

Multi-Asset Solutions Strategy Report

Global markets and multi-asset portfolios

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In brief

- Financial sector stress appears relatively contained. Recent data flow remains consistent with subtrend global growth and some easing in inflation pressures. Recession risks continue to be elevated.
- In our view, China's economy offers more cyclical upside than other economies as consumption recovers and the property sector stabilizes. Continued policy support should help rebuild private sector sentiment.
- Our portfolio positioning is cautious. We remain overweight longer-term duration and keep a modest underweight to equities. But we see relative opportunities across regions and expect resilience in emerging market equities, supported by China's economic recovery, attractive valuations and USD weakness.

China's recovery powers emerging market equity resilience

Markets have calmed following the early March turmoil in the banking sector. Recent data suggest that banking stresses have remained relatively contained as funding pressures have eased. The Federal Reserve's (Fed's) emergency lending to banks has largely stabilized after an initial burst of activity. Since mid-March, when fears of contagion from the banking sector began to dissipate, volatility in both the equity and bond markets has declined notably. Emerging market (EM) equities have also rebounded from their mid-March lows, signaling that damage from the banking stresses was limited.

Overall, our core macro scenario envisions resilient but distinctly subtrend growth, combined with stubborn inflation and elevated recession risk. That's not typically a great setup for EM stocks. Yet we see the potential for resilience in EM equities, which will benefit from a strong recovery in China, a weakening U.S. dollar and supportive valuations.

We believe China's economy offers more cyclical upside than other major economies. It can thus provide countercyclical uplift as growth outside China stalls. Since the Chinese economy reopened in January, the data have increasingly pointed to a robust recovery: Q1 GDP data highlighted rebounding in consumption and services activity.

Significantly, the worst of the China property downturn appears to be over. New home sales recovered strongly in March, pushing year-on-year growth back to positive territory for the first time since mid-2021. In the wake of a policy push to ensure that builders deliver completed homes, worries about unfinished housing projects seem to be fading, especially in major cities.

After a strong start, a sustainable recovery

We are confident that the Chinese economic recovery – which has been stronger than expected – will prove sustainable, boosted by tailwinds from the reopening and continued policy support. Macro policy will likely remain accommodative – but not aggressively stimulative – at least through Q2. That reflects muted inflationary pressure, a lagged recovery in the labor market (youth unemployment is close to 20%) and a highly uncertain outlook for external demand.

A policy put remains in place. As the new premier starts the first year of his 10-year term, we envision very limited government tolerance for a China GDP growth rate below 5%, the conservative official growth target for 2023. Additional stimulus seems likely if China's economic recovery falls below expectations.

Both fiscal and credit policy support came through firmly in the first quarter, pointing to front-loaded macro policy support. China's credit data surprised to the upside for each of the past three months. Improvement in the credit impulse will likely lead to stronger economic growth after another quarter or two.

On the fiscal front, year-to-date issuance of local government special bonds has been on par with 2022 levels, suggesting robust fiscal support for infrastructure investment activity. We believe infrastructure investment can play an important role in anchoring aggregate demand and supporting private sector confidence, given its spillover effect on employment.

Rebuilding private sector confidence will be key to a sustained recovery, in our view. While the release of pent-up demand in Q1 should spur the initial stage of a consumption recovery, labor market improvement will likely propel the next stage.

The strong recovery in China's domestic demand should also help to support growth momentum in the rest of Asia, which accounts for a significant share of the EM equity market. EM Asia's exports weakened notably from late 2021 amid slowing global demand and supply disruptions in China.

Mainland China-bound shipments acted as a key drag on Korea's and Taiwan's export performance, with year-on-year growth falling to its lowest level since the global financial crisis. Sluggish electronics exports also contributed to export weakness throughout the region. We expect the strong trade headwinds from both China and the tech sector to abate in the coming months.

Ingredients in place for EM equity resilience

Against this macro backdrop, we hold a relatively positive view of EM equities, with a preference for Chinese assets.

History tells us that the main ingredients for EM outperformance are stable global growth, low volatility and a weakening dollar. All three went missing for most of last year as EM equities faced twin challenges: a rapid hiking cycle across developing markets and a cloudy global growth outlook. But now the central bank hiking cycle is nearing its end and the global economy has proved to be more resilient than many had expected.

