Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

March 16, 2020

IN BRIEF

- Dual shocks from COVID-19 and falling oil prices have hit the global economy. The key concern now is that significant dislocation in financial markets ricochets back onto the real economy, raising risks for the outlook.
- At the margin, we see a path to the U.S. beginning a gradual recovery in 2H20. However, the risks are clearly rising to this base case. Policymakers around the world are reacting swiftly with both fiscal and monetary stimulus. This will aid any rebound but the situation is set to remain uncertain and volatile in the near term.
- Global corporate profits are likely to be hit hard in the first two quarters before recovering in 2H20 if our base case is correct. Overall this should leave global EPS growth in 2020 modestly negative, but we expect stronger growth in 2021.
- We have largely neutralized our risk positions and added to duration. Even at current levels of bond yields, there is still a role for duration in portfolios, given its hedging properties in times of heightened uncertainty. Over the intermediate term we would expect stocks to rebound, but the extent of lasting economic damage is difficult to quantify, adding to a tone of caution in our portfolio positioning.

TWIN ECONOMIC SHOCKS TRIGGER FORCEFUL POLICY STIMULUS

The world economy and financial markets, already deeply shaken by the COVID-19 outbreak, last week received a second exogenous shock in the form of a dramatic fall in oil prices. Despite these dual shocks, and after an initial sharp hit to global economic growth in the first two quarters of this year, an eventual recovery in the U.S. economy during the second half remains a plausible outcome. However, uncertainty in both the wider global economy and financial markets has increased substantially, since no one can reliably predict the precise interplay of these two significant shocks.

The focus of recent trading sessions continues to be the spread of, and policy response to, COVID-19; but we should not forget the turmoil in energy markets. From an economic standpoint, in the medium term lower oil prices are a positive for the majority of economies across the globe, as lower oil prices help both consumers and energy-using companies. In the near term, however, they are a headwind to investment spending in the resources sector, and thus cheaper oil can offset positive economic effects to some degree. Further, the benefit from lower oil prices may be more moderate than in

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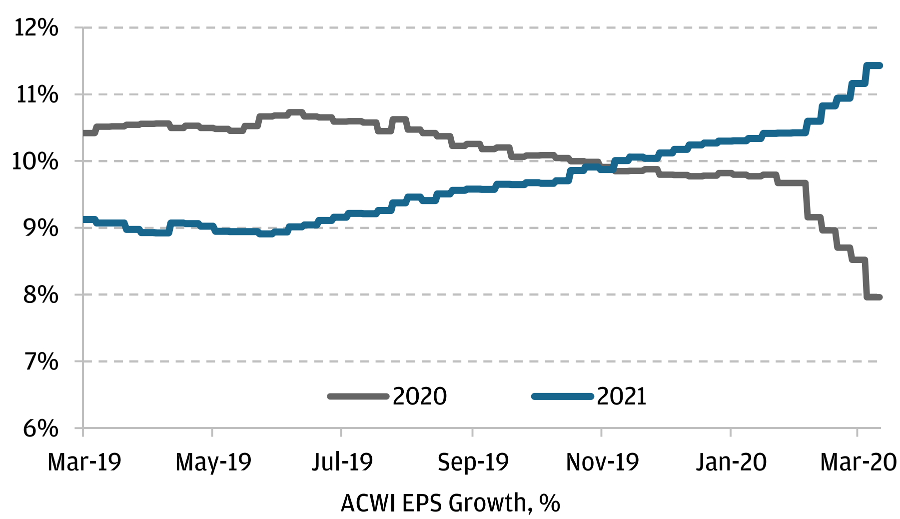
previous periods given the demand shock from the COVID-19 outbreak. Specifically, the transportation and travel sectors are being hit particularly hard. Lower oil prices will also affect oil exporters' demand, hurting export-focused economies and potentially slowing the recovery in Asia. This is in addition to the economic hit from the spread of COVID-19. While it is likely early innings in Europe and the U.S., the Asian economies seem to have made some progress in managing the virus. While investors were most concerned about disrupted supply in the early stages of the virus outbreak, fears over suppressed demand from both official measures to contain the virus as well as depressed sentiment are increasingly coming to the fore.

