Multi-Asset Solutions Strategy Report

Global markets and multi-asset portfolios

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In brief

- The recent data flow looks most consistent with a solid growth and stubborn inflation scenario – our current base case. Near-term slowdown scenarios look less likely.
- The combination of less certainty about the path of inflation, alongside resilience in growth, points to the possibility of more monetary tightening than previously expected. That has made it difficult to take strong directional positions in multi-asset portfolios.
- Our preference to overweight duration reflects our outlooks for rates (moving modestly lower) and correlation (declining or turning negative again). But we have low conviction in this view.
- We remain close to neutral in our portfolio positioning. We favor relative value positions in equities and fixed income, leaning toward cheaper stock markets with more cyclical upside, such as emerging markets, and away from bond markets with greater scope for further monetary policy tightening, including Japan.

Shifting scenarios: Resilient growth, stubborn inflation

Financial market developments during the past few months have reflected shifts in the prospects for both growth and inflation. Late last year, market participants focused on the severity of a likely downturn in global economic activity amid a noticeable improvement in the trajectory of inflation. More recently, the near-term growth outlook has brightened in the U.S., Europe, and China, while incoming information about inflation has turned more mixed.

This recent combination of resilient growth and stubborn inflation has renewed the uncertainty about global monetary policy cycles. That has made it difficult, in our view, to take strong directional positions in multi-asset portfolios.

Exhibit 1 lays out a set of near-term scenarios and our current assessment of their relative likelihood. While the descriptions focus on the U.S. economy, we believe they apply more broadly. The probability distribution appears to have shifted, away from the "slowdown" stories (scenarios 3 and 4) and toward the "resilience" states of the world (scenarios 1 and 2). The recent data flow looks most consistent with the solid growth and stubborn inflation of scenario 2 – our current base

case. The data shows decent (though hardly robust) growth and inflation that is moderating but still above central bank targets.

The wide range of plausible economic scenarios map onto a diverse set of potential market outcomes

Exhibit 1: Near-term scenarios for U.S. growth and inflation

Near-term Scenarios				Prob (%)
#	Scenario	U.S. growth	U.S. inflation	
1	**Inflation dissipates**	Growth holds up, labor market adjusts through wages, not jobs	Wage inflation normalizes and CPI inflation drops below 3%	5
2	**Resilient growth, stubborn inflation**	Growth runs close to trend as saving rates stabilize	Core services inflation moves sideways, inflation tracks closer to 4%	40
3	**Painful rebalancing**	Sluggish growth with clear labor market adjustment	Inflation fades slowly, around 3% at end-2023	35
4	**Hard landing**	Economy enters recession, driven by business caution	Contraction flushes inflation out of system, run-rate of core at target	10
5	**Supply shock**	Sharper recession thanks to real income hit	Headline inflation jumps; sticky expectations threaten core disinflation	10

Source: J.P. Morgan Asset Management Multi-Asset Solutions; data as of February 2023.

Better than expected growth

Measures of U.S. growth have turned upward after a slide toward the end of 2022. Retail sales surged in January after a December slump, although changing seasonal spending patterns likely exaggerated those swings. Payroll employment also reaccelerated at the start of the year, and a continued low pace of new unemployment insurance claims likewise suggest ongoing strength in the labor market. Private sector surveys, which were moving lower in the fourth quarter, have generally stabilized or improved.

The collapse of natural gas prices seems to be allowing the euro area economy to dodge a recession that appeared all but inevitable last year. Not much European "hard data" is available yet for 2023, but historically reliable surveys indicate weak but positive growth. And China's post-COVID-19 reopening process has proceeded with less disruption than feared, paving the way for a strong bounce in activity that we think will already be reflected in first quarter data.

Further, we expect global industry to stabilize in the coming months after weakening sharply late last year. That downturn appears to have realigned output with demand, ending a period of unwelcome inventory accumulation and setting up a return to modest expansion.

Restrained enthusiasm for risk assets

Although troughs in global growth, especially in factories, generally foreshadow strong performance for risk assets, three factors currently temper our enthusiasm.

First, we still see some potential cyclical hazards, especially in the form of a downturn in the credit cycle. Bank lending standards have tightened in the U.S. and Europe to a degree generally not seen outside of recessions. As with many other features of this unusual cycle, we think this development may be sending a misleading signal as banks have prepared themselves unusually early for a downturn that might not arrive in 2023. A sustained and broad move toward restrictive credit conditions, however, could toggle the economy back toward the "landing" scenarios, whether soft or hard.

Second, with saving and unemployment rates both low, a sustained period of above-trend growth appears unlikely, although this point applies more firmly to the U.S. than elsewhere. Third, those limited buffers leave the economy vulnerable to supply shocks, such as another energy crunch – scenario 5 in Exhibit 1. The probability of this outcome seems to have declined recently, with China's reopening doing little to boost oil prices, but we think it remains a plausible tail risk.

