What to do when sentiment rules the markets?

Defying apparent economic fundamentals, sentiment has driven erratic equity market swings this year. We recommend a balanced stance for tactical investors and, potentially, trading volatility in a turbulent campaign season.

It's our view that U.S. equity market performance this year has been driven more by sentiment than hard data. From a certain perspective, fundamentals—especially the declining discount rate—actually support a bullish outlook. Yet soft indicators are sending mixed signals. And another wild card is about to be played: a U.S. electoral cycle that is likely to be stormy.

Tactical investors should remain generally defensive, with a focus on alpha over beta, but should look to capitalize on volatility when it heightens, as it likely will in the coming months when the 2020 U.S. presidential campaign season ramps up.

MAKING SENSE OF MIXED SIGNALS

Recessions are unambiguous when they unfold. All the economic data begin to weaken and risky assets (like stocks and high yield bonds) lose value. Right now, though, the economic data are sending very mixed signals, weakening the argument that a recession is imminent.

Economic indicators can be bucketed into one of two categories: hard data and soft data. Think of hard data as covering real and measurable activity, like the components of GDP, volumes of freight traffic or Netflix subscriptions. Soft data, on the other hand, tend to be exposed through survey responses that help us understand business and consumer expectations.

SHOULD WE TRUST WEAKNESS IN SOFT DATA?

Neither hard nor soft data are perfect. While hard data are typically reliable, the information can take a long time to collect and is often published with a delay. If investors wait until hard data weaken substantially, they could be too late in identifying a slowdown.

Soft data are more timely, but they rely on people's feelings about how the economy is evolving. And, as we all know, feelings are not always accurate.

That's why we always look at both hard and soft data to get a full picture of the economic backdrop.

Right now, we see two main issues in the data.

INVESTMENT AND INSURANCE PRODUCTS ARE: • NOT FDIC INSURED • NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY • NOT A DEPOSIT OR OTHER OBLIGATION OF, OR GUARANTEED BY, JPMORGAN CHASE BANK, N.A. OR ANY OF ITS AFFILIATES • SUBJECT TO INVESTMENT RISKS, INCLUDING POSSIBLE LOSS OF THE PRINCIPAL AMOUNT INVESTED

For Informational/Educational Purposes Only: The author's views may differ from other employees and departments of JPMorgan Chase & Co. Views and strategies described may not be appropriate for everyone, and are not intended as specific advice/recommendation for any individual. You should carefully consider your needs and objectives before making any decisions, and consult the appropriate professional(s). Outlooks and past performance are not guarantees of future results. **Please read Important Information section.**

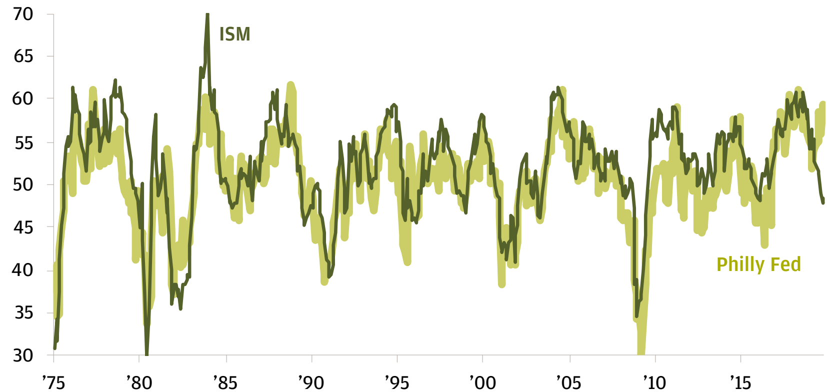
1. SOFT DATA GENERALLY HAVE WEAKENED BUT NOT ALL SOFT INDICATORS AGREE

To see how much the soft data have moved from harmony to disagreement, look at **Figure 1**. The chart compares more than 50 years of the ISM manufacturing index to the Philadelphia Federal Reserve (Fed) manufacturing index. Both are soft indicators measuring the health of the manufacturing sector (locally for the Philly Fed, nationally for the ISM). The manufacturing sector is, no doubt, the weak link in the U.S. economy right now. But the contradictory signals sent by the two data sets in late 2019—recessionary activity per the ISM, euphoric conditions per the Philly Fed—seem unrealistic.

