Market Review

3 July 2017

Review of markets over the second quarter of 2017

After a slight pause for breath in early April, equity markets continued upwards through to the end of May. June was less kind, with UK and European markets giving up most of the quarter's gains, though still up year to date. The US, Japanese and emerging equity markets managed to hold on to most of their gains for the quarter. Having fallen since March, government bond yields saw a sharp spike upwards at the end of June as investors responded to a less dovish tone from central bankers. Neither equities nor bonds reacted well to speeches that suggested the European Central Bank (ECB) could soon begin reducing its quantitative easing (QE) purchases and the Bank of England (BoE) might raise interest rates this year. One of the key questions for the rest of the year will be the extent to which bond and equity markets can withstand a gradual reduction in monetary stimulus, which has helped to support markets in recent years.

Exhibit 1: Asset class and style returns (local currency)

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	YTD	2Q 2017
MSCI EM 35.8%	REITS 34.4%	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 15.0%	MSCI EM 6.7%
Small cap 23.3%	MSCI EM 28.8%	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 12.2%	Growth 4.1%
Cmdty 21.4%	Value 21.2%	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%	DM Equities 8.6%	Small cap 3.1%
Value 16.7%	DM Equities 16.1%	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%	Small cap 7.5%	DM Equities 2.9%
DM Equities 16.3%	Small cap 13.6%	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%	REITs 5.4%	Global Agg 2.6%
Growth 16.0%	Growth 11.2%	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%	Value 5.2%	REITs 2.4%
REITS 8.3%	Global Agg 6.6%	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 4.4%	Value 1.7%
Global Agg -4.5%	Cmdty 2.1%	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 -5.3%	Cmdty -3.0%

Source: Barclays, Bloomberg, FactSet, MSCI, J.P. Morgan Asset Management. 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: MSC World Small Cap. All indices are total return in local currency. Data as of 30 June 2017.

AUTHOR

Michael Bell
Global Market Strategist

J.P.Morgan
Asset Management

As well as being a busy quarter for central bank watchers, this was also a period filled with key political developments. At the start of the quarter, the markets were not expecting an election in the UK and were worried about elections in France. By the end of the quarter, Marine Le Pen's anti-euro campaign in France had been rejected, with pro-euro and pro-reform candidate Emmanuel Macron elected as president, with a majority in parliament. As a result, Mario Draghi noted recently that "political winds are becoming tailwinds" in Europe. In contrast, in the UK, Theresa May's decision to call an election has weakened both the strength and stability of her government at a crucial time for the country, as it embarks on Brexit negotiations. So, while political uncertainty in Europe declined over the quarter, it increased in the UK.

Mario Draghi's recent speech in Sintra was one of the most market-moving events of the quarter, with bonds and equities selling off. Draghi emphasised that the ECB believes the forces currently weighing on eurozone inflation are temporary. He noted that core inflation measures do not always give a clear reading of underlying inflation dynamics. This implies that he believes weak core inflation data is understating the underlying inflationary pressures gradually building in the eurozone. Importantly, he said that "as the economy continues to recover, a constant policy stance will become more accommodative". Bond and equity markets reacted badly to the idea that the ECB thinks it will need to reduce its degree of stimulus just to keep the policy stance unchanged. This reduction in monetary stimulus could continue to put pressure on government bond markets over the next 12 months.

However, it should be remembered that the reason the ECB may soon look to reduce its QE purchases is that the eurozone economy is in a much better condition than it was a few years ago. Unemployment has been falling steadily. Draghi has pointed out that broader measures of eurozone unemployment remain much higher than the headline level, but even these broader measures have been falling, and are only about 4% above their pre-crisis lows. Eurozone consumer confidence, meanwhile, is the highest since 2001. Businesses are also upbeat about the economic outlook, and manufacturing businesses, in particular, have only been more positive about the outlook 6% of the time since the start of 2000. Against this healthy economic backdrop, the outlook for European corporates earnings should remain positive, unless the removal of central bank stimulus leads to a very large and sharp upward adjustment in corporate borrowing costs and the euro. Our expectation is that the adjustment in borrowing costs will be gradual enough for European equity markets to continue to make positive progress, helped by the boost to margins and earnings from stronger sales growth.

