The Year Ahead | 2018
A Year of GIVE and Take: Growth, Inflation, Valuations and Errors

Following an impressive year of market returns, we expect some of the positive momentum to be carried over into the new year, but there are also new challenges emerging that will require investors to actively manage their asset allocation. We summarize the four key influencing factors to watch out for under the acronym of GIVE: Growth, Inflation, Valuations and Errors.

• Growth: From acceleration to cruising speed
   Global economic growth accelerated in 2017 and leading indicators suggest this momentum should stabilize into 2018, which would underpin a constructive outlook for risk asset fundamentals. Although monetary policy is being normalized by a number of central banks, it remains accommodative to support growth. This benign growth environment should also translate into a healthy global trade cycle, crucial for Asia and emerging markets.

• Inflation: Hot and cold
   Global inflation is still expected to remain subdued, with the U.S. as a possible exception considering a weaker U.S. dollar and tight labor market. A gradual pick up of inflation in the U.S. would persuade the Federal Reserve (Fed) to steadily raise policy rates. The rest of the world has more flexibility to keep policy loose, but selected central banks in Asia may also start to consider nudging their interest rates higher.

• Valuations: Finding a good deal in an expensive mall
   There are few cheap assets in the market today. U.S. equity valuations are relatively high at this point of the cycle and the same applies to corporate credit spreads in the U.S. and Europe. Steady fundamentals should continue to support this value, yet investors should look to diversify. Emerging market debt and European and Asian equities have seen their valuations re-rated in the past 18 months but still offer opportunities to investors due to renewed growth momentum in these regions.

• Errors: Bridging politics and fundamentals
   Policy errors, elections and geopolitical uncertainties have been high on the list of investor worries in recent years. However, it is important to establish the link between these events and economic and corporate fundamentals to make a rational assessment of the impact on asset allocation.
What does GIVE – our theme for the 2018 investment backdrop – mean for investors?

Global fundamentals are in their best shape since the Global Financial Crisis and this has resulted in very constructive market performance in 2017. This should underpin our optimism for risk assets such as global equities, corporate credits and emerging market assets. That said, this rally has also raised valuations for a range of assets, from U.S. equities and corporate credits to emerging market fixed income, which investors will need to actively manage. The global market environment is also complicated by the fact that a number of central banks are normalizing their policies. This could lead to greater volatility in government bond yields, and subsequently the level of risk-free rates and valuations in a wide range of markets.

This implies investors will need to construct a well-diversified portfolio with a broad range of assets that can deliver returns that meet their financial objectives.

This Year Ahead uses 17 charts* from the Guide to the Markets – Asia to illustrate themes across the 2018 investment landscape that we believe investors should monitor to construct an informed and rational view and guide investment decisions in 2018.

We hope these charts, along with our Market Insights program, can help you navigate 2018’s investment environment.

Regards,

Tai Hui, Managing Director
Chief Market Strategist Asia

*Unless otherwise stated, data of these 17 particular slides selected from the 4Q 2017 Guide to the Markets - Asia reflect most recently available as of September 30, 2017.
Global Growth: From acceleration to cruising speed

Accelerating growth momentum in 2017 is likely to transform into steady expansion in 2018, with both developed and emerging markets making a contribution.

**EUROPE: GENERATING GROWTH MOMENTUM AMID POLITICAL NOISES**

- Despite various elections and political challenges in recent years, the eurozone has achieved positive economic growth consistently since 2013, with both core and peripheral Europe contributing.
- Improvement in the jobs market, with the lowest unemployment rate since the Global Financial Crisis, has boosted consumer confidence, which is translating into stronger household spending.
- Corporate sentiment has also improved and this has led to greater demand for bank lending. This - combined with the greater confidence of lenders - has spurred loan growth. The dampening impact from a stronger euro on exports has been partially offset by stronger global demand.

