Factor Views

Themes from the quarterly Quantitative Beta Research Summit

2Q 2019

IN BRIEF

- Factor performance was bifurcated over the quarter amid sharp market reversals.
- Equity factors were negative across the board; since 1990, this had happened only once before.
- Event-driven factors delivered generally positive returns, led by merger arbitrage, share repurchase and spinoff factors.
- Macro factors were led by carry, which drove gains across asset classes.
- We believe in diversifying across a broad range of compensated factors while minimizing exposure to uncompensated risks, even if the risk of recession has been pushed out on the horizon.

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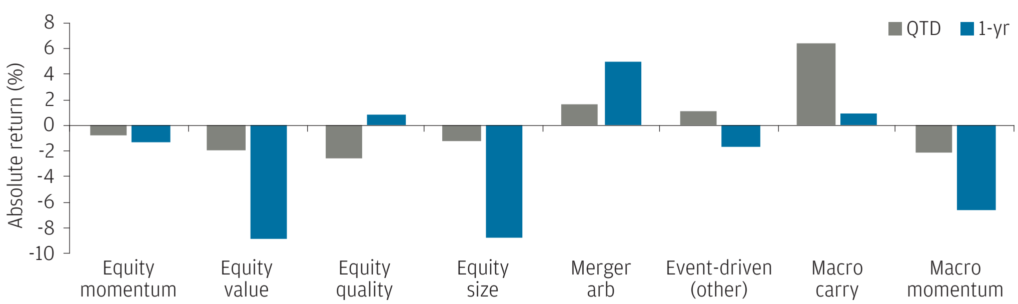
OVERVIEW

Risk assets surged to their best quarter in nearly a decade following a dismal year-end in which financial markets priced in increasing odds of a recession amid a range of economic, monetary policy and geopolitical concerns. The sharp reversal, which appeared to be driven by a dovish shift across central banks, led to bifurcated outcomes across the factors that we favor (**EXHIBIT 1**). Shifting crosscurrents negatively impacted each of our equity factors while event-driven and macro factors generally performed well. In fact, Q1 2019 was only the second time since 1990 when all four of our equity factors were negative (the other occurrence was Q1 2009, when markets bounced off of financial crisis lows). While prospects for economic growth are subdued and markets are projecting that the Federal Reserve (Fed) will cut rates before resuming a hiking path, it appears that the global economy has sidestepped a recession and that major economies will remain in late-cycle territory for some time to come. That backdrop has varying implications for factors.

Factor performance was bifurcated over the quarter

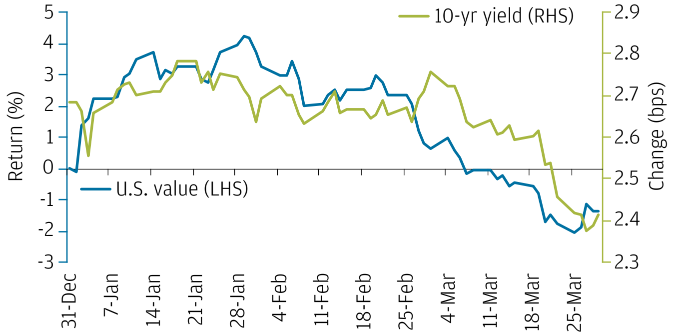
EXHIBIT 1: QUANTITATIVE BETA STRATEGIES LONG/SHORT FACTOR RETURNS



Source: J.P. Morgan Asset Management; data as of March 31, 2019. Note: Factors presented are long/short in nature. Equity factors represented as 100% long notional exposure, macro factors as aggregation of 5% vol sub-components. Valuation spread is a z-score between the median P/E ratio of top-quartile stocks and bottom-quartile stocks as ranked by the value factor.

