

# Quarterly Perspectives

U.S. | 3Q 2019

J.P. Morgan Asset Management is pleased to present the latest edition of *Quarterly Perspectives*. This piece explores key themes from our *Guide to the Markets*, providing timely economic and investment insight.

## THIS QUARTER'S THEMES

- 1 U.S. economy: Health risks in old age
- 2 Fixed income: Flexibility in an uncertain environment
- 3 U.S. equities: Adding income amidst uncertainty
- 4 International equities: Navigating choppy waters



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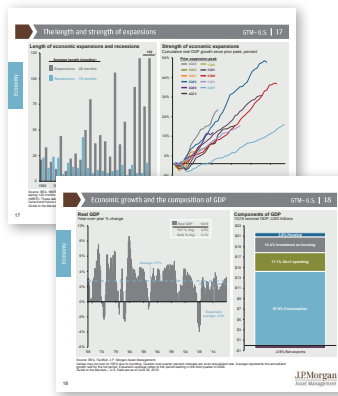
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## U.S. economy: Health risks in old age

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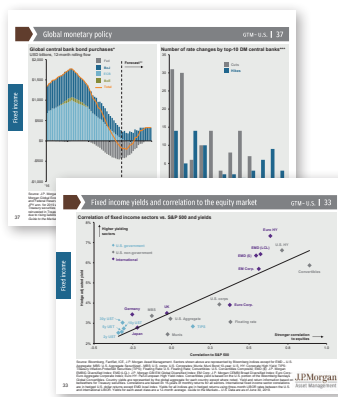


- OVERVIEW
- July will officially mark the current expansion as the longest on record at 11 years, surpassing the 10-year expansion of the '90s.
  - While growth surprised to the upside in the first quarter at 3.2% y/y, recent data on manufacturing, trade, capital investment and consumer activity suggest second-quarter growth may be weaker than expected.
  - Going forward, we still expect growth to decelerate to a more trend-like 2.0% y/y pace by the fourth quarter. However, there are downside risks, given trade tensions continue to cast a cloud of uncertainty.

## Fixed income: Flexibility in an uncertain environment

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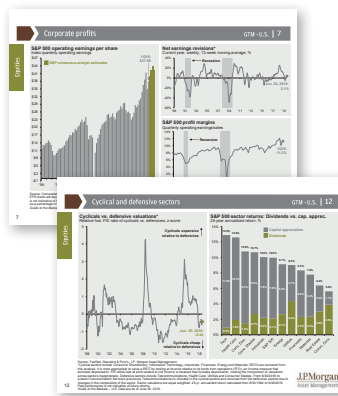


- OVERVIEW
- Global central banks are likely to be accommodative in the face of deteriorating economic data.
  - Given slowing growth and intensifying trade tensions, the Federal Reserve (Fed) may cut rates twice in 2019. Global central banks are broadly mirroring the Fed's caution, carefully taking stock of their respective economies and prospects for growth.
  - Investors prepared for rising rates may consider falling rates once again, and review their fixed income holdings in light of potential monetary policy changes ahead.

## U.S. equities: Adding income amidst uncertainty

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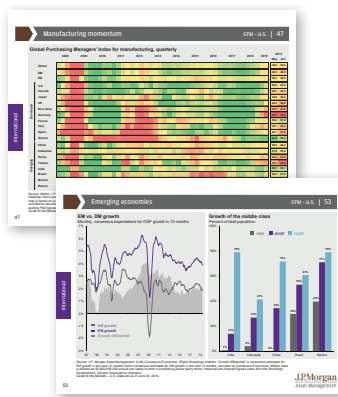


- OVERVIEW
- Renewed trade tensions should lead to continued volatility in equity markets and prevent multiples from expanding.
  - With multiples likely capped, any further appreciation in equity markets will have to be driven by earnings growth, which is likely to be low to mid single digits in 2019 and 2020.
  - Late cycle dynamics combined with elevated geopolitical and policy uncertainty increase the need for investors to dampen volatility by striking a more balanced total return profile between dividends and capital appreciation.

## International equities: Navigating choppy waters

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- OVERVIEW
- In early 2019, sentiment improved, as investors grew more optimistic that global economic growth would soon stabilize. However, this optimism was disrupted by the escalation of trade tensions in May.
  - In the medium term, the most likely path seems one in which lingering trade uncertainty continues to dampen global business and investor sentiment.
  - Nonetheless, international equities, particularly emerging markets, continue to deserve a place in portfolios.

