

# The investment outlook for 2019

The investment outlook for 2019: Late-cycle risks and opportunities



## IN BRIEF

- The U.S. economy should slow but not stall in 2019 due to fading fiscal stimulus, higher interest rates and a lack of workers. Even as unemployment falls further, inflation should be relatively contained.
- Central banks in the U.S. and abroad will tighten monetary policy in 2019 - this should continue to push yields higher. In the later stages of this cycle, investors may want to adopt a more conservative stance in their fixed income portfolios.
- Higher rates should limit multiple expansion, leaving earnings as the main driver of U.S. equity returns. With earnings growth set to slow, and volatility expected to rise, investors may want to focus on sectors that have historically derived a greater share of their total return from dividends.
- After a sharp fall in valuations in 2018, steady economic growth and less dollar strength may provide international equities some room to rebound in 2019. However, the climb will be bumpy and investors should ask themselves, in the short run, whether they have the right exposure within different regions and, in the long run, whether their exposure to international equities overall is adequate.
- There are significant risks to the outlook for 2019. The Federal Reserve may tighten too much; profit margins may come under pressure sooner than anticipated; trade tensions may escalate or diminish; and geopolitical strife may force oil prices higher.
- Timeless investing principles are especially relevant for investors in what appears to be the later stages of a market cycle. Investors may wish to tilt towards quality in portfolios along with an emphasis on diversification and rebalancing given higher levels of uncertainty.

## INTRODUCTION

2018 has been a difficult year for investors as long bull markets in both U.S. equities and fixed income have encountered strong headwinds, and international stocks have underperformed following a very strong 2017. Shifting fundamentals in an aging expansion have certainly played their part in slowing investment returns, as the U.S. Federal Reserve (Fed) has gradually tightened U.S. monetary policy, a new populist government in Italy has revived Eurozone fears and Middle East turmoil has led to more volatile oil prices.

However, the single most important issue moving global markets in 2018 was rising trade tensions, and this will likely also be the case in 2019. In a benign scenario, the U.S. and China come to an agreement on trade issues, potentially allowing the dollar to fall and emerging market (EM) stocks to rebound following a very rocky 2018. In an alternative scenario, an escalating trade war could slow both the U.S. and global economies with negative implications for global stocks.

While investors will likely focus attention on trade tensions and other risks to the forecast, it is also important to form a baseline view of the outlook. And so in the pages that follow, we outline what we believe is the most likely scenario for the U.S. economy, fixed income, U.S. equities and the global economy and markets. We also include a section exploring some risks to the forecast and end with a look at investing principles and how they can help investors weather what could be a volatile year ahead.

## U.S. ECONOMICS: FINDING MORE RUNWAY

Entering 2019, the U.S. economy looks remarkably healthy, with a recent acceleration in economic growth, unemployment near a 50-year low and inflation still low and steady. Next July, the expansion should enter its 11th year, making this the longest U.S. expansion in over 150 years of recorded economic history. However, a continued soft landing, in the form of a slower but still steady non-inflationary expansion into 2020, will require both luck and prudence from policy makers.

On growth, real GDP has accelerated in recent quarters and is now tracking a roughly 3% year-over-year pace. However, growth should slow in 2019 for four reasons:

First, the fiscal stimulus from tax cuts enacted late last year will begin to fade. Under the crude assumption of an immediate fiscal multiplier of 1, the stimulus from tax cuts would have added 0.3% to economic activity in fiscal 2018 (which ran from October 2017 to September 2018), 1.3% in fiscal 2019 and 1.1% in fiscal 2020. However, it is the *change* in stimulus, rather than the level of stimulus that impacts economic growth, so this tax cut would have added 0.7% and 0.6% to the real GDP growth rate in the current and last fiscal years, respectively, but should actually subtract 0.1% from the GDP growth rate in the next fiscal year.

Second, higher mortgage rates and a lack of pent-up demand should continue to weigh on the very cyclical auto and housing sectors.

