PORTFOLIO INSIGHTS

# Multi-Asset Solutions Weekly Strategy Report

A review of global markets and portfolio positioning in August

**September 10, 2018**

## IN BRIEF

- Global equity markets produced a decent 0.8% return in August, driven by the U.S. Excluding the U.S., global equities declined 2.3%, dragged down by emerging markets.
- NAFTA negotiations took a step forward but the U.S. administration implemented a second round of tariffs on Chinese imports and seemed determined to carry out a third round; as investors sought safe havens, developed market (DM) sovereign bonds rallied across the globe.
- Economic data out of developed markets was generally solid, with upward surprises in U.S. economic activity. In emerging markets, currency routs out in Argentina and Turkey were the major developments.
- We retain a pro-risk stance in our portfolios with an overweight to U.S. assets but are moderating our position. We have become incrementally more positive on duration.

## AUGUST IN REVIEW

***We review trends across markets and economies in August 2018, consider what they mean for our multi-asset portfolios and present a positioning update.***

Strong U.S. returns continued in August, supporting the positive performance of major risk markets. Elsewhere, however, markets had a down month. The MSCI All-Country World Index finished up 0.8% for the month but when U.S. returns are excluded, ended the month down 2.3%. Global growth indicators were generally sound, supported by developed economies, particularly the U.S. Emerging markets (EM) were more somber. Activity in China continued to decelerate while currency routs in Argentina and Turkey further tightened financial conditions for EM economies.

The possibility of a further escalation in protectionist trade measures remains the preeminent risk to our otherwise solid macroeconomic forecast and risk-on bias. NAFTA negotiations took a step forward in August, providing some relief when Mexican and U.S. officials came to an agreement. However, active skirmishes remain on the other fronts of the trade war. The U.S. and Canada need to reach an agreement to finalize NAFTA negotiations and U.S.-EU negotiations are ongoing, with particular focus on auto imports.

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Most importantly, the U.S. administration showed no signs it would ease up on China. A second round of tariffs was implemented, on $16 billion in Chinese imports, while President Donald Trump threatened to increase the tariff rate to 25% (from 10%) on a proposed third round that would affect $200 billion more of Chinese imports. The steadfastness with which tariffs have been imposed on Chinese goods has come as a surprise and we anticipate a noticeable impact on the U.S. economy should the third round be imposed. We expect the trade measures enacted so far will have only a modest impact on the relevant economies, but feel the risk of further measures, with more severe consequences, ticked up over the month.

**U.S. growth leads, EM vulnerabilities bite**

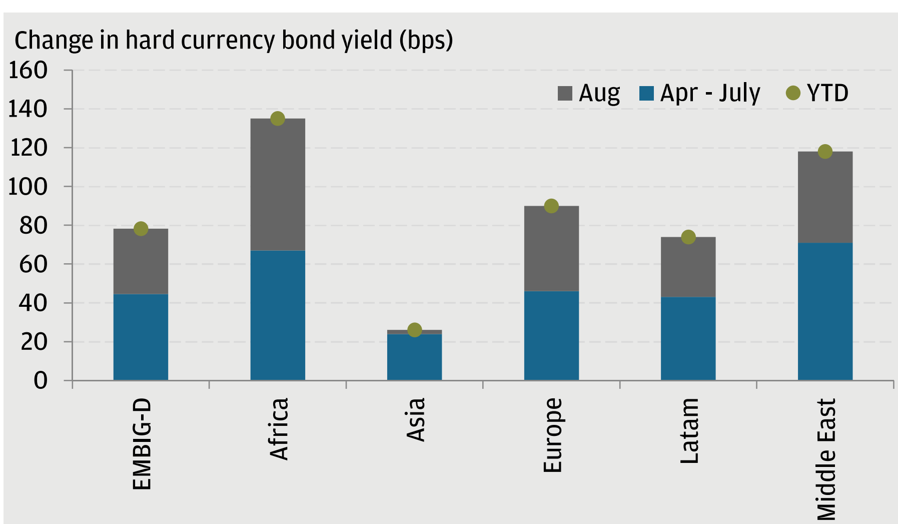
While it is still too early to asses the impact of the trade measures on activity, global growth looks well-supported in the near term. Business sentiment surveys have moderated globally, to be sure, yet remain at strong levels. The U.S. economy seems to be sustaining its growth momentum after a 4.2% annualized pop in second quarter GDP—investment and consumption indicators beat expectations in July. Other data suggested the already extended U.S. cycle can continue further over the medium term. Productivity grew at its fastest quarterly pace in three years in the second quarter and the savings rate was revised meaningfully higher, showing little deterioration during the current cycle and suggesting households could weather a negative income shock. Furthermore, the credit cycle—which historically tightens well ahead of a recession—has yet to turn. The Federal Reserve Senior Loan Officer Survey showed U.S. banks lowered their credit standards this past quarter.