# 1 U.S. economy: Health risks in old age

## GETTING TO SLOWER, FASTER

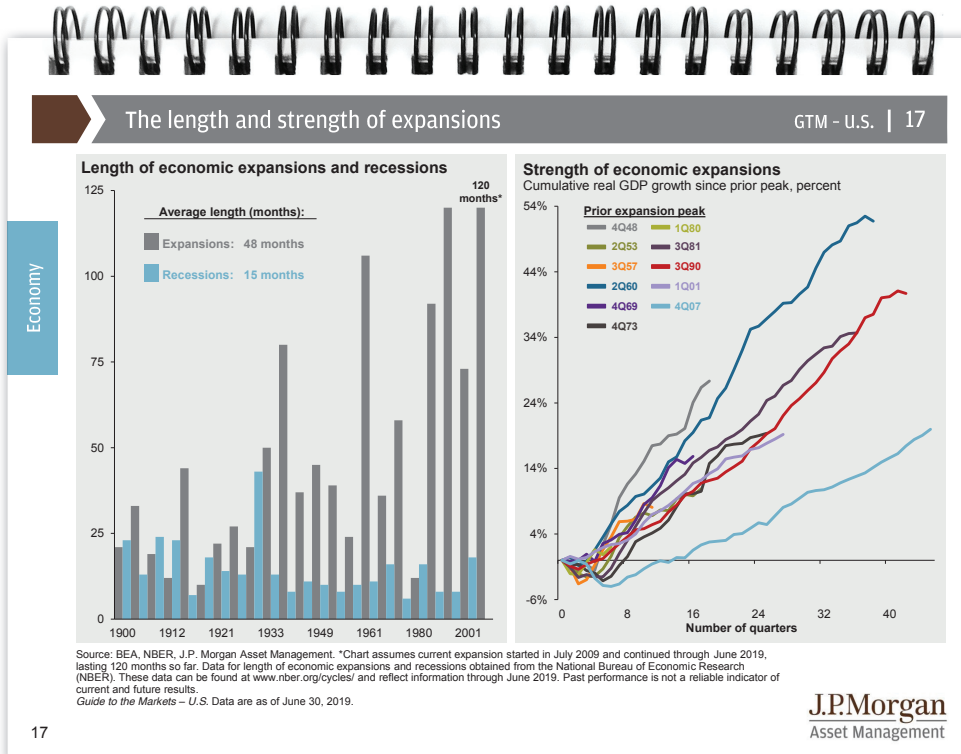
The U.S. economic expansion reaching its 11th year is an impressive feat. While expansions don't die of old age, we'd argue they can't last forever. The current expansion, in our view, has the potential to continue, but growth will decelerate from the current above-trend pace experienced through 2018.

The U.S. economy should slow to a 2.0% pace by the end of this year, and due to rising trade tensions, could slow as soon as the third quarter. Importantly, investors should remember that slower growth does not mean recession.

- The current expansion has been the slowest in the post-WWII era, and has occurred following the deepest recession over that same time period. This dynamic can be ascribed, in part, to slowing labor force and productivity growth.
- The acceleration of growth in 2018 through the first quarter of this year will start to fade, with growth moderating to slightly below trend of 1.5%-2.0%. This is primarily due to fading fiscal stimulus, the absorption of remaining labor market slack and continued relatively muted capital investment. However, with still tepid inflation and more dovish monetary policy, the expansion can continue to muddle along for longer than might be expected.

### OVERVIEW

- July will officially mark the current expansion as the longest on record at 11 years, surpassing the 10-year expansion of the '90s.
- While growth surprised to the upside in the first quarter at 3.2% y/y, recent data on manufacturing, trade, capital investment and consumer activity suggest second-quarter growth may be weaker than expected.
- Going forward, we still expect growth to decelerate to a more trend-like 2.0% y/y pace by the fourth quarter. However, there are downside risks, given trade tensions continue to cast a cloud of uncertainty.



The current expansion has now surpassed the expansion of the 1990s and is the longest economic expansion on record.

The relative weakness of this expansion compared to past expansions suggests the next recession should be milder.

