Market Bulletin

June 4, 2019

Lots of talk about tariffs

In brief

- Actions over the past four weeks have made it increasingly clear that trade uncertainty will persist over the next few quarters, with the potential increasing that trade tensions escalate even further. Even absent a full-on trade deluge scenario, the lingering of the trade uncertainty clouds will dampen businesses sentiment and economic growth globally.
- The U.S. Federal Reserve (Fed) will likely loosen monetary policy in 2019 but the amount of future rate cuts depends on how trade talks progress. Within fixed income, quality should outperform credit if trade fears continue; however, yields will likely rebound if the trade clouds clear and confidence picks up.
- Trade uncertainty will cap valuations for international equities as well, while keeping volatility high especially for emerging markets and cyclical sectors. A more targeted and defensive approach to international investing makes sense for the short-term, while investors should not lose sight of the long-term potential for the asset class.

Gabriela Santos
Executive Director
Global Market Strategist

David Lebovitz
Executive Director
Global Market Strategist

Alex Dryden, CFA
Vice President
Global Market Strategist

Trade was the hot topic of 2018, with the U.S. administration engaging in negotiations with many major trading partners. Some tariffs were imposed along the way, with solar panels, washing machines, steel, aluminum and about half of Chinese imports (25% on USD 50billion and 10% on USD 200billion) all finding themselves in the crosshairs. This increased the U.S. tariff rate from 1.4% in 2017, the lowest in the world after decades of globalization, to 3.2% at the

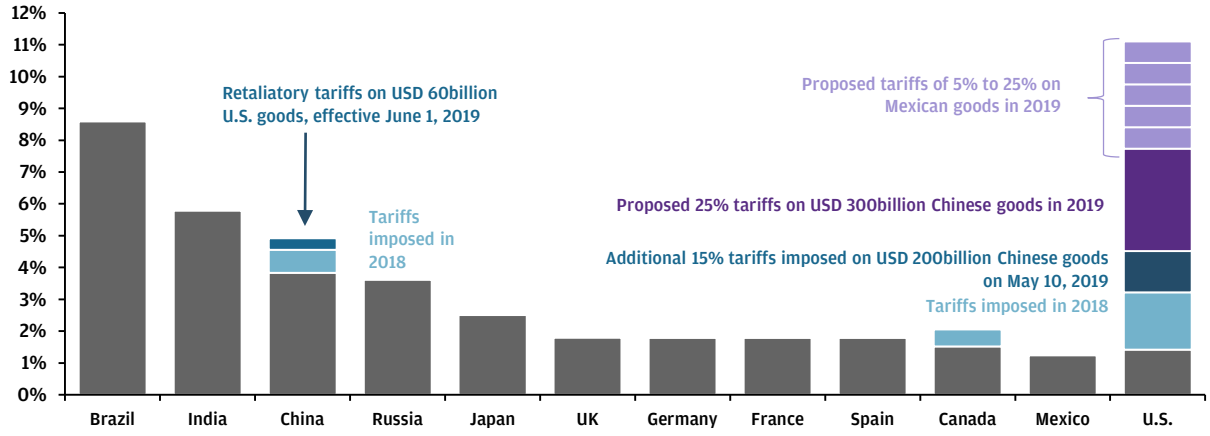
end of 2018, already higher than most developed countries **(Exhibit 1)**. In retaliation, trading partners like China, the European Union, Mexico and Canada enacted tariffs on U.S. goods. The negative economic effects of these moves were most evident for big export economies like those of Japan, Europe, China, Taiwan and Korea, leading manufacturing activity to weaken significantly over the course of last year. This manufacturing-led weakness led to a downshift in the pace of global growth to below trend levels by the end of 2018. The U.S. economy, on the other hand, held up much better, partly due to the fiscal stimulus boost, partly due to a lower reliance on exports and partly due to the still small dollar amount of the applied tariffs.

Over the first four months of this year, it seemed like the trade clouds were slowly beginning to part, with the U.S. and China close to a trade deal and the signing of a new agreement with Mexico and Canada. This progress, however, was derailed on May 5, as the U.S. administration announced an increase of the current 10% tariff on USD 200billion of Chinese imports to 25%; China retaliated by imposing up to 25% tariffs on USD 60billion of U.S. goods, and both of these increases took effect June 1. This has increased the weighted average U.S. tariff rate to 4.5%, close to China's rates.

As a next step, preparations have begun to impose 25% tariffs on the remaining USD 300billion of Chinese imports. In addition, on May 30 the administration announced plans to increase tariffs on all Mexican imports, starting at 5% on June 10 and increasing every first of the month until reaching 25% on October 1. The list of tariffed goods from China and Mexico in this next round would be disruptive for the U.S. economy, as it would: 1) increase the U.S. tariff rate to 11.1%, greater than that of any major economy; and 2) include many Chinese end-consumer goods (which would weigh more directly on U.S. consumer prices) and intra-supply chain trade with Mexico (which would significantly harm U.S. businesses).