**U.S.: CONSUMPTION AND INVESTMENT HOLDING THE FORT**

- Following several years of strong recovery, consumption and the housing market have reached a point of steady expansion. Household spending is expected to be well supported by a job market that is effectively at full employment, even though wage growth has yet to pick up.
- Corporate investment is also improving as business confidence picks up on the back of better domestic and global growth, even as many pro-business reforms pledged by the White House have not been implemented. A softer U.S. dollar has also helped to improve the country’s trade deficit, which would be less of a drag to economic growth.
- Potential upside to U.S. economic growth could come from tax cuts and reforms. However, the timing and magnitude of such stimulus will depend on a complicated and lengthy political process. Political parties will also be eyeing the mid-term elections in late 2018 when they calculate their response on policy changes.
CHINA: A BALANCING ACT OF GROWTH AND STABILITY

- The latest leadership transition reinforces our view that the authorities are focusing more on the quality of growth than speed. Given Beijing’s income target for 2020, we expect a GDP growth target of 6%-6.5% would be retained but the government will be looking to balance a broad range of economic objectives, including managing financial sector risks.

- Consumption and services are expected to play a growing role given the rise of China’s middle class, facilitated by a broad range of technological advances.

- Fixed asset investment in recent years has been propped up by public sector spending, while the private sector has held back due to weaker global growth and challenges in obtaining liquidity. This trend is likely to continue, but we expect the private sector to play a bigger role in innovation and research and development, instead of traditional manufacturing capacity building.

ASIA: RIDING THE MOMENTUM

- The sharp recovery in Asian exports in 2017 was brought about by stronger global demand, including from China, and a rebound in commodity prices. The positive commodity price effect is fading and this would imply softer, but more sustainable, export growth in Asia. This would, in turn, stimulate a broad range of industries including financials, logistics and local labor markets.

- Further acceleration in consumption is constrained by the high level of household debt in a number of Asian economies. Yet, there is room for improvement in investment in Southeast Asia, given the need for better infrastructure. This could be funded by an inflow of international capital, which would, in turn, help to keep local borrowing costs down.
Inflation: Hot and cold

Overall global inflation should remain subdued since most economies are still operating with spare capacity, or a positive output gap. The U.S. could see more inflationary pressure since supply-side constraints are slowly kicking in. The Federal Reserve is expected to normalize policy rates gradually, but other central banks could still prefer to stay put.

GLOBAL INFLATION: WARM SPOTS AMID A COOL WORLD

- Core inflation in the U.S. has come in below the Fed’s target and it is likely to stay this way in the near term. However, the tight jobs market and a weaker U.S. dollar could introduce some inflationary impetus to the U.S. economy.
- While global growth is firm, there is still plenty of spare capacity globally before inflationary pressures become a threat to the central bank’s target.

CENTRAL BANK POLICY: NORMALIZATION AT GLACIAL PACE

- Selected developed market (DM) central banks, such as Canada and the United Kingdom, have already opted for higher rates. Some emerging market (EM) central banks may also choose to follow. But the pace of tightening is likely to be modest at best given the lack of immediate inflationary pressure.
- The Fed should be leading the way in normalization, or three 25bps hikes in 2018 according to the Federal Open Market Committee median forecast. Its balance sheet reduction could also ease into the back of investors’ minds given the Fed’s careful guidance.
- The European Central Bank will slow down its asset purchase while the Bank of Japan’s yield targeting policy also gives it more flexibility with its quantitative easing. We expect G4 central banks should combine to become a net seller of assets by late 2018.

CHINA: DE-LEVERAGING AND CONTAINING RISKS

- The People’s Bank of China is expected to maintain a cautious stance on feeding liquidity to the economy. Rate cuts are unlikely given economic growth is broadly in line with Beijing’s target. It does not want to fuel speculation in financial assets and real estate, but needs to facilitate economic development.
- Regulation of wealth management products and the shadow banking system should also remain relatively tight in order to manage the systemic risks facing the financial system. The newly established Financial Stability Committee could improve the coordination amongst financial regulators and reduce regulatory arbitrage.
Valuations: Finding a good deal in an expensive mall

There are few cheap assets in the market today. U.S. equity valuation is at a cyclical high and corporate credit spreads in the U.S. and Europe are also tight. Although this is well supported by economic and earnings fundamentals, further valuation re-rating is unlikely. We see less demanding valuations in Europe, emerging markets and Asia for equities, and emerging market sovereign bonds for fixed income.

