Asset Allocation Views

Key findings from the Multi-Asset Solutions Strategy Summit

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IN BRIEF

- We expect slow but positive growth with limited recession risk. Nevertheless, the level of growth is too low and valuations too high to ignore worsening financial conditions and increasing tail risk. We expect muted returns and prefer carry over capital growth, quality over apparent cheapness, and relative value over directional bets.
- This is reflected by taking stock-bond down modestly to neutral, and increasing our preference for credit over equity. We remain neutral on duration and commodities, and prefer developed markets over emerging markets.
- The path of the dollar and central bank policy remain key factors this year; a consolidation in the dollar could improve the outlook for emerging markets and U.S. earnings; while pragmatic central bank policy around the globe is critical for financial conditions and risk appetite in general.

ASSET CLASS VIEWS CHART (PAGE 3)

Asset class		Opportunity set	Change	Negative	Neutral	Positive
MAIN ASSET CLASSES		Equities/bonds	▼	○ ○ ○	●	○ ○ ○
		Duration		○ ○ ○	●	○ ○ ○
		Credit	▲	○ ○ ○	○	● ● ○
		Commodities		○ ○ ○	●	○ ○ ○
		Cash		○ ○ ●	○	○ ○ ○
REGIONAL PREFERENCE BY ASSET CLASS	EQUITIES	U.S. large cap		○ ○ ○	○	● ● ○
		U.S. small cap		○ ○ ●	○	○ ○ ○
		Europe ex-UK	▼	○ ○ ○	○	● ○ ○
		UK		○ ○ ○	●	○ ○ ○
		Japan	▼	○ ○ ●	○	○ ○ ○
		Pacific ex-Japan		○ ○ ●	○	○ ○ ○
		Emerging markets	▲	○ ○ ●	○	○ ○ ○
		U.S. REITs		○ ○ ○	●	○ ○ ○
	SOVEREIGN FIXED INCOME	U.S. Treasuries		○ ○ ○	○	● ○ ○
		Euro, core (Bund)		○ ○ ●	○	○ ○ ○
		Euro, periphery (BTP)		○ ○ ○	●	○ ○ ○
		UK Gilts		○ ○ ●	○	○ ○ ○
		Japanese JGBs		○ ○ ○	●	○ ○ ○
		Canadian gov't bonds		○ ○ ●	○	○ ○ ○
		Australian gov't bonds		○ ○ ○	○	● ● ○
	CREDIT	Investment grade		○ ○ ○	●	○ ○ ○
		U.S. high yield	▲	○ ○ ○	○	● ● ○
		European high yield		○ ○ ○	○	● ○ ○
		Emerging markets debt		○ ○ ●	○	○ ○ ○
	FX	USD		○ ○ ○	○	● ○ ○
		EUR		○ ○ ●	○	○ ○ ○
		GBP	▼	○ ○ ●	○	○ ○ ○
		JPY	▲	○ ○ ○	●	○ ○ ○

The start of 2016 saw the post-global financial crisis (GFC) expansion enter its seventh year; U.S. GDP grew for the 20th straight quarter and continues to expand despite volatility. Yet on many metrics, sentiment is fragile: High yield spreads hit a post-crisis high of 839 basis points (bps), oil fell to a 13-year low of $26/bbl, and global equities flirted with a bear market. We maintain our expectations of subdued growth but no recession, and note that equity bull markets are often seen to "climb a wall of worry." But this is no ordinary wall of worry. So despite our conviction in low but positive growth, we adopt a cautious tone, seeking out carry over capital growth, quality over apparent cheapness and relative value over directional bets.

Our positive view of growth should be supportive for stocks, but nominal growth is *too low* and valuations *too high* to ignore worsening financial conditions and increasing tail risks. The U.S. and Europe look set to grow slightly above trend, but persistent weakness in emerging markets (EM) will weigh on global growth. The good news is that the worst of the EM contraction is likely behind us; but equally, excess global capacity and debt continue to dampen inflation and aggregate demand—in turn constricting nominal growth.

Some of the recent market turmoil can be traced back to policy divergence and waning confidence in central banks. Anxieties around the start of the U.S. hiking cycle in the face of lackluster growth were an acute issue early in the year, but these are dissipating as the

Federal Reserve (Fed) moderates its path of hikes to balance U.S. domestic strength with global vulnerabilities. The case for positive growth in 2016 is underpinned by the strength of U.S. consumption, household balance sheets and the labor market.

