Market Review

1 November 2018

Review of markets over October 2018

Market volatility returned in October. The S&P 500 moved up or down by more than 1% in a single day on ten occasions last month – two more times than in the whole of 2017. What is more curious is that there was no clear catalyst for the movements in broader asset markets. Economic fundamentals remain strong, with unemployment globally continuing to fall. The third-quarter earnings season got off to a good start, particularly in the US, where over 85% of companies that have reported thus far have beaten earnings-per-share estimates.

The S&P 500 ended the month down 6.8%, which now leaves the index up 3.0% year-to-date in total return terms. All other equity markets also fell on the month and value outperformed growth. Despite the risk-off sentiment, the Global Aggregate Bond Index also ended down 1.1%.

Exhibit 1: Asset class and style returns in local currency

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	Oct 2018
MSCI EM 33.6%	Global Agg 4.8%	MSCI EM 62.8%	REITS 27.6%	REITS 7.3%	REITS 20.1%	Small cap 35.8%	REITS 27.1%	Growth 6.5%	Value 15.1%	MSCI EM 31.0%	Growth 2.1%	Global Agg -1.1%
Cmdty 16.2%	Cmdty -35.6%	Small cap 40.8%	Small cap 24.4%	Global Agg 5.6%	Small cap 18.4%	Value 29.7%	Growth 11.5%	Small cap 2.8%	Small cap 14.5%	Growth 24.5%	DM Equities -0.2%	Cmdty -2.2%
Growth 10.5%	REITS -37.3%	Growth 29.4%	Cmdty 16.8%	Value -4.9%	MSCI EM 17.4%	DM Equities 29.6%	DM Equities 10.4%	DM Equities 2.6%	Cmdty 11.8%	Small cap 19.1%	REITs -0.9%	REITs -2.6%
Global Agg 9.5%	Value -37.7%	REITS 27.4%	MSCI EM 14.4%	DM Equities -5.0%	Growth 16.5%	Growth 29.5%	Value 9.2%	REITS 2.3%	MSCI EM 10.1%	DM Equities 19.1%	Value -2.5%	Value -4.7%
DM Equities 5.2%	DM Equities -38.3%	DM Equities 26.5%	Growth 12.7%	Growth -5.1%	DM Equities 16.4%	MSCI EM 3.8%	Small cap 6.7%	Value -1.2%	DM Equities 9.6%	Value 14.1%	Global Agg -3.5%	DM Equities -6.8%
Value -0.0%	Growth -39.0%	Value 23.6%	DM Equities 10.6%	Small cap -8.7%	Value 16.3%	REITS 3.2%	MSCI EM 5.6%	Global Agg -3.2%	REITs 9.3%	REITS 9.3%	Small cap -3.6%	MSCI EM -7.8%
Small cap -3.8%	Small cap -40.4%	Cmdty 18.9%	Value 8.4%	MSCI EM -12.5%	Global Agg 4.3%	Global Agg -2.6%	Global Agg 0.6%	MSCI EM -5.4%	Growth 4.4%	Global Agg 7.4%	Cmdty -4.1%	Growth -8.7%
REITS -17.8%	MSCI EM -45.7%	Global Agg 6.9%	Global Agg 5.5%	Cmdty -13.3%	Cmdty -1.1%	Cmdty -9.5%	Cmdty -17.0%	Cmdty -24.7%	Global Agg 2.1%	Cmdty 1.7%	MSCI EM -10.1%	Small cap -9.4%

Source: Barclays, Bloomberg, FactSet, FTSE, MSCI, J.P. Morgan Asset Management.DM Equities: MSCI World; REITs: FTSE NAREIT All REITs; Cmdty: Bloomberg UBS Commodity Index; Global Agg: Barclays Global Aggregate; Growth: MSCI World Growth; Value: MSCI World Value; Small cap: MSCI World Small Cap. All indices are total return in local currency. Data as of 31 October 2018.

US

While equity markets have struggled to find a firm footing, the US economy is showing no signs of wobbling. The unemployment rate for September fell to 3.7% – the lowest in almost 50 years. Falling unemployment has supported consumer confidence, which remains close to record highs.

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The US 10-year Treasury yield breached 3.2% in October. This sharp move higher appeared to concern some market commentators. It's worth noting that most of the increase in yields was driven by real rates moving higher, rather than concerns over rising inflation. In fact, the headline consumer price index fell to 2.3% year on year in October. Thus, the increase in 10-year Treasury yields was for positive reasons, which suggests the growth outlook is still healthy.