EQUITIES: GREAT EXPECTATIONS

- While U.S. equity valuations are above average both in P/E and P/B terms, the earnings outlook remains constructive. Moreover, there are sectors, such as financials, that we believe can still deliver returns to investors. Furthermore, U.S. equities still look less expensive compared with government bonds. Overall, rich valuation is a constraint to potential returns for the broad market and this makes sector and company selection more critical in generating returns.

- P/E ratios for Europe, Asia (including Japan) and emerging markets are slightly above their 15-year averages. Positive economic fundamentals and structural factors, such as a rising middle class, should help to support earnings growth in 2018, which would, in turn, make the P/E ratios more appealing.

FIXED INCOME: KNOW YOUR SOURCES (OF RETURN)

- Corporate credit spreads in the U.S. and Europe have reached a cyclical low. While this is well justified by low default rates and strong economic fundamentals, room for further tightening is limited. This implies the majority of return from this asset class should be derived from the coupon, instead of the bond price.

- Emerging market sovereign bonds’ spread to worst is in line with their 10-year averages, both for local and hard currencies. Also relative to their developed market counterparts, EM government bond yields are consistent with the long-term average. This would imply better potential for capital appreciation, especially with international capital flows returning to emerging markets under a weak U.S. dollar environment.
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POPULISM, NATIONALISM AND GEOPOLITICS

• Growing income inequality in developed economies has weakened popular support for globalization and free trade. Meanwhile, emerging economies, whose populations have benefited from globalization and have been lifted out of poverty, are much more supportive. While we expect most countries will still adhere to the principles of free trade, free trade area negotiations are likely to be more challenging with a shift in favor of bilateralism instead of multilateralism. This should not have an immediate impact on global trade recovery, but could have sector-specific investment implications.

• Geopolitical tensions, whether in the Korean peninsula or the Middle East, are likely to be with us for the foreseeable future. The “muddle through” scenario is still the most likely for the North Korea situation. Instead of avoidance, investors need to establish the economic connections with these incidents. It could be oil supply (Middle East) or global industry supply chains (Korean peninsula).

ELECTIONS: THINK LOCAL

• There are always a large number of elections around the world each year and their impact on investment is often local, instead of global. In 2018, elections are scheduled in the U.S. (Congress mid-term), Italy (general), Malaysia (parliamentary), Thailand (general), Russia (presidential), Mexico (general) and Brazil (general), to name a few. China is also expected to announce its new cabinet following the 19th Party Congress this year with Chinese President Xi Jinping’s new Politburo.

• The run-up to the U.S. mid-term elections could influence the outcome of tax reform and de-regulation, which would be closely followed by global investors. For other countries, the impact from their elections or political transitions would be more local and sector-specific, such as the banking sector in Italy or state-owned companies in Brazil following a number of corruption scandals. In China, we expect the authorities to focus on mitigating systemic risks in the financial system and to maintain growth rates to achieve their medium-term income objectives. State-owned enterprise reforms will still be much talked about, but with significant variation amongst different industries.

Policy errors: Bridging politics and fundamentals

Global investors are becoming more experienced in adjusting their investment strategies with elections, geopolitical events and policy errors. While many of these events have grabbed news headlines and affected short-term risk appetite and sentiment, it is important to react rationally and establish the link between these risk factors with direct impact on economic and corporate fundamentals.
What does GIVE give you?

In brief, we have global growth at cruising speed, benign inflation leading to gradual central bank normalization, rich valuations in many asset classes and ongoing elections and political events. In this environment, we need to filter out the noise and construct our portfolio to achieve specific investment objectives.

2017 WAS EXCEPTIONAL IN MANY WAYS

- Asset returns in the first ten months of 2017 have been nothing short of spectacular. USD-based investors have enjoyed positive returns in most asset classes, even in developed market government debt. Market volatility has been exceptionally low this year. Investors should appreciate this is far from the norm.

- Investors’ asset allocations should always be prepared for different types of weather. This exceptionally low volatility environment is very likely to change as central banks engage in gradual normalization. To put this in context, the largest intra-year decline in the first ten months of 2017 was 3%, compared to a median of 17% for the past 30 years.

