

# The investment outlook for 2018

A difficult place to start - investing in 2018 and beyond



## IN BRIEF

- The levels of key economic variables look very good. The more troubling question centers on rates of growth from here.
- As monetary policy is normalized around the developed world, yields should move gradually higher, pointing to the need for flexibility in fixed income investing.
- Equity market performance in the coming year should hinge on three variables: earnings, inflation and interest rates. Earnings are a function of economic growth, and we expect that the healthy pace of economic growth seen in the second half of 2017 can continue into next year.
- We expect global economic momentum to continue in 2018, which, combined with still low levels of inflation in the developed world and a gradual normalization of monetary policy, is a positive backdrop for international equities to continue outperforming those in the U.S. in the year ahead.
- Heading into 2018, it is important to remember some time-tested principles for successful long-term investing: cash isn't always king, diversification is essential, harness the power of compounding and don't let volatility derail you.

## A DIFFICULT STARTING POINT

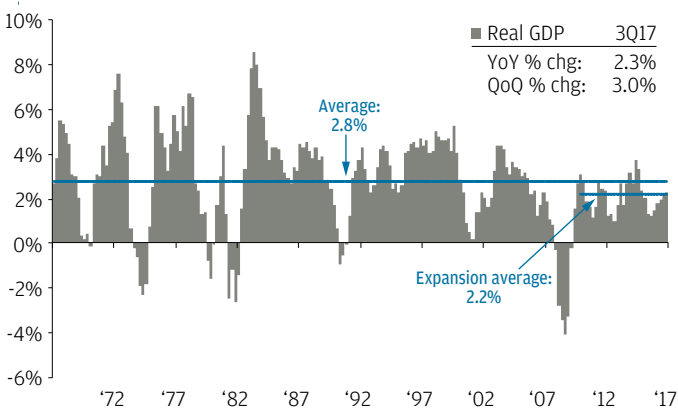
Many years ago, I remember seeing a TV commercial promoting a well-known brand of Irish beer. A man with a thick Spanish accent walks into a pub and asks the assembled Dubliners if they could please tell him the way to Ail-ez-bury Road (which local viewers would have recognized as the location of the Spanish embassy).

Now Irish people will always offer directions, whether they know the way or not, because it is just friendly to offer advice, and so a variety of unlikely routes are loudly suggested to the tourist. One suggests that he start by heading north up O’Connell Street. Another proposes that he commence his journey by heading west along the canal. After a cacophony of confusion, a wiser punter gives him a brimming pint of beer and says: “To tell you the truth, I wouldn’t start from here.” And so he settles into the pub for the night.

Entering 2018, most American investors should feel richly rewarded by a long economic expansion and extended bull markets in equities and bonds. However, looking forward, they should also recognize that this is not a great starting point and that the very length and strength of the bull markets to this point will limit returns going forward. This makes choosing portfolio overweights and underweights even more important and makes it critical that investors control their enthusiasm for the most expensive assets.

### Economic growth could pick up in the short run

EXHIBIT 1: REAL GDP YEAR-OVER-YEAR % CHANGE



Source: BEA, FactSet, J.P. Morgan Asset Management.

Average represents the annualized growth rate for the full period. Expansion average refers to the period starting in the second quarter of 2009. *Guide to the Markets – U.S.* Data are as of November 15, 2017.

As seen in **Exhibit 1**, the U.S. economic expansion, which has provided just 2.2% growth per year since its inception in 2009, appeared to pick up its pace in the middle of 2017 as falling unemployment boosted both consumer and business confidence. Real GDP grew by roughly 3% annualized in both the second and third quarters of 2017 and may be rising at a similar pace in the fourth quarter, as repairing, restoring and replacing after a tough hurricane season have added to demand.

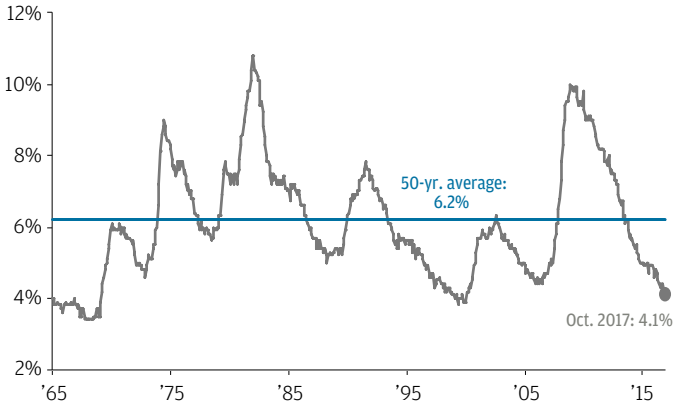
Our base case scenario is that this above-trend pace of growth will continue into the first half of 2018 as lower income tax withholding and corporate tax cuts promote increased consumer and investment spending. However, it should be noted that an extended delay in passing a tax act might be more harmful than having no tax reform at all, since uncertainty about the nature of tax cuts could cause companies to delay investments until they receive more clarity.

