MARKET THOUGHTS

# Follow the Leader

September 20, 2016

Global assets are playing a game of "follow the leader," with markets being led around by central bank policy action and misguidance. Bond prices are distorted by monetary policy that is proving to be far less impactful to the real economy, with about 30% of developed market government bond yields trading with negative interest rates. More than 70% of developed market government bond yields are trading with yields below 1% (Figure 1). In Japan, all government bonds are trading at yields of less than 1%; that number is about 85% for the eurozone.[1]

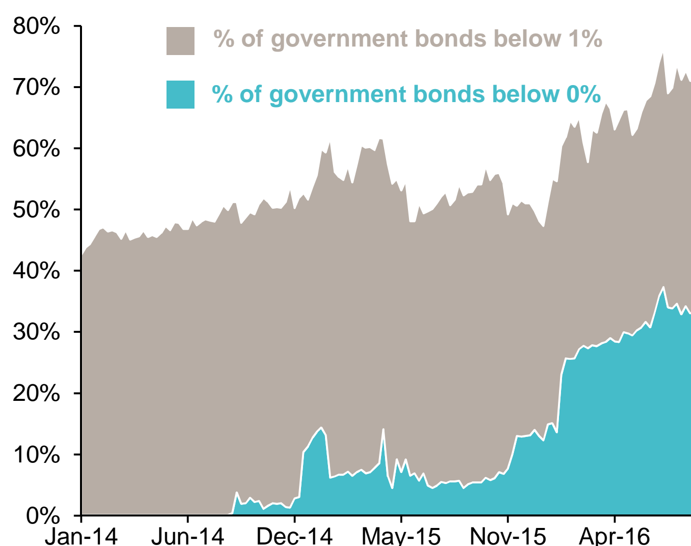
**IN BRIEF**

- Monetary policy action has driven yields lower, but central banks are reaching the limits of their incremental influence
- The sustainability of equity market appreciation will greatly depend on earnings growth
- Significant political risks abound globally—this makes steady hands around investing essential
- We continue to tilt toward the relative quality of the United States over other equity markets
- We favor the carry embedded in U.S. high yield and hard currency emerging market debt in the context of valuations across asset classes

Government bonds act as a force of "gravity" for markets; they define the risk-free rate for pricing all risk assets—from credit and equity to foreign exchange markets. To borrow a phrase, bond yields today can't seem to stand up for falling down. In addition to the impact of monetary policy, low yields reflect the macro environment, and we believe they will remain low well into next year. Global growth is stable but uninspiring. The same can be said about inflationary pressure—particularly across Europe and Japan. Investors are now expecting less incremental influence from monetary policy—I say that as a positive observation.

Markets have grappled this year with repeated bouts of energy market sell-offs, Britain's vote to exit the European Union and a fear of China collapsing into a competitive devaluation cycle and recession. We have seen acts of global violence; political unrest and terrorism each weigh on sentiment. In addition, we have the United States presidential election cycle that is fast moving into full gear—after the start to a year where a U.S. recession was considered imminent. We are in the later stages of this bull market, which is clearly reflected in valuations. Nothing is cheap, which is meant as an observation about managing return expectations and a reflection of how we are positioned in portfolios—we are not overreaching in our risk taking.

**Figure 1. A low yielding universe of government debt**




Source: Bloomberg, BofA/Merrill Lynch, J.P. Morgan Asset Management Guide to the Markets. Index shown is the BoFA/ML Global Government Bond index. Data as of August 26, 2016.

Over the next 12 months, I continue to hold a base case 25% probability of the U.S. falling into recession. For Europe, it is closer to 30% but with greater downside risk because of Brexit. In the United Kingdom, markets have tried to make Brexit an event, when in fact it will be a protracted process. The chance of the U.K. falling into recession is a little higher than in either the U.S. or Europe. Unfortunately, the referendum result is going to weigh on the U.K. outlook for an extended period as "Brexit means Brexit" is clarified by policy action.

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[1] Calculations use the BofA/ML Global Government Bond Index.

