July 2018

U.S. Stocks Gain in June, But Foreign Assets Remain Pressured by Political Uncertainty

Overview

In June, U.S. stocks rose, but foreign stock indices again declined. Economic data in the U.S. continued to be strong, but political uncertainty abroad, particularly in Europe and in emerging market countries due in part to trade policy, rattled investors. The Federal Reserve, as expected, raised its key benchmark rate on June 13 by 0.25% to a target range of 1.75% and 2.00%. Meeting minutes suggest an assessment of continued overall U.S. economic strength and balanced inflation dynamics. In this installment of *Insights*, we focus on three key topics of interest to global investors: the flattened slope of the U.S. bond yield curve, trade policy skirmishes, and the investment landscape in emerging markets (EM). In our view, the shape of the yield curve bears watching, especially if it flattens significantly further, but we think that the risk of recession within the next year is unlikely. Trade policy rhetoric has increased, and the risk is real that it may escalate, but we still believe that existing and currently proposed tariffs will likely not derail further global economic expansion. EM assets have sold off in recent months due to negative, protectionist trade policies, and U.S. dollar strength; however, EM production and consumption have continued, and the emerging/developed market growth differential has widened, which is typically positive for EM assets. Overall, we foresee continued global expansion that is consistent with a relatively low near-term risk of recession in the U.S. in view of the tailwind from tax reform, strong corporate earnings, solid manufacturing activity, and positive consumer sentiment.

Performance

Core U.S. bond yields were mixed in June: taxable bonds edged down, municipals inched up.

	June	2018 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.09	-0.25	3.53	4.43	US Muni Bonds
BarCap US Agg Bond TR USD	-0.12	-1.62	2.27	3.72	US Taxable Bonds
BoAML US High Yield Master II TR USD	0.35	0.08	5.51	8.03	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-1.19	-5.23	5.15	6.75	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-2.86	-6.44	-1.40	2.58	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-0.67	0.24	3.04	-0.43	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-0.49	-0.73	12.96	10.78	US Equity -- Large
S&P 500 TR	0.62	2.65	13.42	10.17	US Equity -- Large
NASDAQ Composite TR USD	0.98	9.37	18.54	13.87	US Equity -- Large
Russell 1000 TR USD	0.65	2.85	13.37	10.20	US Equity -- Large
Russell Mid Cap TR USD	0.69	2.35	12.22	10.23	US Equity -- Mid-sized
Russell 2000 TR USD	0.72	7.66	12.46	10.60	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-1.88	-3.77	5.99	2.54	Int'l Equity -- Comprehensive
MSCI EM NR USD	-4.15	-6.66	5.01	2.26	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-3.50	0.00	-6.40	-9.04	Commodities
HFRX Global Hedge Fund USD	-0.19	-0.85	1.32	-0.40	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 06/30/2018

Year-to-date through June, the Bloomberg Barclays U.S. Aggregate Bond Index has declined 1.62% in conjunction with rising bond yields.

