Global Asset Allocation Views

Themes and implications from the Multi-Asset Solutions Strategy Summit

3Q 2019

AUTHOR

John Bilton, CFA
Managing Director
Head of Global Multi-Asset Strategy
Multi-Asset Solutions

ASSET CLASS VIEWS (PAGE 3)

Max negative ● ● ● Neutral ● Max positive ● ● ●

Asset class		Opportunity set	Change	Negative			Neutral	Positive		
MAIN ASSET CLASSES		Equities/bonds		○	○	●	○	○	○	○
		Duration	▼	○	○	○	●	○	○	○
		Credit		○	○	○	○	●	○	○
		Commodities		○	○	○	●	○	○	○
		Real estate		○	○	○	●	○	○	○
		Cash		○	○	○	●	○	○	○
PREFERENCE BY ASSET CLASS	EQUITIES	U.S. large cap		○	○	○	○	●	●	○
		U.S. small cap	▼	○	○	●	○	○	○	○
		Canada		○	○	○	●	○	○	○
		Europe ex-UK	▲	○	○	●	○	○	○	○
		UK		○	○	○	●	○	○	○
		Japan		○	○	○	●	○	○	○
		Australia		○	○	○	●	○	○	○
		Asia Pacific ex-Japan		○	○	○	●	○	○	○
		Emerging markets	▼	○	○	●	○	○	○	○
	REAL ESTATE	Direct real estate		○	○	○	●	○	○	○
		U.S. REITs		○	○	○	●	○	○	○
	SOVEREIGN FIXED INCOME	U.S. Treasuries		○	○	○	○	●	○	○
		U.S. TIPS		○	○	○	○	●	○	○
		Euro, core (Bund)		○	○	○	●	○	○	○
		Euro, periphery (BTP)		○	○	○	●	○	○	○
		UK Gilts	▲	○	○	○	●	○	○	○
		Japanese JGBs		○	○	○	●	○	○	○
		Canadian gov't bonds		○	○	●	○	○	○	○
		Australian gov't bonds		○	○	○	○	●	○	○
	CREDIT	Investment grade		○	○	●	○	○	○	○
		U.S. high yield		○	○	○	○	●	○	○
		European high yield		○	○	○	○	●	○	○
		Emerging markets debt	▼	○	○	○	●	○	○	○
	FX	USD	▲	○	○	○	●	○	○	○
		EUR	▼	○	○	○	●	○	○	○
		GBP	▼	○	○	●	○	○	○	○
		JPY	▲	○	○	○	○	●	○	○

IN BRIEF

- The global economy has slowed, and trade disputes are raising the downside risks to our forecast for slightly subtrend growth. That said, while remaining wary of the signals coming from the bond market, we don't see the trade shock as truly recessionary for the U.S.
- We retain our mild underweight to stocks and prefer to take risk in carry assets like credit, while remaining conscious of the liquidity risks. Easier policy may support equity valuations at the margin, but the environment remains late-cycle and we don't see a strong upside to earnings. Reflecting valuations, we downgrade duration from overweight to neutral.
- We maintain our preference for U.S. stocks over European ones but have dialed down our preference for emerging market stocks, where we see a weak earnings outlook, with downside risks stemming from the trade concerns. U.S. Treasuries remain our favorite bond market, and we upgrade UK Gilts, noting that the risk of a hard Brexit is rising.

SO FAR, 2019 HAS BEEN A YEAR OF SUPERLATIVES. The strongest January equity rally since 1987, the lowest weekly U.S. jobless claims since 1969, the lowest German Bund yield ever and, if we make it unscathed to the end of June, the longest U.S. economic expansion on record. Less constructively, we have the weakest eurozone manufacturing data since the sovereign debt crisis, the flattest U.S. yield curve since the global financial crisis (GFC) and tariffs at their highest level in half a century. Smoot-Hawley it isn't (at least not yet), but the trade dispute is having a tangible impact on asset markets and the global economic outlook.

