

MARKET THOUGHTS

# Beginning of a Great Adventure



By Richard Madigan, Chief Investment Officer

January 30, 2017

Markets are transitioning from a world that has predominantly been driven by monetary policy to one where politics have taken center stage. Political headlines will likely have greater influence on investor sentiment and market volatility this year than last. We believe the volatility from those headlines can create interesting investment opportunities (Figure 1). Patience is going to be particularly important this year as investors navigate a more stable macro landscape against greater political headline risk.

There is an illusion of certainty currently around reflationary policy—especially in the U.S.—that needs to be rationalized. Pace is going to matter as an energized White House is forced to reconcile policy priorities and implementation risk with Congress. We have important elections in the Netherlands, France and Germany this year as well. Italy and Greece may also see early elections called. Politics is front and center, and politics can be messy. To borrow a phrase: It's the beginning of a great adventure as we move from a macro to a politics- and policy-driven world.

How the Trump administration engages with Russia, China, Mexico and NATO allies may create all sorts of headlines—positive and negative alike. Also, we are monitoring trade policy—not only from the U.S. administration, but also from the U.K., as negotiations regarding exit from the European Union begin to accelerate. We are late in the current expansion, and while this year seems to be setting itself up as a pro-growth year, we do not expect markets to move in the straight line they have been in since last November.

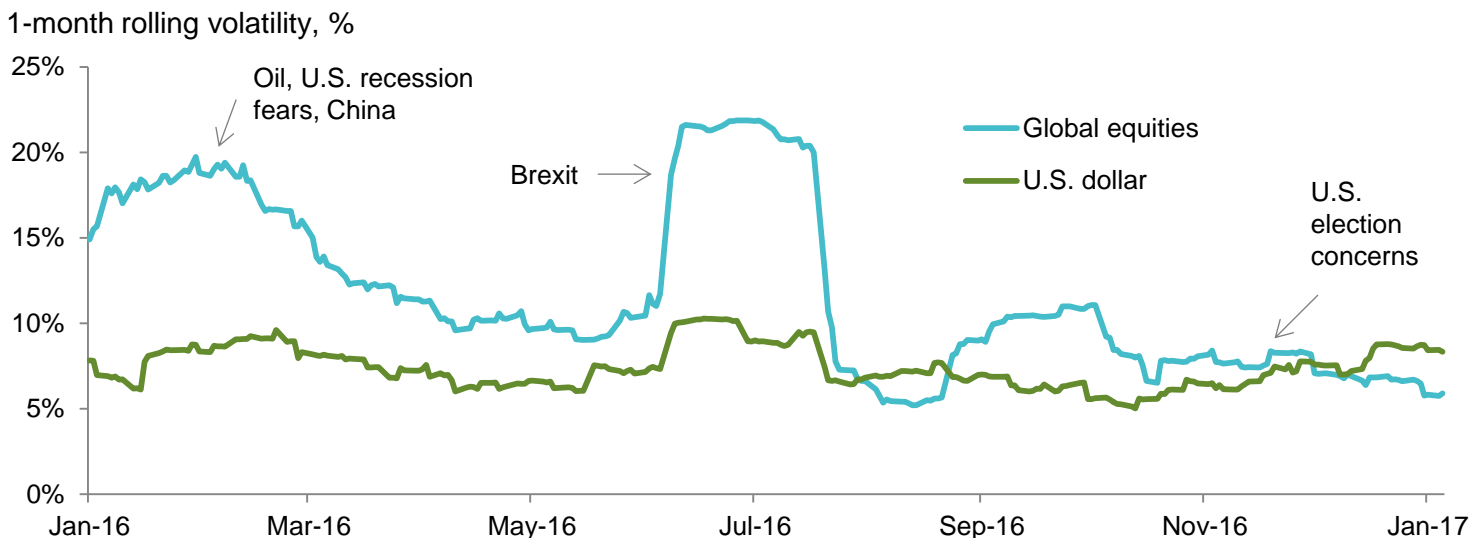
**IN BRIEF**

- The outcome of the U.S. election has further propelled an ongoing shift in investor focus from monetary policy to politics and fiscal action. With politics front and center, patience will be particularly important for investors in 2017.
- We continue to favor the prudence of a fully invested and pro-cyclically positioned multi-asset portfolio capable of benefiting from a recovery in earnings growth, though return expectations should be modest at this stage of the cycle.

**GREAT EXPECTATIONS**

Expectations can directly influence markets, and expectations feel a little ahead of themselves right now. For the moment, markets are seizing on the direction of policy change—they perceive a macro environment that is pro-business, pro-investment and pro-growth.

