PORTFOLIO INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

April 20, 2020

IN BRIEF

- We have focused on several aspects of the news flow during the crisis, including funding stress, policy responses to the crisis, implications of economic data, and the path of the virus itself.
- Although it has not normalized across the board, funding stress has eased significantly.
- The policy response has also largely taken shape, although governments are still in the process of scaling up fiscal stimulus plans.
- Economic data shows a double-digit pace of contraction, intense fallout in labor markets, and a trend toward disinflation.
- With virus caseload growth slowing, the focus is shifting to tentative plans for lifting of restrictions.
- We expect developments on that front to take over as the major driver of markets in coming weeks, with information likely coming in more gradually than has been the case in the earlier phases of the crisis.

MARKETS WAIT ON PLANS FOR THE ECONOMY TO RESTART

Since the coronavirus shock began, we have focused on several broad categories within the information flow: bank funding and market operational stress; the policy response; messages from economic data; and, most importantly, the outlook for the virus itself. Following their earlier collapse, risk assets have benefited from strong tailwinds: easing funding pressures, aggressive monetary and fiscal policy action, and fairly generalized improvement in virus case curves. These supports have allowed equities and corporate credit to absorb an unprecedented collapse in economic activity indicators, which has revealed the existence and scale of the current recession much more quickly than usual. From here, we expect that the outlook for restrictions to be lifted and economic activity to re-start will play a dominant role in driving markets. Current indications suggest that this news may arrive only gradually.

Funding stress has broadly eased as various support programs created by the Federal Reserve (Fed) and other central banks have come online. Aggressive Fed buying of Treasury bonds helped re-liquefy that market quickly, and swap arrangements with foreign central banks lessened the international shortage of dollars that became evident

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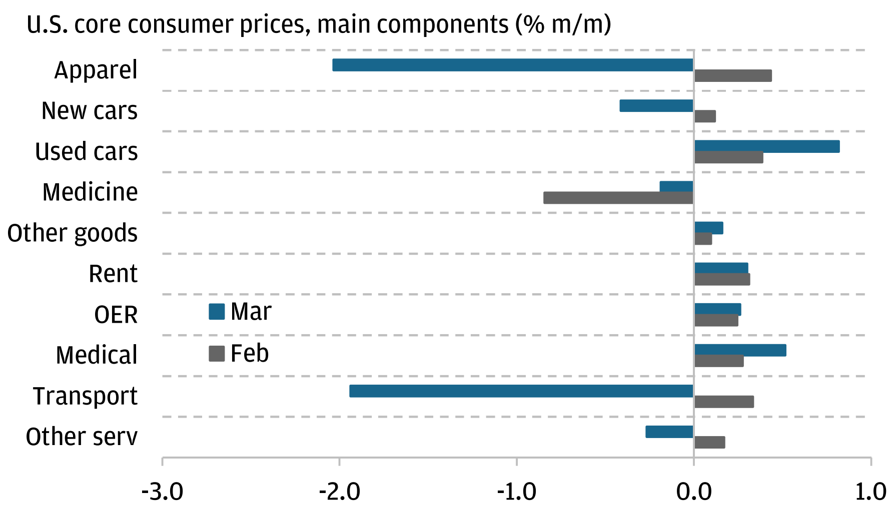
in March. The Fed took a little longer to get its commercial paper (CP) purchase facility up and running, but it began purchases this past week. Partly as a consequence, CP spreads and other indicators of bank funding pressure, such as FRA-OIS spreads (the difference between interbank interest rates and the overnight index rate) have narrowed somewhat. One still-open question concerns the correlation between stocks and bonds. That relationship turned positive in March as a poorly functioning Treasury market put unwarranted upward pressure on yields, eliminating their hedge properties vs. risky assets. In the calmer Treasury market of recent days, the usual negative correlation—which risk-parity strategies and, for that matter, all balanced funds depend upon to some degree—has begun to reassert itself. But the restoration is not yet complete.

