Global Asset Allocation Views

Insights and implications from the Multi-Asset Solutions Strategy Summit

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IN BRIEF

- The global recovery is set to broaden out, with 2021 likely to see growth above trend. Ample slack in the economy suggests inflation will pick up only slowly, so monetary policy is likely to remain supportive throughout the year.
- Nevertheless, the main driver of asset returns likely transitions from liquidity to growth over the course of 2021. This implies potential for short-lived pockets of volatility, but over the year as a whole we anticipate benign market conditions and a continued decline in volatility.
- We maintain a pro-risk tilt, spread across stocks and credit. We prefer cyclical equities and are overweight (OW) U.S. small cap, emerging markets (EM), Europe and Japan, and neutral on U.S. large cap and the UK. In credit, we temper our enthusiasm for U.S. corporate credit a little, and diversify credit holdings further with EM debt.
- Despite our pro-growth stance, we move duration from underweight (UW) to neutral, given ongoing central bank buying. We prefer to play upside risks to inflation via a UW to USD.

ASSET CLASS VIEWS (PAGE 3)

Underweight ● Neutral ● Overweight ●

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

A COMMON MEME AMONG FINANCIAL ANALYSTS MAKING THEIR YEAR-AHEAD FORECASTS IS TO PROJECT WHICH YEAR IN HISTORY THE UPCOMING ONE WILL MOST TAKE AFTER. While we can't say with certainty which year from the past 2021 will most resemble, we can say with some conviction that it will be very different from 2020.

True, we'll start the new year with the same easy monetary policy that helped us through 2020, and COVID-19 will dictate our social and working interactions for the first quarter or two. But we approach 2021 with a new cycle broadening out. Fiscal stimulus, which plugged gaps in 2020, will likely recede as the private sector rebounds. And a global vaccine rollout is already beginning to push coronavirus from a present threat to a historic event. All of these issues have a bearing on asset markets. But for investors, the transition from a market fueled largely by emergency liquidity and stimulus to one driven increasingly by a global economic recovery may present the biggest challenge.

We will begin 2021 with a renewed conviction that the economic recovery is robust. As the year progresses, we expect growth to broaden out and "left behind" sectors like travel and leisure to show new signs of life – particularly as vaccine rollouts extend to the wider population. Certainly, the distortions to the labor market and to Main Street will take some time to heal, but in our view the extent of permanent scarring is surprisingly contained, leaving the supply side of the economy mostly intact.

The debate around inflation risk

Nevertheless, we expect monetary policy to remain extremely accommodative. The Federal Reserve (Fed) will likely prefer a little more inflation risk to the risk of scuppering the recovery through premature withdrawal of policy support. For investors, the debate around inflation risk is central both to return expectations and to the outlook for market volatility over 2021. Market participants who believe that inflation risks are likely to elicit a policy reaction are generally more cautious. We see only limited upside for inflation in the near term and fully expect the Fed to look through it were it to arise. But we also note that inflation is not well discounted in asset markets. As we turn to our asset allocation views, it is a factor we need to consider, if only at the margin.

Our positive outlook on the economy in 2021 calls for a pro-risk tilt in our multi-asset portfolios. As a result we stay overweight (OW) both equity and credit, with our exposure balanced across the two asset classes. While we see some path to yields drifting higher as growth broadens out, we believe that monetary policy will control the pace at which yields can rise. With 10-year U.S. Treasury yields closing in on 1% but few signs that the Fed or other central banks intend to wind down their quantitative easing (QE) any time soon, we move from underweight to neutral on duration. At the same time, the risk that inflation expectations pick up implies that real yields along the curve are likely to remain profoundly negative; hence, we move cash to underweight (UW).

Across the equity complex, we take a cyclical tilt but equally prefer to remain well diversified. The economic rebound is global, we believe, and regional leadership is thus more nuanced. In particular, we are OW U.S. small cap and emerging market (EM) equities, which are well exposed to the broadening recovery. We also have a mild OW to Japanese equities, and to European stocks, which though cyclically geared face some near-term risks from recent lockdowns and Brexit. We upgrade UK equities from UW to neutral and are also more neutral on U.S. large cap stocks in our portfolios, given the headwind from elevated valuations.

In credit we trim U.S. investment grade (IG) to neutral and keep high yield (HY) at OW but with a reduced conviction. Spreads across the credit complex tightened sharply in 4Q20, but we still believe credit as a whole is well geared to the wider recovery. We also diversify our credit exposure by moving EM debt to OW. In sovereign bonds, we once again prefer U.S. Treasuries to core European bonds. But in general, we will be looking to play any upward repricing of U.S. inflation through a short on the U.S. dollar rather than an underweight to duration.