**Figure 1. Low volatility conditions unlikely to persist**



Source: Bloomberg. Data as of January 2017. Global equities represented by the MSCI World Index and the U.S. dollar by the DXY U.S. Dollar Index.

Directionally, we agree with that observation. However, we are facing an environment with greater uncertainty and with animal spirits slowly reigniting. That is an interesting backdrop for a market where risk assets appear to be fully valued—stocks and bonds alike. Diversification matters in a market where nothing stands out as particularly cheap.

In portfolios, that leaves us fully invested, but not overreaching for risk—right now, we prefer to diversify how we are taking risk across a multi-asset portfolio. We remain constructive on risk assets, but want to see some moderation of the reflationary exuberance that has captivated markets since the U.S. election. Earnings growth will be crucial this year for equity markets. We believe consensus earnings forecasts remain too high at +10–12%. We continue to believe +5–8% global earnings growth is a reasonable starting point.

Global economic growth this year should be around 3%. We see the U.S. economy growing by 2.0–2.5%, with both Europe and Japan growing right around 1.5%. Developed markets should grow around 1.5–2.0% this year, with emerging economies growing 4.0–4.5%, led by developing economies in Asia, where we expect to see growth of 5.0–5.5%. Inflation is moving higher, but we do not believe it is at a point where central banks find themselves behind the curve. Some of the observed increase in inflation is the result of a base effect as energy prices reset higher on a year-over-year basis. Also, the knock-on effects of a weaker euro and pound are incrementally going to be seen passing through to inflation figures in Europe and the U.K. Across developed markets, inflation should range between 1.5% and 2.0%. That is an important backdrop, especially

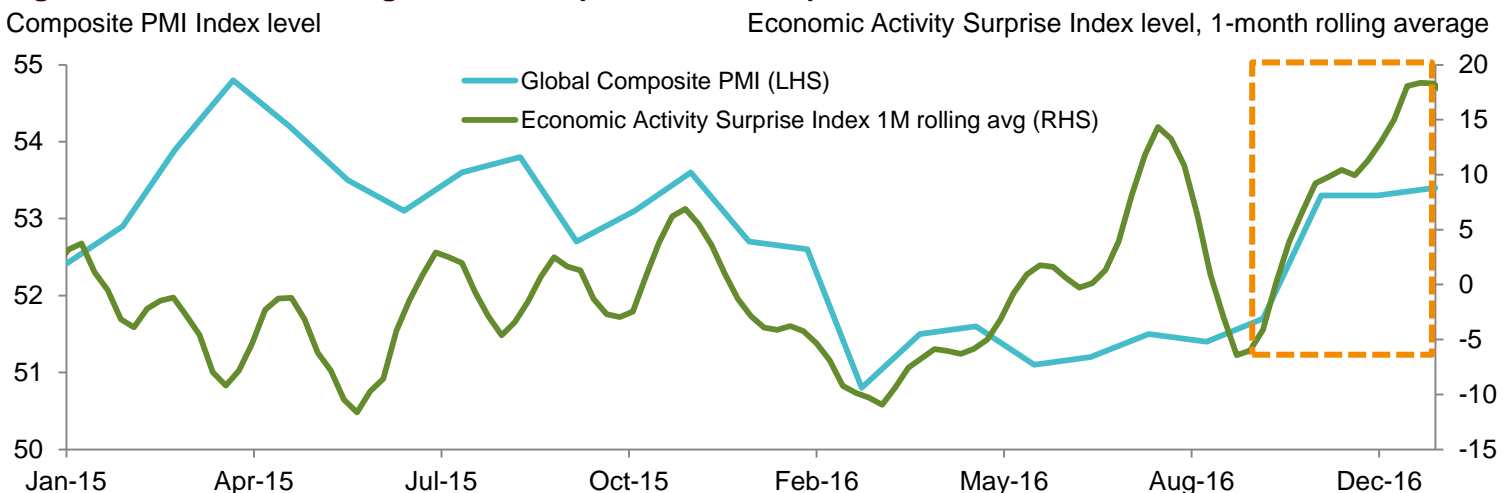
with regard to the sustainability of current equity market valuations—not to mention government bond yields, as they will likely move higher.

Developed market government bond yields effectively hit reset late last year, retracing back to levels we came into 2016 with—before a collapse in energy prices and fear of China and the global economy falling into recession became the narrative. We said throughout last year that we didn't believe that a recession was likely in the near term, and we want to reiterate that view again for the year ahead. However, the longer the current expansion goes on, the closer we get to the next recession. Barring a policy or geopolitical misstep, we continue to believe the risk of recession this year is right around 20–25%. There is improbable precision in stating a number like that, but it's important to anchor our base case view that we do not believe the global economy slips into recession in 2017.

