Global Asset Allocation Views

Themes and implications from the Multi-Asset Solutions Strategy Summit

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IN BRIEF

- Hopes for fiscal stimulus have driven a regime shift in markets from “lower for longer” toward reflation. The lows in bond yields are behind us as the risk of deflation fades, but how much of a growth boost can really be delivered remains to be seen.
- As the reflationary picture takes hold, we expect domestic U.S. equities, small caps and value stocks to benefit. Bonds, by contrast, are likely to suffer, but rising yields should provide a boost to the dollar and to Japanese equities. Credit remains supported but is now unlikely to outperform stocks.
- Rising commodity prices and reasonable valuations offset some of the risks facing emerging market assets, but European assets face poor earnings growth and political risks in 2017. Asset markets are taking higher rates and dollar strength in their stride, but this may change if reflation turns to stagflation, and hopes for real growth are dashed.

ASSET CLASS VIEWS CHART (PAGE 3)

Asset class		Opportunity set	Change	Negative	Neutral	Positive
MAIN ASSET CLASSES		Equities/bonds		○ ○ ○	○	● ○ ○
		Duration	▼	○ ○ ●	○	○ ○ ○
		Credit	▼	○ ○ ○	○	● ○ ○
		Commodities		○ ○ ○	●	○ ○ ○
		Real estate		○ ○ ○	○	● ○ ○
		Cash		○ ○ ●	○	○ ○ ○
REGIONAL PREFERENCE BY ASSET CLASS	EQUITIES	U.S. large cap	▼	○ ○ ○	○	● ○ ○
		U.S. small cap	▲	○ ○ ○	○	● ● ○
		Europe ex-UK	▼	○ ○ ●	○	○ ○ ○
		UK	▼	○ ○ ●	○	○ ○ ○
		Japan	▲	○ ○ ○	○	● ○ ○
		Asia Pacific ex-Japan		○ ○ ○	●	○ ○ ○
		Emerging markets		○ ○ ○	○	● ○ ○
	REAL ESTATE	Direct real estate		○ ○ ○	○	● ○ ○
		U.S. REITs		○ ○ ○	●	○ ○ ○
	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		○ ○ ○	○	● ○ ○
	CREDIT	Investment grade		○ ○ ○	●	○ ○ ○
		U.S. high yield		○ ○ ○	○	● ○ ○
		European high yield		○ ○ ○	○	● ○ ○
		Emerging markets debt	▼	○ ○ ●	○	○ ○ ○
	FX	USD	▲	○ ○ ○	○	● ○ ○
		EUR		○ ○ ○	●	○ ○ ○
		GBP		○ ○ ●	○	○ ○ ○
		JPY	▼	○ ● ●	○	○ ○ ○

Historians will debate exactly when the outlook shifted from “lower for longer” to reflation. But for now, at least, 2016 looks set to be a watershed year—politically, socially and economically. The Brexit vote in June and the election of Donald Trump in November may have marked a trend toward populism. But the contrasting reaction of bond markets to each event hints at a profound shift in the underlying economic environment—from monetary to fiscal primacy.

Recent history is littered with examples of populism ultimately ending in unfavorable economic outcomes, but in its early stages populism’s promise of even a meager fiscal boost may unleash animal spirits and bring forward consumption. To be clear, pro-cyclical fiscal stimulus is uncharted territory, but thus far the reaction of the S&P 500 and the Russell 2000—up 3% and 11%, respectively, since the U.S. election—suggests markets are prepared to give it the benefit of the doubt. Only time will tell whether fiscal policy can unleash the American economy’s inner tiger or will merely grab an inflationary Tigger by the tail.

The reality may well not live up to the hyperbole. While we expect a modest fiscal boost, it is unlikely to exceed 0.5% of GDP and will be back-loaded to the second half of 2017 at best, translating to slightly above-trend growth, on average, in 2017. The better news is that global growth in general was already settling into a pattern of near-trend growth for 2017. On balance, this leaves us with a modest growth backdrop and limited recession risk but with a clearly more reflationary picture than we’ve had for some years.

The U.S. economy continues to progress through a mid-cycle phase, but the emergence of fiscal stimulus as an accepted policy tool may yet hasten the economy's move toward late-cycle as 2017 progresses. The cycle may eventually conclude with a burst of exuberance and excess valuation, but we believe that this will not be a concern for next year. Nevertheless, as we shift from a "lower for longer" world toward a more reflationary regime, we expect later-cycle plays to come into vogue across many asset markets.

