Multi-Asset Solutions Monthly Strategy Report

Global markets and multi-asset portfolios

October 2020

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The tick chart and views expressed in this note reflect the information and data available up to September 28, 2020.

EXHIBIT 1: MAS ASSET CLASS VIEWS FROM SEPT STRATEGY SUMMIT

Asset class		Opportunity Set	UW	N	OW	Chg	Conviction
MAIN ASSET CLASSES		Equities	○	○	●		Moderate
		Duration	●	○	○		Low
		Credit	○	○	●		High
		Cash	○	●	○		
PREFERENCE BY ASSET CLASS	EQUITIES	U.S.	○	○	●		Low
		Europe	○	○	●		Moderate
		UK	●	○	○		Low
		Japan	○	●	○		
		Emerging markets	○	○	●		Low
	FIXED INCOME	U.S. Treasuries	○	●	○		
		G4 ex-U.S. sovereigns	●	○	○		Moderate
		EMD hard currency	○	●	○		
		EMD local FX	○	●	○	▲	
		Corporate inv. grade	○	○	●		Moderate
		Corporate high yield	○	○	●		High
	FX	USD	●	○	○	▼	Moderate
		EUR	○	○	●	▲	Low
		JPY	○	●	○	▼	
		EM FX	○	●	○	▲	

IN BRIEF

- A new business cycle has begun, a cause for optimism both for the economy and for asset returns. But the traditional "early cycle playbook" may not apply this time around given the exceptional nature of monetary easing and the sheer scale of fiscal support in response to the coronavirus recession.
- In the past, cyclical stocks have been highly correlated with value stocks. But from the market's March lows, cyclicals have recovered sharply vs. defensives, while value has struggled against growth.
- A sustained rotation into value stocks would require higher U.S. government bond yields, reflecting greater confidence in economic growth, and brightening the outlook for banks – a key value sector. In the first instance, however, faltering performance by the technology sector could also begin to narrow the gap between growth and value.
- We continue to take a diversified, pro-risk position in our portfolios. We overweight equities and credit, mildly underweight duration and our portfolios will benefit from a weaker dollar. If tail risks play out in the fourth quarter and lead to market choppiness, we would be inclined to add risk in periods of weakness.

Welcome to our first Monthly Strategy Report. These monthly notes, which replace our Weekly Strategy Reports, will cover key research themes and prevailing market issues, highlighting how these topics are reflected in our multi-asset portfolios.

STYLES AND SECTORS FOR A NEW BUSINESS CYCLE

The coronavirus pandemic has dominated news flow throughout 2020. Looking forward, even after the first acute phase of the pandemic has passed, its imprint on our economy and indeed on the very fabric of our lives will likely be prolonged and profound. From an economic standpoint, the COVID-19 induced recession has already entered the history books as the shortest but sharpest on record.

With the recession now behind us, we are embarking on a new business cycle. In our view, this is a cause for optimism – both for the economy and for asset returns – but the unusual cause of the recession, and the unprecedented response to it from policymakers, means we should be thoughtful in how we apply the "early cycle playbook" this time around.

Although the recession and subsequent rebound happened at lightning speed, we see similarities to the market topography of previous cycles. Monetary easing from central banks averted immediate liquidity concerns, fiscal support from governments shored up confidence, risk assets found a floor and rallied, and bond yields rose off their lows.

However, given the nature of monetary easing and the sheer scale of fiscal support in the coronavirus recession, the rebound, and the cycle ahead, display unique characteristics.

The classic early cycle playbook suggests that as a new business cycle begins, rates are low but yield curves are steep. Credit spreads are wide but tightening quickly, safe haven currencies are starting to sell off, and stocks are cheap but rallying hard, typically led by beaten up cyclicals and value sectors. Today rates are certainly low but curves are rather flat. Credit spreads are doing largely as expected – especially now that the Federal Reserve is a buyer of last resort in credit markets – and the trade-weighted dollar is down 10% from its summer peak. Stocks did rally very quickly, but with unusual leadership at a sector and style level.

