MARKET THOUGHTS

Hurdle Race

By Richard Madigan, Chief Investment Officer

June 2018

It's important to pause and reflect on where we are in the current market cycle as well as our fundamental outlook. I think of this note as a mid-term report card of sorts. There is a lot to discuss as we look out over the next 12 months. I expect a bumpy ride.

This year, investors have been stuck in what feels like a never-ending hurdle race. Equity markets have been racing around the same track, jumping up and down, and effectively returning to the same starting point. I sense there are more laps ahead. Hurdling can be exhausting. I've just started training for the NYC Marathon with my son, which we are running in November. Fortunately, that race will have an open road and no hurdles.

Government bond markets sold off at the start of this year with yields pressing higher, reflecting stronger global growth (Figure 1). We leapt some hurdles in fixed income early this year, and rising interest rates remain something portfolios are well positioned to navigate.

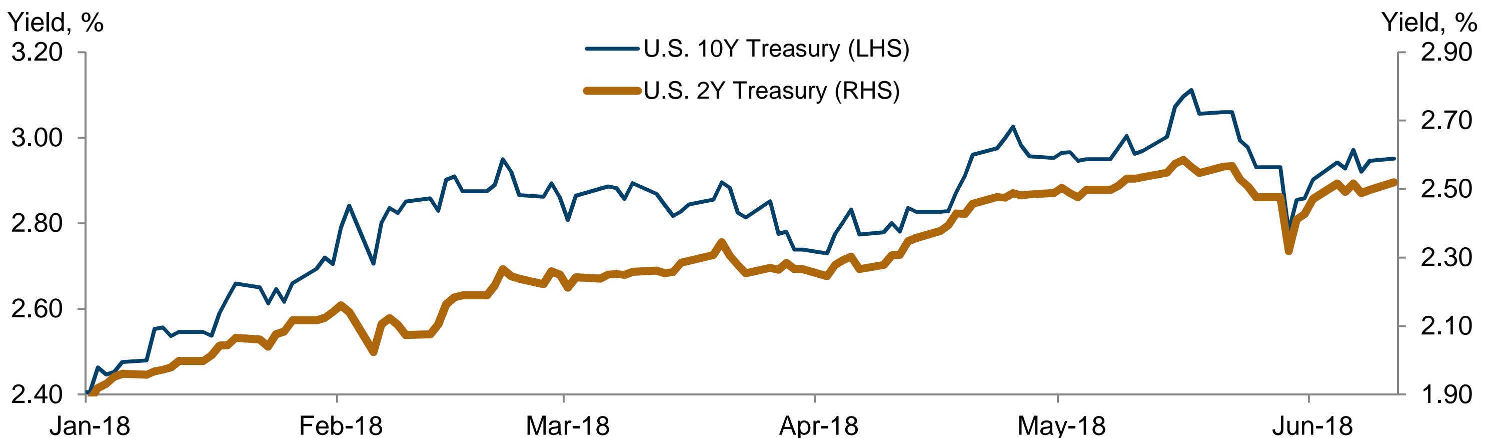
IN BRIEF

- After the past few years of balanced global growth, divergence is creeping into the macro narrative
- We've recalibrated our regional equity overweights as a result, tilting more into the U.S.
- The Federal Reserve will become increasingly important as markets remain jittery about the level where the Fed will have tightened too much
- Escalating tariff retaliation will continue to weigh on global business sentiment and investment

The first quarter saw a particularly volatile re-pricing of government bonds, especially in the United States. This hurt fixed income performance. Despite rising rates over the past few years, we've been able to generate alpha in our fixed income allocations. I'm not dismissive of the first-quarter setback in fixed income, but I am cognizant that this is a longer journey.

For our managed fixed income portfolios, we've redeployed some of our core bond exposure into higher-quality, short-duration credit. We intend to capitalize on rising yields in the front end of credit curves, given the flattening we've seen across government bonds since February. We own bonds to help navigate drawdowns in equity markets, diversifying the risk we are taking elsewhere in portfolios. We believe that bonds can continue to serve this purpose.

Figure 1. U.S. yields have pressed higher this year



Source: Bloomberg. Data as of June 2018.

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SYNCHRONICITY

We haven't seen the balanced global growth experienced in the past few years in over a decade, and this anchors our pro-cyclical portfolio positioning. To keep it simple: it allowed us to remain overweight stocks and underweight bonds. However, we moderated the risk of these positions with reduced allocations to credit and have favored less directional alternative investment strategies—for portfolios that hold hedge funds or liquid alternatives.

