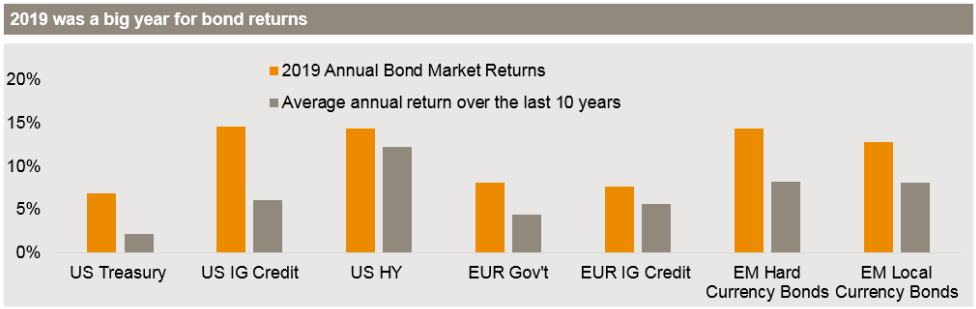
**INTRODUCTION:**

The Federal Reserve's (Fed's) pivot at the start of 2019 set in motion a global wave of accommodative monetary policy that successfully offset the impact of an escalating trade war and damaged global trade. Suddenly, as we head into the New Year, a combination of overwhelming central bank easing and the de-escalation in trade tensions has provided a powerful backdrop for the markets.

In the paragraphs below, we lay out the reasons why despite a strong year for fixed income returns in 2019, **2020 will continue to be a good year to invest in the debt market**. Global central bank easing will have a lasting impact on asset performance. Furthermore, attractive valuations still remain in sectors of the fixed income universe which have lagged behind.

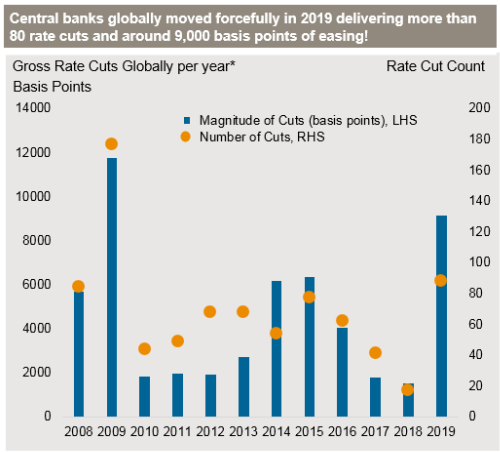
**MACRO & MARKET BACKDROP:**

Across the fixed income spectrum, nearly all sectors experienced above average returns benefiting uniformly from falling risk-free rates and somewhat less uniformly from credit spread compression.

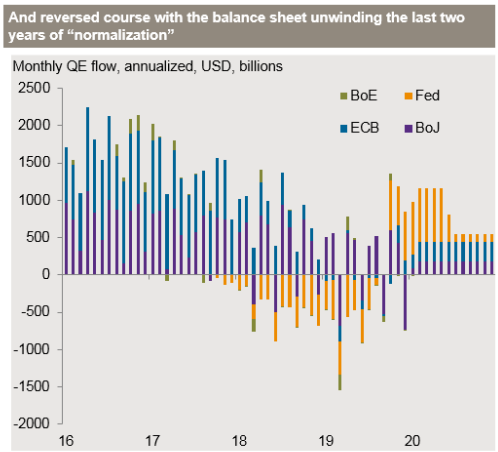


Source: Bloomberg: As of 12/31/2019

**There was significant criticism at the start of 2019 that the central banks had very little firepower left to offset a growth slowdown. This proved to be a serious underestimation.** Globally, central banks cut rates more than 80 times for a total of nearly 9,000 basis points worth of easing! And this doesn't even include balance sheet policy: in addition to all the rate cuts, the ECB restarted its QE program and the Fed ended balance sheet normalization.

