Market Review

1 October 2018

Review of markets over the third quarter of 2018

A booming US economy has driven US stocks and Treasury yields higher this quarter, leaving US equities some way ahead of the pack over the year as a whole. In September, US consumer confidence hit its highest level since 2000, while the monthly average of initial jobless claims fell to the lowest level since 1969. Wage growth rose to the highest level since 2009, supporting retail sales growth of over 7% year on year. Also, the National Federation of Independent Business's survey showed that small businesses were the most optimistic they've been since the survey began in 1974. Against this remarkably strong growth backdrop it's not surprising that US equities have delivered attractive returns.

At the start of the year the market thought there was only a 20% probability that, by now, the Federal Reserve (Fed) would have already raised rates three times this year. Even at the start of July, markets thought there was a 40% chance that the Fed wouldn't increase rates again in the third quarter. However, by the time the Fed raised rates last week, bond markets had already fully priced in the increase, with Treasury yields drifting higher over the quarter.

Exhibit 1: Asset class and style returns in local currency

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	3Q 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 11.8%	Growth 6.2%
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%	DM Equities 7.1%	DM Equities 5.4%
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%	Small cap 6.4%	Value 4.6%
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%	Value 2.3%	Small cap 2.5%
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%	REITs 1.8%	REITs 0.7%
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%	Cmdty -2.0%	MSCI EM 0.1%
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%	Global Agg -2.4%	Global Agg -0.9%
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 -2.6%	Cmdty -2.0%

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 September 2018.

AUTHOR

Michael Bell
Global Market Strategist

Emerging market (EM) equities have been weighed down by a slowdown in the pace of Chinese credit growth, fears over the vulnerability of some economies to tighter US monetary policy and concerns about the potential impact of global trade tensions. China has successfully slowed the pace of non-bank credit growth but, faced with the external headwind of US tariffs, the authorities are now easing policy to support domestic growth, while maintaining regulatory pressure on shadow lending. This should provide some support for those EM countries that depend on Chinese demand.

On the other hand, the EM economies that are most reliant on external funding are finding the tightening in US monetary policy challenging. As the Fed continues to raise rates and unwind its balance sheet, EM countries with large dollar-denominated debts and significant, or widening, current account or fiscal deficits may continue to struggle. Higher oil prices are not helpful in this context for those EM economies that are large oil importers, particularly those whose currencies have fallen sharply, further increasing the cost of imports in local currency terms. The tightening in interest rates that some economies have been forced into to defend their currencies and control inflation will prove a drag on growth.

UK equities have been weighed down by fears of a no-deal Brexit. Interestingly, the inverse correlation between the pound and UK equities has broken down recently. Perhaps, as the deadline for a deal edges closer, investors are becoming less willing to view the possiblity of a no-deal Brexit as a positive for the stock market, even with the sterling weakness that would accompany such an outcome.

It is possible that investors view deadlock within the Conservative Party as increasing the risk of a Labour government with a populist agenda. This concern complicates the outlook for UK investors, who had become used to a weak pound helping UK stocks. In our view, a relatively soft Brexit would remove much of the existing Brexit risk premium in equities but likely cause a meaningful rally in the pound and a faster pace of rate rises than is currently expected. This makes the outlook for UK equities particularly hard to predict, even if you knew the likely outcome of the negotiations, which clearly remains uncertain despite our base case that a no-deal scenario will be avoided.

Exhibit 2: World stock market returns in local currency

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	3Q 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 10.6%	US S&P 500 7.7%
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%	Japan TOPIX 2.0%	Japan TOPIX 5.9%
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 1.4%	MSCI Europe ex UK 1.9%
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%	UK FTSE 100 1.0%	MSCI EM 0.1%
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 -2.6%	UK FTSE 100 -0.7%
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%	MSCI Asia ex Japan -3.5%	MSCI Asia ex Japan -0.9%

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 September 2018.

In Japan, there are now more jobs available per applicant than at any point since 1974. Banks also continue to expand credit, in stark contrast to the deflationary period in the early 2000s. The rally in the dollar against the yen, helped by rising interest rate differentials, has been supportive of Japanese equities over the quarter.

Since the beginning of the year, there has been a material weakening in the eurozone manufacturing new export orders survey. Much of the weakness appears to have come from a sharp slowdown in exports to China. As the Chinese ease policy to support domestic demand this pressure could ease but a potential further deterioration in the external environment continues to pose a risk to eurozone growth. The main risk is that weaker exports combined with higher oil prices feed into weaker domestic consumption, which has so far held up pretty well, supported by falling unemployment. Consumer confidence has fallen steadily since the start of the year, with a particularly sharp decline in France. Italian political developments and the pending approval of the new budget could also prove a source of volatility over the coming quarter, although Italian government bond yields have already risen materially since April.

The most obvious near-term risk to the global economy is the potential for a further escalation in trade tariffs emanating from the US, and the subsequent retaliation. So far the US is imposing tariffs on about $250 billion of imports from China, and China has retaliated with tariffs on about $110 billion of US exports to China. The tariff rate is scheduled to increase in January if a deal cannot be reached and an escalation to imposing tariffs on all of China's exports to the US has been threatened. This trade conflict has already escalated further than we initially expected and we have limited visibility over how it will develop. The worst case scenario could prove a meaningful drag on global growth at the same time as pushing prices higher. However, the trade negotiations haven't been all bad news, with a new NAFTA deal and a cooling in threats to impose tariffs on US auto imports, at least for now.

