PORTFOLIO INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

July 31, 2017

IN BRIEF

- U.S. inflation has slowed since early 2017, with a string of downside surprises in core CPI readings as well as some cooling in wages.
- Our inflation projections focus on slack rather than near-term growth momentum, and we thus do not attribute this decline to unexpected cyclical weakness in the U.S. economy.
- Nor do we think a Federal Reserve policy error in the coming year seems likely, as the Fed's stance will remain accommodative through most of 2018 and Fed officials have already begun displaying some sensitivity to incoming inflation news.
- To the contrary, we think the string of tame inflation readings makes Fed over-tightening and an abrupt end to the current expansion less probable, reinforcing our preference for risky assets in portfolios.
- At the same time, the likely gradual nature of any increase in bond yields, as well as the limited prospect of a true monetary policy shock, lead us to hold only moderate underweights to duration.

THE RECENT DROP IN INFLATION AND ITS PORTFOLIO IMPLICATIONS

Earlier this year, U.S. inflation appeared to be grinding higher in the context of steady economic growth and a tight labor market. The core CPI inflation rate, which excludes food and energy prices, hit 2.3% year-over-year (y/y) in February. And the core PCE deflator, the index targeted by the Federal Reserve, ran at a 1.8% y/y clip in that same month, within shouting distance of the Fed's 2% goal. Our forecasts called for ongoing, gradual acceleration. Instead, inflation has gone into reverse during the past several months, with both indices dipping well below 2% in year-over-year terms. By some measures, wage inflation has also cooled recently. What has caused this slowdown, and what implications does it hold for multi-asset portfolios? While we see some effects, at the margin, for monetary policy and bond yields, we have not changed our broad preference for risky assets.

The inflation drop has sparked two related concerns, first that it may be signaling weakness in the economy and second that the Fed's apparent determination to continue tightening policy might constitute an error that could put the economy into recession. On both counts, we take a more sanguine view. To be sure, no single explanation accounts for the string of low-side inflation surprises. Importantly, however, we see little near-term

AUTHOR

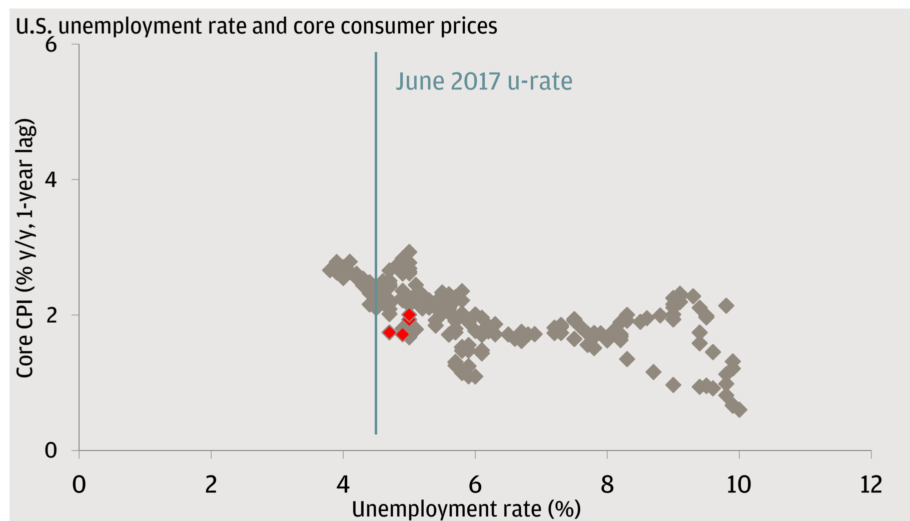
Michael Hood
Managing Director
Global Strategist
Multi-Asset Solutions