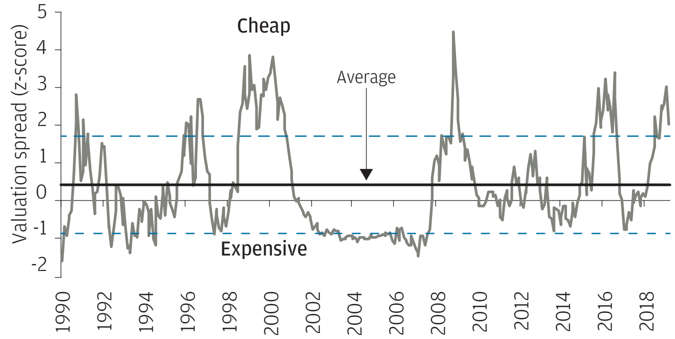
The value factor again rose early in the quarter, before falling alongside yields

EXHIBIT 2: Q1 2019 PERFORMANCE



The opportunity set for the value factor remains attractive

EXHIBIT 3: VALUE FACTOR VALUATION SPREAD (GLOBAL)



Source: J.P. Morgan Asset Management; data as of March 31, 2019. Note: Valuation spread is a z-score between the median P/E ratio of top-quartile stocks and bottom-quartile stocks as ranked by the value factor.

FACTORS IN FOCUS

Equity factors: Down across the board

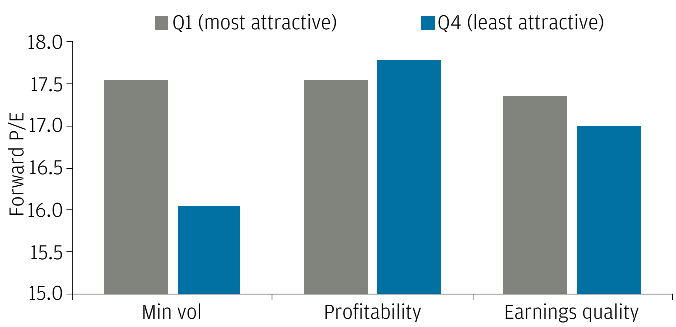
The value, quality, momentum and size factors were each negative for the quarter, as conditions remained choppy for equity factors, leaving quality the only positive factor over the past 12 months. Factors remained broadly uncorrelated to one another, experiencing downdrafts at different times over the quarter. Momentum suffered in January, in particular within the U.S., as markets quickly rebounded from last year's correction. Value started the year strongly but peaked toward the end of January and fell alongside yields over the remainder of the quarter (**EXHIBIT 2**). Quality delivered the worst performance over the quarter, declining in both January and March, as each of the underlying metrics in our quality composite, other than minimum volatility, was negative. Size was positive in both January and February before falling sharply in March (within the U.S. in particular).

When we upgraded the value factor in Q3 2018, we posited that higher interest rates and a progression from late to end cycle could spark a reversal in the value factor, catalyzing a rebound from value's historically cheap levels. Unfortunately, the factor has been negative in two of the three quarters since our upgrade and recent trends in rates may act as a headwind for the factor until deteriorating company fundamentals refocus the market on the high refinancing risks associated with expensive/growth stocks when compared with their value counterparts. The value factor has historically been uncorrelated to interest rates and the yield curve. However, a relationship appears to have formed following the global financial crisis, with the factor's performance linked in part to changes in the yield curve (as measured by 10-year yields less two-year yields); indeed, the correlation—with a flatter yield curve linked to weaker factor performance—has risen to statistically significant levels. This relationship is not surprising in light of the relatively higher portion of expensive/growth stock value that is driven by future cash flows and the rise in corporate leverage amid a historically low rate environment as companies borrow to fuel future growth. We caution, though, that the relationship between value factor performance and the yield curve is but one potential driver of the value factor's returns. Given the cheap valuations of the value factor, relatively lower debt maturities for value companies on the horizon and an already visible downshift in company fundamentals (whether measured by profit margins, interest coverage ratios or the proportion of expensive companies with negative earnings and negative cash flows), we remain firmly bullish on the prospects for the value factor (**EXHIBIT 3**).

