March 2019

Equities Rise again in February Due to Steady Fed and Trade Optimism

Overview

In February, U.S. and foreign stocks again appreciated. The monthly return for the S&P 500, for instance, was 3.21%, U.S. small company stocks in the Russell 2000 Index climbed 5.2%, and non-U.S. stocks in the MSCI ACWI ex-USA gained 1.95%. Markets continued to respond favorably to Fed Chairman Powell's and other Board governors' insistence throughout the month that the Fed would patiently assess whether any additional rate hikes were justified. Optimism also returned that the U.S. and China would announce a trade agreement sometime in March. In the interim an increase in tariffs that was scheduled to go into effect at the beginning of March was delayed. While we are pleased with February's additional performance gains, we also continue to encourage restrained expectations given how much markets have moved higher in just the first two months of the year and the fading effects of fiscal stimulus in the U.S., which will likely contribute to decelerating corporate earnings and U.S. economic growth as the year progresses. In this issue of *Insights*, we update our outlook on (1) the global economic and investment scene, (2) the effects of developments in the U.S./China trade policy dispute, and (3) the current state and likely path forward for Brexit (i.e., the U.K.'s exit from the European Union).

Performance

February was another positive month for U.S. and foreign stocks, as well as certain bonds (see table below).

	Feb.	2019 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.54	1.30	3.44	4.55	US Muni Bonds
BarCap US Agg Bond TR USD	-0.06	1.00	2.32	3.71	US Taxable Bonds
BoAML US High Yield Master II TR USD	1.69	6.36	4.54	11.49	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	1.00	5.45	5.43	8.76	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-1.09	4.30	0.06	5.10	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	1.16	5.13	0.43	2.04	Hybrid/Hedged Equity
DJ Industrial Average TR USD	4.03	11.62	12.38	16.84	US Equity -- Large
S&P 500 TR	3.21	11.48	10.67	16.67	US Equity -- Large
NASDAQ Composite TR USD	3.60	13.74	13.12	19.86	US Equity -- Large
Russell 1000 TR USD	3.39	12.05	10.39	16.82	US Equity -- Large
Russell Mid Cap TR USD	4.30	15.55	8.56	17.81	US Equity -- Mid-sized
Russell 2000 TR USD	5.20	17.03	7.36	16.60	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	1.95	9.66	2.50	9.63	Int'l Equity -- Comprehensive
MSCI EM NR USD	0.22	9.01	4.13	10.32	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	1.01	6.51	-8.81	-2.19	Commodities
HFRX Global Hedge Fund USD	0.63	2.77	-0.31	1.75	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 2/28/2019

The S&P 500 rose 3.21% on the month, in line with the Russell 1000 Index of large companies (up 3.39%). The Russell 2000 Index of small companies appreciated 5.20% in the month and is up 17.03% in 2019. The MSCI ACWI Index Ex-USA index, which is a measure of all stocks outside the U.S., rose 1.95% and is up 9.66% YTD. The MSCI Emerging Market Index also rose, edging up 0.22% and still up 9.01% YTD through February.

The Bloomberg Barclays U.S. Aggregate Bond Index inched down 0.06% but remains positive with a gain of 1.00% for the year through February. With additional indications of steady interest rate policy from the Federal Reserve, high yield bonds gained 1.69%.

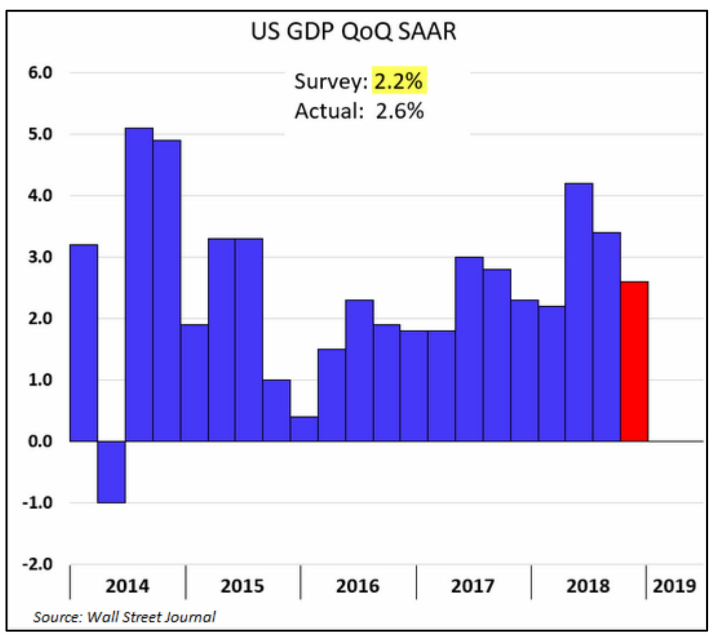
Foreign, U.S. dollar-denominated emerging market bonds in the JPMorgan EMBI Global Diversified Index gained 1.00%. Because the local currency EM bond index, the JPMorgan GBI EM Global Diversified, lost 1.09%, and had been about 1 percentage point higher than the USD-denominated index through January, the two indices essentially traded YTD performance positions. A 50/50 blend of the two EM bond indices continues to have a YTD gain, through February, of approximately 4.88%.