**REFLATION AND OUR OUTLOOK FOR BONDS**

Markets have quickly focused on the reflationary aspects of what lighter regulation, tax cuts and pro-investment policy (including infrastructure spending) mean for U.S. growth and inflation. Global growth is improving, and central banks have stepped back from the shock-and-awe of protracted easing. The Federal Reserve is raising rates, the Bank of Japan has backed away from extending negative interest rates and there is a risk that the European Central Bank will announce further tapering of quantitative easing later this year. Economic surprise indicators are moving higher along with business sentiment (Figure 2). That's the constructive backdrop we start the year with.

**Figure 2. Global economic growth has improved over the past several months**



Source: J.P. Morgan. Data as of December 2016.

While we recognize the shift in sentiment and also the return of sidelined investors to equity markets, there is an important difference between where markets believe we are heading and how we get there. The first 100 days of the Trump administration are going to be critical to watch. Investors will need to separate the rhetoric from the policy priorities and recognize not only implementation risks, but also the lagged impact of tax, trade and regulatory reform on investment and earnings. It's too soon to have an informed view on what significant policy changes like these would mean for markets. There is a lot to be said in life for recognizing what you can't yet know.

For the U.S., we continue to believe that government bond yields are moving higher. We said at this point last year that 2.25–2.50% seemed to be the right target for year-end 2016 on the 10-year Treasury and, with lots of twists and turns, we got there. Coming into 2017, I would venture that a base case target of 2.50–3.00% on 10-year U.S. government bonds seems reasonable for year-end. That reflects our base case of 2–3 hikes from the Federal Reserve this year.

We continue to expect the Bank of Japan to stick to its 0% target on 10-year Japanese government bonds and believe the European Central Bank may announce further tapering in the second-half of this year. That effectively means we are targeting a range of 0.60–0.90% on 10-year German Bund yields by year-end.

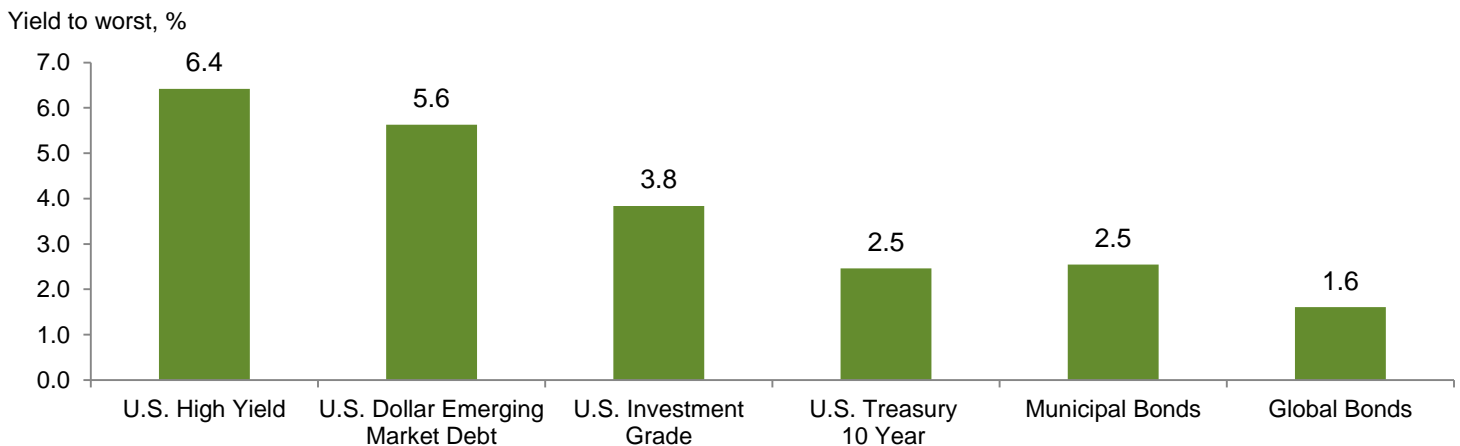
Our largest underweight across portfolios remains to core bonds. We are underweight core duration, but continue to hold onto short to intermediate bonds to help diversify risk and navigate the bumps ahead. Owning no core bonds is the wrong answer in a diversified portfolio—it's what you own across fixed income markets that matters.

