Market Bulletin

September 2018

Turning the dial: Portfolio considerations in the late cycle

IN BRIEF

- Much of Europe has enjoyed an unusually warm summer. But as the nights draw in and leaves turn brown, we know that winter is somewhere around the corner.
- Like summers, economic expansions do not last forever. The US recovery is now the second longest on record. There is nothing to suggest it will end in the near future, so the broad prognosis for risk assets remains good. But we know that—like weather forecasters—economists struggle to precisely time a change in the outlook.
- This report does not therefore seek to pinpoint the timing of the next global recession. Instead, it provides a number of strategies for investors who are looking to slowly turn the dial towards a more defensive portfolio. We discuss challenges in today's bond markets and suggest that investors think carefully about which areas of the market will provide adequate protection. We highlight a number of other strategies that have served to shield portfolios in the past, when the snow, and stocks, start to fall.

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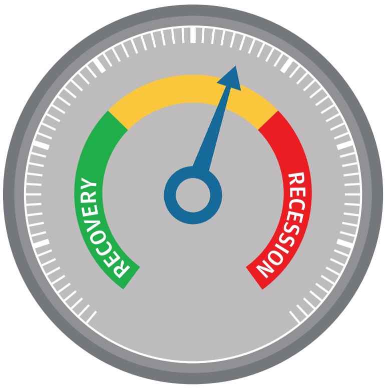


Portfolio considerations for investors concerned about a downturn:

1. Move towards neutral in equities but avoid underweights.
2. Remain regionally diversified in equities.
3. Rotate away from overweights in mid- and small-cap equities.
4. Reconsider overweights in growth stocks, add to quality and value stocks.
5. Consider fixed income strategies that can shift across regions, duration and risk.
6. Cash and short-dated liquidity instruments may provide ballast.
7. Consider strategies with low correlation to risk assets.

Why do expansions end?

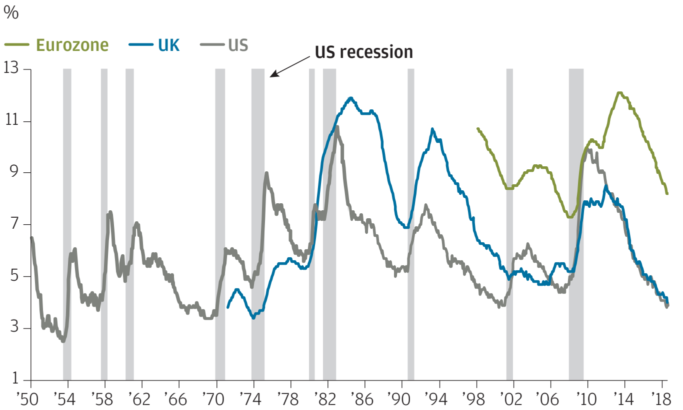
As the US expansion approaches its 10th birthday, investors may wonder how much longer this expansion has to run.

While no two recessions are exactly the same, the playbook often runs as follows: unemployment falls; emboldened workers ask for higher pay; central banks hike rates to stem inflationary pressure; higher wages and rising interest costs squeeze profits, which leads to job shedding. Fearful of losing work, consumers rein in spending, demand falls and the recession takes hold.

This looks simple, so why are economists so notoriously bad at forecasting recessions? The reason is that economic relationships can change. Workers may not ask for more pay. Central banks may not slam on the brakes. And households and firms may keep spending despite higher interest rates if animal spirits are running high. All of these can extend the economic cycle. And, of course, the playbook might change entirely in the event of a financial crisis or geopolitical shock.

The cycle is more advanced in the US and UK than in the eurozone

EXHIBIT 1: UNEMPLOYMENT RATES



Source: BLS, Eurostat, ONS, Thomson Reuters Datastream, J.P. Morgan Asset Management. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates. Past performance is not a reliable indicator of current and future results. Data as of 31 August 2018.

It is hard to say where we sit in the current US economic cycle with any precision. The unemployment rate—at an almost fifty-year low—suggests the expansion is in its twilight years. However, a rise in productivity indicates that firms are managing to squeeze more out of their existing staff. And with wage growth remaining subdued there hasn't yet been a squeeze on corporate profits. Even stripping out the effect of the corporate tax reduction, earnings for S&P 500 companies rose at a solid double-digit rate in the second quarter.

