INVESTMENT INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

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IN BRIEF

- Weaker commodity prices, a policy of central bank tightening and some faltering economic momentum in the second quarter have markets concerned that China could be the source of a negative impulse to the global economy.
- We believe that strong first quarter economic growth and improving bank asset quality gave China's authorities the confidence to step up their efforts to reform the financial system. Tightening measures particularly target those lenders that either rely on interbank funding or do not meet more stringent macroprudential assessments. We believe the tightening is not designed to materially slow the overall economy.
- Financial stability is China's primary objective for 2017. We do not expect that the authorities will allow growth momentum to weaken materially. We remain overweight emerging market equities as part of a broadly pro-risk asset allocation.

CHINESE FINANCIAL REFORM TOUCHES, BUT DOESN'T THREATEN, ECONOMIC GROWTH

In recent years China's economy and related financial markets have experienced several mini-cycles. Over the past few months, a moderation in leading economic indicators, and significant change in financial regulation, has led to heightened concerns that the economy is at the beginning of another downslope. Indeed, a closely-followed survey of global fund managers recently revealed that credit tightening in China had become the biggest tail risk facing markets.

The tightening of monetary policy began at the end of January in the form of a small interest rate hike in one of the People Bank of China's (PBoC) several lines of liquidity (lending facilities) to banks. After the Chinese New Year in mid-February, additional hikes to other lending facility rates swiftly followed. But only in the last two months have market concerns reached a critical level, sparked largely by a sharp fall in China-dependent commodity prices (iron ore is down by a third since mid-March, largely because of oversupply and high inventories, not demand concerns) and increased efforts to improve financial regulation.

Amid tightened liquidity, the China Banking Regulation Commission (CBRC), newly headed by Guo Shuqing, has published several documents outlining a toughened stance toward

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shadow lenders and banks that are heavily dependent on interbank funding (as opposed to customer deposits). Among other moves, the CBRC has also signaled a tightening of regulatory loopholes that allowed banks to effectively lend without incurring capital charges.

Economic health a necessary condition for financial reform

We do not believe these actions aim to slow the broader economy. We emphasize the targeted nature of the policy moves (reminiscent of the city-specific measures to cool the housing market in recent times) and note the authorities' unwillingness to engage in broad tightening measures such as raising benchmark lending and deposit rates or reserve requirement ratios. As we see it, the new policies look to address the well-documented high leverage in parts of the economy and improve the long-run health of the financial system.

The strength of the Chinese economy in late 2016 and early 2017 likely gave the authorities confidence to initiate substantial changes in financial regulation, along with targeted tightening. Economic stability is a necessary condition for undertaking such reform and we expect that the declared 2017 goal of financial and economic stability has primacy over a clean-up of the financial system.

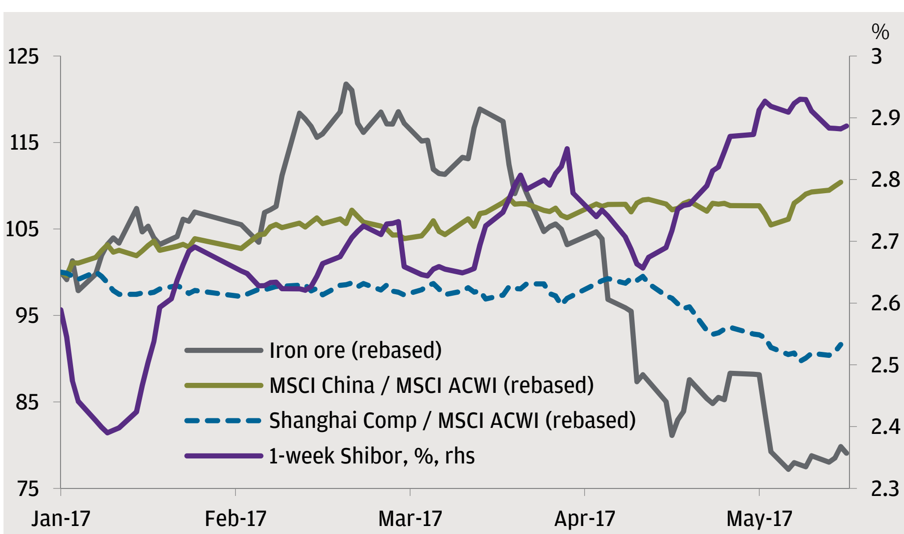
Should growth concerns spike we anticipate the PBoC would loosen liquidity constraints. An injection of CNY459 billion by the PBOC on May 12 is a good example of the central bank balancing the needs for financial reform and economic stability and we note interbank lending rates have moderated in recent weeks.

