Fixed Income Focus

Key findings from the Global Fixed Income, Currency & Commodities Investment Quarterly

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AUTHOR

Robert Michele
Chief Investment Officer and Head of the Global Fixed Income, Currency & Commodities Group

IN BRIEF

Our base case scenario for what markets will be pricing in over the next three to six months remains: sub-trend growth and inflation, with a probability of 60% (up from 50%).

In the near term, the Federal Reserve's (Fed's) more dovish stance and substantial liquidity coming as the European Central Bank (ECB) undertakes extraordinary easing are tailwinds for bond markets.

Longer term, we view a global recession as inevitable but not imminent, with the likelihood increasing through 2017. We have raised the probability that markets will price in a recession over the near term, from 5% to 20%.

In our view, mindful of near-term opportunities and longer-term risks:

- High quality duration provides shorter-term benefits as well as longer-term stability.
- Corporate credit offers attractive carry, supported by a flood of liquidity from central banks.
- European high yield remains our top investment idea.
- U.S. investment grade credit deserves more caution, and we continue to be wary of the emerging markets.

Short-term tailwinds, longer-term headwinds

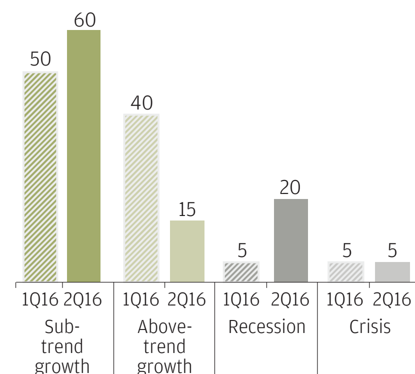
Our March meeting took place following several months of extreme risk-off/risk-on market sentiment and a dovish reaction from the Federal Reserve. Such an environment naturally begs the question: "How near is the next recession and what could trigger it?"

A global growth slowdown is certainly under way. Developed market growth is close to trend, but is being dragged down by slowing, below-trend growth in the emerging markets. But a global recession, while inevitable, is not imminent. Short-term tailwinds from extremely accommodative central bank policy should help keep a global recession at bay and provide the liquidity to support risk assets in the near term.

However, the probability of recession will increase through 2017 in the face of longer-term headwinds from the unwinding of "unsustainable excesses" (especially emerging market leverage) amassed since the global financial crisis.

We weigh these competing forces and assess their investment implications.

SCENARIO PROBABILITIES (%)



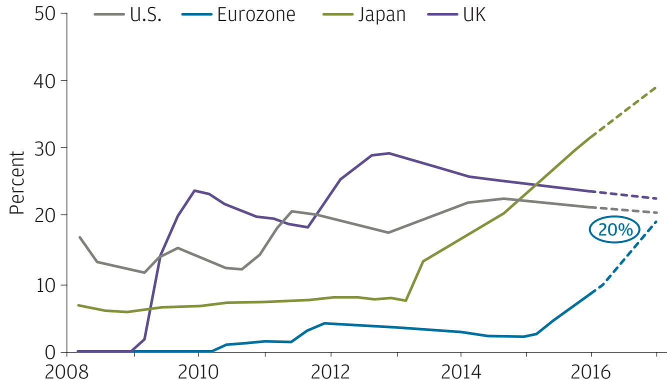
Source: J.P. Morgan Asset Management. Views are as of March 2016.

MACRO/MARKET BACKDROP

Our base-case scenario for what markets will be pricing in over the next three to six months calls for continued sub-trend growth and low inflation—a bond-friendly environment.

Extraordinary easing to provide short-term tailwinds. The ECB will hold close to 20% of the government bond market by 1Q 2017

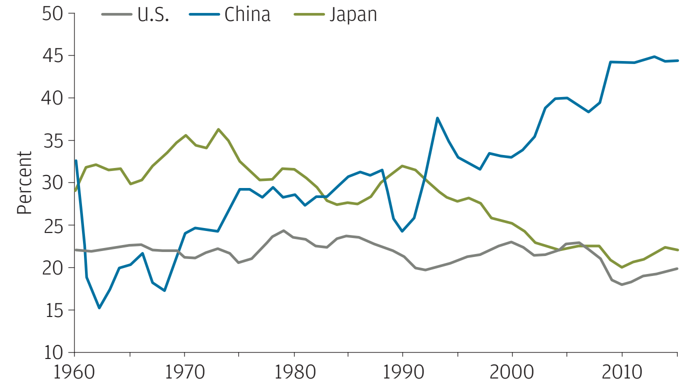
PERCENT OF GOVERNMENT BOND MARKET HELD BY CENTRAL BANK



Source: Barclays, Citibank, Goldman Sachs, LLC., Westpac, J.P. Morgan Asset Management, J.P. Morgan Securities, LLC.