Perhaps the most worrying impact from the oil price shock is the potential for it to create an added dislocation in already stressed financial markets ricocheting back onto the real economy. In particular, U.S. credit markets are heavily exposed to oil companies, and this may deliver a further hit to confidence. In sum, the odds of a U.S. (and consequently a global) recession have certainly increased. However, our base case scenario anticipates that the U.S. will avoid a traditional recession even though the near-term economic impact on its economy and others, including Europe, will be severe. We expect to see data and earnings begin to improve in the second half of the year, but, again, the timing and shape of any rebound is uncertain. Policymakers are reacting swiftly to the economic shocks, one reason to maintain some optimism about the economic outlook. Monetary stimulus has already led to record low bond yields. Due to the timing and origin of the virus, Chinese authorities have been at the vanguard of easing—with a host of measures such as increased local government bond issuance, liquidity injections and rate cuts. Outside China, the Federal Reserve (Fed) has taken the lead, with an emergency rate cut of 50 basis points (bps). This is likely to be just the start of another easing cycle. Indeed we see a high probability that by April the U.S. policy rate will be cut to 0%. However, rate cuts are likely not enough and the imperative now is a focus on liquidity provision and avoiding USD funding shortages. In that context, the increase in U.S. repo operation limits and the likelihood of ongoing and substantial of policy accommodation via a wide range of measures will be welcome to markets.

The European Central Bank (ECB) and the Bank of England (BoE) have followed the Fed's lead, announcing wide-ranging easing measures. ECB easing focuses on measures to support credit conditions through new long-term repo operations and an additional 120 billion euros

EXHIBIT 1: CONSENSUS GLOBAL EPS GROWTH EXPECTATIONS FOR 2020 & 2021

The chart shows bottom-up consensus EPS growth expectations for the global MSCI ACWI index for 2020 and 2021. The usual drop in growth expectations for 2020 has begun to accelerate in the wake of the COVID-19 outbreak, but it has been offset to some degree by a rise in 2021 growth expectations.



Source: Refinitiv Datastream, J.P. Morgan Asset Management Multi-Asset Solutions; data as of March 11, 2020. For illustrative purposes only.

in asset purchases this year. The BoE cut rates by 50bps and announced a long list of credit easing tools on the same day the Treasury unveiled its fiscal stimulus. This global easing impulse is likely to persist over the coming months to mitigate tightening in credit conditions and/or job cuts while public health authorities work to contain and manage the spread of the virus.

The fiscal response is also important. Fiscal measures are now in the works across major world economies including the U.S., Italy, Australia, Germany and Japan, while the UK is combining emergency measures with a long-expected fiscal expansion. Crucially, fiscal spending need not be large to be effective. Targeted measures that reduce costs for sick leave, delays or forbearance for mortgage and rental payments, tax rebates and relief for small businesses in sectors severely affected by the virus might be more effective at stemming the economic impact than broad-based public spending. Combined fiscal and monetary measures should eventually stabilize sentiment and moderate the second round effects of the twin shocks of the virus outbreak and oil price plunge.

How quickly markets could recover may depend on the impact of those shocks on corporate profits. At the start of the year, the market consensus expected global profits to grow by just under 10% in 2020 (MSCI ACWI). That seemed too optimistic even at the time, when growth rates of around 5% seemed more realistic. That level of growth could still have supported markets. Now the outlook is sure to be worse and decidedly less clear. The first half of 2020 should see a sharp drop in corporate profits as the combined demand and supply shocks take effect, to be followed by a strong profit bounce later in the year as the economy recovers, as we expect it will. This might leave global profit growth for the full year moderately negative. However, it is important to realize that much of this lost profit—although not all—should still be made up in 2021. In other words, as 2020 profit growth gets hit, stronger growth in 2021 should compensate at least to some degree (**Exhibit 1**). The energy sector is less important to stock markets than it once was, and as a result the negative impact from lower oil prices will be modest: the earnings weight of energy in the global equity universe index in 2019 was just 6% (MSCI ACWI), although in some individual markets such as the UK and Canada, it is much higher.

ASSET CLASS IMPLICATIONS

As the crisis has unfolded we have neutralized risk exposures and added duration in our multi-asset portfolios. Even at current levels of bond yields, we believe there is a role for duration exposure in portfolios, given low inflation and duration's hedging properties in times of heightened uncertainty. Within equities, we prefer regions such the U.S. and emerging markets (driven by China) that have the most firepower, both monetary and fiscal, to manage the economic shocks. Among emerging market asset classes, we prefer equities over debt given that Asian economies dominate the index—they are overwhelmingly oil importers, and they also experienced the pain from the COVID-19 outbreak earlier than others. Within bonds we favor positive yielding markets like the U.S., Canada and Australia, where there is more room for monetary easing.

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