Outlook

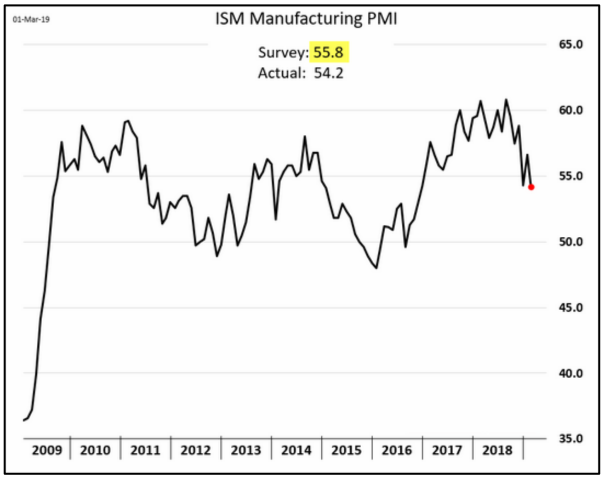
Economic data in the U.S. remains sound but broadly decelerating. We continue to think that the near-term risk of recession is low. Stocks, in particular, have run up very quickly this year off of the lows reached in late December. We do not think that these gains are unjustified given the 4Q2018 sell-off, but we do wonder to what extent they may be maintained in view of slowing economic growth in the U.S. and in Europe and the possibility that markets have already priced in both a softer Brexit and a coming conclusion to the trade tensions between China and the U.S.

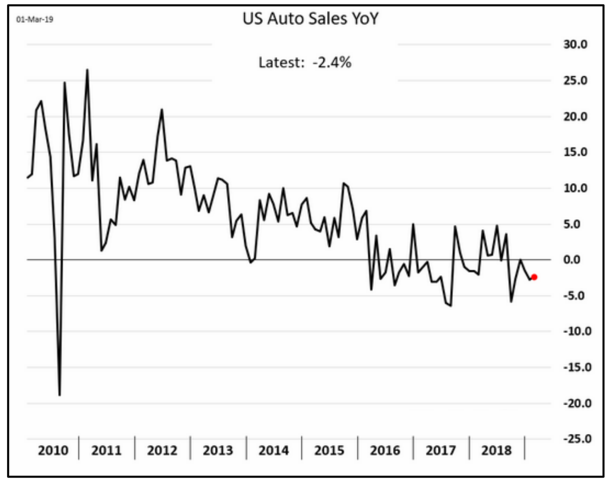
The Global Economic and Investment Complexes

The U.S. economy grew at a 2.6% quarter-over-quarter annualized rate in Q4 of 2018. Although this was strong compared to growth in other developed market countries like Japan and Germany, it was notably lower than the previous two quarters, which registered growth in the 3-4% range. The trend to decelerating economic growth as fiscal stimulus from tax reform fades is likely to be a key theme on investors' minds throughout this year. It is natural for the pace of growth to slow after an initial fiscal boost, and so it is not alarming, but it does bear monitoring.



A declining growth rate reflects specific activity within the broad economy. The chart from the *Wall Street Journal* below on the left shows how U.S. manufacturing activity seems to have topped out in mid-2018 and has been expanding at a slower pace since then. Orders for manufactured goods have slowed in tandem with, or in response to, slower rates of consumer spending, which is evident for instance in recent auto sales data (see the chart from the *Wall Street Journal* below on the right).