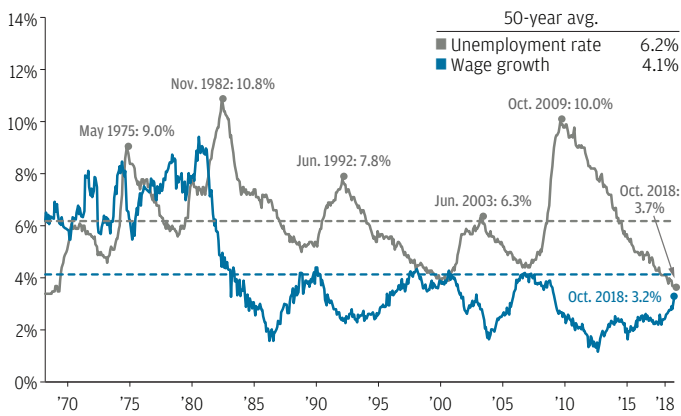
Third, under our baseline assumptions, the trade conflict with China worsens entering 2019 with a ratcheting up of tariffs to 25% on USD 200 billion of U.S. goods. Even if the conflict does not escalate further, higher tariffs would likely hurt U.S. consumer spending and the uncertainty surrounding trade could dampen investment spending.

Finally, a lack of workers could increasingly impede economic activity. Over the next year, the Census Bureau expects that the population aged 20 to 64 will rise by just 0.3%, a number that might even be optimistic given a recent decline in immigration. With the unemployment rate now well below 4.0%, a lack of available workers may constrain economic activity, particularly in the construction, retail, food services and hospitality industries.

Under this scenario, the U.S. unemployment rate should fall further. Real GDP growth impacts employment growth with a lag, and a few more quarters of above-trend economic growth could cut the unemployment rate to 3.2% by the end of 2019, which would be the lowest rate since 1953. However, we do not expect the unemployment rate to fall much below that level, as remaining unemployment at that point would largely be non-cyclical.

## Civilian unemployment rate and year-over-year wage growth for private production and non-supervisory workers

EXHIBIT 1: SEASONALLY ADJUSTED, PERCENT



Source: BLS, FactSet, J.P. Morgan Asset Management.  
*Guide to the Markets* - U.S. Data are as of October 31, 2018.

As unemployment continues to fall, wage growth may rise somewhat further, as it did in October, as shown in **Exhibit 1**. However, the lack of responsiveness of wages to falling unemployment this far in the expansion speaks to a lack of bargaining power on the part of workers that should persist into 2019, holding overall wage inflation in check.

Finally, consumer inflation should remain relatively stable in 2019. A mild acceleration in wage growth will, undoubtedly, put some upward pressure on consumer prices. However, a recent rise in the U.S. dollar and fall in global oil prices should both work to keep inflation in check. Higher tariffs might, of course, add to consumer inflation in the short run. However, their depressing effect on economic activity would likely counteract this. With or without higher tariffs, we expect consumer inflation, as measured by the personal consumption deflator, to end 2019 in much the same way as 2018, very close to the Fed's 2.0% long-run target.

With regards to the U.S. dollar, the currency may face some further upward pressure early in 2019 as U.S. growth remains strong and uncertainty around trade abounds. However, later into the year, the combination of a slowing U.S. economy, a more cautious Fed and tightening by international central banks should cause the U.S. dollar to end 2019 flat to down compared to the end of 2018.

## FIXED INCOME: TIME FOR THE BUBBLE PACK

U.S. fixed income investors have faced a tough environment in 2018. Faster growth, growing fiscal deficits and balance sheet reduction pushed the U.S. 10-year yield from 2.40% at the end of 2017 to 3.15% by mid-November. The Bloomberg Barclays U.S. Aggregate has fallen 2.3% year-to-date, looking set to end 2018 in negative territory - only the fourth year since 1980 that the benchmark has registered an annual decline. So what might 2019 hold for investors in bonds?

