

Global Asset Allocation Views

Moderately greater risk tolerance: An update to our views

2Q 2020 Update

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IN BRIEF

- A changed economic and market environment leads us to an off-cycle update of our asset allocation views, typically published after our quarterly Strategy Summits. Overall, our views reflect a moderately greater risk tolerance and a recognition that central banks are “all in.”
- The current crisis has unfolded faster than any previous crisis, and while the recession is likely to be deep, it could be relatively short-lived. Disruption from COVID-19 is easing at the margin, and the economic outlook is improving.
- We are neutral stocks vs. bonds. We see balanced tail risks and believe central bank buying of credit acts as an offset to the overhang of corporate leverage. Within stocks, we once again prefer the U.S. Should the equity rally continue, leadership will likely shift more decisively to cyclicals and higher beta regions. We thus maintain a moderate conviction overweight in emerging market equity and push Europe up to neutral.
- With sovereign yields at record lows, we reduce duration to a small underweight; we keep cash at an overweight. In credit, we have the greatest conviction in being overweight investment grade.

ASSET CLASS VIEWS (PAGE 3)

Underweight ● Neutral ● Overweight ●

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

WHEN WE PUBLISHED OUR SECOND QUARTER ASSET ALLOCATION VIEWS AT THE END OF MARCH, WE HAD JUST WITNESSED THE FASTEST STOCK MARKET SELL-OFF ON RECORD. While central banks had already moved decisively, the fiscal response had only just begun. What followed over April and early May was a commitment of fiscal support at a speed and scale never before seen in peacetime, matched by an extension of central bank intervention in asset markets unimaginable just a few weeks earlier.

Two months on, equity and credit markets have come a long way, but sentiment is impaired and positioning light. Few participated fully in the sharp rebound in stocks that appeared to run entirely counter to truly shocking macroeconomic and earnings data, and the episode of negative oil prices that occurred in April continues to serve as a stark reminder that asset markets remain fragile.

Nevertheless, much progress has been made and the current outlook differs profoundly from the views we held in late March. Countries around the world are reopening their economies,

high frequency data show signs of bottoming, earnings forecasts have been cut sharply to align with the economic outlook, and policy support is widespread and comprehensive.

Above all, this crisis has unfolded faster than any previous crisis, and while the economic contraction is likely to be deep, the recession may well be relatively short-lived. Indeed, in the recent mark-to-market of our Long-Term Capital Market Assumptions, which cover a 10- to 15-year investment horizon, we noted that long-run potential GDP growth is unlikely to be meaningfully impaired by the current crisis. There may even be reason to be constructive on future productivity, as technology adoption has recently had a big boost, in part because of work-from-home trends.

Returning to the more immediate horizon, the disruption from COVID-19 is easing at the margin and the economic outlook is improving. There are tail risks to consider—including the recent war of words between Washington and Beijing—but light positioning, muted investor sentiment and powerful base effects from the recent collapse in activity paint a more constructive picture. Asset markets, and especially stock markets, price in future growth—and from the currently low base in activity, the trajectory of growth is likely to be positive. Indeed, we believe that the economy has already passed through the trough of an admittedly very steep recession. However, market participants continue to debate the slope and shape of the recovery to come.

TAIL RISKS BALANCED IN BOTH DIRECTIONS

This shift in the economic and market environment leads us to some modest updates to our asset allocation views. Typically, these are published after our quarterly Strategy Summits, but given the fast-moving economic and policy backdrop, an off-cycle update seems appropriate. Overall, it reflects a moderately greater risk tolerance and a recognition that central banks are “all in.”

At an asset class level, we are neutral stocks-bonds vs. an equity underweight in late March. We see tail risks balanced in both directions and believe central bank buying of credit acts as an offset to the overhang of corporate leverage.

Indeed, we learned in the last crisis not to “fight the Fed,” so our initial preference to add risk mainly in equity is now more balanced across equity and credit. We note that low bond yields and central bank asset purchases have the potential to push equities higher, suggesting that current market levels are more sustainable than improving economic activity might justify on its own. With sovereign yields at record lows, we reduce duration to a small underweight, also reflecting the negative signals from our quant models. And despite our improved outlook, we keep cash at an overweight, both as portfolio ballast and as dry powder.