But the Federal Reserve is slowly lifting interest rates. This will be an increasing burden—particularly for the companies that have leveraged up in recent years. Higher interest rates may well start to bite just at the time when the almighty fiscal stimulus begins to fade.

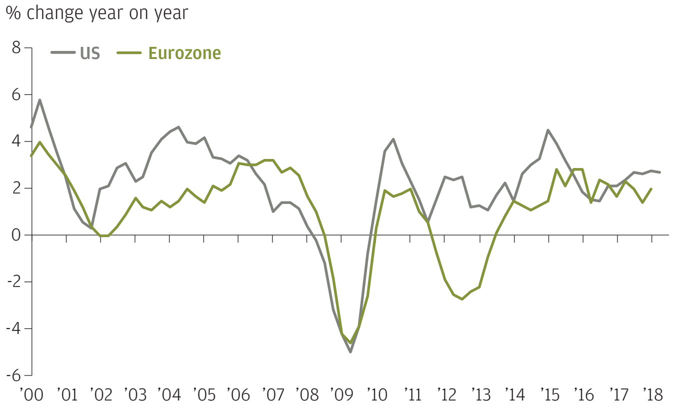
The European economic cycle is less advanced. Having "double-dipped" with the sovereign crisis, unemployment is still relatively high in much of the region. There is ample spare capacity, which is keeping core inflation low. As a result the European Central Bank appears to have very little intention of lifting interest rates until at least the summer of 2019.

In the UK, the recovery was more aligned to that of the US until the uncertainty surrounding the Brexit referendum slowed the pace of activity. Despite the fact that unemployment is at a multi-decade low, the Bank of England seems for now, more hesitant about raising rates.

Although these economic cycles aren't aligned, it seems likely that a downturn in the US would filter through to a global slowdown. Europe is still a very export-dependent region and relies on demand from the US consumer.

The US sneezes and Europe catches a cold

EXHIBIT 2: REAL DOMESTIC GDP



Source: BEA, Eurostat, Thomson Reuters Datastream, J.P. Morgan Asset Management. Real domestic GDP is total real GDP excluding the net exports component. Past performance is not a reliable indicator of current and future results. Data as of 31 August 2018.

An old-fashioned recession

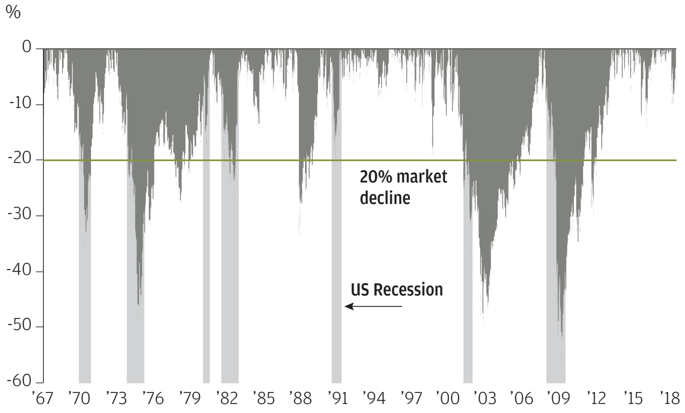
Although it is hard to pinpoint the start date of the next recession, we can say with more conviction that the next equity market contraction is likely to be less severe than the close-to-50% corrections seen in the last two recessions.

There has been a tremendous regulatory drive to reduce the likelihood of another financial crisis. The financial system is better capitalised and more transparent, which should reduce the risk of contagion. A "traditional" recession—whereby corporate profits are eventually squeezed by rising interest costs and unit labour costs—seems most likely.

And equity market expectations of future growth are considerably more modest than they were ahead of the tech bust. In March 2000, the S&P 500 technology sector peaked with a price-to-earnings (P/E) ratio of 55x, and the stock market as a whole was on a multiple of 25x. While some tech firms today have very high valuations, the tech sector as a whole now has a P/E ratio of 19x, and the S&P 500 multiple is broadly in line with its average of the past 25 years.

