INVESTMENT INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

March 28, 2016

IN BRIEF

- In recent weeks a confluence of factors has sparked a sizzling emerging markets (EM) rally: an easing of global growth concerns, a recovery in the oil price, a retracing in the U.S. dollar and a change in investor positioning.
- The Federal Reserve (Fed) has played a critical role in moderating interest rate expectations. By signaling its relative dovishness at recent meetings, the Fed has been able to check the dollar's rise. Financial conditions within emerging markets have loosened in response.
- We doubt this rally can be sustained given the prospect of Fed rate hikes later in the year and a resumption of dollar strength. External headwinds are strong, and the EM earnings outlook remains poor. As a result, we continue to underweight EM equities in our multi-asset portfolios.

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EMERGING MARKETS: WHAT EXPLAINS THEIR RECENT STRENGTH?

Emerging market equities have rallied explosively over the past eight weeks. Since its trough on January 21, the MSCI EM index has risen by 14.0%[1] in local currency terms and 19.6%[1] once EM currency effects are taken into account. Rallies of this magnitude are not unusual: since the peak of the MSCI EM index in May 2011 there have been six previous instances of trough-to-peak gains in excess of 10%, all of which subsequently faded. The question now is whether there is cause for the current improvement in sentiment to broaden into a durable recovery.

EM gains have been sparked by a confluence of factors: an easing of global growth concerns; a recovery in commodity prices, especially the price of oil; a retracing in the U.S. dollar against a wide range of emerging market currencies; and a major change in investor positioning in multiple markets. We can see these influences are linked from the dates on which a number of well-established trends reached their recent lows. Brent crude troughed at USD28.58 per barrel on January 20, the MSCI EM index bottomed at 688 a day later, and the J.P. Morgan indices of EM currencies and EM sovereign bonds,

[1]Returns to March 23, 2016

J.P.Morgan
Asset Management

as well as the prices of commodities such as iron ore and copper, all reached their recent lows on or around January 21. The high degree of correlation within all these markets points to a common factor – a change in risk appetites – in driving these short-term changes in the market trend.

The critical influence of the Federal Reserve

The Fed can claim much of the credit for sustaining the EM equity rally of the past eight weeks. The two Federal Open Market Committee (FOMC) meetings held so far this year have substantially moderated the Fed's view of expected policy rate increases for the balance of 2016. The crux of the current policy debate within the Fed is, first, the extent to which financial stresses globally are either influenced by, or independent of, the FOMC's policy choices; and, second, how large the spillover effects of the stresses on the U.S. economy might be. The U.S. dollar has been the key transmission channel through which these policy choices have impacted the global economy. By signaling relative dovishness at its most recent meetings, the Fed has been able to check the ongoing rise in the dollar and thus help stabilize market conditions after the sharp selloff in the early weeks of the year.

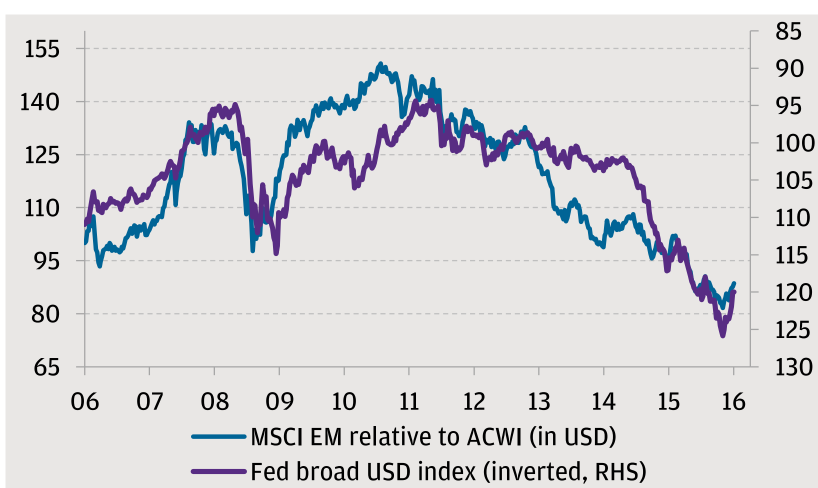
Why does the path of the U.S. dollar matter so much for EM equities? History shows that EM equities tend to outperform their developed market (DM) counterparts significantly during periods of pronounced dollar weakness and underperform in equal measure during periods of pronounced dollar strength (**Exhibit 1**). In the two periods of greatest dollar strengthening over the last 20 years, EM equities have underperformed DM equities by 25.75% on average. Conversely, in the two periods of most extensive USD weakening over the last 20 years, EM equities have outperformed DM equities by 26.20% on average. The sample size, admittedly, is small and relative performance over these periods was not solely driven by currency effects. Nevertheless, the change in financial conditions, as proxied by changes in the level of the U.S. dollar, tends to have a significantly greater impact on EM equities than it does on their DM counterparts.

