PORTFOLIO INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

A review of global markets and portfolio positioning in August

September 9, 2019

IN BRIEF

- The U.S. and China's exchanged tariff hikes, hurting confidence and making August a risk-off month amid ongoing trade tensions.
- Trade concerns, plus some weak macroeconomic data prints, helped spur a historic rally in bond yields—U.S. 30-year U.S. Treasuries reached all-time lows.
- In Europe, the formation of a new Italian government lowered political risk, for now; on the monetary front, expectations rose for a European Central Bank easing package.
- Markets generally struggled in August: Global equity indices declined with emerging markets leading the losses and U.S. small caps fared poorly on expectations for weaker U.S. growth. The euro and emerging market currencies weakened; in credit, higher quality outperformed. Iron ore was down sharply on slowing Chinese steel output.
- We remain cautious on the risk environment and are underweight stocks vs. bonds. We are neutral on duration; although valuations look very expensive, technicals should keep downward pressure on yields.

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AUGUST IN REVIEW

We review trends across markets and economies in August 2019, consider what they mean for our multi-asset portfolios and present a positioning update.

August started with a bang as President Donald Trump announced a 10% tariff on USD 300 billion of Chinese goods. The statement came despite the positive mood music that had been emanating from the Chinese and U.S. administrations since the G20 summit in May, and reminded markets that changes to trade policy remain a key risk to global growth. China retaliated with its own tariff measures and the Trump administration escalated tariff levels yet again. These developments, alongside lukewarm economic data, led to a risk-off month of August.

The hit to confidence from changes to trade policy has weakened the global manufacturing sector, however, the services part of the global economy, especially in the U.S., looks relatively stronger, which is why investors remain focused on the health of global consumers. Some data released in August suggested services may be starting to take a hit, as well. For example, the U.S. Markit Services PMI posted a limp score just above 50, matching recent lows, and the University of the Michigan Consumer Sentiment Index was revised lower to 89.8, the lowest monthly reading since October 2016, reflecting that tariffs are weighing on sentiment. Still, it's hard to have too dismal a view of the U.S. consumer, given other measures of confidence: U.S. retail sales were particularly strong in July and the consumption component of U.S. second quarter GDP was revised higher.

Data showed the European economy faring somewhat better than expected over August. European growth appears to have come down to about trend level but sentiment around the region is poor, centered on somewhat puzzling weakness in Germany. The German manufacturing PMI remains a very weak 43.5, despite the improvements in some other European countries that took the region's overall August manufacturing PMI to 47. German GDP actually fell 0.1% in Q2, quarter-over-quarter, raising the risk of a technical recession. Other eurozone activity signals were less worrisome. The euro area composite PMI was revised up a tenth to 51.9.

On the political front, a botched attempt by Italian Deputy Prime Minister Matteo Salvini to force an early election led to a new Italian governing coalition, in which the Five Star Movement (M5S) and the Democratic Party (PD) formed an unlikely alliance. These parties are expected to be less aggressive in negotiations with the European Union over Italy's adherence to fiscal rules, reducing political risk in the region for now.

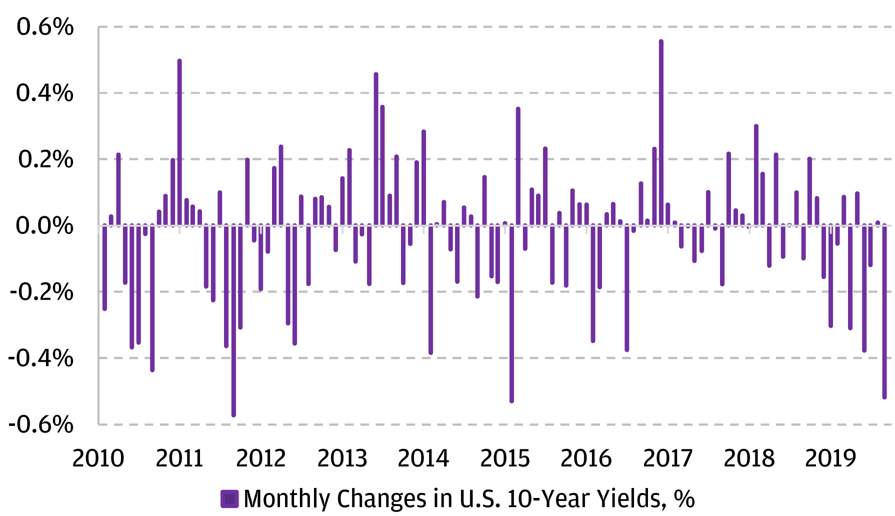
Following the Federal Reserve (Fed) rate cut at the end of July, August was a quieter month for global monetary policy. One much-anticipated event was Fed Chair Jerome Powell's speech at the annual at Jackson Hole Economic Policy symposium, which the market took as marginally dovish. It came after a week in which other Federal Open Market Committee members had sounded cautious notes about the prospect of additional rate cuts.

