Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

MEETING DATE: January 15, 2020

SUBJECT: Education: Global Markets Outlook

		Deliberation	Receive
SUBMITTED FOR:	___ Consent	___ and Action	_X_ and File

RECOMMENDATION

Staff recommends the Board receive and file the education presentation provided by J.P. Morgan Asset Management summarizing the macroeconomic environment and asset allocation outlook.

PURPOSE

This item supports the 2019 Annual Investment Plan to provide education to Board members.

SUMMARY

The U.S. economic expansion continued in 2019, making the current expansion the longest on record lasting over 10 years since the global financial crises ended 2009. U.S. and International equity markets produced strong returns in 2019, with the Russell 3000 up over 30% and global equity benchmarks up over 20%. Bond markets also produced strong returns during the year, with the Barclays U.S. Aggregate Index up almost 9% and the U.S. Corporate and High Yield market returns in the mid-teens. Coordinated easing of monetary policy by Central Banks across the globe, as well as a notable reduction in trade war risks that were present earlier in the year, helped fuel strong returns for financial assets.

Despite the strong market returns in 2019, and an economic expansion in the U.S. lasting over a decade, the forward outlook is uncertain and significant risks remain. With high equity valuations and low current bond yields, expected future returns have declined. The next year could present risks that increase volatility, such as geopolitical tensions and the upcoming U.S. elections.

As detailed in SCERS' 2019 Annual Investment Plan, SCERS looks to leverage the resources of its investment service providers, such as J.P. Morgan, to gain access to their specialized knowledge and expertise. Additionally, implementation of the strategic asset allocation involves assessing the status of the economic and market cycles to position the portfolio accordingly.

Benjamin Mandel, PhD, is an Executive Director and Global Strategist in the Multi-Asset Solutions Group at J.P. Morgan Asset Management. Dr. Mandel previously worked as an economist at the Federal Reserve Board and in the International Research group at the Federal Reserve Bank of New York, and received his PhD in Economics from University of California, Davis. Dr. Mandel will present viewpoints on the current macroeconomic outlook and impacts on asset allocation.

ATTACHMENT

- J.P. Morgan Asset Management, Macro & Asset Allocation Outlook, January 2020

Prepared by:

_____
Brian Miller
Investment Officer

Reviewed by:

_____   _____
Steve Davis   Eric Stern
Chief Investment Officer   Chief Executive Officer

Time-tested projections
to build stronger portfolios

Macro & Asset Allocation Outlook

January 2020

Benjamin Mandel, PhD | Global Multi-Asset Strategist

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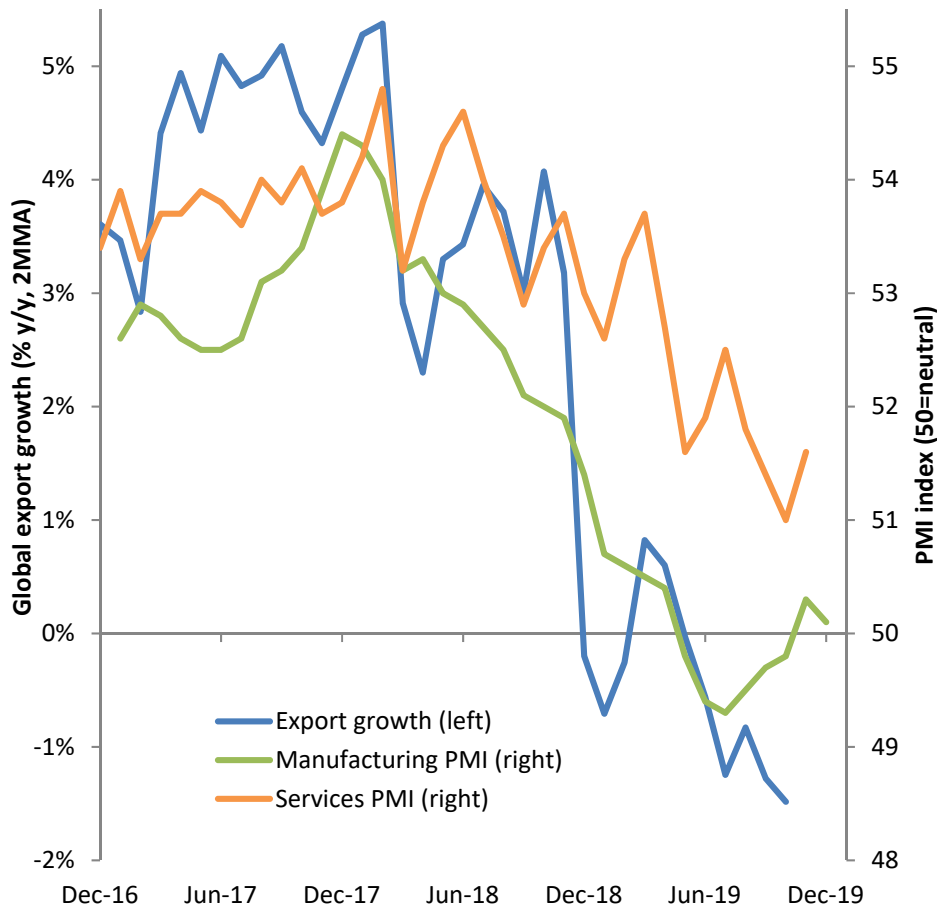# Tactical asset allocation outlook (12-18 months)