While the all-important credit impulse is fading (as is almost inevitable following such a surge) other timely barometers of economic health do not paint an overly gloomy picture. Steel demand and related construction and infrastructure activity are still strong, electricity output is up 16% year-on- year and retail sales growth is stable at around 11%. House prices edged up in April, but on low transaction volumes, and housing starts are likely to weaken with some smaller developers facing restricted access to finance. We see a limited downside to prices given low inventory levels. To be sure, the economy will slow, but only modestly.

The recent declines in commodity prices will likely lead to waning headline producer price inflation, thus quieting some of the investor cheer that has been heard since China's producer prices began to revive in 4Q16 after four years in negative territory. To some extent, capacity cuts in certain industries were probably part of the financial

EXHIBIT 1: IN 2017, CHINESE EQUITIES HAVE OUTPERFORMED GLOBAL BENCHMARKS DESPITE HIGHER INTERBANK RATES AND FALLING IRON ORE PRICES

The combination of tightening liquidity conditions, rising interbank lending rates and falling iron ore prices has increased investor concerns about the health of the Chinese economy. The MSCI China index, dominated by better quality banks and technology companies, has outperformed global equity markets, while lower quality domestic markets have underperformed.



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of May 18, 2017. For illustrative purposes only.

reform plan. By closing capacity, industry utilization rates were pushed up, prices moved higher and industrial profitability improved, thereby enhancing bank asset quality. That in turn helped to anesthetize any potential ill effects from deleveraging brought about by tighter financial regulations and the removal of central bank liquidity. In terms of underlying inflation, core CPI and consumer goods PPI are at six- and four-year highs, respectively. This should keep nominal growth at sufficiently healthy levels to facilitate debt servicing and bank asset quality.

Not all about the 19th Party Congress

Much of the market's discussion of Chinese politics has centered on the 19th Party Congress, scheduled for the autumn, and the associated re-staffing of the Politburo's Standing Committee. But market participants should not overlook the significance of the overhaul of the financial regulatory bodies. The appointment of Guo Shuqing as the new chairman of the CBRC brings much-needed experience from all key areas of the Chinese economy. Guo has been Chairman of China Construction Bank and the China Securities Regulator, worked at the PBoC and State Administration of Foreign Exchange (SAFE), and served as governor of Shandong province. He is likely to orchestrate a more cohesive and rational approach to financial stability and may have as great an influence over the economy as the Standing Committee itself. It is worth noting that the authorities' recent economic and financial actions reportedly have the full support of President Xi Jinping.

Of course, the 19th Party Congress will be an important event, part of a political process that strives always to maintain social stability. Aside from the difficult task of a controlled deleveraging, mid-single digit economic growth and job security are tough goals to achieve against the backdrop of a declining workforce, poor Social Security system (leading to high savings rates) and an ongoing threat to employment from automation. One saving grace for President Xi is that, having spent several years overseeing a wide-reaching anti-corruption campaign, he faces very few plausible threats to his power base. Some speculate that he could even extend his tenure beyond 2022. What appears to be the beginning of a friendly rapport with U.S. President Donald Trump, coupled with wide coverage of China's recent One Belt One Road summit (a far-reaching international infrastructure plan) could help to further cement President Xi's domestic support as his global profile rises.

ASSET CLASS IMPLICATIONS

We remain vigilant to risks emanating from China, but we do not expect significant downside risks to materialize. We therefore maintain our pro-risk asset allocation, which includes an overweight in emerging market equities. Financial reforms are welcome in China since they should reduce the systemic risk of a highly leveraged economy. In this context, we underscore that the large cap banks with well-funded balance sheets, representing a large weight in emerging market equity benchmarks, have been little impacted by recent tightening measures. At the same time, as seen in **Exhibit 1**, equity indices with greater exposure to companies impacted by tightening liquidity conditions (as well as falling iron ore prices) have delivered notably worse performance.

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