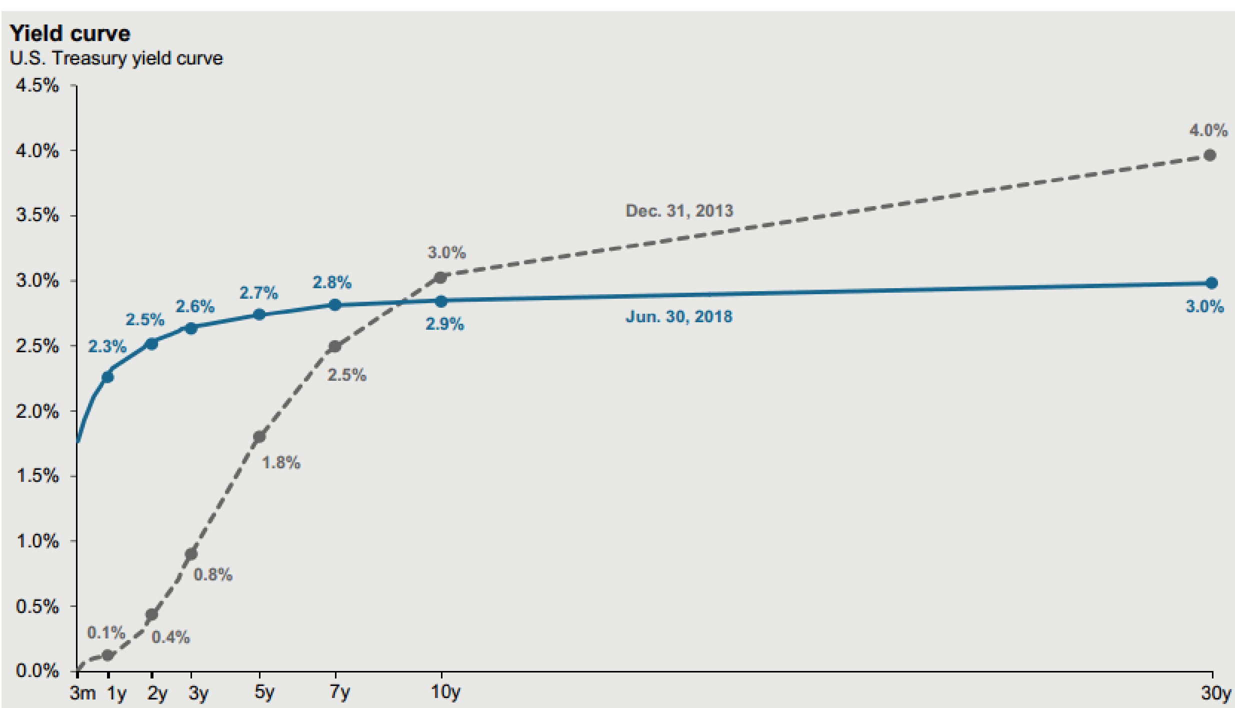
U.S. large, mid-, and small-sized stocks gained once again in June. The S&P 500 Index now has risen 2.65% YTD through June. The Russell 2000 Index of small-cap stocks is now up 7.66% YTD through the last month.

In May, EM bonds declined for several reasons, including continuing worry about global trade, short-term currency fluctuations, and the rising U.S. interest rate trajectory. U.S. dollar-denominated debt (represented by the JPMorgan EMBI Emerging Market Diversified Index) fell nearly 1.2%, and they are now down for the year through June by approximately 5.2%. Local currency EM bonds dropped by nearly 2.9%, and they are now down approximately 6.4% for the year, according to the JPMorgan GBI Emerging Market Diversified Index. EM equities also fell 4.15% in June, as measured by the MSCI Emerging Market Index.

Outlook

Despite the elevation in protectionist trade policy and the jitters that has caused among investors, our base case outlook for further global economic expansion remains intact. We hold this view even though over the last month economic data in Europe has continued to moderate and the U.S. Treasury yield curve has additionally flattened. As we explain further below, we continue to anticipate a reasonable rate of inflation in the U.S., a largely measured and telegraphed U.S. Federal Reserve policy, and supportive economic growth in both the U.S. and emerging markets. We recognize that investors are concerned about three areas in particular, and we want to address them squarely: the flat yield curve, trade policy, and emerging markets.