- **Positioning**: Moderately optimistic, with overweight to equities / underweight bonds

- **Fundamentals**:

  1. <u>Growth</u>: The global outlook is emerging from a series of shocks to global trade and manufacturing; Tracking back towards trend growth over the course of H1 2020

  2. <u>Business Cycle</u>: Mature U.S. cycle more prone to shocks, 12-month recession odds contained

  3. <u>Policy</u>:

     - Monetary: FOMC's 2019 recalibration is over, but sensitive to growth and inflation softness

     - Trade: Tensions easing from 2019 crescendo; Endgame uncertainty for U.S.-China dispute

     - Fiscal: Neutral for the most part, with a slight easing bias

  4. <u>Balance of Risks</u>: Tilt to the downside, with the resilience of corporate sentiment a key factor
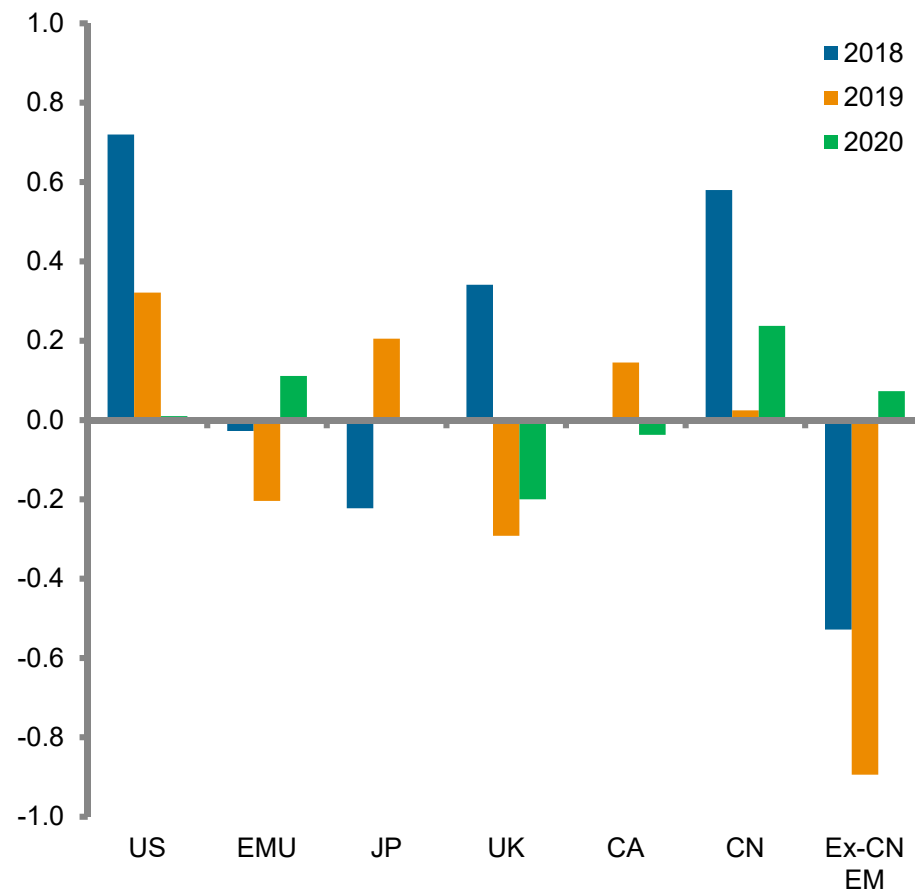
Source: JPMAM Global Multi-Asset Strategy; assessments as of January 2020.