Where does the truth lie? We believe that conditions in the manufacturing sector are somewhere in the middle of the ISM and Philly Fed measures. Indeed, that is what the latest employment data indicate **(Figure 2)**.

FIGURE 1: TWO SOFT INDICATORS ARE TELLING CONTRADICTORY STORIES ABOUT MANUFACTURING

ISM vs. Philly Fed; diffusion Index, +50/-50 = expansion/contraction

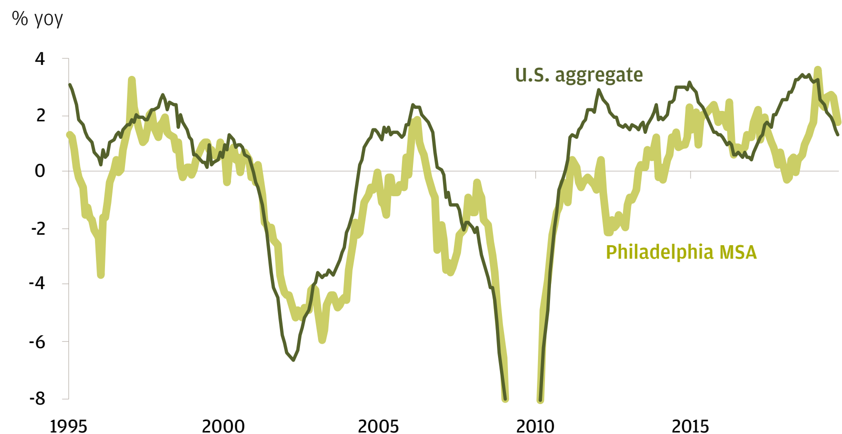


Source: ISM, Philadelphia Federal Reserve. Data as of October 31, 2019.

FIGURE 2: HARD DATA SUGGEST THE TRUTH LIES BETWEEN THE DISPUTING SOFT INDICES

Employment in goods-producing sectors still growing

% yoy



Source: BLS. Data as of September 30, 2019. The Philadelphia series refers to the metropolitan statistical area including Philadelphia, Camden and Wilmington.

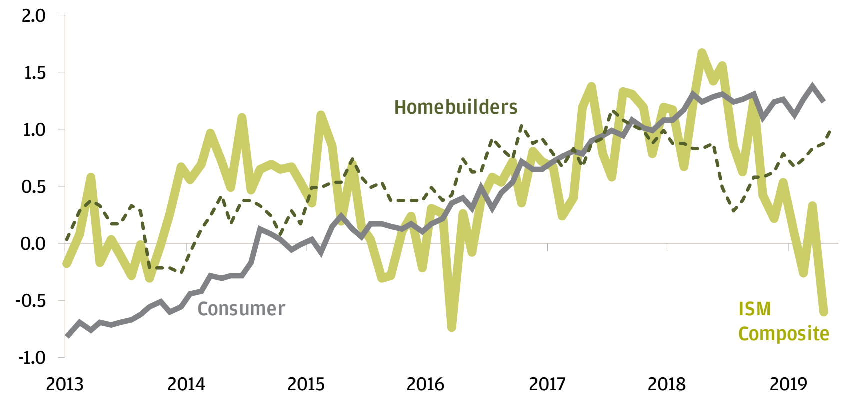
Here's another disconnect from the soft ISM numbers that are suggesting weakness: Both housing and consumer sentiment data are still signaling stable growth **(Figure 3)**. Mortgage rates are low and consumer balance sheets continue to be in a healthy place, especially compared to prior cycles. The latest GDP data for Q3, which showed a healthy pace of consumer spending and a rebound in housing investment, helped confirm the relatively bright outlook displayed in the consumer and housing soft data.