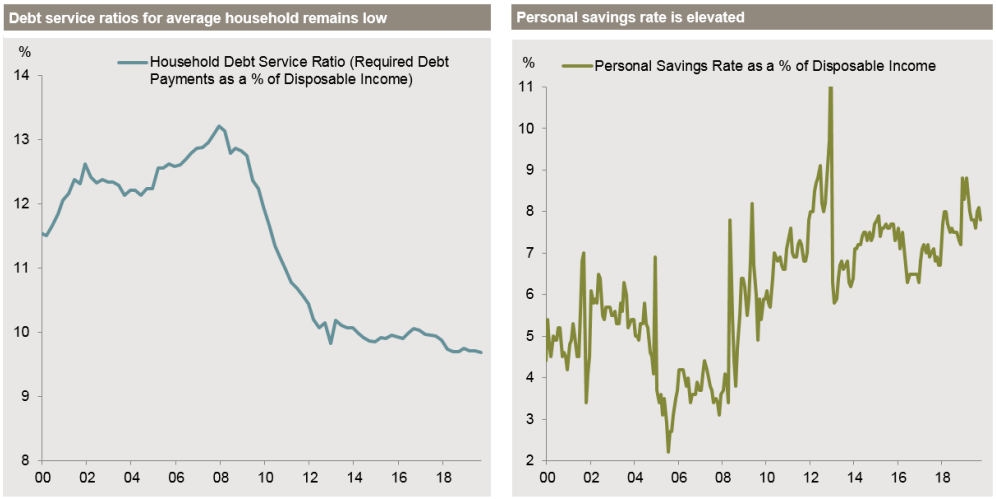


Source: JPMAM. *12 DM countries and 36 EM countries; As of 12/31/2019



Source: Bloomberg, J.P. Morgan Asset Management; As of 1/31/2020
Assumptions: The Fed starts buying bills in mid-October 2019 at a pace of 60bln per month and then slows the bill purchases in Q2 2020 to a pace to match the growth in currency in circulation. The Bank of Japan (BoJ) purchases at an annualized run rate of 20 trillion yen; the Bank of England (BoE) does not make any additional QE purchases; The European Central Bank (ECB) re-starts QE at a pace of $20bln per month in November 2019 which continues through 2020.
All monthly figures represent annualized pace of purchases. Forecasts use current spot FX rates (January 2020. Historical FX Rates are used for realized/actual monthly flows.

In the U.S., 75bps of interest rate cuts led to a surge in home mortgage refinancing, freeing up consumer income to spend on more housing and durable goods. Further, the reduced cost of debt servicing has strengthened already pristine consumer balance sheets.



Source: JPMAM ,BLS, Bloomberg, Federal Reserve; As of 12/31/2019

But perhaps the biggest economic surprise occurred in emerging market (EM) economies. EM countries were expected to get caught in the downdraft of a tariff-induced economic slowdown in China, but a tremendous amount of rate cutting and some fiscal stimulus from China, Asia and Europe limited the downside.

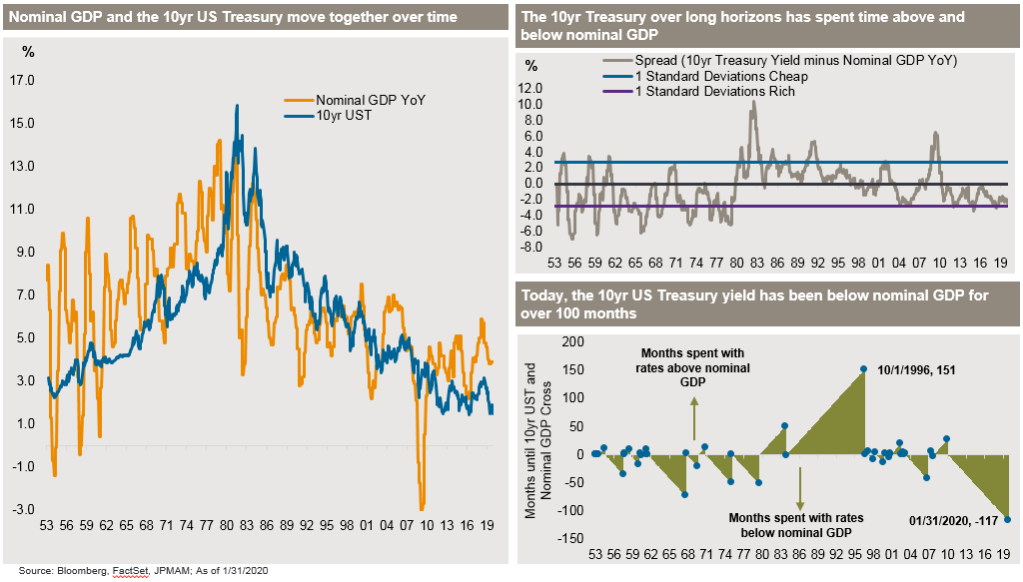
**YIELDS ARE WHATEVER CENTRAL BANKS WANT THEM TO BE:**

While in hindsight it may have been clear that the Fed's transition away from three years of hiking policy rates to lowering them would lead to a significant easing of financial conditions, the magnitude and impressive length of time in which the bond market has been unduly influenced by the power of central bank policy dates back before 2019.