The initial estimates for third-quarter US GDP came in at 3.5% quarter-on-quarter annualised, beating consensus expectations. US consumer spending was a significant driver of the strong GDP reading. However, net exports were a drag on output, with businesses likely to have bought forward imports ahead of scheduled tariff increases. Increased tariff measures from the US have been a source of concern for investors and S&P 500 companies have been highlighting the potential increase in costs that higher tariffs will bring. We are just past halfway in this quarter's earnings season and results have been strong so far but guidance on the future earnings outlook has been weaker than expected, which has contributed to the increased volatility.

Exhibit 2: World stock market returns in local currency

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	Oct 2018
MSCI Asia ex Japan 38.0%	UK FTSE 100 -28.3%	MSCI Asia ex Japan 67.2%	MSCI Asia ex Japan 15.6%	US S&P 500 2.1%	Japan TOPIX 20.9%	Japan TOPIX 54.4%	US S&P 500 13.7%	Japan TOPIX 12.1%	UK FTSE 100 19.1%	MSCI Asia ex Japan 35.9%	US S&P 500 3.0%	UK FTSE 100 -4.9%
MSCI EM 33.6%	US S&P 500 -37.0%	MSCI EM 62.8%	US S&P 500 15.1%	UK FTSE 100 -2.2%	MSCI Europe ex UK 20.0%	US S&P 500 32.4%	Japan TOPIX 10.3%	MSCI Europe ex UK 9.1%	US S&P 500 12.0%	MSCI EM 31.0%	UK FTSE 100 -3.9%	MSCI Europe ex UK -5.6%
UK FTSE 100 7.4%	Japan TOPIX -40.6%	MSCI Europe ex UK 29.0%	MSCI EM 14.4%	MSCI Europe ex UK -12.1%	MSCI Asia ex Japan 19.7%	MSCI Europe ex UK 24.2%	MSCI Asia ex Japan 7.7%	US S&P 500 1.4%	MSCI EM 10.1%	Japan TOPIX 22.2%	MSCI Europe ex UK -4.2%	US S&P 500 -6.8%
MSCI Europe ex UK 6.6%	MSCI Europe ex UK -42.7%	UK FTSE 100 27.3%	UK FTSE 100 12.6%	MSCI EM -12.5%	MSCI EM 17.4%	UK FTSE 100 18.7%	MSCI Europe ex UK 7.4%	UK FTSE 100 -1.3%	MSCI Asia ex Japan 6.4%	US S&P 500 21.8%	Japan TOPIX -7.6%	MSCI EM -7.8%
US S&P 500 5.5%	MSCI EM -45.7%	US S&P 500 26.5%	MSCI Europe ex UK 5.1%	MSCI Asia ex Japan -14.6%	US S&P 500 16.0%	MSCI Asia ex Japan 6.2%	MSCI EM 5.6%	MSCI Asia ex Japan -5.3%	MSCI Europe ex UK 3.2%	MSCI Europe ex UK 14.5%	MSCI EM -10.1%	Japan TOPIX -9.4%
Japan TOPIX -11.1%	MSCI Asia ex Japan -47.7%	Japan TOPIX 7.6%	Japan TOPIX 1.0%	Japan TOPIX -17.0%	UK FTSE 100 10.0%	MSCI EM 3.8%	UK FTSE 100 0.7%	MSCI EM -5.4%	Japan TOPIX 0.3%	UK FTSE 100 11.9%	MSCI Asia ex Japan -13.0%	MSCI Asia ex Japan -9.9%

Source: FactSet, FTSE, MSCI, Standard & Poor's, TOPIX, J.P. Morgan Asset Management. All indices are total return in local currency. Data as of 31 October 2018.

EMERGING MARKETS

There have been concerns over a broader slowdown in China, partly due to the increase in trade tensions with the US and partly due to the prior intentional shift from the Chinese authorities to slow the pace of credit growth. China recorded GDP growth of 6.5% (year on year) for the third quarter. This is marginally lower than consensus expectations but still robust. A further escalation in trade tensions could weigh on growth but the depreciation in the renminbi against the US dollar has partially offset the impact of higher tariffs. More importantly, the authorities in China are now looking to put their foot back on the accelerator and provide some stimulus to the domestic economy in order to prevent a meaningful slowdown. In October, the People's Bank of China (PBoC) cut its reserve requirement ratio yet again. In doing this, the intention of the PBoC is to support bank credit growth and hence the economy while continuing to limit the pace of credit growth in the shadow banking sector.

Emerging markets more broadly have been hurt by the increase in yields in the US. While the US 10-year government bond yield has now come down from the highs of the month, the pace of the move through 3.2% will have been a concern for those emerging markets with high dollar-denominated debts. This, coupled with the recent risk-off environment, troubled emerging market equities, as well as Asian equities, throughout the month, with both falling by more than 7%.