2. HARD DATA—ESPECIALLY SERVICES SECTOR MEASURES—HAVE SHOWN RESILIENCE

This second issue is more fundamental. So far, the hard data do not support the narrative that demand weakness in manufacturing is materially bleeding into services. The main pillar of the U.S. economy right now is the consumer, driven by income generation in the services sector (which makes up close to 80% of U.S. GDP). The most timely read on how the services sector is progressing comes from a hard data source—the monthly jobs report. Over the last few months, we've seen a sizable disconnect between that report's hard data on labor income in the services sector, which shows robust income generation, vs. the downshift that the ISM non-manufacturing survey's soft data show **(Figure 4)**.

FIGURE 3: CONSUMER AND HOMEBUILDER CONFIDENCE IS HOLDING UP AS ISM DOWNSHIFTS

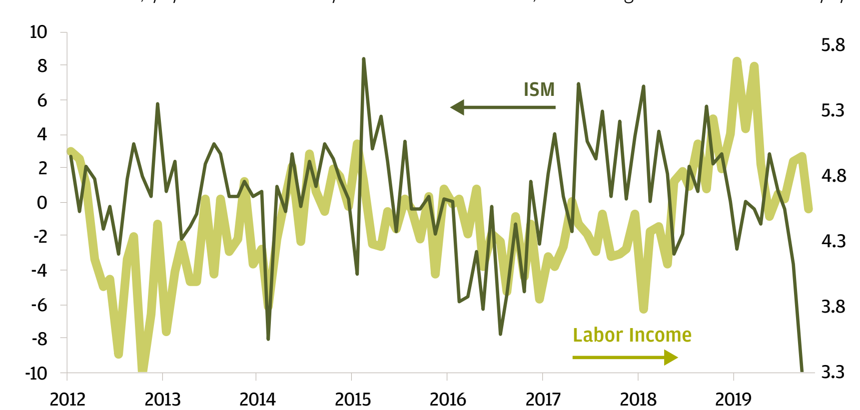
Z-Scored level Consumer confidence, National Assn. of Home Builders, ISM



Source: Conference board, NAHB, ISM. Data as of October 31, 2019. Z-score is based on data from 1997 to present.

FIGURE 4: ISM DATA SUGGESTS THE SLOWDOWN HAS INFECTED THE SERVICES SECTOR. BUT HAS IT?

Diffusion index, yoy difference: steady services labor income, weakening soft data % yoy



Source: BLS, ISM. Data as of September 30, 2019. ISM series refers to the non-manufacturing employment component; labor income refers to production of non-supervisory employment.

DOES MIXED DATA AFFECT ASSET PERFORMANCE?

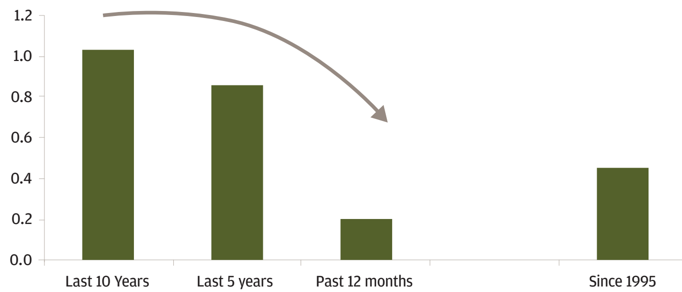
If we flip the conversation to markets, the disconnect between hard and soft economic data can help us understand asset performance so far this year. Indeed, U.S. equity markets are facing the same issue of competing data and here, too, the soft data—sentiment surrounding various risks—have been overriding hard earnings numbers.

Believe it or not, forward earnings estimates for the U.S. equity market have been quite stable over the past year (at USD 165/per share for MSCI US). But all the while, stock valuations (i.e., the multiple) have been swinging on repeated bouts of pessimism and optimism about recession risks and the U.S.-China trade negotiations. This volatility has

made for a poor Sharpe ratio (a measure of risk-adjusted return) over the last year, especially compared to earlier stages in the cycle **(Figure 5)**.

FIGURE 5: STOCKS HAVE HAD BELOW AVERAGE RISK-ADJUSTED RETURNS OVER THE LAST YEAR

MSCI US: Stocks' Sharpe ratio has deteriorated



Source: Bloomberg. Data as of October 2019. Uses monthly returns, risk-free rate used is 3-month Treasury bills.

