OVERVIEW

Risk assets were mixed over the third quarter as concerns mounted over a range of topics, including inflation, supply chain disruptions, potentially peaking economic growth, market uncertainty about Chinese regulatory action and drama surrounding the U.S. debt ceiling. Equity markets declined in September, offsetting gains from earlier in the quarter. Choppy conditions prevailed in other asset classes as well, and market leadership continued to shift. Rates markets sold off over the quarter as Federal Reserve (Fed) policymakers seemingly confirmed plans to taper by year-end, energy commodities continued to rally and the U.S. dollar bounced back. The factors that we favor were generally positive against this backdrop, with equity factors performing particularly well (EXHIBIT 1).

We continue to expect a prolonged period of above-trend global economic growth and leave our core factor views relatively unchanged. We retain our strong conviction in our optimism

EXHIBIT 1: QUANTITATIVE SOLUTIONS LONG/SHORT FACTOR RETURNS

Note: Factors presented are long/short in nature. Equity factors are represented as 100% long notional exposure, macro factors as aggregation of 5% volatility subcomponents. *Long/short beta-neutral implementation of the value factor was hurt by the beta effects on value stocks compared with their expensive/growth counterparts. However, long-only versions of the factor performed well relative to the market.

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about the equity value factor: Valuations remain supportive, and companies may benefit from a pickup in earnings growth or an environment in which yields continue to tick higher. We also continue to regard the equity quality factor positively; it remains extremely cheap and may help mitigate losses elsewhere in investor portfolios should economic growth prove disappointing.

FACTORS IN FOCUS

Equity factors: Continuing to navigate uncertain markets

Equity factors were up in aggregate for a third consecutive quarter. The pervasive narrative is that equity markets are being increasingly driven by the macroeconomic environment; still, the pattern of returns across factor quartiles appears to be signaling that company-specific fundamentals are back when it comes to market pricing, particularly within U.S. markets.

Momentum was the top-performing factor in the third quarter. Stocks of companies with positive earnings revisions significantly outperformed those in a downgrade cycle (i.e., those with low momentum scores). The quality factor also rose, although mostly in the U.S. and driven mainly by low quality companies’ underperformance, as high quality companies barely outpaced broader markets (EXHIBIT 2). Expensive stocks, or those with low value factor scores, underperformed as well—particularly unprofitable companies. Value performed well in the U.S., driven by these dynamics, although it was negative across all other regions.

All told, this asymmetry in factor performance—stocks with poor scores severely underperforming while stocks with strong scores were barely positive—was better captured by long/short factor strategies than by long-only. This environment may be a positive signal for the factor landscape in general because if rationality and fundamentals trump sentiment, they may allow attractive valuations across factors to shine through. From this vantage point, factors remain at historically cheap levels.

Investors seem to lack conviction, as common pair trades have ebbed and flowed on markets daily—e.g., cyclicals vs. defensives, value vs. growth, short duration vs. long duration or rate sensitive. Under these conditions, we recommend broadly capturing a diversified range of equity factors and anchoring on valuation support. The value and quality factors are as cheap as at any time since the height of the dot-com bubble (EXHIBIT 3A and 3B). Momentum is as cheap as it has been since the dot-com bust (EXHIBIT 3C). In a departure from the momentum factor’s general long-term bias toward growth/expensive stocks, it now favors value stocks.

Merger arbitrage factor extends all-time highs despite a notable deal failure

The merger arbitrage factor was positive for a sixth consecutive quarter, despite the failure of the Aon/Willis Towers Watson deal in late July, which pressured merger arbitrage spreads broadly due to its size (about USD 30 billion). Technical imbalances in the merger arbitrage market were also an issue. The merger arbitrage factor is now up over 15% since March 2020, with rolling three-year returns that exceed the long-term average.
Looking ahead, while the merger arbitrage space has been bolstered by a steady stream of new deal activity—aggregate deal levels are slightly above their 10-year average—the clouds have darkened slightly. The potential exists for a more aggressive antitrust regime in the U.S., and uncertainty about China and China-U.S. relations seems to be on the rise. Still, it is possible to capture sufficiently healthy deal premia, which have risen over the quarter, and a steady incidence of counterbids or improved offers could potentially mean additional upside.