Over long periods of time, bond investors are trained to expect that sovereign yields should trade with a relationship to the nominal growth rate of the economy (real gross domestic product [GDP] plus inflation). In the US, the 10yr Treasury has spent time both above and below this fair value measure. Today, the 10yr Treasury yield has been trading below nominal GDP for over 100 months – the longest period of time we have available on record.

But that isn't to say there haven't been times where things have swung the other way. For over a decade between the mid-1980s to mid-1990s, the 10yr traded above nominal GDP. After bringing inflation below 5% in the early 1980s, central bankers were still keen to keep policy tighter than they otherwise would in order to opportunistically bring inflation lower. At the same time, investors demanded additional term premium given that the high inflation and aggressive central bank policy of the late 1970s were still fresh in their minds.

In many ways, the opposite exists today: with inflation low and stable and a bias to keep policy looser in order to boost inflation, investors skeptically demand little term premium especially with many major central banks in developed markets outside the US still at the zero lower bound or using negative rates to try to simulate growth. Nothing to us suggests this trend should be expected to change any time soon, specifically in the absence of immense fiscal stimulus.

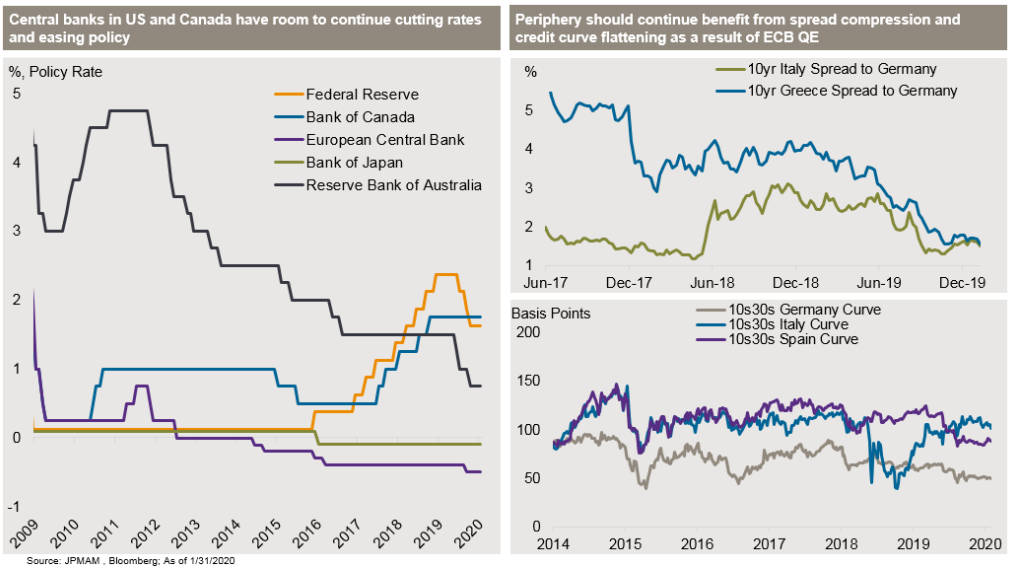



**STRATEGY IMPLICATIONS:**

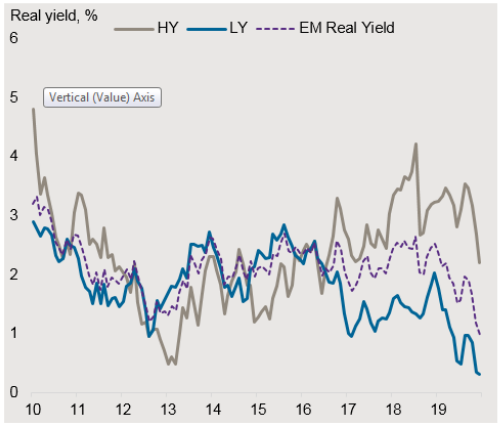
While 2019 featured strong fixed income returns, 2020 will continue to be opportunity-laden for investors with flexibility to shift allocations into pockets that have lagged behind and have room to benefit from global central bank easing.