Our base case remains that global growth will be positive but unspectacular and that a recession is unlikely over the next 12 months. However, our hopes of a decent second-half rebound in activity – particularly in trade and capex – are fading, and global growth is on track to come in a little below trend for the year as a whole. Recession risks are certainly higher than they were at the start of the year, as a cursory glance at the inverted U.S. yield curve will suggest. But with labor markets robust and household balance sheets strong – on the basis of economic data, at least – risk of contraction over the near term is relatively contained. Further out, however, risks may be more negatively skewed.

The trade dispute is the most eye-catching of these risks and would pose a clear threat to the global economic outlook were it to escalate. The risk of a negative growth shock is among the reasons for the Federal Reserve's (Fed's) increasingly dovish tone for U.S. rates. A less well telegraphed but equally valid reason for the Fed's renewed dovishness is the weakness of inflation data this year. Certainly, the shift in rate expectations has been profound, and markets are now pricing the fastest pace of rate cuts in more than 30 years, absenting the GFC. This is all the more notable given that just six months ago the market was still pricing rate hikes, and the Fed's dovish reset coincided with a U.S. first-quarter GDP print that was the strongest in four years.

While it is clear that the outlook for policy has eased meaningfully, rates themselves have not actually moved yet. In our view, the market might be overstating the pace of rate cuts. If inflation remains muted, there is clearly capacity for a couple of "insurance" cuts, but the notion that the Fed may cut aggressively in the absence of a further downgrade to the growth outlook might be wide of the mark. Either way, we do not see that easier policy is an unalloyed positive for risk assets; while it shrinks the denominator in present value calculations, it does little for the numerator – earnings – which remain hostage to sluggish levels of global industrial activity.

For now, the resilience of the equity market may well be emboldening the Trump administration to ratchet up trade rhetoric, but this is surely a drag on corporate confidence and earnings. Equity returns and bond yields are likely capped to the upside as a result, while to the downside easy policy, and the likelihood that trade rhetoric would soften if stocks fell sharply, provide a floor to equities. Even if a deal on trade is forthcoming, it is unlikely to be comprehensive and even less likely to address some of the strategic differences between Washington and Beijing that have recently been laid bare.

Our asset allocation reflects this cautious tone. We keep our small underweight (UW) to stocks, supported by our quant models and reflecting the view that equities are near the upper end of their trading range. At the same time, we acknowledge that growth remains positive and policy easy, which together support our overweight (OW) to credit. Nevertheless, we are mindful that as the cycle matures the liquidity risk in credit may eventually overwhelm the attractive level of carry.

The drop in bond yields over the second quarter prompts a downgrade on duration from OW to neutral. With just under a quarter of global government bonds yielding less than zero, we believe that, absenting a further downgrade to global growth, yields are at the lower end of their fair value range. Regionally, we still favor the U.S. in both equities and bonds but note that it is U.S. large cap stocks specifically where we are moderately upbeat on earnings. Europe remains a less favored region, and our outlook on emerging market (EM) assets is cooling again as trade uncertainty creates a persistent headwind for growth in those economies.

Overall, this reflects a guarded macro outlook, increased tail risks and a scarcity of compelling relative value opportunities, barring our preference for U.S. assets. Over the next few months, it is likely that the pendulum swings between hopes of growth rebounding and rates falling, and fears of intensified trade tension. As this unfolds, opportunities will present themselves, but with geopolitics driving the macro agenda, allocation may be as much about timing as it is about fundamentals.

KEY THEMES AND THEIR IMPLICATIONS

Theme		Macro and asset class implications
GLOBAL THEMES	Global policy divergence	The Fed's dovish tack takes some pressure off USD, but other central banks following suit
	Supply-side weakness	Protectionist policies pose a threat to globalization. Wage inflation is picking up, creating mild headwinds for margins
	Widespread technology adoption	Tech in crosshairs for regulation and trade issues, a near-term risk to the sector, but structural adoption trends persist
DEVELOPED MARKETS THEMES	Maturing U.S. cycle	Yield curve inversion causing intensified end-of-cycle chatter, but labor market strength suggests low near-term recession risk
	Europe in the balance	Domestic growth generally holding up while industrial and export sectors weak, at risk if trade war intensifies
	Japan beyond Abenomics	Corporate governance improving and BoJ on hold, with JPY strength a frequent spoiler for equities
EMERGING MARKETS THEMES	Emerging market convergence	Growth and confidence under pressure from trade dispute, especially apparent in north Pacific Rim economies
	China in transition	Structural changes subverted to growth stabilization objectives; magnitude of stimulus lower than recent experiences

Source: J.P. Morgan Asset Management Multi-Asset Solutions; data as of June 2019. For illustrative purposes only.