## PUSHING ON A STRING

The essential theme that has changed in the current market narrative is a realization that monetary policy has, for the most part, played itself out. Going forward, central bank easing may prove about as impactful as pushing on a string. It is already wearing on confidence.

Policymakers and politicians are shifting their focus to fiscal stimulus—listen closely as campaigning in the U.S. heats up into November. Fiscal policy is "the new black" as monetary policy is seen to be less effective. Investors are expecting less from central bank policy, which is a positive for markets; it lessens the anxiety around policy action ahead. Ramping up fiscal policy will bring its own set of costs and challenges, but it is where we are—and what we need—in the current cycle. Monetary policy is affected directly by central banks, while fiscal policy is dependent on politicians acting together—something we haven't seen a lot of. Equity markets tend to respond positively to fiscal stimulus.

Until the global macro environment signals more robust growth and higher inflation expectations, investors are adjusting to lower interest rates and flatter term structure as a more lasting environment. That wasn't the case six months ago, when the Federal Reserve (Fed) was still forecasting four rate hikes this year. At the start of this year, I thought we would be lucky to see two rate hikes from the Fed. Right now, my number is down to one. Every Fed meeting is a "live meeting," where the Fed can decide to raise rates. However, the global landscape continues to argue for Fed tightening temperance.

> Monetary policy has, for the most part, played itself out

Since 2014, we have lengthened fixed income duration primarily by adding to credit allocations. We have done that opportunistically again this year—with investment grade, high yield and emerging market hard currency debt. The fixed income allocation in a Balanced Portfolio today is yielding about 3.0–3.5%, some +150–200 basis points above 10-year U.S. government bonds. This is due to our allocation to credit, which remains our largest overweight across portfolios.

> Investors are being pushed out of cash and into risk assets, whether they like it or not

While credit has become more of a consensus trade, our conviction in the overweight continues to be grounded in a fundamental view that default risk is reasonably priced in and developed market government bond yields will remain lower-for-longer, making us comfortable about being able to earn the embedded yield in credit. At current market levels, we own credit for the carry—we do not expect significant credit spread compression from here. Year-to-date, high yield has returned approximately 15%, as has emerging markets (EM) hard currency debt. Investment grade corporate credit in the U.S. has returned almost 9%, and about 6% in Europe.

If the fast-paced game of "follow the leader" between markets and central banks is in fact slowing down, we should see less anxiety in markets. Markets are trying to move from policy unease to acceptance. Acceptance reflects less uncertainty, which supports credit spreads and equity market multiples. The fact that corporate earnings are beginning to stabilize is a positive for equity and credit markets alike—investors have begun to look ahead, into next year. For the first six months of this year, investors weren't willing to look much beyond a few days—to the next headline, data release or monetary policy action.

## THERE IS NO ALTERNATIVE

TINA is an acronym for: There Is No Alternative. It's used to reflect the financial repression that comes from zero interest rate policy (ZIRP) and negative interest rate policy (NIRP)—the Tweedledee and Tweedledum of central bank policy action. With cash yielding zero (or less), investors are being pushed out of cash and into risk assets, whether they like it or not—that's where the "repression" part comes in (Figure 2). Financial repression was bearable when valuations across risk assets were lower, but it has created significant anomalies today across markets and investor behavior.

It's been too easy to be negative about equity markets this year. Equity valuations are high across the board, and in the U.S., returns have been led by defensive sectors that investors have hidden in, including utilities and telecom. In developed markets broadly, what investors have stayed away from have been cyclical sectors—including discretionary, technology and financials. We can clearly see the impact of this safe-harbor flight within active manager holdings and performance—in mutual funds and across hedge funds. Active managers were particularly hard hit in the first half of this year because they were positioned in sectors they thought were fundamentally cheap—cyclicals.

The important question to ask is whether lagging cyclical sectors can catch up to more defensive sectors. We have begun to see that happen over the past few months as cyclically oriented sectors have outperformed. There is a lot going on under the surface of an equity market that otherwise seems to have been range-bound since mid-July. We continue to watch the recovery across cyclicals as a signal that investors are taking incrementally more balanced investment risk as they inch away from safe-harbor investments.