Within stocks, our preference for the U.S. remains, but after such a strong rally in large cap names, particularly in the tech sector, we look for a greater small cap exposure within our U.S. equity allocation. Should the equity rally continue, leadership will likely shift more decisively to cyclicals and higher beta regions. For this reason, we maintain a moderate conviction overweight in emerging market equity and push Europe up to neutral—reflecting recent positive policy changes related to a more coordinated fiscal response. Japan remains an underweight due to persistent domestic weakness and risk of further currency appreciation; it is also a region that is not favored by our quant models.

Within fixed income, we are neutral U.S. Treasuries, preferring to own TIPS to nominals, and are modestly underweight non-U.S. government bonds. At a more granular level, our quant models favor low volatility bond markets such as Japan and higher yielding ones like Australia, but overall we believe yields globally have limited scope to fall. In credit, we have the greatest conviction in being overweight investment grade, and while spreads have already tightened a good deal, we believe that the carry on offer from credit compares favorably with sovereign yields. Finally, in high yield we are cautiously neutral, seeing balanced risks but an elevated scope for default losses.

Overall, the changes are modest, reflecting a small increase in risk tolerance. We look for a portfolio balanced in its exposure to topside risks, while recognizing that these are early days on the path to greater macroeconomic stability.

Multi-Asset Solutions Key Insights and “Big Ideas”

These Key Insights and “Big Ideas” reflect the collective core views of the portfolio managers and research teams within Multi-Asset Solutions. They 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.

- The phase has changed; we are now in a new cycle, which will have its own unique characteristics.
- Fiscal stimulus is the new normal; monetary stimulus, however, remains a first responder.
- Bond yields will likely remain low as we go through recession, but in the medium term curves will be steeper.
- Credit losses could be drawn out as corporate leverage comes down, but official buying limits spread widening.
- Leadership in equities has scope to change in this new cycle, factor-wise as well as regionally.
- “Enough” policy support may coincide with a peak in the dollar.
- As we add risk, a balance across stocks and credit best reflects monetary policy support.
- The next leg in a move higher in stocks would likely feature greater cyclical leadership.

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 a 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	○	●	○	▲		EPS downgrades have come through very quickly, equities will start to price 2021 rebound	
	Duration	●	○	○	▼	Low	Disliked on quant signals, central bank buying reflected in prices; real yields negative	
	Credit	○	●	○	▲		Fed buying removes some tail risks, but default cycle still looming; carry attractive	
	Cash	○	○	●		Moderate	Disinflationary risks offset zero rates; as market stabilizes, also provides dry powder	
PREFERENCE BY ASSET CLASS	EQUITIES	U.S.	○	○	●		Low	Big surge in U.S. large cap makes further upside likely to be led by cyclicals and small cap
		Europe	○	●	○	▲		Improved fiscal support in Europe a game changer, scope to perform in early cycle
		Japan	●	○	○		Low	Domestic weakness a drag and headwinds from currency a risk, not liked by quant models
		Emerging markets	○	○	●	▲	Moderate	Valuations cheap, scope to cut rates, Asia recovery on track and could boost EPS outlook
	FIXED INCOME	U.S. Treasuries	○	●	○	▼		Higher yielding and subject to strong demand from Fed and market buyers, but yields low
		G4 ex-U.S. sovereigns	●	○	○	▼	Low	Negative yields limit returns, but some markets like JGBs have portfolio role due to low vol
		EMD hard currency	○	●	○			Higher grade EMD at attractive valuation levels, but ongoing funding issues limit upside
		EMD local FX	●	○	○		Low	Funding issues persistent and put pressure on EM FX and local currency EMD for now
	CURRENCY	Corporate investment grade	○	○	●		High	Powerful support from Fed for IG, but downgrade risks still need to be considered
		Corporate high yield	○	●	○	▲		Fed buying of BBs a significant factor in stabilizing spreads, but default risks remain
USD		○	●	○			Starting to turn lower as funding pressures recede and markets look toward recovery	
EUR		○	●	○	▲		Fiscal package from France and Germany shows strong intent to remove tail risks in EUR	
	JPY	○	○	●		Low	Natural safe haven status lends support if crisis worsens	
	EM FX	●	○	○		Low	USD funding stress and pressure on EM CBs to ease put pressure on EM FX	

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments are made using data and information up to May 2020. For illustrative purposes only.

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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 March 31, 2020.

NEXT STEPS

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