In the EU, expectations rose for a European Central Bank (ECB) easing package, particularly after the *The Wall Street Journal* suggested that Bank of Finland Governor Ollie Rehn did not rule out the ECB starting equity purchases. The ECB is unlikely to unveil an equity purchase program at its September meeting but many market participants do expect rate cuts, tiering and a restart of QE programs.

A historic rally in bond yields in August captured the difficulties in trade negotiations and weakening macro

EXHIBIT 1: MONTHLY CHANGES IN U.S. 10-YEAR YIELDS

August's rally in global bond markets was felt keenly in the U.S., where the 10-year bond yield fell 52 basis points, the largest monthly move since early 2015. August also saw 30-year U.S. Treasuries reach all-time lows. Markets now expect rate cuts from the Fed over the coming years, and appear to be pricing very weak growth outcomes.



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of September 5, 2019. For illustrative purposes only.

data. The U.S. 10-year yield fell 52 basis points, to 1.5%, as the curve flattened and led by real rates. It was the largest monthly move in the U.S. 10-year yield since January 2015. Meanwhile, 30-year U.S. Treasuries reached all-time lows (**Exhibit 1**). German bond yields also rallied, though not to the same degree, and Japanese 10-year bond yields also fell. Italian bonds were another major winner over August with yields falling to 1% in response to the country's improving political outlook.

UK developments keep sterling flat

In FX markets, the U.S. dollar, as measured by the DXY index, rose 0.4% over the month despite sharply lower U.S. bond yields. This was partly due to the weakness of the euro, which was down 0.8%, and more substantial weakness in EMFX, which was down 4% as measured by the JPMorgan Emerging Markets Currency Index. Pound sterling was flat over August, tracking the to-and-fro in Brexit negotiations. Later in the month, the UK government announced its intention to discontinue parliament's session in September, making it harder for members of Parliament to use legislation to stop a no-deal Brexit. However, further developments saw the expulsion of Conservative rebels, a cross-party majority of MPs voting to take control of parliamentary business and an attempt to force the government of Prime Minister Boris Johnson to ask the EU for an extension of the UK's membership.

Within credit markets, higher quality credit outperformed high yields, with U.S. investment grade credit returning 3.1%. U.S. high yield returned 0.4%, brought down by the energy component of the index, which underperformed as West-Texas Intermediate Oil prices fell 5.9% in August. Iron ore fell a sharp 25% following a slowdown in Chinese steel output.

Equities struggled in August with the MSCI ACWI ending the month down 2.6%. Emerging market indices led the losses, falling 5.1%. Developed market stocks fared marginally better, declining 2.2%. By region, European stocks performed better than average, supported by the prospect of monetary easing by the ECB. Canadian stocks also had a relatively strong month, bolstered by gains in the technology and materials sectors. Despite a steady pound sterling over the month, UK equities underperformed as flattening global bond yields hurt the country's financial sector. U.S. small cap stocks continued to perform poorly, reflecting expectations for weaker U.S. growth. By sector, defensive stocks continued to lead: utilities, real estate and consumer staples saw the largest gains within the S&P 500.

ASSET CLASS IMPLICATIONS

We remain cautious on the risk environment overall and have an underweight stance on equities vs. bonds. The escalation of trade tensions has increased the odds of a U.S. recession in the next 12 months and 2020 earnings expectations look too optimistic. By region, we maintain our preference for U.S. equities, while remaining underweight emerging market equities. We are neutral on duration—although valuations look very expensive, negative net issuance should keep downward pressure on yields. We prefer U.S. high yield to equities, though we are wary of liquidity and downside risks, especially for lower quality issuers.

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