Global Asset Allocation Views

Themes and implications from the Multi-Asset Solutions Strategy Summit

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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		○	○	○	○	●	○	○
	Europe ex-UK	▼	○	○	●	○	○	○	○
	UK		○	○	○	●	○	○	○
	Japan		○	○	○	○	●	○	○
	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

- A challenging first half for asset markets doesn't obfuscate the positive global growth outlook for 2018. While it is true that the pace of growth has moderated it remains above trend, and with both expectations and positioning less stretched we see scope for better asset returns in the second half.
- Investors' tail risk fears have shifted from concern about inflation overshooting and triggering more rapid rate hikes, to growth undershooting and crimping earnings. Against this backdrop, bonds are an effective portfolio hedge, and with real yields moving higher duration is less costly to hold in portfolios.
- We keep a moderate overweight to equities with a preference for U.S. and emerging market stocks; we close our duration underweight and keep a neutral stance on credit and cash. At the margin the moderation in the pace of global growth leaves us a touch less convicted on our pro-risk tilt, but our increased appetite to hold bonds within portfolios mitigates our risk to a good degree.

Based on the market narrative from early January, 2018 hasn't exactly gone according to script thus far. It was all so clear at the start of the year: Coordinated global growth and booming earnings would drive bumper first-half gains before rising rates eventually caught up and spoiled the party, leading to a more challenging second half. But as of the end of May, total year-to-date returns for world equities were essentially flat, with the U.S. up 2% and the rest of the world down 2%. Meanwhile, U.S. 10-year yields rose 50 basis points (bps) but German 10-year yields were essentially unchanged. It's almost like the second half of the year happened six months early.

So what went wrong? While growth has moderated, it is still above trend, and earnings have been good; certainly, geopolitical anxiety and risks to global trade have ticked up, but the macro environment is generally supportive of taking risk. In our view, the tricky market dynamics in the first half of the year were driven partly by the unwinding of frothy sentiment and stretched positioning. For the rest of 2018, the growth outlook is solid, so with policy still accommodative and investors' expectations reset to more reasonable levels we see scope for returns to improve in the second half. Nevertheless, if the early part of the year did nothing else, it should remind us that late-cycle economies give little quarter to complacency and still less to exuberance.

In the second half of 2018, we expect stable, above-trend growth, balanced inflation risks and gradual removal of central bank accommodation. At the same time, concerns about trade, geopolitics and the simple length of this expansion are likely to occasionally bubble up. Yet a pragmatic recognition of risks to a broadly constructive base case is probably a healthier backdrop for asset markets than the flirtation with exuberance we saw in January.

Recession risk is still quite low, particularly considering the length of the U.S. expansion, and historically it is unusual for stocks to underdeliver for a prolonged period when the economy is expanding. With expectations and sentiment now reset to a more reasonable level, equity markets should be better able to respond well to favorable data—albeit probably at a more measured pace than in the second half of 2017.

Another subtle shift in the investing calculus also occurred over the first half of the year as investors went from being most fearful about inflation overshooting to being more concerned about growth undershooting. While a pickup in U.S. inflation data may have catalyzed the correction in February, threats to growth—oil prices, dollar strength, eurozone political angst, etc.—now seem to worry investors rather more than inflation. To be clear, these are tail risks, but as investors shift the focus of their fears from inflation risk to growth risks, bonds become a more compelling part of the portfolio.

At the margin, this gives us latitude to maintain a constructive view in portfolios while still acknowledging that tail risks have ticked up—we are still moderately pro-risk, but our conviction is a touch lower. With higher U.S. Treasury yields better reflecting inflation risks, we can balance our portfolio risk with a little more duration rather than simply trimming equity overweights at a time when we believe stock markets are regaining their poise. We maintain our moderate overweight (OW) to stocks but close our duration underweight (UW), and stay neutral on credit and cash.

The U.S. and emerging markets (EM) are our preferred equity markets. We see further earnings upside to U.S. stocks, as well as a favorable sector exposure to technology. EM equities faced headwinds from a dollar rebound in the first half, but as this burst of strength fades we expect the superior pace of growth in many EM economies to drive earnings upgrades. By contrast, we see eurozone equities struggling a little in the second half as the 2017 surge in European growth moderates and political risks present an unwelcome distraction.

In sovereign fixed income, we expect higher yielding countries like the U.S. and Australia to outperform German Bunds and Canada. UK Gilts could also perform quite well, despite their modest yields, as Brexit uncertainty weighs on the economy. In credit, corporate leverage is a key factor to monitor, but with recession risks low we don't see it as a binding constraint just yet and expect low but positive returns from corporate bonds.

Asset returns in the second half of 2018 should be an improvement on the first half, but there is a growing sensitivity to any threat to economic growth. The return of U.S. short-end rates to positive territory means a higher hurdle for deploying capital to riskier assets; but equally the higher yields on bonds also means that diversifying pro-risk positions in portfolios is less costly. U.S. yields at around 3% do not seem to be the constraint on equity returns that was feared, and indeed may—for the time being—even grant investors a level of comfort in keeping a risk-on tilt as the economy moves deeper into late cycle.

