Global Asset Allocation Views

Insights and implications from the Multi-Asset Solutions Strategy Summit

4Q 2020

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ASSET CLASS VIEWS (PAGE 3)

Underweight ● Neutral ● Overweight ●

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

IN BRIEF

- The economic recovery is gaining pace as macro data improves and business and consumer confidence strengthens. An unprecedented level of monetary and fiscal stimulus will continue to fuel a powerful pickup in growth.
- Nevertheless, we see looming event risks in the fourth quarter. Among them: uncertainty about the U.S. election outcome, the shape of any Brexit deal and rising COVID-19 case counts in Europe. Still, there are also potential upside risks, particularly relating to fiscal policy and a vaccine.
- While our constructive central case leads us to maintain a risk-on tilt in our multi-asset portfolios, we anticipate some volatility over the autumn and look to remain well diversified and nimble. We spread our risk between stocks and credit, while within equities we favor a broad regional diversification. We also move to underweight USD, which has scope to weaken as the global recovery gains momentum. Although we are mildly underweight duration, central bank backstops in credit markets sometimes allow us to use high quality corporate credit as a proxy for duration.

THE VOLATILITY IN GLOBAL EQUITY MARKETS SINCE LABOR DAY CONTRASTS MARKEDLY WITH THE SERENE UPWARD MARCH OF STOCK PRICES THAT CHARACTERIZED THE SUMMER MONTHS. The combined effect of improving macro data, a better than expected earnings season and a decline in virus cases in Europe and the U.S. buoyed equity and credit markets for much of the third quarter. But as we approach the fourth quarter, it appears the event risks we face in the coming months are back on investors' minds, just as virus stats in Europe appear to be worsening.

The balance between improving macro momentum and near-term tail risks underpinned much of the discussion at our mid-September Strategy Summit. In our view, the economic recovery is gaining pace and we expect a robust expansion into 2021, but the tail risks—in both directions—are palpable. Our constructive central case leads us to maintain a risk-on tilt in our multi-asset portfolios. At the same time, the fatter and flatter distribution of tail risks, together with extremely low bond yields, calls for thoughtful portfolio construction.

Our optimism on the underlying economic trajectory may seem at odds with the recent news flow, but away from the hyperbolic headlines macro data continue to improve.

New orders data imply further strength in purchasing manager surveys, Asian export data point to a robust goods market, high savings rates suggest reasonable resilience in the household sector, and confidence is improving among businesses and consumers alike.

Further, the level of monetary and fiscal stimulus is unprecedented. We have remarked previously that the alignment of monetary and fiscal stimulus will distinguish this cycle from the last one. While we acknowledge that there is uncertainty about the extensions of fiscal packages in some regions, the combined effect of zero rates and the 13.1% of GDP committed by G20 nations to fiscal stimulus this year continues to fuel a powerful economic recovery.

Nevertheless, we see looming event risks in the fourth quarter. Uncertainty about the U.S. election and the shape of any Brexit deal between the UK and the European Union is acute. While we expect fiscal packages to be extended and monetary policy to remain extremely accommodative, hawkish voices are becoming louder and fears about debt sustainability—muttered only in hushed tones during the height of the coronavirus crisis—are increasingly vocalized. The path of the virus is central to the uncertainty many feel, and the recent uptick in caseloads in Europe is of concern. While we don't anticipate a repeat of the large-scale lockdown that occurred in the second quarter, some disruption is inevitable.

The apparently growing level of risks in the fourth quarter might suggest it is time to reduce portfolio risk levels. However, while some prudence may be justified, there are tail risks in both directions. Certainly, we should not ignore the upside risks around a vaccine, further monetary accommodation and renewed fiscal support. We also note that corporate earnings are starting to rebound and there are powerful base effects as we enter 2021; moreover, signs of a pickup in capex and a rebuilding of inventories present further upside risks.

At a portfolio level, we maintain an overweight to equities and to credit while sticking to our underweight to bonds. We also downgrade our view on the dollar to underweight, as we see further, but gradual, downside for the greenback ahead.

We look to spread our risk between stocks and credit. Within equities we favor a broad regional diversification and are overweight European and emerging market (EM) equities, as well as U.S. equities, with a tilt toward small caps. Our least favored equity region is the UK, although we note that our quant models are flagging the cheap relative valuations of UK stocks.