connection between growth developments and overall inflation outcomes. Instead, we relate inflation to the level of slack in the economy. Over the past two decades, even that relationship has proved fairly weak. While we think that slack continues to matter, and the very weak recent inflation prints do lie within the boundaries of historically expected outcomes, other forces have overwhelmed the Phillips curve (the relationship between inflation and unemployment) since early 2017 (**Exhibit 1**). Inflation has slowed in major categories with limited short-run relationships to the business cycle, such as medical care and rents. A big one-off shift in cellular telephone data plans has weighed on the CPI. And several highly volatile components, such as airfares, happen to have recorded low-side readings since February. In a handful of cases, we do think that price data may reflect near-term demand fluctuations. For example, new car prices have softened recently as sales have slowed. We view this decline as a relative price swing: while auto sales were down, overall consumer spending has held firm. Whether technological and working-pattern changes are holding back inflation, in part by holding down wages, remains an open question. These forces, though, do not seem to explain why inflation has suddenly slowed in the past several months after a convincing upward trend before that.

While acknowledging the recent inflation weakness, the Federal Open Market Committee (FOMC) has not yet signaled any obvious course correction for monetary policy. This behavior contrasts with the high degree of data dependence in the Fed's approach during 2015 and 2016. However, for two reasons we see only a limited probability of a policy error during the coming year. First, we think policy remains in solidly accommodative territory and will begin leaning against growth only after several more rate hikes. Even assuming that the neutral real fed funds rate stands around zero at the moment, the FOMC's "dots" have it reaching that level only around the end of 2018, with further distance to travel subsequently before policy becomes noticeably restrictive. Second, we do not expect the Fed to pursue its policy path blindly, without reference to incoming information. In general, FOMC members likely think about inflation in a fashion similar to ours, looking at the low level of the unemployment rate and concluding that the probable direction for inflation over time is higher. Given the absence of a superior forecasting model, it will take a longer deviation of inflation from its trend to produce a major impact on Fed thinking. Already, however, several FOMC participants have spoken about the inflation decline and its

EXHIBIT 1: THE INFLATION SLOWDOWN IN A PHILLIPS CURVE CONTEXT

This chart relates the U.S. unemployment rate – a proxy for slack in the economy – with inflation outcomes a year hence. It shows the modest upward slope of this version of the Phillips curve, while also suggesting that any particular level of joblessness can be consistent with a wide range of subsequent inflation rates. The three most recent inflation readings, highlighted in the chart, stand within but near the lower end of the historical range.



Source: Haver Analytics, J.P. Morgan Asset Management Multi-Asset Solutions; data through June 2017. For illustrative purposes only.

possible influence on their thinking by the end of 2017 and into next year. In that sense, the Fed is indeed displaying a degree of sensitivity to the news, reducing the likelihood that it will over-tighten.