Figure 5 also illustrates the important point that, compared to its long-run average back to 1995, the Sharpe ratio earlier in the cycle was higher than usual, and more recently has been lower than usual.

Given that the hard data are holding up well relative to the soft data, one could make a bullish argument for equity markets right now, downplaying the recent shifts in investor sentiment. The argument rests on the notion that there has been a significant decline in the perceived discount rate over the last few quarters. (Equity prices are, in theory, the discounted future earnings of corporations. As discount rates fall, valuations should rise because future earnings are more attractive in a present-value sense.) Going into this year, the Fed estimated that the so-called "neutral" interest rate—the rate that doesn't stimulate nor restrict growth—for the U.S. economy was close to 3%. However, given the economy's greater-than-expected sensitivity to higher interest rates (as evidenced, for example, by last year's weakness in the housing sector), neutral rates are clearly lower than 3%.

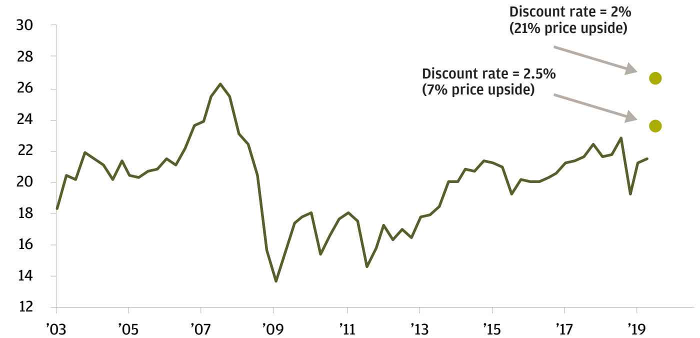
Using a fairly standard equity risk premium (ERP) model, we can back into where the S&P 500 multiple would be if the discount rate were 2.5%, or even 2%, instead of the 3% estimated by the Fed **(Figure 6)**. Remarkably, based on this analysis, we wouldn't be surprised to see the S&P 500 trade 10% to 20% higher than where it is now. It is crucial to note that the output of this model operates in a vacuum, assuming everything else is equal.

THE "SOFT METRIC" IN COMMAND: POLITICAL UNCERTAINTY

Clearly, everything else is not equal right now. The challenge for multiples is that as the discount rate has fallen, economic and

FIGURE 6: LOW INTEREST RATES SUPPORT EQUITY UPSIDE BASED ON DECLINING DISCOUNT RATE

S&P 500 cyclically adjusted price-earnings ratio

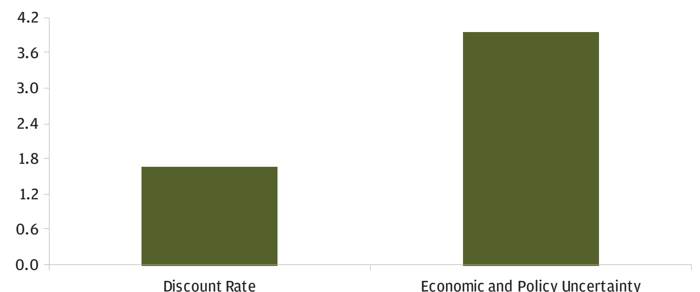


Source: S&P. Data as of Q2 2019. Multiple is price over HP-filtered EPS. Dots show the multiple that shrinks the ERP bac to the 2017/2018 average assuming the discount rate falls to 2.5%–2%.

*Note: We calculate this result by taking an average of the ERP for 2017 and 2018, then examining the widening in the ERP year-to-date. Then we ask, What multiple shrinks the ERP back to its 2017–2018 level, assuming the discount rate falls from 3% to 2.5% or 2%.