Active allocation views

These asset class views apply to a 12- to 18-month horizon. Up/down arrows indicate a positive (▲) or negative (▼) change in view since the prior quarterly Strategy Summit. These views should not be construed as a recommended portfolio. This summary of our individual asset class views indicates strength of conviction and relative preferences across a broad-based range of assets but is independent of portfolio construction considerations.

Max negative ● ● ● Neutral ● Max positive ● ● ●

Asset class		Opportunity set	Change	Negative			Neutral	Positive			Rationale
MAIN ASSET CLASSES		Equities/bonds		○	○	●	○	○	○	○	Upside capped by trade dispute and earnings; downside protected by looser policy
MAIN ASSET CLASSES		Duration	▼	○	○	○	●	○	○	○	A quarter of global govies now yield <0; already discounts meaningfully slower growth
MAIN ASSET CLASSES		Credit		○	○	○	○	●	○	○	Easy Fed policy, low inflation and slow growth favor credit, but be aware of liquidity
MAIN ASSET CLASSES		Commodities		○	○	○	●	○	○	○	Oil range-bound given proactive OPEC supply response; some upside to base metals
MAIN ASSET CLASSES		Real estate		○	○	○	●	○	○	○	Supply discipline remains good despite maturity of cycle, but valuations quite full
MAIN ASSET CLASSES		Cash		○	○	○	●	○	○	○	U.S. policy rates at cycle peak; aggregate real cash rates under pressure
PREFERENCE BY ASSET CLASS	EQUITIES	U.S. large cap		○	○	○	○	●	●	○	Most resilient in EPS terms to further trade issues; valuations, fair given RoE strength
PREFERENCE BY ASSET CLASS	EQUITIES	U.S. small cap	▼	○	○	●	○	○	○	○	Very high earnings expectations a struggle to achieve; valuations not supportive
PREFERENCE BY ASSET CLASS	EQUITIES	Canada		○	○	○	●	○	○	○	Decent support across EPS, macro and valuations but prefer U.S. large cap
PREFERENCE BY ASSET CLASS	EQUITIES	Europe ex-UK	▲	○	○	●	○	○	○	○	Flows and earnings revisions bottoming, but still constrained by fragile banks
PREFERENCE BY ASSET CLASS	EQUITIES	UK		○	○	○	●	○	○	○	High dividend yield, high quality and defensive, but outlook marred by Brexit risks
PREFERENCE BY ASSET CLASS	EQUITIES	Japan		○	○	○	●	○	○	○	A laggard this year; scope to rally if trade issues resolved, but earnings revisions weak
PREFERENCE BY ASSET CLASS	EQUITIES	Australia		○	○	○	●	○	○	○	Slowing economy and earnings cap upside, but yield and defensiveness lend support
PREFERENCE BY ASSET CLASS	EQUITIES	Asia Pacific ex-Japan		○	○	○	●	○	○	○	Cheap valuation, but negative flows and pro-cyclical sector mix hold the index back
PREFERENCE BY ASSET CLASS	EQUITIES	Emerging markets	▼	○	○	●	○	○	○	○	Poor 2019 EM ex-China growth outlook; insufficient global growth to lift EM equity
PREFERENCE BY ASSET CLASS	REAL ESTATE	Direct real estate		○	○	○	●	○	○	○	Late in cycle for real estate; returns decent, but limited upside given sluggish growth
PREFERENCE BY ASSET CLASS	REAL ESTATE	U.S. REITs		○	○	○	●	○	○	○	Tracking bond yields; outperformed in 2Q19 as yields fell, but valuations now rich
PREFERENCE BY ASSET CLASS	SOVEREIGN FIXED INCOME	U.S. Treasuries		○	○	○	○	●	○	○	Still has positive real yield despite 50bps rally; support from Fed buying to come in 4Q
PREFERENCE BY ASSET CLASS	SOVEREIGN FIXED INCOME	U.S. TIPS		○	○	○	○	●	○	○	Market pricing U.S. inflation below spot for next 30 years; TIPS a hedge against a spike
PREFERENCE BY ASSET CLASS	SOVEREIGN FIXED INCOME	Euro, core (Bund)		○	○	○	●	○	○	○	Positive roll-down despite negative yield means positive returns, esp. hedged to USD