We are in an environment today where markets recognize the Fed wants to raise rates but is likely to do so gradually. The Bank of Japan, the European Central Bank and the Bank of England remain committed to easing, should they need to do more. The net effect is a market where investors are more comfortable with a lower-for-longer interest rate environment. That is providing support for equity market multiples—in a low inflation and stable interest rate environment, markets are willing to pay a higher multiple for companies able to grow earnings.

The sustainability of equity market support needs to come from earnings growth. We have seen negative earnings growth for over a year. However, as the dollar and energy prices stabilize, we are seeing less negative realized earnings growth and positive expectations for next year. Expectations always start high, and today markets are forecasting +12–13% global earnings growth in 2017. Our base case is for global equity earnings to grow +5–8% next year. There is going to be a great deal of market focus on second-half 2016 earnings announcements.

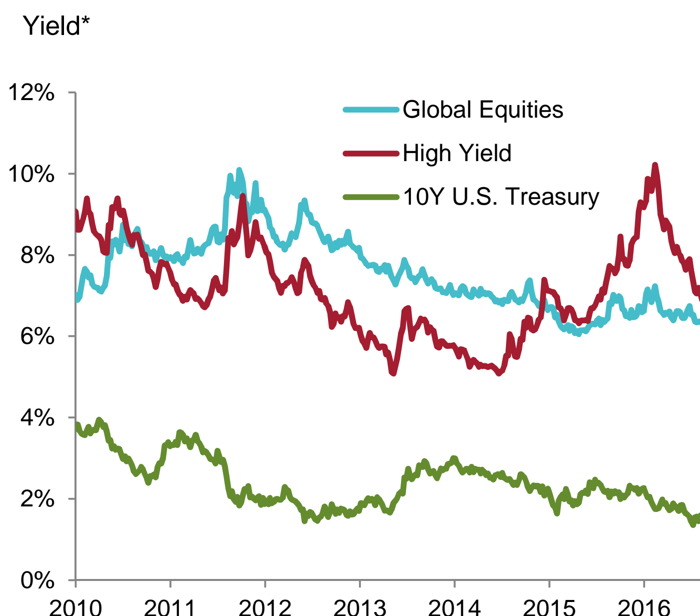
## POLICY MATTERS MORE THAN POLITICS

Markets are keenly focused on the U.S. election. Like Brexit, I think it's a vote that is closer than it appears to be in the polls. I mention this because politics have played a bigger role this year in our investment committee discussions than they have in a long time. Also, like Brexit, it isn't obvious to me that markets will mechanically sell off if a particular candidate wins or loses the U.S. presidential election. Ultimately, what matters will be policy, and the policy implications for these elections won't be defined by the White House alone, so we are watching congressional elections closely.

I am more concerned about the knock-on effects across Europe of Prime Minister Renzi losing the Italian constitutional referendum on the structure of parliament scheduled for October—in particular, should the vote turn into a referendum on Renzi. Polls continue to show a slight lead for Prime Minister Renzi's position. But political polls this year have proven unreliable at best.

The uncertainty, more broadly coming from the political landscape because of the potential for policy change both in the U.S. as well as Europe, has us staying "close to home" in our current portfolio risk positioning. Anyone trading the momentum and sentiment into and after the Brexit vote was harshly whipsawed by markets. We held steady through the vote with our positioning—steady hands continue to serve us well.

**Figure 2. Markets are discounting lower returns**




Source: FactSet, Bloomberg. *Yield is next 12 months earnings yield for global equities, yield to worst for high yield and yield to maturity for 10Y U.S. Treasury. Global equities = MSCI All Country World Index, High Yield = J.P. Morgan Developed High Yield Index. Data as of September 2, 2016.

### THIS YEAR'S DIFFICULT CONDITIONS FOR ACTIVE MANAGERS

It's been a tough year for portfolios, in particular for those that hold active managers. Portfolios that have no active managers or alternatives are about in line with benchmark performance, while portfolios with allocations to active managers, including alternatives, are underperforming benchmarks this year.

We have seen a strong few months of recovery, but the start to this year was particularly challenging for active managers, as certain common trades among managers reversed. Our tactical views around markets are working; implementation of those views this year is not. We are responsible both for our tactical investment views and how we express them in portfolios. I am disappointed by this year's performance.

