Global Asset Allocation Views

Themes and implications from the Multi-Asset Solutions Strategy Summit

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IN BRIEF

- The growth outlook for 2018 remains robust, but emergence of two-sided inflation risks, and moderation in both the pace of growth and earnings revisions, lead to a mild dip of confidence in our moderately pro-risk tilt. Recent market volatility represents a repricing of tail risks and an overdue correction rather than anything more sinister.
- Policy rates are set to tighten steadily but remain accommodative and supportive for risky assets. We keep a moderate overweight to stock-bond and a small underweight to duration but close our underweight on cash, as real rates are rising. Within our equity exposure, we are placing increasing emphasis on relative value positions rather than the overall level of equity exposure, with the U.S. and emerging markets our preferred regions.
- We expect further flattening of yield curves, particularly as the global bid for duration remains supported at higher prevailing yields both by ongoing central bank buying and demand from liability driven investors. Credit still offers modestly positive returns, but tight spreads in high quality corporates lead us to downgrade U.S. investment grade credit.

ASSET CLASS VIEWS (PAGE 3)

Asset class	Opportunity set	Change	Negative			Neutral	Positive		
MAIN ASSET CLASSES	Equities/bonds		○	○	○	○	●	●	○
	Duration		○	○	●	○	○	○	○
	Credit		○	○	○	●	○	○	○
	Commodities		○	○	○	●	○	○	○
	Real estate		○	○	○	●	○	○	○
	Cash	▲	○	○	○	●	○	○	○
PREFERENCE BY ASSET CLASS – EQUITIES	U.S. large cap		○	○	○	○	●	○	○
	U.S. small cap		○	○	○	○	●	○	○
	Europe ex-UK	▼	○	○	○	●	○	○	○
	UK		○	○	○	●	○	○	○
	Japan		○	○	○	○	●	○	○
	Asia Pacific ex-Japan	▼	○	○	○	●	○	○	○
	Emerging markets		○	○	○	○	●	○	○
PREFERENCE BY ASSET CLASS – REAL ESTATE	Direct real estate		○	○	○	●	○	○	○
	U.S. REITs	▼	○	○	●	○	○	○	○
PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	U.S. Treasuries		○	○	●	○	○	○	○
	U.S. TIPS		○	○	○	●	○	○	○
	Euro, core (Bund)		○	●	●	○	○	○	○
	Euro, periphery (BTP)		○	○	○	●	○	○	○
	UK Gilts		○	○	○	●	○	○	○
	Japanese JGBs		○	○	○	●	○	○	○
	Canadian gov't bonds		○	○	●	○	○	○	○
	Australian gov't bonds		○	○	○	●	○	○	○
PREFERENCE BY ASSET CLASS – CREDIT	Investment grade	▼	○	○	●	○	○	○	○
	U.S. high yield		○	○	○	●	○	○	○
	European high yield		○	○	○	●	○	○	○
	Emerging markets debt		○	○	○	○	●	○	○
PREFERENCE BY ASSET CLASS – FX	USD		○	○	○	●	○	○	○
	EUR		○	○	○	○	●	○	○
	GBP		○	○	●	○	○	○	○
	JPY		○	○	○	●	○	○	○

If January 2018 felt much like a continuation of 2017, only more so, then the tone in markets since February could not have been more different. In short order, we were reminded that stocks can go down, as well as up; that volatility can rise, as well as fall; and that inflation can surprise positively, as well as negatively. We do not believe that recent market jitters are anything more sinister than a repricing of two-sided economic risks. We remain constructive and expect stocks to outperform bonds in 2018. But the re-emergence of two-sided inflation risk in some regions and the moderation in certain higher frequency growth indicators suggest we need to subtly shift how we express our constructive view as the economy moves through late cycle.

We expect that the pattern of coordinated, above-trend global growth we've enjoyed for the past few quarters will extend throughout 2018. Yet the initial acceleration in growth is fading and the second derivative—how quickly the rate of growth is rising—is slowing. This may seem contradictory, but a prolonged period of stable, above-trend growth is far from unprecedented; the sub-tlety is that the scope for further upside surprise is diminishing. Stocks should perform well in this environment, but the surge in global earnings expectations may be moderating, ushering in a phase where consistent *delivery* rather than the *promise* of earnings is most rewarded.