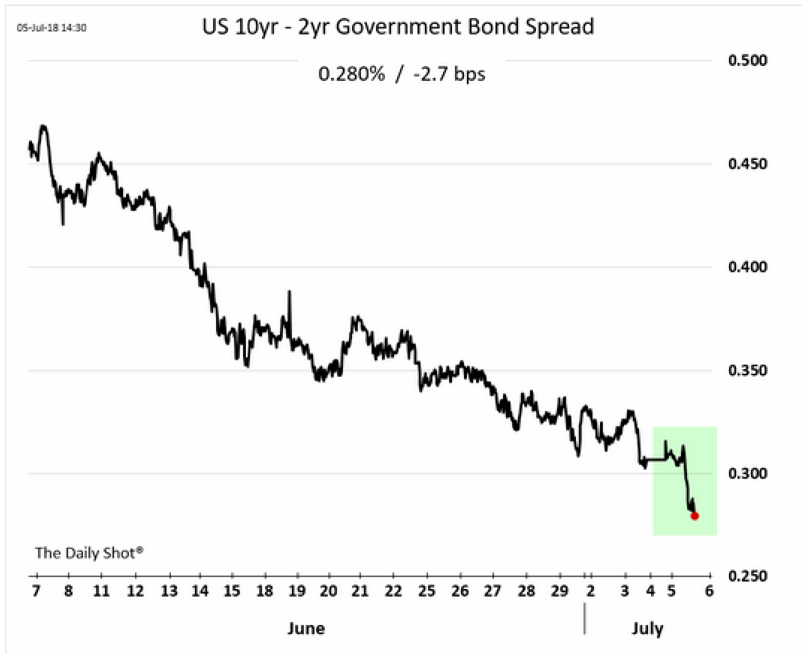
First, the current flat slope of the U.S. Treasury yield curve has attracted more attention over the last month, even though the slope has been flattening and relatively flat for some time. The graph below depicts the change from the end of 2013 (the year of the Taper Tantrum) through June of this year.



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of June 30, 2018.

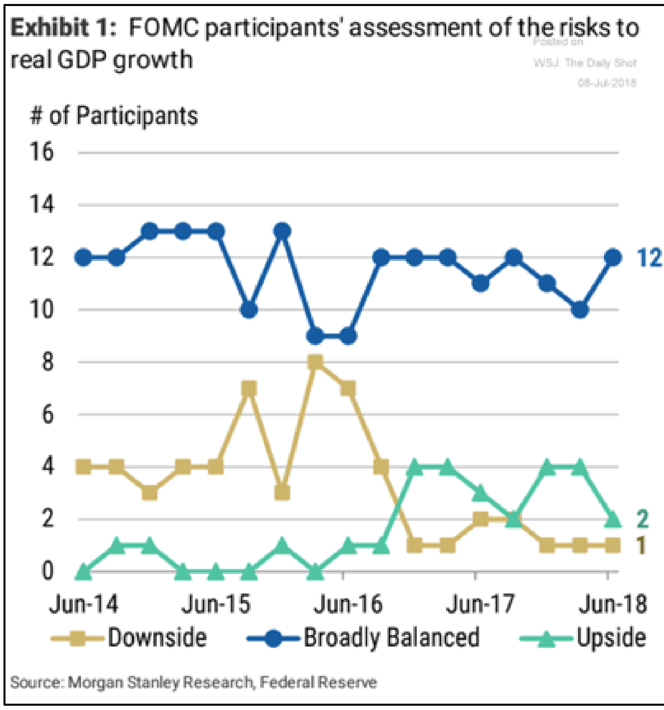
In a normal yield curve, bonds with long-dated maturities carry a higher yield than short-dated maturities to compensate for the risk that inflation could reduce the value of interest payments in the future. In a flat yield curve like the current one above, there is very little difference in yields between bonds with short and long maturities. The difference between the 2-year and 10-year Treasury notes was, as of June 30, merely four-tenths of a percentage point. At the end of 2013, in contrast, the 2-to-10-year spread was 2.6 percentage points. The yield gap from 2 to 10 years is at its narrowest since August of 2007.