More importantly, either way, economic growth will likely slow down to a 2% or slower pace later in 2018 and beyond. The reason for this can be found in the jobs market.

As this is being written, the U.S. unemployment rate has fallen from a peak of 10.0% in October 2009 to 4.1% today (**Exhibit 2**, next page). However, this decline in the unemployment rate has been accelerated by very slow 0.5% annual growth in the labor force. This, in turn, largely reflects a wave of workers retiring, a trend that started in earnest in 2012 as the first baby boomers turned 65. An “Indian summer” of economic growth in 2017 and early 2018 may well push the unemployment rate down to 3.5% by late next year. However, it is unlikely to go much lower than that given the everyday friction and churning that occurs in the jobs market. At that point, and barring a surge in immigration, the U.S. economy will have to get by with roughly 0.5% annual employment growth per year. Moreover, a lack of investment spending in recent years has meant that output per worker has grown by just 0.9% per year over the past decade (**Exhibit 3**, next page).

**...but with unemployment near 50-year lows**

**EXHIBIT 2: CIVILIAN UNEMPLOYMENT RATE, SEASONALLY ADJUSTED, PERCENT**

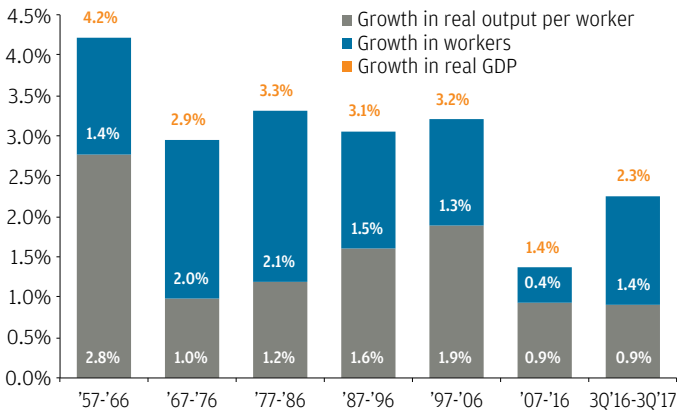


Source: BLS, FactSet, J.P. Morgan Asset Management. *Guide to the Markets - U.S.* Data are as of November 15, 2017.

Adding the pieces together suggests that, barring major structural change, the U.S. will not be able to sustain growth above 2%, never mind 3%, in the years ahead. However, we believe that a slower expansion with slightly higher inflation could be sustained for a few more years to come, making this the longest expansion in U.S. history.

**...the economy is supply-side constrained**

**EXHIBIT 3: DRIVERS OF GDP GROWTH, AVERAGE YEAR-OVER-YEAR PERCENT CHANGE**



Source: BEA, BLS, FactSet, J.P. Morgan Asset Management. GDP drivers are calculated as the average annualized growth between 4Q of the first and last year, excepting the most recent period. *Guide to the Markets - U.S.* Data are as of November 15, 2017.

The profit picture, in late 2017, also looks good, with S&P 500 operating earnings posting a nearly 10% year-over-year gain for the third quarter. It should be noted that this strong year-over-year gain is largely being driven by a revival in energy company profits and a year-over-year decline in the dollar, which has boosted overseas revenues. Earnings should continue to look strong in the first half of 2018 but then, like economic growth itself, earnings could come under pressure from low top-line revenue growth and the higher interest rates and wage costs that could accompany an economy operating at the peak of its capacity.

It should also be recognized that the corporate tax cut currently being debated by Congress would help boost earnings going forward. As this is being written, the final form of such a bill is very much in doubt. However, we know that, to gain passage in the Senate, the total tax cuts for both households and businesses cannot exceed \$1.5 trillion over 10 years, or an average of \$150 billion per year. If we assume that S&P 500 companies get \$60 billion of this, the tax cut would amount to roughly 5% of projected S&P 500 company profits for the next 12 months. Even this is probably an overestimate of the net benefit to corporate profits since the tax cut would be financed through deficit spending and so would have to be paid for by either higher taxes or lower government spending in some future years. In addition, the higher interest rates and wage costs that fiscal stimulus might generate could also eat into profits. Corporate profit growth, like economic growth, could fall back later in 2018 following a few quarters of excellent gains.

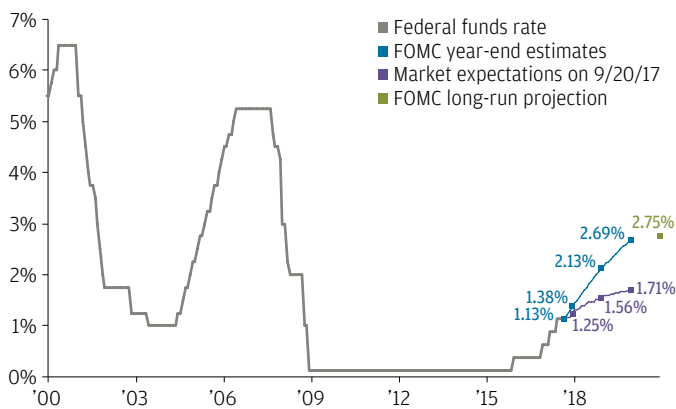
One of the great puzzles of the economic expansion throughout the developed world has been the low level of consumer inflation. In a highly competitive global economy, both wages and consumer prices have not responded to continuous infusions of central bank liquidity. In general, we expect this pattern to continue in the year ahead with the Fed's preferred inflation measure, the personal consumption deflator, only rising from 1.6% year-over-year growth in October 2017 to about 2.0% year-over-year by the end of 2018. However, we believe that excess liquidity could continue to push a wide range of asset prices higher, boosting consumer wealth but also raising the specter of asset bubbles.