- While we are upbeat on risk assets and believe the outlook for developed market government bonds is very challenging, a well-diversified portfolio remains critical to prepare for the unexpected.

RISK ASSETS THRIVE UNDER HIGH YIELD AND A WEAKER DOLLAR

- Rising interest rates are expected to lead to higher government bond yields in the developed world. This is a reflection of good global growth. Naturally, this is a more constructive environment for risks assets, including equities, corporate debt and emerging market assets, as economic growth facilitates corporate earnings growth and suppresses default rates.

- In addition, we also believe the U.S. dollar remains on a multi-year downtrend, with bouts of technical rebound. Historically, this adds additional boost to risk assets, especially emerging market equities and debt. Despite the U.S. dollar’s correction since 2016, its valuation, on a trade-weighted basis, remains above its long-term average. Improvement in global growth relative to the U.S. will also put downward pressure on the currency.
EQUITIES: OPPORTUNITIES IN EUROPE AND ASIA, SELECTIVE IN THE U.S.

- With a comprehensive recovery in earnings across the world and less demanding valuations, the catch-up potential from Europe, emerging markets and Asia is arguably more appealing than the U.S. market. This trend started in 2017 and we believe it can continue into 2018, albeit with more volatility.

- Meanwhile, we believe there are still selective opportunities in the U.S, but this will require careful sector and company selection. Financials, industrials and technology continue to enjoy a positive outlook. Bond-like defensives are likely to face a greater challenge under the rising yield environment.

- Prospects for a stronger currency should not deter investors from Europe. The historical relationship between the euro and European equity performance is far from consistent. Moreover, companies feeding off improving domestic demand are also less sensitive towards a stronger currency. European companies are also finally delivering long-awaited earnings growth after several years of disappointment.

ASIAN EQUITIES: MORE COMPREHENSIVE EARNINGS PERFORMANCE

- The Asian technology sector has captured investor attention in 2017, from Chinese tech services to Taiwan and Korea electronics manufacturers. We believe steady global trade growth should help to enhance the breadth of this earnings recovery.

- Some of the laggards of 2017, including Chinese onshore market (A-shares) and ASEAN, should be able to enjoy some catch-up momentum. While they may fall short on the tech appeal, their economic structure (rising middle class, infrastructure needs) should attract investor attention once more.
FIXED INCOME: RESEARCH-DRIVEN ALLOCATION

- The risk of rising yields implies investors will need to seek higher yields or credit spread tightening to compensate for duration risk.

- As we mentioned earlier, credit spreads in the DM corporate debt market are already tight, implying coupon would be the main source of return. This credit spread is also vulnerable to sector-specific events, such as a temporary correction in oil prices. This requires bottom-up company financial analysis and well-diversified allocation.

- Valuation in emerging market sovereign debt is less demanding. Many emerging market bond yields are positive in real terms. Currency valuation, especially in Latin America and Europe, the Middle East and Africa, remains competitive after a sharp depreciation following the 2013 “Taper Tantrum” and 2014/15 commodity price collapse. Nonetheless, idiosyncratic factors are still at play. Domestic political developments, central bank policy and the impact of commodity prices and other economic activities will need to be carefully understood.

INCOME GENERATION: STILL NECESSARY

- Although we anticipate that global growth will be constructive to capital gains for equities, income generation remains important for many Asian investors. Combating negative real cash return, generating income to support retirement and having a less volatile investment component in a portfolio are all good reasons to continue allocating to assets that generate income, especially for investors with a more conservative risk appetite.

- In addition to high yield corporate debt and emerging market bonds, investors can also generate income via high dividend equities and alternative assets.

- Emerging market equities offer a large selection of companies that offer high dividends. Many of these companies also belong to cyclical sectors that can benefit from the uptick of the global cycle.

Conclusion

Investment is often about give and take - it’s a trade-off between risk and potential rewards. After a rewarding 2017, we believe investors can remain optimistic as global growth is still supportive of risk assets. Yet we should not be complacent about some of the challenges ahead, such as the Fed’s policy normalization, rich valuations and potential policy errors by governments. A well-diversified portfolio can help investors to navigate this environment and achieve their objectives.
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