Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

February 18, 2019

IN BRIEF

- The worst December for the S&P 500 since 1931 was followed by the best January since 1987. And investors who were probably too cautious in December may be a bit too sanguine now.
- Trend-like growth is no bad thing for the U.S. economy. But the slower pace of growth in 2019 creates headwinds for corporate earnings, in turn limiting equity upside.
- Easier financial conditions in the U.S. may lend support to asset prices in China and other emerging markets, particularly if the U.S. dollar weakens in 2019. However, high inventory levels and continued weakness in capex may keep data - and asset prices - under pressure. European economic data have been persistently soft, yet forecasts of 2019 corporate earnings have barely budged.
- In our view, this is not a year for taking large outright equity positions. Within equities, our portfolios are overweight the U.S. relative to Europe. In late cycle, with the Federal Reserve on pause, we see a good argument for a sizeable allocation to duration within a balanced portfolio.

AUTHOR

John Bilton, CFA
Managing Director
Head of Global Multi-Asset Strategy
Multi-Asset Solutions

A WALK ON THE WILD SIDE

Well, that was a wild ride: The worst December for the S&P 500 since 1931, followed by the best January since 1987 – all helped along by a sharp volte face from the Federal Reserve (Fed). Looking beyond the gyrations in the stock market, the shift in sentiment is instructive and a good starting point from which to evaluate the investing landscape for 2019.

December's headlines told a baleful tale of earnings downgrades, inexorably tightening monetary policy and simmering trade-related angst – and were quite happy to ignore the positive news from labor markets and the consumer. By contrast, the headlines last month sliced through the usual January gloom with optimism over trade and applause for every earnings beat – even if from a low base – while studiously ignoring the ongoing earnings downgrade cycle, weakness in European data and the limited participation in the rally. As is so often the case, both were overreactions, and between hopes of boom or fears of bust, the truth is perhaps more nuanced. For investors, a sober analysis of what drove the market excesses in both directions can help plot a course through what looks set to be a volatile year.

In the U.S., the bellwether for the world economy, we see a region in the late stage of its cycle but with a limited risk of recession. It is important, however, not to confuse the Fed's recent action of "easing off the brakes" for "pressing on the accelerator." In 2016, with a U.S. economy still in mid cycle, significant stimulus hitting the Chinese economy, and real interest rates well below zero across the world, the Fed's patience was a big boost. Roll forward to today and, while the Fed's pause has given welcome relief to a nervous market, it is at least in part responding to slower economic growth. To be clear, trend-like growth is no bad thing for the U.S., particularly when the household sector is in generally good health. But a decline in the pace of growth simply doesn't augur well for a reacceleration of corporate earnings growth from an already elevated level – especially when the world economy ex-U.S. looks decidedly less robust.

Trade outlook

In China, as in the U.S., hopes for a resolution to the trade dispute gave a boost to sentiment. Clearly, avoiding the planned increase in tariff levels from 10% to 25% on USD 200 billion of Chinese exports to the U.S. would be a positive step, but a deal is unlikely to fully unwind the tariffs already imposed. Nor is it likely to meaningfully address the deeper impasses over intellectual property rights, cybersecurity, and how any deal going forward will be monitored.

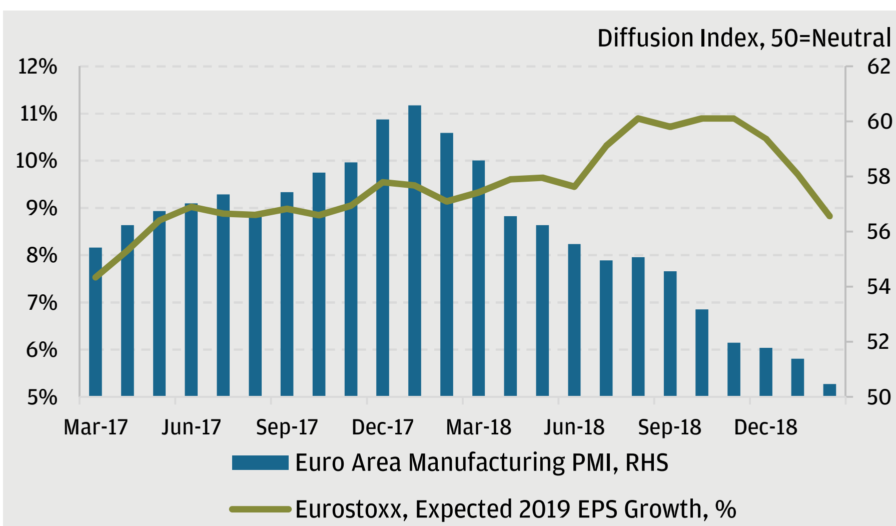
A further complication is that importers appear to have been stockpiling essential Chinese goods to protect their supply chain. Despite tariff threats and persistently weak global capex data, Chinese export data held up well in 2018, which suggests that even if a deal is reached, excess inventories will need to be run down – in turn, creating a headwind for Chinese data in the first half of 2019. This may elicit further stimulus from Beijing, but before getting too carried away, we should note that stimulus so far has yet to fully unwind the tightening of the last few years. Moreover, as Chinese policymakers are anxious to avoid stoking asset bubbles, stimulus measures are likely to focus on specific sectors of the economy rather than simply aim at boosting aggregate activity.