The global economy should maintain strong growth into 2018. Europe has seen solid improvement over the past year, despite tensions from Brexit and in Catalonia and, with 8.9% unemployment, clearly still has plenty of capacity for above-trend growth. Japan has also had a good year and a lower yen could help maintain economic momentum even though inflation is slow to respond to very low unemployment. China will emphasize the quality of growth rather than its pace in the years ahead but there seems little reason to fear an abrupt slowdown. And other emerging markets should continue to improve following the commodity slump of 2015/2016, with a reform agenda in many countries holding out hope for more stable growth going forward. Importantly, although global central banks will generally be tightening in 2018, these are the very early days of a tightening cycle when economic effects of increases in interest rates tend to be mildest for developed countries and emerging markets alike.

For the Federal Reserve, the economy of 2018 should provide ample justification for further tightening (**Exhibit 4**). Very low unemployment, slowly rising inflation, faster-rising asset prices, a weaker dollar, strong overseas growth and domestic fiscal stimulus all suggest that monetary policy remains too loose. The Fed has already laid out a clear plan for the reduction of its balance sheet and, barring a recession, we expect this plan to be implemented. In addition, presuming Jerome Powell is confirmed as Fed chair, he may be more likely to follow the balance of opinion on the FOMC with regard to tightening, a consensus that may be more hawkish than in 2017, given a turnover in personnel at the Fed.

**...suggesting higher interest rates and slower growth later in 2018**

**EXHIBIT 4: FOMC AND MARKET EXPECTATIONS FOR THE FED FUNDS RATE**



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management. Market expectations are the federal funds rate priced into the fed futures market as of the date of the September 2017 FOMC meeting. *Guide to the Markets - U.S.* Data are as of November 15, 2017.

All of this presents an interesting economic backdrop for investors. In the ninth year of economic expansion, the economy is in a good place with regard to the levels: high economic activity, low unemployment, high levels of profits and low levels of inflation and interest rates. However, the direction of change in many of these variables looks less positive, particularly later in 2018 and 2019, even if the economy avoids shocks. This is why, in 2018, a more thoughtful approach to investment strategy is essential.

– Dr. David Kelly, CFA

**FIXED INCOME: PREPARING FOR MONETARY POLICY NORMALIZATION**

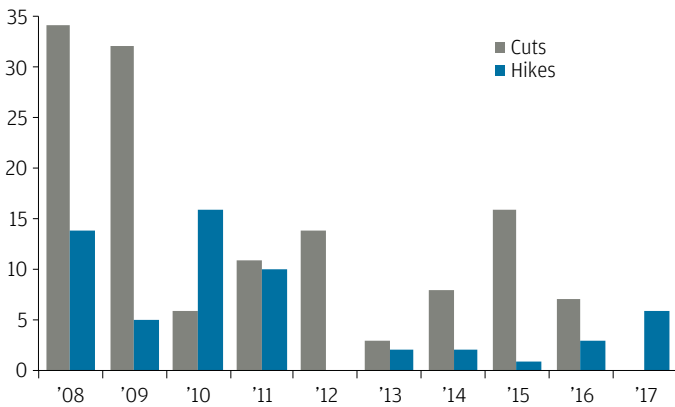
2017 has been characterized by strong growth around the world. A faster-moving economy is no doubt a good thing for investors’ portfolios, helping to boost earnings, lift sentiment and move risk assets higher. However, faster economic growth also presents a challenge to global central bankers and fixed income investors.

In many ways the global economy has been like a sick patient in a hospital. Upon admission, doctors, in the form of central bankers, have pumped the patient full of monetary policy medicine. With the patient now looking healthier, the doctors must change their approach and wean the patient off of the medicine. As anyone who has given up sugar or coffee will know, breaking an addiction doesn’t come without its side effects. With central banks hiking interest rates, reducing asset purchase programs and shrinking balance sheets, there will be some negative withdrawal effects around the world over the next 12 months, particularly in fixed income markets.

