I thought it was important to reflect on current portfolio positioning and our outlook, given the unexpected result of the U.S. elections and recent market activity. It is helpful to separate the emotion and desire for a quick, knee-jerk reaction in markets from the pragmatism of political reconciliation that lies ahead. Like Brexit, the U.S. election is more about a process than an event. The pragmatism, steady hands and investment discipline that we continue to exercise in managing portfolios remain crucial.

Markets are behaving quite rationally. Now that we are past the U.S. election, investors will refocus on the fundamental outlook, which remains constructive with regard to growth (Figure 1). This is a macro view we have held throughout this year. However, markets today are anticipating greater upside—both to growth and inflation—than we currently expect.

Bonds markets are having a “re-do” of sorts as yields move back to levels we saw late last year, before fear of global recession crept into the market narrative. Interest rates are likely to move higher, and we are positioned accordingly. We continue to expect the bond market ride to be bumpy; it has been a rollercoaster ride for government bonds all year.

We came into the U.S. election well positioned to navigate the air pockets, with dry powder to take advantage of the right opportunities as they present themselves. Our positioning may change, as it did in the weeks after Brexit, but today we like what we own in portfolios and do not intend to chase headlines—as many mistakenly did immediately around Brexit.

**IN BRIEF**

- Our portfolios are well positioned to navigate the volatility resulting from a broadly unexpected U.S. election outcome
- While we have lowered overall portfolio risk over the past 12 months, our portfolios remain overweight risk assets and fully invested for the long term
- Elevated levels of uncertainty reinforce the importance of a diversified, multi-asset-class portfolio in order to diversify return streams and risk across markets

As I mentioned in our September note (“Follow the Leader”), there is a shift happening around expectations for what central bank policy easing can still deliver. The essential theme that changed for markets in the third quarter is a realization that monetary policy has, for the most part, played itself out. That has led markets to refocus on the need for fiscal stimulus and private sector investment.

**Figure 1: Global GDP and inflation**

<table>
<thead>
<tr>
<th>Year</th>
<th>World Real GDP</th>
<th>World CPI</th>
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</thead>
<tbody>
<tr>
<td>2000</td>
<td>2%</td>
<td>4%</td>
</tr>
<tr>
<td>2002</td>
<td>4%</td>
<td>2%</td>
</tr>
<tr>
<td>2004</td>
<td>6%</td>
<td>4%</td>
</tr>
<tr>
<td>2006</td>
<td>8%</td>
<td>6%</td>
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<tr>
<td>2008</td>
<td>8%</td>
<td>6%</td>
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<tr>
<td>2010</td>
<td>6%</td>
<td>4%</td>
</tr>
<tr>
<td>2012</td>
<td>4%</td>
<td>2%</td>
</tr>
<tr>
<td>2014</td>
<td>2%</td>
<td>0%</td>
</tr>
<tr>
<td>2016</td>
<td>0%</td>
<td>-2%</td>
</tr>
</tbody>
</table>

POLICY TRUMPS POLITICS

What matters most around an election are the policy implications. Any changes to the fundamental macro outlook will take time to materialize as we navigate through the near-term uncertainty of political transition. This was a divisive U.S. election, and emotion needs to be wrung out ahead of a formal transition of power next January.

On paper, if I were to list the issues and policy objectives each candidate ran under for U.S. President, Trump’s campaign scorecard appears to be more in line with a pro-cyclical and pro-growth outlook. Markets are focusing on Trump’s promise for tax reform, deregulation and investment. Headlines have pointed to the recent market rally, but in reality we are still trading in the same broad range we have been in since mid-July. What has changed most since the election is a repricing of bond markets—and defensive equity sectors (Figure 2)—anticipating that a transition from monetary to fiscal policy stimulus will keep the expansion going. We believe it can, but that it will be slower moving than markets today expect. I say that as a positive, not a negative, remark.

If those really are the next administration’s priorities, markets will continue to support this policy change of the guard. A sweep of government is generally embraced by markets, as it gives more ability to provide policy clarity and affect change. A pro-growth and pro-investment agenda, accompanied by the ability of Congress to break years of gridlock, is what is providing support to equity markets and the U.S. dollar while weighing on government bonds. Each of those market reactions is fundamentally grounded and plays well to our current portfolio positioning. We are underweight duration, underweight core bonds, overweight credit and overweight U.S. equity markets.

PORTFOLIOS ARE FULLY INVESTED

Our portfolios continue to reflect a cautious outlook and a market environment where risk assets remain fully valued. We have the least amount of tracking error across portfolios that we have held in the past five years. We have diversified our risk taking and have been trimming risk for well over a year, consistent with our view that no particular risk asset stands out as inexpensive.