The Fed should continue to raise rates early in 2019, adding two more rate hikes by mid-summer and pushing the federal funds rate to a range of 2.75%-3.00%. However, if economic growth slows in the second half of 2019, inflation should remain remarkably stable for this late in the cycle. This could allow the Fed to pause its hiking cycle at that point, and economic data may not give them reason to resume tightening again.

A number of other central banks will also join the Fed in gradually tightening monetary policy in 2019. The European Central Bank will finish purchasing assets by January 2019 and should begin raising rates by mid-2019. Other central banks, such as the Bank of England and the Bank of Japan, should engage in some form of modest tightening.

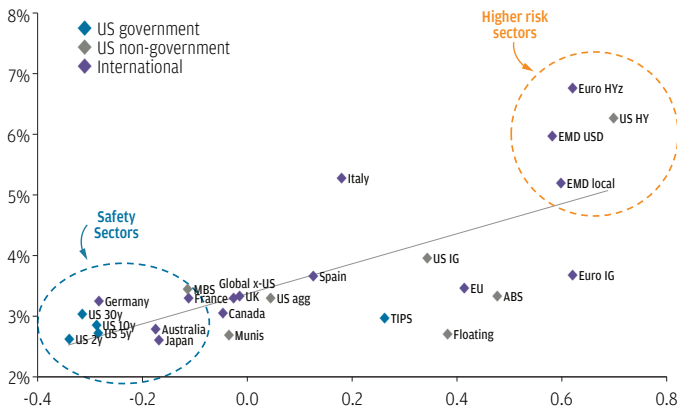
Some investors may see this global tightening as a concerning development since, in many ways, central banks have provided the training wheels to help stabilize markets over the course of this cycle. However, the gradual removal of these training wheels shows that central banks believe economies can now cycle on without their support - a sign of strength, not of weakness. Nevertheless, while the removal of this support should be viewed as a positive, it could trigger increased volatility and gradually rising yields.

So how should investors be positioned going into next year? As we get later into this economic cycle, it is important that investors begin to bubble pack their portfolios. This, in effect, means dialing back on some of the riskier bond sectors and seeking the safety of traditional fixed income asset classes. This step may involve sacrificing some upside in the short term for additional protection.

At this point in the cycle, investors should remember the diversification benefits of core bonds, as highlighted in **Exhibit 2**. **Exhibit 2** shows that higher yielding, riskier asset classes, such as EM debt or high yield, may offer more yield, but with stronger correlations to the S&P 500. Therefore, if equities fall sharply, riskier bond sectors will not provide much protection. In short, higher yield equals higher risk.

**Late in the cycle investors should remember higher yield equals higher risk**

EXHIBIT 2: CORRELATION OF FIXED INCOME SECTORS VS. S&P 500 AND YIELDS



Source: Bloomberg, FactSet, ICE, J.P. Morgan Asset Management. Data are as of July 7, 2018.

International fixed income sector correlations are in hedged US dollar returns as U.S. investors getting into international markets will typically hedge. EMD local index is the only exception - investors will typically take the foreign exchange risk. Yields for all indices are in hedged returns using three-month London interbank offered rates (LIBOR) between the U.S. and international LIBOR. The Bloomberg Barclays ex-U.S. Aggregate is a market-weighted LIBOR calculation. Data are as of September 12, 2018.

A common theme in this cycle has been the hunt for yield, with investors moving into unfamiliar asset classes searching for higher returns to offset the low yields in core bonds. This isn't necessarily an incorrect strategy in the early or middle stages of an economic expansion; however, in the late cycle this approach becomes riskier. Instead, investors should consider trimming higher-risk sectors and rotating into safer, higher-quality assets. Areas like short duration bonds offer some yield to investors with downside protection.

The key takeaway for investors is that central banks will continue to tighten monetary policy in 2019, inflicting some pain on bond-holders. However, at this stage in the cycle, the focus should begin to switch from yield maximization to downside protection. In short, now is the time to start adding bubble pack to portfolios.