However, it is becoming clear that monetary stimulus alone is a stabilizer, not an accelerant; other factors, such as incentives for corporate investment or increased fiscal support, will be needed to further boost growth—and these do not seem to be imminent. A key issue is that prior policy action borrowed returns from the future, and now that future is here. So, while recession risk is low, we anticipate a period of sluggish growth and muted returns. Yet a more cautious view on asset returns does not mean a lack of opportunity. Indeed, recent volatility has reinforced many of our themes and presented dislocations and opportunities.

We make two key changes to our active allocation views: We take our relative view on stocks vs. bonds down to neutral and increase our positive view on credit. An environment of low but positive growth, together with relative valuations of credit and equity, implies equity-like returns from high yield credit and makes it an attractive proxy for stocks. We remain neutral on duration and see U.S. 10-year Treasury yields in a lower range of 170–230bps, commensurate with two Fed hikes in 2016. We also stay neutral on commodities and mildly negative on cash.

At a more granular level, we are overweight (OW) U.S. large cap equity; high yield credit (primarily as a substitute for equities); Europe ex-UK equity; U.S. and Australian government bonds; and the U.S. dollar. We are underweight (UW) U.S. small cap equity; Japanese stocks; emerging market debt; German, Canadian and UK government bonds; euro and sterling. We remain UW emerging market equity, but at a reduced level.

The path of the U.S. dollar remains a key consideration. We expect some residual strength but see the dollar consolidating by mid-year as the market prices in the Fed's glacial path of hikes. If more-stable and uniform global growth aids dollar consolidation, that would signal increased risk appetite and a better outlook for emerging markets. But if the dollar falters because of sputtering U.S. growth, the outlook would darken for risk assets generally. Ultimately, we remain optimistic about global growth and anticipate a more virtuous end to the dollar cycle, but the risks to this core view reinforce our more cautious allocation stance.

KEY THEMES AND THEIR IMPLICATIONS

Theme		Macro and asset class implications
GLOBAL MACRO THEMES	Low inflation	Low inflation but not *no* inflation; slack in global economy keeps inflation subdued even as CPI data slowly rises
	Global policy divergence	Fed continues to normalize slowly as other central banks pursue stimulus policies; yields should rise modestly
	Supply-side weakness	Across developed markets, low productivity and labor force growth will ultimately cap longer-dated yields
DEVELOPED MARKETS MACRO THEMES	U.S. economic strength	Domestic U.S. economy remains resilient; recession risks overpriced for 2016; good environment for high yield
	Europe gradual growth recovery	Europe's expansion is on track; monetary policy a key factor supporting EU stocks and credit markets
	Japan: beyond Abenomics	Japanese economic risk becoming more binary; asset returns more geared to fiscal response
EMERGING MARKETS MACRO THEMES	Emerging markets rebalancing	EM data stabilizing and valuations undemanding; near-term risks remain but expected to improve in 2016
	China in transition	China committed to shifting from resources to services; this will continue to weigh on global trade

Source: J.P. Morgan Asset Management Multi-Asset Solutions; data as of March 2, 2016. For illustrative purposes only.

Active allocation views

These asset class views apply to an intermediate-term horizon (that is, 12 to 18 months). Up/down arrows indicate a positive (▲) or negative (▼) change in view since the prior quarterly Strategy Summit. This summary of our individual asset class views shows absolute direction and strength of conviction but is independent of portfolio construction considerations.