However, central bankers are not going to make financial markets go “cold turkey” by withdrawing monetary policy stimulus all at once. Assuming inflation remains relatively subdued, it is likely to be a long and gradual journey back toward a more normal approach to monetary policy. **Exhibit 5** on the next page shows the number of rate hikes and rate cuts done by the top-10 developed market (DM) central banks since 2008. Notably, in 2017, none of the major DM central banks cut rates for the first time since the global financial crisis; instead, they have seven hikes among them, with an additional potential hike from the Federal Reserve in December 2017. Beyond interest rate hikes, asset purchase programs by two major central banks – the European Central Bank (ECB) and the Bank of Japan (BoJ) – are also set to slow in 2018.

**2017 has seen a number of central banks raise rates, a trend that should continue in 2018**

EXHIBIT 5: NUMBER OF RATE CHANGES BY TOP-10 DM CENTRAL BANKS\*



Source: Bank of Canada, Bank of England, Bank of Japan, Bank of Norway, Bloomberg, Central Bank of Sweden, European Central Bank, FactSet, Federal Reserve System, National Bank of Denmark, Reserve Bank of Australia, Swiss National Bank, J.P. Morgan Asset Management. \*Includes: Australia, Canada, Denmark, eurozone, Japan, Norway, Sweden, Switzerland, UK, U.S. Data are as of October 31, 2017.

As the rest of the world begins to normalize policy in 2018, the U.S. Federal Reserve (Fed) will already be well along its way, having been the first mover in both interest rate hikes and balance sheet reduction. We believe the Fed will continue to be relatively aggressive, raising interest rates three times in 2018 beyond the likely hike in December 2017. The Fed's balance sheet reduction program, kick-started in late 2017, will likely ramp up over the course of the next 12 months, which should see the balance sheet contract by about \$400bn by the end of 2018. As monetary policy is normalized around the developed world, bond prices should fall and yields should move gradually higher.

As we enter this unprecedented period of monetary policy normalization, it is important to ask: how should fixed income investors be positioning their portfolios? First, U.S. investors should expect a little less from their core fixed income holdings. Since 1990, the Bloomberg Barclays U.S. aggregate index has yielded, on average, 5.0%, with an annual return of 6.2%. Over the next year, this historical performance is unlikely to be repeated. Investors should look to clip the coupon and brace for some small negative movements in bond prices.

With a tepid return outlook for core U.S. holdings, it will become even more tempting for investors to search for additional yield outside of their traditional fixed income holdings while simultaneously diversifying. However, it is important to be selective in this search. With the global economic backdrop looking robust, areas such as emerging market debt look particularly attractive, while in the U.S., sectors with atypical responses to rising interest rates, like high yield and emerging market debt, could play a part in helping to lift returns. That said, broad fixed income

diversification runs the risk of coming with increased correlation to S&P 500 returns. This increased correlation, in turn, has the potential to make a portfolio less diversified from a risk perspective. Therefore, maintaining an exposure to core fixed income remains a critical part of an investment portfolio.

In summary, the reduction in monetary policy stimulus is likely to lead to some withdrawal effects for fixed income investors over the next year. Central banks are likely to continue raising rates, reducing asset purchase programs and shrinking balance sheets, albeit gradually. Such steps are likely to drive down bond prices and hamper the returns on fixed income holdings in 2018. However, investors should not completely despair; with the help of areas such as high yield and emerging market debt, returns from fixed income holdings are likely to be positive, just lower than history.

– Alexander Dryden, CFA

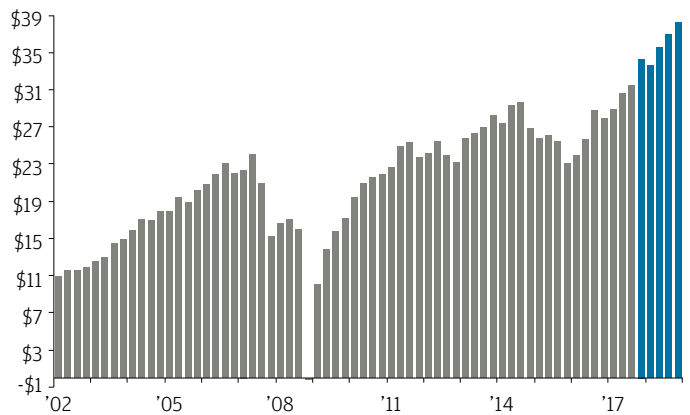
**U.S. EQUITIES: BACK TO SCHOOL**

For equity investors, the turn of each calendar year is much like a student's first day at a new school. They are excited by the prospect of a fresh environment, which they know will be full of new questions and unforeseen challenges, but simultaneously a bit nervous as they are forced to leave a world in which they had become comfortable.

At the beginning of 2017, investors were plagued by uncertainty. How many times would the Fed hike interest rates, and how would that impact markets? What would the first year of a new administration in the White House bring? Would the underperformance of growth stocks ever come to an end? How much longer would corporate profits remain under pressure?

**Profits look set to continue rising next year**

EXHIBIT 6: S&P 500 EARNINGS PER SHARE



Sources: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. *Guide to the Markets - U.S.* Data are as of October 31, 2017.



