PORTFOLIO INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

August 14, 2017

IN BRIEF

- Record levels for global equities are driven mostly by the U.S. Apart from the S&P 500 – up nearly 60% from its 2007 peak – among the other major benchmark indices only the UK and Germany have surpassed their 2007 peaks, and by much smaller amounts.
- Market history shows that bear markets can begin at a wide range of valuations, both below and above current levels. While currently elevated levels of valuations will prove a drag on long-run returns, we do not believe that elevated equity valuations are a good guide for the direction of markets over the near- to medium-term. In our view, the single most important determinant of overall equity market direction is whether a recession is on the horizon or not.
- Reflecting a moderate pro-risk stance, our multi-asset portfolios remain overweight stocks vs. bonds. We seek broad regional diversification in our equity positions to take advantage of the breadth of global growth, the remaining catch-up potential for non-U.S. markets and historically low cross-regional equity correlation.

OF ANNIVERSARIES AND VALUATIONS

As we approach the 10th anniversary of the financial crisis, global equity markets are again making new records on a regular basis (notwithstanding current jitters related to geopolitics). This has sparked a steady drumbeat of commentary on the current state of financial markets, much of it voicing concern about high equity (and other risk asset) valuations. Valuations across many risk assets- credit as well as equities- are certainly elevated, and this will indeed pose a constraint on long-run returns and the 10- to 15-year return expectations in our *Long-Term Capital Market Assumptions* framework. However, we do not believe that elevated equity valuations are a good guide for the direction of markets over the near- to medium-term.

It is important to bear in mind that current record levels for global equities are driven mostly by the U.S. and a limited number of other regional markets, while many others still remain well below their 2007 highs. **Exhibit 1** shows that apart from the bellwether S&P 500 – up nearly 60% from its previous peak – of the other major benchmark indices only the UK and Germany have surpassed their 2007 peaks, and by much smaller amounts, roughly 11% and 7%, respectively. The Japanese Topix, many continental European indices, the Australian market, Chinese stocks and emerging market equities as a whole – all remain well below their peaks. At first glance, at least, this perspective suggests a potential for a catch-up of international equities relative to their U.S. counterparts, but this of course assumes that the level of U.S. equities is sustainable in the first place.

AUTHOR

Patrik Schöwitz, CFA
Executive Director
Global Strategist
Multi-Asset Solutions

Although "everyone knows" that market timing is very difficult, we don't think of equity valuations as a reliable tool for anyone trying to time a market top or anticipate the start of a bear market. To pick a simple example for the U.S. market, where valuations are now the most extended of any major global index: At the 2007 market top, U.S. equities traded on a P/E of 17.5x – not particularly expensive compared to a post-1970 average of 17x, and well below today's multiple of around 23x. In contrast, at the top of the tech bubble in March 2000, US equities' ultra-high P/E of 31x certainly was at least a good warning indicator. But the roughly 20% market drop of the early 1990s started at a P/E level of about 16x, while U.S. stocks crashed on Black Monday in 1987 at a P/E of 20X.

Varied valuations at the start of bear markets

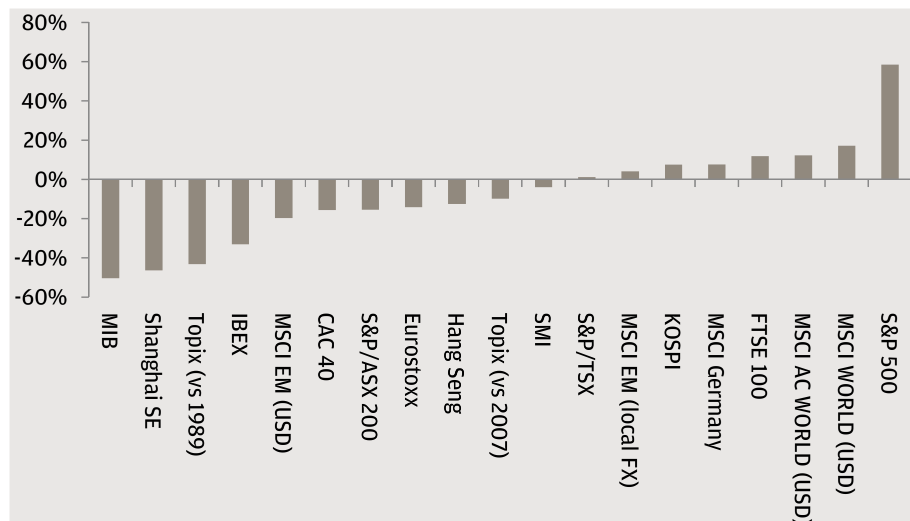
The point here is that equity bear markets can get underway at a wide range of valuations (**Exhibit 2**), both below and above current levels. And while it is true that one should always use a range of valuation metrics, and that metrics other than the P/E multiple – such as price-to-book ratios, or the cyclically-adjusted PE (CAPE*) – can often give a truer reflection of underlying equity valuations, they still don't do a good job at market timing. Valuations aren't even necessarily a good indicator of the downside potential once a bear market starts. Case in point: the 2007-2009 U.S. bear market started at a fairly pedestrian valuation, but it led to the largest decline (57%) in U.S. equites since the Great Depression, larger than the drop (49%) that followed the extremely high valuations of the 2000 market peak.