Overall, our portfolio aligns to expectations of above-trend global growth and easy policy. We acknowledge the risk of rising inflation expectations but believe that should such a repricing spur volatility the Fed would respond swiftly. As the principal driver of asset returns pivots from policy to growth, we expect cyclical equities to benefit. But with global policy remaining easy, bonds may be among the last, rather than the first, of the major assets to react to the broadening recovery.

Multi-Asset Solutions Key Insights & "Big Ideas"

In previous editions of our Global Asset Allocation Views, we included a map and table of key global themes. Those themes helped us discuss the economic and market outlook, and shape the asset allocation that Solutions reflected across portfolios. While some of those themes are still in play, we now choose to share the Key Insights and "Big Ideas" discussed in depth at the Strategy Summit. These reflect the collective core views of the portfolio managers and research teams within Multi-Asset Solutions and are the common perspectives we come back to and regularly retest in all our asset allocation discussions. We use these "Big Ideas" as a way of sense-checking our portfolio tilts and ensuring they are reflected in all of our portfolios.

- Rebound accelerates with above-trend growth in 1H21
- Inflation muted, but upside inflation risks rising and underpriced
- Fiscal and monetary stimulus persists well into the new cycle
- QE is capping yields, but they will rise as growth picks up
- The U.S. dollar is entering an extended but gradual downtrend
- Credit supported by growth as central bank support is pared back
- We look to diversify portfolio risk across equity and credit
- Equity earnings improving: prefer cyclicals, U.S. small cap and emerging market equity

Active allocation views

In normal times, these asset class views apply to a 12- to 18-month horizon; however, given current volatility and uncertainty, they reflect a horizon of several months but are subject to revision as new information becomes available. We will update this tick chart at minimum monthly during this period of volatility. The dots represent our directional view; up/down arrows indicate a positive (▲) or negative (▼) change in view since the last revision. 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.

Underweight ● Neutral ● Overweight ●

Asset class		Opportunity set	UW	N	OW	Change	Conviction	
MAIN ASSET CLASSES		Equities	○	○	●		Moderate	Growth broadening out, earnings set to pick up with base effects supportive in 1H21
		Duration	○	●	○	▲		U.S. 10-yr yields around 1% imply more even discounting of growth vs. inflation risks
		Credit	○	○	●		Moderate	Scope for spread tightening diminishing, but growth outlook still supportive to credit
		Cash	●	○	○	▼	Moderate	Ultra-easy policy and inflation past its lows suggest cash real returns will be poor
PREFERENCE BY ASSET CLASS	EQUITIES	U.S.	○	○	●		Low	Strong preference for U.S. small cap supported by quant models and fundamental views
		Europe	○	○	●		Low	Cyclically geared market, but near-term Brexit-related disruption a headwind
		UK	○	●	○	▲		2020's major underperformer, a messy Brexit may weaken GBP, in turn boosting EPS
		Japan	○	○	●	▲	Low	Sluggish performance in 2020, but gearing to global cyclicals is an attractive feature
		Emerging markets	○	○	●		Moderate	Weaker dollar and ample capital supportive, valuations rich, but EPS rebounding
	FIXED INCOME	U.S. Treasuries	○	●	○			At around 1% 10-yr yield, expect international demand to increase, Fed continues to buy
		G4 ex-U.S. sovereigns	●	○	○		Moderate	Negative yields in Europe appear vulnerable as growth recovers, even with ECB QE
		EMD hard currency	○	○	●	▲	Low	EM economic outlook continues to improve but long duration presents a headwind to returns
		EMD local FX	○	○	●	▲	Moderate	Geared to both improving EM economic and FX outlook giving further boost to returns
		Corporate investment grade	○	●	○	▼		Spreads now very tight; a reasonable alternative to duration, but excess return outlook low
		Corporate high yield	○	○	●		Moderate	Still some scope for tighter spreads, but increasingly will be led by low rated segments
	CURRENCY	USD	●	○	○		Moderate	Easy Fed policy and even distribution of global growth suggest further USD downside
		EUR	○	○	●		Low	Performed strongly in 2H20 despite easy ECB policy; still meaningfully undervalued
		JPY	○	●	○			BoJ likely to remain broadly accommodative, but little reason to expect unilateral easing
		EM FX	○	○	●	▲	Moderate	Broadening global growth and pickup in goods market activity helpful for EM economies

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments are made using data and information up to December 2020. 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.

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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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