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Global growth forecast: Modestly up from here

Source: Haver Analytics, JPMAM Multi-Asset Solutions; data and forecasts as of January 2020.

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What causes recessions? The historical record

- The famous Dornbusch remark about expansions being murdered by the Fed seems wide of the mark

- Among the nine postwar expansions, monetary tightening looks like the major contributor to two, with two owing to fiscal tightening, two to oil shocks, and two to financial crises (with one mystery)

US Expansions and Their Tragic Ends

Start	Finish	Expansion Duration (in months)	Recession Duration (in months)	Likely Cause of Recession
May-54	Aug-57	39	8	Fiscal tightening
Apr-58	Apr-60	24	10	Monetary tightening
Feb-61	Dec-69	106	11	Fiscal tightening
Nov-70	Nov-73	36	16	Oil shock
Mar-75	Jan-80	58	6	Oil shock
Jul-80	Jul-81	12	16	Monetary tightening
Nov-82	Jul-90	92	8	Unknown (Kuwait, S&L?)
Mar-91	1-Mar	120	8	Equity bubble popped
1-Nov	7-Dec	73	18	Financial crisis
9-Jun	?	125	?	?

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The qualitative business cycle scorecard for the U.S.

		Early Cycle	Mid Cycle	Late Cycle	Recession
Economic metrics	**Overall economic output**	Below potential, rising	Near potential, rising	**Above potential, rising**	Contracting
	Consumption	Low, lagging income	Recovering	**High, ahead of income**	Falling
	Capital investment	Low as % of GDP	Rising, moderate as % of GDP	**High as % of GDP**	Falling
	Residential investment	Low as % of GDP	Rising, moderate as % of GDP	**High as % of GDP**	Contracting
	Price inflation	Below central bank target, stable	**Below CB target, rising**	Above CB target	Falling
	Wage inflation	Low, stable	**Moderate, rising**	High	Falling
	Private credit formation	Low, starting to rise	Rising in line with output	**Rising faster than output**	Falling
	Personal saving rate	High relative to income	**Starting to decline**	Low relative to income	Rising vs. income (excl. deep recession)
	Unemployment	Well above NAIRU	Above NAIRU	**Around or below NAIRU**	Rising sharply
	Consumer confidence	Low	Moderate	**Exuberant**	Falling
Asset market metrics	**EPS revision ratios**	Downgrade cycle, improving trend	Upgrade cycle, improving trend	Upgrade cycle, falling trend	**Downgrade cycle, falling trend**
	Corporate margins	High	Peaking	**Declining**	Low
	Credit spreads	Wide, contracting	Tight, stable	**Past cyclical trough**	Wide, unstable
	Aggressive issuance	Low as share of total	**Moderate as share of total**	High as share of total	Nonexistent
	M&A activity	Low	Moderate	**High**	Nonexistent
	Yield curve	Rates low, curve steep	Rates rising, curve flattening	**Rates high, curve flat**	Rates falling, curve steepening
	Volatility	Vol high, skew falling	Vol low, skew low	**Vol starting to rise, skew rising**	Vol high, skew high

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Recession monitor: More lateral movement than trend at the end of 2019

- A slide in indicators gauging the labor market, business sentiment, consumer confidence, the housing market and credit conditions is a necessary condition for a broad downturn

- Most indicators moved sideways in December. Claims/credit conditions edging down but at decent levels; ISM/consumer conf. moving sideways; housing perking up