While we now have answers to many of these questions, investors have found themselves faced with a new laundry list of issues for the coming year. In 2017, economic growth surprised to the upside. Will this better-than-expected growth continue? Will a corporate tax cut get passed? What are the market implications of a shift in both monetary and fiscal policy? How far can rates rise before they begin to weigh on equity market performance?

Equity market performance in the coming year should hinge on three variables: earnings, inflation and interest rates. Earnings are a function of economic growth, and we expect that the healthy pace of economic growth seen in the second half of 2017 can continue into next year. However, potential growth for the U.S. economy remains around 2%, suggesting that the above-trend pace we have seen should begin to moderate in the second half of 2018.

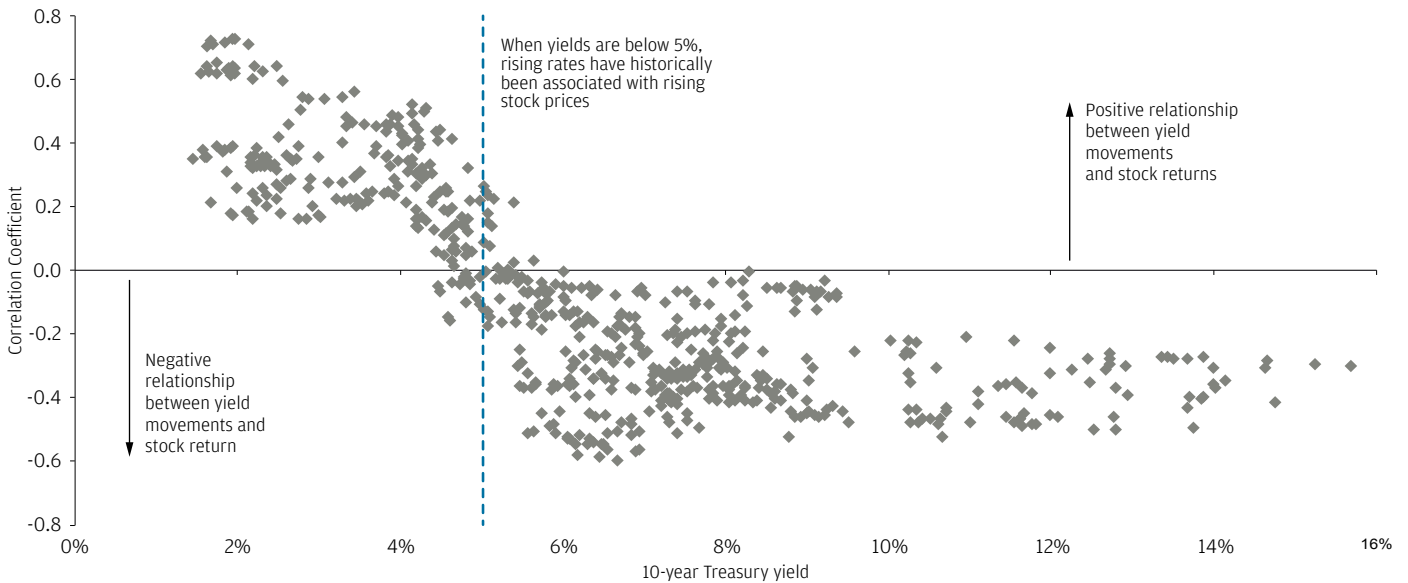
That said, even a moderate pace of underlying growth, coupled with a slight acceleration in the pace of inflation, could lead to stronger-than-expected revenue growth and potentially offset any downward pressure on margins stemming from a rise in wages. Over time, stock prices follow earnings, and given our expectation that the economy will avoid recession in the coming 12 months, profit growth should continue, providing fundamental support for equity markets to push higher (**Exhibit 6**, previous page). Any fiscal stimulus in the form of a corporate tax cut will be the icing on the cake.

There is the potential that above-trend growth, coupled with fiscal stimulus, could lead inflation to pick up more than expected. While there is still room for inflation to accelerate before it comes in conflict with the Fed's 2% target, any meaningful acceleration in inflation could lead market-based expectations of interest rates to re-price, potentially undermining the low interest rate and low volatility environment that has underpinned the melt-up in multiples seen over the past year.

However, with earnings continuing to grow, we expect that any volatility on the back of a repricing in interest rate expectations should remain relatively contained. Yes, it could lead to the elusive 10% correction investors have been searching for, but with equities still cheap relative to fixed income and the fundamentals looking solid, the risk of a bear market in the immediate future seems a bit remote. The question then becomes: at what level will rising rates begin to weigh on equity markets? As shown in **Exhibit 7** below, historically the 10-year U.S. Treasury yield has been able to rise to a level of 5% before interest rates and equity markets become negatively correlated.

**Rising rates should not be a headwind for equities, yet...**

EXHIBIT 7: CORRELATIONS BETWEEN WEEKLY STOCK RETURNS AND INTEREST RATE MOVEMENTS, S&P 500, 10Y UST



Source: FactSet, FRB, Standard & Poor's, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Markers represent monthly 2-year correlations only. *Guide to the Markets - U.S.* Data are as of October 31, 2017.

