2019 investment outlook: Mid-year update

Tweets, trade and turmoil: Going nowhere fast

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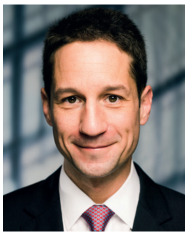

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IN BRIEF

- The US economic expansion has now broken historical records. But political upheaval threatens the outlook. While the tariffs themselves are unlikely to be fatal for the expansion, the indirect consequences on corporate investment pose more of a risk.
- The Federal Reserve is under enormous pressure to cut rates and keep the US show on the road ahead of the presidential election next year. This may support activity to some degree but the US economy and earnings will slow as the effects of the tax cuts fade.
- Any reticence that Beijing has shown over opening the spigots to defend China's growth is well behind us. The questions now are around the speed with which policy measures will take effect and the overseas implications.
- Europe is the region that appears most vulnerable to trade war repercussions. While it's not yet clear whether the European auto industry is next on President Trump's hit list, the uncertainty is taking a toll – and the scope for policy support is limited.
- Historically, investors have tended to benefit from de-risking towards the end of the cycle, but with the picture unusually clouded and central banks having failed to normalise rates this time around, it's less clear that domestic bonds and cash will play their usual role for European investors.
- It therefore seems to make sense to maintain a defensive equity allocation for now, while looking to alternatives such as macro funds and real assets to provide a potential portfolio cushion.

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WILL THE TRADE WAR PROVE FATAL FOR THE GLOBAL RECOVERY?

In July, the US economy will have recorded the longest expansion in history. Unemployment is at or near multi-decade lows in the US, Germany, Japan and the UK. And yet there are few obvious signs that the global economy is overheating. Sectors prone to exuberance – housing and investment – are far from booming. Inflation – often the harbinger of economic doom – is notably absent. Indeed, if anything, the worry for the global economy is that inflation remains stubbornly low. Overall, despite its age, the global expansion doesn't look to have reached its natural limits.

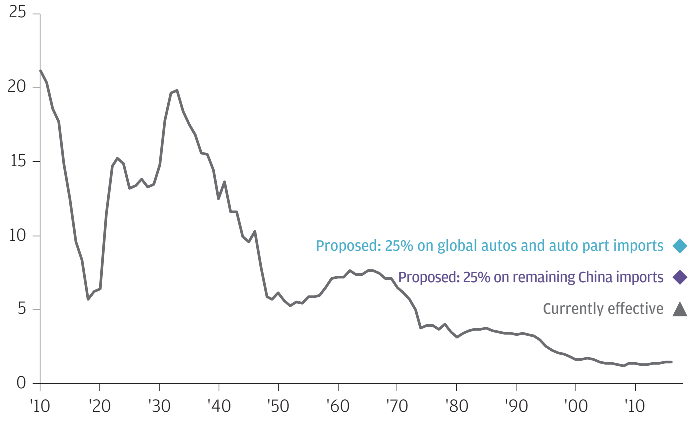
But political upheaval is threatening the outlook. UK prime minister Theresa May has given up hope of achieving a Brexit deal that can appeal both to her Conservative colleagues and the rest of the UK parliament. The Italian government is at loggerheads with Brussels. And, of more systemic concern for the global economy, trade negotiations between the US and China appear to have broken down.

At the root of the US-China dispute is a deep disagreement over technology. The US administration believes that the state-led subsidies China offers its tech sector provide its firms with an unfair advantage over US tech companies. Overlaying the issue of "fairness" is a concern that Chinese technology could also threaten US national security. Beijing denies the security threat and is reluctant to abandon the support it provides to its flourishing tech sector. There seems to be no common ground. Even if a deal can be struck in the coming months, it is likely to be partial and highly conditional. Exhibit 1 shows the extent to which the tariffs are reversing a multi-decade period of globalisation.

Directly, the tariffs themselves are unlikely to be fatal for the global expansion. The US exports 0.6% of its GDP to China. China has more at stake given it exports 3.6% of its GDP to the US. But even after the recent escalation, the direct numbers at this stage are relatively small. Although in theory the tariffs should raise inflation, we suspect the final inflationary impact will be small and instead Chinese producers and a moderately weaker renminbi will absorb some of the cost and US profit margins much of the rest.