Exhibit 3: Fixed income sector returns in local currency

2011	2012	2013	2014	2015	2016	2017	YTD	3Q 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%	US HY 2.5%	US HY 2.4%
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%	Euro HY 0.1%	EM Debt 1.9%
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%	Euro Treas. -0.5%	Euro HY 1.7%
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%	US Treas. -1.7%	Global IG 0.4%
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%	Global IG -2.8%	US Treas. -0.6%
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%	IL -3.3%	Euro Treas. -1.0%
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 -3.5%	IL -1.6%

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 September 2018.

Fixed income returns have been pretty uninspiring, with high yield credit outperforming government bonds. Against a backdrop of very strong growth, rising inflation and rising interest rates in the US, it is notable that, while unexciting, fixed income returns haven't been as bad as some might have predicted. Year to date, EM debt has been the clear underperformer although it should be noted that the worst performing EM credits make up a small part of the index. Looking ahead, we believe investors should focus on liquidity within fixed income markets and be aware of elevated leverage in US investment grade credit. Within government bond markets we believe US Treasuries are a more attractive risk hedge than eurozone or UK government bonds.

Exhibit 4: Fixed income government bond returns in local currency

2011	2012	2013	2014	2015	2016	2017	YTD	3Q 2018
UK 16.8%	Italy 21.3%	Spain 11.3%	Spain 17.0%	Italy 4.9%	UK 10.7%	US 2.5%	Spain 1.9%	Spain -0.5%
US 9.9%	Spain 6.0%	Italy 7.4%	Italy 15.7%	Spain 1.7%	Spain 4.2%	UK 1.9%	Germany 0.7%	US -0.7%
Germany 9.8%	Germany 4.5%	Japan 2.2%	UK 14.1%	Global 1.3%	Germany 4.1%	Global 1.3%	Japan -0.5%	Germany -0.8%
Spain 6.6%	Global 4.1%	Global -0.4%	Germany 10.5%	Japan 1.3%	Japan 3.6%	Spain 1.1%	Global -1.1%	Global -1.0%
Global 6.3%	UK 2.6%	Germany -2.3%	Global 8.5%	UK 1.2%	Global 2.9%	Italy 0.8%	UK -1.5%	Japan -1.2%
Japan 2.3%	US 2.2%	US -3.4%	US 6.1%	US 0.9%	US 1.1%	Japan 0.2%	US -1.8%	UK -1.9%
Italy -5.9%	Japan 1.8%	UK -4.2%	Japan 4.8%	Germany 0.4%	Italy 0.8%	Germany -1.4%	Italy -4.6%	Italy -1.9%

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 September 2018.

Overall, global growth remains positive but less synchronised than last year. For now, the US stands out as the clear leader in terms of growth. In the near term, the main risk appears to be that the trade conflict will escalate and weigh on business and consumer sentiment. So far there are some signs that this may be happening outside the US, but the US itself has remained resilient. The extent to which the US and the rest of the world can withstand the impact of the latest round of tariffs and any further escalation will be key for the outlook and unfortunately remains uncertain.

In the medium term, the primary risk seems to be that the US economy, while currently booming, is in the later stages of the business cycle, and no recovery lasts forever. The combination of these near-term and medium-term risks argue for turning the dial[1] closer to neutral in portfolios, to reflect the fact that—while growth currently remains healthy—the risks are gradually rising.

[1] *Turning the dial: Portfolio considerations in the late cycle*, Karen Ward & Michael Bell, J.P. Morgan Asset Management, September 2018

Exhibit 5: Index returns for September 2018 (%)

INDEX	GBP	USD	JPY	EUR	LOC
Equities (MSCI)					
MSCI World Index	0.3	0.6	3.0	0.8	0.8
MSCI USA	0.1	0.5	2.9	0.6	0.5
MSCI Europe ex UK	-0.5	-0.1	2.3	0.0	0.0
MSCI United Kingdom	1.4	1.8	4.2	1.9	1.4
MSCI Japan	2.8	3.2	5.7	3.3	5.7
MSCI AC Asia ex JP	-1.7	-1.4	1.0	-1.2	-1.4
MSCI EM Latin America	4.4	4.7	7.3	4.9	1.9
MSCI EM (Emerging Markets)	-0.8	-0.5	1.9	-0.3	-1.1
Bonds					
JP Morgan GBI Global (Traded)	-1.4	-1.1	1.3	-0.9	-0.7
JP Morgan GBI United States (Traded)	-1.3	-1.0	1.4	-0.9	-1.0
JP Morgan GBI Japan (Traded)	-3.0	-2.7	-0.3	-2.5	-0.3
JP Morgan GBI United Kingdom (Traded)	-1.7	-1.3	1.1	-1.2	-1.7
JP Morgan EMU	-0.6	-0.3	2.1	-0.1	-0.1
Currencies					
Sterling	n/a	0.3	2.8	0.5	n/a
US dollar	-0.3	n/a	2.4	0.2	n/a
Yen	-2.7	-2.4	n/a	-2.2	n/a
Euro	-0.5	-0.2	2.3	n/a	n/a

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

CONTACT

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

0903c02a823b2199

LV–JPM51472 | 10/18