INVESTMENT INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

February 1, 2016

IN BRIEF

- Recent developments have called into question our upbeat view on the U.S. economy; markets are much less optimistic.
- Two developments since late 2015 carry potential implications for the outlook. Growth lost momentum in the fourth quarter of last year, and the market sell-off has itself tightened financial conditions.
- We are downplaying the GDP growth swoon, regarding it as temporary, and take some comfort from continued strength in employment, consumer confidence and bank lending, while we are closely watching the upward drift in jobless claims.
- Tighter financial conditions will represent a drag on growth, but likely a manageable one, especially because the dollar has not continued its sharp appreciation.
- We remain broadly neutral on both stocks vs. bonds as well as duration.

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TAKING STOCK OF THE U.S. ECONOMIC OUTLOOK

We entered 2016 with a fairly upbeat view of U.S. economic prospects, envisioning continued expansion at a modestly above-trend pace. Financial markets, though, sold off sharply in early January, seemingly reflecting a more downbeat scenario, or at a minimum a significantly more skewed perception of the risks around base-case projections. This divergence forces us to take stock of our outlook, to identify what factors may have changed and understand which aspects of the environment deserve particularly close monitoring.

Our forecast rests in part on our judgment that the U.S. economy remains in the middle portion of its expansion and is not displaying typical late-cycle characteristics. Emblematic of this assessment are still-moderate levels of spending on housing, durable goods, and business investment; an unemployment rate around, rather than noticeably below, its long-term neutral level; and low rates of wage and price inflation. All of these conditions suggest that the economy still possesses room to grow. Meanwhile, household balance sheets in good condition—combined with a somewhat elevated personal saving rate and a well-performing labor market—should support a strong rate of consumer spending growth. Although the Federal Reserve (Fed) has begun a tightening cycle, monetary policy remains accommodative, and fiscal policy should add a bit of stimulus in 2016. On the other side of the ledger, dollar strength and weak foreign (especially

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emerging) economies mean trade flows will act as an ongoing drag, preventing growth from accelerating to 3% or beyond.

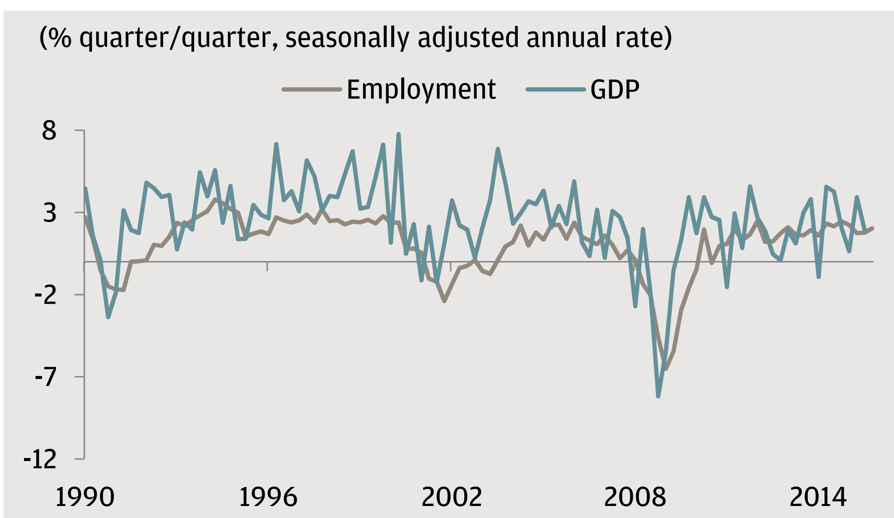
What has changed recently ? Two developments since late 2015 carry possible implications for the near-term outlook on the U.S. economy. First, growth itself weakened at the end of last year. Real GDP expanded at an anemic 0.7% clip in the fourth quarter, far below original expectations. Sudden loss of momentum in the latter stages of expansions often signals a swing toward recession, so markets' downbeat reaction to the growth pothole comes as no surprise. We are inclined to downplay the fourth quarter weak spot, though, for three reasons. Some of the slowdown owed to an ongoing inventory correction. Stock-building subtracted 0.5 percentage points from GDP growth during the quarter. This headwind should eventually end. Further, part of the disappointment came from consumer spending. Not only do we see a solid foundation for consumption, but typically reliable coincident indicators of spending, like confidence and consumer bank loans, have held up well (in contrast to business sentiment, which looks much less cheery). Finally, employment accelerated during 4Q15. Admittedly, the labor market often lags at inflection points for the economy, and strong job gains late last year do not prove that the economy has not since gone into recession. Still, employment gives a steadier read on economic conditions than do volatile GDP prints (Exhibit 1), and its favorable trend does contain information that serves as a counterweight to the message from other activity indicators.