Some cyclical sectors have performed strongly, but others, especially financials, have lagged. Moreover, growth sectors like technology, which are expensive and have led the market higher for some years, extended their outperformance through the crisis.

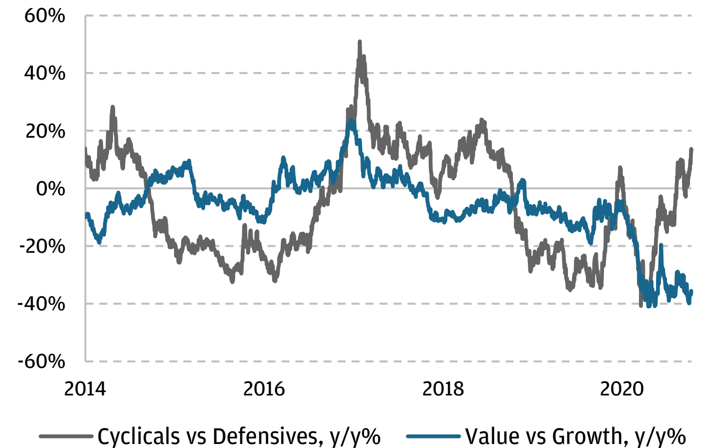
Cyclicals don't equal value

In the past, cyclical stocks have been highly correlated with value stocks.[1] However, in the aftermath of the stock drawdowns associated with COVID-19, cyclicals have recovered sharply vs. defensives, while value has struggled against growth (**Exhibit 2**).

While there is a historical correlation between value and cyclical stocks, we shouldn't expect it to apply at a time when interest rates are depressed, yield curves are flat, and energy prices are low. Both sides of the value vs. growth trade have worked against the pair this year. On the value side, financial companies have been hit hard by the reduction in economic activity associated with COVID--19, the broadly deflationary impulse of the crisis, and the sense that banks are exposed to considerable default risk from companies currently receiving government support. At the same time, energy companies have struggled amid lower oil prices. On the growth side, technology stocks reflected the group's earnings resilience and their increased relevance as working styles and social interactions changed dramatically during the pandemic.

While cyclicals have rebounded strongly, value has struggled

EXHIBIT 2: CYCLICALS VS. DEFENSIVES, VALUE VS GROWTH, 2014-2020



Source: Bloomberg, Morgan Stanley, J.P. Morgan Asset Management Multi-Asset Solutions; data as of October 2020.

The cyclicals vs. defensives trade has told a different story, though. Cyclicals – notably industrials, materials and consumer discretionary stocks – have captured the rebound in economic activity. Defensives, like utilities and consumer staples, have taken part in the equity market recovery, but to a lesser degree. Now investors ask: What could change?

What could support a sustained rotation?

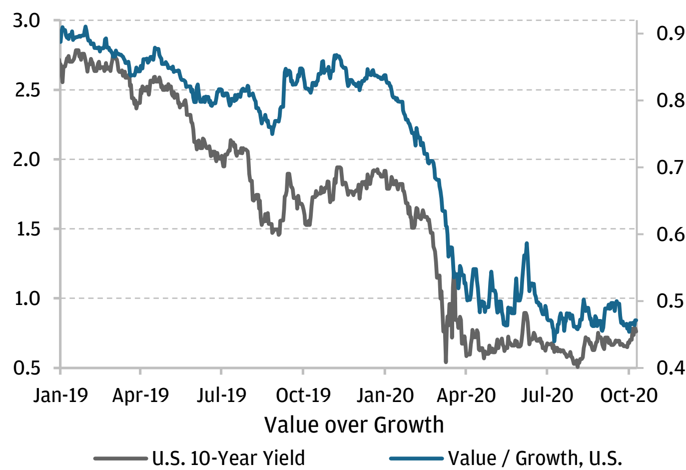
Since March, and notwithstanding the wobbles in mega-cap U.S. stocks in September, investors did well with a barbell strategy of growth and cyclical stocks. The cyclicals vs. defensives trade is GDP sensitive, and our forecast for above-trend growth leads us to own cyclicality in our portfolios through exposure to European and emerging market equities. We see a higher bar for a rotation into value stocks: higher U.S. government bond yields, which help value stocks via growth expectations, and higher net interest margins earned by banks (**Exhibit 3**).