Activity indicators
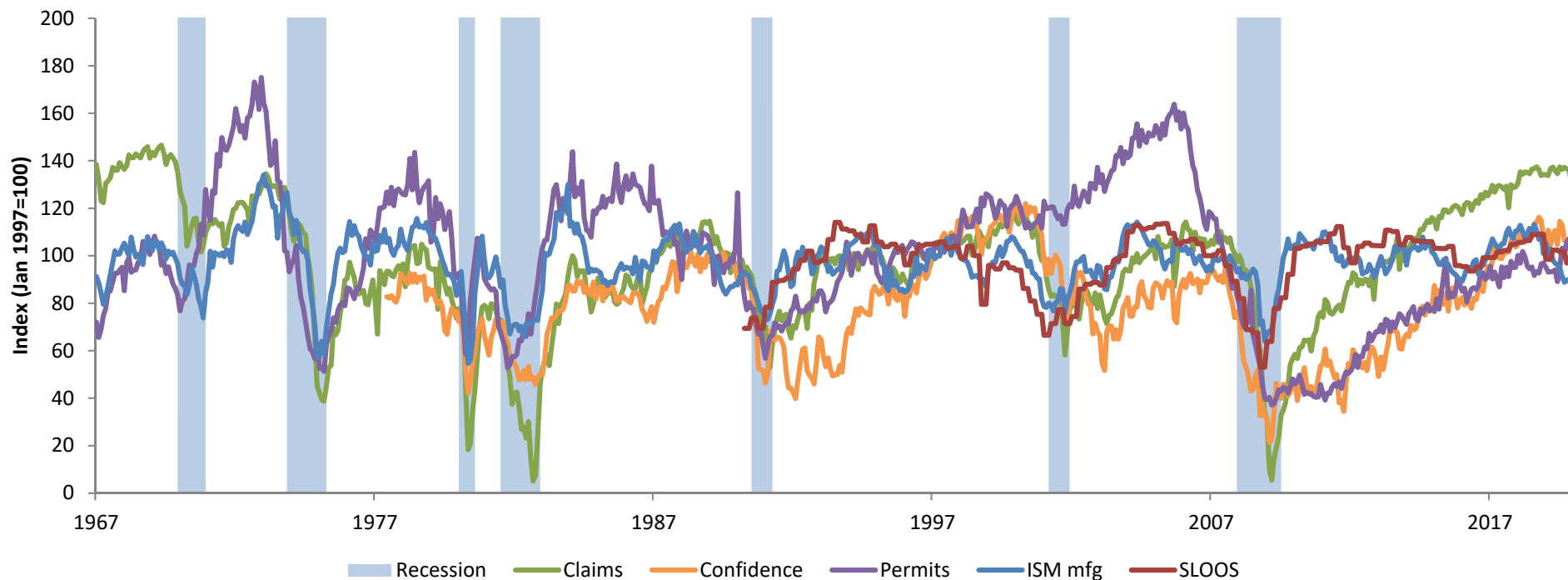
Source: Bloomberg, Haver Analytics, JPMAM GIM Multi-Asset Solutions; data as of January 2020.

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The FOMC's 2019 policy recalibration has petered out

- While growth accounted for a lot of Treasury volatility, easier policy drove its trend