Every day now, the trade-related headlines are flying and the puzzle pieces are shifting around; however, a picture of the puzzle image is starting to become more visible **(Exhibit 2)**. It seems very unlikely that we will return to the pre-2018 world, where trade uncertainty completely disappears and it's sunshine and blue skies for the global economy and global markets. It does seem, however, that this administration is willing to

EXHIBIT 1: U.S. tariff rates now higher than DM countries, approaching EM countries
TARIFF RATE, APPLIED, WEIGHTED MEAN, ALL PRODUCTS



Source: IMF, U.S. ITC, World Bank, J.P. Morgan Asset Management. Historical tariff rates are 2017 figures. Data are as of May 31, 2019.

EXHIBIT 2: TRADE RISK: WHAT DO ALL THE PIECES OF THE PUZZLE SHOW US?

	Trade uncertainty cloud disappears	Trade uncertainty lingers like a dark cloud	Trade deluge
Likelihood	Unlikely short term	Likely	Increasingly likely (although not base case)
What does it look like?	Trade deals signed; tariffs & threats disappear; tech restrictions disappear	Zig-zag negotiations & tariffs; threats linger; tariffs used for broad policy goals	Tariffs increased even more; retaliation occurs against U.S. companies; tech restrictions disruptive
Global economy	Higher gear; manufacturing-led rebound	Downshift not stall; manufacturing weak vs. services	Stall a real possibility; services weakens too
Global earnings	Above consensus; double-digit ex-U.S.	At consensus for 2019; mid-to-low-single digit	Below consensus 2019 & 2020; low to negative
Global multiples	Multiple expansion; above average P/Es	Multiples capped at average	Multiple contraction; below average P/Es
Regional mix	Broad outperformance of EM and DM ex-U.S.	More targeted and defensive international approach	U.S. outperformance in short term; EM suffers more
Return/volatility	High return/low volatility	Lower return/higher volatility	Low or negative return/high volatility
Global rates	Fed hikes back on table; bond yields move higher	Fed cuts once; bond yields move a little higher, but capped	Fed cuts twice; bond yields move lower

Source: J.P. Morgan Asset Management, Getty Images. Data are as of May 31, 2019.

use tariffs as a negotiating tool for a variety of policy objectives, from trade to technology to immigration.

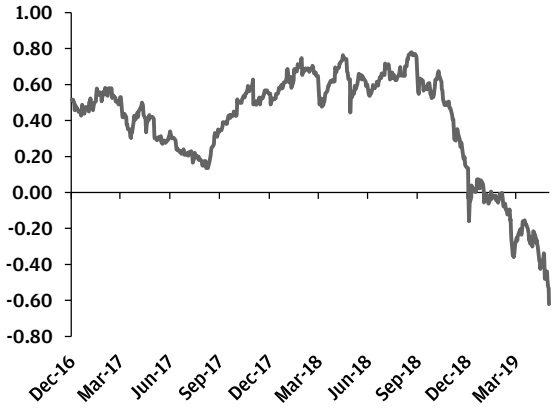
As a result, there are two other more likely paths: 1) trade uncertainty lingers like a dark cloud; or 2) the trade deluge arrives, with the U.S. administration following through on its plans for tariffs on the remainder of Chinese imports and on all Mexican imports. The second option of further trade escalation would be very harmful for both the global and U.S. economies. The life vest for the global economy thus far has been the consumer and services, with job growth remaining solid, consumer prices remaining low and consumer confidence still robust. Should this life vest deflate, we would no longer be talking about only a downshift, but a possible stall in global growth. This second option is increasingly likely, but not guaranteed due exactly to its potentially negative effects.

The reality is that even if it doesn't actually start to pour, the fact that the dark cloud will continue to linger is important in and of itself. Broad uncertainty regarding trade is likely to continue depressing business investment and investor confidence, resulting in lower growth and more market volatility. While last year's effects were felt in U.S. stock markets, but not the U.S. economy, the combination of fading fiscal stimulus, an aging cycle and higher tariff dollar amounts might mean the U.S. economy is not immune this time around. Already, U.S. business investment plans have declined over the past two quarters, and while this is not entirely due to trade tensions, businesses are citing the issue as a key risk. In the following sections, we attempt to provide insight as to how these various scenarios would impact different asset classes.

WILL THE FED BOW TO THE MARKET?