Max negative ● ● ● Neutral ● Max positive ● ● ●

Asset class	Opportunity set	Change	Negative	Neutral	Positive	Rationale
MAIN ASSET CLASSES	Equities/bonds	▼	○ ○ ○	●	○ ○ ○	Growth outlook positive, but insufficient to drive meaningful EPS upside
MAIN ASSET CLASSES	Duration		○ ○ ○	●	○ ○ ○	Sluggish growth, bottoming inflation metrics keep yields range-bound
MAIN ASSET CLASSES	Credit	▲	○ ○ ○	○	● ● ○	Excessive risk of recession priced in, credit an attractive alternative to stocks
MAIN ASSET CLASSES	Commodities		○ ○ ○	●	○ ○ ○	Signs of a bottom in oil, but inventory and supply overhangs remain a concern
MAIN ASSET CLASSES	Cash		○ ○ ●	○	○ ○ ○	Negative and near-negative rates a disincentive to holding cash
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	U.S. large cap		○ ○ ○	○	● ● ○	High-quality bias, scope for some earnings recovery as oil, USD normalize
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	U.S. small cap		○ ○ ●	○	○ ○ ○	Full valuations, slower baseline growth are challenges for small cap firms
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	Europe ex-UK	▼	○ ○ ○	○	● ○ ○	Moderating but still positive data; supportive margins and operating leverage
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	UK		○ ○ ○	●	○ ○ ○	Political uncertainty to increase in 2Q, little sign yet of earnings bottoming
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	Japan	▼	○ ○ ●	○	○ ○ ○	Possible fiscal stimulus but waning confidence in reforms, moderating profits
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	Pacific ex-Japan		○ ○ ●	○	○ ○ ○	China economic data questionable, growing investor concerns about debt
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	Emerging markets	▲	○ ○ ●	○	○ ○ ○	Valuations undemanding; headwinds in earnings downgrades, macro pressure
REGIONAL PREFERENCE BY ASSET CLASS – EQUITIES	U.S. REITs		○ ○ ○	●	○ ○ ○	Sensitive to rising rates; fair valuation vs. equity; prefer core real estate
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	U.S. Treasuries		○ ○ ○	○	● ○ ○	Attractive on real yield terms against other sovereigns despite rising rates
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	Euro, core (Bund)		○ ○ ●	○	○ ○ ○	Real yield unattractive; tactical short on dips into negative yield at 10-year point
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	Euro, periphery (BTP)		○ ○ ○	●	○ ○ ○	ECB policy supportive, but on a stand-alone basis all-in returns unattractive
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	UK Gilts		○ ○ ●	○	○ ○ ○	Political risks not fully priced in, expensive compared with other G4 bonds
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	Japanese JGBs		○ ○ ○	●	○ ○ ○	Negative yields unattractive, but primary market demand can keep JGBs rich
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	Canadian gov't bonds		○ ○ ●	○	○ ○ ○	Economic impact of oil slump fully priced, spread to U.S. bonds now extreme
REGIONAL PREFERENCE BY ASSET CLASS – SOVEREIGN FIXED INCOME	Australian gov't bonds		○ ○ ○	○	● ● ○	Attractive yield and carry plus possible rate cuts keep a bid for AUD bonds
REGIONAL PREFERENCE BY ASSET CLASS – CREDIT	Investment grade		○ ○ ○	●	○ ○ ○	Late in credit cycle for IG, scope for steady issuance from large corporates
REGIONAL PREFERENCE BY ASSET CLASS – CREDIT	U.S. high yield	▲	○ ○ ○	○	● ● ○	Spreads pricing in significant U.S. economic weakness; equity-like returns
REGIONAL PREFERENCE BY ASSET CLASS – CREDIT	European high yield		○ ○ ○	○	● ○ ○	EU HY sold off with U.S., further ECB action keeps bid in place for EU credit
REGIONAL PREFERENCE BY ASSET CLASS – CREDIT	Emerging markets debt		○ ○ ●	○	○ ○ ○	Mostly unattractive debt dynamics; if U.S. yields rise, hard currency bonds at risk
REGIONAL PREFERENCE BY ASSET CLASS – FX	USD		○ ○ ○	○	● ○ ○	Some residual USD strength as Fed normalizes, see USD stabilizing mid-2016
REGIONAL PREFERENCE BY ASSET CLASS – FX	EUR		○ ○ ●	○	○ ○ ○	ECB policy support keeps EUR upside capped, attractive as a funding trade
REGIONAL PREFERENCE BY ASSET CLASS – FX	GBP	▼	○ ○ ●	○	○ ○ ○	Fundamental outlook unattractive, complication in mid-2016 from Brexit vote
REGIONAL PREFERENCE BY ASSET CLASS – FX	JPY	▲	○ ○ ○	●	○ ○ ○	Seeing limitation of monetary policy; a bid for JPY amid market stress

Source: J.P. Morgan Asset Management Multi-Asset Solutions; data as of March 2, 2016.

Diversification does not guarantee investment returns and does not eliminate the risk of loss. Diversification among investment options and asset classes may help to reduce overall volatility.

MULTI-ASSET SOLUTIONS

J.P. Morgan Multi-Asset Solutions manages USD $180 billion in assets and draws upon the unparalleled breadth and depth of expertise and investment capabilities of the organization. Our asset allocation research and insights are the foundation of our investment process, which is supported by a global research team of 20-plus dedicated research professionals with decades of combined experience in a diverse range of disciplines.

Multi-Asset Solutions' asset allocation views are the product of a rigorous and disciplined process that integrates:

- Qualitative insights that encompass macro-thematic insights, business cycle views and systematic and irregular market opportunities
- Quantitative analysis that considers market inefficiencies, intra- and cross-asset class models, relative value and market directional strategies
- Strategy Summits and ongoing dialogue in which research and investor teams debate, challenge and develop the firm's asset allocation views

As of December 31, 2015.

NEXT STEPS

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

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