In the United States, inflation is steadily reappearing, but it remains subdued across many other developed economies. Divergence is slowly creeping into the macro narrative. It's not enough to derail our pro-cyclical positioning, but it is enough for us to have recently recalibrated our regional equity overweights, tilting more into the United States. Expanding political nativism across countries, along with rising trade policy bombast, were two reasons for a recent equity reduction in portfolios. Market risks are higher.

Equity markets have been volatile and, broadly speaking, range-bound—though they have risen in our favor since adding to equity positions in early February. We funded those equity additions from credit to make sure we weren't over-reaching for risk late in the cycle. We've now reduced our equity overweight, rotating into short-term fixed income and cash. We remain constructive on global growth, but pockets of the world are becoming less robust. We expect to see greater regional differences ahead.

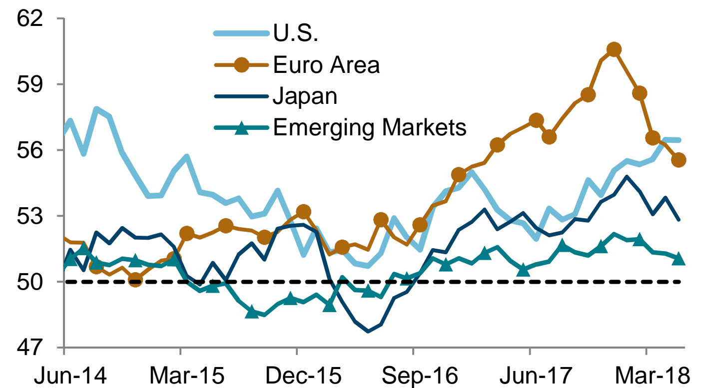
DIVERGENCE

At the start of this year, I walked through what made me feel comfortable about the current macro cycle extending further, and why I believed we would not quickly fall into recession. At its core, it was the simple observation that global growth was better balanced and running above trend, without a meaningful threat from inflation. The United States and China were no longer doing all of the heavy lifting; the global economy was growing in concert, with almost every major economy pitching in.

The macro environment remains durable. But the synchronicity we've seen in central bank policy and global growth is beginning to diverge (Figure 2). The U.S. economy, thanks in part to fiscal stimulus, remains strong, and this is our base case looking ahead. Across other developed economies this is no longer the case—for Europe in particular.

Figure 2. Growth is slowing outside of the United States

Markit Manufacturing Purchasing Managers' Index



Source: Markit, Haver Analytics. Data as of May 2018. Index > 50 generally indicates expansion, and index < 50 contraction.

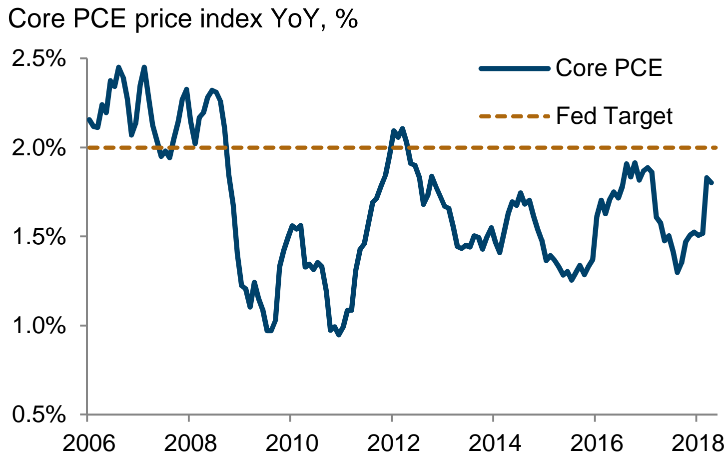
The Federal Reserve (Fed) will become increasingly important to markets. I expect the Fed to continue raising policy rates. So far, they are managing the transition to higher rates with aplomb. I do not expect political populism in Italy or increasing pressure on emerging economies—which has been rising because of higher U.S. interest rates and a strong dollar—to stall Fed rate hikes.

Fed Chairman Jerome Powell, along with other Federal Open Market Committee members, has signaled that the Fed may allow inflation to drift above its 2% long-term target. The question is the tolerance for how high and for how long. This is going to keep bond bears eager to push yields higher, and that may keep fixed income markets volatile. That is not said as a negative, just as a simple observation that markets will remain jittery about the level where the Fed will have tightened too much. We aren't there yet.

In the short-term, I expect the Fed to allow inflation to perhaps drift as high as 2.25-2.50% before becoming concerned. This is a subjective observation. For perspective, we've been under the Fed's 2% inflation target for over six years, since the core personal consumption expenditures price index (PCE—the Fed's preferred inflation measure) briefly went over 2% in early 2012. You have to go back to September 2008 to find when inflation was last sustainably above the Fed's target (Figure 3).