- The policy impulse levelled off just prior to the September FOMC meeting

Actual and rule-implied Fed funds rate (%)
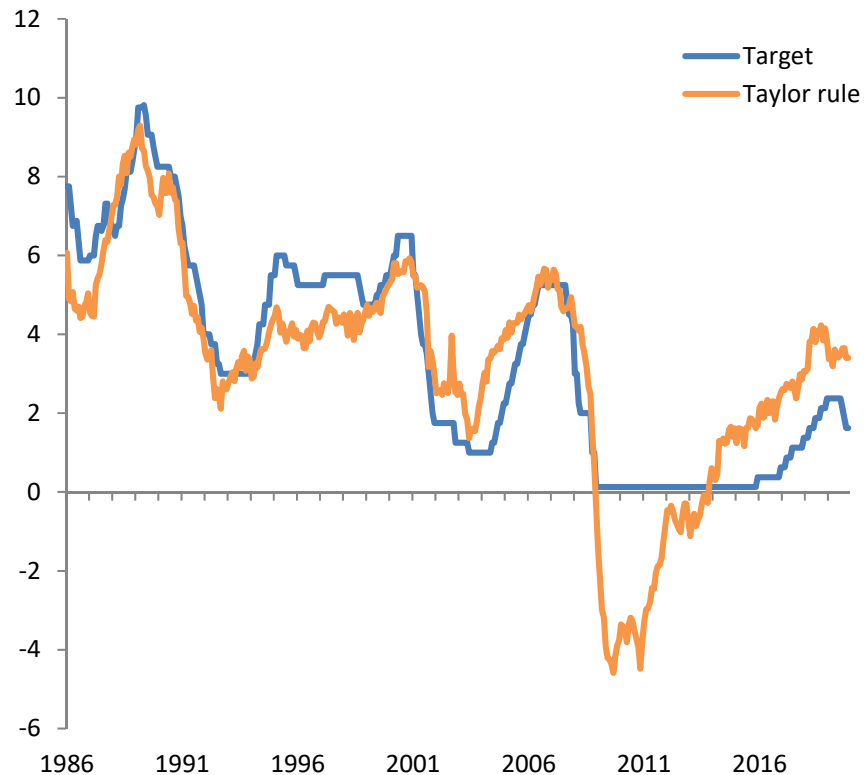
**Cumulative change in 10-year Treasury yield in 2019 (p.p.)**
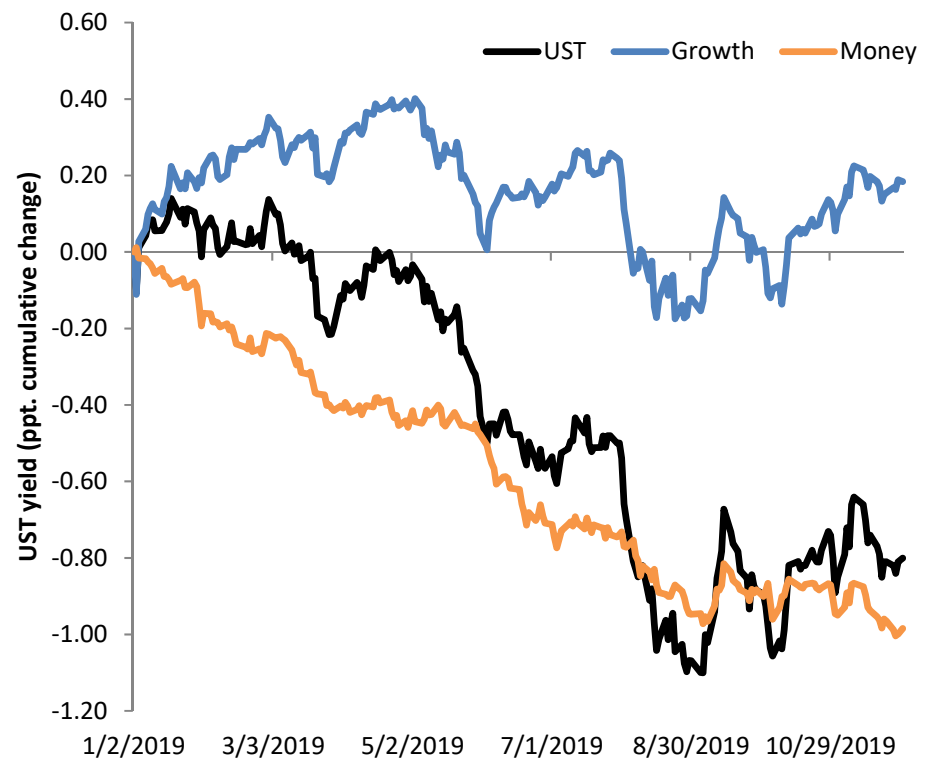
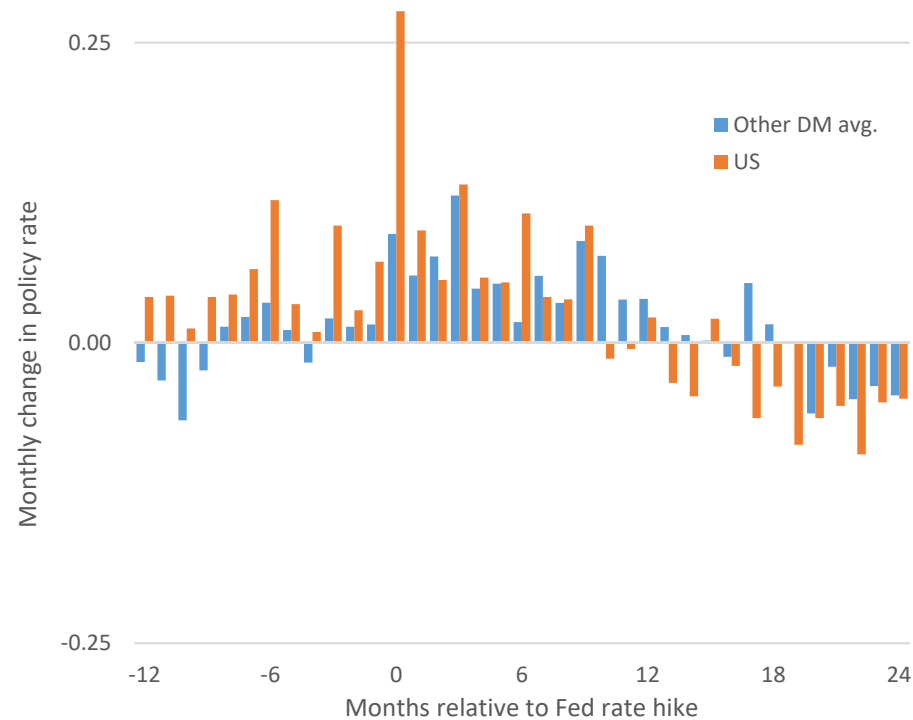Source: Haver Analytics, JPMAM GIM Multi-Asset Solutions; data as of December 2019.