50% equity market drawdowns are not the norm

EXHIBIT 3: S&P 500 DECLINES FROM ALL-TIME HIGHS



Source: Bloomberg, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates. Past performance is not a reliable indicator of current and future results. Data as of 31 August 2018.

Portfolio resilience: Be *selective* in fixed income

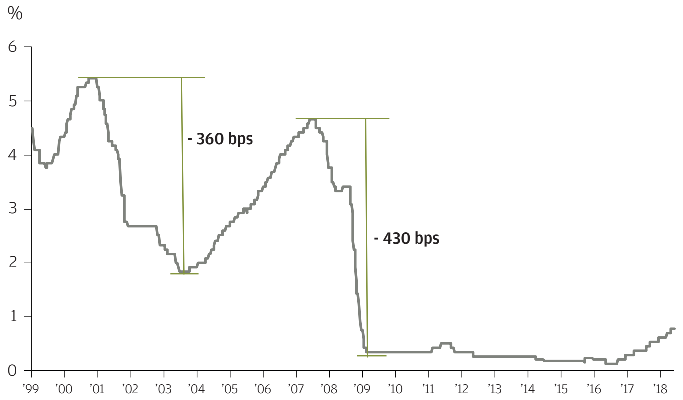
With the US economy still booming and valuations looking reasonable, it isn't obvious that any dramatic shift in portfolio allocation is required. Investors looking to time the market have rarely been rewarded for their efforts. But it seems wise to consider what assets can be added to a portfolio to increase resilience.

In times past, those looking to add ballast might have reached for a higher allocation to government bonds. This cushioned the losses to an overall portfolio as the equity market declined (see detailed table in Exhibit 5).

The difficulty we face this time around is that interest rates in much of the developed world are still near record lows. Consider a simple average of the US, eurozone and UK central bank policy rates. This measure fell from roughly 5.5% in 2000 to less than 2% in 2003, and then from 4.7% in 2007 to less than 0.5% in 2009. Given the current average of these policy rates is just 0.8%, there is clearly no room for a fall in interest rates of this magnitude.

There is less scope for central banks to cut rates… and so less scope for bond prices to rise

EXHIBIT 4: AVERAGE CENTRAL BANK POLICY RATE



Source: Thomson Reuters Datastream, J.P. Morgan Asset Management. Calculated as the simple average of the US Federal funds rate, European Central Bank overnight deposit rate and UK Bank of England base rate. Bps is basis points. Past performance is not a reliable indicator of current and future results. Data as of 31 August 2018.

The US government bond market does offer some protection given rates have now risen. Indeed, if the US 10-year government bond yield fell from 2.9% to 1.5% that would produce a roughly 15% return.

It's much less obvious where investors can find cover in European government bond markets. The German 10-year Bund yield is just 0.4%. Elsewhere in Europe, the expansion has not been strong enough for governments to repair their balance sheets. A near-term downturn could once again lead to questions about the ability of certain European governments to sustain high levels of debt. And if another economic downturn caused a further political shift towards the more radical policies advocated by populist parties, the market could question the "risk-free" nature of some government bonds. This could be an issue beyond the European periphery.

Investors should also be mindful of the potential risks in some other areas of fixed income. Corporate leverage has increased substantially, and almost half of the US investment grade index is now comprised of the lowest eligible grade (BBB) of bonds.

Put simply, investors considering running for the shelter of fixed income should consider very carefully which areas of the market will provide them with a solid roof.