The problem is that a backdrop of steadily falling rates over the past 35 years, coupled with central bank policy that has kept yields at artificially low levels during this business cycle, suggests the threshold for a shift in correlations may be lower than it has been historically. While the exact level is subject to debate, a qualitative analysis of why rates are rising can tell us what we need to know. If rates are rising for all of the right reasons - namely better economic growth, more normal monetary policy or healthier rates of inflation - equities should continue to move higher. However, if rates begin rising for the wrong reasons - the economy is overheating, the Fed is trying to cool things off or inflation is getting a bit too hot - equities, and equity multiples, will likely begin to come under pressure.

Given a backdrop of moderate economic growth, decent earnings growth, minimal inflation and gradually rising interest rates (from low levels), U.S. equities should be capable of generating mid-to-high single digit returns next year. The risk to this view stems from the fact that the U.S. is late cycle; with the unemployment rate expected to fall further, higher inflation and a more hawkish Fed seem inevitable.

Furthermore, as we consider the investment options available in the coming year, economies outside the U.S. are far earlier in their respective business cycles, and still experiencing double-digit profit growth. Thus, with the first day of school just around the corner, investors would be wise to choose a curriculum that allows them to study abroad.

– *David Lebovitz*

## INTERNATIONAL EQUITIES IN 2018: STILL CLIMBING

At one time or another, we have all sat next to a nervous flier on a plane. They are easy to spot: the enhanced alertness to any announcement over the loud speaker, the preoccupied focus on the plane's course on the map and sometimes even the outstretched hand when turbulence surfaces. Oftentimes, that behavior is the result of a prior bad experience on a flight, so the concern is understandable. I have actually been that person myself. Over time, I realized that I cannot let a previous situation hold me back from reaching my destination or prevent me from enjoying the ride, especially when I trust the pilot.

After four years of international equity underperformance relative to U.S. equities, with many worries along the way, it makes sense that some investors are scared to board the flight again or to relax during the journey. However, after over a year of strong, synchronized global economic and earnings growth, investors should recognize that the scariest part of the flight is behind us. We are now past 10,000 feet, the moment when the pilot allows the flight attendants to walk around, turns the wi-fi on and tells everyone to enjoy the ride. After a tepid acceleration in global growth in mid-2016, the global economy picked up speed over the course of 2017 with all of the major regions participating in the recovery. As we write this piece, 96% of major economies have a PMI figure above 50, indicating acceleration. This has created a virtuous cycle of consumption, earnings growth and investment around the world. We expect this momentum to continue in 2018, which, combined with still low levels of inflation in the developed world and a gradual normalization of monetary policy from major central banks, is a positive backdrop for international equities to continue outperforming those in the U.S. in the year ahead (**Exhibit 8**).

2018 should be another year of strong global economic growth and, crucially, another year of strong earnings growth as well. Profits in several regions around the world grew at a double-digit pace in 2017; however, investors should remember that there is still plenty of room for them to keep climbing. While U.S. companies have been reporting record-high earnings since 2011, emerging market earnings would have to grow by 10% to reach their previous peak, and eurozone earnings would have to grow by 59% to reach theirs. With the encouraging acceleration in economic growth continuing, we can expect these gaps to continue to close.

## After years of U.S. earnings outpacing international, a reversal is beginning

EXHIBIT 8: MSCI ACWI EX-U.S. VS. S&P 500 FORWARD EPS, USD, JAN. 2002 = 100

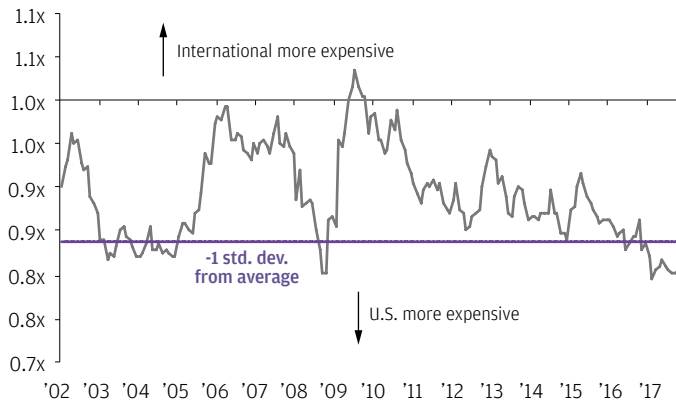


Sources: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. Data are as of November 10, 2017.

Overall, international valuations are now at average levels after 18 months of rallying markets (**Exhibit 9**). The plane is no longer at the beginning of the climb, but at these levels, and especially compared to U.S. valuations, it is tough to conclude that we are at the end of the ascent.

### International at almost record cheap levels relative to the U.S.

EXHIBIT 9: MSCI ACWI EX-U.S. VS. S&P 500 FORWARD PRICE-TO-EARNINGS RATIO



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. Data are as of November 10, 2017.