Keeping an eye on jobless claims

We therefore expect stronger performance out of the economy in early 2016, although we acknowledge that the upward drift in jobless claims during January poses a challenge to that view. Claims historically have served as a high-quality coincident indicator of conditions not only in the labor market but also in the economy as a whole. Their steady downtrend between 2013 and 2015 thus provided reassurance during earlier weak spots. Claims troughed early in the fourth quarter, though, and have moved up significantly, especially in January. For now, we attribute this move primarily to difficulty in adjusting the raw data for the surge in temporary hires around the holidays. This seasonal quirk might mean that payroll employment itself benefited from exaggeration in the fourth quarter. Slower employment gains in the next few months seem likely and would not call the forecast into question. But a continued rise in jobless claims would ring alarm bells.

EXHIBIT 1: U.S. PAYROLL EMPLOYMENT AND REAL GDP

GDP growth fluctuates widely, while employment provides a steadier read on the underlying trend in the economy. Indeed, the quarterly growth rate in jobs contains exactly as much information about the next quarter's GDP growth as does the current quarter's GDP print. The 2% annualized payroll increase in 4Q15 thus provides some reassurance that the weak GDP figure understates the economy's strength.



Source: J.P. Morgan Securities LLC, J.P. Morgan Asset Management Multi-Asset Solutions; data through 4Q 2015. For illustrative purposes only.

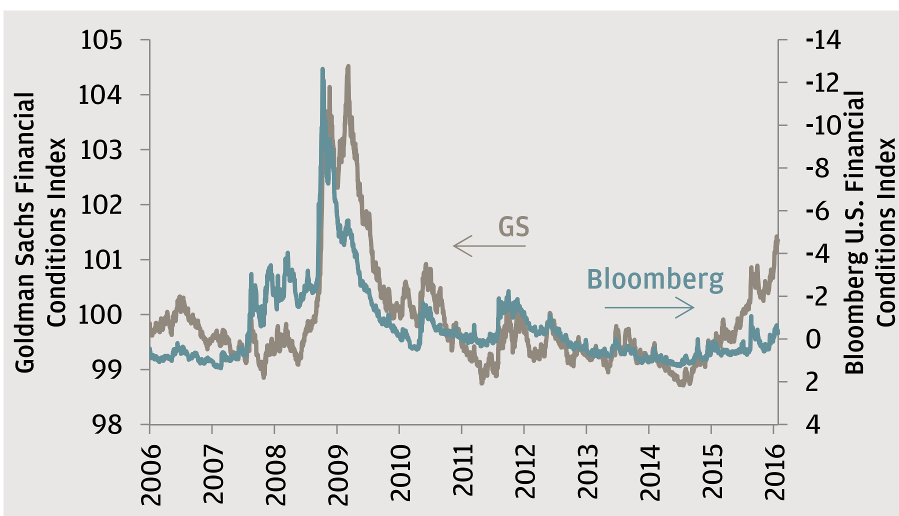
Market pricing is the second factor that could possibly change our near-term economic outlook. Regardless of whether markets are "correct" in their understanding of the environment, the plunge in equities and the widening of credit spreads have tightened financial conditions facing the economy. These moves should operate through various channels, leaning against consumer spending via a wealth effect and crimping corporate investment by making borrowing more expensive. Less favorable financial conditions should therefore chip away at growth in coming quarters, creating downside risk to our forecast. For now, though, we do not think this effect will prove severe, for several reasons. First, financial conditions already tightened sharply during 2015, thanks to the surge in the U.S. dollar, which has displayed more stability recently. In the second half of last year, the economy already dealt with a move in financial conditions indices comparable to the one experienced thus far in 2016 (Exhibit 2). Second, although stock prices have slumped, the ongoing rise in house prices should provide significant offset for consumer balance sheets and spending decisions. Third, tighter financial conditions have accompanied a renewed drop in oil prices, which has disconcerted markets in the short run but which we still regard as a modest long-term plus for U.S. growth.

ASSET CLASS IMPLICATIONS

Our assessment of the U.S. economy carries three implications for multi-asset portfolios. First, even as we respect market price action, we are not turning significantly negative. Having already de-risked portfolios in recent months, we are reluctant to go underweight stocks vs. bonds. Second, with the Fed likely in risk-management mode, we do not expect sharp jumps in bond yields in coming months, leaving us broadly neutral in duration and more focused on international relative-value opportunities. Third, we remain overweight high yield, believing that spreads are pricing in a higher risk of recession than we have projected in our outlook.

EXHIBIT 2: THE MARKET SELL-OFF HAS TIGHTENED FINANCIAL CONDITIONS

Financial conditions have tightened in early 2016, as a result of the drop in equity prices and wider credit spreads. The stalling-out of the dollar rally, though, means that this year's move looks fairly comparable to the tightening that the economy had already dealt with in 2015. Moreover, these indices do not include house prices, which have continued to rise and which should help offset the negative stock-price wealth effect.



Source: Bloomberg; data through January 27, 2016. For illustrative purposes only.

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II-AA-WEEKLY-020116