Source: Guide to the Markets - U.S. 3Q 2019, page 17

SYMPTOMS OF OLD AGE

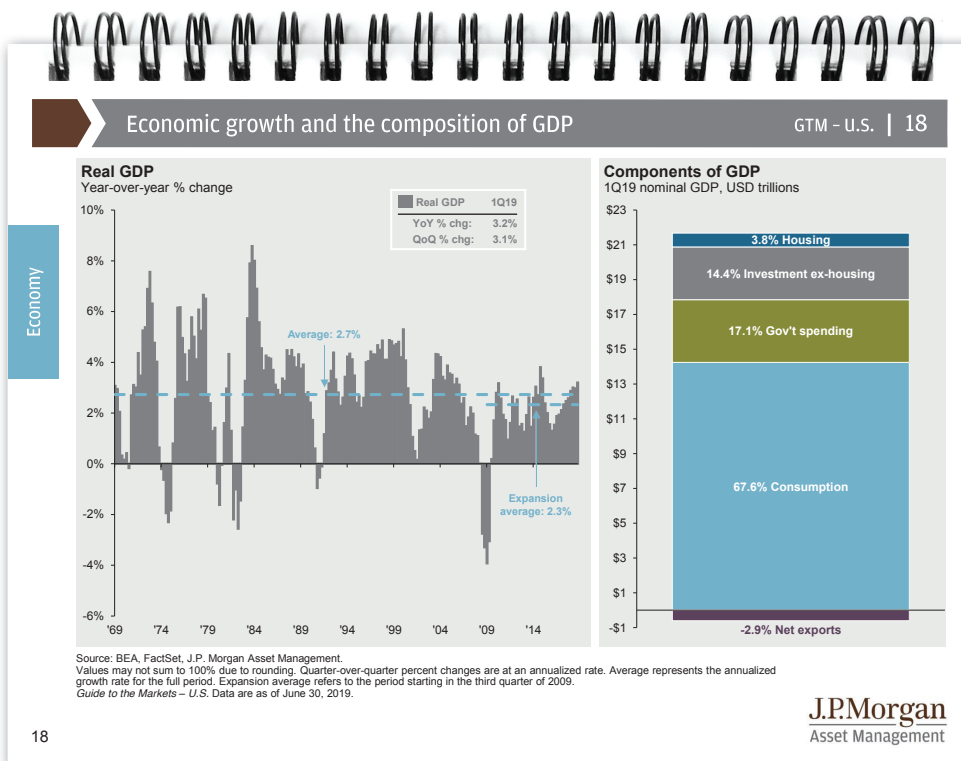
As the human body ages, it becomes more susceptible to health issues and any illness contracted will tend to be more damaging because of this. The U.S. economy can be viewed in a similar way. As we enter into the 11th year of this economic expansion, and the pace of economic growth naturally slows, any ailment has the potential to knock things off course.

The prevailing sickness for the U.S. has been trade tensions. Last year, data suggested these tensions were not particularly damaging to the U.S. economy due to fiscal stimulus, low inflation and some additional slack in the labor market, which helped offset any negative effects. However, this sickness is showing signs of worsening. The symptoms by way of higher inflation, declining capital investment and a worsening trade deficit could cause the economy to dip into recession.

- The 3.1% q/q GDP gain registered for the first quarter was much stronger than expected. However, much of the growth was due to gains in the volatile inventory and international trade categories.
- Trade and inventory gains are very likely to be reversed in the second quarter, as businesses were likely front-running expected increases in tariffs last quarter.
- Moreover, in April, real consumer spending was flat, the trade balance in goods worsened as both imports and exports fell, new durable goods orders fell sharply and, more recently, the May flash U.S. manufacturing PMI slipped to 50.5.

INVESTMENT IMPLICATIONS

- While trade tensions, in our view, have become the biggest threat to the U.S. economy, low interest rates throughout the developed world and a lack of excess in cyclical economic sectors will likely cause the U.S. to settle back into an uninspiring but still steady 1.5%-2.0% growth pace.
- While slowing growth means another surge in the stock market is unlikely, moderate valuations, moderate earnings growth and low interest rates are enough to prevent a further sharp decline in markets. Investors should gradually move into “wait-and-see” mode in front of the next U.S. election, which could result in a change in trade policy.



While the consumer is the largest component of GDP, trade tensions can curtail consumption through higher prices, further hurting economic growth prospects.

The looming threat of tariffs and potential tariffs makes it very difficult for firms to plan, therefore hurting investment spending.

Source: Guide to the Markets - U.S. 3Q 2019, page 18

## 2 Fixed income: Flexibility in an uncertain environment

### GLOBAL CENTRAL BANKS ARE LIKELY TO BE ACCOMMODATIVE IN THE FACE OF DETERIORATING ECONOMIC DATA

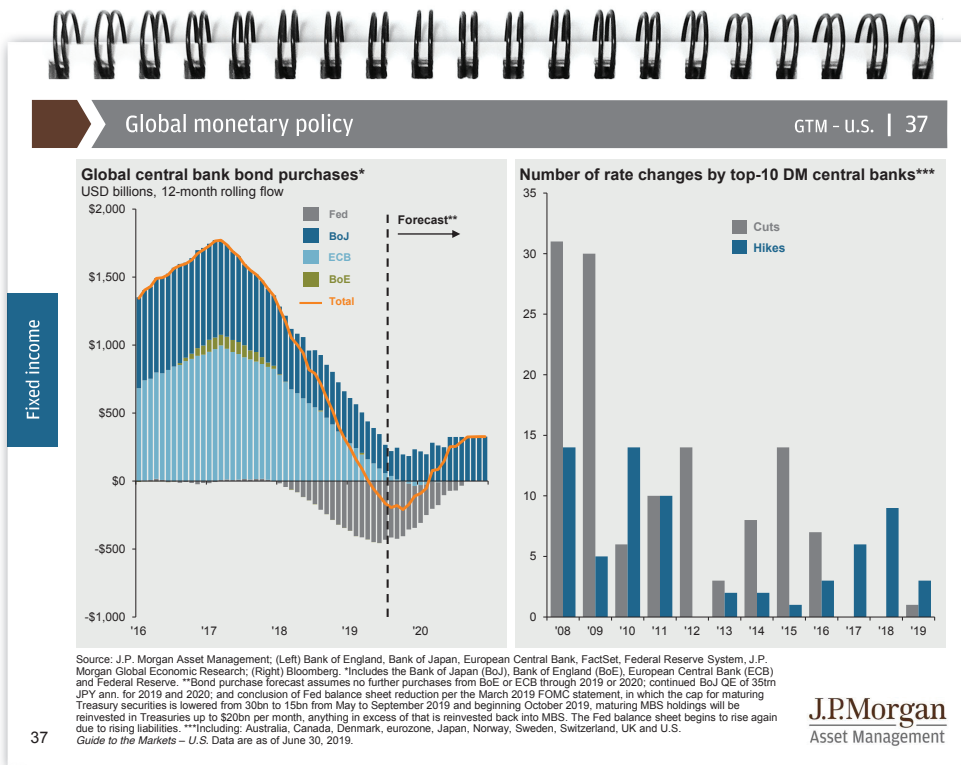
Globally, most major central banks are now trending toward more accommodative monetary policy after a pause in tightening this year due to slowing economic growth across the world.