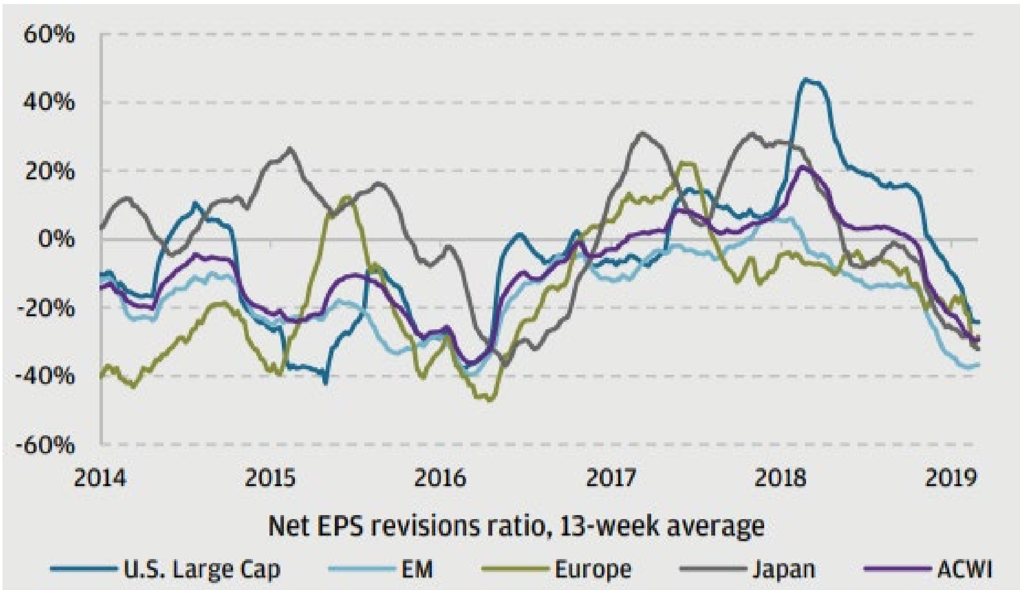




We anticipate that the Q1 GDP growth rate will be slower than Q4 of 2018. This is primarily due to an expected drag from weak consumption momentum at year-end, declining inventories, a likely decline in residential investment, and a notable effect from the partial government shutdown.

U.S. corporate earnings estimates have been revised lower, which also reflects slower economic growth and the fading effects of fiscal stimulus via tax reform. Earnings expectations seem to have peaked in 3Q2018 and have dropped sharply since then. This has occurred for the S&P 500 Index companies across sectors.

Downward earnings per share (EPS) revisions have not been confined to the United States. The chart below shows the 13-week average U.S. large cap EPS revisions in the context of those in emerging market (EM) nations, Europe, Japan, and the combined global corporate landscape via the MSCI All Country World Index (ACWI). The several lines make the chart a tad busy; however, the main point to draw is fairly conspicuous if you look at the far right: EPS expectations have been falling sharply over the last year as corporations have looked ahead.



Source: Datastream, J.P. Morgan Asset Management; data as of February 28, 2019.

These observations about slowing economic growth and declining corporate earnings growth expectations both in the U.S. and abroad inform our guarded outlook in the wake of this year's steep equity gains through February. These developments also help to explain why the Federal Reserve has increasingly reinforced its data-dependent, wait-and-see approach to monetary policy in general and any potential future rake hikes in particular, as you can see from the collection of recent communications immediately below.

Recent Comments from the Federal Reserve Reinforce Patient/Restrained Rate Policy

James Bullard on February 1
*"I would like to think that **we're out of the business of penciling in further increases** that have to be made. I don't think we're in that game anymore… there wouldn't be any presumption now anymore that we're going to move in one direction or the other."*

Robert Kaplan on February 7
*"My own attitude has been, at the Fed, we would be well served and **the country would be well served if we paused and were patient** for some number of months."*

Lael Brainard on February 14
*"We want to see the data as it comes in. But you know, I think in terms of the **let's be on hold for now** while we learn about what's going on in the economy."*
"And so I think we'll have to wait and see what the right move, if any, later in the year is"

Mary Daly on February 15
*"I have moved down from having a penciled-in number to **having a very patient outlook**… And if we continue to see muted inflation and growth coming in around potential, the 2 percent, and fighting up against these headwinds, then the argument for raising rates would be much less."*

Loretta Mester on February 19
"In my view, **monetary policy does not appear to be far behind or far ahead of the curve**."