The re-emergence of two-sided inflation risks in regions like the U.S., Canada and the UK reinforces our outlook. Over the last year, the economic environment was characterized by a broad-based pickup in growth with benign inflation; we may be transitioning to a broad-based pickup in inflation with a benign growth backdrop. In nominal terms, the quantum of overall growth is similar. But while an increase in real growth gives a shot in the arm to earnings generally, normalization of inflation hands an earnings advantage to regions and firms with pricing power and superior cost controls. We see little risk of runaway inflation—particularly

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with eurozone and Japanese core inflation still subdued—but we do see global inflation steadily rising.

There's an irony that a central aim of quantitative easing (QE) was to normalize inflation, and now that it's finally happened, investors are concerned that central banks are behind the curve. A case of being careful what you wish for, perhaps, but the reality is rather more mundane—simply, investors are having to dust off the playbook on trading a sustained rate hiking cycle for the first time in a decade. Investors are also calibrating how far and how fast rates can rise, as well as adjusting for the uncertainty of both a new Federal Reserve (Fed) chairman and the diver-gence of policy around the globe. We expect 25 basis points (bps) hikes to U.S. rates roughly quarterly through to the end of 2019—a pace that markets should take in their stride.

In late-cycle environments, stocks tend to perform well until monetary policy becomes genuinely restrictive—which is some ways off. Nevertheless, two-sided inflation risk plus policy uncertainty will likely translate to a modestly higher level of market volatility. In this environment, earnings growth rather than multiple expansion is set to be the key driver of equity returns. We maintain our moderate overweight to equities, but with a little less conviction and with an expectation of more regional diver-gence. Markets with pricing power, solid earnings delivery and pro-cyclical gearing should outperform regions with currency headwinds, margin vulnerability or an overly defensive sector mix. Last year our preference for a broadly diversified global equity exposure served us well, but in 2018 we anticipate an increasing emphasis on relative value equity positions. Within our equity overweight, our order of regional preference is the U.S. and emerging markets ahead of Japan, the euro area and the UK, which are ahead of Canada and Australia.

We expect bond yields to increase in 2018 as U.S. policy rates are tightened. But ongoing central bank bond buying in Europe and Japan will put a cap on how far bond yields can rise, resulting in flatter U.S. yield curves. We maintain our small underweight on duration but close our underweight on cash, as real yields are increasing and we are becoming less inclined to deploy leverage in our multi-asset portfolios. Credit markets in aggregate should deliver modestly positive returns this year, but we are concerned that spreads have tightened unsustainably in some higher grade credits and so introduce a small underweight to U.S. investment grade (IG), even though we stay neutral on credit overall.

In sum, our allocation represents a continued pro-risk tilt, but the greater emphasis on relative value positions in equities reflects the maturing cycle, two-sided risk in inflation and greater policy uncertainty. To be clear, the Fed has not yet "taken away the punch bowl," nor do we expect it to this year; and while we believe markets can withstand higher rates, investors will be sensitive to any data that might accelerate the pace of rate hikes.

KEY THEMES AND THEIR IMPLICATIONS

Theme		Macro and asset class implications
GLOBAL THEMES	Global policy divergence	Global central bank policy direction is similar, but timing varies greatly; USTs now setting the direction for G4 bond markets
	Supply-side weakness	Now seeing two-sided inflation risks but no surge in wage pressure thus far; scope for U.S. curves to flatten as Fed hikes
	Widespread tech-nology adoption	Potential to add over a point to trend GDP over the decade, but will disrupt some sectors; tech stocks in a secular uptrend
DEVELOPED MARKETS THEMES	Maturing U.S. cycle	U.S. is moving through late cycle, but current phase of above-trend growth and gradual hikes supportive for stocks
	Europe: gradual growth recovery	Above-trend eurozone growth and easy ECB policy showing up in EUR strength and steeper curves more than equity returns
	Japan: beyond Abenomics	Corporate governance reforms are supporting Japanese stocks, but JPY beginning to strengthen as BoJ assesses QQE program
EMERGING MARKETS THEMES	Emerging market convergence	Domestic economic momentum building as weaker USD creates a tailwind; further upside likely for EM FX, debt and equity
	China in transition	2018 growth likely to remain solid in China; the economy is moving very slowly toward services and the consumer

Source: J.P. Morgan Asset Management Multi-Asset Solutions; data as of March 2018. For illustrative purposes only.

Active allocation views

These asset class views apply to a 12- to 18-month horizon. Up/down arrows indicate a positive (▲) or negative (▼) change in view since the prior quarterly Strategy Summit. 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.

