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. Welcome to the economic and market update for the second quarter of 2019.

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'll get a little bit 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 equities have much in common with an aging runner. Both are now entering their 11th years. And both should be sustained throughout 2019. However, they should advance at a slower pace than a few years ago. And both will be more vulnerable to accident.

And this being the case, investors will need to be more disciplined, both in the design and the implementation of a strategy. And any such strategy should start with a broad understanding of today's financial environment. As expected, economic growth slowed in the second half of 2018, as the effects of the tax cuts enacted in late 2017 began to fade.

Without any fresh tax cuts and with the dragging effect of trade uncertainty and the government shutdown, overall GDP growth is likely to slide back to roughly 2% for the rest of this expansion. However, it's important to recognize that barring a major shock, the economy should be able to avoid recession and sustain this pace into 2020.

They're 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 to be overextended. Nor does there appear to be a particularly dangerous area of financial excess. And without a boom, it's hard to generate a bust.

Second, the Federal Reserve appears to be on pause and may not raise rates at all in 2019. They've indicated that the normalization process for the balance sheets may also conclude later this year. This would end the tightening cycle at a much lower level of interest rates and is typical in a long expansion.

And they can do this, because, in contrast to previous cycles, inflation has remained remarkably stable and has even drifted down so far in 2019. But by doing so, they may enable the economy to continue to grow for longer than will usually be the case, as well as maintain the valuation argument for riskier assets relative to government bonds.

For the bond market, the Fed pauses led to a negatively slope yield curve in some ranges. That is to say, some short-term treasury rates are higher than long maturity yields, as well as generally low nominal and real yields. However, we do not believe that even a more general yield curve inversion would be as clear recession signal as it has been in the past, as the yield curve itself has been distorted by unprecedented central bank buying of long-term bonds.
We also don’t believe in inverted yield curve, which actually harm the economy and could even boost demand by pushing up consumer income from short-term accounts while limiting the rise in mortgage rates. In the short run, a pause in rising rates and a growing economy still favors stocks over bonds.

Within the bond market, core fixed income still plays a critical role in a properly diversified portfolio. And whether there may be opportunities in higher yielding sectors, investors should consider dialing back on some of the most risky sectors. 2018 marked 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, its 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, 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 on cash remain close to zero. In a world of very cautious central banks, investors no longer get paid for saving. They only really get paid for investing.

Looking forward, we still think the global economy and current valuations justify a diversified approach to long-term investing, and one with smaller overweights and underweights relative to a normal portfolio, and a heightened willingness to adjust to asset allocation, as valuation differences diminish and late cycle risks gradually rise.

[MUSIC PLAYING]
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