Investors, who have grown accustomed to rising rates over the last few years, should review duration and sector exposure, and plan to be nimble as potential easing may be on the horizon.

- The Federal Reserve (Fed) may be poised for multiple rate cuts this year, as it vows to “act as appropriate to sustain the expansion.” Balance sheet normalization will still conclude by September.
- In the developed international markets, the European Central Bank introduced new stimulative measures earlier this year, slightly reversing course after it ended its bond-buying program last year; meanwhile the Bank of Japan maintains easy monetary policy.
- In emerging markets, the People’s Bank of China implemented easing measures so far this year, which it is likely to continue in the months ahead, depending on economic conditions.

#### OVERVIEW

- Global central banks are likely to be accommodative in the face of deteriorating economic data.
- Given slowing growth and intensifying trade tensions, the Federal Reserve (Fed) may cut rates twice in 2019. Global central banks are broadly mirroring the Fed’s caution, carefully taking stock of their respective economies and prospects for growth.
- Investors prepared for rising rates may consider falling rates once again, and review their fixed income holdings in light of potential monetary policy changes ahead.



The Fed now appears to be poised for two rate cuts this year.

This could bring a halt to global monetary policy normalization.

Across developed markets, top central banks have only hiked, not cut, rates since 2017. However, the pace of hikes has slowed, and cuts may yet again be on the horizon.

Source: Guide to the Markets - U.S. 3Q 2019, page 37

KNOW WHAT YOU OWN

Yields have risen over the past few years, and the economy has entered into the later stages of its expansion. It is important that investors fully understand their fixed income allocations, and strike a balance between seeking yield and being opportunistic about attractive pockets in the market, but also preparing their portfolios for a future downturn.

Reviewing duration and sector exposure, assessing overall fixed income positioning and diversifying is critical.

- Government bond yields still remain at historic lows, which means investors have had to get creative about finding yield. Sometimes that has led them to uncharted territory.
- In light of this, investors should fully understand the characteristics of the fixed income investments they own, and how they are likely to perform in different environments. Higher yield often means higher risk, so it is important to balance attractive opportunities with core holdings.
- Often higher yielding sectors are also more highly correlated to equities, so investors would be wise to ensure they are not only diversified within fixed income, but also across all asset classes.

INVESTMENT IMPLICATIONS

- Navigating the difficult combination of rising interest rates and a relatively low yield environment has been challenging for investors, but now a potential monetary easing adds greater uncertainty to the mix.
- In this environment, high-quality fixed income still provides critical ballast to a well-diversified portfolio, but investors should look to dial back on some of the riskier sectors.

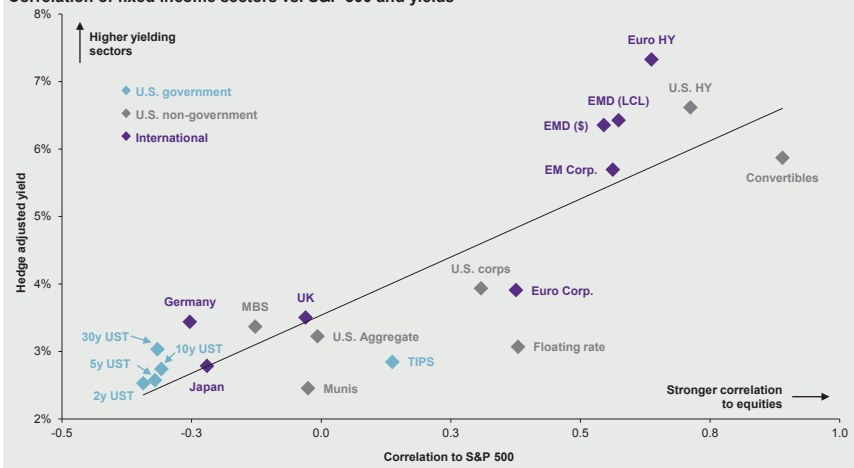


Fixed income yields and correlation to the equity market

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Correlation of fixed income sectors vs. S&P 500 and yields