Exhibit 2: World stock market returns (local currency)

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	YTD	2Q 2017
Japan TOPIX 45.2%	MSCI EM 28.8%	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 19.9%	MSCI Asia ex Japan 8.8%
MSCI EM 35.8%	MSCI Asia ex Japan 28.6%	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 15.0%	Japan TOPIX 6.8%
MSCI Europe ex UK 28.6%	MSCI Europe ex UK 22.5%	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%	MSCI Europe ex UK 10.0%	MSCI EM 6.7%
MSCI Asia ex Japan 24.1%	US S&P 500 15.8%	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 9.3%	US S&P 500 3.1%
UK FTSE 100 20.8%	UK FTSE 100 14.4%	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%	Japan TOPIX 7.4%	MSCI Europe ex UK 2.7%
US S&P 500 4.9%	Japan TOPIX 3.0%	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 4.7%	UK FTSE 100 1.0%

Source: FactSet, MSCI, Standard & Poor's, TOPIX, J.P. Morgan Asset Management. All indices are total return in local currency. Data as of 30 June 2017.

The US economy also continues to look healthy, with unemployment now lower than it has been 96% of the time since 1970. Broader measures of unemployment have also been falling sharply. Given the tight labour market, the Federal Reserve (Fed) raised rates again in June and announced that it is likely to start reducing the size of its balance sheet "relatively soon". Like the ECB, the Fed believes the factors weighing on inflation are most likely temporary and so it is likely to continue tightening monetary policy gradually, given its belief that the economy is already past the level of unemployment that should soon start to generate domestic wage inflation. This adds to the reasons to be cautious on the outlook for global government bonds, with the ECB and the Fed likely to be reducing monetary stimulus simultaneously in the near future. US equities have historically been resilient in periods of rising interest rates. Value stocks such as financials could stand to benefit further from a rising rate and yield environment. On the other hand, the more expensive bond proxy and defensive parts of the US equity market may come under some pressure as central bank accommodation is gradually reduced.

In the UK, the economic and political outlook remains highly uncertain. Falling real wage growth and consumer confidence do not bode well for consumption. A sharp fall in the savings rate and rising consumer credit may be able to support consumption in the short term, but raise questions about its sustainability. On the other hand, corporate investment intentions have improved recently. The balance between these factors will be key in determining whether the BoE feels the need to join the central bank tightening trend and raise rates. While it is still probably not the most likely scenario, recent comments from the BoE suggest the probability of a rate rise this year has risen.

Exhibit 3: Fixed income sector returns (local currency)

2010	2011	2012	2013	2014	2015	2016	YTD	2Q 2017
US HY 15.1%	IL 10.2%	Euro HY 23.3%	Euro HY 8.8%	Euro Treas. 13.1%	EM Debt 1.8%	US HY 17.5%	EM Debt 6.3%	Global IG 3.5%
Euro HY 14.3%	US Treas. 9.8%	EM Debt 18.0%	US HY 7.4%	EM Debt 6.2%	Euro Treas. 1.6%	Euro HY 10.1%	Global IG 5.2%	EM Debt 2.4%
EM Debt 11.8%	EM Debt 9.2%	US HY 15.5%	Euro Treas. 2.2%	Euro HY 5.5%	US Treas. 0.8%	EM Debt 9.6%	US HY 4.9%	US HY 2.1%
US Treas. 5.9%	US HY 4.4%	Global IG 11.2%	Global IG 0.3%	US Treas. 5.1%	Euro HY 0.5%	Global IG 4.3%	Euro HY 3.7%	Euro HY 2.1%
Global IG 5.8%	Global IG 4.3%	Euro Treas. 11.0%	US Treas. -2.7%	IL 3.4%	Global IG -3.6%	IL 3.9%	IL 3.4%	IL 2.0%
IL 3.0%	Euro Treas. 3.4%	IL 8.5%	IL -3.2%	Global IG 3.1%	US HY -4.6%	Euro Treas. 3.2%	US Treas. 1.9%	US Treas. 1.2%
Euro Treas. 1.1%	Euro HY -1.1%	US Treas. 2.0%	EM Debt -8.3%	US HY 2.5%	IL -5.0%	US Treas. 1.0%	Euro Treas. -1.0%	Euro Treas. 0.5%

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 EMBI+. All indices are total return in local currency. Data as of 30 June 2017.

Emerging market (EM) equities have been the best performing equity region and EM debt has been the best performing fixed income market so far this year. The performance of both asset classes has been helped by the weakness in the dollar and by improving EM growth. As we head into the second half of the year, selectivity could be key within emerging markets. We expect Chinese growth to slow, with rising interbank lending rates potentially leading to a slowdown in the housing market and construction. Satellite data also suggests that Chinese activity is already cooling down. This, combined with tighter global monetary policy, suggests that some emerging markets could experience more volatility in the second half of the year.

