Market Review

2 January 2019

Review of Markets over the fourth quarter of 2018

The final quarter of 2018 was not good for equity markets. Investors have had to contend with rising US central bank interest rates, a sharp slowdown in eurozone business confidence, weaker Chinese growth and rising geopolitical concerns (including Brexit, Italian politics and the ongoing trade conflict between the US and China). This all proved an indigestible cocktail for investors. On the plus side, over the quarter as a whole government bonds at least lived up to their traditional role as the defensive part of a well balanced portfolio.

Exhibit 1: Asset class and style returns in local currency

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	4Q2018
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%	Global Agg -1.2%	Global Agg 1.2%
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%	REITS -4.1%	REITS -6.1%
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%	Growth -5.1%	MSCI EM -7.4%
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%	DM Equities -6.9%	Cmdty -9.4%
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%	Value -8.7%	Value -10.8%
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%	MSCI EM -9.7%	DM Equities -13.0%
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 -11.2%	Growth -15.1%
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%	Small cap -12.2%	Small cap -17.5%

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 December 2018.

US

The quarter's volatility started with the Federal Reserve (Fed) chairman Jerome Powell's comment that the US policy rate was still "a long way" from neutral, implying that the Fed wasn't about to stop increasing interest rates any time soon. US government bond yields moved higher to price in a faster pace of rate rises, with the US 10-year Treasury yield briefly rising above 3.2%. Equity investors soon started to worry about the potentially faster-than-expected pace of rate rises and equities sold off through October.

There was a brief bounce in early November but when US 10-year yields rose above 3.2% for a second time, again equity markets took fright. From the second week of November, equities fell with US government bond prices rising in a classic risk-off trade, with investors selling equities and buying Treasuries.

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Markets have started to worry that the US is late in its economic cycle. Tax cuts helped boost growth and corporate earnings in 2018 but investors are aware that the fiscal stimulus will fade beyond the first half of 2019. The midterm elections in early November were important in this regard, as the Republican Party might have backed further tax cuts to support growth through to the next presidential election had they maintained control of the House of Representatives. However, with the Democrats winning the House, the likelihood of further meaningful fiscal stimulus, prior to the next US election, is significantly reduced.

In November, Fed chairman Powell changed his tune slightly, although not the song, saying rates were "just below" the range of estimates for neutral. This shift was interpreted as dovish, so much so that by the December meeting markets had moved to price in a greater than 50% probability that US interest rates won't rise beyond 2.5% in 2019. However, while the Fed did lower its guidance from three to two rate hikes next year after the December meeting, this was less dovish than markets had been expecting, particularly given Powell's insistence that the plan to reduce the central bank's balance sheet was essentially on autopilot.

Exhibit 2: World stock market returns in local currency

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	4Q2018
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 -4.4%	MSCI EM -7.4%
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 -8.7%	MSCI Asia ex Japan -8.9%
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 EM -9.7%	UK FTSE 100 -9.6%
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%	MSCI Europe ex UK -10.6%	MSCI Europe ex UK -11.8%
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 Asia ex Japan -12.0%	US S&P 500 -13.5%
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%	Japan TOPIX -16.0%	Japan TOPIX -17.6%

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 December 2018.

Europe

In Europe, business surveys have been weakening all year but this quarter moved closer towards the level that has historically been consistent with not just a slowdown in the pace of growth but an outright contraction. Political tensions likely contributed to a sharp fall in both the Italian and French business surveys. Germany appears to be slowing but still growing, at least for now.

Part of the reason for the slowdown in Europe has been a sharp decline in the manufacturing sector's new export orders, which appears attributable – at least in part – to a slowdown in demand from China. But domestic political factors have also been a drag. The Italian government's confrontation with the European Union over its budget led to higher borrowing costs in Italy over the course of 2018. The Italian government has since submitted a budget with a lower projected deficit, helping to bring borrowing costs back down. Meanwhile in France, protests surrounding the cost of petrol led to widespread unrest in key cities and this appears to have significantly dented business confidence.

President Macron has since announced fuel duty cuts and other stimulus measures to ease the tensions. Despite the slowdown in growth, the European Central Bank ended its quantitative easing programme in December, noting the broad-based nature of the firming in wage growth across the region.