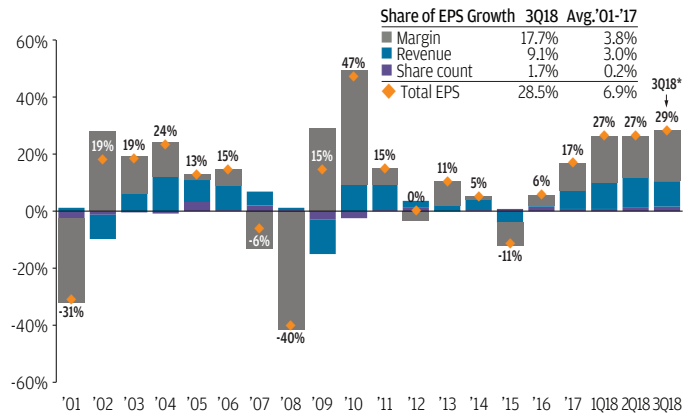
**EQUITIES: A LITTLE MORE DEFENSE AS THE LIQUIDITY SAFETY NET IS REMOVED**

The end of 2018 has served as a reminder that stock market volatility is alive and well. Investors have recognized that trees do not grow to the sky, and that the robust pace of profit and economic growth seen this year will gradually fade in 2019 as interest rates move higher. While history suggests that there are still attractive returns to be had in the late stages of a bull market, the transition away from quantitative easing and toward quantitative tightening has contributed to broader investor concerns. Many equate this new environment to walking on an investment tightrope without the liquidity safety net that has been present for over a decade.

While it is true risks are beginning to build, there are still some bright spots. First, earnings growth looks set to slow from the +25% pace seen this year, but does not look set to stop, as shown in **Exhibit 3**. Consensus forecasts point to annual earnings growth of 10%-12% next year; risks to this forecast are to the downside, but earnings could still grow at a mid to high single-digit pace in 2019, providing support for the stock market to move higher.

**S&P 500 year-over-year EPS growth**

EXHIBIT 3: ANNUAL GROWTH BROKEN INTO REVENUE, CHANGES IN PROFIT MARGIN & CHANGES IN SHARE COUNT



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.

Earnings per share levels are based on annual operating earnings per share except for 2018, which is quarterly. \*3Q18 earnings are calculated using actual earnings for 68.3% of S&P 500 market cap and earnings estimates for the remaining companies. Percentages may not sum due to rounding. Past performance is not indicative of future returns. *Guide to the Markets* - U.S. Data are as of October 31, 2018.

The risks to earnings, however, lie in profit margins and trade. 2018 has seen profit margins expand significantly on the back of tax reform, but with both wage growth and interest rates expected to rise further next year, margins should begin to come under pressure. Importantly, we believe that profit margins should revert to the trend, rather than the mean, and as such we are not expecting a sharp adjustment from current levels.

Trade is a less quantifiable risk - we believe an escalating trade war with China could have a significant direct impact on S&P 500 profits, and could have further indirect costs depending on the extent of Chinese retaliation and the dampening impact of the turmoil on business confidence and the global economy. However, on a close call, we believe that the U.S. and China will avoid escalation beyond an increase in tariffs on USD 200 billion of Chinese goods, scheduled for January 1st, and a predictable Chinese response to this move.

A backdrop of rising rates will not only pressure profit margins and earnings, it will also pressure valuations. Years of quantitative easing by the world's major central banks pushed investors into risk assets - most notably equities - as they sought to generate any sort of meaningful return. However, short-term interest rates are now positive after adjusting for inflation, creating some viable competition for stocks. With the Fed expected to hike rates at least two more times in 2019, higher yields seem set to remain a headwind to stock market valuations over the coming months.

Slower earnings growth and more muted valuations certainly do not seem like an ideal fundamental backdrop for equities. While it is true that the outlook is beginning to look less bright, it is important to remember two things: markets care about changes in expectations more than they care about expectations themselves, and the stock market tends to generate solid returns at the end of the cycle.