EXHIBIT 1: US TARIFFS COMPARED TO HISTORY

%, effective tariff rate (tariffs collected as % of all imported goods)

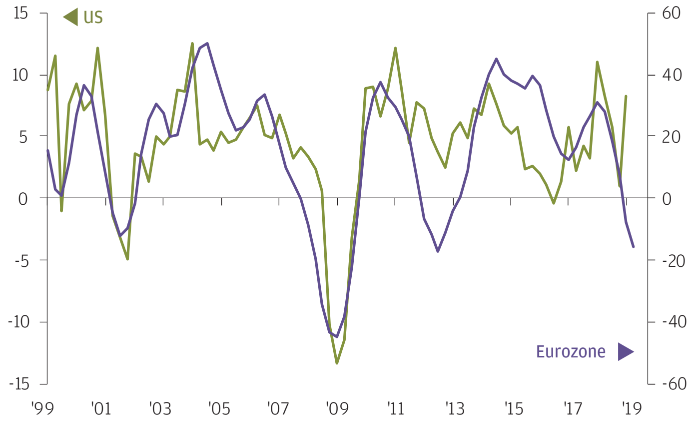


Source: Esteban Ortiz-Ospina and Max Roser "International Trade", US International Trade Commission, USITC, US Census, J.P. Morgan Asset Management. Currently effective tariffs includes tariffs on washing machines, solar panels, steel and aluminium, as well as tariffs implemented on approximately USD 250 billion of China imports. Remaining China imports and global autos (including auto parts) are measures proposed on approximately USD 290 billion worth of goods for each. Data as of 13 June 2019.

The indirect effects are likely to be of much greater magnitude. These include the disruption to supply chains as companies reroute or onshore processes currently completed abroad. The greatest economic impact will be companies scaling back investment plans, a process the data suggests is well underway (Exhibit 2).

EXHIBIT 2: EUROZONE AND US FUTURE CAPEX INTENTIONS

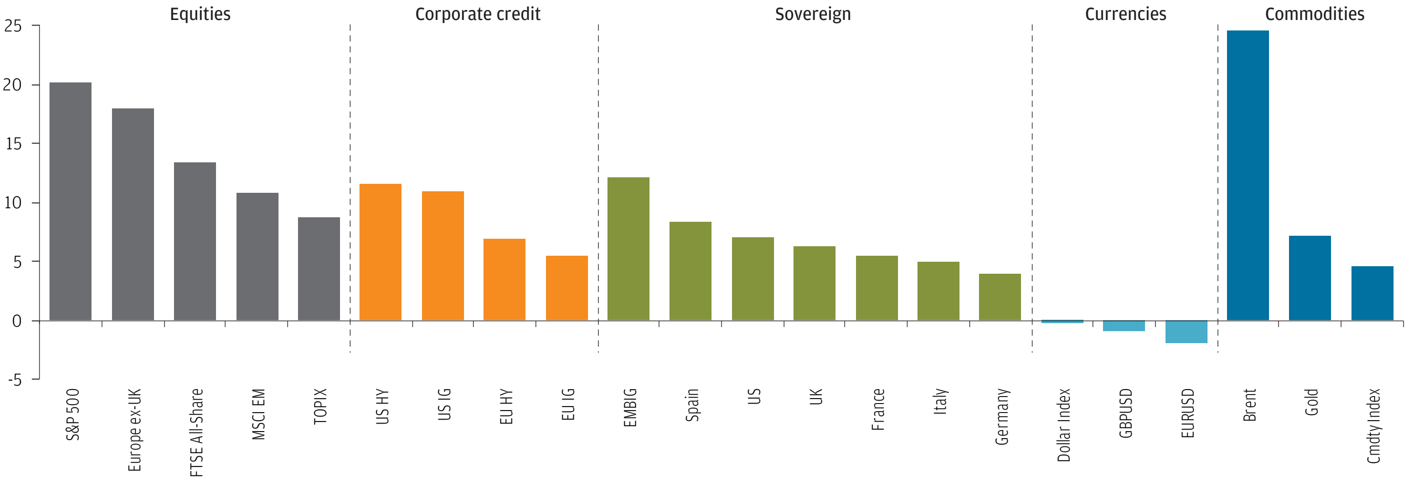
% change year on year (LHS); index level, 4Q moving average (RHS)