Of course, investors do not consider equity valuations in a vacuum, and relative to the low level of bond yields, equities still look to be reasonably valued, even in the U.S. Our estimate of the equity risk premium (ERP) for the U.S. equity market is currently at 5.7%; that compares with a long-run average of 4.5% and a recent high of around 7.5% at the market low at the end of 2008.

While many factors come into play, in our view the single most important determinant of overall equity market direction is whether a recession is on the horizon or not. Historically only U.S. recessions have acted to trigger a global equity bear market. This is simply because only the U.S. economy is large and interconnected enough to set off a global recession. (As they say, "when the U.S. sneezes, the rest of the world catches a cold.") Localized recessions can spur over- or under-performance of regional markets, but they are not enough to trigger an

EXHIBIT 1: STOCK MARKET LEVELS RELATIVE TO PREVIOUS PEAKS

Exhibit 1 shows the current level of a range of equity benchmark indices relative to their respective peaks (generally in 2007), and demonstrates that record highs for global indices are mostly driven by the U.S. While the S&P 500 is nearly 60% above its 2007 peak, other indices that are above their 2007 highs, such as the FTSE 100 or MSCI Germany, are up by much smaller amounts. A range of continental European indices as well as Japan's Topix remain well below previous peaks.



Source: ThomsonReuters Datastream; J.P. Morgan Asset Management Multi-Asset Solutions; data as of August 8, 2017. For illustrative purposes only.

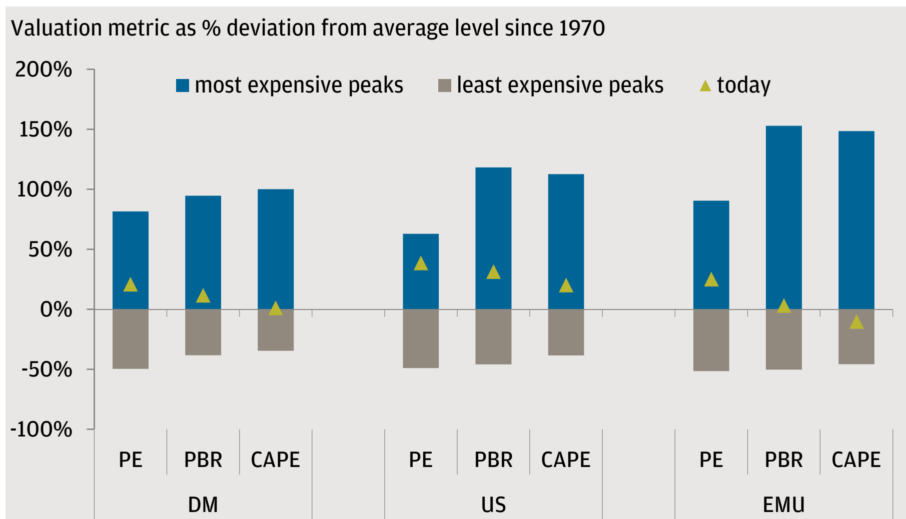
equity bear market at the global level. Even then the timing of equity market peaks with respect to the onset of recession is quite variable, having ranged from zero months to 12 months over just the last three U.S. recessions. As long as we don't see an elevated risk of a U.S. recession over the next year or so—and we don't—our default position is to stick with risk assets, extended valuations notwithstanding. We do acknowledge that the U.S. economic cycle is getting long in the tooth, but we think it may last a few years yet.

ASSET CLASS IMPLICATIONS

In our multi-asset portfolios we retain a moderate pro-risk stance and remain overweight stocks relative to bonds. This is driven by a macro backdrop of robust and broad-based global growth, in which we see no particularly elevated recession probability in the near- to medium-term. We continue to seek broad regional diversification in our equity positions to take advantage of the breadth of global growth, the remaining catch-up potential for non-U.S. markets, and historically low cross-regional equity correlations. Our equity overweight positions are in the U.S., euro area, Japan, and emerging market equities, while the UK remains our key underweight.

EXHIBIT 2: VALUATIONS AT EQUITY MARKET PEAKS HAVE VARIED WIDELY

Equity market valuations are a poor indicator of near-to medium-term market direction. Exhibit 2 shows that valuations levels at equity market peaks have varied widely. For each metric we show - across the last six major equity market peaks since 1980 – the range between the highest and lowest peak levels for each metric, expressed as a percentage of that metric's average since 19070 (i.e. 0% represents long-run average for that metric).



Source: ThomsonReuters Datastream; J.P. Morgan Asset Management Multi-Asset Solutions; data as of August 9, 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-081417 | 0903c02a81e32db3