Our asset allocation for early 2017 reflects that, while the lows in bond yields are likely behind us, we remain in a world of easy policy and somewhat fragile growth. We maintain a small overweight (OW) to equities but with greater conviction than we had in September. By contrast, we take an underweight (UW) view on duration for the first time since 2014, acknowledging that the range for U.S. yields has risen and that while the anchoring influence from low yields in Europe and Japan persists, it has weakened significantly.

We expect U.S. policy to remain accommodative at the margin but now see the Federal Reserve (Fed) "dots" as the central path for rates rather than the upper bound. As such, we expect the U.S. dollar to resume its appreciation, albeit at a steadier pace than before. This should provide some relief to emerging market (EM) assets, which face headwinds from protectionist rhetoric and a rising dollar but have some support from higher commodity prices and improving data. On balance, we take a neutral aggregate view on EM assets, with a small OW to EM equity and an UW to EM debt.

We maintain a preference for credit over government bonds but in absolute terms trim our credit OW to a more modest level, as scope for further spread compression looks limited. We also keep our OW to real estate, with a preference for direct exposure rather than REITs given the greater valuation cushion against higher rates.

In aggregate, our portfolio is designed for a world of roughly trend growth with some upside risks to both growth and inflation. The biggest threats would be a sharp rise in stock-bond correlation or rapid appreciation of the U.S. dollar. Hints that reflationary attempts are resulting merely in inflation and not growth could spur such outcomes, but for the time being we are reassured by the underlying momentum of the economy and take a commensurately more pro-risk tone in our portfolios.

KEY THEMES AND THEIR IMPLICATIONS

Theme		Macro and asset class implications
GLOBAL MACRO THEMES	Global policy divergence	Fed rate hikes while global policy remains easy drives up USD, and U.S. yields lead global yields higher
	Supply-side weakness	If fiscal policy stokes inflation alone, this could leave the Fed behind the curve and hasten onset of "late cycle"
DEVELOPED MARKETS MACRO THEMES	U.S. economic strength	Underlying U.S. momentum improving; scope for modest fiscal boost supports domestic and small cap stocks
	Europe: gradual growth recovery	Europe's recovery continues, but monetary policy a negative for bank earnings; prefer to play via credit
	Japan: beyond Abenomics	Japanese economic risks easing for now; JGB yield peg keeps yen weak and supports Japanese stocks
EMERGING MARKETS MACRO THEMES	Emerging markets rebalancing	Protectionist rhetoric a headwind for now, but rebalancing toward consumer should boost long-run growth
	China in transition	Financial liberalization gives scope for further CNY downside; additional rounds of mini-stimulus are feasible

Source: J.P. Morgan Asset Management Multi-Asset Solutions; data as of November 30, 2016. For illustrative purposes only.