With this in mind, and considering the experience of different asset classes and sectors in the past, we can summarise seven broad strategies that investors looking for a more defensive portfolio should consider:

1. **Move towards neutral in equities but avoid underweights,** because of the tendency for equity markets to perform well at the tail end of the cycle.
2. **Remain regionally diversified in equities.** A shift in regional allocation rarely helps cushion performance in a market correction.
3. **Rotate away from overweights in mid- and small-cap equities.** Large-cap stocks tend to perform better in a downturn.
4. **Reconsider overweights in growth stocks, adding to quality and value stocks.** Quality stocks are the only investment style that have outperformed the index in every recent downturn. Value stocks usually outperform the index during bear markets. The exception was the global financial crisis, but this was because of the high weighting of financials in the value index during a crisis in the financial system. Value stocks have tended to strongly outperform growth when the period preceding the downturn has seen a significant rise in the relative valuation of growth stocks.
5. **Consider fixed income strategies that can shift across regions, duration and risk** as the cycle matures. An ability to shift across regions is critical to take advantage of markets where there is scope for central banks to cut rates.
6. **Cash and short-dated liquidity instruments** may play a greater role in providing ballast.
7. **Consider strategies with low correlation to risk assets** such as macro funds and equity long-short funds, particularly those with the ability to take their net equity exposure to zero.

CONCLUSION

There are few signs that either the US or global economy is about to fall into recession. But as US interest rates normalise and the fiscal stimulus fades the headwinds will mount. While a 50% correction in equity markets seems less of a risk, some investors—particularly those more sensitive to potential downside—may wish to consider what changes can be made to a portfolio to add resilience.

Traditionally, government bonds were considered the first line of defence. We question whether they will prove quite so useful this time around given there is limited scope for interest rates to be cut, particularly in Europe. Investors should think about how they can dynamically use fixed income and liquidity products, how they should alter the equity styles within their portfolios, and whether alternative strategies such as macro funds and equity long-short funds will serve as a better cushion in the coming years.

EXHIBIT 5: ASSET CLASS RETURNS DURING S&P 500 DRAWDOWNS

Asset classes (total return)	Aug ’87 - Dec ’87	Jul ’90 - Oct ’90	Mar ’00 - Oct ’02	Oct ’07 - Mar ’09
S&P 500	-27%	-19%	-47%	-55%
US Small cap (Russell 2000)	-38%	-29%	-41%	-59%
Russell 1000 Growth	-29%	-15%	-64%	-51%
Russell 1000 Value	-24%	-14%	-28%	-60%
S&P 500 Quality	-	-12%	-39%	-36%
MSCI Europe ex-UK	-29%	-25%	-53%	-57%
MSCI Europe ex-UK SMID cap	-	-	-51%	-61%
FTSE All-share	-30%	-13%	-40%	-44%
FTSE Small cap	-33%	-18%	-46%	-56%
FTSE Mid cap (FTSE 250)	-31%	-16%	-32%	-47%
MSCI Emerging Markets	-	-15%	-32%	-50%
US Treasuries	2%	1%	31%	15%
US Investment grade	1%	-1%	26%	-6%
US High yield	-	-	-9%	-29%
Macro hedge funds	-	-1%	10%	8%
Trade weighted US dollar	-4%	-3%	10%	13%
US dollars per euro	-	-	2%	-10%
US dollars per British pound	11%	9%	-2%	-32%
US dollars per Japanese yen	8%	15%	-13%	18%
US dollars per Swiss franc	11%	12%	10%	2%
S&P 500 Peak	25 August 1987	16 July 1990	24 March 2000	9 October 2007
S&P 500 Trough	4 December 1987	11 October 1990	9 October 2002	9 March 2009

Source: Bloomberg Barclays, Federal Reserve, FTSE, HFRI, MSCI, Russell, Standard & Poor’s, Thomson Reuters Datastream, J.P. Morgan Asset Management. S&P 500 Quality index is the top quartile quality stocks in the S&P 500 determined by JPMAM Quantitative Beta Strategies based on measures of profitability, financial risk and earnings quality. Russell Value and Growth indices are selected based on three different factors. For Value, stocks are selected based on considerations of price-to-book ratio. For Growth, stocks are selected based on considerations of forecasted medium term growth and historical sales per share growth. US Treasury: Bloomberg Barclays US Agg. Treasury; US inv. grade: Bloomberg Barclays US Corporate Investment Grade; US high yield: BofA/Merrill Lynch US High Yield Constrained; Hedge funds: HFRI Macro Hedge Fund Index. All values are total return in local currency, unless currency is otherwise specified. Periods of downturn defined by the S&P 500 peak to trough. Past performance is not a reliable indicator of current and future results. Data as of 31 August 2018.

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