Market Review

2 July 2018

Review of markets over the second quarter of 2018

After a tricky first quarter, most equity markets have had a better second quarter. This has been helped by data confirming that the first-quarter weakness in US consumption was a temporary blip. US retail sales grew by over 6% year-on-year in May and unemployment fell to 3.8% – the lowest level since 1969.

Exhibit 1: Asset class and style returns in local currency

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	2Q 2018
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 31.0%	Growth 5.3%	REITS 8.3%
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 24.5%	Small cap 3.9%	Small cap 5.5%
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%	Small cap 19.1%	DM Equities 1.6%	Growth 5.5%
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%	DM Equities 19.1%	REITS 1.1%	DM Equities 3.8%
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%	Value 14.1%	Cmdty -0.0%	Value 1.9%
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%	REITs 9.3%	Global Agg -1.5%	Cmdty 0.4%
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 7.4%	Value -2.1%	Global Agg -2.8%
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 1.7%	MSCI EM -2.7%	MSCI EM -3.4%

Source: Barclays, Bloomberg, FactSet, FTSE, MSCI, J.P. Morgan Asset Management. DM Equities: MSCI World; 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: MSCI World Small Cap. All indices are total return in local currency. Data as of 30 June 2018.

A strong US economy gave the Federal Reserve (Fed) the confidence to raise interest rates again in June and signal two further hikes to come this year, followed by three more next year. In contrast, after a string of disappointing data and still low core inflation, the European Central Bank (ECB) announced that interest rates will not be going up until at least the summer of next year, although they did confirm that eurozone quantitative easing would come to an end by the end of this year. At the end of last quarter, markets were convinced that the Bank of England would raise rates in May. However, May and then June came and went with no action. Nevertheless, a bounce back in UK retail sales, combined with the lowest unemployment since 1975 and surveys indicating firming wage pressure, suggest that rates will rise this year and next unless Brexit negotiations prove disruptive. Against this backdrop, government bond returns have been broadly flat other than in Italy.

AUTHOR

Michael Bell
Global Market Strategist

Exhibit 2: Fixed income government bond local returns

2011	2012	2013	2014	2015	2016	2017	YTD	2Q 2018
UK 16.8%	Italy 21.3%	Spain 11.3%	Spain 17.0%	Italy 4.9%	UK 10.7%	US 2.5%	Spain 2.4%	Germany 1.3%
US 9.9%	Spain 6.0%	Italy 7.4%	Italy 15.7%	Spain 1.7%	Spain 4.2%	UK 1.9%	Germany 1.5%	Japan 0.2%
Germany 9.8%	Germany 4.5%	Japan 2.2%	UK 14.1%	Global 1.3%	Germany 4.1%	Global 1.3%	Japan 0.7%	UK 0.1%
Spain 6.6%	Global 4.1%	Global -0.4%	Germany 10.5%	Japan 1.3%	Japan 3.6%	Spain 1.1%	UK 0.4%	US 0.1%
Global 6.3%	UK 2.6%	Germany -2.3%	Global 8.5%	UK 1.2%	Global 2.9%	Italy 0.8%	Global -0.1%	Global -0.2%
Japan 2.3%	US 2.2%	US -3.4%	US 6.1%	US 0.9%	US 1.1%	Japan 0.2%	US -1.1%	Spain -1.3%
Italy -5.9%	Japan 1.8%	UK -4.2%	Japan 4.8%	Germany 0.4%	Italy 0.8%	Germany -1.4%	Italy -2.8%	Italy -5.3%

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 2018.

Unfortunately, the recent weakness in the euro has not benefited European equities. A sharp increase in Italian government borrowing costs, in reaction to the potential risk of fiscal largesse from the new government, has left Italian equities as a notable underperformer this quarter. On the plus side, contagion to other European bond markets has been minimal. The Eurobarometer survey for March showed that support for the euro in Italy has actually risen, with only 29% in favour of leaving the euro, 61% in favour of staying and the rest unsure. As a result, we think Italian politics is unlikely to become a systemic issue for European markets but it could remain a source of volatility in the near-term.

The dollar has not just rallied against the euro this quarter but against most currencies, and this has had important implications for equity markets. Sterling's weakness against the dollar has helped the FTSE 100 to deliver strong returns in local currency terms, as foreign revenues are repatriated. In emerging markets, a stronger dollar has often proved a headwind to equity performance and that was certainly the case this quarter. The direction of the dollar is likely to remain important for relative equity performance going forward and unfortunately is currently particularly difficult to predict, with different factors pulling the dollar in different directions. In the short-term, the outperformance of US growth and interest rates may support the dollar, but at some point ever-rising levels of government debt and a large current account deficit will likely weigh on the currency.

Exhibit 3: World stock market returns in local currency

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	2Q 2018
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 35.9%	US S&P 500 2.6%	UK FTSE 100 9.6%
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 31.0%	UK FTSE 100 1.7%	US S&P 500 3.4%
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%	Japan TOPIX 22.2%	MSCI Europe ex UK -0.5%	MSCI Europe ex UK 2.7%
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 21.8%	MSCI Asia ex Japan -2.6%	Japan TOPIX 1.1%
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%	MSCI Europe ex UK 14.5%	MSCI EM -2.7%	MSCI Asia ex Japan -3.1%
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 11.9%	Japan TOPIX -3.7%	MSCI EM -3.4%

Source: FactSet, FTSE, MSCI, Standard & Poor's, TOPIX, J.P. Morgan Asset Management. All indices are total return in local currency. Data as of 30 June 2018.