Tensions between Turkey and the US eased due to the safe release of Pastor Brunson by Turkey. The Turkish lira also found some relief in October after the central bank increased rates in September, abating concerns over central bank independence.

Exhibit 3: Fixed income sector returns in local currency

2011	2012	2013	2014	2015	2016	2017	YTD	Oct 2018
IL 10.2%	Euro HY 23.3%	Euro HY 8.8%	Euro Treas. 13.1%	Euro Treas. 1.6%	US HY 17.5%	EM Debt 9.3%	US HY 0.9%	Euro Treas. -0.0%
US Treas. 9.8%	EM Debt 18.5%	US HY 7.4%	EM Debt 5.5%	EM Debt 1.2%	EM Debt 10.2%	Global IG 9.1%	Euro Treas. -0.5%	US Treas. -0.5%
EM Debt 8.5%	US HY 15.5%	Euro Treas. 2.2%	Euro HY 5.5%	US Treas. 0.8%	Euro HY 10.1%	IL 8.7%	Euro HY -0.8%	Euro HY -1.0%
US HY 4.4%	Global IG 11.2%	Global IG 0.3%	US Treas. 5.1%	Euro HY 0.5%	Global IG 4.3%	US HY 7.5%	US Treas. -2.1%	IL -1.1%
Global IG 4.3%	Euro Treas. 11.0%	US Treas. -2.7%	IL 3.4%	Global IG -3.6%	IL 3.9%	Euro HY 6.1%	Global IG -4.4%	US HY -1.6%
Euro Treas. 3.4%	IL 8.5%	IL -3.2%	Global IG 3.1%	US HY -4.6%	Euro Treas. 3.2%	US Treas. 2.3%	IL -4.4%	Global IG -1.7%
Euro HY -1.1%	US Treas. 2.0%	EM Debt -6.6%	US HY 2.5%	IL -5.0%	US Treas. 1.0%	Euro Treas. 0.2%	EM Debt -5.6%	EM Debt -2.2%

Source: Barclays, BofA/Merrill Lynch, FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management. IL: Barclays Global Inflation-Linked; Euro Treas: Barclays Euro Aggregate Government - Treasury; US Treas: Barclays US Aggregate Government - Treasury; Global IG: Barclays Global Aggregate - Corporates; US HY: BofA/Merrill Lynch US HY Constrained; Euro HY: BofA/Merrill Lynch Euro Non-Financial HY Constrained; EM Debt: J.P. Morgan EMBIG. All indices are total return in local currency. Data as of 31 October 2018.

EUROZONE

Recent purchasing managers' indices (PMIs) continued to disappoint in the eurozone. The flash estimate for the composite PMI fell to 52.7 for October. Manufacturing data in Germany was dragged lower by new and time-consuming car emissions tests, which contributed to a sharp fall in the German PMI. However, the German Ifo business survey fell to a much lesser extent.

What might be concerning investors is that trade tensions appear to have affected activity in Europe, with the new export orders component of the PMI having fallen particularly sharply this year. However, not all the activity data in Europe has been disappointing. Loan growth to non-financial corporates for September picked up to 3.1% year on year – the highest since 2009. The recent bank lending surveys from the European Central Bank (ECB) also suggest that credit demand is still healthy and lending standards remain loose. This should keep the domestic economy growing. The ECB, in its recent monetary policy meeting, concluded that the incoming data was somewhat weaker than expected but still consistent with an ongoing broad-based expansion. The central bank remains on course to end its net asset purchases at the end of the year.

Political concerns in Europe have also not dissipated. The Italian government submitted a budget plan to the European Commission that would see the 2019 deficit rise to 2.4% of GDP. The Commission rejected its proposal and has asked that revisions be made so that the budget meets the fiscal targets set by the European authorities. The spread between

Italian 10-year government bonds and the German 10-year equivalent rose to 320 basis points as bond markets became concerned over the Italian fiscal situation. Moody's downgraded Italy's sovereign debt by one notch but crucially the rating was not moved below investment grade by either Moody's or Standard & Poor's. Euro government bonds remained flat on the month and Italian bonds fell 1.4%. The flight to safer euro-denominated debt lifted German bunds by 0.6%.