With regard to active equity managers, over the past few years we have taken passive equity allocations from less than 10% of our global equity allocations to about 70% currently. We believe in active managers, and I hope we are at a low with regard to allocations. However, it has been the right thing to reduce these allocations in this market environment.

We have reduced absolute allocations to alternatives in Balanced and Growth portfolios. We have also significantly repositioned hedge fund strategies to be less directional for portfolios that hold them. Like many of the headlines around poor performance, both for hedge funds and active managers, longer-term underperformance is really a reflection of how challenging the last 12 months have been. Active manager underperformance has been systemic, across equities, bonds and alternatives.

### HOW ARE PORTFOLIOS POSITIONED?

Across developed equity markets, we continue to favor the U.S. over other developed markets—reflecting a quality bias to the U.S. and a view that global equity markets are fully valued. For more aggressive equity portfolios, we tactically hold sector allocations to discretionary, technology and healthcare. We like small- and mid-cap stocks in developed equity markets outside of the U.S.—including Europe and Japan, where those stocks tend to be more defensive in nature and can display stronger earnings growth.

With regard to emerging markets, we favor EM hard currency debt over broad EM equity markets. For certain client portfolios in Asia, we continue to hold and have added to EM Asia equity allocations this year. EM equity markets are underowned and reflect the bounce we have seen in commodities—led by oil. But underowned doesn't mean inexpensive, and we view EM equity markets as near full valuation. A less threatening view of a more aggressive Fed and dollar strength is helping EM assets recover. We have preferred to take emerging markets exposure in extended credit—which year-to-date has performed in line with broad emerging equity markets.

We have done a great deal of tactical repositioning this year across portfolios. Today, we are taking less directional risk across markets than we have in the past two years. Our single largest overweight remains credit. We continue to have a cautious and constructive market outlook—though we expect volatility will continue to pick up heading into year-end. Our tactical positioning clearly reflects a preference for carry rather than additional equity beta. We like the amount of absolute investment risk we hold in portfolios currently, and we remain better buyers on significant pullbacks—in both credit and equity markets.

## RICHARD MADIGAN
## CHIEF INVESTMENT OFFICER

Richard Madigan is Chief Investment Officer for J.P. Morgan Private Bank. In this role, he is responsible for the development of investment strategy, tactical and strategic asset allocation for $1 trillion in high-net-worth and institutional client assets, including the firm's Global Access Portfolios. Richard is Chair of the Private Bank's Global Investment Committee.

The CIO Team comprises market research, portfolio management and analytics, as well as a dedicated quantitative research team that oversees investment risk.

Richard brings over 20 years of experience in portfolio management and international capital markets to the firm. Prior to his current role, Richard held the title of CIO, Global Access Portfolios, where he and his team managed in excess of $16 billion in client assets. Before joining J.P. Morgan, Richard was Managing Director, Head of Emerging Markets Investments and Senior Portfolio Manager at Offitbank, a New York–based wealth management boutique, where he managed peak assets in excess of $1 billion in both domestic and offshore portfolios, including the firm's flagship emerging markets mutual fund. He was also a senior member of the firm's investment committee. Before joining Offitbank, Richard worked for J.P. Morgan's Investment Banking division in New York in the emerging markets securities business. He previously spent six years with Citicorp, first as a banker in Mexico, and then in the firm's international corporate finance division in New York.

Richard's commentaries have appeared in the *Financial Times, The New York Times, The Wall Street Journal, Bloomberg* and *Reuters*. He is a frequent guest speaker on CNBC, and has also appeared on CNN and Bloomberg News, as well as various industry conferences. Richard holds a master's degree from New York University, where he majored in Finance and International Business. He has lived both in Europe and Latin America, and currently resides with his wife and children in New York City.

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The MSCI All Country World Index captures large and mid-cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,475 constituents, the index covers approximately 85% of the global investable equity opportunity set.

**MSCI Emerging Markets Index**
The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

**MSCI World Index**
The MSCI World Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed markets. It captures large- and mid-cap representation across 23 developed market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

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