At the start of this year, EM equities got a boost from China's decision to lift its zero-COVID policy. But geopolitical tensions and weak investor sentiment have caused Chinese equities, both onshore and offshore, to underperform developed market stocks this year to date.

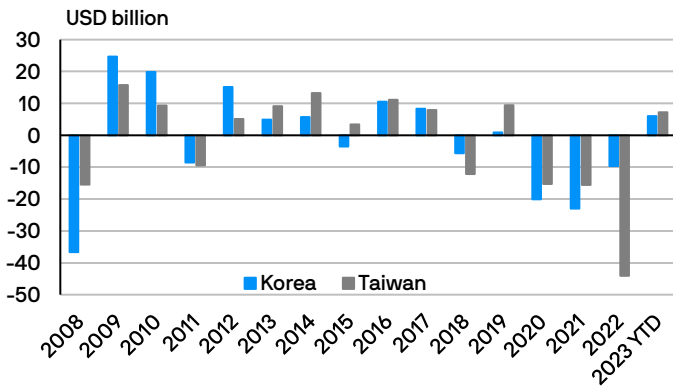
We believe the fundamental story of China's growth recovery and policy support remains intact. Market valuations continue to be attractive and we see further potential for multiple expansion if a cyclical recovery drives a stronger profit cycle. Positioning also looks supportive given that, post-COVID-19, global investors have largely steered clear of Chinese equities as they try to evaluate the country's longer-term growth prospects.

But after a three-year absence, foreign investors have moved back into EM markets ex-China (for example, Taiwan and Korea), which have outperformed the

broader EM Index so far this year (**Exhibit 1**). Attractive valuations and secular tech themes in these markets provide investors with defensive exposure in their equity portfolios – a useful attribute in the current environment.

Global equity investors have returned to Taiwan and Korea

Exhibit 1: Net foreign equity investment, USD billion



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

Taiwan and Korea dominate the EM Asia ex-China complex. While Taiwan leads the computing chip (personal computers and CPUs) manufacturing space, Korea is a global leader in memory chip (DRAM and NAND) production. Both are thus geared to the global goods demand cycle, which exposes them to some idiosyncratic risks.

Consensus earnings expectations do remain depressed for both Taiwan and Korea equities. But optimism about companies’ tech inventory management and enthusiasm about artificial intelligence have led Taiwan equities higher. In addition, the PC demand cycle seems to be entering a re-stocking phase, which will help drive further performance.

At the same time Korean stocks have found support from improved supply chains and resilient demand for autos and consumer products. DRAM prices have been declining since last year due to oversupply. But now, the spread between new electronics orders and inventories seem to be stabilizing, suggesting that markets might be approaching a trough in prices. Together these tailwinds should help drive EM equity

performance.

We note one caveat to our relatively positive view of EM equities: In a deep recession, EM stocks could underperform if markets were to experience a capital flight to safety.

Across all EM markets, FX has been a key driver of our views. We believe FX markets have entered a new regime, characterized by a weaker dollar. The Federal Reserve is no longer the most hawkish central bank on the job. The divergence in policymaker response to regional growth and inflation data could drive currency trades over the coming quarters.

In the absence of a global recession, these factors could send DXY lower. What’s more, we could find opportunities for EM currencies, especially CNY, to appreciate without losing their price competitiveness, given their relatively attractive valuations. These currency dynamics can also lend support to parts of the EM complex that are largely pro-cyclical or have significant commodity exposure, such as the Brazilian lira and the Mexican peso.

Asset allocation implications

Recent macro data have confirmed our view of resilient but subtrend growth and elevated recession risk. Longer-term duration looks attractive as the global tightening cycle approaches its end, but central banks will continue to hold rates in restrictive territory to fight inflation that remains above target.

In our portfolio positioning, we maintain a small underweight to equities overall but find relative value opportunities in EM equities. We expect lower U.S. bond yields and relative USD weakness to lend support to EM equities broadly. In China, an economic recovery and policy support should help Chinese assets to be resilient even in the case of a more pronounced global slowdown.

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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Multi-Asset Solutions’ asset allocation views are the product of a rigorous and disciplined process that integrates:

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- 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, 2023.

Next steps

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