FIGURE 7: MACRO UNCERTAINTY HAS A FAR GREATER IMPACT ON MULTIPLES THAN DISCOUNT RATES

%pt impact on PE ratio (1 standard deviation move in absolute value)

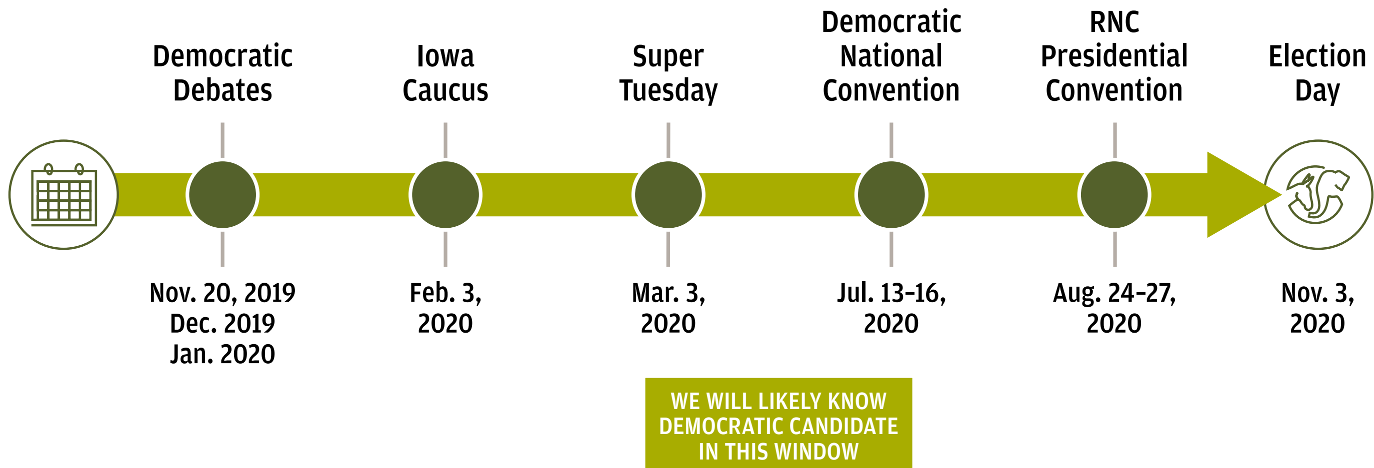


Source: S&P, New York Federal Reserve, Philadelphia Federal Reserve, EPU. Data as of June 30, 2019. Based on regression results shown in the Appendix.

policy uncertainty has risen. Economic and policy uncertainty easily swamp the discount rate in influencing multiples in the short run, according to our multivariate regression analysis. To put numbers to it, a one standard deviation movement in economic and policy uncertainty has more than double the impact on multiples than a one standard deviation movement in discount rates **(Figure 7)**. (For the full regression analysis, see the Appendix.)

The upshot is that multiples likely will not rise definitively until economic and policy uncertainty fall.

FIGURE 8: ELECTION CALENDAR IMPORTANT DATES



To be sure, sentiment about the economy is changeable and economic or recession uncertainty may already be in the process of waning. The global manufacturing backdrop is showing tentative signs of stabilization, and President Trump seems to be easing off the gas pedal in his tariff war with China (at least in the near term, in a likely bid to juice his re-election chances[1]).

Policy uncertainty, however, is likely here to stay. In the tug-of-war between hard and soft data that has whipsawed investors and markets, uncertainty may win out, fueled by the current U.S. campaign cycle. We expect political uncertainty to increase in the first half of 2020 as the Democrats determine who their candidate will be in the 2020 presidential election. Given the magnitude of the economic and tax changes that progressive Democrats are proposing (see here for a deep dive on these potential changes by Michael Cembalest, our Chairman of Market and Investment Strategy), it feels quite unlikely that multiples will expand definitively before Super Tuesday (March 3, 2020). The Super Tuesday timeline shows a handful of other significant moments on the campaign calendar that could easily catalyze new rounds of fear and optimism **(Figure 8)**.[2]

So, we're left with a glass-half-full conclusion for stocks. Making a bullish ERP argument right now is probably too much of a stretch until we see who wins the Democratic primary. At the very least, we can say that equity markets have an attractive discount-rate buffer as the 2020 election calendar gets into full swing. Tactical investors should remain generally defensive, with a focus on alpha over beta, but should look to capitalize on volatility when it ramps up, as it likely will in the coming months.

