Snapshot of the economic and market update for the first quarter of 2019

January 2, 2019

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Hello. This is David Kelly. I'm chief strategist here at JP Morgan Funds. And I head the team that produces the Guide to the Markets.

For many years, I've been an enthusiastic, although distinctly untalented, long distance runner. Each year, as I get older, the experts tell me I will get a little slower and a little bit more prone to injury. And each year, because of this, I need to be a little bit more disciplined in my training strategy.

The current economic expansion and bull market in equities have much in common with an aging runner. Both should stay on the road in 2019, but both should advance at a slower pace than a few years ago, and both will be more vulnerable to an accident. This being the case, investors will need to be more disciplined both in the design and implementation of a strategy. And any such strategy should start with a broad understanding of today's financial environment.

Helping provide this understanding is, of course, the fundamental goal of the Guide to the Markets. However, it's important to do so concisely. There is 65 pages in the guide, but that's way too many for any conversation with an investor about the markets. So what we do here is boil it down to just the top 10 slides in the guide and how you can use these to describe the investment environment. In particular, I'd like to talk about growth, jobs, profits, inflation, the global picture, the Federal Reserve, fixed income, US equities, international equities, and diversified investing.

Starting with economic growth, the US economy accelerated in 2018, with real GDP growth reaching 3% year over year by the third quarter. This was a fairly predictable result of a big tax cut that kicked in at the start of the year. However, as we enter 2019, it is equally predictable that growth will slow down again. In retrospect, the tax cut appears to be more effective at stimulating consumer spending than investment. And without any fresh tax cuts, overall GDP growth is likely to slide back to the roughly 2% pace that it averaged between 2010 and 2016. However, it's important to recognize that barring a major shock, the economy should be able to avoid a recession and sustain this pace into 2020.

There are really two reasons for this judgment. First, none of the cyclical sectors of the economy, such as autos, housing, business investment, spending or inventories, appear overextended. Nor does there seem to be any particular danger of financial excess. Without a boom, it's hard to generate a bust.

Second, while we expect the Federal Reserve to raise interest rates twice more in 2019, they will likely end this tightening cycle at a much lower level of interest rates than is typical for a long economic expansion. They can do this because in contrast to previous cycles, inflation has remained remarkably stable. But by doing so, they may enable the economy to continue to grow for longer than would usually be the case, as well as maintain the valuation argument for riskier assets relative to government bonds.

In the short run, in a rising rate environment and a growing economy, current valuations still favorite stocks over bonds. Within the bond market, this environment should also favor taking some credit risk in areas like high yield, rather than duration risk and very long-term interest rate sensitive bonds. However, if interest rates do gradually rise in the months ahead, this positioning will have to be continually monitored as bonds approach more normal valuations.

2018 marks the 10th anniversary of the onset of the global financial crisis, which precipitated a bear market in equities around the world and the biggest global recession since the Great Depression. While both financial markets and economies have fully recovered from this trauma in memory continues to induce a more cautious attitude among investors. This is as it should be. And investors need to maintain balance in order to be prepared for the next downturn, whenever it occurs.

In addition, investors should recognize that a low interest rate environment combined with a long bull market in stocks limits potential portfolio returns going forward. However, with both the US and global economies growing, opportunities remain across the spectrum of global financial markets. And while the bull market in equities is old, it has no particular expiration date.

Equally relevant is the fact that despite Fed tightening, real yields in cash remain close to zero. In a world of very cautious central banks, investors no longer get paid for saving. They only get paid for investing.

Looking forward, we still think the global economy at current valuations justify a diversified approach to long-term investing. However, as interest rates rise and equity prices rise, it will become increasing important for investors to move back to a more balanced approach. The economy in markets still have room to run. But an older expansion and bull market call for a more disciplined approach, with smaller overweights and underweights relative to a normal portfolio and a heightened willingness to adjust asset allocation as valuation differences diminish and late cycle risks gradually rise.

[MUSIC PLAYING]

Chart 1: Source: BEA, FactSet, J.P. Morgan Asset Management.
Values may not sum to 100% due to rounding. Quarter-over-quarter percent changes are at an annualized rate. Average represents the annualized growth rate for the full period. Expansion average refers to the period starting in the third quarter of 2009.
Guide to the Markets – U.S. Data are as of November 30, 2018.

Chart 2: Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for November 2018, where real yields are calculated by subtracting out October 2018 year-over-year core inflation.
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Chart 3: Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Barclays Global HY Index, Fixed Income: Bloomberg 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 Bloomberg Barclays US Aggregate, 5% in the Bloomberg Barclays 1-3m Treasury, 5% in the Bloomberg 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.) represents period of 12/31/02 – 12/31/17. Please see disclosure page at end for index definitions. All data represents total return for stated period. Past performance is not indicative of future returns.
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J.P.Morgan
Asset Management