While governments are still scaling up fiscal support, the broad outline of the policy response has become clear. On the monetary side, central banks are operating along three main channels: pushing short-term interest rates to zero or thereabouts; engaging in quantitative easing to pull down long-term yields; and creating (or reinstating) various programs to ensure proper market functioning and to encourage the flow of credit. Such programs include the Fed's backstop for banks engaging in payroll protection lending or the European Central Bank's targeted refinancing operations to incentivize loans to small enterprises. Most of these announcements have likely already occurred, but the Fed in particular has continued to move creatively to expand its policy footprint. Meanwhile, governments have pushed through stimulus legislation that, in developed economies, should result in fiscal thrust equivalent to between 2% and 5% of GDP—with the euro area at the low end of the scale, Australia at the top, and the U.S. in the middle. Governments and parliamentarians in most countries have expressed willingness to increase the size of this stimulus, a process we expect to occur more gradually in coming months than in the extremely rapid first wave.

In the *economic data*, we discern three main messages. First, the level of economic activity is falling at a double-digit pace, and fairly uniformly across countries. Surveys point to a much sharper decline than during the financial crisis. The global composite PMI, for example, fell in March to a deeply recessionary 39.4, only about three points above its 2008 trough, which was reached nearly a year into that downturn. Hard data are beginning to confirm this move. U.S. retail sales fell 8.7% in March and industrial production contracted 5.4%, and both readings captured the post-lockdown period only partially.

EXHIBIT 1: DISINFLATION, NOT DEFLATION

Early evidence points to a disinflationary impulse from the coronavirus shock. But we do not expect outright deflation to settle in. Significant price falls in categories like transport and apparel look like level shifts in response to shutdowns and restrictions. A much broader swath of prices slowed their pace of increase rather than declining. Unless inflation expectations become de-anchored, we think U.S. inflation will hold between 1% and 2% over the medium term.



Source: Haver Analytics, J.P. Morgan Asset Management Multi-Asset Solutions; data as of March 2020. For illustrative purposes only.

Second, this recession looks uniquely damaging for the labor market, at least temporarily. In the U.S., the past four weeks' figures for jobless claims stand as the four largest in history, owing to the shutdowns in labor-intensive sectors such as restaurants. Consumer services, which normally hold up fairly well during downturns, are taking it on the chin this time around. With roughly 14% of the workforce having filed an initial benefits claim in the last month, the jobless rate will move easily into double-digit territory—although some job losers will exit the labor force and therefore will not officially be counted as unemployed. We remain hopeful that a significant portion of these jobs will return fairly quickly as activity re-starts, given the flexible nature of employment and the relative lack of firm-specific knowledge in many services sectors. We also expect to see more differentiation across countries in labor market performance than in activity data. In Europe and Japan, less flexible labor markets—under most circumstances considered a weakness—may act, in concert with official schemes to subsidize reductions in hours worked, against a temporary surge in unemployment.

Third, the downturn appears disinflationary. Of course, we generally assume that recessions push down inflation, but the unusual nature of this crisis, which combines supply and demand shocks, makes the price implications more ambiguous. Demand destruction appears to be winning out. Again looking at the PMIs, the various price components for manufacturing and services fell in March. And incoming inflation data tell the same story. U.S. core consumer prices edged down in March, and movements in Asia, which entered the crisis ahead of developed market economies, have looked similar in the last two months.

With growth rates of the caseload slowing in most countries, the focus in terms of the virus' path has turned to prospects for reopening economies. The early experience in China and Korea suggests mixed messages: lifting restrictions can work, if done in a gradual fashion, and with careful surveillance of new cases. Europe is now conducting a set of laboratory experiments along these lines, with some countries partially reopening schools, others allowing some shops to reopen, and others focusing on getting factories up and running. In all cases, the plan is to resume activity over at least a six-week period, with some aspects taking much longer. In the U.S., plans seem somewhat less advanced, and in any case will very likely proceed at the level of individual or small groups of states, making the reopening particularly staggered.

ASSET CLASS IMPLICATIONS

The coronavirus crisis and the associated market moves have unfolded with extraordinary speed. The S&P 500 plunged from its peak to its low (for now, at least) in a month, and then recovered half of that decline in three weeks. Policy responses and labor market fallout have come through almost instantaneously. Markets have gone through a collapse phase and a retracement phase and have, we think, likely entered a new phase, one that will be dominated by news flow about restarting the economy that will likely come in more gradually than the past rounds of information. The Fed's new program to buy investment grade bonds and lend directly to high-rated companies has reduced our previous preference for equities over credit. Meanwhile, tremendously accommodative monetary policy and the emerging disinflationary impulse leave us with a neutral-to-positive view on duration despite very low yield levels.

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NEXT STEPS

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