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Multi-Asset Solutions Strategy Report

Global markets and multi-asset portfolios

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In brief

- In our base case view of sub-trend growth, equities probably set the cycle lows last October. Should the economy avoid recession, we may be approaching a trough in earnings expectations which could strengthen fundamental support for stocks in the medium term.
- Nevertheless, near-term risks must be managed. Potential for seasonal profit-taking in the AI-driven and now quite expensive mega-cap tech sector, which is responsible for most of S&P 500 gains year-to-date, leaves the wider index vulnerable. U.S. regional banks and commercial real estate remain key fragilities, but thus far contagion is contained.
- As inflation cools and rates volatility subsides, stock-bond correlations are coming down sharply. And as correlations approach negative territory, over the medium term we expect to see a growing argument for pairing duration overweights with increased exposure to equities to build a diversified portfolio.

Near-term risks for stocks obscure medium-term potential

If the first few months of last year were shocking –notably Russia's invasion of Ukraine and the surge in inflation – then the first few months of this year could be described as frustrating. For the equity bulls, stock valuations are too high for comfort and the market has failed to provide a dip to buy. For the equity bears, the widely anticipated recession is always a quarter or more away.

Our base case for the economy is less fatalistic than consensus. While we acknowledge elevated risks, we do not believe recession is inevitable. Growth will likely be sluggish, and inflation will cool slowly. While sentiment is muted for consumers and businesses, this is an environment in which earnings grind lower slowly, rather than collapse all at once. On one point bulls and bears agree: the stock market is expensive. The bulls want a buying opportunity, while the bears want to be proven right.

In our base case view, the equity market has hit its lows for this cycle. Full-year 2023 earnings expectations have now declined, implying roughly flat bottom-line growth compared with 2022. Delivered earnings

have, so far, beaten this lowered bar. It is true that 2023 earnings expectations may have a little further to fall, but the downgrade cycle is well advanced. Full year 2024 earnings expectations are also a little ambitious at 12% year-over-year implied growth. However, if the economy does indeed avoid recession and delivers positive, albeit sluggish growth, then 2024 earnings expectations seem merely a stretch as opposed to unrealistic.

The first quarter earnings season confirmed that nominal growth continues to support top-line revenue numbers, while margin declines suggest that corporate pricing power has probably reached its limit. Overall, a reasonable earnings season – even if calibrated for lower expectations – confounds widespread cautious sentiment and light positioning.

Does this mean that a cautious stance has been proven wrong? To answer this in perhaps the most frustrating way in the English language: it's complicated. Allowing for recession risk, probability-weighted returns for stocks are flat to moderately lower. But absent a recession, and with the Fed on pause and earnings expectations looking more reasonable, further upside in equities seems plausible.

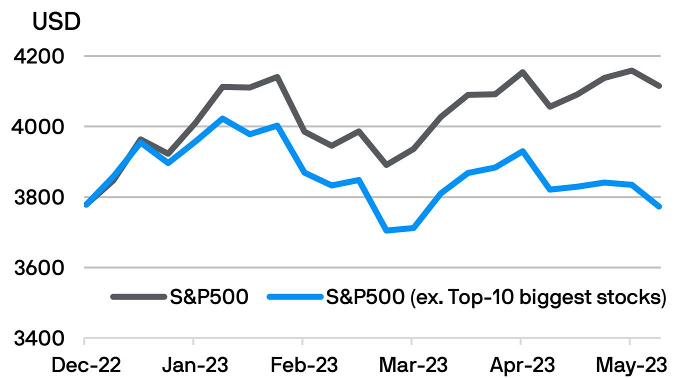
In our multi-asset portfolios, we continue to avoid excessive underweights to equity and express conviction around heightened recession risks instead through an overweight to duration. Nevertheless, both narrow leadership in U.S. equities and seasonality present near-term risks to be managed.

Narrow equity market leadership

Narrow leadership in the S&P 500 is a concern for equity bulls. A rally can begin on narrow leadership, but a self-sustaining bull market relies on breadth. The top-10 largest stocks in the S&P 500 have alone driven the index's 9% year-to-date gains. Put another way, the S&P 500 excluding these top-10 names – most of them mega-cap tech stocks – would today trade around the 3770 level (flat year-to-date) (**Exhibit 1**).