With developed economy inflation trends remaining muted and a fresh objective from the Central Banks to target higher prices over a business cycle, **markets will be supported by monetary policy makers who possess a much stronger proclivity to ease policy further rather than to remove accommodation.**

**Developed Market Government Bonds –** owning duration in central banks supported markets with the highest real yields such as the US and Canada as well as European periphery sovereign debt remains an attractive allocation in fixed income portfolios.

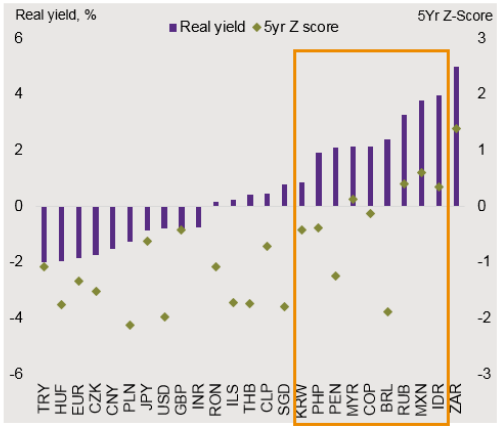



**Emerging Market Debt –** the hunt for yield and the favorable influence from global central bank policy supports EM markets with high real yields. We focus on countries with room to continue cutting policy rates in 2020 as well as Asian countries benefitting from stabilizing global growth.



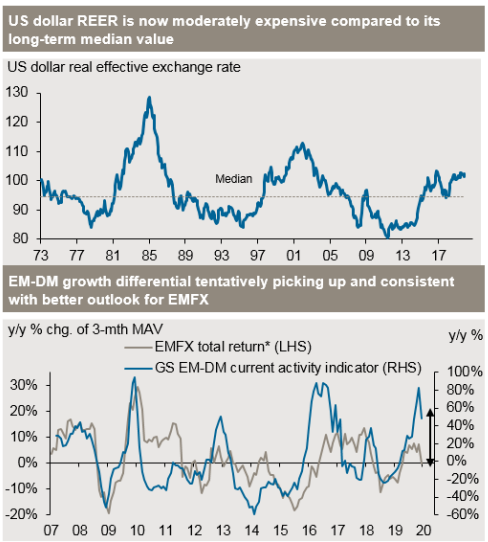

Source: J.P. Morgan Asset Management, J.P. Morgan, Bloomberg. Real yield is calculated as the 10-yr yield minus realized CPI (Consumer Price Index) % yoy. HY: High yield; LY: Low yield; EM: Emerging markets. As of January 31, 2020.

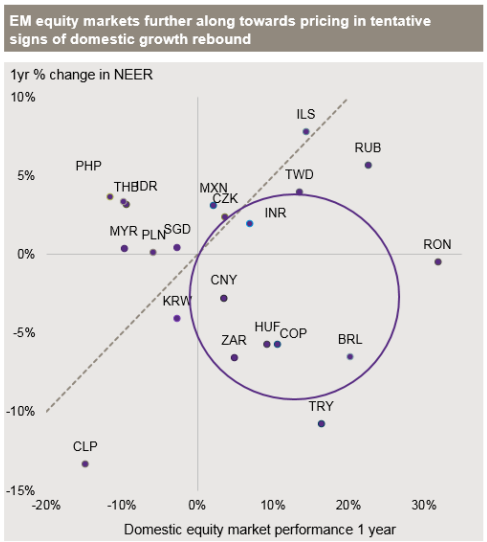
High Yield (HY) = Peru, Korea, Malaysia, China, Israel, Philippines, Singapore, Thailand, Chile
Low Yield (LY) = Serbia, Romania, Czech Republic, Hungary, Poland




Real yield = 10yr bond yield minus realized CPI yoy
Source: J.P. Morgan Asset Management, Bloomberg. January 31st 2020