Source: Duke CFO Global Business Outlook, Haver Analytics, IFO, Refinitiv Datastream, J.P. Morgan Asset Management. Duke CFO future capex intentions is expected growth in next 12 months. Past performance is not a reliable indicator of current and future results. Data as of 13 June 2019.

EXHIBIT 3: ASSET CLASS RETURNS YEAR TO DATE

% total return in EUR



Source: FactSet, Barclays, Bloomberg, BofA/Merrill Lynch, FTSE, MSCI, TOPIX, Thomson Reuters Datastream, Standard & Poor's, J.P. Morgan Securities, US Federal Reserve, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 19 June 2019.

THE FED IS OFF THE BRAKE, IS IT BACK ON THE ACCELERATOR?

The equity and credit markets are coping with trade uncertainty remarkably well. This appears to sit in contrast to the government bond market, which paints a considerably bleaker picture of the outlook. Indeed, all assets across the risk spectrum have rallied significantly this year.

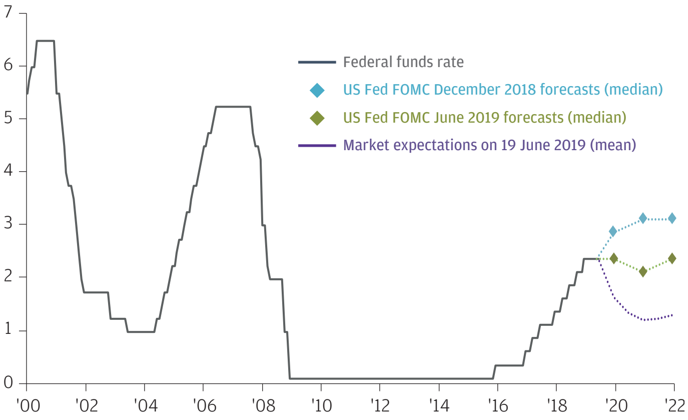
At face value, this looks like the bond and equity markets are out of sync. In fact the circle can be squared: the market is expecting the Federal Reserve (Fed) to pick up the pieces and sustain the US expansion. In global terms, we are learning once again that this expansion needs low interest rates to keep it going; "normal" interest rates are not coming back.

The Fed is certainly under considerable political pressure. The US president has explicitly stated (via Twitter) that the Fed is a deciding factor in whether the US "wins" the trade war. We should be careful about assuming that because the Fed is operationally independent it is necessarily free of political interference. If a narrative builds that the Fed is not a "national champion", the public could start to question whether it deserves the powers afforded it. If the recovery falters, the Fed will be the fall guy.

There is already enough weakness in the economic data and uncertainty in the outlook to justify a cut. Core inflation as measured by the personal consumption expenditure deflator is soft. Indeed, the Fed is undertaking a review of its framework given the problem of consistently low inflation. The end result of this may be the Fed aiming for a period of higher inflation in the coming years. The market has already priced 3 cuts by year end. Though it seems an extraordinary shift from the 2 hikes priced for 2019 last September, we wouldn't argue against the idea that these cuts will be delivered.

EXHIBIT 4: FEDERAL FUNDS POLICY RATE EXPECTATIONS

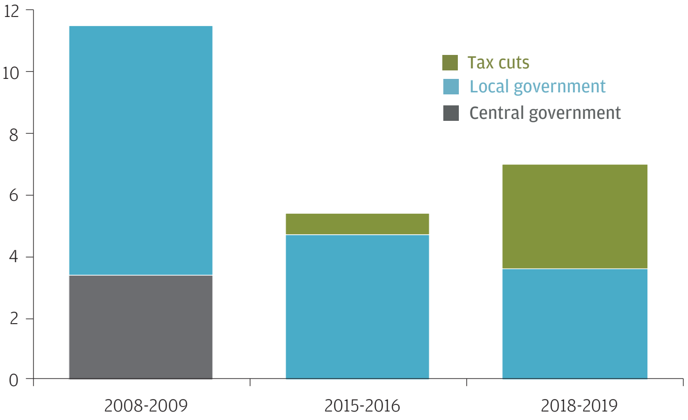
% Fed funds rate, FOMC and market expectations