Can this rally be sustained?

We are skeptical that the recent rally in EM equities can be sustained. In order for the improved sentiment to deepen into something more durable, we believe the market needs to see a combination of the following: a continued retracing in the U.S. dollar to allow EM financial

EXHIBIT 1: THE RELATIVE PERFORMANCE OF EMERGING MARKET EQUITIES IS HIGHLY CORRELATED TO THE U.S. DOLLAR

For EM equities, the direction of the U.S. dollar matters! In USD down-markets, EM tends to outperform DM, and in USD up-markets the reverse happens. Assuming past trends hold, a decisive reversal in the USD is required to sustain the EM relative uptrend.



Source: Thomson Datastream, J.P. Morgan Asset Management Multi-Asset Solutions; data as of March 24, 2016. For illustrative purposes only.

conditions to ease further; a pickup in global activity to allow growth in emerging economies to switch from domestic to external demand drivers; and a significant improvement in corporate earnings momentum to offset current valuation constraints (**Exhibit 2**). In each instance it is difficult to develop a positive narrative.

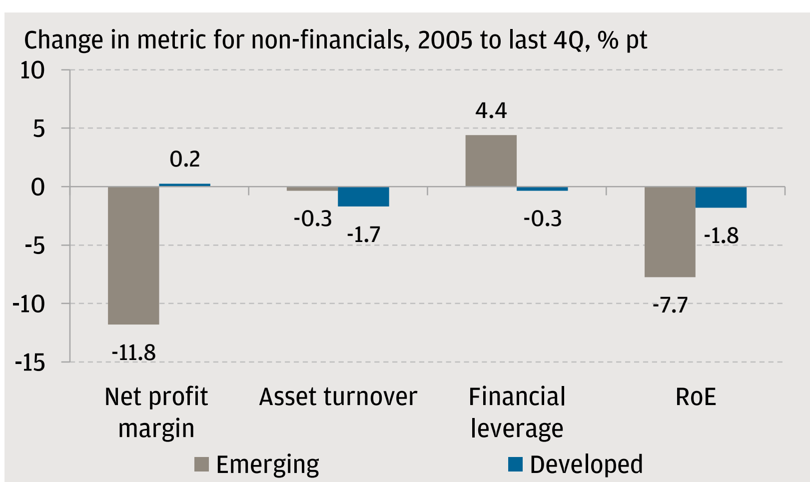
Much of the pullback in the U.S. dollar during the past eight weeks has been the result of moderating rate expectations. But if U.S. economic activity gains enough momentum to assuage the Fed's concerns over financial conditions, expectations for an earlier-than-forecast Fed rate hike could begin to reappear. For many EM economies, particularly in Asia, external headwinds have intensified as export volume growth has slowed and as manufacturing sentiment has weakened. The external demand impulse appears to be faltering. At a headline level earnings revisions data may have become less negative, while earnings momentum estimates have improved. But these can almost entirely be explained either by upgrades to currency or commodity price inputs, which are inherently fragile; or by misleading base effects. There has been little real improvement in the underlying earnings outlook across emerging markets.

ASSET CLASS IMPLICATIONS

We continue to underweight EM equities in our multi-asset portfolios. While we have been on the wrong side of this trade in recent weeks, we believe the EM rally will ultimately fade, in view of a still-challenging macro backdrop in most emerging economies, the potential for higher Fed policy rates (and a stronger U.S. dollar) as global growth fears recede, and no real improvement in the underlying EM earnings outlook. Given these obstacles, we doubt the preconditions are yet in place to mark a more decisive change in trend.

EXHIBIT 2: EMERGING MARKET EQUITIES HAVE DE-RATED SIGNIFICANTLY AS RETURNS ON EQUITY HAVE DETERIORATED

EM equities are cheap relative to DM equities, but they're cheap for a reason. Cyclically, profitability needs to rise to sustain recent gains. But EM managements also need to raise their game (through greater operating efficiencies, higher asset turns, and reduced dilution) to improve returns.



Source: Thomson Datastream, J.P. Morgan Asset Management Multi-Asset Solutions; data as of March 24, 2016. For illustrative purposes only.

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NEXT STEPS

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