The next move from the Fed could hinge on how trade discussions impact economic conditions. According to the latest Fed forecasts provided in March, the Fed itself believes it will be on hold for all of 2019. However, as we highlight in **Exhibit 3**, investors are pricing in a significant chance of a rate cut within the next 12 months, a big shift from only 6 months ago. Should trade fears ease in the near future, it will likely be supportive of economic growth in the second half of 2019, allowing the Fed to stay on hold this year and, depending on the state of inflation, potentially consider a rate hike in 2020. Meanwhile, should the trade clouds remain on the horizon but not darken further, the Fed will likely cuts rates once by year-end to help support economic growth.

EXHIBIT 3: IMPLIED FORWARD 12-MONTH CHANGE IN SHORT-TERM RATES
BASED ON FUTURES MARKET PRICING OF 3-MONTH LIBOR



Source: Bloomberg, J.P. Morgan Asset Management. Data are as of May 30, 2019.

However, a concerning development in the latest series of tariffs has been not just the size of the threatened tariffs but also the sectors they impact. Initially, tariffs were concentrated on soy beans and washing machines meaning the economic impact was somewhat limited however, in the latest tariff threats the focus has shifted towards cars and technology. The shift in focus has increased the potential pain that could be felt by consumers from rising tariffs and could hurt growth. An environment of slowing economic growth and growing recessionary fears will likely be a significant enough catalyst to prompt the Fed into cutting interest rates twice by the end of 2019. In short, we think the Fed will likely cut rates this year, however, the magnitude of any future rates cuts depends on how the trade talks progress.

What does this mean for fixed income markets? If the clouds clear and trade fears ease, global economic growth should pick up. With economic growth rebounding, Treasury bond yields should rise and credit spreads would tighten, leading U.S. high yield to outperform Treasuries. Should the middle-of-the-road scenario prevail, yields are unlikely to move too much, meaning that investors are likely to be compensated for taking on carry positions within areas like high yield and emerging market debt. However, if you believe that the trade war is likely to escalate from here, it would likely damage economic growth, forcing the Fed into a rate cut. In this environment, investors should focus on quality and duration over credit, as Treasuries would likely outperform the rest of the market.

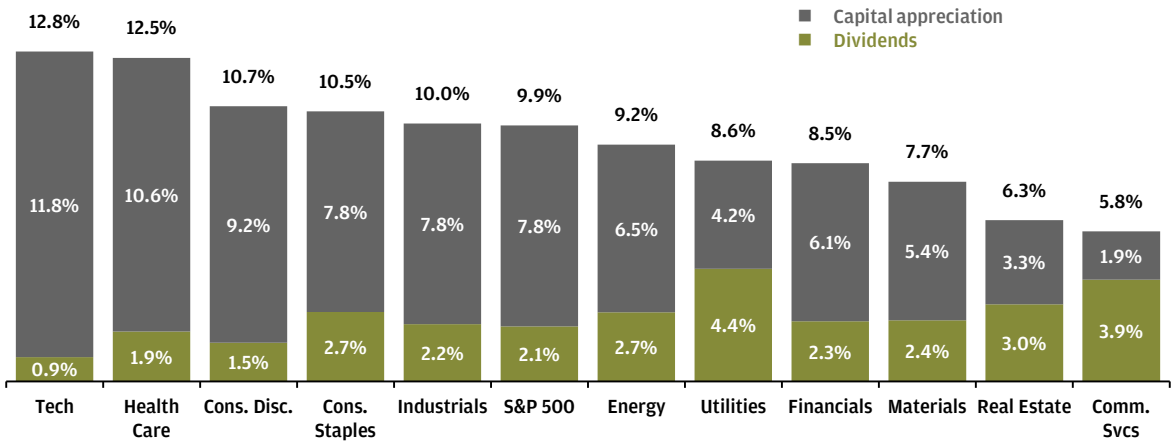
VALUE? GROWTH? NEITHER?

While it is unclear how the trade situation will evolve from here, it is important to consider the implications of each scenario for equity markets. Thus far, any escalation or de-escalation in the trade outlook has manifested itself in valuations, with the forward price-to-earnings ratio of the S&P 500 ranging between 14.1x and 16.9x since the beginning of this year. Based on the macro environment, fair value for the S&P 500 multiple seems to be around 16.5x, and we expect that valuations will oscillate around that level depending on whether trade tensions are ratcheting higher or lower.

With multiples likely range bound, the bigger question for investors is what will happen with earnings, as that will be the primary driver of returns. At the current juncture, 25% tariffs on USD 250billion of Chinese goods appears to be priced into earnings estimates for both 2019 and 2020. Our own forecast for 2019 profits is in line with consensus estimates at ~4%, but there is downside risk to the 2020 figures. Consensus is currently looking for 11% earnings growth in 2020, well above our own estimate of 5%, and neither of these forecasts include the potential for the remaining USD 300billion of Chinese imports to be taxed at a 25% rate. In the event that we were to see further escalation in U.S.-China trade tensions, we expect that would detract about USD 2 from 2019 EPS and USD 4 from 2020 EPS, pushing this year's growth rate to 3% and 2020's growth rate to 2.5%. The impact on earnings from the recently announced tariffs on Mexico are more difficult to quantify, but represent an additional downside risk to our earnings forecasts.