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Follow the Fed: FOMC rate cuts tend to cast a long shadow

- Historically, Fed easing cycles have reverberated more persistently at other DM central banks

- Hiking cycles tend to operate more in lockstep

Average change in policy rate around Fed rate cuts (1985-2019)
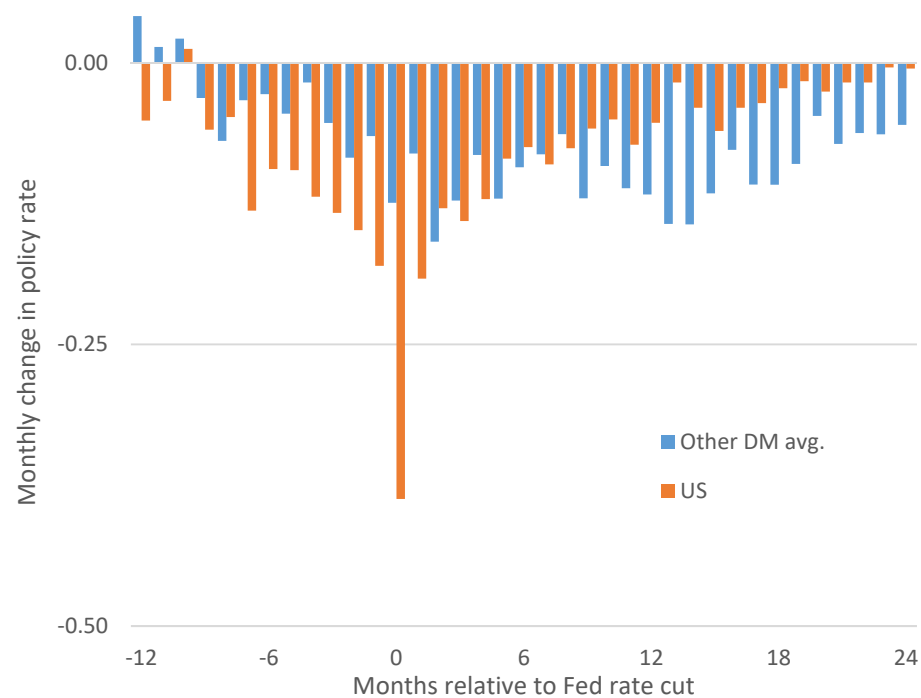
**Average change in policy rate around Fed rate hikes (1985-2019)**

Source: Haver Analytics, JPMAM GIM Multi-Asset Solutions; data as of December 2019.