As prospects for slower economic growth become clearer in the middle of next year, the Fed may signal it will pause. Such a signal, or a trade agreement with China, could lead multiples to expand, pushing the stock market higher and potentially adding years to this already old bull market. However, even if the bull market does end in the next few years, it is important to remember that late-cycle returns have typically been quite strong.

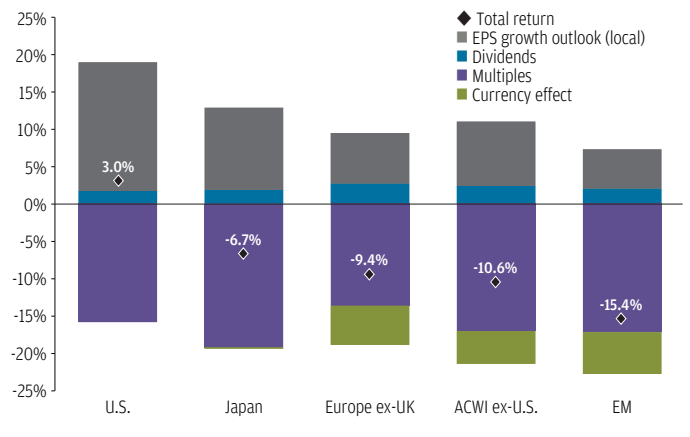
This leaves investors in a tough spot - should they focus on a fundamental story that is softening, or invest with an expectation that multiples will expand as the bull market runs its course? The best answer is probably a little bit of each. We are comfortable holding stocks as long as earnings growth is positive, but do not want to be over-exposed given an

expectation for higher volatility. As such, higher-income sectors like financials and energy look more attractive than technology and consumer discretionary, and we would lump the new communication services sector in with the latter names, rather than the former. However, given our expectation of still some further interest rate increases, it does not yet seem appropriate to fully rotate into defensive sectors like utilities and consumer staples. Rather, a focus on cyclical value should allow investors to optimize their upside/downside capture as this bull market continues to age.

### INTERNATIONAL EQUITIES: DOES THE FOG LIFT IN 2019?

Going into 2018, we had expected international equities to continue the climb they began the prior year. As the year comes to a close, major regions outside of the U.S. seem set to deliver negative returns in U.S. dollar terms. Looking at a breakdown of international returns in 2018, as shown in **Exhibit 4**, it is easy to see that the climb was halted not because the plane itself was not solid, but because there was a lot of fog on the runway. Said another way, fundamentals themselves were positive in 2018, but a multitude of risks dented investor confidence, causing significant multiple contraction and currency weakness across the major regions. As a result, the question for 2019 is whether the fog will begin to lift, improving sentiment toward international investing and permitting international equities to take off once again.

**2018 was a year of souring sentiment towards international**  
**EXHIBIT 4: SOURCES OF GLOBAL EQUITY RETURNS, TOTAL RETURN, USD**



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. All return values are MSCI Gross Index (official) data, except the U.S., which is the S&P 500. Multiple expansion is based on the forward P/E ratio and EPS growth outlook is based on next twelve month actuals earnings estimates. Data are as of October 31, 2018.



The first factor affecting confidence abroad was disappointment around economic growth. In absolute terms, global economic data remained on much more solid footing in 2018 compared to the crisis-filled years of 2011 to 2016. This allowed earnings growth to continue improving, a process that began only in 2016 for many regions outside of the U.S. However, economic data did cool a bit from 2017's hot climate and, crucially, it did disappoint expectations, especially in the Eurozone and Japan. We do expect economic data in these regions to improve a bit in 2019, giving investors greater confidence in the 10% and 8% 2019 earnings estimates for the Eurozone and Japan, respectively.