Macro factors were mixed across asset classes

Macro factors were muted over the quarter. Fixed income carry, the top-performing factor, successfully navigated the general backup in government bond interest rates, since predictive yield curve signals proved reasonably accurate. The commodity time-series momentum factor also performed well, benefiting from long natural gas exposure, in particular, as energy prices skyrocketed across the globe. Fixed income time-series momentum, on the other hand, suffered from long-duration positioning in European, U.S. and Canadian markets. Commodity carry caught the other side of the natural gas trade, offsetting a portion of the aforementioned gains from commodity time-series momentum. Elsewhere, equity time-series momentum gave back gains in September as the global equity market rally faltered. FX momentum whipsawed for a second consecutive quarter, reflecting a lack of conviction and consensus across currency markets.

The environment for macro factors has become less attractive, with carry spreads generally tight and price dispersion within asset classes muted. Time-series momentum positioning reflects a reflationary posture, remaining long across equity markets in aggregate and, currently, short duration in aggregate. However, risk levels have fallen in concert with a decline in the number of statistically significant trends across equity and fixed income markets.

CONCLUDING REMARKS

The factors that we favor by and large performed well in the third quarter and continue to appear attractive.

Equity factors look to offer the most interesting opportunity set, with spreads historically wide for both equity value and equity quality. While we remain optimistic about the prospects for equity factors, we believe, as always, in diversifying across a broad range of compensated factors while minimizing exposure to uncompensated risks.
FACTOR OPPORTUNITY SET

The table below summarizes our outlook for each of the factors accessed by the Quantitative Solutions platform. It does not constitute a recommendation but, rather, indicates our estimate of the attractiveness of factors in the current market environment.

FACTOR VIEWS

<table>
<thead>
<tr>
<th>Rationale</th>
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<tbody>
<tr>
<td>Equity Momentum</td>
<td>— Attractive on valuation, neutral on dispersion</td>
</tr>
<tr>
<td>Equity Valuation</td>
<td>— Attractive on valuation, attractive on dispersion</td>
</tr>
<tr>
<td>Equity Quality</td>
<td>— Attractive on valuation, attractive on dispersion</td>
</tr>
<tr>
<td>Equity Size</td>
<td>— Neutral on valuation</td>
</tr>
<tr>
<td>Event-driven Merger arb</td>
<td>— Neutral on deal premia, attractive on % of friendly deals, neutral on activity level</td>
</tr>
<tr>
<td>Macro Carry</td>
<td>▼ Negative on FX spreads, neutral on fixed income spread (decrease from last quarter), neutral on commodity spread</td>
</tr>
<tr>
<td>Macro Momentum</td>
<td>▼ Negative on FX price dispersion (decrease from last quarter), neutral on commodity price dispersion, attractive on significant price trends</td>
</tr>
</tbody>
</table>

Source: J.P. Morgan Asset Management; for illustrative purposes only.

Our framework for evaluating factor outlooks is centered on the concepts of dispersion, valuation and the opportunity for diversification. For equity factors, we measure dispersion and valuation spreads between top-quartile and bottom-quartile stocks on a market, region and sector-neutral basis. For event-driven factors, we measure implied carry and the level of corporate activity as indicative of the ability to minimize idiosyncratic stock risk. For macro factors, we measure the dispersion or spread between top-ranked and bottom-ranked markets, as well as the number of significantly trending markets.

GLOSSARY

- **Equity momentum**: Long/short global developed stocks based on price change and earnings revisions; sector and region neutral
- **Equity value**: Long/short global developed stocks based on book-to-price, earnings yield, dividend yield, cash flow yield; sector and region neutral
- **Equity quality**: Long/short global developed stocks based on financial risk, profitability and earnings quality; sector and region neutral
- **Equity size**: Long/short global developed stocks based on market capitalization; sector and region neutral
- **Merger arb**: Long target company and short acquirer (when offer involves stock component) in announced merger deals across global developed markets
- **Event-driven (other)**: Conglomerate discount arbitrage, share repurchases, equity index arbitrage, post-reorganization equities and shareholder activism
- **Macro carry**: FX G10 carry, FX emerging market carry, fixed income term premium, fixed income real yield, commodity carry
- **Macro momentum**: FX cross-sectional momentum, commodity cross-sectional momentum and time-series momentum across equity, fixed income and commodity markets
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