[1] Looking out longer term, we still see little chance of a comprehensive trade deal between the United States and China. For more commentary on this, please see this article by Alex Wolf, the Head of Investment Strategy for Asia.

[2] That would be consistent with how the 2016 election season played out, from the perspective of interest rates and equity multiples. Then, interest rates fell early in the year amid easy Fed and ECB policies but the general backdrop remained uncertain—with the Brexit vote in June and concerns surrounding Donald Trump as the Republican's presidential candidate. It wasn't until Trump won and appeared to act presidential in his victory speech that multiples broke out.

DEPENDENT VARIABLE: Δ% PE RATIO

Estimated time frame: 1969–present Excluding recessions, includes lagged dependent variable			
Independent Variables	**Coefficients**	**T-Stats**	**P-Values**
Constant	0.87	1.78	0.08
Δ Anxious Index	-1.48	-2.86	0.00
Δ% Policy Uncertainty	-2.47	-4.81	0.00
Δ Discount Rate	-1.65	-3.32	0.00

R-squared = 0.3
Durbin-Watson Statistic = 1.82
All independent variables are normalized

APPENDIX

The above table shows the results from a multivariate regression of the cyclically adjusted S&P 500 price-earnings ratio (current prices divided by HP-filtered EPS) on:

i) the discount rate (proxied by the N.Y. Fed's estimated risk-free neutral 10-year yield),

ii) recession risk (proxied by the Philly Fed's Anxious Index, which surveys the probability of a decline in one quarter ahead real GDP), and

iii) policy uncertainty (proxied by the Economic Policy Uncertainty Index, the news-based version).

The regression also includes, as an explanatory variable, a one-period lagged version of the dependent variable, and excludes recessionary quarters using a dummy variable. Finally, all variables in the equation are expressed as changes (either percent changes or first differences) and the three investigated explanatory variables are normalized to answer the question: A one standard deviation movement influences the multiple by what percent?

As you can see, all variables are highly statistically significant and yield coefficients that have the correct sign. The key insight is that the estimated coefficients for recession risk and policy uncertainty are much bigger in an absolute sense (2.4X) than is the coefficient for the discount rate.

IMPORTANT INFORMATION

Key Risks

This material is for informational purposes only, and may inform you of certain products and services offered by J.P. Morgan's wealth management businesses, part of JPMorgan Chase & Co. ("JPM"). **Please read all Important Information.**

The price of equity securities may rise or fall due to the changes in the broad market or changes in a company's financial condition, sometimes rapidly or unpredictably. Equity securities are subject to "stock market risk" meaning that stock prices in general may decline over short or extended periods of time.

General Risks & Considerations

Any views, strategies or products discussed in this material may not be appropriate for all individuals and are subject to risks. **Investors may get back less than they invested, and past performance is not a reliable indicator of future results.** Asset allocation/diversification does not guarantee a profit or protect against loss. Nothing in this material should be relied upon in isolation for the purpose of making an investment decision. You are urged to consider carefully whether the services, products, asset classes (e.g., equities, fixed income, alternative investments, commodities, etc.) or strategies discussed are suitable to your needs. You must also consider the objectives, risks, charges and expenses associated with an investment service, product or strategy prior to making an investment decision. For this and more complete information, including discussion of your goals/situation, contact your J.P. Morgan representative.

Non-Reliance

Certain information contained in this material is believed to be reliable; however, JPM does not represent or warrant its accuracy, reliability or completeness, or accept any liability for any loss or damage (whether direct or indirect) arising out of the use of all or any part of this material. No representation or warranty should be made with regard to any computations, graphs, tables, diagrams or commentary in this material, which are provided for illustration/reference purposes only. The views, opinions, estimates and strategies expressed in this material constitute our judgment based on current market conditions and are subject to change without notice. JPM assumes no duty to update any information in this material in the event that such information changes. Views, opinions, estimates and strategies expressed herein may differ from those expressed by other areas of JPM, views expressed for other purposes or in other contexts, and **this material should not be regarded as a research report**. Any projected results and risks are based solely on hypothetical examples cited, and actual results and risks will vary depending on specific circumstances. Forward-looking statements should not be considered as guarantees or predictions of future events.