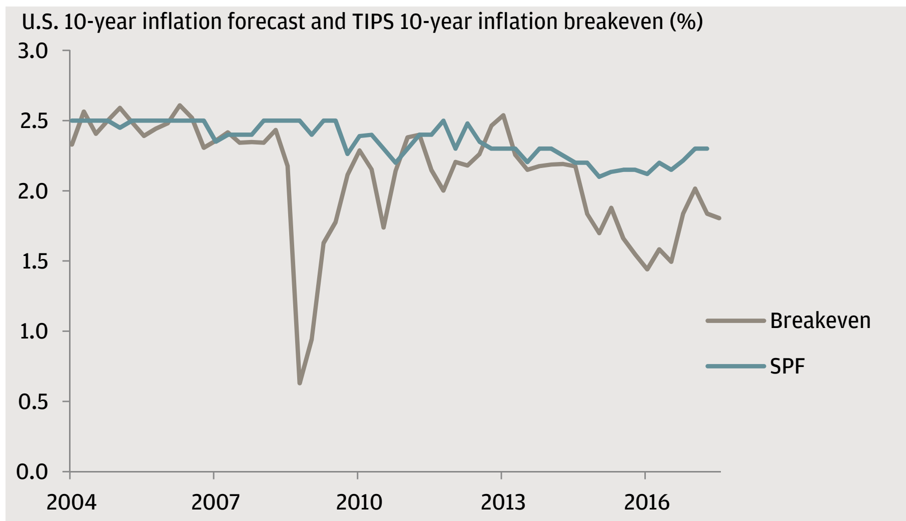
ASSET CLASS IMPLICATIONS

While we believe the U.S. economy is transitioning into the later part of its cycle, inflation's tame behavior suggests no need for aggressive monetary policy tightening and thus reinforces our confidence that near-term recession risk remains fairly low. In turn, we remain comfortable with our tilt in portfolios toward risky assets. That later-cycle U.S. view, though, leads us to a preference for stocks over credit, where performance tends to worsen as expansions mature, as well as for international equity markets that are enjoying more favorable cyclical dynamics. At the same time, we are holding only a modest underweight to duration.

As central bank balance sheet policies shift from expansion to contraction, we expect some upward pressure on bond yields. Stable inflation, though, points to only a gradual rise in policy interest rates, leaning against those increases in the longer end of curves. And the low probability of a monetary policy shock suggests that government bonds will remain an effective hedge for risky assets. Within the bond portfolio, we favor overweights to U.S. Treasuries, where yields are higher than in most other government markets and where the monetary policy outlook seems fairly priced. While we expect some eventual normalization of the inflation risk premium (**Exhibit 2**), the near-term news flow does not seem likely to bring about any surge in such fears, and we therefore are not currently tilting portfolios toward TIPS at the expense of nominal Treasuries.

EXHIBIT 2: TRACKING THE INFLATION RISK PREMIUM

From the early 2000s through 2014 – except during the financial crisis - breakeven inflation rates implied by U.S. TIPS closely tracked consensus forecasts for inflation, such as from the Survey of Professional Forecasters. In the past few years, the market appears to have adopted a negative inflation risk premium, with breakevens falling below projected inflation. That trend began reversing in 4Q 2016, but the gap has widened again since core inflation began surprising on the low side.



Source: Bloomberg, Federal Reserve Bank of Philadelphia; data as of July 25, 2017. For illustrative purposes only.

Global Multi-Asset Strategy:

John Bilton
Head of Global Multi-Asset Strategy
London

Patrik Schöwitz
Global Strategist, Editor
New York

Michael Hood
Global Strategist
New York

Thushka Maharaj
Global Strategist
London

Benjamin Mandel
Global Strategist
New York

Mark Richards
Global Strategist
London

Michael Albrecht
Global Strategist
New York

Diego Gilsanz
Global Strategist
New York

Timothy Lintern
Global Strategist
London

NEXT STEPS

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

Important Disclaimer:

This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit, and accounting implications and determine, together with their own professional advisers, if any investment mentioned herein is believed to be suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yields is not a reliable indicator of current and future results.

J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide. This communication is issued by the following entities: in the United Kingdom by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions by JPMorgan Asset Management (Europe) S.à r.l.; in Hong Kong by JF Asset Management Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited; in Singapore by JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601586K), or JPMorgan Asset Management Real Assets (Singapore) Pte Ltd (Co. Reg. No. 201120355E); in Taiwan by JPMorgan Asset Management (Taiwan) Limited; in Japan by JPMorgan Asset Management (Japan) Limited which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Korea by JPMorgan Asset Management (Korea) Company Limited; in Australia to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Cth) by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919); in Brazil by Banco J.P. Morgan S.A.; in Canada for institutional clients' use only by JPMorgan Asset Management (Canada) Inc., and in the United States by JPMorgan Distribution Services Inc. and J.P. Morgan Institutional Investments, Inc., both members of FINRA/SIPC.; and J.P. Morgan Investment Management Inc.

In APAC, distribution is for Hong Kong, Taiwan, Japan and Singapore. For all other countries in APAC, to intended recipients only.

Copyright 2017 JPMorgan Chase & Co. All rights reserved

PI-AA-WEEKLY-073117 | 0903c02a81e32db3