Europe still under pressure

Although not an explicit target, Europe found itself caught in the middle of the Sino-American trade dispute. The integrated nature of global supply chains, together with Europe's position as, simultaneously, a supplier of capital

EXHIBIT 1: EURO-AREA MANUFACTURING PMI AND EUROSTOXX EXPECTED EARNINGS PER SHARE GROWTH

While euro area macroeconomic data have deteriorated sharply, expectations for earnings growth in 2019 have moved lower in a more moderate fashion. There is a risk that earnings expectations 'catch down' to the weaker data. If European earnings expectations continue to move lower, reflecting the poor macroeconomic environment in Europe as well as a slower global growth outlook, it will likely prove a headwind for European stocks.



Source: Datastream, Haver, J.P. Morgan Asset Management; data as of February 15, 2019.

equipment and a consumer of Chinese intermediate goods, put the region in a precarious position. Industrial activity data, factory orders, business sentiment and reported GDP growth all took a significant hit in the second half of 2018 as European growth slowed abruptly.

The combination of febrile politics and a deeply intertwined state and banking system remains Europe's Achilles' heel. To be sure, Europe is far more stable than it was seven years ago, but the sheer size of its banking sector, the weight of financials in its equity index, and the dominant role of bank lending in company financing all detract from the region's resilience. As global growth slows to trend, we think Europe's bank balance sheets can likely weather weaker growth, but bank earnings may not – especially with the European Central Bank's negative rate policy now likely to remain in place through 2019.

Stitching this all together, we are left somewhat in limbo. Growth is positive if unexciting and the rate of change in growth is still pointing downwards. This creates a headwind for earnings that will likely persist through the first half of 2019. Investors were probably too cautious in December – then as now, the probability of a global recession in 2019 is quite low. But equally, they may be a bit too sanguine now – 2019 is not 2016 redux and the Fed's pause was not a reflection of economic strength. On the bright side, however, if slower growth means lower earnings expectations, then U.S. markets have probably factored in much of that slowdown. Trend-like U.S. economic growth of 1.75% would support low single-digit earnings growth, in our view, and monetary policy on pause probably also gives some support to price/earnings multiples. The issue today is that markets have moved rapidly to reprice this changed environment, and with the S&P 500 at around 2750, further meaningful upside may rely more on hope than reality, at least in the near term.

Elsewhere, the outlook may be even cloudier. Easier financial conditions may support asset prices in China and other emerging markets, particularly if the U.S. dollar weakens in 2019. However, as companies unwind inventories built up in anticipation of trade friction, it may keep macro data and asset prices under pressure for a while yet. But Europe is where we are most concerned. Data has been persistently weak, yet forecasts of 2019 corporate earnings have barely budged – despite a distinctly lackluster reporting season. As 2019 European earnings expectations are scaled back to reflect a slowing global growth outlook and earnings trends in other regions, including the U.S., it will create a meaningful headwind for European stocks.

ASSET CLASS IMPLICATIONS

In sum, we believe that this is not a year for taking large outright equity positions. Instead, as earnings trends reset, relative value trades across regions could provide good sources of return. At the moment, we favor the U.S. over most other regions, especially the eurozone, and see a rather better outlook for some carry assets following the Fed's pause. But investors should bear in mind that in late cycle, with the Fed on pause, there is a good argument for a sizeable allocation to duration within a balanced portfolio.

Global Multi-Asset Strategy:

John Bilton
Head of Global Multi-Asset Strategy
London

Patrik Schöwitz
Global Strategist, Editor
Hong Kong

Michael Hood
Global Strategist
New York

Thushka Maharaj
Global Strategist
London

Benjamin Mandel
Global Strategist
New York

Sylvia Sheng
Global Strategist
Hong Kong

Michael Albrecht
Global Strategist
New York

Diego Gilsanz
Global Strategist
New York

Tim Lintern
Global Strategist
London

NEXT STEPS

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

PI-AA-WEEKLY-021819 | 0903c02a81f59f1d