Credit remains our single largest overweight across portfolios. We like what we hold in high yield, dollar-denominated emerging market debt as well as investment grade credit. However, coming into this year, return expectations need to be reset lower. We believe credit spreads fairly reflect fundamentals—that means returns will be driven this year by yield (Figure 3), not by spread tightening. Directionally, that implies low to mid single-digit returns as a starting point—higher than core bonds, but significantly less than 2016 returns.

**EQUITY MARKETS DRIVE PORTFOLIO RETURNS**

Sentiment has shifted positively for equity markets, and while a pro-cyclical policy bent in the U.S. has certainly helped, earnings growth is what investors have anchored on. Third-quarter earnings growth in the U.S. turned positive as energy prices stabilized. That allowed markets to shift into more balanced risk taking. One of the more positive signals we have seen over the past quarter has been the catch-up trade across cyclical sectors, at the expense of what became fairly crowded trades in defensive sectors.

**Figure 3. Large yield differentials across fixed income sectors**



Source: Bloomberg, J.P. Morgan. Data as of January 2017. U.S. High Yield represented by the J.P. Morgan Domestic High Yield Index, U.S. Dollar Emerging Market Debt by the J.P. Morgan EMBI Global Diversified Index, U.S. Investment Grade by the J.P. Morgan JULI Index, Municipal Bonds by the Bloomberg Barclays Municipal Bond Index, and Global Bonds by the Bloomberg Barclays Global Aggregate Index.

Investors weren't rushing indiscriminately to buy everything; they have been buying laggards as visibility and the outlook has improved. Investors are being less defensive and more balanced in their risk taking.

We continue to be overweight U.S. equity markets across portfolios and modestly overweight Japan versus Europe. We expect developed markets earnings growth to range between 5% and 8% as a base case. We have the highest conviction in the U.S. currently and expect earnings to grow at the high end of this range with upside, depending on what happens with tax reform. We see similar high earnings growth in Japan this year. Europe is the outlier, where returns may remain challenged as we start the year.

We are far more constructive on emerging equity markets than we have been in quite a while. What keeps us cautious is the tail risk around U.S. trade policy. "Currency manipulator" headlines for China and "renegotiations are coming" headlines around NAFTA could be particularly destabilizing, putting additional pressure on EM foreign exchange markets. Valuations don't stand out as particularly inexpensive in EM equity markets either. That explains our current pause on adding EM equity to portfolios.

We continue to see a stronger dollar this year for the simple fact that we expect the Federal Reserve to continue to raise rates. Higher U.S. interest rates support the dollar. For U.S. dollar-denominated portfolios, we hedged yen exposure over the last several years in our portfolios as it weakened from 85 to 125 versus the dollar. We aren't hedging the yen or euro today, as we do not expect a similar move higher in the dollar.

### MODEST RETURN EXPECTATIONS

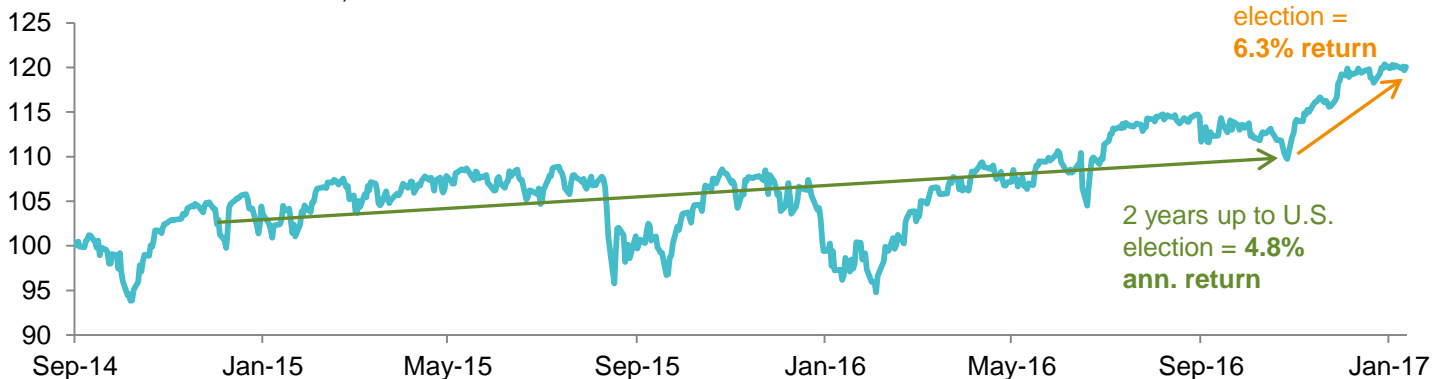
Markets are off to a slow-and-steady start to the year. However, they are facing greater uncertainty than they have in quite a while. Last year, while painful, you either believed the global economy was falling into recession and cut risk, or held on and tactically navigated through what was a particularly challenging first half. Politics was present as an overhang last year—Brexit being a good example—but it was macro that dominated the overall market narrative. The fundamental outlook for 2017 is more stable, but politics and policy are now driving the narrative, creating more uncertainty and headline risk.