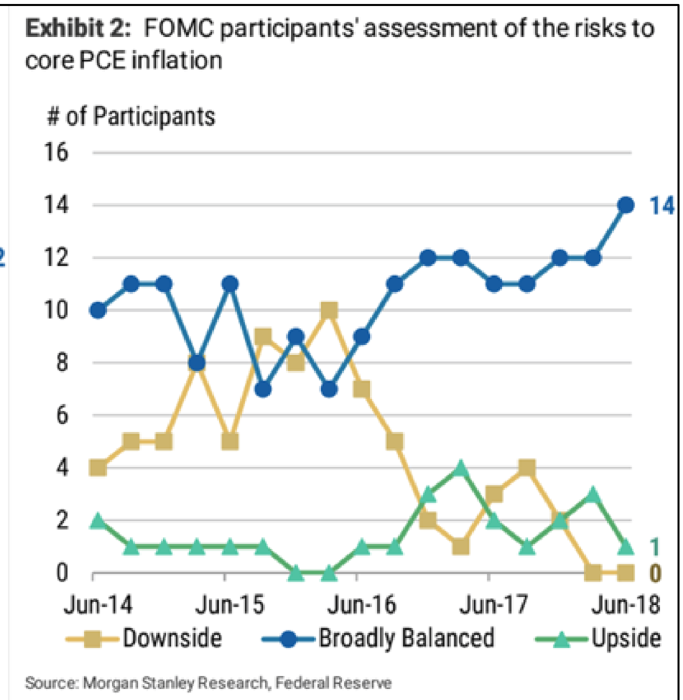
U.S. Treasury bonds are often attractive to global investors who seek safety amid global trade uncertainty. That is especially the case now because U.S. bond yields are higher than comparable developed market safe haven bonds issued by Germany or Japan. The 2-year German bund, for instance, has a negative yield at present, and the 10-year bund yields 0.32%, as of July 9, whereas the comparable Treasury notes yield 2.57% and 2.87%, respectively. (The nearby graph, from July 5, shows the similar tight spread.) The Federal Reserve's recent rate increases have been pushing up the short end of the curve, while high demand for longer-maturity bonds from global investors (who see scant yields in places like Germany and Japan) and from pension plans (who seek to match long-term income with long-term liabilities) has been depressing the long end of the curve.



The flat slope of the yield curve can be worrying to investors, because typically when yields on the back end dip below yields on the front end (i.e., an inverted yield curve) a recession has followed within 6 to 24 months. It is important to note that it is not a flat yield curve that has this often-cited "predictive" effect; it is *inverted* curves. The present curve is not inverted; it is flat. Curves can remain flat for some time, and they can normalize just as they can invert. In our view, we do not believe at present that the yield curve will invert this year, although it may flatten more as the entire curve shifts higher in conjunction with the Fed's gradual tightening policy. A 50 basis point increase to the overnight rate by the Fed does not entail a 50 basis point move equally at every maturity increment along the curve, which means that a flat but still slightly upward slope looks to be the most likely scenario throughout 2018 and into 2019.

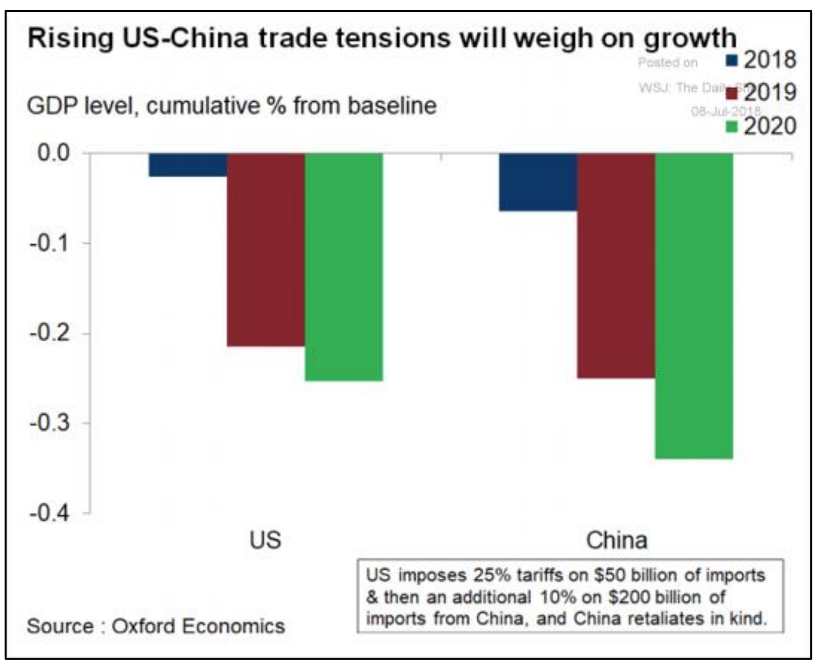
The Fed itself currently sees the outlook for real GDP growth and inflation to be stable, as you can see in the two charts side-by-side below. Taken together, the members of the Federal Reserve do not anticipate either a spike in inflation (which might cause them to raise rates more aggressively to slow growth) or an alarming slowdown in economic growth (which could lead to a recession). This is important to recognize, because it can help to put into perspective certain anxieties about the effect of heightened protectionist trade policy and rhetoric on economic growth and inflation. The Fed takes into account all global factors as part of its outlook. Among those are global trade ties, pricing pressures, political risk, and other foreign central bank activity.