Active allocation views

These asset class views apply to an intermediate-term horizon (that is, 12 to 18 months). Up/down arrows indicate a positive (▲) or negative (▼) change in view since the prior quarterly Strategy Summit. In this edition, we have added real estate—both REITs and direct real estate—as well as TIPS into our active asset allocation views. This summary of our individual asset class views shows absolute direction and strength of conviction 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 improving and earnings picking up give upside risks to equity markets
MAIN ASSET CLASSES	Duration	▼	○ ○ ●	○	○ ○ ○	Beginnings of a more reflationary environment put upward pressure on yields
MAIN ASSET CLASSES	Credit	▼	○ ○ ○	○	● ○ ○	Prefer credit to government bonds, but may lag stocks if growth accelerates
MAIN ASSET CLASSES	Commodities		○ ○ ○	●	○ ○ ○	Better supply-demand picture in oil, but speculative position is a worry
MAIN ASSET CLASSES	Real estate		○ ○ ○	○	● ○ ○	Real assets well supported by valuations and scope for fiscal stimulus
MAIN ASSET CLASSES	Cash		○ ○ ●	○	○ ○ ○	Negative and near-negative rates a disincentive to holding cash
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	U.S. large cap	▼	○ ○ ○	○	● ○ ○	Pro-cyclical fiscal policy supports growth; higher rates support financials
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	U.S. small cap	▲	○ ○ ○	○	● ● ○	Preferred to large cap as a domestic U.S. play with greater cyclical exposure
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	Europe ex-UK	▼	○ ○ ●	○	○ ○ ○	Europe's economy and banks' earnings improving; stock markets held back by politics
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	UK	▼	○ ○ ●	○	○ ○ ○	Currency and commodity tailwinds now in price, valuations high
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	Japan	▲	○ ○ ○	○	● ○ ○	Later-cycle tone to markets supports Japanese equity; weak yen a further boost
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	Asia Pacific ex-Japan		○ ○ ○	●	○ ○ ○	Positive on Australia; more cautious on HK
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	Emerging markets		○ ○ ○	○	● ○ ○	EM equity vulnerable to dollar and protectionism, but valuations are supportive
REGIONAL PREFERENCE BY ASSET CLASS – REAL ESTATE	Direct real estate		○ ○ ○	○	● ○ ○	Core and value-add U.S. real estate attractive portfolio diversifiers
REGIONAL PREFERENCE BY ASSET CLASS – REAL ESTATE	U.S. REITs		○ ○ ○	●	○ ○ ○	Vulnerable to higher yields, but may have pockets of attractiveness
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	U.S. Treasuries	▼	○ ○ ●	○	○ ○ ○	Higher yielding than most other G7 bonds, but prone to further reflationary risk
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	U.S. TIPS		○ ○ ○	●	○ ○ ○	Less compelling vs. nominals than they were, but remain a good inflation hedge
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	Euro, core (Bund)	▲	○ ○ ○	●	○ ○ ○	Ongoing monetary support from ECB keeps Bunds bid despite low yields
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	Euro, periphery (BTP)		○ ○ ○	●	○ ○ ○	EU event risk grows in 2017, but periphery yields are underpinned by ECB
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	UK Gilts		○ ○ ●	○	○ ○ ○	Less clearly overvalued than they were, but twin deficits remain a risk
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	Japanese JGBs		○ ○ ○	●	○ ○ ○	Yields pegged to zero by BoJ, but prefer to play Japan via currency or equity
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	Canadian gov't bonds	▼	○ ○ ●	○	○ ○ ○	Expensive on real yield terms and scope for rate cuts being priced out
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	Australian gov't bonds		○ ○ ○	○	● ○ ○	Attractive yield and carry maintain support for AUD bonds
REGIONAL PREFERENCE BY ASSET CLASS – CREDIT	Investment grade		○ ○ ○	●	○ ○ ○	Further into credit cycle than HY; primary supply still relatively high
REGIONAL PREFERENCE BY ASSET CLASS – CREDIT	U.S. high yield		○ ○ ○	○	● ○ ○	Spreads nearer fair value, but carry still attractive and lower recession risk in 2017
REGIONAL PREFERENCE BY ASSET CLASS – CREDIT	European high yield		○ ○ ○	○	● ○ ○	ECB action keeps bid in place for EU IG, which will spill over into HY
REGIONAL PREFERENCE BY ASSET CLASS – CREDIT	Emerging markets debt	▼	○ ○ ●	○	○ ○ ○	EM balance sheets improving, but more vulnerable than EM equity to rising USD
REGIONAL PREFERENCE BY ASSET CLASS – FX	USD	▲	○ ○ ○	○	● ○ ○	Upside pressure from fiscal boost and Fed, but expect a gradual appreciation
REGIONAL PREFERENCE BY ASSET CLASS – FX	EUR		○ ○ ○	●	○ ○ ○	ECB deposit rate unlikely to be cut further, trade surplus puts a floor under euro
REGIONAL PREFERENCE BY ASSET CLASS – FX	GBP		○ ○ ●	○	○ ○ ○	Fundamental outlook poor; further pressure likely as Brexit realities bite
REGIONAL PREFERENCE BY ASSET CLASS – FX	JPY	▼	○ ● ●	○	○ ○ ○	Higher U.S. yields while JGBs are pegged should translate to yen weakness

Source: J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2, 2016.

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.

MULTI-ASSET SOLUTIONS

J.P. Morgan Multi-Asset Solutions manages USD $201 billion in assets and draws upon the unparalleled breadth and depth of expertise and investment capabilities of the organization. Our asset allocation research and insights are the foundation of our investment process, which is supported by a global research team of 20-plus dedicated research professionals with decades of combined experience in a diverse range of disciplines.

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, 2016.

NEXT STEPS

For more information, contact your J.P. Morgan representative.

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