Fixed income



Source: Bloomberg, FactSet, ICE, J.P. Morgan Asset Management. Sectors shown above are represented by Bloomberg indices except for EMD - U.S. Aggregate, MBS: U.S. Aggregate Securitized - MBS; U.S. corps: U.S. Corporates; Munis: Muni Bond 10-year; U.S. HY: Corporate High Yield; TIPS: Treasury Inflation-Protected Securities (TIPS); Floating Rate: U.S. Floating Rate; Convertibles: U.S. Convertibles Composite; EMD (\$): J.P. Morgan EMBIG Diversified Index; EMD (LCL): J.P. Morgan GBI EM Global Diversified Index; EM Corp: J.P. Morgan CEMBI Broad Diversified Index; Euro Corp.: Euro Aggregate Corporate Index; Euro HY: Pan-European High Yield index. Convertibles yield is based on the U.S. portion of the Bloomberg Barclays Global Convertibles. Country yields are represented by the global aggregate for each country except where noted. Yield and return information based on bellwethers for Treasury securities. Correlations are based on 15-years of monthly returns for all sectors. International fixed income sector correlations are in hedged U.S. dollar returns except EMD local index. Yields for all indices are in hedged returns using three-month LIBOR rates between the U.S. and international LIBOR. Yields for each asset class are a 12-month average. Guide to the Markets - U.S. Data are as of June 30, 2019.

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After years in a low rate environment, investors hunted for yield in potentially unfamiliar territory.

Investors should know what they own: often higher yield means higher risk, and greater correlation to equities. Investors may want to ensure proper fixed income diversification in the context of their overall portfolios.

Source: Guide to the Markets - U.S. 3Q 2019, page 33

### 3 U.S. equities: Adding income amidst uncertainty

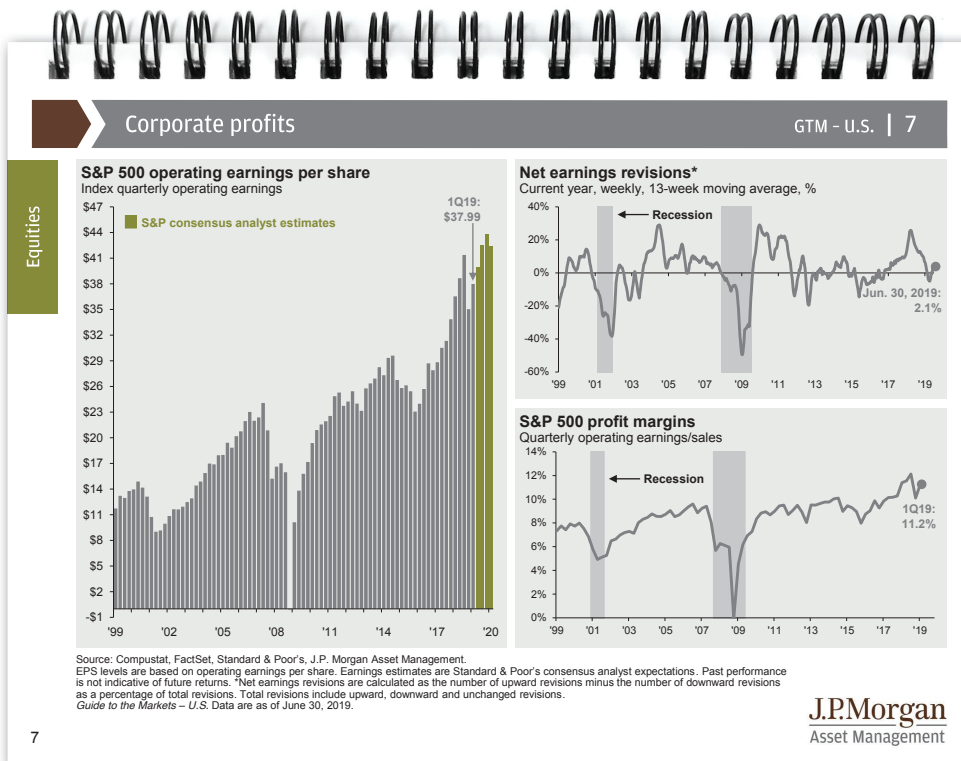
#### POSITIVE GROWTH, BUT PLENTY OF DOWNSIDE RISKS

Despite initial estimates calling for a contraction, the 1Q19 earnings season was better than feared with first quarter operating earnings rising 4.4% from a year prior. From a sector standpoint, strong growth was seen in the financials and health care sectors, while most other sectors saw profits contract on a year-over-year basis. Overall, we continue to expect that full-year 2019 operating profits should grow at around 3%-5%.