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Trade war: Stabilization on two of four fronts

- U.S-China Phase I and USMCA deals dial down some the systemic threats from the trade war

- However, likely resurgence of tariff rhetoric (and tariffs) on European exports and the paralysis of the WTO suggest persistent levels of background uncertainty associated with trade

Pre-trade war U.S. imports by source (2017)
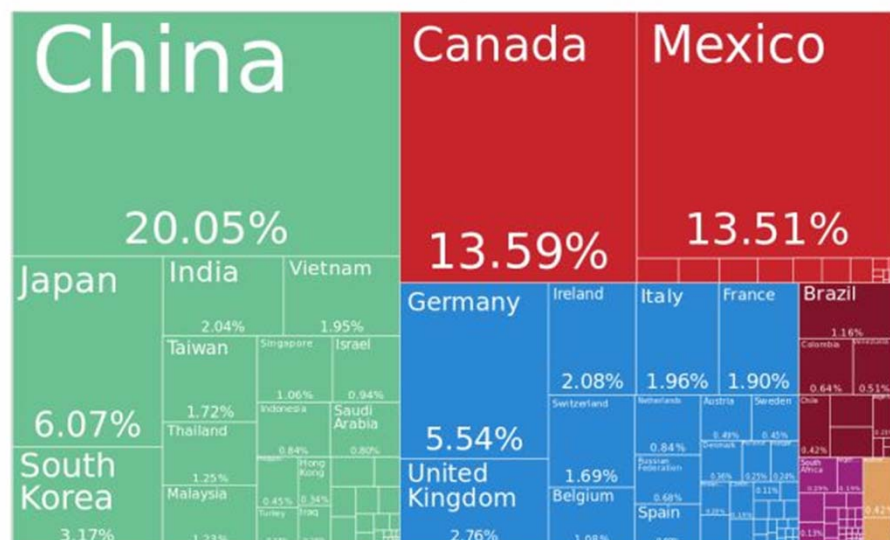
Pre-trade war U.S. exports by destination (2017)
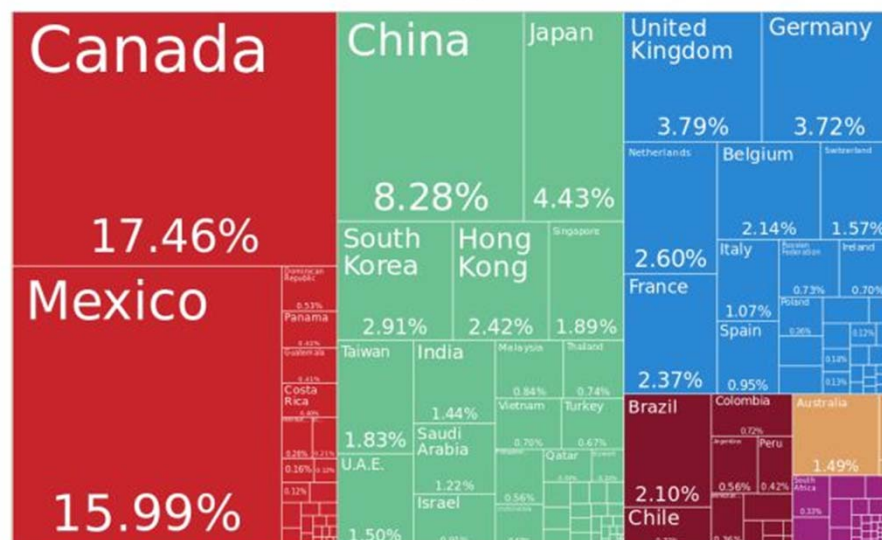
Source: JPMAM Global Multi-Asset Strategy; assessments as of January 2020.