Source: Bloomberg, US Federal Reserve, J.P. Morgan Asset Management. Forecasts are median estimates of Federal Open Market Committee (FOMC) participants. Market expectations are calculated using OIS forwards. Past performance is not a reliable indicator of current and future results. Data as of 19 June 2019.

EXHIBIT 5: CHINA STIMULUS

% of GDP



Source: Ministry of Finance of China, J.P. Morgan Securities Research, J.P. Morgan Asset Management. Central government spending is the incremental expenditure by the central government on infrastructure construction and subsidies to certain economic sectors. The spending is financed by tax revenue and issuance of treasury bonds. Local government spending is mostly composed of infrastructure investment conducted by local governments and their financing vehicles. These investments are mainly financed by bank loans, issuance of special local government bonds, policy bank loans and Private Public Partnership (PPP) projects. Tax cuts include cuts to VAT, personal income tax, corporate taxes and tariffs. Data as of 13 June 2019.

This is unlikely to prevent the US economy from slowing. Fiscal stimulus is wearing off, and that alone is likely to take a percentage point off growth by the end of the year. Whether the slowdown is more meaningful depends on how US companies respond to the global hostilities. At present, the US household sector is in good shape: its financial situation looks strong compared to history and unemployment is at a near 50-year low. But if the corporate sector is spooked by the trade agenda and chooses to cut jobs as well as capex, consumer spending could falter. We'll be watching indicators of employment intentions very closely, but for now expect growth in the US economy and in earnings to experience a period of stagnation rather than meaningful contraction. On the earnings front, it's worth noting that even stagnation would be well below analysts' expectations for next year which currently sit at 11% growth for the S&P 500.

BEIJING WILL DO WHATEVER IT TAKES

While there are questions over exactly how aggressively the Federal Reserve (Fed) will act to support the US economy, Beijing's commitment to keep the show on the road is in no doubt. If China cannot "win" the trade war, it will ensure its economic ambitions remain on track. Early reticence to open the monetary and fiscal spigots is fading. Local government bonds are being issued to fund infrastructure projects, and taxes are being cut to boost consumer spending, as shown in **Exhibit 5**. We do not doubt the intention of policymakers to keep growth in the region of 6%. The only question is how quickly and powerfully the authorities' efforts bear fruit, and whether that stimulus eventually serves to support growth in China-dependent countries.

TRADE WAR IMPACT MOST ACUTE IN EUROPE

The damage from the trade war is likely to be seen most clearly in Europe. Europe is highly dependent on global trade and capex – the two components of global growth that are faltering. The European Union (EU) is also waiting to hear whether it is next on President Trump's list of trade injustices to correct. The EU currently charges a tariff of 10% on cars that enter from the US, which compares to a tariff of 2.5% on EU cars entering the US. It is plausible that the harder the US administration goes after China, the less it will risk adding the EU to the agenda. But we can't be sure. Auto production accounts for as much as 5% of total GDP in Germany, so this is a sizeable dark cloud.

Unfortunately there appear to be few domestic policy levers that can be pulled to support European domestic activity in the face of falling external demand. The only countries willing to use fiscal stimulus are those that are already heavily indebted, such as Italy. The war of words between Brussels and Rome continues, and Italy may be placed under an excessive deficit procedure. Matteo Salvini, leader of the League party, is undeterred. Emboldened by his victory in the European elections, he wants to step up fiscal expansion with a flat tax. Although these plans will continue to draw consternation in Brussels, it seems unlikely the European Commission will issue financial sanctions on the eurozone's third-largest country. Italy is too large to be treated in the same manner as Greece.

