce higher yields, but are subject to greater fluctuations in value. Usually, the changes in the value of fixed income securities will not affect cash income generated, but may affect the value of your investment. Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Such default could result in losses to an investment in your portfolio.

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