Mega-cap tech names have delivered the bulk of this year's returns for the S&P 500

Exhibit 1: S&P 500 vs. S&P 500 (ex top 10 biggest stocks) YTD



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

Without the mega-cap tech names whose fortunes are closely linked to the excitement around artificial intelligence (AI), the U.S. large cap equity market would be the laggard among regional equity markets this year. Taking an "ex-tech" approach may better capture the balance of economic risks, with the U.S. appearing most vulnerable to recessionary risks, Europe doing better than feared, and China enjoying a reopening dividend.

We think AI and technology adoption are in the early stages of an important super-cycle, but as with all trends in asset markets, we expect an ebb and flow. Today, mega-cap tech trades at a 40% valuation premium to the S&P 500, with earnings expectations for the sector holding roughly steady since the start of the year. Even after accounting for the potential of AI and better cost control across mega-cap tech companies, we see limited additional near-term earnings support for the sector. In short, mega cap tech's rich valuation signals vulnerability for the U.S. equity index.

Investors should consider how to respond to any seasonal or concentration-led dip in stocks. Even as macro data improves from subdued levels and key tail risks such as the U.S. debt ceiling seem to be grinding toward compromise, weakness in risk assets could lead to a resurgence in more bearish

economic narratives. From an economic perspective, tighter credit conditions and elevated policy rates are certainly a concern, but household and corporate balance sheets still look resilient.

Contained risks in regional banks and commercial real estate

There are pockets of fragility within the market – regional U.S. banks and commercial real estate are the most well-telegraphed – but these appear contained so far. Concerns surrounding further deposit flights and high costs of funding have added to recession fears, and the KBW Regional Banking Index fell to its lowest level since 2020. We see some risk of a negative chain-reaction playing out in the banking sector, in which the sector's poor performance intensifies the perception of sector risks, leading to more deposit outflows – and the cycle continues.

Intriguingly, though, the pummelling of the index coincided with some positive news on bank deposits, with Fed data suggesting little to no worsening of deposit-related stresses. We do not think that the banking crisis needs necessarily to become a self-fulfilling prophecy: Amid stronger bank regulation and supervision, the global banking sector looks sufficiently capitalized and resilient.

Markets are finely balanced between near-term risk and medium-term potential. Lack of exposure among real money investors suggests buyers could emerge quickly on weakness. Multiples are above average but have proved resilient as anticipated rate cuts have been taken out of the U.S. yield curve. Finally, earnings are holding up even as margins are squeezed.

In the absence of new negative information, a dip could be just that, the result of profit taking but no deep pessimism. On balance, there's a case for modest weakness in stocks over the near term, but in any bout of market weakness we expect investors to move quickly to buy on the dip.

Asset allocation implications

In 2022 surging inflation resulted in positive stock-bond correlations which in turn intensified the challenges facing investors. As equities and bonds sold off in tandem, portfolio protection through diversification was limited. Now, as inflation declines and rates volatility subsides, stock-bond correlation is once again moving lower. This may allow a portfolio construction that pairs a positive stance on bonds with a more constructive stance on equities, re-introducing the natural hedge that bonds provide to stocks in a negative correlation environment. Investors may increasingly adopt this approach as growth fears now dominate inflation fears for many market participants.

In sum, we are still cautious in the short term and maintain an overweight to duration and a modest underweight to equity as stocks trade at the top of their range. But should the economy continue to show resilience and assuming earnings downgrades may have run their course, any pullback may offer potential for positive, albeit unexciting equity returns in the medium term. Near-term vulnerabilities arising from seasonality and concentration should therefore not be confused with a renewal of concerns about economic fundamentals. The near-term risks could well provide an attractive entry point, but given light positioning, investors will need to be nimble.

Exhibit 2: MAS Asset Class Views

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

The tick chart and views expressed in this note reflect the information and data available up to March 2023.

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As of March 31, 2023.

Next steps

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