Figure 3. Inflation in the United States has been below the Fed's target for much of the cycle

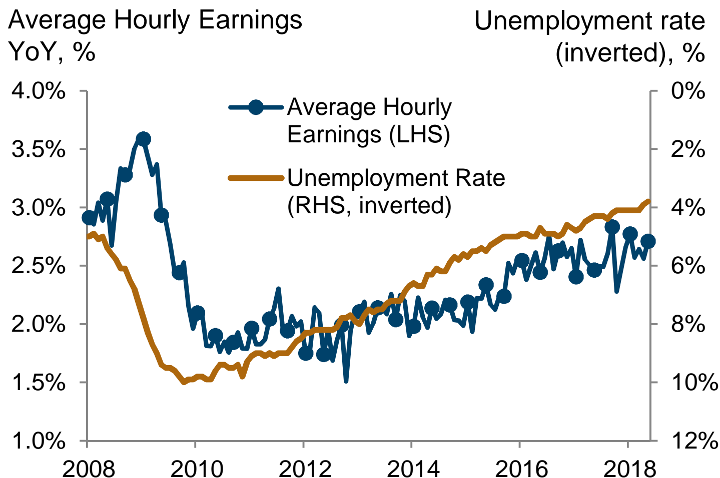
Core PCE price index YoY, %



Source: BEA. Data as of April 2018.

The U.S. labor market is incredibly strong. To put that remark in context, reported job openings are higher than the estimated number of unemployed workers. A strong U.S. labor market will support consumption and, by extension, revenue growth. Absent an improvement in productivity or labor force growth, the unemployment rate is likely to press lower—something not lost on the Fed. Higher wages and rising inflation should follow. Average hourly earnings are growing at 2.7% as of May (Figure 4). Looking back at prior cycles, wage growth tends to become an obstacle to the Fed as it moves above 4%. We're not there yet, but we're watching this closely.

Figure 4. U.S. wages are growing gradually as the unemployment rate declines



Source: BLS. Data as of May 2018.

CONSISTENCY

Markets like consistency, especially when it comes to central bank policy. One way to tell if a central bank is doing a good job is to see whether markets anticipate policy action, which makes it less disruptive. That has certainly been the case with recent Fed rate hikes. I would say the same for the European Central Bank (ECB).

Markets are beginning to play a guessing game around ECB tightening. Following the June ECB meeting, we continue to believe that the ECB will not raise policy rates at least until the summer of 2019, if not later. That is important for several reasons. It should support the U.S. dollar. It may also promote flat term-structure for longer in the United States as dollar-denominated corporate and government bonds attract inflows from global investors because of higher relative interest rates.

While monetary conditions and liquidity are gradually tightening, they are by no means tight. The good news is that monetary policy remains relatively accommodative. With the Fed already in motion, it's important to keep an eye on the ECB. As they wind down quantitative easing, markets run the risk of seeing volatility rise. Liquidity is slowly being withdrawn from global markets. That will create air-pockets.

UNCERTAINTY

In a heated discussion, when a long-time friend turns to you and says: "what did you just say?" you aren't being asked to repeat what you said. You are being given a chance to change it. That's how I imagine Europe, Japan, Canada and Mexico must feel about the application of tariffs on steel and aluminum by the United States.

I generally don't let politics influence tactical asset allocation decisions. As I mentioned in my last note, I try to ignore, as best I can, political bread and circuses. With regard to markets, trying to read political tea-leaves is largely a fool's errand—just look at recent elections. But when politics pushes its way into effecting change to actual policy, I pay close attention.

The announced tariffs on metals are unlikely to have a large direct impact on the economy. Steel represents less than 2% of global trade, and it is a tiny percentage of the global economy. But the fact that tariffs are being applied makes me believe that tail risk has risen.

If we see an escalation in tit-for-tat retaliatory tariffs, this can quickly turn into something far worse for markets. This is particularly the case if allies begin to take this personally, as only friends can. For the moment, the general response from countries—including China—has been to pause and respond, not over-react. So far, so good. No one wins a trade war—everyone loses.

Better global trade terms are welcomed. But the path Washington is on is causing confusion with allies, as well as global businesses that rely on trade for growth. It would be wonderful to see consistent policy toward bettering global trade terms. Unfortunately, we seem a long way away from that today.

In the short-term, I'm concerned about how escalating tariff retaliation can weigh on sentiment and, by extension, investment. It was important to note the parade of CEOs into the White House when the new administration took office. It signaled a willingness from the global business community to proactively engage. I will make the observation that I see far fewer CEOs in Washington today. It's a simple observation, but one worth noting.

Our base case remains: no trade war and no trade peace. Should European autos be dragged into the trade tussle, investors will likely become more concerned. A decision on NAFTA, at this point, seems pushed-off until next year. Mexico has an important presidential election on July 1, and the U.S. Congress doesn't seem to have the policy bandwidth to get something done this year. Should trade skirmishes escalate further, I believe that markets outside the United States have the most to prove.