Richard Clarida on February 21
*"**We can afford to be patient** and we can afford to let the data come in and tell us a little bit about where the global economy is going. But we think policy is in a good place right now."*

From the minutes as well
*"**Participants pointed to a variety of considerations that supported a patient approach to monetary policy** at this juncture as an appropriate step in managing various risks and uncertainties in the outlook"*

*"Participants noted that maintaining the current target range for the federal funds rate for a time **posed few risks at this point. The current level of the federal funds rate was at the lower end of the range of estimates of the neutral policy rate.** Moreover, inflation pressures were muted, and asset valuations were less stretched than they had been a few months earlier. Many participants suggested that it was not yet clear what adjustments to the target range for the federal funds rate may be appropriate later this year."*

Source: BlackRock; excerpts from published Fed minutes and Governors' speeches.

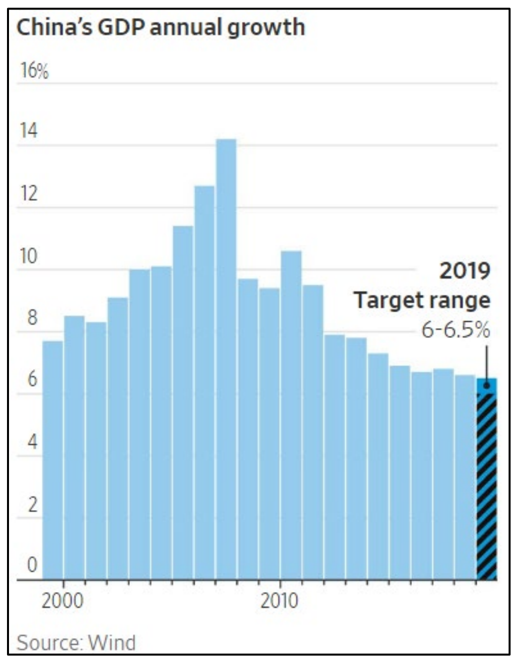
An additional interest rate increase later this year remains possible, but the hurdle rate to clear in order to warrant a move seems rather high. The Fed, too, is aware of global growth deceleration, which it sees as occurring against a backdrop of stable inflation and wage growth, on the one hand, and the lack of risks of financial imbalance, on the other.

It is worth mentioning that headline and core inflation figures may increase slightly as the year progresses, however, we do not anticipate an inflation spike, and the Fed has said that it will allow inflation to run for a while modestly above its long-term target rate. That is, unless inflation rises to a level that is persistently at or above the higher-end of its longer-term target, the Fed is unlikely to raise rates further.

One implication is that the core U.S. fixed income investment environment is likely to be stable for the time being. Another implication is that global liquidity may return to other assets that offer higher yields (such as EM bonds) or higher capital appreciation prospects (such as EM equities) because the Fed's pause has stopped or slowed the appeal of risk-free assets with steadily increasing interest rates in the form of U.S. Treasuries. If the Fed pivots in either policy or communication guidance, however, volatility may return to these assets.

Developments in U.S./China Trade Policy

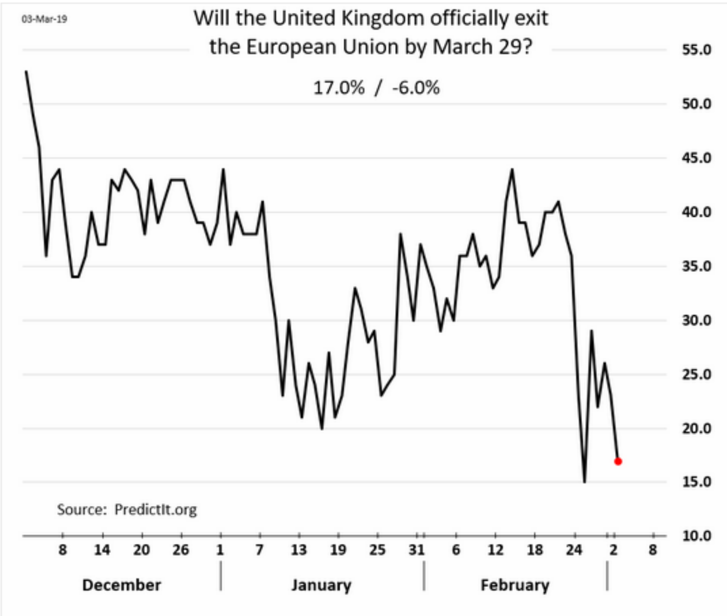
On the trade front, the U.S. and China still have many details to work out before an agreement is reached, but both sides appear increasingly motivated. Officials have reported making steady progress toward an agreement. In the final week of February, the deadline to reach an agreement before additional trade tariffs were scheduled to increase was extended indefinitely from its prior March 1 cutoff. Trump and Xi plan to meet in Florida near the end of March to discuss terms of an agreement and potentially to finalize an agreement.