- Margins bounced back in 1Q19 to 11.3% after a sharp decline in 4Q18, and while there may be some downward pressure on margins from higher wages and input costs, the larger downside risk to earnings stems from escalating trade tensions.
- Looking ahead, 2020 estimates, at roughly 11% y/y, are likely still too high and should see downward revisions as the year progresses. We expect 2020 earnings growth to be a similar 4%-6% y/y absent of any further trade escalations.
- 2019 and 2020 estimates have likely already incorporated all of the currently imposed tariffs, but any further increase in tariffs could cause either margins or demand to come under pressure, which could cut our current EPS growth estimates in half.

#### OVERVIEW

- Renewed trade tensions should lead to continued volatility in equity markets and prevent multiples from expanding.
- With multiples likely capped, any further appreciation in equity markets will have to be driven by earnings growth, which is likely to be low to mid single digits in 2019 and 2020.
- Late cycle dynamics combined with elevated geopolitical and policy uncertainty increase the need for investors to dampen volatility by striking a more balanced total return profile between dividends and capital appreciation.



Trade uncertainty has likely left multiples range bound, so any further capital appreciation in equities will need to come from earnings growth.

Downside risks to earnings are more balanced between margins and sales and depend on whether companies absorb higher tariff costs or pass them on to consumers.

Despite downside risks, earnings should remain in positive territory in 2019 and 2020, providing support for the equity market.

Source: Guide to the Markets - U.S. 3Q 2019, page 7

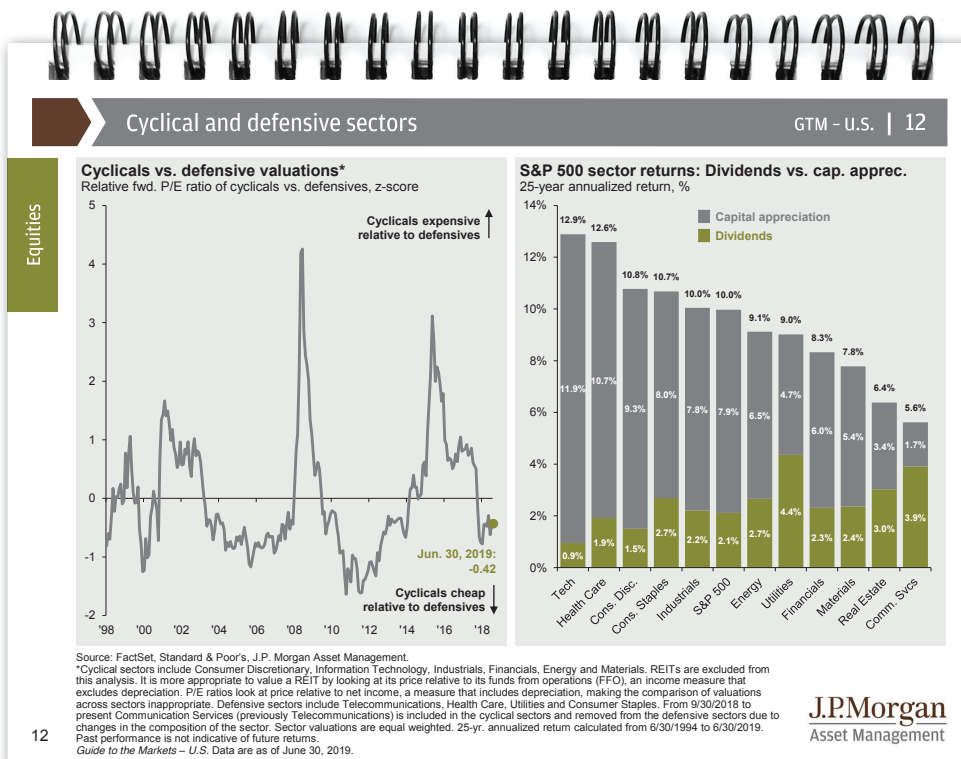
EQUITY INCOME IN AN UNCERTAIN WORLD

Equity markets became increasingly volatile in the second quarter as trade uncertainty came roaring back. Additionally, uncertainty surrounding the trajectory of Federal Reserve (Fed) policy has also weighed on markets. While the fixed income markets are already pricing in multiple rate cuts this year, the Fed has only hinted that it would be open to rate cuts in 2019 and remain data-dependent. This dynamic has led to “risk-off” moves for investors from equity to fixed income, with yields on the 10-yr. Treasury reaching the lows seen in 2017.

- While the U.S. economy should continue to grow positively, risks to the outlook are beginning to build. For investors, this means taking some chips off the table in some of the sectors that rely primarily on capital appreciation for their returns.
- Lower rates have caused defensives to remain overvalued when compared to their cyclical peers. This suggests that it may be premature to rotate into a fully defensive equity allocation.
- Striking a better balance between income and capital appreciation allows investors to buffer volatility on the downside, yet still participate on the upside. We prefer a tilt toward the financials, energy and real estate sectors.