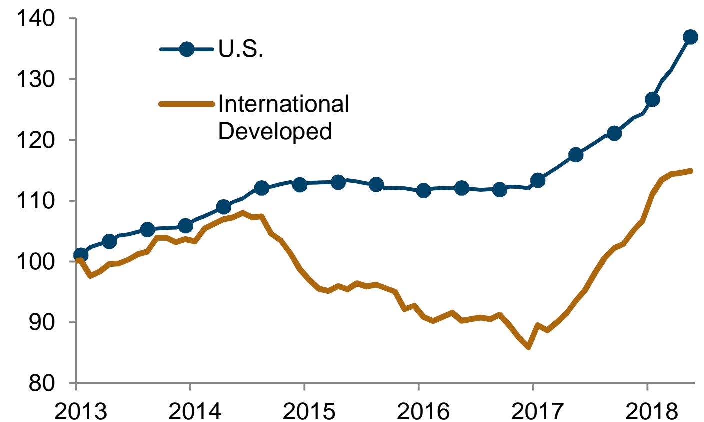
HURDLES AHEAD

There are likely to be more hurdles ahead of us. From a macro perspective, the divergence we are seeing across regions—in growth and central bank policy—is important. Our recent cut to equity overweights leaves us overweight the United States and close to neutral, in aggregate, across other regional equity markets. Of the major developed equity markets, the United States is likely to have the strongest earnings growth this year at around 18-20% earnings growth (Figure 5). For 2019, our base case starts at 6-8%. When we started this year with the United States as our largest overweight, it was very much a contrarian view.

We remain watchful for an entry point to add emerging markets (EM) but rising U.S. rates, a stronger U.S. dollar and tariff-tantrum rhetoric continue to leave us cautious.

Figure 5. U.S. earnings have remained strong against other developed markets

Earnings per share in USD, index 100 = 12/31/2012



Source: Factset, MSCI. Data as of May 2018. U.S. = MSCI USA, Int'l Developed = MSCI EAFE. Trailing 12 month data.

There are pockets across EM that are under a tremendous amount of pressure, and that pressure is rising. Growth is holding up across emerging economies in general, but it can easily be pulled lower. We see greater downside risk in EM today than in the United States. Near-term, we see the upside risk to broad markets capped as well.

The first-quarter economic slowdown seen in Europe isn't bouncing back quickly. Europe still seems to be growing above trend, but the rate of growth continues to slow, which makes us more cautious as we enter the summer. Italy is a bigger tail-risk than investors recognize. The new Italian government has to balance promised fiscal profligacy while maintaining a working relationship with European policy makers. We will learn more when the new Italian government reveals its budget plans in September.

We remain underweight fixed income, core bonds and duration across portfolios. Given the rise in short-term rates, we've added to short-term credit, as well as cash positions. In due course, we will be better buyers of longer-dated core bonds, but not at current levels.

Markets have a lot to prove over the coming months. That said, the macro outlook remains well supported. We trimmed equity overweights to reflect the challenging few months we expect ahead. However, we continue to believe that stocks will outperform bonds. If we are offered the right opportunity to add to equities, we will. For the moment, markets continue hurdling.

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Richard Madigan is Chief Investment Officer for J.P. Morgan Private Bank. In this role, he is responsible for the development of investment strategy, tactical and strategic asset allocation for $270 billion in high-net-worth and institutional client assets. Richard is Chair of the Private Bank's Global Investment Committee.

The CIO Team comprises market research, portfolio management and analytics as well as a dedicated quantitative research team that oversees investment risk.

Richard brings over 20 years of experience in portfolio management and international capital markets to the firm. Prior to his current role, Richard held the title of CIO, Global Access Portfolios, where he and his team managed in excess of $16 billion in client assets. Before joining J.P. Morgan, Richard was Managing Director, Head of Emerging Markets Investments and Senior Portfolio Manager at Offitbank, a New York–based wealth management boutique. He was also a senior member of the firm's investment committee. Before joining Offitbank, Richard worked for J.P. Morgan's Investment Banking division in New York in the emerging markets securities business. He previously spent six years with Citicorp, first as a banker in Mexico, and then in the firm's international corporate finance division in New York.

Richard's commentaries have appeared in the *Financial Times*, *The New York Times*, *The Wall Street Journal*, *Bloomberg* and Reuters. He is a frequent guest speaker on CNBC, and has also appeared on CNN and Bloomberg News, as well as at various industry conferences. Richard holds a master's degree from New York University, where he majored in Finance and International Business. He has lived both in Europe and Latin America and currently resides with his wife and children in New York City.

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