Exhibit 4: Fixed income government bond returns in local currency

2011	2012	2013	2014	2015	2016	2017	YTD	Oct 2018
UK 16.8%	Italy 21.3%	Spain 11.3%	Spain 17.0%	Italy 4.9%	UK 10.7%	US 2.5%	Spain 1.6%	UK 1.0%
US 9.9%	Spain 6.0%	Italy 7.4%	Italy 15.7%	Spain 1.7%	Spain 4.2%	UK 1.9%	Germany 1.4%	Germany 0.6%
Germany 9.8%	Germany 4.5%	Japan 2.2%	UK 14.1%	Global 1.3%	Germany 4.1%	Global 1.3%	Japan -0.3%	Japan 0.2%
Spain 6.6%	Global 4.1%	Global -0.4%	Germany 10.5%	Japan 1.3%	Japan 3.6%	Spain 1.1%	UK -0.5%	Global -0.1%
Global 6.3%	UK 2.6%	Germany -2.3%	Global 8.5%	UK 1.2%	Global 2.9%	Italy 0.8%	Global -1.2%	Spain -0.3%
Japan 2.3%	US 2.2%	US -3.4%	US 6.1%	US 0.9%	US 1.1%	Japan 0.2%	US -2.3%	US -0.5%
Italy -5.9%	Japan 1.8%	UK -4.2%	Japan 4.8%	Germany 0.4%	Italy 0.8%	Germany -1.4%	Italy -6.0%	Italy -1.4%

Source: FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management. All indices are J.P. Morgan GBIs (Government Bond Indices). All indices are total return in local currency. Data as of 31 October 2018.

UK

In the UK, economic data was broadly positive. Under normal circumstances this would mean the Bank of England should be raising rates faster than its current pace. First, wage growth (excluding bonuses) grew at an annual pace of 3.1%. This is the highest reading for wage growth in the UK since the financial crisis. Inflation came down as the impact of imported inflation began to fade but domestic inflation appears to be firming. Both falling inflation and rising wages should be supportive of the UK consumer. The outlook for the UK could improve further if there is news of a deal on Brexit. However, a summit between the European Union (EU) and the UK did not achieve a breakthrough in October, and the deadline to reach a deal is fast approaching. We continue to think that it is in the interests of both of the EU and the UK to ensure that there is a deal, and that the eventual agreement will probably resemble a relatively soft Brexit.

Markets have experienced a wobble in October, but without a clear catalyst. The fundamental backdrop has not changed materially. The US, where we are probably latest in the cycle, is still growing at a healthy pace and so the economic story has not really changed. There are some risks in Europe, with continued Brexit uncertainty and concern over the Italian government's fiscal position. In our last review, we pointed to the trade conflict as being the largest near-term risk. It is this risk that has started to filter through into the commentary of US corporates in their earnings outlooks. While the trade tensions are not a concern to be dismissed, we should remember that market volatility is quite normal. This year, the S&P 500 has seen a maximum drawdown of 10%. Over the last 38 years, in years when the S&P 500 ended with positive returns, the average maximum drawdown has been 11%. The economic data has not turned yet and that should provide us with some comfort. But in times of higher volatility, and as we approach the later stages of the cycle, investors may want to consider building some resilience into portfolios.

Exhibit 5: Index returns in October 2018 (%)

INDEX	GBP	USD	JPY	EUR	LOC
Equities (MSCI)					
MSCI World Index	-5.4	-7.3	-7.9	-5.0	-6.8
MSCI USA	-5.0	-6.9	-7.5	-4.6	-6.9
MSCI Europe ex UK	-6.1	-8.0	-8.5	-5.6	-5.6
MSCI United Kingdom	-4.8	-6.8	-7.4	-4.4	-4.8
MSCI Japan	-6.6	-8.5	-9.0	-6.2	-9.0
MSCI AC Asia ex JP	-9.0	-10.8	-11.4	-8.6	-9.9
MSCI EM Latin America	5.6	3.5	2.8	6.1	2.0
MSCI EM (Emerging Markets)	-6.8	-8.7	-9.3	-6.4	-7.8
Bonds					
JP Morgan GBI Global (Traded)	1.1	-0.9	-1.6	1.5	-0.1
JP Morgan GBI United States (Traded)	1.5	-0.5	-1.2	2.0	-0.5
JP Morgan GBI Japan (Traded)	2.9	0.8	0.2	3.4	0.2
JP Morgan GBI United Kingdom (Traded)	1.0	-1.1	-1.7	1.4	1.0
JP Morgan EMU	-0.5	-2.5	-3.1	0.0	0.0
Currencies					
Sterling	n/a	-2.0	-2.6	0.4	n/a
US dollar	2.1	n/a	-0.6	2.5	n/a
Yen	2.7	0.6	n/a	3.2	n/a
Euro	-0.4	-2.4	-3.1	n/a	n/a

Source: MSCI, FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management. Data as of 31 October 2018.

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