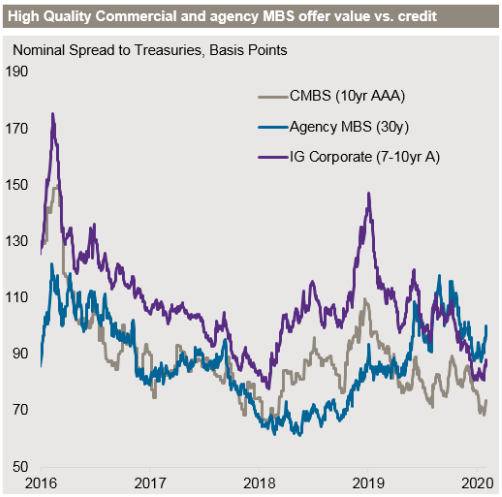
**Emerging Market FX –** after years of USD dollar dominance, 2020 will see the dollar on the back foot just enough to give EMFX a fighting chance just as activity is recovering more quickly in EM than DM. We view solid EM equity market performance and strong inflows as technical drivers of future expected EMFX outperformance.

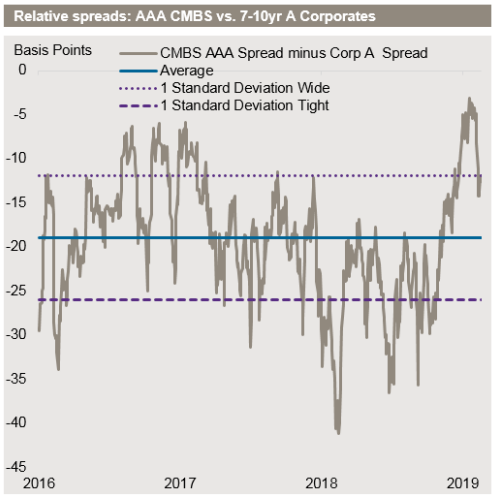



*EMFX basket based on EM Quant Directional model (TRY, RUB, ZAR, PLN, BRL, MXN, THB, IDR); MAV = Moving average
Source: J.P. Morgan Asset Management, Federal Reserve, Bloomberg. REER = Real effective exchange rate. NEER = JPM Nominal Effective Exchange Rate.
Data as at January 31st, 2020

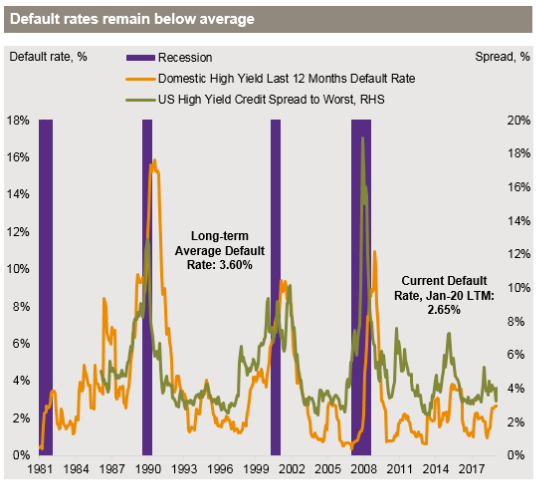
**US Securitized Credit –** asset backed securities underwritten by the healthy consumer presents a yield advantage both on an outright and risk-adjusted basis as the US consumer balance sheet remains rock solid. Moreover, relative value has emerged between the yields of securitized credit products (CMBS) versus investment grade. Given the relative outperformance of investment grade, we like tilting toward securitized credit while watching out for structurally challenged sectors such as brick and mortar retail and minimizing concentration risk in the traditional consumer space.



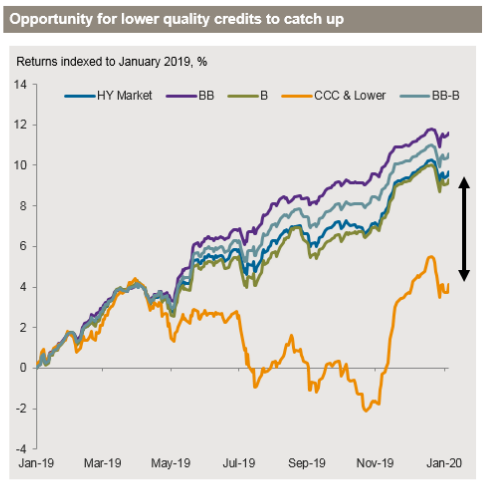




Source: JPM Morgan Markets, J.P. Morgan Asset Management. As of January 31st, 2020.
CMBS: Commercial mortgage-backed securities; MBS: Mortgage-backed securities

**US High Yield –** low relative default rates, the continued search for yield from the international community and decreased hedging costs lend continued support for the asset class. Security selection can help you steer clear of the worst names but the powerful tailwinds of central bank easing may revive the troubled CCC sector after they have spent much time lagging behind over the past year. Not to mention, the energy component of the lower quality universe could also benefit from any geopolitical tensions.