At a very simple level, long-term money is meant to stay invested. For anyone that cut risk over the two years preceding the U.S. election, you would have missed the returns that came in the second half of last year (Figure 4)—in the face of the U.K. voting to leave the European Union and a U.S. presidential election that defied market expectations. I'm stating the obvious, but sometimes it's useful to state the obvious.

Our portfolios are fully invested, and as I said at the start of this note, our current positioning clearly reflects a macro environment we continue to feel constructive about—but also, one where equity and bond markets appear fully valued. That explains my earlier remark about not overreaching for risk. Patience and pace are going to be operative themes as we navigate through the headlines. I am sure we will see market opportunities ahead.

**Figure 4. Equity returns are not evenly distributed across time**

S&P 500 Total Return Index, 8/29/2014 = 100



Source: Bloomberg. Data as of January 2017.

I think one of the biggest challenges for investors is grappling with greater headline risks in the face of lower expected returns. Interest rates are still extraordinarily low, and equity valuations appear to fully reflect a constructive outlook. We believe earnings can grow into current multiples and, with the right fiscal policy, valuations can offer some upside as well—but it's likely to come in fits and starts.

We have significantly reduced allocations to active managers over the past few years and feel good about current positioning. We have also cut allocations to hedge funds in Balanced and Growth portfolios that hold them. For portfolios with alternatives, we've tactically repositioned liquid alternative and hedge fund allocations to be less directional in risk taking—focused much more on generating alpha and as complements to core bonds.

We saw a healthy bounce back in manager excess returns in the fourth quarter of last year, but there is still a great deal to prove. Alternatives have to earn their place in a portfolio, and we've reduced allocations where they haven't. That is still very much our mindset as we start this year.

Markets are coming into this year expecting the best, but we believe they are well grounded on fundamentals because of a more constructive macro outlook. This isn't an environment where we are seeing investors taking indiscriminate risk. That is a very healthy backdrop for broader markets as we start the year. We are happy buyers of risk assets where and when we see the opportunity to buy value. I say that starting from a portfolio position that is already invested—which takes me back to my point about investing long-term money. Long-term money is meant to stay invested.

We have an interesting year ahead of us as markets shift their focus to politics. That means louder and more frequently distracting headlines that will weigh on market volatility as well as investor sentiment. It's the beginning of a great adventure.



**RICHARD MADIGAN**  
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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. Richard is Chair of the Private Bank's Global Investment Committee.

The CIO Team is comprised of 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. 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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### **Bloomberg Barclays Global Aggregate Bond Index**

The Bloomberg Barclays Global Aggregate Bond Index tracks investment grade government and corporate bonds globally.

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The Bloomberg Barclays Municipal Bond Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

### **DXY U.S. Dollar Index**

The DXY U.S. Dollar Index indicates the general international value of the USD. It does this by averaging the exchange rates between the USD and major world currencies. The ICE computes this by using the rates supplied by some 500 banks.

### **JPM Domestic High Yield Index**

The JPM Domestic High Yield Index is an index designed to track the performance of the investable universe of the U.S. dollar domestic high yield corporate debt market.

### **JPM Economic Activity Surprise Index**

The JPM Economic Activity Surprise Index tracks growth perceptions by looking at the recent history of economic activity surprises from consensus estimates.

### **JPM EMBI Global Diversified Index**

The JPM EMBI Global Diversified Index tracks emerging market sovereign bonds denominated in U.S. dollars.

### **JPM Global Composite PMI**

The JPM Global Composite Purchasing Manager Index gives an overview of the global manufacturing sector based on monthly surveys of over 10,000 purchasing executives from 32 of the world's leading economies.

### **JPM High Grade (JULI) Index**

The JPM High Grade (JULI) Index provides performance comparisons and valuation metrics across a carefully defined universe of investment grade corporate bonds, tracking individual issuers, sectors and sub-sectors by their various ratings and maturities.

### **MSCI World Index**

The MSCI World Index is a capitalization-weighted index that monitors the performance of developed market stocks from around the world.

### **S&P 500 Index**

The S&P 500 is a capitalization-weighted index of 500 stocks from a broad range of industries. The component stocks are weighted according to the total market value of their outstanding shares.

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