Max negative ● ● ● Neutral ● Max positive ● ● ●

Asset class	Opportunity set	Change	Negative			Neutral	Positive			Rationale
MAIN ASSET CLASSES	Equities/bonds		○	○	○	○	●	●	○	Growth remains above trend; slowing second derivative reduces confidence a little
	Duration		○	○	●	○	○	○	○	Two-sided inflation risk and rate normalization pushing yields up, but not too far
	Credit		○	○	○	●	○	○	○	Credit cycle now distinctly mature; favor stocks over credit, but credit over govies
	Commodities		○	○	○	●	○	○	○	Commodities have rallied as growth picks up, but oil supply response limits upside
	Real estate		○	○	○	●	○	○	○	REITs underperforming as yields increase; late in cycle for real estate now
	Cash	▲	○	○	○	●	○	○	○	Rising real rates and less inclination to use leverage argue for upgrade to neutral
PREFERENCE BY ASSET CLASS – EQUITIES	U.S. large cap		○	○	○	○	●	○	○	P/E quite high, but reliable earnings delivery and good cash flow yields lend support
	U.S. small cap		○	○	○	○	●	○	○	Valuations and strong domestic growth supportive, but ERR flattered by tax cuts
	Europe ex-UK	▼	○	○	○	●	○	○	○	Surge in eurozone growth didn't translate to equity returns; EUR strength an issue
	UK		○	○	○	●	○	○	○	Withstood rise in GBP quite well, supported by valuations and strong cash return
	Japan		○	○	○	○	●	○	○	Corporate governance is improving, margins are stable, and top lines are doing well
	Asia Pacific ex-Japan	▼	○	○	○	●	○	○	○	Australia less favored, but other Pac Rim markets supported by global growth
	Emerging markets		○	○	○	○	●	○	○	Geared to global growth, with improving EM data and weaker USD adding support
PREFERENCE BY ASSET CLASS – REAL ESTATE	Direct real estate		○	○	○	●	○	○	○	Late in cycle for real estate; pickup in supply well flagged but still a constraint
	U.S. REITs	▼	○	○	●	○	○	○	○	Vulnerable to further yield rises; fair valuations not lending much support
PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	U.S. Treasuries		○	○	●	○	○	○	○	Long end yields set to rise further, but relatively high yield means favorable carry
	U.S. TIPS		○	○	○	●	○	○	○	U.S. inflation moving back to trend in 2018 provides modest support
	Euro, core (Bund)		○	●	●	○	○	○	○	Demand increasing for Bunds, but low yield vs. U.S. means a carry disadvantage
	Euro, periphery (BTP)		○	○	○	●	○	○	○	Decent carry pickup vs. Bunds and withstanding political uncertainty quite well
	UK Gilts		○	○	○	●	○	○	○	Fears over UK growth outlook offset pricing of BoE hikes and political uncertainty
	Japanese JGBs		○	○	○	●	○	○	○	Yields pegged to near zero by BoJ; prefer to play Japan via currency or equity
	Canadian gov't bonds		○	○	●	○	○	○	○	BoC rate hikes well reflected in CAD curve, but spread to U.S. has scope to close
	Australian gov't bonds		○	○	○	●	○	○	○	Yield pickup vs. G4 bonds; now trading through the U.S., but domestic data are soft
PREFERENCE BY ASSET CLASS – CREDIT	Investment grade	▼	○	○	●	○	○	○	○	Spreads tight; issuance set to pick up; scope for buyers to switch back to govies
	U.S. high yield		○	○	○	●	○	○	○	Provides reasonable carry, but bottom-up risks prevent further spread tightening
	European high yield		○	○	○	●	○	○	○	Expensive in absolute terms, but duration adjusted to U.S. HY still looks reasonable
	Emerging markets debt		○	○	○	○	●	○	○	EM balance sheets improving; spreads a bit tight but reflect better credit quality
PREFERENCE BY ASSET CLASS – FX	USD		○	○	○	●	○	○	○	Medium-term trend likely to be lower, but scope for some support from Fed hikes
	EUR		○	○	○	○	●	○	○	Positive growth momentum keeps EUR supported, still below long-term fair value
	GBP		○	○	●	○	○	○	○	Limited upside from here on a Brexit deal but significant downside on hard Brexit
	JPY		○	○	○	●	○	○	○	USDJPY at low end of recent range; BoJ looks set to keep YCC in place through 2018

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments are made using data and information up to March 2018. 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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As of December 31, 2017.

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