The solid macroeconomic backdrop has allowed U.S. assets to continue to outperform, extending a year-long trend. The S&P 500 (up 3.3%) and Russell 2000 (up 4.3%) were the two best-performing equity markets in our investment universe in August. U.S. credit markets also posted decent returns. The decline in Treasury yields allowed investment grade to return 0.5%, despite a slight spread widening. High yield returned 0.7%, thanks to the solid growth impulse and a summer lull in corporate issuance.

Major DM equity markets outside the U.S. failed to react in kind to favorable economic data releases. Business sentiment surveys in Europe edged upwards in August, the labor market continued to tighten and credit growth remained robust, all of which suggested growth could accelerate from the first half's trend-like pace, yet the Euro Stoxx 50 declined 3.7% in August. Financials continue to weigh down the index amid lower German

**EXHIBIT 1: EM FINANCIAL CONDITIONS HAVE TIGHTENED**

Bond yields have risen across emerging markets for much of the year, as the steady drumbeat of trade war risks has made headlines. Argentina and Turkey exacerbated investors' concerns with less-than-credible policy announcements, causing another sell-off across the emerging market debt spectrum. Asian debt withstood the turn in sentiment, however. Chinese monetary stimulus and liquidity injections have kept a lid on both government and corporate yields.




Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of September 6, 2018.

Bund yields and concerns over Turkey's economy—European banks are the largest international holders of Turkish liabilities. In Japan, second quarter GDP growth posted a strong at 1.9% annualized rate; absent weather-induced weakness in July data, the Japanese economy's underlying trend looks solid. Yet the Topix finished the month down 1.0%.

The outlook for emerging markets in aggregate deteriorated on the margin as investors' risk appetite turned even more unfavorable over the month, tightening financial conditions for several markets (**Exhibit 1**). Trade war risks and a strong dollar have hampered investor sentiment throughout the year but in August, events in Argentina and Turkey—economies with large current account deficits and questionable policy frameworks—set off further EM underperformance. The Turkish lira depreciated 33% in August as President Recep Tayyip Erdogan called for an economic war against the U.S. and investors lost hope that the country's high inflation and external imbalance would be addressed with tighter monetary policy or economic reform. In Argentina, the currency also declined steeply; markets responded poorly when the IMF failed to confirm it would release loan funds early, counter to the Argentine government's assessment that loan disbursements would be front-loaded thanks to new fiscal austerity measures.

The news out of emerging markets wasn't all bad. Chinese growth decelerated a bit more than expected in July, but stimulative fiscal and monetary measures that were recently announced are expected to allow growth to stabilize through year-end. August also saw the first signs of a smartphone-induced upswing in emerging East Asian industrial and trade activity, which should help support the region's economies in the third quarter. Nevertheless, in aggregate, August proved to be tough month for EM assets, with MSCI EM Index equities down 2.7%. Hard currency sovereign debt, as tracked by JP Morgan EMBIG - Diversified Index, fell 1.7%.

**Bond yields rally**

Sovereign bonds in developed markets rallied during the month. The 10-year U.S. Treasury yield declined 10 basis points (bps), to 2.86%, remaining for a sixth month within a 30bps trading band. One reason for its relative stability has been the steady policy outlook of the Federal Reserve (Fed). Minutes from the August Fed Open Market Committee meeting (FOMC), and Fed Chairman Jerome Powell's speech at an annual symposium in Jackson Hole, Wyoming, didn't waver much from recent rhetoric. Both suggested that ongoing EM stress and trade war risks are, as of now, insufficient cause for the FOMC to deviate from its current path of hiking rates at every other meeting.

Bunds joined the global rally with yields down 12bps amid an absence of any real policy noise from the European Central Bank and a modest disappointment in Germany's flash August inflation print. Ten-year Japanese government bond yields rose 4bps for the month, continuing a gradual edge upwards in the wake of the Bank of Japan's upward adjustment to its yield peg.

## ASSET CLASS IMPLICATIONS

We maintain a positive risk bias in our portfolios, supported by our underlying view that global growth will remain above trend over the next several quarters, but have moderated our view given the ongoing developments in trade talks. A U.S. overweight remains central to our equity positioning; we anticipate solid earnings growth momentum, supported by what we forecast will be a strong U.S. economy. We remain underweight European equities, despite our sound view on the regional economy. European equities remain hamstrung by an assortment of lingering risks, including the Italian budget, Turkish debt holdings among major banks and the potential for auto tariffs. We have moved incrementally more positive on duration and retain a preference for higher-yielding Treasuries. We are neutral on credit overall, with a slight preference for U.S. high yield.

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### NEXT STEPS

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



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