In Germany there is seemingly little political appetite for government spending or tax cuts, even though the interest rate on German government debt is now negative to 15 years and the cost to the German government of servicing its debt has plummeted. Germany remains unwilling to solve the key problem facing the eurozone: deficient demand.

As in the US, the pressure to keep the show on the road is falling on the central bank. But unlike the Federal Reserve, the European Central Bank's (ECB's) fuel tank is running very low given that interest rates are already in negative territory. The ECB has committed to keep interest rates at this level at least through the first half of 2020, and provided further liquidity. This leaves investors contemplating whether the ECB might eventually be forced to cut rates into deeper negative territory. In turn, this is weighing on the financial stocks that account for roughly 20% of the European benchmark (see **Exhibit 6**).

EXHIBIT 6: MSCI EUROPE EX-UK FINANCIALS AND NON-FINANCIALS

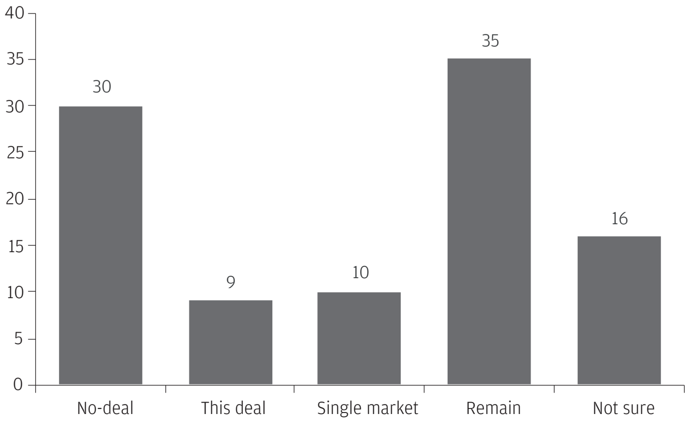
Index level, rebased to 100 in January 2004

Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Data shown are price index levels in local currency. Past performance is not a reliable indicator of current and future results. Data as of 13 June 2019.

Meanwhile, the further decline in sterling demonstrates the impact of ongoing Brexit uncertainty on investor sentiment towards UK assets. There is much excitement about Theresa May's successor and the potential for this to shift the process forward (see our *On the Minds of Investors* article[1]). Our view is that the new prime minister is likely to face the same challenges as the last. Passage of any deal remains difficult when the House of Commons remains divided over what it wants from Brexit, which in turn reflects a population ever polarised between leaving the EU with no-deal and a desire to remain (see **Exhibit 7**).

EXHIBIT 7: IF YOU HAD TO CHOOSE ONE OUTCOME OF BREXIT, WHAT WOULD YOU PREFER TO SEE?

% of respondents



Source: YouGov, J.P. Morgan Asset Management. Survey fieldwork was carried out on 10-11 April 2019.

This polarisation is significantly shifting the landscape of UK politics. At some point, one might assume that the heads of the Conservative and Labour parties will realise they have an incentive to work together to deliver Brexit to stem the damage being done to their respective parties. How quickly this realisation dawns, and the degree of damage to the economy in the interim, is still very much in question. In the meantime, investors need to understand the impact that no-deal Brexit would have on markets, vs the impact of a change of government.

No-deal would potentially send sterling lower, but UK Gilts and international FTSE 100 stocks higher, as repatriated earnings benefited from the weaker exchange rate. Meanwhile, a general election risks a change of government to the Labour party, which potentially would focus on less market-friendly practices. A Labour party advocating much higher government spending and a renationalisation of utilities and transport might result in a fall in the price of Gilts and domestic-focused FTSE 100 companies, in particular. Given these scenarios, a bias in the UK away from small- and mid-cap companies, which tend to be more domestically focused, seems prudent. This should also help build in some resilience to portfolios were a recession scenario to materialise, as UK small-cap stocks have underperformed large-cap in each of the last three US recessions.