Quality factor returns have diverged of late, depending on how one defines the factor. Our quality composite is based on a wide range of underlying metrics related to profitability, earnings quality and measures of financial risk, such as minimum volatility. Over the long term, these metrics are closely related. On a short-term basis, however, minimum volatility has outperformed our quality composite—with excess returns of ~4% over the past year (**EXHIBIT 4**). This divergence in performance informs our view of our opportunity set. Currently, minimum

On a short-term basis, minimum volatility has outperformed our quality composite

EXHIBIT 4: QUALITY METRIC VALUATION



Source: J.P. Morgan Asset Management; data as of March 31, 2019.

volatility stocks are more expensive than their higher volatility peers, and while our overall view on quality is slightly bearish, minimum volatility may be expected to underperform other metrics going forward as a result of its richness.

Strong performance across event-driven factors

Event-driven factors broadly performed well in the first quarter. These factors have benefited from a significant rise—over 50%—in corporate activity levels since the passage of U.S. tax reform in December 2017. The merger arbitrage factor has continued to earn a healthy carry and attractive risk-adjusted returns in 2019. Our expanded suite of event-driven factors also performed well, recovering from a difficult Q4, with gains driven by both the share repurchase and spinoff factors.

We maintain a positive outlook for event-driven factors, believing that the rise in overall corporate activity levels supports the prospects for performance going forward. Merger arbitrage spreads[1] remain healthy, above their average level over the past five years. More than 90% of deals are characterized as friendly in nature, offering higher odds of completion than unfriendly deals and thus better prospects of earning investor returns.

[1] The difference between the target company stock price and the announced acquisition price

FACTOR OPPORTUNITY SET

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

Macro factors bolstered by carry across asset classes

Despite the violent reversal in equity markets in January and a similar, albeit more moderate, reversal in commodity markets, macro factors were supported by the strong performance of carry across asset classes. Fixed income carry benefited from a general compression in yields across the globe. FX carry profited from a general underperformance of low yielding currencies and commodity carry was well positioned across a variety of markets. These gains, in contrast to losses from momentum exposures, serve as another example of the potential diversification benefits in combining both carry and momentum within portfolios.[2]

The spread between high yielding and low yielding currencies remains below its long-term average, particularly for G10 currencies, as does the difference in term premia across G10 government bonds, suggesting a diminished potential to capture carry in those markets. Among momentum factors, dispersion in price moves across currencies and commodities is below average, while the number of significantly trending levels has increased again, with fixed income markets trending positively across the globe, commodity markets biased negative and equity markets mixed.

CONCLUDING REMARKS

Sharp market reversals and crosscurrents within equity markets battered certain factors in Q1, while others benefited from the shifts. Looking ahead, we see potential catalysts in place across the equity, event-driven and macro spaces. As always, we believe in diversifying across a broad range of compensated factors while minimizing exposure to uncompensated risks.

[2] Yazann Romahi, Albert Chuang and Garrett Norman, "Managed futures strategies: Diversifiers, but no tail risk hedge," J.P. Morgan Asset Management Portfolio Insights (June 2018).

FACTOR VIEWS

VS. LAST QUARTER: ▲ Upgrade ▼ Downgrade – No change

		Opportunity		Rationale
Equity	Momentum		–	Negative on valuation, neutral on dispersion
	Valuation		–	Attractive on valuation, attractive on dispersion
	Quality		▼	Negative on valuation (decrease from last quarter), neutral on dispersion
	Size		–	Attractive on valuation
Event-driven	Merger arb		–	Attractive on deal premia, attractive on % of friendly deals, negative on activity level
	Other*		▲	Attractive on activity level (increase from last quarter)
Macro	Carry		–	Neutral on FX spreads (upgrade from last quarter), negative on fixed income spread (decrease from last quarter), positive on commodity spread
	Momentum		–	Negative on FX and commodity price dispersion, attractive on significant price trends (increase from last quarter)

Source: J.P. Morgan Asset Management; for illustrative purposes only.
*Other: Conglomerate discount arbitrage, share repurchases, equity index arbitrage, post-reorganization equities and activism.

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 EM 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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