Global Asset Allocation Views

Insights and implications from the Multi-Asset Solutions Strategy Summit
2Q 2020

IN BRIEF

• Just as headwinds from trade policy were beginning to dissipate, the outbreak of COVID-19 has pushed the global economy into recession. The speed and depth of the ‘sudden stop’ in the economy is unprecedented, but should the virus be contained, we could see an economic recovery later this year.

• We doubt that we have seen the bottom in equities. Bear markets bring with them the risk of short squeezes, but we are anticipating a large hit to earnings. We like duration, where we expect weak growth to push yields lower. We retain a preference for USD-denominated cash, which may become useful as dry powder.

• Within equities, the high quality of U.S. equities is attractive, and we remain cautious on European equities, whose links to the global cycle should be a headwind. Within credit, we like investment grade which has a strong support from the Federal Reserve, and in bonds we prefer higher yielding U.S. Treasuries to European bonds. News flow surrounding the virus continues to impact the economic outlook meaningfully, so we expect to stay nimble with regards to our relative value positions.

We are in a time of extreme volatility and uncertainty. New information, policy announcements and data are becoming available every day. As we navigate this crisis, we expect to increase the frequency of updates of our multi-asset allocation views to, at minimum, a monthly basis. The tick chart and views expressed in this note reflect the information and data available up to March 27, 2020.

In late 2019, the world was beginning to look brighter. A trade agreement, insurance cuts from the Federal Reserve (Fed) and a tentative turn in the macro data spurred a year-end rally in risk assets. But just as investors were focusing on the scope for economic momentum to rebound in 2020, the coronavirus was catching the attention of medics in China. Three months later, we are in the grip of a pandemic, a global recession is assumed for 2020, stocks are in a bear market, and we have a fiscal and monetary response that was unimaginable just a few weeks ago.

The speed with which the crisis ripped through asset markets is unprecedented. While investors and policymakers alike are operating in uncharted territory, the economic backdrop that will characterize the next business cycle is being forged in the fires of the current market volatility. The late-cycle economy of the last three years is no more, and the longest U.S. expansion on
record is over. But the 2020 recession will also kick off a new economic cycle, and while it is right to be cautious now, over time the economy and asset markets will recover from this shock.

Price action in March had the hallmarks of a liquidity crisis. The scramble for cash resulted in days where bonds, gold and other safe assets were sold indiscriminately alongside riskier assets. Asset markets are trying to discount both the liquidity shock and the economic shock – the scale and contour of which are unclear.

This recession and the new cycle will have their own distinct characteristics. Policymakers have responded more extensively than in any previous crisis, and just as easy monetary policy defined the last cycle, the extensive use of fiscal policy will define the next one. For now, monetary policy is the first responder to the crisis and will remain so until funding stresses recede – likely signaled by a sustained reversal of recent USD strength.

We cannot predict the long-term impact of the fiscal triage unleashed to support the real economy over recent days. But massive and ongoing fiscal support is surely required to address the prevailing deflationary pressures. Moreover, now the fiscal genie is out of the bottle, it will be hard to put back in. Thus, we expect fiscal stimulus to run alongside monetary stimulus well into the next expansion.

As growth slumps in 2020, we expect bond yields to fall further and for negative stock-bond correlation to reassert itself. But further out, fiscal stimulus together with low policy rates may ultimately have a bigger inflationary impulse than monetary policy alone, resulting in steeper yield curves at equilibrium.

Steeper curves and greater fiscal intervention could also redefine equity market leadership over the next cycle: returns driven more by nominal earnings growth than multiple expansion, dividends preferred to buybacks, operating leverage rewarded more than financial leverage and value beginning to close the gap on growth. Depending on how effectively different countries and regions deploy fiscal stimulus, international equities could, over time, start to catch up to U.S. stocks.

First, however, we must navigate the equity bear market. At the time of writing, global equities were down 25% year-to-date, but central bank intervention was starting to lend support. Stocks are currently oversold and prone to short squeezes, but we may not see the cycle lows in equities until the full extent of the hit to earnings is known and the contour of the recovery is clearer.

When markets do find their base, we expect stocks to recover more quickly than credit. Corporate leverage was a known issue before this crisis began and, as we have written previously, could be an accelerant now a crisis is upon us. Certainly, the Fed’s backstop of investment grade (IG) credit offers powerful support for higher quality firms with stable cash flows. However, its purchases do not extend to high yield (HY) – where exposure to weak energy markets is the greatest – and will not forestall ratings downgrades for firms with an impaired cash flow outlook.

For now, our multi-asset portfolios are on a recession footing and positioned for ongoing volatility: overweight cash and duration with modest underweights to equity and credit. We are mindful of the risk of short squeezes but do not expect to hit the lows in stocks until midyear, when the damage to earnings is clearer. Without question, some assets are oversold, and where policymakers have provided backstops – for instance, in higher quality credit – there are opportunities to selectively add risk. But for the time being, we acknowledge that conviction is likely to stay low and a cash buffer is important.

