Investors have gone from expecting extended central bank patience to assuming synchronous and assertive easing. The truth lies somewhere in between. It’s been quite a change in perspective, with the biggest shift coming from the Fed. Rising expectations of central bank rate cuts should help keep risk assets and bond markets supported.

Concern of a new and more damaging phase of the trade war caught investors off guard in August. Prospects of a currency war between the United States and China has weighed on investor sentiment as well. This is a dramatic shift from where we were just a few weeks ago. No one wins a currency war, particularly between the world’s largest economies.

We continue to focus on trade as a risk to markets ahead. This is one of the reasons we’ve kept portfolio risk-taking contained this year. While we believe the United States and China will eventually reach an acceptable resolution, it is too early to have a clear view. The direct impact of increased trade conflict is a negative, but the difficult-to-estimate indirect effects on sentiment, investment and hiring can be far more damaging.

WHEN THE FACTS CHANGE

As I mentioned in May, I can’t recall a time when a central bank has shifted positioning as quickly as the Fed has this year, outside of a major shock or market event. The Fed recognized it over-reached in its policy tightening last year. It’s reversing course (Figure 1).

**IN BRIEF:**

**Market outlook**

- Central bank rate cuts should help keep risk assets and bond markets supported. A change in monetary policy is creating an environment where the longest U.S. expansion in history can run further.
- The direct impact of increased trade conflict remains a negative. The difficult-to-estimate indirect effects on sentiment, investment and hiring are a real concern. I continue to watch this closely.
- Weaker inflation has opened the door to easier monetary policy across global economies. Emerging economies are jumping in on the policy easing bandwagon.
- Risk assets and government bonds aren’t cheap. This is not a time to be over-reaching for investment risk. These are observations about managing expectations and diversifying portfolio risk, not exiting markets.

**Portfolios**

- We’ve kept focus on where we believe we are in the cycle and steadfastly steered through the noise. Our modest overweight to equities remains the right positioning.
- Our overweight to U.S. equities continues to feel like the right regional tilt as well. I continue to believe it’s the region where we have the clearest visibility around top-line and earnings growth.
- Hedge funds are doing their job this year. That is clearly not the case for portfolios that invest in liquid alternatives, which have delivered mixed results. In those portfolios, we have cut allocations to liquid alternatives in half.
- Our strongest tactical investment calls have been adding to U.S. equity overweights while continuing to add to core bonds. Each of these decisions has served portfolio performance well.

![Figure 1. The Fed cut after hiking nine times](image-url)
We are in the late stages of this cycle. The difference between getting monetary policy right or wrong has tremendous consequence to extending or ending the current cycle. A change in monetary policy is creating an environment where the longest U.S. expansion in history can run further.

As the facts change, re-examine your position. That’s exactly what the Fed is doing. The United States started its eleventh year of expansion in July. I continue to believe the Fed is a central bank anchored on fundamentals, not political distraction. For anyone concerned that the U.S. cycle can’t last longer, Australia is in its 28th year of expansion.

AN OUNCE OF PREVENTION

The market narrative has shifted to a debate about whether the U.S. economy needs a few “insurance” rate cuts or more substantial policy easing to keep growth on track. Incoming U.S. economic data does not yet demand a more aggressive easing cycle, but it has become clear that the Fed is increasingly concerned about the impact weak global growth and trade uncertainty are having on the U.S. economy.

The Fed isn’t the world’s central bank until the world starts weighing on the U.S. economy. Then it is. The Fed has the ability to buy insurance today. The market has done the heavy lifting in lowering interest rates for them. You buy insurance when it’s cheap and before it’s needed. That said, U.S. interest rate futures are pricing in about 100 basis points of additional cuts by the end of 2020. That feels overdone.

Changes in Fed policy will continue to have knock-on effects for other central banks. With inflation subdued, central banks aren’t facing the same constraint that they normally see as economies approach the later stages of the business cycle. Weaker inflation opens the door to easier policy across global economies (Figure 2). Emerging economies are jumping in on the easing bandwagon. All aboard.