In the Eurozone, we should see an improvement from 2018's somewhat mysterious slowdown, with growth averaging closer to 2%. While we expect the European Central Bank to take its first steps toward policy normalization in mid-2019, this will be a very gradual process. As a result, monetary conditions will remain very accommodative in the region, providing ongoing support to private credit growth, a falling unemployment rate, rising wages and high consumer and business confidence. Our base case assumption of a continued détente between the European Union and the U.S. on trade should also provide support to business confidence and activity; however, a stronger euro will limit the support net exports are able to provide to growth. In addition, as usual, domestic politics will continue to provide pockets of turbulence. We do not expect an easy resolution to the budget standoff between the Italian government and the European Commission, keeping growth in Italy subdued, but we also do not expect a departure of Italy from the euro, which greatly limits the contagion to the rest of the region.

In addition, March marks the official departure of the UK from the European Union. The road to a deal will not be easy, but we ultimately assume that a deal occurs, avoiding a scenario in which the UK "crashes" out of the European Union. This would remove a key uncertainty for the UK, resulting in an acceleration in business investment and consumer spending. As the Bank of England speeds up its normalization next year, we are likely to see sterling strengthen.

For Japan, 2018 also brought some economic disappointments, with some clearly temporary as a result of a multitude of natural disasters. Growth should pick up a bit above 1% next year, as nascent but rising wage growth supports consumption early in the year and our base case of no escalation of trade tensions between the U.S. and Japan provides some support to business sentiment and activity. However, some adjustment in the Bank of Japan's policy may place some upward pressure on the yen, limiting the support from net export growth. Lastly, growth may become very bumpy during the second half of the year if the Japanese government does decide to proceed with the VAT hike in October.

While an improvement in economic growth in Europe and Japan in 2019 would get the international plane further down the runway, investors should take note that the resulting monetary policy normalization and currency strength will create winners and losers in these markets. Big exporters, which make up a significant portion of these markets, will likely see their earnings come under pressure once converted back into local currency. However, the financial sector may finally see some tailwinds after years of headwinds from low or negative interest rates.

The second factor affecting confidence in 2018 was the multi-front trade fight between the U.S. and its major trading partners. In our base case scenario, we do not expect a quick resolution to trade tensions between the U.S. and China in 2019 and investors will be very sensitive to Chinese economic data during the year. Ultimately, we do expect the multitude of stimulus measures from the Chinese government to provide a floor to Chinese GDP growth at 6%. Should economic data falter more than expected, we expect the Chinese government to enact further fiscal stimulus in order to shore up activity and confidence. This would lift a very crucial fog for EM economies and risk assets more broadly.

The last major issue affecting confidence in 2018 was the strength of the U.S. dollar, as it put into doubt the EM economic and earnings story. Our expectation of further dollar strength early in the year will likely restrain EM assets; however, as Chinese data stabilizes, the Fed pauses and the dollar's climb reverses later in the year, EM assets may finally have some room to take off. However, as global liquidity continues to be drained next year, not all EM planes will fly at the same altitude. Investors are likely to continue being very selective, focusing on countries where economic growth differentials are widening versus developed markets, fiscal policy remains responsible and external vulnerabilities are kept in check. For specific EM countries, domestic politics will play an idiosyncratic role in performance, with delivery from newly elected leaders important in several big Latin American countries, and with key elections in focus in Asia, such as India's May general election.

While the checklist of concerns for the global economy remains long in 2019 it is important to note that valuations fell sharply in 2018 to reflect them. If economic growth picks up in Europe and Japan, Chinese growth finds a floor and the U.S. dollar weakens, international equities could rebound. This would be especially true if, as we expect, the U.S. economy slows down but does not show signs of imminent recession.

However, the climb will be bumpy - as such, it may not a year to make big bets on international over U.S. equities. Rather, investors should ask themselves whether they have the right exposure in different regions. In addition, for many U.S. investors, the right question is not whether to overweight international equities this year, but whether to move anywhere close to being equal weight. The reality is that U.S. investors remain under-allocated to international equities, which comprise only 22% of equity holdings compared to a 45% weighting in the MSCI global benchmark. Given structurally higher economic growth in EM and cyclically more favorable starting points in other developed markets, this international exposure will be crucial for long-term U.S. investors over the next decade.