We also note that eventually the current recession will yield to a new economic expansion – and the cash that provides portfolio protection today will, in time, be the dry powder to start adding risk in anticipation of the new cycle.
Multi-Asset Solutions Key Insights & “Big Ideas”

In previous editions of our Global Asset Allocation Views, we included a map and table of key global themes. Those themes helped us discuss the economic and market outlook, and shape the asset allocation that Solutions reflected across portfolios. While some of those themes are still in play we now choose to share the Key Insights and “Big Ideas” discussed in depth at the Strategy Summit. These reflect the collective core views of the portfolio managers and research teams within Multi-Asset Solutions and are the common perspectives we come back to and regularly retest in all our asset allocation discussions. We use these “Big Ideas” as a way of sense-checking our portfolio tilts, and ensuring they are reflected in all of our portfolios.

- The phase has changed; we are now in a new cycle, which will have its own unique characteristics.
- Fiscal stimulus is the new normal, but monetary stimulus continues to be the first responder.
- “Enough” monetary support may well coincide with a peak in the dollar.
- Negative stock-bond correlation will reassert itself as funding fears ease.
- Bond yields have room to fall as we go through a recession, but in the medium term, curves are set to be steeper.
- Credit losses may be deep and drawn out as leverage comes down, but the Fed backstop to IG is a key step.
- Leadership in equities has scope to change, sector- and factor-wise, as well as regionally, in this new cycle.
- It may be too soon to add risk, but when we do we’d rather add to stocks than credit.

Active allocation views

In normal times, these asset class views apply to a 12- to 18-month horizon, however given current volatility and uncertainty they reflect a horizon of several months but are subject to revision as new information becomes available. We will update this tick chart at minimum monthly during this period of volatility. The dots represent our directional view, up/down arrows indicate a positive (△) or negative (▼) change in view since the last revision. 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.

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Opportunity set</th>
<th>UW</th>
<th>N</th>
<th>OW</th>
<th>Change</th>
<th>Conviction</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MAIN ASSET CLASSES</strong></td>
<td>Equities</td>
<td>▲</td>
<td>▼</td>
<td>▲</td>
<td>Moderate</td>
<td>Expect a big hit to EPS; risk of short squeezes but ultimate market lows likely in midyear</td>
</tr>
<tr>
<td></td>
<td>Duration</td>
<td>▲</td>
<td>▼</td>
<td>▲</td>
<td>Moderate</td>
<td>Recession set to push yields lower; central bank bond buying also compresses yields</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>▲</td>
<td>▼</td>
<td>▲</td>
<td>Moderate</td>
<td>Disinflationary risks offset zero rates as market stabilizes, also provides dry powder</td>
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<tr>
<td><strong>U.S.</strong></td>
<td>Moderate</td>
<td>Could be choppy near term as virus cases rise, but quality is supportive during crisis</td>
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<tr>
<td><strong>Europe</strong></td>
<td>Low</td>
<td>Focal point of crisis for now; fiscal stimulus coming, but link to global cycle a headwind</td>
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<tr>
<td><strong>Japan</strong></td>
<td>Low</td>
<td>Global supply-chain disruption and sudden stop in activity a headwind</td>
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<tr>
<td><strong>Emerging markets</strong></td>
<td>▲</td>
<td>▼</td>
<td>▲</td>
<td>Low</td>
<td>China the first to emerge from crisis and businesses beginning to restart activity</td>
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<tr>
<td><strong>G4 ex-U.S. sovereigns</strong></td>
<td>▲</td>
<td>▼</td>
<td>▲</td>
<td>Moderate</td>
<td>Yields likely to remain persistently low, but negative yields limit returns</td>
<td></td>
</tr>
<tr>
<td><strong>EMD hard currency</strong></td>
<td>▲</td>
<td>▼</td>
<td>▲</td>
<td>Moderate</td>
<td>Higher grade EMD at attractive valuation levels, but ongoing funding issues limit upside</td>
<td></td>
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<tr>
<td><strong>Corporate investment grade</strong></td>
<td>▲</td>
<td>▼</td>
<td>▲</td>
<td>Moderate</td>
<td>Powerful support from Fed for IG, but does not entirely alleviate downgrade risk</td>
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<td><strong>Corporate high yield</strong></td>
<td>▲</td>
<td>▼</td>
<td>▲</td>
<td>Low</td>
<td>Significant exposure to weak oil markets; some opportunities in higher rated segment</td>
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<tr>
<td><strong>USD</strong></td>
<td>Moderate</td>
<td>Balanced between safe haven demand and central banks, efforts to ease funding stress</td>
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<tr>
<td><strong>EUR</strong></td>
<td>▼</td>
<td>▲</td>
<td>▼</td>
<td>Low</td>
<td>ECB easing puts pressure on EUR; Italy and Spain virus issues also a headwind</td>
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<tr>
<td><strong>JPY</strong></td>
<td>▲</td>
<td>▼</td>
<td>▼</td>
<td>Low</td>
<td>Natural safe haven status lends support if crisis worsens</td>
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<tr>
<td><strong>EM FX</strong></td>
<td>▲</td>
<td>▼</td>
<td>▼</td>
<td>Moderate</td>
<td>USD funding stress and strain on EM central banks to ease put pressure on EM FX</td>
<td></td>
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</table>

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments are made using data and information up to March 2020. 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.
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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 December 31, 2019.

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