Without inflation acting as a constraint, policymakers are focusing on growth and acting to prevent persistent disinflationary pressure from turning into something worse. Europe and Japan need to firmly address below-trend growth and a continued decline in inflation expectations. The Fed today cares most about growth. To borrow from Chair Powell: “An ounce of prevention is worth a pound of cure.”

PUSHING ON A STRING

As investors ready themselves for additional policy easing, it’s important to recognize that valuations across risk assets and government bonds are in much better shape than they were when quantitative easing (QE) first came about. Return expectations and the amount of risk taken in a portfolio need to be managed accordingly.

Returns will likely be lower ahead. This is no time to be over-reaching for investment risk. These are observations about managing expectations and diversifying risk, not exiting markets. Long-term money is meant to stay invested.

The impact monetary policy can have today is far more limited than right after the financial crisis. There is a market phrase used to help bring to life when central bank policy no longer has impact: pushing on a string. It’s a great visual. We aren’t there yet, but it’s important to keep that phrase in mind. There is only so much monetary policy can do to sustain this cycle.
Central banks have a wide-ranging toolkit, but it’s no longer as effective with interest rates already so low. Central banks will need to become more creative as they exhaust simple interest rate cuts. That is particularly the case in Europe and Japan. While the Fed is focused on buying inexpensive policy insurance, both the BoJ and ECB need more substantial and sustained monetary easing. They also need fiscal stimulus. That’s possible in Japan but politically unlikely in Europe.

For the U.S. economy, our base case is for trend growth to hold – that’s around 2%, plus or minus 50 basis points. We continue to run below-trend growth in Europe, which is right around 1%. That’s too close to stall speed for the ECB not to pursue ardent easing. With Japan readying to increase value-added taxes this fall, they should ease ahead of tax hikes.

One area of uncertainty appears to be resolved with Christine Lagarde set to lead the ECB. Her experience in negotiating and managing divergent constituencies seems particularly well-suited to the structure of the ECB as well as the current economic environment. Importantly, her nomination should represent continuity with Mario Draghi’s recently announced policy easing bias.

We continue to hold full duration government bonds in portfolios. We’ve reset lower our base case target for where we begin to think bonds are either expensive or cheap. Today, we view them as fully valued. As the facts change, we’ll revisit positioning.

WHEN BAD NEWS IS GOOD

Isn’t it bad when bad news is thought to be good? It depends on what happens next and why. With trade acting like a sword of Damocles of sorts over investors’ heads, it’s important to hear that the Fed is clearly aware of the downside macro consequences of Washington going “all in” on a trade or currency war with China.

At times over the past few months, bad news has somehow become good news for markets. Whether it be weak global growth or faint inflation data, the Fed has clearly emphasized each as a concern. Bad news became good because investors now believe it can turn an insurance rate cut or two from the Fed into sustained easing. We’ll see.

Expectations for a “Fed put” have popped into the market narrative. I believe a policy put is always present to address a shift in the macro landscape that the Fed feels can be nudged back into place. It isn’t there to stymie investor anxiety, and I believe has a higher bar to be used today given the noise that continues to be directed at the Fed by the Administration around interest rates and the dollar.

MID-YEAR REPORT CARD

It’s hard to believe we’re already into the second-half of 2019. It feels a little like readying for the Madigan twins’ 21st birthday this year. I keep reminding my wife that 21 is just a number and that parenting is a lifelong charge – like managing money. Time flies when you’re having fun.

As this year has flown by, markets have clawed back returns from late last year. I’ve used the line “steady hands prevail” before to describe my belief that being good at managing money means bringing a clear understanding of the fundamental market and macro cycle, as well as an unemotional and disciplined approach to investing. That discipline continues to serve us well. We have a strong, proven and repeatable investment process. It’s working.

There remains a great deal of emotion driving markets. Some of the hubris from doomsayers has moderated, but the instinct from many pundits is to be first out with the next loud headline. I say that because there remain substantial risks to markets and the outlook. Noisy headlines aren’t going away.