INVESTMENT IMPLICATIONS

- The current policy and economic environment leads us to prefer cyclical and value-oriented equities, but we remain selective across sectors within these areas.
- With risks beginning to brew and volatility here to stay, investors should strike a balance between returns from income and capital appreciation in their equity allocation, allowing them to play both offense and defense.
- Slower economic and profit growth, combined with continued geopolitical and policy uncertainty, will require a more tactical approach in equities.



With risks beginning to build, investors should look to equity income.

Outright defensive positioning is not yet warranted as cyclical sector valuations look attractive when compared to their defensive peers.

Sectors that provide a good mix of capital appreciation and income offer a cushion during volatility, while also participating in the upside when markets rise.

Source: Guide to the Markets - U.S. 3Q 2019, page 12

## 4 International equities: Navigating choppy waters

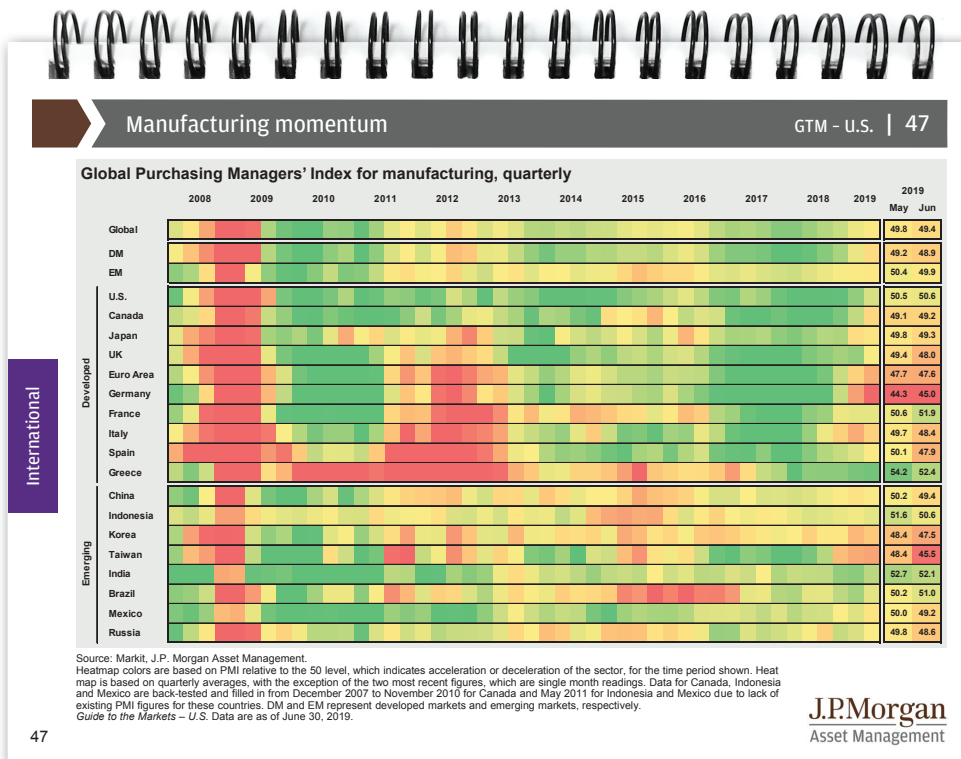
### DO DARK CLOUDS MEAN A DELUGE?

Global risk assets saw strong gains in the first four months of 2019, driven by: 1) the Fed pause, 2) a cease-fire in trade tensions between the U.S. and China and 3) early signs of stabilization in the Chinese economy. However, trade tensions heated up once again in May, dashing investor optimism.

- There are now indications that we are closer to a “deluge” scenario, in which the U.S. follows through on its plans for tariffs on the remainder of Chinese imports, on all Mexican imports and/or on auto imports. In this scenario, global growth would not only slow but also possibly stall.
- That said, the more likely scenario is one in which the dark cloud of trade uncertainty lingers. In this path, we avoid further tariffs but current ones and threats remain. This would continue to weigh on business confidence, depressing business investment and resulting in lower but still positive global growth.
- The trade uncertainty scenario has already been showing its negative effects on global economic data, especially in Europe and Asia. The May global manufacturing PMI fell into contraction territory at 48.9, the lowest level since October 2012. Recent events show that we have moved further away from the “synchronized global growth” period of 2017 and that global economic stabilization may take a bit longer to arrive.