So how should investors think about navigating equity markets given the range of potential outcomes? The answer to this lies in income—if you believe that trade tensions will not escalate further, it makes sense to focus on sectors like technology and communication services, which have historically derived the majority of their return from capital appreciation **(Exhibit 4)**. If you believe that we are headed for the worst case scenario, one should focus on defensive, income-producing sectors like utilities and consumer staples. The middle-of-the-road scenario would suggest investors embrace those sectors that have a more balanced total return profile, but are not overly exposed to the global economy or trade. This would include financials, energy and real estate; industrials and materials will likely remain at the mercy of trade policy, but can be allocated to in a tactical fashion based on the perceived direction of travel at any given juncture.

EXHIBIT 4: S&P 500 SECTOR RETURNS: DIVIDENDS VS. CAPITAL APPRECIATION
25-YEAR ANNUALIZED RETURN, %



Source: S&P, J.P. Morgan Asset Management. Data are as of May 30, 2019

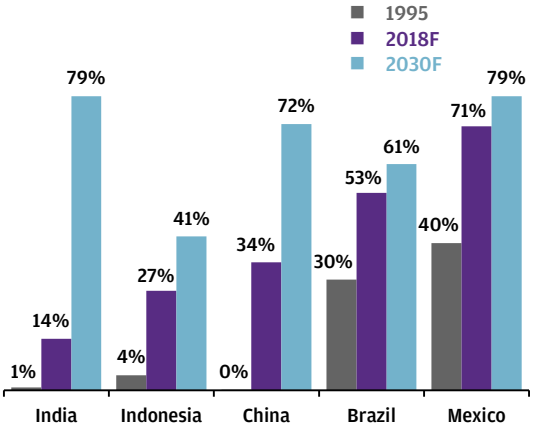
INTERNATIONAL BOAT WILL BE ROCKED BY THE STORM, BUT AN EYE ON THE HORIZON HELPS

After a tough period for international equities relative to the U.S. from 2010 to 2016, the pieces fell into place in 2017, as economic and earnings growth accelerated around the world, multiples expanded from low levels and the U.S. dollar fell. This was a story of broad regional outperformance relative to the U.S., led by cyclical sectors and emerging markets. Unfortunately, the sudden emergence of trade clouds over the course of 2018 rocked the international boat very hard, with a sizable downshift in economic growth and more uncertainty about the path of earnings.

In the scenario of lingering trade uncertainty clouds, global economic growth is unlikely to shift into higher gear, given the relevance of exports and manufacturing to the major markets in Europe and Asia. As a result, earnings growth will be more muted, multiples will remain capped and the U.S. dollar will have trouble weakening significantly. In the short term, the international equity story is likely to remain less broad, with a more targeted and defensive approach making sense. Should it begin to pour, emerging markets in particular have further scope to fall, given their exposure to China and technology, two key current battlegrounds, as well as their higher sensitivity to equity and currency moves.

Thinking beyond the short-term weather forecast, eventually the sun will shine once again and international will have its day. Emerging markets, in particular, continue to offer a long-term story of higher economic and earnings growth driven by a rapidly expanding middle class **(Exhibit 5)**, which this trade episode does not change. The potential for multiple expansion and currency appreciation versus the U.S. dollar is an added cherry on top. For investors with very limited exposure to emerging markets, further volatility related to tariffs would offer the opportunity to accumulate a more representative allocation to the asset class. Keeping an eye on the horizon will help to get through the choppy waves.

EXHIBIT 5: GROWTH OF THE MIDDLE CLASS
PERCENT OF TOTAL POPULATION



Source: Brookings Institute, J.P. Morgan Asset Management. Middle class is defined as USD 3,600-USD 36,000 annual per capita income in purchasing power parity terms. Historical and forecast figures come from the Brookings Development, Aid and Governance Indicators.

INVESTMENT IMPLICATIONS

- Given the likelihood that trade uncertainty lingers for the next 18 months, global economic and earnings growth will remain below average and volatility will persist.
- The Fed is likely to loosen monetary policy in 2019 but the magnitude is dependent on the economic impact of trade tensions. Bond yields will likely remain low and carry-trades could do well in this environment.
- When allocating to equities, investors should strike a balance between capital appreciation and income, focusing on those sectors with above-benchmark yields that are less exposed to global growth and trade. There are solid long-term growth stories tied to the growing middle class in emerging markets that could perform well despite the trade uncertainties.

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J.P.Morgan
Asset Management