Our equity colleagues think that much of the selling pressure for value stocks may be behind us. While this could be the case, we

[1] In this piece, we refer to the index definition of value, rather than a sector-neutral one.

A rotation back to value likely requires higher government bond yields

EXHIBIT 3: U.S. 10-YEAR YIELD, VALUE VS GROWTH, 2019-2020



Source: Bloomberg, Morgan Stanley, J.P. Morgan Asset Management Multi-Asset Solutions; data as of October 2020.

believe that evidence of a sustained path to higher interest rates and growing confidence in the economic growth outlook will be needed to prompt a positive rotation back into value. Still, the wide performance gap between growth and value styles could start to converge if tech stocks begin to struggle amid stricter regulation.

As the tech sector accounts for more than a quarter of the S&P 500, this raises one important question: Can the U.S. beat non-U.S. equities in the next cycle as it did in the last? It's hard to identify a catalyst for when value might start to catch up to growth. But we believe diversification across equity regions gives us valuable exposure to the global recovery and helps prevent us getting caught on the wrong side of a rotation towards value.

PORTFOLIO IMPLICATIONS

Our regular readers will know that each quarter we hold a Strategy Summit that involves all of our investment and research teams around the globe. Here we create our "tick chart" (**Exhibit 1, front page**) which captures our broad preferences, by asset class, looking over a roughly 6-12 month horizon. Typically the views reflected here are fairly stable over a quarter, but on occasion we make updates at our Monthly Asset Allocation meetings. In our October meeting, while we made some marginal shifts within portfolios, they remain well aligned to the views captured in the tick chart from our September Strategy Summit. We continue to operate with a moderate pro-risk tilt, mindful of the tail risks we face through October and early November.

Our pro-risk tilt reflects our belief that the sharp rebound of 3Q20 is now moving into a more normal early cycle phase, with above-trend growth in 2021. Monetary and fiscal policy are pointing in the same direction and the environment is broadly supportive. The U.S. election, Brexit negotiations, the path of COVID-19 and debate over fiscal packages suggest meaningful tail risks. But risks operate in both directions: continued positive surprises on trade, strong household balance sheets, and potential for a COVID-19 vaccine all present upside risks.

Given our positive views, we maintain an overweight to equities and credit across our portfolios. We are mildly underweight duration and our portfolios will benefit from a weaker dollar. While we acknowledge that equity valuations are optically quite rich, on the basis of normalized earnings we do not think valuations are particularly stretched, especially relative to bonds. Our diversified equity exposure favors the U.S. market (notably small caps, which score well in our quant models), European and emerging market (EM) equities. We keep a negative view on UK equity, although favorable relative valuations are starting to be reflected in our quant models.

Credit plays a hybrid role in our portfolios, with low beta to equity and, in the investment grade universe, a substitute for duration. While acknowledging meaningful event risk in October and November, we expect the economic outlook to continue to brighten into 2021 – lending support to credit. Nevertheless Fed support of credit markets offers some further downside protection. At this time we maintain only a mild underweight to duration, despite strongly negative signals from our quant models. With Fed bond purchases set to continue well into 2021, we don't expect rates to rise significantly in the near term.

In sum, we continue to take a diversified, pro-risk position in our portfolios but recognize that ongoing policy support likely means rates remain low for some time. If tail risks play out in 4Q20 and lead to market choppiness, we would be inclined to add risk in periods of weakness.

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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 September 30, 2020.

NEXT STEPS

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