The truth is that the plane ride to Paris or Tokyo or Shanghai can be long and can be bumpy, but the destination is worth it - and tickets are on sale right now.

## RISKS TO THE OUTLOOK: WHAT COULD GO WRONG?

Our outlook, as outlined above, is generally positive, though cautiously so. But there are risks to that outlook, and they are worth discussing in some detail.

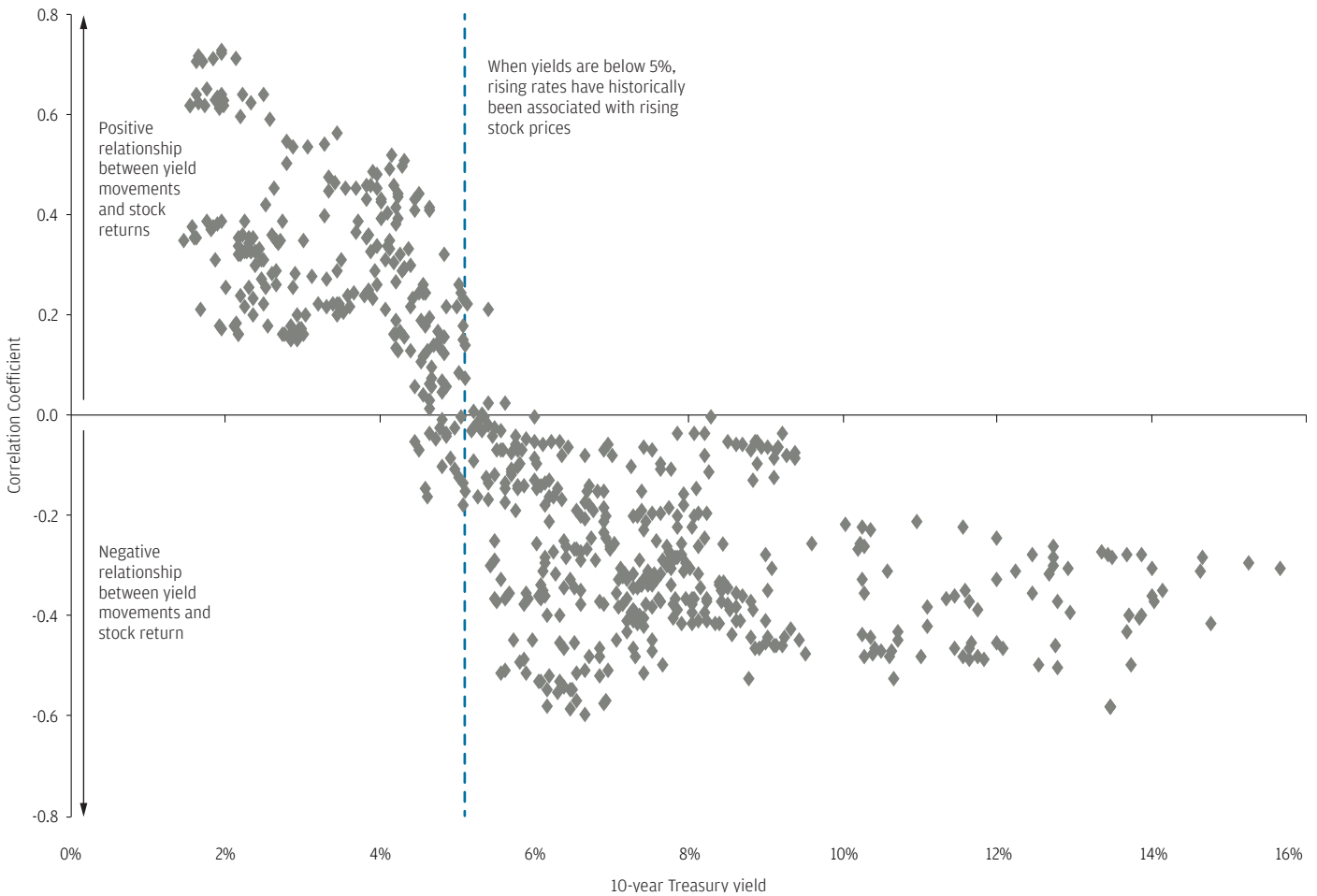
The macro backdrop for 2019 should remain supportive, with above-trend growth slowing to more sustainable levels in the second half. But this outlook relies on a specific set of circumstances, namely the persistence of only modest trade tensions between the U.S. and China and a moderate Fed. Unfortunately, these circumstances are far from guaranteed. The path of trade negotiations is unclear: an escalation in tensions could further slow economic growth, both in the U.S. and abroad, though a swifter resolution could be supportive of improved global growth. In addition, while not our base case, the recent strength in wage growth could be sustained and feed through to higher inflation. This could force the Fed to drive interest rates higher, muzzling growth and increasing the probability of a recession.