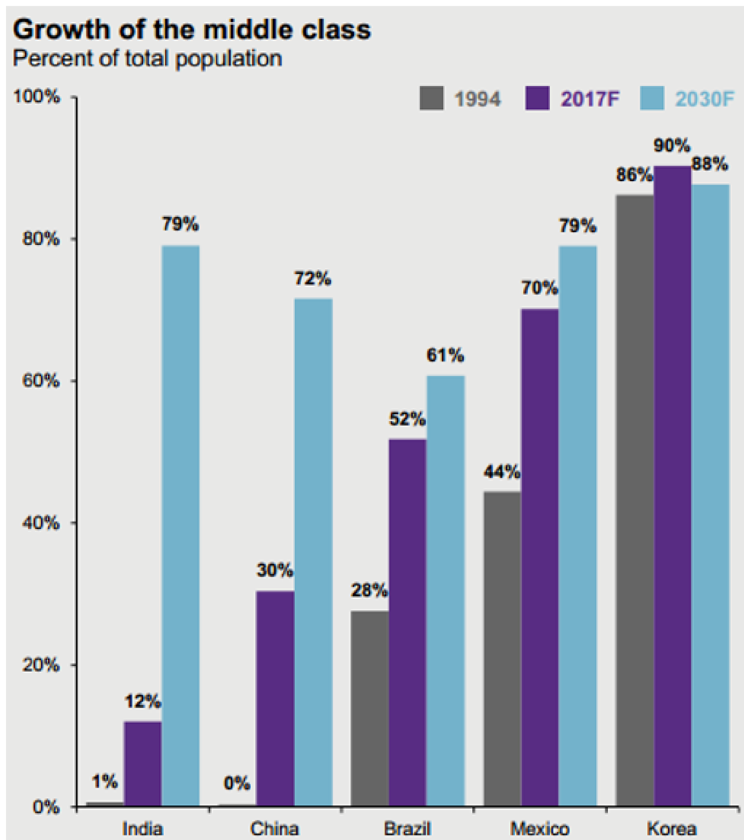
Second, then, we turn to questions about trade tariffs. This can be a confusing topic because discussion in the press does not always make clear the distinction between enacted policy and potential proposals. For instance, on Friday, July 6, the U.S. implemented the original schedule of $34 billion in tariffs on Chinese goods. This itself was less than the approximately $60 billion initially floated, and it is different from the current talk about potentially an $200 billion in tariffs on top of the additional $14 billion already scheduled. In our view, protectionism will likely continue to stoke market worries as long as the rhetoric continues, and it will likely exert a slight economic drag; however, the key word in the last clause is "slight."

The U.S. nominal gross domestic product in the first quarter of 2018 was approximately $20 trillion. The amount of Chinese imported goods on which tariffs have been imposed is minuscule compared to that total GDP amount. But what if things escalate and the additional $200 billion is imposed? What will the economic effect then be to economic growth in both the U.S. and China? The nearby graph suggests that the cumulative hit to U.S. GDP growth in 2020 would be about 2.5 tenths of a percent, and about 3 tenths of a percent to China's GDP growth. The potential effect is not nothing, but it is also not a lot. Protectionist policy will slow growth, but by itself it will not tip the U.S. or China into recession.