Exhibit 4: Fixed income government bond returns (local currency)

2010	2011	2012	2013	2014	2015	2016	YTD	2Q 2017
UK 7.5%	UK 16.8%	Italy 21.3%	Spain 11.3%	Spain 17.0%	Italy 4.9%	UK 10.7%	US 2.0%	US 1.3%
Germany 6.4%	US 9.9%	Spain 6.0%	Italy 7.4%	Italy 15.7%	Spain 1.7%	Spain 4.2%	Global 0.5%	Italy 1.1%
US 6.1%	Germany 9.8%	Germany 4.5%	Japan 2.2%	UK 14.1%	Global 1.3%	Germany 4.1%	UK 0.2%	Spain 1.1%
Global 4.2%	Spain 6.6%	Global 4.1%	Global -0.4%	Germany 10.5%	Japan 1.3%	Japan 3.6%	Spain 0.2%	Global 0.6%
Japan 2.5%	Global 6.3%	UK 2.6%	Germany -2.3%	Global 8.5%	UK 1.2%	Global 2.9%	Japan -0.4%	Japan 0.1%
Italy -0.6%	Japan 2.3%	US 2.2%	US -3.4%	US 6.1%	US 0.9%	US 1.1%	Italy -1.0%	Germany -1.1%
Spain -4.2%	Italy -5.9%	Japan 1.8%	UK -4.2%	Japan 4.8%	Germany 0.4%	Italy 0.8%	Germany -1.9%	UK -1.3%

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 30 June 2017.

Exhibit 5: Index returns for June (%)

INDEX	GBP	USD	JPY	EUR	LOCAL
Equities (MSCI)					
MSCI World Index	-0.2	0.4	2.0	-1.0	0.1
MSCI USA	0.0	0.6	2.2	-0.8	0.6
MSCI Europe ex UK	-1.3	-0.7	0.9	-2.1	-2.1
MSCI United Kingdom	-2.5	-1.9	-0.4	-3.3	-2.5
MSCI Japan	0.5	1.1	2.7	-0.3	2.7
MSCI AC Asia ex Japan	1.0	1.7	3.3	0.2	2.3
MSCI EM Latin America	0.1	0.7	2.3	-0.7	0.9
MSCI EM (Emerging Markets)	0.5	1.1	2.7	-0.3	1.7
Bonds					
JP Morgan GBI Global (Traded)	-0.8	-0.2	1.4	-1.6	-0.5
JP Morgan GBI United States (Traded)	-0.8	-0.1	1.5	-1.5	-0.1
JP Morgan GBI Japan (Traded)	-2.5	-1.9	-0.3	-3.3	-0.3
JP Morgan GBI United Kingdom (Traded)	-2.0	-1.4	0.1	-2.8	-2.0
JP Morgan EMU	0.3	0.9	2.5	-0.5	-0.5
Currencies					
Sterling	n/a	0.6	2.2	-0.8	n/a
US dollar	-0.6	n/a	1.6	-1.4	n/a
Yen	-2.2	-1.6	n/a	-3.0	n/a
Euro	0.8	1.4	3.1	n/a	n/a

Source: MSCI, FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management; Data as of 30 June 2017.

IS THE RECENT WEAKNESS IN EQUITY MARKETS THE START OF THE NEXT BEAR MARKET?

Equity investors have enjoyed strong returns in the first half of this year and fantastic returns since the nadir of the financial crisis in March 2009. Is now the time to lock in those gains in preparation for the next bear market?

Bear markets are nearly always caused by recessions, and our view is that while the probability of a recession in the next three years is now over 50% and rising, the probability of a recession in the next 12 months remains low, at under 20%. That's not to say that we couldn't see some volatility in markets over the summer: equities don't go up in a straight line, with a small pullback in markets seen at some point in every single year. The announcement of quantitative tightening from the Fed, combined with the announcement of a reduction in QE from the ECB and a slowdown in Chinese growth in response to tightening there, could well be the cause of this year's pull-back.

However, these relatively small intra-year pullbacks in equity markets are all but impossible to time. With this in mind, we acknowledge the potential for more volatility in the second half of the year, but stick with our conviction that a still-healthy global economy will continue to drive higher sales and earnings, which should be supportive for equity markets over the next 12 months. Given that the next moves from central banks are likely to involve tightening rather than easing in monetary policy, it seems too early for investors to go underweight equities and seek refuge in an overweight to government bonds and duration.

We therefore stick with a broad and diversified overweight to equities over government bonds for now. However, we are cognisant both of the potential for greater volatility in the second half of the year and of the fact that we are entering the late stage of the US economic cycle, meaning the moment to reduce equity risk to underweight will likely come in the next three years—but just not quite yet.

CONTACT

For any enquiries about this document, please contact:

Michael Bell – michael.j.bell@jpmorgan.com

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