Recent inflation news, meanwhile, seems more aligned with the resilient growth, stubborn inflation story (scenario 2) than with the dissipating inflation of scenario 1. To be sure, inflation momentum likely peaked in the second half of 2022, and early 2023 figures have surprised to the low side in Europe. But in the U.S., "pipeline" indicators of goods prices have stopped falling, core CPI inflation ticked upward in

January, and some measures of underlying inflation have also remained high. Inflation breakeven pricing in the bond market has correspondingly shifted higher from very low levels coming into 2023.

This combination of less certainty about the path of inflation, alongside resilience in growth, points to the possibility of more monetary tightening than previously expected. Central banks continue to signal that they are nearing the end of their hiking cycles. We think any reacceleration in the pace of tightening is unlikely, with rates already in restrictive territory. But central banks could administer a few extra doses of hawkish policy medicine if incoming information continues to point to scenario 2 – with stubborn inflation – as the most likely path for the economy.

More positive on bonds, but with an eye on alternative scenarios

For the year ahead, the wide range of plausible U.S. macroeconomic scenarios map onto a diverse set of potential market outcomes. Fixed income markets, which last year were especially volatile relative to their history, continue to face uncertainty.

In most states of the world, we see rates moving at least modestly lower, a result of waning price and wage pressures and moderate growth. We also expect correlation between stocks and bonds to decline or turn negative again. A market focus on inflation and Fed rate expectations tends to push stocks and bonds in the same direction, driving positive correlation. But we expect that focus to fade in the coming months.

Our preference to overweight duration reflects our outlooks for both rates and stock-bond correlation. However, our conviction in this view remains low. That's largely because we also assign a 40% likelihood to a bond-bearish scenario of "resilient growth" and more "stubborn inflation"—essentially some continuation of the last year's economic surprises.

What features of the environment could lead us in this direction and away from our modestly positive view on duration?

1. Stubborn consumer price and wage inflation that would prompt the Fed to tighten policy more than markets have currently priced, raising real rates in the near term. Such additional tightening would also likely further invert the yield curve, although we would expect upward pressure on intermediate yields as well as the policy rate.

2. Mostly resilient activity in the face of significantly higher policy rates, which would suggest an economy that is structurally less rate-sensitive than expected. Evidence of resilience would thus increase investors' expectations of average policy rates over the longer term, putting direct upward pressure on longer-dated yields.

3. Still-stubborn inflation later this year that could potentially encourage the Fed to relax its near-term focus on hitting its 2.0% target, especially if the costs of getting there seem substantial and inflation expectations remain well-contained. Changing the inflation target would be a shock to markets, which makes a formal shift unlikely. But the Fed might become more comfortable tolerating an extended period of above-target inflation closer to the 2.5%–3.0% range.

Were it to materialize, this scenario would likely lead bonds to underperform cash. It would also keep the stock-bond correlation in positive territory, as markets continue to focus on inflation and monetary policy.

Asset allocation implications

Incoming information looks consistent with an economy in the resilient growth, stubborn inflation scenario (scenario 2), at least for now. This leads us away from strong directional views in portfolios. The current state of affairs may persist for a while, but not indefinitely, and it will likely resolve itself in the form of one of the other scenarios.

Each of these possible alternative states of the world, though, carry very different implications for stocks and bonds, leaving us close to neutral in our portfolio positioning. We favor relative value positions in equities and fixed income, leaning toward cheaper stock markets with more cyclical upside, such as emerging markets, and away from bond markets with greater scope for further monetary policy tightening, including Japan.

Exhibit 2: Multi-Asset Solutions Asset Class Views

Asset class		Opportunity Set	UW	N	OW	Chg	Conviction
Main Asset Classes		Equities	●	○	○		Low
		Duration	○	●	○		
		Credit	○	○	●	▲	Low
		Cash	○	○	●		Moderate
Preference by Asset Class	Equities	U.S.	●	○	○		Moderate
		Europe	○	●	○	▲	
		UK	●	○	○		Low
		Japan	○	●	○		
		Emerging markets	○	●	○	▲	
	Fixed Income	U.S. treasuries	○	○	●		Low
		G4 ex-U.S. sovereigns	●	○	○		Moderate
		EMD hard currency	●	○	○		Low
		EMD local FX	○	●	○	▲	
		Corporate inv. grade	○	○	●		Moderate
		Corporate high yield	●	○	○		Low
	FX	USD	○	●	○	▼	
		EUR	○	●	○	▲	
		JPY	○	○	●	▲	Low
		EM FX	○	●	○		

The tick chart and views expressed in this note reflect the information and data available up to December 2022.

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As of December 31, 2022.

Next steps

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