Nothing in this document shall be construed as giving rise to any duty of care owed to, or advisory relationship with, you or any third party. Nothing in this document shall be regarded as an offer, solicitation, recommendation or advice (whether financial, accounting, legal, tax or other) given by J.P. Morgan and/or its officers or employees, irrespective of whether or not such communication was given at your request. J.P. Morgan and its affiliates and employees do not provide tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any financial transactions.

Legal Entity, Brand & Regulatory Information

In the **United States**, bank deposit accounts and related services, such as checking, savings and bank lending, are offered by **JPMorgan Chase Bank, N.A.** Member FDIC.

JPMorgan Chase Bank, N.A. and its affiliates (collectively **"JPMCB"**) offer investment products, which may include bank-managed investment accounts and custody, as part of its trust and fiduciary services. Other investment products and services, such as brokerage and advisory accounts, are offered through **J.P. Morgan Securities LLC ("JPMS")**, a member of FINRA and SIPC. JPMCB and JPMS are affiliated companies under the common control of JPM. Products not available in all states.

In **Luxembourg**, this material is issued by J.P. Morgan Bank Luxembourg S.A. (JPMBL), with registered office at European Bank and Business Centre, 6 route de Treves, L-2633, Senningerberg, Luxembourg. R.C.S Luxembourg B10.958. Authorized and regulated by Commission de Surveillance du Secteur Financier (CSSF) and jointly supervised by the European Central Bank (ECB) and the CSSF. J.P. Morgan Bank Luxembourg S.A. is authorized as a credit institution in accordance with the Law of 5th April 1993. In the **United Kingdom**, this material is issued by J.P. Morgan Bank Luxembourg S.A., London Branch. Prior to Brexit (Brexit meaning that the United Kingdom leaves the European Union under Article 50 of the Treaty on European Union, or, if later, loses its ability to passport financial services between the United Kingdom and the remainder of the EEA), J.P. Morgan Bank Luxembourg S.A., London Branch is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from us on request. In the event of Brexit, in the United Kingdom, J.P. Morgan Bank Luxembourg S.A., London Branch is authorized by the Prudential Regulation Authority, subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. In **Spain**, this material is distributed by J.P. Morgan Bank Luxembourg S.A., Sucursal en España, with registered office at Paseo de la Castellana, 31, 28046 Madrid, Spain. J.P. Morgan Bank Luxembourg S.A., Sucursal en España is registered under number 1516 within the administrative registry of the Bank of Spain and supervised by the Spanish Securities Market Commission (CNMV). In **Germany**, this material is distributed by J.P. Morgan Bank Luxembourg S.A., Frankfurt Branch, registered office at Taunustor 1 (TaunusTurm), 60310 Frankfurt, Germany, jointly supervised by the Commission de Surveillance du Secteur Financier (CSSF) and the European Central Bank (ECB), and in certain areas also supervised by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). In **Italy**, this material is distributed by J.P. Morgan Bank Luxembourg S.A., Milan Branch, registered office at Via Cantena Adalberto 4, Milan 20121, Italy and regulated by Bank of Italy and the Commissione Nazionale per le Società e la Borsa (CONSOB). In addition, this material may be distributed by **JPMorgan Chase Bank, N.A. ("JPMCB"), Paris branch,** which is regulated by the French banking authorities Autorité de Contrôle Prudentiel et de Résolution and Autorité des Marchés Financiers or by **J.P. Morgan (Suisse) S.A.**, which is regulated in Switzerland by the Swiss Financial Market Supervisory Authority (FINMA).