We remain vigilantly optimistic. China's practices regarding intellectual property rights remain a major sticking point in negotiations, but recent rhetoric has been positive from both sides. The stakes in the U.S./China conflict are important. A return to more normalized political and trade relations could be positive for both economic growth and investment sentiment. China, for instance, has recently lowered its guidance for its 2019 GDP growth, anticipating it to fall within a range of 6.0% to 6.5%. China has been stimulating its economy to counter negative effects from the trade dispute with the U.S., but it has also been attempting to rein in government spending and reduce debt levels in recent years. It has reversed course on those fronts to maintain stability. An end to the trade dispute with the U.S. could help return both economic and political stability to China where the two are integrally related.

Prospects for Brexit

Various political moves by both U.K. Prime Minister Theresa May and opposition Labour Party leader Jeremy Corbyn in February resulted in a sharply decreased chance that there would be a hard Brexit (i.e., without a deal in place) on March 29 and in a sharply increased probability that there would be a delayed and softer Brexit later this year or perhaps no Brexit at all. The chart below, as of March 3 estimates, reflects the increased likelihood of a delay beyond March 29.



As we have maintained in recent months, the political situation in the U.K. regarding Brexit remains highly fluid. In February, Corbyn announced, contrary to his long-held position, that he and his opposition Labour party would be open to a second referendum on the question of whether the U.K. should exit the E.U. This move prompted Prime Minister May to concede, contrary to her own long-maintained stance, that she would be open to seeking a delayed exit beyond March if no satisfactory agreement were reached.

May had been tactically maneuvering so that the prospect of a hard Brexit might pressure lawmakers into adopting the terms that she had previously introduced to Parliament, which were rejected soundly on January 16 with 432 votes against and only 202 in favor. Corbyn undermined that move by enticing EU-supporters within May's Conservative party with the prospect of seeing a do-over referendum. Lest she lose more votes or face more resignations from members with in her own party, May gave ground.

Where do things go from here with the clock winding down? The graphic to the right outlines the key dates ahead. In our view, at present the most likely scenario is that the U.K. seeks a delayed exit, and May hopes for Parliament to pass the eventual terms sometime this summer.

A delayed exit would likely be welcomed by markets because it avoids the worst-case scenario of a hard Brexit, which might easily tip the U.K. into recession. Which road is eventually taken, however, remains unclear. We are content to remain patient with our basically neutral foreign developed market stock positions rather than try to guess the precise outcome.

Key Dates

March 12, 2019
By March 12, U.K. lawmakers vote again on a new deal outlining the terms of the U.K.'s divorce from the EU.

March 13, 2019
If that Brexit bill is rejected, lawmakers vote on whether to leave the EU without an agreement.

March 14, 2019
If lawmakers reject a so-called no-deal Brexit, they will vote on whether to seek a delay to the U.K.'s separation from the EU.

March 21, 2019
Two-day summit begins. EU leaders meet to consider the state of the Brexit process.

March 29, 2019
Without an extension, the U.K. is scheduled to leave the EU

Summary and Conclusion

Domestic economic growth seems durable if decelerating, inflation remains low, and employment remains high. The U.S. economy is likely to continue to grow but at a slower pace than it has recently, as fiscal stimulus slows and the cost of borrowing remains stable but higher than a year ago. We remain generally positive on the global economic outlook despite the unfinished trade agreement and ongoing uncertainties in Europe, including the growth slowdown there and the nature of Brexit. We continue to be of the opinion that in time China and the U.S. will strike a trade deal, but the precise path may still be filled with ups and downs.

As we move further into 2019, we do not think that the rate of gains realized in the first two months are likely to continue in subsequent months throughout the year. We continue to take a hopeful but realistic view about decelerating economic growth and corporate earnings growth globally. We are encouraged about the possibility of soon clearing out one geopolitical risk that has been weighing on both economic and investor sentiment, the U.S.-China trade dispute, but we recognize that another, the nature and path of Brexit, remains unresolved and will likely be extended. We are more comfortable now than last year with intermediate-term core bonds, given the still lingering risk factors globally and a more patient, steadier Fed. However, we still believe that a balanced approach to portfolio asset allocations is warranted, rather than skewing allocations toward one type of investment or another.