Our modest underweight to duration is concentrated in negatively yielding regions like core Europe, but the low yields in all markets lead to a negative aggregate duration signal from our quant models. The dilemma for portfolio construction is that low yields also reduce the degree of protection bonds offer. Indeed, a large notional bond exposure would be necessary for duration to function as an effective hedge, which would in turn hit portfolio returns if the low growth expectations priced into yields start to rebound. Central bank backstops in credit markets allow us to use high quality corporate credit as a proxy for duration in some cases; but, above all, diversifying exposure across assets remains a focus.

Our multi-asset portfolios reflect our optimism that the recovery which began in the second quarter will extend over the next 12 months. Nevertheless, we anticipate some volatility over the autumn and expect to remain well diversified and nimble, in equal measure, as we navigate the final months of 2020.

Multi-Asset Solutions Key Insights & "Big Ideas"

In previous editions of our Global Asset Allocation Views, we included a map and table of key global themes. Those themes helped us discuss the economic and market outlook, and shape the asset allocation that Solutions reflected across portfolios. While some of those themes are still in play, we now choose to share the Key Insights and "Big Ideas" discussed in depth at the Strategy Summit. These reflect the collective core views of the portfolio managers and research teams within Multi-Asset Solutions and 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.

- Expansion gathering pace, but tail risks are elevated in 4Q.
- Fiscal and monetary stimulus persists well into the new cycle.
- Quantitative easing is capping yields, but they will rise as growth picks up.
- The dollar is entering an extended but gradual downtrend.
- Credit default risks more than offset by central bank support.
- We prefer to diversify portfolio risk across equity and credit.
- Equity earnings improving; we favor a broad regional exposure.
- Cyclical sectors lead, but value rotation unlikely until rates rise.

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 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	○	○	●		Moderate	2Q20 earnings much better than expected, and scope for strong earnings recovery in 2021
		Duration	●	○	○		Low	Disliked on quant signals; central bank buying reflected in prices; real yields negative
		Credit	○	○	●		High	Defaults stable and central banks underpin market; resilient in recent equity weakness
		Cash	○	●	○			Profoundly negative real rates and improving macro data make cash much less attractive
PREFERENCE BY ASSET CLASS	EQUITIES	U.S.	○	○	●		Low	Increasingly prefer small cap stocks; high valuations in tech beginning to affect large caps
		Europe	○	○	●		Moderate	PMIs moderating a little, but fiscal stimulus and cyclical composition of index attractive
		UK	●	○	○		Low	Domestic weakness/political risks remain, but valuations cheap and have lagged this year
		Japan	○	●	○			Attractive cyclical exposure in index offset by unclear trajectory of domestic macro data
		Emerging markets	○	○	●		Low	Valuations no longer cheap, but Asia leads global growth and goods demand supportive
	FIXED INCOME	U.S. Treasuries	○	●	○			Fed buying likely to cap yields around 100bps in U.S. 10-year, but real yields are negative
		G4 ex-U.S. sovereigns	●	○	○		Moderate	Negative nominal yields make Bunds unattractive; quant duration signals very negative
		EMD hard currency	○	●	○			EM spreads have compressed already, but carry pickup is attractive
		EMD local FX	○	●	○	▲		EM FX finding some support, and capital concerns for EM nations beginning to ease
		Corporate investment grade	○	○	●		Moderate	Powerful support from Fed for IG means it can operate as a duration proxy
		Corporate high yield	○	○	●		High	Fed policy and high investor cash balances support HY; default risks slowly easing
	CURRENCY	USD	●	○	○	▼	Moderate	Key support levels broken, but USD still rich; scope for more downside with Fed rates at zero
		EUR	○	○	●	▲	Low	Strong move up over summer, but still a long way from fair value and growth improving
		JPY	○	●	○	▼		Natural safe haven status lends support if crisis worsens; currency also undervalued
		EM FX	○	●	○	▲		Virus concerns in LatAm easing, and growth accelerating in key Asian nations

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

Diversification does not guarantee investment returns and does not eliminate the risk of loss. Diversification among investment options and asset classes may help to reduce overall volatility.

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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 September 30, 2020.

NEXT STEPS

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