UK

In the UK, wage growth has also been accelerating, rising at the fastest pace since the financial crisis. On the other hand, the ongoing uncertainty surrounding the Brexit negotiations has weighed on business and consumer confidence. House prices, and particularly the number of transactions, are also being affected by the uncertainty. Against this backdrop the Bank of England maintained rates at 0.75%. The political theatre around Brexit will inevitably reach its most dramatic point in this final act. In our view, the ability of the UK parliament to revoke Article 50, combined with the fact that a no-deal Brexit would lead to a hard border in Ireland and significant repercussions for the UK economy, means a no-deal scenario remains unlikely. If we're right and the current government doesn't fall, sterling should eventually rally.

China

In China, growth has also slowed, explaining part of the weakness in global exports, with Chinese imports having slowed from 37% year-on-year growth in January to 3% in November. Following a clampdown on lending from the shadow banking sector, Chinese money supply growth has slowed, coinciding with a slowdown in the pace of retail sales growth and industrial production. In response to this slowdown, China is seeking to stimulate the economy with a combination of monetary and fiscal measures, particularly in the face of external headwinds emanating from the ongoing trade dispute with the US. With the potential for either a deal or further escalation in the trade negotiations, there are two-way risks for investors.

Exhibit 3: Fixed income sector returns in local currency

2012	2013	2014	2015	2016	2017	2018	4Q2018
Euro HY 23.3%	Euro HY 8.8%	Euro Treas. 13.1%	Euro Treas. 1.6%	US HY 17.5%	EM Debt 9.3%	Euro Treas. 1.0%	US Treas. 2.6%
EM Debt 18.5%	US HY 7.4%	EM Debt 5.5%	EM Debt 1.2%	EM Debt 10.2%	Global IG 9.1%	US Treas. 0.9%	Euro Treas. 1.5%
US HY 15.5%	Euro Treas. 2.2%	Euro HY 5.5%	US Treas. 0.8%	Euro HY 10.1%	IL 8.7%	US HY -2.3%	IL -0.8%
Global IG 11.2%	Global IG 0.3%	US Treas. 5.1%	Euro HY 0.5%	Global IG 4.3%	US HY 7.5%	Global IG -3.6%	Global IG -0.8%
Euro Treas. 11.0%	US Treas. -2.7%	IL 3.4%	Global IG -3.6%	IL 3.9%	Euro HY 6.1%	Euro HY -3.6%	EM Debt -1.2%
IL 8.5%	IL -3.2%	Global IG 3.1%	US HY -4.6%	Euro Treas. 3.2%	US Treas. 2.3%	IL -4.1%	Euro HY -3.8%
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 -4.6%	US HY -4.6%

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 December 2018.

Credit markets have struggled this quarter. Non-financial corporate debt-to-GDP has risen to the highest level in over 70 years and the credit quality of the US investment grade index has deteriorated. Given liquidity is much lower than it was before the financial crisis, a wave of downgrades could put further stress on credit markets. There are also concerns about the covenant quality in the leveraged loan market and subprime debt in the auto loan market. Against this backdrop fixed income investors need to be selective.

The oil price plunged this quarter as rising supply, led by US shale production, caught up with demand. Fears around the outlook for global growth and hence demand for oil have also weighed on the price. Falling oil prices create both winners and losers. Oil producers will be hurt and business investment in the energy sector will fall. However, oil consumers—both households and many businesses—will benefit from lower energy costs, providing a potential upside surprise to the currently gloomy mood in markets.

Overall, the risks are probably higher now than they have been at any point since the eurozone crisis. But there are risks both to the downside and the upside. Things that could potentially help the global economy in 2019 include Chinese stimulus, avoidance of a no-deal Brexit, a potential trade deal between the US and China and lower oil prices boosting growth and slowing the pace of interest rate rises.

On the downside, Europe could have a recession, potentially restarting concerns about the sustainability of European sovereign debt. US growth is likely to slow and a recession in late 2019 or 2020 can't be ruled out. Trade tensions could escalate and British politicians may fail to provide a near-term Brexit solution. Lower oil prices, higher US interest rates and slowing growth could also cause trouble in some of the emerging markets. High leverage in credit markets is a risk, particularly with central banks reducing global liquidity and low dealer inventories reducing trading liquidity. The housing sector in several smaller economies also looks vulnerable heading into 2019.