The trade concerns have also weighed on equity markets, with markets outside the US most affected. This has dragged on Chinese and emerging market equities. European equities have also been affected, with auto companies suffering on fears that US tariffs could be applied to car imports. The conclusion of this scuffle is hard to predict, but the longer this drags on the greater the risk that it starts to impact sentiment more broadly. In addition to trade concerns, the most vulnerable emerging markets, with large current account deficits (external funding requirements), such as Turkey and Argentina, have come under significant pressure with sharp currency and equity market falls. Further US interest rate rises or dollar strength could put additional pressure on the most vulnerable emerging market economies. However, the market has shown some ability to distinguish between the weak and the strong, with Indian equities up over the quarter.

Exhibit 4: Fixed income sector returns

2011	2012	2013	2014	2015	2016	2017	YTD	2Q 2018
IL 10.2%	Euro HY 23.3%	Euro HY 8.8%	Euro Treas. 13.1%	Euro Treas. 1.6%	US HY 17.5%	EM Debt 9.3%	Euro Treas. 0.6%	US HY 1.0%
US Treas. 9.8%	EM Debt 18.5%	US HY 7.4%	EM Debt 5.5%	EM Debt 1.2%	EM Debt 10.2%	Global IG 9.1%	US HY 0.1%	US Treas. 0.1%
EM Debt 8.5%	US HY 15.5%	Euro Treas. 2.2%	Euro HY 5.5%	US Treas. 0.8%	Euro HY 10.1%	IL 8.7%	US Treas. -1.1%	Euro Treas. -0.9%
US HY 4.4%	Global IG 11.2%	Global IG 0.3%	US Treas. 5.1%	Euro HY 0.5%	Global IG 4.3%	US HY 7.5%	Euro HY -1.5%	Euro HY -0.9%
Global IG 4.3%	Euro Treas. 11.0%	US Treas. -2.7%	IL 3.4%	Global IG -3.6%	IL 3.9%	Euro HY 6.1%	IL -1.7%	Global IG -2.4%
Euro Treas. 3.4%	IL 8.5%	IL -3.2%	Global IG 3.1%	US HY -4.6%	Euro Treas. 3.2%	US Treas. 2.3%	Global IG -3.2%	IL -3.3%
Euro HY -1.1%	US Treas. 2.0%	EM Debt -6.6%	US HY 2.5%	IL -5.0%	US Treas. 1.0%	Euro Treas. 0.2%	EM Debt -5.2%	EM Debt -3.5%

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 EMBIG. All indices are total return in local currency. Data as of 30 June 2018.

A notable theme this quarter has been the widening in investment grade credit spreads. With corporate leverage elevated in the US investment grade market and interest rates rising, we remain cautious on the outlook.

Overall, growth still looks healthy and corporate earnings are growing strongly, but there are a number of potential political risks to markets over the second half of the year. The strength of the US economy is also causing the Fed to gradually remove the punch bowl from the party. The US fiscal stimulus should keep growth going strong into 2019, but once the fiscal sugar rush wears off at around the same time that tighter monetary policy could start to bite, the economy could be left nursing a hangover heading into 2020. The currently healthy economy, balanced against political risks and the late stage of the US economic cycle, argues for a slightly more balanced approach to risk. As we progress deeper into the late stage of this economic cycle and get closer to the end of the party, it probably pays to dance a little closer to the cloakroom.

Exhibit 5: Index returns for June 2018 (%)

INDEX	GBP	USD	JPY	EUR	LOC
Equities (MSCI)					
MSCI World Index	0.8	0.0	1.9	0.0	0.4
MSCI USA	1.5	0.7	2.6	0.7	0.7
MSCI Europe ex UK	0.3	-0.5	1.4	-0.5	-0.3
MSCI United Kingdom	-0.2	-1.0	1.0	-1.0	-0.2
MSCI Japan	-1.7	-2.5	-0.6	-2.5	-0.6
MSCI AC Asia ex JP	-4.0	-4.7	-2.9	-4.8	-3.6
MSCI EM Latin America	-2.3	-3.0	-1.2	-3.1	-1.4
MSCI EM (Emerging Markets)	-3.3	-4.1	-2.2	-4.1	-2.4
Bonds					
JP Morgan GBI Global (Traded)	0.5	-0.3	1.7	-0.3	0.2
JP Morgan GBI United States (Traded)	0.8	0.0	2.0	0.0	0.0
JP Morgan GBI Japan (Traded)	-1.1	-1.9	0.1	-1.9	0.1
JP Morgan GBI United Kingdom (Traded)	-0.6	-1.4	0.5	-1.4	-0.6
JP Morgan EMU	1.6	0.8	2.8	0.8	0.8
Currencies					
Sterling	n/a	-0.8	1.2	-0.8	n/a
US dollar	0.8	n/a	2.0	0.0	n/a
Yen	-1.1	-1.9	n/a	-1.9	n/a
Euro	0.8	0.0	2.0	n/a	n/a

Source: MSCI, FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management. Data as of 30 June 2018.

CONTACT

For any enquiries about this document, please contact:
Michael Bell – michael.j.bell@jpmorgan.com

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J.P.Morgan
Asset Management