In **Hong Kong**, this material is distributed by **JPMCB, Hong Kong branch**. JPMCB, Hong Kong branch is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission of Hong Kong. In Hong Kong, we will cease to use your personal data for our marketing purposes without charge if you so request. In **Singapore**, this material is distributed by **JPMCB, Singapore branch**. JPMCB, Singapore branch is regulated by the Monetary Authority of Singapore. Dealing and advisory services and discretionary investment management services are provided to you by JPMCB, Hong Kong/Singapore branch (as notified to you). Banking and custody services are provided to you by JPMCB Singapore Branch. The contents of this document have not been reviewed by any regulatory authority in Hong Kong, Singapore or any other jurisdictions. You are advised to exercise caution in relation to this document. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. For materials which constitute product advertisement under the Securities and Futures Act and the Financial Advisers Act, this advertisement has not been reviewed by the Monetary Authority of Singapore. JPMorgan Chase Bank, N.A. is a national banking association chartered under the laws of the United States, and as a body corporate, its shareholder's liability is limited.

With respect to countries in **Latin America**, the distribution of this material may be restricted in certain jurisdictions. We may offer and/or sell to you securities or other financial instruments which may not be registered under, and are not the subject of a public offering under, the securities or other financial regulatory laws of your home country. Such securities or instruments are offered and/or sold to you on a private basis only. Any communication by us to you regarding such securities or instruments, including without limitation the delivery of a prospectus, term sheet or other offering document, is not intended by us as an offer to sell or a solicitation of an offer to buy any securities or instruments in any jurisdiction in which such an offer or a solicitation is unlawful. Furthermore, such securities or instruments may be subject to certain regulatory and/or contractual restrictions on subsequent transfer by you, and you are solely responsible for ascertaining and complying with such restrictions. To the extent this content makes reference to a fund, the Fund may not be publicly offered in any Latin American country, without previous registration of such fund's securities in compliance with the laws of the corresponding jurisdiction. Public offering of any security, including the shares of the Fund, without previous registration at Brazilian Securities and Exchange Commission—CVM is completely prohibited. Some products or services contained in the materials might not be currently provided by the Brazilian and Mexican platforms.

JPMorgan Chase Bank, N.A. (JPMCBNA) (ABN 43 074 112 011/AFS Licence No: 238367) is regulated by the Australian Securities and Investment Commission and the Australian Prudential Regulation Authority. Material provided by JPMCBNA in Australia is to "wholesale clients" only. For the purposes of this paragraph the term "wholesale client" has the meaning given in section 761G of the Corporations Act 2001 (Cth). Please inform us if you are not a Wholesale Client now or if you cease to be a Wholesale Client at any time in the future.

JPMS is a registered foreign company (overseas) (ARBN 109293610) incorporated in Delaware, U.S.A. Under Australian financial services licensing requirements, carrying on a financial services business in Australia requires a financial service provider, such as J.P. Morgan Securities LLC (JPMS), to hold an Australian Financial Services Licence (AFSL), unless an exemption applies. **JPMS is exempt from the requirement to hold an AFSL under the Corporations Act 2001 (Cth) (Act) in respect of financial services it provides to you, and is regulated by the SEC, FINRA and CFTC under U.S. laws, which differ from Australian laws.** Material provided by JPMS in Australia is to "wholesale clients" only. The information provided in this material is not intended to be, and must not be, distributed or passed on, directly or indirectly, to any other class of persons in Australia. For the purposes of this paragraph the term "wholesale client" has the meaning given in section 761G of the Act. Please inform us immediately if you are not a Wholesale Client now or if you cease to be a Wholesale Client at any time in the future.

This material has not been prepared specifically for Australian investors. It:

- May contain references to dollar amounts which are not Australian dollars;
- May contain financial information which is not prepared in accordance with Australian law or practices;
- May not address risks associated with investment in foreign currency denominated investments; and
- Does not address Australian tax issues.

References to "J.P. Morgan" are to JPM, its subsidiaries and affiliates worldwide. "J.P. Morgan Private Bank" is the brand name for the private banking business conducted by JPM.

This material is intended for your personal use and should not be circulated to or used by any other person, or duplicated for non-personal use, without our permission. If you have any questions or no longer wish to receive these communications, please contact your J.P. Morgan representative.

© 2019 JPMorgan Chase & Co. All rights reserved. PROD-19-1100