PREFERENCE BY ASSET CLASS	SOVEREIGN FIXED INCOME	Euro, periphery (BTP)		○	○	○	●	○	○	○	Italian politics becoming more fractious; expensive to short, but risks building
PREFERENCE BY ASSET CLASS	SOVEREIGN FIXED INCOME	UK Gilts	▲	○	○	○	●	○	○	○	BoE one of the last banks standing in the hawkish camp, despite deteriorating UK data
PREFERENCE BY ASSET CLASS	SOVEREIGN FIXED INCOME	Japanese JGBs		○	○	○	●	○	○	○	Yield peg widened but still in place; yields anchored a little above zero for 10-year JGBs
PREFERENCE BY ASSET CLASS	SOVEREIGN FIXED INCOME	Canadian gov't bonds		○	○	●	○	○	○	○	Strong macro data of late have potential to keep yields supported in relative terms
PREFERENCE BY ASSET CLASS	SOVEREIGN FIXED INCOME	Australian gov't bonds		○	○	○	○	●	○	○	Australian economy flagging; RBA in cutting mode; prefer the three-year sector
PREFERENCE BY ASSET CLASS	CREDIT	Investment grade		○	○	●	○	○	○	○	Some evidence of self-help in BBB sector, but all-in yields now uninspiring
PREFERENCE BY ASSET CLASS	CREDIT	U.S. high yield		○	○	○	○	●	○	○	Slow growth and easy Fed lend support to U.S. HY, but illiquidity risk may be an issue
PREFERENCE BY ASSET CLASS	CREDIT	European high yield		○	○	○	○	●	○	○	All-in yields above 4% translate well when hedged to USD; illiquidity an acute risk
PREFERENCE BY ASSET CLASS	CREDIT	Emerging markets debt	▼	○	○	○	●	○	○	○	EM macro outlook is under pressure; easy Fed lends support, but not enough for an OW
PREFERENCE BY ASSET CLASS	FX	USD	▲	○	○	○	●	○	○	○	Could weaken a touch on Fed cuts, but U.S. growth differential to RoW limits downside
PREFERENCE BY ASSET CLASS	FX	EUR	▼	○	○	○	●	○	○	○	Upside capped by dovish ECB and slow growth, but a lot of bad news already in price
PREFERENCE BY ASSET CLASS	FX	GBP	▼	○	○	●	○	○	○	○	Increasing bifurcation between no deal and no Brexit; risks likely to rise over 3Q
PREFERENCE BY ASSET CLASS	FX	JPY	▲	○	○	○	○	●	○	○	Safe haven support likely to see JPY slightly higher if trade dispute persists

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments are made using data and information up to June 2019. For illustrative purposes only.

Diversification does not guarantee investment returns and does not eliminate the risk of loss. Diversification among investment options and asset classes may help to reduce overall volatility.

MULTI-ASSET SOLUTIONS

J.P. Morgan Multi-Asset Solutions manages USD 255 billion in assets and draws upon the unparalleled breadth and depth of expertise and investment capabilities of the organization. Our asset allocation research and insights are the foundation of our investment process, which is supported by a global research team of 20-plus dedicated research professionals with decades of combined experience in a diverse range of disciplines.

Multi-Asset Solutions' asset allocation views are the product of a rigorous and disciplined process that integrates:

- Qualitative insights that encompass macro-thematic insights, business-cycle views and systematic and irregular market opportunities
- Quantitative analysis that considers market inefficiencies, intra- and cross-asset class models, relative value and market directional strategies
- Strategy Summits and ongoing dialogue in which research and investor teams debate, challenge and develop the firm's asset allocation views

As of March 31, 2019.

NEXT STEPS

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

PI-GAAV_3Q19 | 0903c02a81cef736

J.P.Morgan
Asset Management