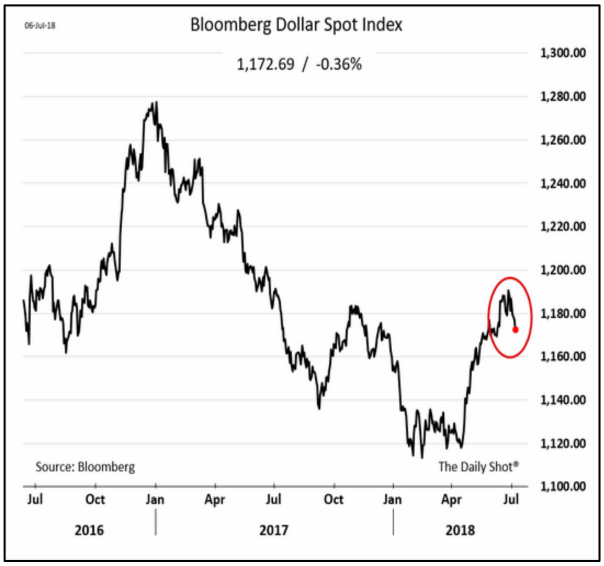
The most likely effect from heightened rhetoric and intensifying policy enactments is that it will increase investor skittishness. This in turn will likely lead to decreased business investment and capital expenditures, higher input costs, and lower profit margins. Exports account for only 8% of U.S. GDP. The election of a new leftist president in Mexico has, in some ways, opened up new possibilities for the renegotiation of NAFTA (the North American Free Trade Agreement), but uncertainty still remains high about how that will play out, and resolution may not come for some time. U.S. tariffs on goods from allies such as Canada and Germany, and their predictable retaliations, will have targeted effects on companies and industries. These measures are likely to curtail investor and business sentiment. Potentially higher prices on certain goods and services for consumers cannot be ignored. Neither can the knock-on effects for lower potential corporate earnings and profits. But for now, although questions might be raised about a protectionist trade policy, the enacted and even the proposed tariffs seem economically manageable.

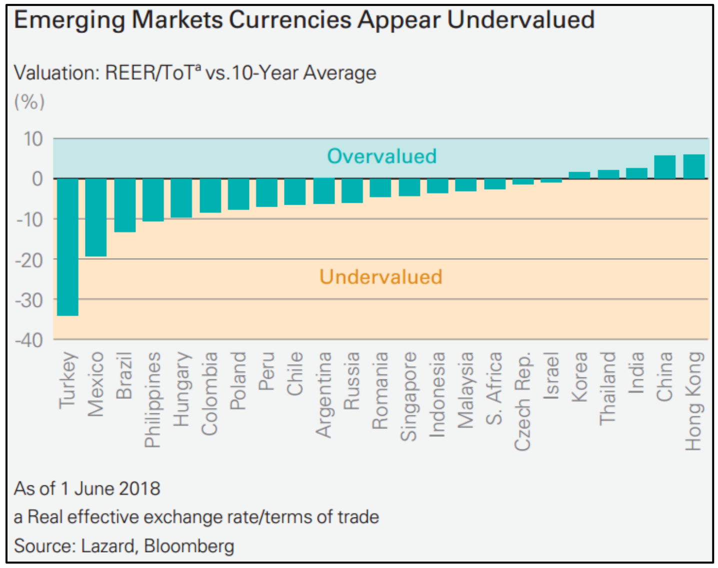
Third, rising interest rate policy in the U.S. and global protectionist policy skirmishes, as well as a resurgence in the strength of the U.S. dollar in large part from rising rate policy, have in recent months hit emerging market assets particularly hard. Questions have arisen about the growth and profits outlook in emerging markets countries. But aside from particular idiosyncratic challenges in places like Venezuela, Argentina, and Turkey, emerging market (EM) growth has remained solid and inflation largely contained. Earnings growth expectations for EM are still 18% and 11% for 2019, according to Lazard. The economic growth differential between EM and DM (developed markets) has widened, which is usually positive for EM assets, both debt and equity. According to Goldman Sachs estimates, GDP in the U.S. for 2018 may be 2.6% compared to 5.5% for EM, a rate more than twice that of the U.S. The theme of the growth of the middle class in EM countries is underway and is leading to increased levels of consumption globally and, in places like China especially, seismic shifts from a manufacturing-based to a service-based economy. This is a trend that is set to continue (as you can see in the nearby graphic), which should, in our view, lead to additional corporate earnings, profit, and eventual stock price appreciation.