### OVERVIEW

- In early 2019, sentiment improved, as investors grew more optimistic that global economic growth would soon stabilize. However, this optimism was disrupted by the escalation of trade tensions in May.
- In the medium term, there are three likely paths: 1) a sunshine one in which trade deals are signed, and tariffs and threats disappear, 2) a dark cloud one in which trade uncertainty lingers, with ongoing negotiations and tariff threats and 3) a trade “deluge” one in which tariffs are further increased.
- The middle path seems the most likely, one in which lingering trade uncertainty continues to dampen business and investor sentiment. Nonetheless, international equities, particularly emerging markets, continue to deserve a place in portfolios.



The manufacturing PMI heatmap is looking less and less green, as trade uncertainty clouds linger and continue to weigh on business confidence.

This signals a downshift in global economic growth, particularly in export-heavy countries in Europe and Asia.

Source: Guide to the Markets - U.S. 3Q 2019, page 47

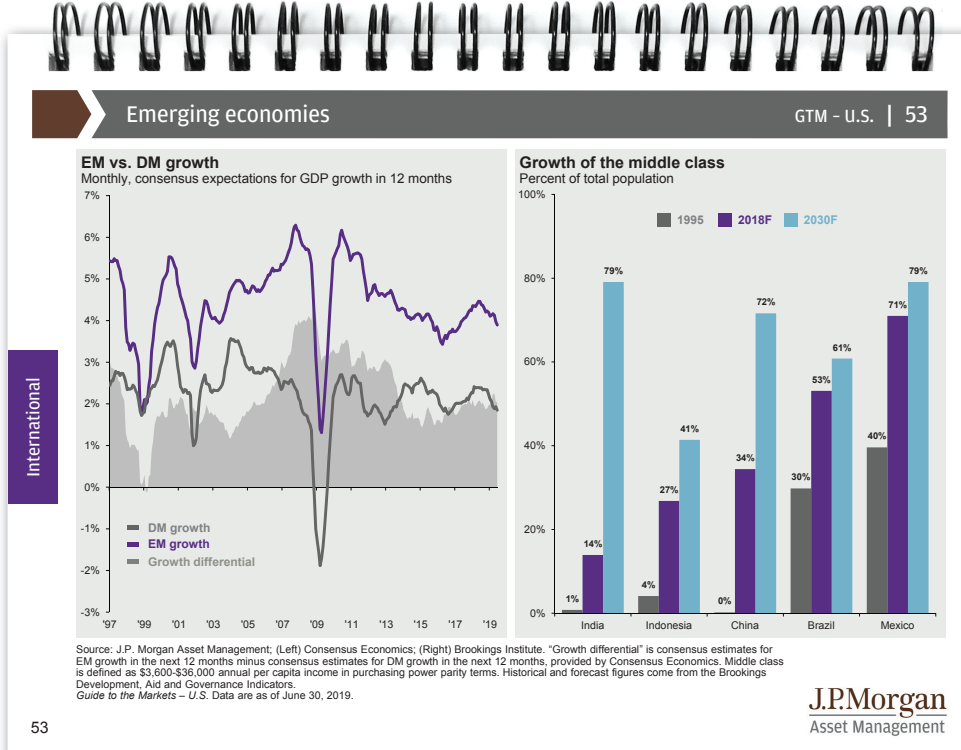
KEEPING AN EYE ON THE HORIZON

Under the lingering trade uncertainty cloud scenario, the upside for international equities would be limited in the short term and emerging markets (EM), in particular, would continue to struggle. However, now is not the time to abandon ship. Instead, investors should keep an eye on the horizon by taking a targeted and defensive approach in the short term, while not losing sight of the long-term potential for international investing.

- In the middle path scenario, trade uncertainty would weigh not only on business confidence but also on investor confidence, keeping equity multiples capped and volatility higher. In this context, investors should focus more on income-producing sectors and less on cyclical sectors, which are exposed to the global economy and trade.
- However, investors should look beyond the short-term effects of trade uncertainty. Emerging markets continue to offer prospects for higher long-term economic and earnings growth driven by its rapidly expanding middle class. Moreover, EM equities have the added support of below-average valuations and potential currency appreciation versus the U.S. dollar over the next few years.
- Overall, current trade concerns do not change the long-term path for international growth. In fact, greater volatility makes risky assets more attractively priced. This could offer investors the opportunity to accumulate a more representative allocation to international equities, especially emerging markets.

INVESTMENT IMPLICATIONS

- Given the likelihood that trade uncertainty lingers for the remainder of 2019, we expect economic and earnings growth to remain below average, multiples to be capped and volatility to persist.
- When investing in international equities, investors should take a targeted and defensive approach in the short term while not abandoning the long-term growth story, especially related to the rise of the middle class in emerging markets.
- In this context, it will be crucial to resist the urge to jump ship when the water stays choppy. To avoid seasickness, the best thing to do is to keep an eye on the horizon.



Higher EM economic growth should translate into faster earnings growth and higher returns over the long term.

The emerging market middle class should continue to surge over the next decade, serving as one of the main growth drivers and opportunities within the asset class.

Source: Guide to the Markets - U.S. 3Q 2019, page 53

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