KEY THEMES AND THEIR IMPLICATIONS

Theme		Macro and asset class implications
GLOBAL THEMES	Global policy divergence	Policy divergence now mainly in timing, not direction; U.S. rates are rising, but trajectory shouldn't be a problem for stocks
	Supply-side weakness	Few signs of labor tightness becoming a binding constraint; were wage pressures to build meaningfully, USD might appreciate
	Widespread technology adoption	Potential to add over a point to trend GDP over the decade, but will disrupt some sectors; tech stocks in a secular uptrend
DEVELOPED MARKETS THEMES	Maturing U.S. cycle	Recession risks remain low despite age of cycle; gradual policy tightening may lengthen cycle; U.S. stocks well supported
	Europe: gradual growth recovery	European growth is moderating but still above trend; political risks still a concern, but as these ease expect EUR to rebound
	Japan: beyond Abenomics	Corporate governance is improving, and BoJ policy is unlikely to change in 2H18; JPY stable, Japanese equity supported
EMERGING MARKETS THEMES	Emerging market convergence	Domestic economic momentum should resume as recent bout of USD strength clears; further upside likely for EM equity
	China in transition	2018 growth data so far robust and showing the economy is moving very slowly toward services and the consumer

Source: J.P. Morgan Asset Management Multi-Asset Solutions; data as of May 2018. 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		○	○	○	○	●	●	○	Above-trend growth supports further EPS upgrades; valuations less of a headwind
		Duration	▲	○	○	○	●	○	○	○	Inflation risk better priced and entry level more attractive with global yields higher
		Credit		○	○	○	●	○	○	○	Credit offers positive, if muted, returns, but corporate leverage requires monitoring
		Commodities		○	○	○	●	○	○	○	Supply issues in 1H drove an oil rally, but expect OPEC to temper production cuts in 2H
		Real estate		○	○	○	●	○	○	○	Real estate sector fundamentals constrained and sector level issues remain
		Cash		○	○	○	●	○	○	○	U.S. real cash rates are now positive in all but the shortest tenors
PREFERENCE BY ASSET CLASS	EQUITIES	U.S. large cap		○	○	○	○	●	○	○	Valuations less of a headwind; EPS upside not fully priced; tech sector recovering
		U.S. small cap		○	○	○	○	●	○	○	Beneficiary of fiscal stimulus, but fewer currency risks if USD appreciates further
		Europe ex-UK	▼	○	○	●	○	○	○	○	Eurozone growth cooling and political risk resurfacing; renewed EUR strength a risk
		UK		○	○	○	●	○	○	○	Improving earnings and attractive yield, but requires weak GBP for outperformance
		Japan		○	○	○	○	●	○	○	Cash distribution continues to improve; soft earnings in 1Q, but expect a rebound
		Asia Pacific ex-Japan		○	○	○	●	○	○	○	HK stocks buoyed by China outlook, cautious on Australia; in sum neutral on region
		Emerging markets		○	○	○	○	●	○	○	USD rally in 2Q hurt EM equity, but as this fades in 2H EPS growth should improve
	REAL ESTATE	Direct real estate		○	○	○	●	○	○	○	Late in cycle for real estate; supply still outstripping absorption rates
		U.S. REITs		○	○	●	○	○	○	○	Late-cycle real estate sector prevent REITs from leveraging above-trend U.S. growth
	SOVEREIGN FIXED INCOME	U.S. Treasuries	▲	○	○	○	○	●	○	○	Yields can probably rise a little further, but higher coupons mitigate rate risks
		U.S. TIPS		○	○	○	●	○	○	○	U.S. inflation moving back to trend in 2018 provides modest support
		Euro, core (Bund)	▲	○	○	●	○	○	○	○	Absent a worsening political crisis, Bund yields will probably rise as ECB tapers in 2H
		Euro, periphery (BTP)		○	○	○	●	○	○	○	Political risks dominate price action for now; if this clears, carry vs. Bund is attractive
		UK Gilts	▲	○	○	○	○	●	○	○	Brexit uncertainty, weak growth and dovish MPC provide support for Gilts
		Japanese JGBs		○	○	○	●	○	○	○	Yields pegged to near zero by BoJ; prefer to play Japan via currency or equity
		Canadian gov't bonds		○	○	●	○	○	○	○	Canadian inflation at target and rising; growth data support higher rates
		Australian gov't bonds	▲	○	○	○	○	●	○	○	Now trading under USTs, but inflation and growth outlook remain muted
	CREDIT	Investment grade		○	○	●	○	○	○	○	Corporate leverage a concern; higher sovereign yields may pull buyers away from IG
		U.S. high yield		○	○	○	●	○	○	○	Little scope for meaningful spread tightening, but carry still attractive
		European high yield		○	○	○	●	○	○	○	Expensive in absolute terms, but duration adjusted to U.S. HY still looks reasonable
		Emerging markets debt	▼	○	○	○	●	○	○	○	Valuation support now spreads have widened, but prefer to play EM via equity
	FX	USD		○	○	○	●	○	○	○	Recent rally beginning to fade; deficit issues weigh on dollar over medium term
		EUR		○	○	○	○	●	○	○	Political risk and dovish ECB pushed EUR down; scope to rebound as QE ends
		GBP		○	○	●	○	○	○	○	Toward middle of trading range, but Brexit risks becoming more apparent
		JPY		○	○	○	●	○	○	○	Likely range-bound against USD with BoJ policy stable and domestic growth better

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments are made using data and information up to May 2018. 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, 2018.

NEXT STEPS

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

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