Source: Brookings Institute and JPMorgan, data as of 6/30/2018

What then about U.S. dollar strength? The U.S. dollar may continue to remain strong relative to many emerging market currencies for two reasons in the near term: the interest rate differential between safe haven bonds in the U.S. compared to Japan and Europe, and intensification of and uncertainty around protectionist trade policy. Both factors can lead investors to shift to U.S. stocks and bonds for perceived short-term safety or opportunity. Those asset flows in turn contribute to U.S. dollar strengthening. However, this may very well be a near-term phenomenon. Some signs suggest that the resurgence in the dollar may be leveling off, such as the chart on the left below from Bloomberg. The ratio of many EM currencies on the basis of the real effective exchange rate/terms of trade also points to undervaluation against the dollar in many places.





In the short-term, U.S. dollar strength continue given global risk-aversion due to trade policy uncertainty and the interest rate differential between the bonds in U.S. and other DM countries; however, the dollar does appear overvalued relative to EM countries, where current account deficits are broadly solid and fundamentals remain strong for economic growth. The U.S., for its part, has a widening current account deficit, which typically leads to U.S. dollar weakness. Beyond the near term, these factors should, in our view, lead to EM asset price appreciation.

In the near term, though, EM assets, both stocks and bonds, could rebound and outperform DM counterparts through some combination of the following catalysts: the reduction of negative trade rhetoric and/or the reversal of U.S. dollar strength. Pessimism toward EM assets is currently extreme, and it could reverse quickly if one or both of these catalysts comes to pass. Moreover, the upside to EM price reversal could also in such a case be extreme.

In summary and conclusion, we acknowledge the reasons why investors have focused their attention on these three areas in particular: the flat slope of the U.S. yield curve, protectionist trade policy rhetoric, and a few macro challenges to emerging markets.

1. First, we understand why the yield curve has been flattening to the extent that it has (increases in rates by the Fed on the short end, and downward pressure on the long end from pension plans and foreign investors seeking higher yielding safe-haven assets), but we do not believe that the curve is likely to invert this year or that recession in the U.S. is a significant near-term risk.

2. Second, trade policy rhetoric has intensified in recent months, and it may escalate further in the near term. This poses a volatility risk to capital markets globally, and it will likely exert a slight, but not massive, economic drag to GDP growth to the major affected countries. Given the small scale of currently imposed and proposed tariffs relative to the size of the U.S. and Chinese economies in

particular, we foresee less impairment on their macroeconomic output than on investor and business psychology and specific company/industry results.

3. Third, emerging markets remain vulnerable in the short term to escalation of protectionist trade policy and additional U.S. dollar strength. However, growth fundamentals remain broadly strong in the EM world, and any unwinding of either or both of those two factors, negative trade talk and dollar strength, could initiate a rapid return of global capital to EM assets and spark price appreciation in both EM stocks and bonds.

Although we acknowledge the risks from these areas, we believe that investors would should be encouraged by the underlying economic strength globally, especially in the U.S. and emerging markets. These remain bright spots with a number of investment opportunities. Precisely because there are additional investment risks but also potentially extreme negative sentiment in some areas that could quickly reverse, we also believe that investors should remain balanced in their asset allocations and avoid overemphasis of one or two investments relative to others.

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