We have less directional risk in portfolios than we held one year ago. But that risk rotation should be viewed in the context of portfolios that are fully invested for the long term. That is an incredibly important starting point. Our portfolios remain overweight risk assets. The current market environment is the kind of environment that demands diversifying return streams and risk across asset classes. Diversification matters more than ever.

Figure 2: Cyclical equities have recovered

YTD S&P 500 cyclical vs. defensive equity performance

Equities
Across equity markets, we continue to favor the U.S. over other regions. Within the U.S., we like sectors that include technology and healthcare. We hold financials, energy and materials through allocations to active equity managers. After Brexit, as markets moved higher, we reduced equity exposure in Europe as we questioned its impact on European earnings as well as valuations. We are currently neutral to slightly overweight Japan and believe international developed mid-cap exposure can also do well, on a relative basis, across those markets.

The variable I am most concerned about ahead is how a Trump administration will follow through on what has sounded like a strong anti-trade policy position during the campaign. Investors may demand a higher risk premium for international and particularly emerging equity markets until there is greater clarity around the next administration’s trade agenda. We chose not to hold emerging equity markets this year ahead of a Federal Reserve rate hike. With the current market environment so clearly focused on fiscal stimulus and reflation, we continue to prefer to invest in emerging markets via U.S. dollar-denominated debt.

Third-quarter earnings have turned positive in the U.S. We expect mid-single digit earnings growth next year. Earnings growth is crucial for global equity markets, which we believe will drive portfolio returns. If we are wrong about the macro outlook, and inflation expectations quickly move even higher, equity market multiples may be challenged, putting even greater dependence on earnings growth and dividends to drive returns. We do not believe that equity markets are inexpensive anywhere currently (Figure 3). Our portfolios clearly reflect that fundamental view on valuations as a starting point for current positioning.

Fixed Income
In fixed income, we remain underweight duration and most importantly, underweight core bonds. We continue to favor credit markets and would add to positions on a pullback; that includes hard currency emerging markets debt should it suffer an indiscriminate sell-off on anti-trade headlines. Ten-year U.S. government bond yields have now retraced the collapse we saw earlier this year when the Bank of Japan embraced negative interest rates and investors feared global recession.

Figure 3: Markets are discounting low returns

“Earnings growth is crucial for global equity markets, which we believe will drive portfolio returns.”

We said in our 2016 Outlook piece that we thought it would be difficult to see U.S. 10-year bond yields move much higher than 2.25–2.50% this year. That target seems to be back on track—with a chance that we shift it a little higher again for 2017. We will have to see if the U.S. Treasury market can manage to take U.K. and European bond yields higher next year as well. The recent rise in European government bond yields makes sense and, optimistically, yields might also push a little higher there as well. A cap to European yields, however, may prove to be politics—starting with the Italian constitutional referendum in December followed by national elections in the Netherlands, France as well as Germany next year. Politics isn’t going away as a market distraction, it’s simply shifting back toward Europe.

Alternatives
We have dramatically repositioned our hedge fund allocations to be far less directional, favoring macro as well as relative value credit and lower equity beta strategies. We have repositioned hedge funds to be less correlated to risk assets and a better complement to bonds in an environment where, due to the current low interest rate environment, core government bonds simply can’t provide the traditional protection that they normally would. For Balanced and Growth portfolios, we have reduced our allocation to hedge funds over the past 12–15 months. Similar to active equity managers, we are seeing a recovery in manager alpha after what was an incredibly challenged first half.

VIEWS ON THE FED
With regard to central bank policy, I continue to believe the Fed will likely raise policy rates in December for the simple reason that markets have already done the heavy lifting. The Fed can then step back and hopefully signal a few moves next year with less urgency.

Counterintuitively, the Fed choosing not to raise policy rates in December could end up destabilizing markets, as investors wonder what has changed enough to make it hold off hiking. I also hope that Janet Yellen will remain in her role as Chair of the Fed through her four-year term, which expires in February of 2018. Any noise around a change in her role at the Fed would likely be poorly received by markets.

Now that we are through the U.S. election, the most important change for markets is an increase in clarity about the direction of policy. The focus for markets in the U.S. appears to be shifting to inflation expectations. The Fed has to maintain that its policy tightening remains balanced and that inflation expectations are not becoming unanchored. We currently believe the Fed will likely be able to keep inflation contained, and that is a crucial point.

STEADY HANDS PREVAIL
Markets have remained very steady-handed and quite rational in the face of a U.S. election that seemingly surprised almost everyone. We continue to invest portfolios based on fundamentals, valuations and our outlook—not because any particular candidate won or lost the U.S. Presidential election. Portfolios remain balanced in their risk taking, as we remain cautious in our outlook. While taking less directional risk than we did one year ago, we are fully invested and overweight risk assets—in particular, extended credit.
RICHARD MADIGAN
CHIEF INVESTMENT OFFICER, J.P. Morgan Private Bank

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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