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Watch list – How durable is macro and policy improvement?

- **Private Sector Resilience**: Persistent drags on sentiment feeding spillovers into non-manufacturing (Japan as cautionary tale); Latent effects of policy uncertainty; Credit conditions turning?

- **Global Industry**: Sand still in the gears from prior tariff escalation? Tech cycle/China policy head fakes in EM Asia

- **Trade War**: Asymmetry is back; U.S.-China Phase I and done?; What offsets elsewhere – Autos, steel, WTO DSB

- **Geopolitics**: Re-emergence of oil price volatility

- **U.S. Elections**: Weighing potentially large sector-level implications against Trump 2.0; Market timing uncertain

- **Monetary Policy**: Following the Fed less fun when it leads to a pause; How much cushion if inflation reverts to target?

- **European Politics**: Brexit implications of UK general election; Shifting coalitions in Germany and Spain

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Asset	Opportunity set	Chg	Negative				Positive		
MAIN ASSET CLASSES	Equities/bonds	▲	○	○	○	○	●	○	○
	Duration	▼	○	○	●	○	○	○	○
	Credit		○	○	○	●	○	○	○
	Real estate		○	○	○	●	○	○	○
	Cash		○	○	○	○	●	○	○
EQUITIES	U.S. large cap		○	○	○	○	●	●	○
	U.S. small cap	▲	○	○	○	●	○	○	○
	Canada		○	○	○	○	●	○	○
	Europe ex-UK		○	○	●	○	○	○	○
	UK		○	○	○	●	○	○	○
	Japan	▼	○	○	●	○	○	○	○
	Australia		○	○	○	●	○	○	○
	Hong Kong	▲	○	○	○	●	○	○	○
	Emerging markets	▲	○	○	○	○	●	○	○
REAL EST.	Direct real estate		○	○	○	●	○	○	○
	U.S. REITs		○	○	○	●	○	○	○
SOVEREIGN FIXED INCOME	U.S. Treasuries		○	○	○	○	●	○	○
	U.S. TIPS		○	○	○	○	●	○	○
	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		○	○	○	●	○	○	○

(Left margin label: PREFERENCE BY ASSET CLASS)

Key Takeaways

- Global growth bottoming, trade risks subsiding (for now)

- Recession risk receding but repeat of 2017 is unlikely

- Policy set to remain easy; The Fed has extended the cycle

- Bond yields can rise, but not far: bid for duration remains in place

- Earnings stabilising and tail risks falling: more constructive on stocks

- Prefer U.S. stocks but outlook for EM & cyclical regions getting better

- Corporate credit still has vulnerabilities in late cycle, prefer EMD

- USD stable, upside risk to EUR, less bid for JPY as outlook better

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments are made using data and information up to December 2019. For illustration only. These asset class views apply to a 12- to 18- month horizon. 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 relative direction and strength of conviction, but is independent of portfolio construction considerations. These views should not be construed as a recommended portfolio. The opinions and views expressed here are those held by the author at the date of publication which are subject to change and are not to be taken as or construed as investment advice. Forecasts, projections and other forward looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections and other forward statements, actual events, results or performance may differ materially from those reflected or contemplated.

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Biographies

Benjamin Mandel

Benjamin R. Mandel, *executive director,* is a global strategist in the Multi-Asset Solutions group at J.P. Morgan Asset Management in New York. He is also an adjunct professor at Columbia University's School of International and Public Affairs. Ben began his career as an economist in the International Finance division at the Federal Reserve Board and in the International Research group at the Federal Reserve Bank of New York. Prior to joining J.P. Morgan, he was a member of the Global Economics team at Citi Research. Ben's academic research has been published in leading scholarly journals, including: American Economic Review, American Economic Journal: Macroeconomics, American Economic Journal: Economic Policy, Quantitative Finance and the Journal of Economic Perspectives. He has a Ph.D. in Economics from the University of California, Davis and a B.Sc. from Cornell University.

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