Exhibit 4: Fixed income government bond returns in local currency

2012	2013	2014	2015	2016	2017	2018	4Q2018
Italy 21.3%	Spain 11.3%	Spain 17.0%	Italy 4.9%	UK 10.7%	US 2.5%	Spain 2.6%	Italy 3.4%
Spain 6.0%	Italy 7.4%	Italy 15.7%	Spain 1.7%	Spain 4.2%	UK 1.9%	Germany 2.3%	US 2.7%
Germany 4.5%	Japan 2.2%	UK 14.1%	Global 1.3%	Germany 4.1%	Global 1.3%	Japan 1.1%	UK 2.1%
Global 4.1%	Global -0.4%	Germany 10.5%	Japan 1.3%	Japan 3.6%	Spain 1.1%	Global 1.0%	Global 2.1%
UK 2.6%	Germany -2.3%	Global 8.5%	UK 1.2%	Global 2.9%	Italy 0.8%	US 0.8%	Japan 1.6%
US 2.2%	US -3.4%	US 6.1%	US 0.9%	US 1.1%	Japan 0.2%	UK 0.6%	Germany 1.6%
Japan 1.8%	UK -4.2%	Japan 4.8%	Germany 0.4%	Italy 0.8%	Germany -1.4%	Italy -1.4%	Spain 0.7%

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 December 2018.

There are always risks, but at the moment the risks seem greater than usual. Although there are risks in both directions, at the late stage of the economic cycle, they are currently probably more skewed to the downside. In September, we started thinking that a balanced portfolio was more appropriate than had been the case for most of the last nine years as detailed in our publications "Turning the dial: Portfolio considerations in the late cycle" and "The dial, in detail". Heading into 2019, a balanced portfolio that avoids big asset allocation bets relative to benchmarks, in either direction, still seems prudent.

We think there are risks to being overweight small cap, growth and low quality stocks. Within fixed income, longer-term US government bonds could act as a balance to equity exposures but overweights to credit seem risky and credit investors will need to be selective. Given some of the risks in parts of the fixed income market, investors may also want to consider alternative, targeted absolute return strategies, with the ability to hedge equity markets without relying solely on fixed income to reduce risk.

Equities, and other risky assets, have delivered strong returns over the past nine years. Our focus in the near-term is locking in those returns with a more balanced portfolio. While volatility is painful, we know that eventually it creates opportunities. When that time comes it is important to have some dry powder.

Exhibit 5: Index returns in December 2018 (%)

INDEX	GBP	USD	JPY	EUR	LOC
Equities (MSCI)					
MSCI World Index	-7.4	-7.6	-10.7	-8.4	-7.8
MSCI USA	-8.8	-9.0	-12.1	-9.9	-9.0
MSCI Europe ex UK	-4.7	-4.9	-8.1	-5.8	-6.0
MSCI United Kingdom	-3.6	-3.8	-7.0	-4.7	-3.6
MSCI Japan	-6.5	-6.7	-9.8	-7.5	-9.8
MSCI AC Asia ex JP	-2.5	-2.7	-5.9	-3.6	-2.8
MSCI EM Latin America	-0.6	-0.7	-4.1	-1.7	-1.2
MSCI EM (Emerging Markets)	-2.4	-2.6	-5.9	-3.5	-2.5
Bonds					
JP Morgan GBI Global (Traded)	2.7	2.5	-1.0	1.5	1.6
JP Morgan GBI United States (Traded)	2.4	2.3	-1.2	1.3	2.3
JP Morgan GBI Japan (Traded)	4.6	4.5	0.9	3.5	0.9
JP Morgan GBI United Kingdom (Traded)	2.5	2.3	-1.2	1.3	2.5
JP Morgan EMU	2.1	1.9	-1.5	0.9	0.9
Currencies					
Sterling	na	-0.2	-3.6	-1.1	na
US dollar	0.2	na	-3.4	-1.0	na
Yen	3.7	3.5	na	2.5	na
Euro	1.1	1.0	-2.4	na	na

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

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