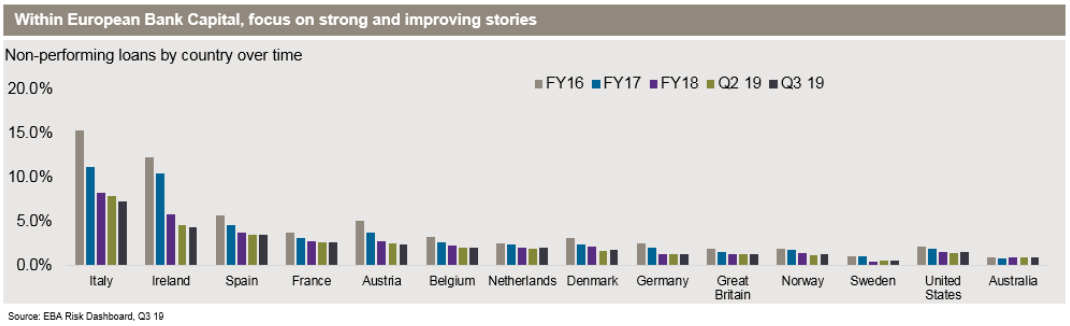



Source: JPMorgan Chase & Co and Moody's Investor Services; As of January 31st, 2020
Default rates are par-weight. Recoveries are issuer-weighted and in 2009 were 22.4 based on prices 30-days post default and were 35.7 based on year-end prices




Source: ICE BofAML US High Yield Indices as of January 31st, 2020. ICE BofAML US High Yield Constrained Index (HUC0) as proxy for broad market returns; ICE BofAML BB US High Yield Constrained Index (HUC1) as proxy for BB's returns/spreads; ICE BofAML Single-B US High Yield Constrained Index (HUC2) as proxy for B's returns; ICE BofAML CCC and Lower US High Yield Constrained Index (HUC3) as proxy for CCC's returns/spreads; ICE BofAML US High Yield Constrained Index (HUC0) energy sector as proxy for energy returns. The above information is shown for illustrative purposes only. Indices do not include fees or operating expenses and are not available for actual investment.

**Investment Grade Credit –** given an extensive business cycle and rising corporate leverage, we selectively focus on European Bank capital emphasizing those credits fundamentally strong and improving country specific stories. An accommodative ECB and a nascent European recovery present an attractive risk-reward profile while avoiding those bank credits most structurally challenged by negative interest rates (such as Germany).




**RISKS**

The biggest risk remains on the trade front. If China and the U.S. cannot agree to a status quo with modest de-escalation, and/or the U.S. looks at putting tariffs on Europe or Latin America, the global economy would invariably shift downward.

As we roll into 2020, the U.S. general election will take center stage, with the campaigning and rhetoric commencing in earnest. An early look suggests that it will be difficult to find a moderate who can win.

What keep us on our toes is the ever shifting checklist of "unknown unknowns". Most recently, this list includes the US conflict with Iran and considerations of broader Middle East stability. We always have our eyes peeled for new risks and way to mitigate them through prudent hedges.

**SUMMARY KEY THEMES 2020**

Our 2020 fixed income investment roadmap has four key takeaways:

- First, invest for a period of trend growth, continued central bank accommodation and little to no fiscal stimulus support; this includes owning government duration in select supported markets. As we like to say, government bond yields are whatever central banks want them to be!

- Second, find markets that have lagged in the bond rally but have tailwinds from central bank easing; this includes Emerging Markets (EM), EMFX, parts of global IG and US structured credit.

- Third, following blockbuster bond returns in 2019, remain invested but keep return expectations moderate.

- Fourth, beware of the tail risks: trade, Brexit, the US elections and the ever-present "unknown unknowns".