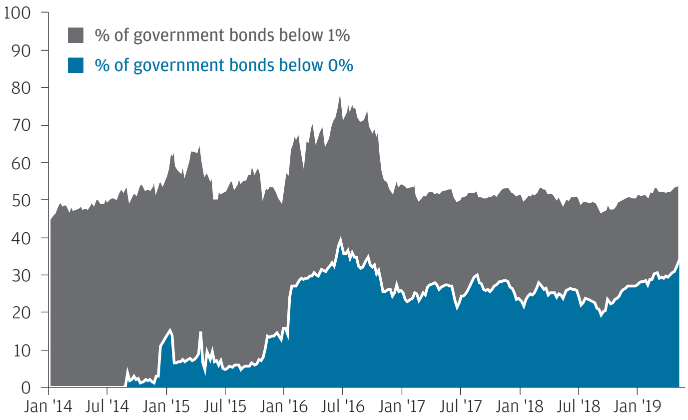
[1] *On the Minds of Investors: How will the Brexit negotiations conclude?* Karen Ward, J.P. Morgan Asset Management, June 2019.

THE CHALLENGES OF ASSET ALLOCATION IN THIS CYCLE

Although timing the cycle is never an easy task, historically investors have been wise to gradually reallocate a proportion of a portfolio from equities to fixed income and cash as the cycle matured and the central bank raised rates. Even if investors moved too early with such a reallocation and equity prices pushed ever higher, they at least received a decent yield on their core government bonds, with the promise of capital returns when interest rates were eventually cut.

EXHIBIT 8: GLOBAL DEVELOPED MARKET GOVERNMENT BOND YIELDS

% of BofA/Merrill Lynch Global Government Bond Index



Source: Bloomberg, BofA/Merrill Lynch, J.P. Morgan Asset Management. Index shown is the BofA/ML Global Government Bond index. Past performance is not a reliable indicator of current and future results. Data as of 19 June 2019.

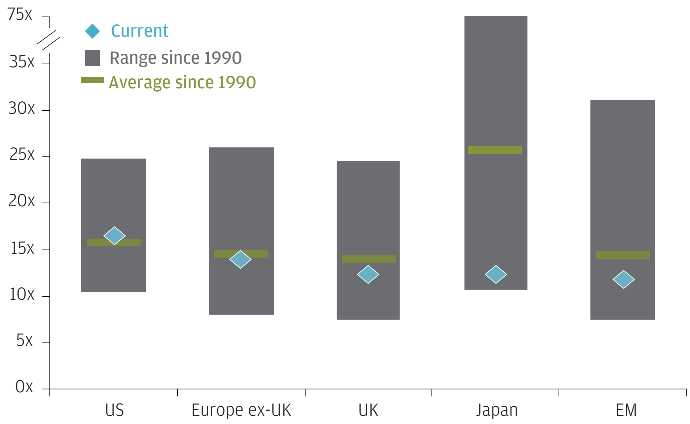
The fact that central banks have not managed to normalise interest rates in this cycle makes it much harder for investors to seek shelter and wait out any storm while at the same time maintaining any kind of decent return.

Moreover, derisking aggressively will prove costly if slowing economic data and a falling stock market prompt the US administration to reassess its trade agenda. The president walks a fine line between wanting to appear tough on trade to fulfil his "America First" electoral promises, and wanting a strong economy and an electorate feeling confident about job prospects ahead of the election in November 2020.

Valuations on a forward-price-to-earnings (P/E) basis are near their historical norms in most parts of the developed world, although our suspicion is that these are predicated on earnings forecasts that are a bit too high. Nevertheless, markets are not painting a screamingly optimistic picture, which provides comfort in terms of the scale of downside risk. The emerging market benchmarks and Japan are the key parts of the global market in which forward P/Es sit at a discount relative to their recent history.

EXHIBIT 9: GLOBAL FORWARD PRICE-TO-EARNINGS RATIOS

x, multiple



Source: IBES, MSCI, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. Earnings and valuation charts use MSCI indices for all regions/countries, except for the US, which is the S&P 500. EM is emerging markets. Past performance is not a reliable indicator of current and future results. Data as of 19 June 2019.