I feel good that we’ve kept focus on where we believe we are in the cycle and have steadfastly steered through the noise with pro-cyclical positioning. Our modest overweight to equities is the right positioning. Our overweight to U.S. equities continues to feel like the right regional tilt as well. I continue to believe it’s the region where we have the clearest visibility around top-line and earnings growth (Figure 3).
While our overweight to U.S. equities has been a strong positive for portfolios, positions in healthcare and energy have been drags on performance. We still hold each sector because we believe valuations are attractive relative to the broader U.S. market, and we continue to monitor and reassess that positioning.

Hedge funds are doing their job this year. That is clearly not the case for portfolios that invest in liquid alternatives, which have delivered mixed results. In those portfolios, we have cut allocations to liquid alternatives in half, tilting into multi-manager strategies.

Our strongest tactical investment calls have been adding to U.S. equity overweights while continuing to add to core bonds. Each of these decisions has served portfolio performance well. We added last year to core bonds and duration when U.S. 10-year yields were trading between +2.7–3.0% and German 10-year yields were +0.4%–0.5%. Given the downshift we’ve seen in global growth, it’s possible that current bond yields move lower. There is around $15 trillion in sovereign and corporate debt today trading with negative interest rates.

**WHAT COMES NEXT?**

The most important question we need to get right is the trajectory of global growth. Also, we need to clearly determine how the cycle is shifting. It’s a fool’s errand to pretend to call an inflection point in a cycle. The trick is to identify how the cycle is changing and know when and where to lean.

We’ve been doing that for well over the past year across portfolios. We cut equity and extended credit exposures, added to core bonds, and diversified risk using more defensive positioning. Never expect an investment that’s working one way to continue to work the same way as a cycle changes course. It’s rarely the case.

The business sector – manufacturing in particular – is the epicenter of the current global deceleration. A more sustained slowdown would have negative knock-on effects to labor markets and consumption. Continued weakness in business confidence and investment activity remain high on my list of things to watch (Figure 4). Concern around trade policy continues to have a negative impact on each.

Central banks are back in easing mode, which should help take markets further away from the edge of the next recession – extending the cycle further. The key is whether central bank easing can reflate inflation expectations that in turn spark economic green shoots. Don’t fight the Fed…especially as they draw other central banks into cutting policy rates along with them.

As we move into late August, I’m going to suggest a lighthearted late-summer read by Michael Lang, the co-creator of the Woodstock Music and Art Fair: “Road to Woodstock.” Woodstock is turning fifty this month. From a spark in its founders’ eyes, it’s proven foundational in its resonance and cultural influence. Three days of peace and music. Something we can all benefit from. Enjoy the rest of your summer. We have a bumpy and busy September ahead of us.
RICHARD MADIGAN  
CHIEF INVESTMENT OFFICER, J.P. Morgan Private Bank

Richard Madigan is Chief Investment Officer for J.P. Morgan Private Bank. In this role, he is responsible for the development of investment strategy, tactical and strategic asset allocation for $270 billion in high-net-worth and institutional client assets. Richard is Chair of the Private Bank’s Global Investment Committee.

The CIO Team comprises market research, portfolio management and analytics as well as a dedicated quantitative research team that oversees investment risk.

Richard brings over 20 years of experience in portfolio management and international capital markets to the firm. Prior to his current role, Richard held the title of CIO, Global Access Portfolios, where he and his team managed in excess of $16 billion in client assets. Before joining J.P. Morgan, Richard was Managing Director, Head of Emerging Markets Investments and Senior Portfolio Manager at Offitbank, a New York–based wealth management boutique. He was also a senior member of the firm’s investment committee. Before joining Offitbank, Richard worked for J.P. Morgan's Investment Banking division in New York in the emerging markets securities business. He previously spent six years with Citicorp, first as a banker in Mexico, and then in the firm’s international corporate finance division in New York.

Richard’s commentaries have appeared in the Financial Times, The New York Times, the Wall Street Journal, Bloomberg and Reuters. He is a frequent guest speaker on CNBC, and has also appeared on CNN and Bloomberg News, as well as at various industry conferences. Richard holds a master’s degree from New York University, where he majored in Finance and International Business. He has lived both in Europe and Latin America and currently resides with his wife and children in New York City.
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