Unwinding of "unsustainable excesses," such as China's credit-fueled capital spending, to result in longer-term headwinds

GROSS FIXED CAPITAL INVESTMENT, % OF GDP



Source: Bloomberg, International Monetary Fund, National Bureau of Statistics-People's Republic of China, Organization for Economic Cooperation and Development.

As of March 17, 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.

Short-term supports

A key element of that supportive environment: ample liquidity provided by central banks around the globe. Extraordinary easing by the ECB includes negative interest rates and asset purchases that now extend to corporate bonds. Even the Fed's inaction is a form of easing—signaling its willingness to be behind the curve rather than potentially contributing to market volatility and the negative feedback loop from markets to consumer confidence to GDP and inflation expectations. We expect, at most, only a single Fed rate hike in 2016 and see the 10-year Treasury as range-bound between 1.75% and 2.00%.

Near-term stabilization in China, supported by increasing infrastructure investment and helped by a weaker dollar, should limit imminent risks.

Longer-term detractors

Nevertheless, we do see recession as inevitable. Along with weaker productivity and aging demographics that are dragging down global growth, "unsustainable excesses," built up since the global financial crisis, will ultimately have to be unwound. It's not the U.S. sub-prime market this time, it's emerging market leverage. The adjustment will be painful. Among the excesses: high levels of non-financial private sector credit and gross fixed capital investment in China and, in the U.S., over investment in shale oil. Additionally, the banking industry will have to continue shrinking its way to profitability.

Risks to our outlook

No one knows precisely when short-term tailwinds will give way to longer-term headwinds, but failure by China to engineer a soft landing is an obvious threat. Uncertainty leading up to Britain's June vote on whether to withdraw from the European Union and the U.S. presidential election in November could add to fear and market volatility.

STRATEGIC RECOMMENDATIONS

As we look at the investment landscape, we are mindful of both near-term opportunities and longer-term risks.

- **High quality duration**—long government bonds and U.S. agency mortgages—can benefit in the near term from central bank accommodation and in the longer term can provide stability in a risk-off environment.
- **Corporate credit** continues to provide attractive carry and should be supported, in the short term, from the enormous amount of liquidity being pumped into the markets by the central banks.
- **European high yield** remains our top investment idea. Yields may seem low, but spreads on a credit-by-credit basis are comparable to those in the U.S. and poised to tighten as investors continue their search for yield. European growth is also supportive of improving fundamentals and potential upgrades.

In the U.S., while recent spread widening has been substantially reversed, we still think high yield spreads (ex-energy, metals and mining) more than compensate for potential defaults, increased volatility and bond market illiquidity.

The key with high yield and other credit sectors, however, is to know when to take your chips off the table. We are increasingly sensitive to signs that downside risks are beginning to outweigh upside opportunities. In some of our more risk-averse strategies, that time may come sooner rather than later.

We are more cautious on U.S. investment grade credit given the sector's slowing top-line growth, potential margin compression and increasing leverage. Finally, we are once again wary of the emerging markets.

SCENARIO PROBABILITIES AND INVESTMENT IMPLICATIONS: 2Q16

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**	
	SUB-TREND Global GDP growth 0-3 ½% Inflation 0-2%	**ABOVE TREND** Global GDP growth >3 ½% Inflation >2%	**RECESSION** Global GDP <0% Inflation <0%	**CRISIS** A disorderly movement in markets causes systemic impact and tail risk
Probability	60%	15%	20%	5%
Change from last quarter	▲ +10%	▼ -25%	▲ +15%	unchanged
Drivers	• Growth slowing: - Developed markets (DM) close to trend - Emerging markets (EM) declining • China risks deferred • Low inflation persists in Europe and Japan • U.S. inflation view is mixed	• Growth and inflation to rise (theoretically) as: - Easy money stimulates demand - Little reward for saving - Fiscal stimulus implemented	• Painful adjustment to past "unsustainable excesses" • Manufacturing drags down service sector globally • China soft landing fails • EM drags down DM • Restructuring of U.S. energy industry hurts employment	• China hard landing; EM crisis unfolds • Britain exits European Union (EU) • Uncertainty in run-up to U.S. elections
Monetary environment	• Extraordinary easing by ECB and Bank of Japan (BoJ) • People's Bank of China (PBoC) easing (and fiscal stimulus) • Fed dovish		• Central banks ease further - More bond purchases - Rates more negative • Potential for Fed policy error	
Market and positioning	• U.S. 10-year: range-bound 1.75%-2.00% • USD remains range-bound • High quality duration offers short- and long-term benefits - Long governments, U.S. agency mortgages • Near-term, demand for yield tightens spreads in high yield - Euro high yield a favorite • Gold could benefit	• Treasury Inflation-Protected Securities (TIPS) continue to rally • Commodities recover • Yield curves: bear steepen	• High quality bonds outperform	

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

NEXT STEPS

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

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