Lastly, we expect the U.S. dollar to continue acting as a tailwind to international returns for U.S. investors. We believe we are still at the beginning stages of a long move down for the dollar, as a result of better global growth, narrowing interest rate differentials, more stable commodity prices and a persistent U.S. current account deficit. This weaker dollar environment should continue to provide a boost to international returns in the year ahead.

2018 does have the potential for some pockets of turbulence, whether they arise from the continued geopolitical tensions in the Middle East and North Korea or from the several elections occurring around the world, such as in Italy and in a multitude of Latin American countries. However, one of the important lessons from 2017 is that investors should not let event risks such as elections restrain them from considering overseas opportunities. Oftentimes, the strong underlying economic momentum wins out. As a result, investors should not overreact to turbulence in the year ahead, and instead pay more attention to the destination.

While it continues to look like a favorable time for international equities, investors should make sure they have the right pilot. Crucially, one who is able to identify the best routes, whether by region or by sector. We continue to favor emerging markets and the eurozone, as well as cyclical over defensive sectors.

As we wrap up a strong year for emerging and developed equities, investors should remember that the climb is not over. For those nervous fliers, there is still time to put fears aside and buy that plane ticket.

– *Gabriela Santos*

### CONCLUSION: FOCUS ON TIME-TESTED PRINCIPLES

We conclude our year-ahead outlook by getting back to the investing principles that hold across market environments and truly are year-agnostic.

Let's compare two very different timekeeping devices: namely a broken clock and a sundial. While hot, flashy investing tactics and behaviors may work for short periods of time or when in "favor," - just as the time frozen on the broken clock's face is correct twice a day, investors should focus on tried and true principles of investing: behaviors that build success in a portfolio with greater consistency, like the way a sundial tells time. While being a simple device, a sundial can consistently and easily - barring very cloudy weather - tell you the time with great accuracy.

The following four investing principles are timeless and their importance holds regardless of what the growth rate of the U.S. economy is, who the Fed chair is or whatever might be going on in China - and that is what makes them indispensable.

First and foremost, cash has and will continue to be a poor long-term investment. Even with rates continuing to normalize in 2018, interest rates and therefore the return on cash will not increase enough to make the overall cash return attractive. When we factor in inflation, we continue to get a negative real return on cash (**Exhibit 10A**, next page) as has been the case in every year since 2009. While cash has a small place in a portfolio, we know there are enormous amounts of cash sitting on the sidelines, almost \$110,000 on a per household basis - well above total home mortgage debt (**Exhibit 10B**, next page).



**Cash earns a negative real return and yet households keep so much of it**

EXHIBIT 10A: ANNUAL INCOME GENERATED BY A \$100,000 INVESTMENT IN A 6-MO. CD

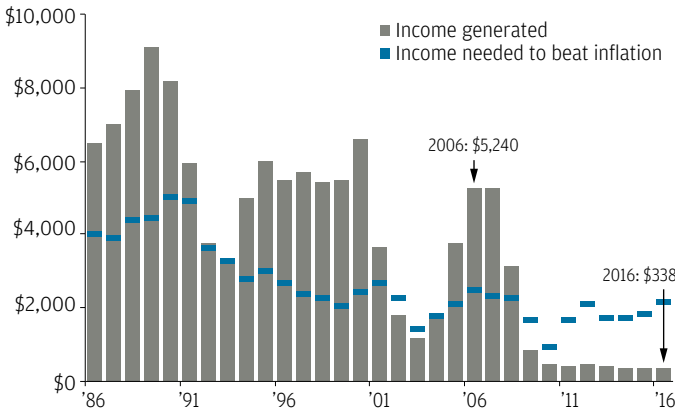
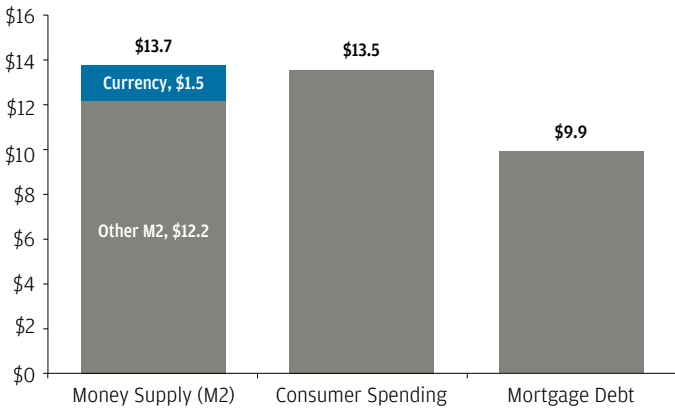


EXHIBIT 10B: TOTAL CASH LEVELS



Source: FactSet, J.P. Morgan Asset Management; (Left) Bankrate.com; (Right) Federal Reserve System, BEA.