SEEKING ASSETS THAT PROVIDE SHELTER IN A TAIL RISK WORLD

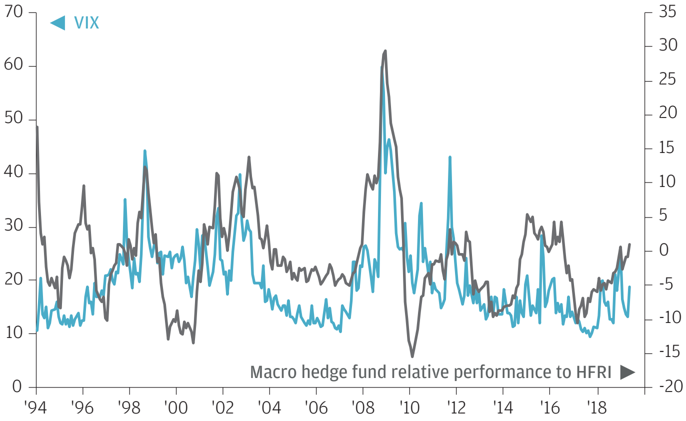
On balance, it seems to make sense to stay exposed to the stock market via stocks that tend to exhibit more defensive properties. By style, this might suggest a shift towards value rather than growth and a focus on larger cap rather than small cap stocks. Screening on quality is particularly important to be sure a portfolio doesn't contain the companies that have overleveraged in this expansion.

It would still be wise to consider assets that will work to cushion a portfolio should the assumption that politicians will eventually act rationally not prove correct. In short, we should look for assets that will work in tail risk scenarios – those with small probability, but high impact.

US Treasuries have rallied a long way but have scope to rise further should it be clear that the US is facing a more significant downturn. Other options include traditional safe-haven currencies such as the Japanese yen or Swiss franc, as well as gold.

EXHIBIT 10: MACRO HEDGE FUND RELATIVE PERFORMANCE & VOLATILITY

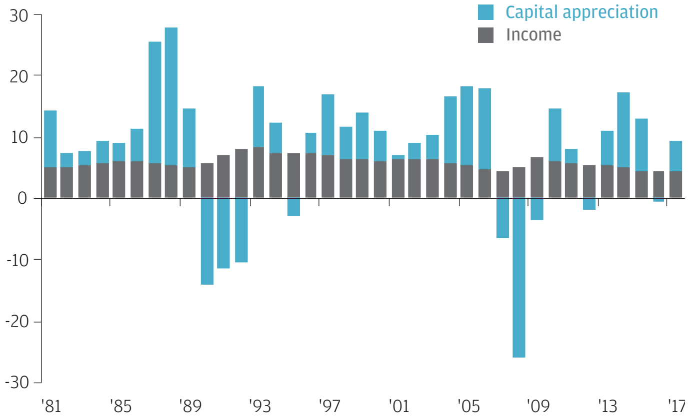
Index level (LHS); % change year on year (RHS)



Source: CBOE, Hedge Fund Research Indices (HFRI), Refinitiv, J.P. Morgan Asset Management. Macro hedge fund relative performance is calculated relative to the HFRI fund weighted hedge fund index. VIX is the implied volatility of S&P 500 Index based on options pricing. Past performance is not a reliable indicator of current and future results. Data as of 31 May 2019.

EXHIBIT 11: UK PROPERTY RETURNS

%, annual returns



Source: MSCI, J.P. Morgan Asset Management. UK property includes retail, office, industrial, residential, and hotel sectors. Past performance is not a reliable indicator of current and future results. Data as of 31 May 2019.

There may also be options in the alternative markets. Macro funds tend to be the most nimble in a politically charged environment and can shift assets globally and by asset class, and use derivatives to insulate portfolios in periods of high volatility.

Real estate and infrastructure tend to have low correlations with public markets and, in return for a lack of liquidity, offer a higher yield.

Moreover, should the next downturn result in more experimental monetary policy – a new chapter in the "printing money" saga – markets are likely to fret, at least initially, about the inflationary consequences (particularly if this is occurring alongside an apparent reversal in globalisation and central bank independence). The added inflation risk may increase the value of these real assets. Similarly, in such a scenario, inflation-linked bonds may command a higher premium.

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