Money supply and consumer spending data as of 9/30/2017. Consumer spending is SAAR Seasonally Adjusted Annual Rate data. Mortgage debt data as of 6/30/2017. M2 includes M1 (currency in circulation and reserve balances) plus savings deposits, small-denomination time deposits and retail money market mutual funds. Annual income is for illustrative purposes and is calculated based on the 6-month CD yield on average during each year and \$100,000 invested. Past performance is not indicative of comparable future results. Data are as of October 31, 2017.

If cash is moved off of the sidelines, where should it go? A second principle is diversification. Being diversified has been key for investors, and that will continue to be the case in 2018. While in any one year a diversified portfolio is never the best or the worst performer when we look across returns of nine asset classes (Exhibit 11, next page), its benefit truly shows over the long run. Over the last 15 years, a hypothetical diversified portfolio had an average annual return of almost 7%, with a volatility of 11% - an attractive risk/return profile. The last 15 years have been filled with all sorts of events - wars, market crashes and natural disasters - namely, the type of events that would make you want to bunker down in cash and gold - and that would have been disastrous for returns. Often diversification gets a bad wrap for not “working,” - especially when one part of the market is roaring ahead, leaving a diversified portfolio to lag behind, but overall, and over time, diversification works and is a winning strategy for long-run investors.

Diversification will be especially important in fixed income, where a rising rate environment will mean that navigating the asset class in an active way will be essential. Holding good quality fixed income as the umbrella for when a storm hits and traversing the gambit of sub-sectors in the market in a flexible and nimble way for returns will be key.

Being diversified and increasingly selective in equities will also be crucial. With returns in the longer term being limited by our starting point in 2018, choosing sectors, factors and regions will be critical for higher returns.

Diversification is a winning strategy for long-run investors

EXHIBIT 11: ASSET CLASS RETURNS OVER THE LAST 15 YEARS AND CUMULATIVE ANNUALIZED RETURN AND VOLATILITY

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	YTD	2002-2016	
																Ann.	Vol.
Comdty 25.9%	EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 32.6%	REITs 10.8%	EM Equity 23.8%
Fixed Income 10.3%	Small Cap 47.3%	EM Equity 26.0%	Comdty 21.4%	EM Equity 32.6%	Comdty 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 22.3%	EM Equity 9.8%	REITs 22.6%
High Yield 4.1%	DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 16.9%	High Yield 9.2%	Small Cap 20.1%
REITs 3.8%	REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty 11.8%	Asset Alloc. 12.0%	Small Cap 8.5%	DM Equity 19.2%
Cash 1.7%	High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Small Cap 11.9%	Asset Alloc. 6.9%	Comdty 19.0%
Asset Alloc. -5.9%	Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 9.9%	Large Cap 6.7%	Large Cap 15.9%
EM Equity -6.0%	Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 6.2%	DM Equity 5.7%	High Yield 11.7%
DM Equity -15.7%	Comdty 23.9%	Comdty 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.2%	Fixed Income 4.6%	Asset Alloc. 11.0%
Small Cap -20.5%	Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Cash 0.6%	Cash 1.3%	Fixed Income 3.5%
Large Cap -22.1%	Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty -1.1%	Comdty -9.5%	Comdty -17.0%	Comdty -24.7%	Cash 0.3%	Comdty -0.8%	Comdty 1.2%	Cash 0.8%

Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management. *Guide to the Markets* - U.S. Data are as of October 31, 2017.

Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Barclays Global HY Index, Fixed Income: Barclays US Aggregate, REITs: NAREIT Equity REIT Index. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Barclays US Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represent period of 12/31/01 - 12/31/16. All data represent total return for stated period. Past performance is not indicative of future returns.

All that said, why not wait for a large correction to create a buying opportunity? Because even in the later stages of the cycle there exist opportunities: international markets are still climbing, while in the U.S earnings growth can support another year of the bull run. But an even more compelling reason to be in the market relates to our third principle: compounding.

The only way to have the power of compounding on your side is to be invested. It's worth noting that while compounding is a long-run phenomenon - supporting the adage "It's about time in the market, not market timing" - compounding starts working immediately, benefiting the investor over shorter time horizons as well. The combination of opportunities in the market and the math that compounding starts working immediately provide persuasive reasons as to why investors should not wait for a correction to invest.

Our last principle concerns volatility, and the value of knowing that volatility is normal. While we do not know what events may occur in 2018, the tide of volatility that has been out for the last few years very well may come in. Government policy, Fed action and events abroad all have the ability to spook the market in different ways. Investors should not let volatility derail their asset allocation or time invested in the market.

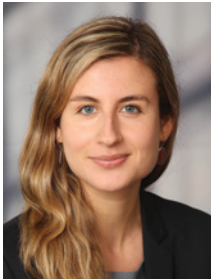
While sundials are not the fanciest way to tell the time and do not work in every single instance, they have served a great purpose, working consistently for countless people all over the world since 700 B.C. The investing principles presented are not as old and distinguished as the sundial, yet they have been a critical component of successful investing throughout modern financial history. And they will continue to be important as investors navigate the challenges of an old expansion and extended bull markets in 2018.

- Samantha Azzarello

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MI-MB 2018 Outlook