A late-cycle surge in inflation would obviously have implications for the bond market, too. On one hand, a rapid rise in U.S. interest rates would lead to more acute pain for fixed income investors in the short run. On the other, to the extent that this tightening stoked recession fears, higher-quality debt would look relatively more attractive. Investors, in turn, may be forced into a difficult juggling act: balancing short-term duration risk with a long-term need for a portfolio ballast. Beyond this, should trade tensions escalate further and global growth slow, international central banks may be forced away from normalization, resulting in persistently low interest rates overseas.

As it currently stands, though, the valuation argument for overweighting stocks and underweighting bonds still seems clear, although less compelling than a year ago. Moving into 2019, bond yields may rise relative to stock dividend yields and earnings growth should slow. As shown in **Exhibit 5**, history tells us that rising interest rates should drag on equity performance. This suggests the need to gradually move U.S. stock/bond allocations to a more neutral stance.

Correlations between weekly stock returns and interest rate movements

EXHIBIT 5: WEEKLY S&P 500 RETURNS, 10-YEAR TREASURY YIELD, ROLLING 2-YEAR CORRELATION, MAY 1963 - OCTOBER 2018



Source: FactSet, FRB, Standard & Poor's, J.P. Morgan Asset Management.

Returns are based on price index only and do not include dividends. Markers represent monthly 2-year correlations only. *Guide to the Markets* - U.S. Data are as of October 31, 2018.

The near-term outlook for international equities is perhaps even more uncertain than for U.S. stocks. Recent volatility, particularly around mounting trade tensions, has left international equities trading at a deep discount to both the U.S. and history. But the question of whether or not this valuation advantage will result in relatively better returns in 2019 is a close call. Though meaningful progress has been made on numerous fronts, the outlook for U.S.-Chinese trade relations is murky; should tariff negotiations collapse, sentiment would erode and global growth may slow further. By contrast, if relations improve and trade tensions ease, growth may be stronger, both in the U.S. and abroad, than anticipated. The relative risk allocation, between stocks and bonds and between the U.S. and international, could therefore shift.

Moving into 2019, investors will need to be mindful of the risks while rooting out investing opportunities in a late-cycle environment. U.S. bonds will be further challenged, though duration may be more harmful should inflation get out of hand; U.S. stocks look attractive, though that may change as rates continue to rise; and international equities look fundamentally sound, but trade uncertainty makes their near-term prospects unclear. Moreover, lurking beneath the surface is a final point of contention: the direction of oil prices. Given multiple Middle-East hot spots, a spike in energy costs is certainly possible and would have broad-based ramifications: slowing global growth, reduced spending power and limited interest in risk assets. If this transpires, the outlook for 2019 would change for the worse.



INVESTING PRINCIPLES: DIMMING THE DIALS

We conclude our year-ahead outlook by revisiting investing principles that hold across market environments. While these principles are timeless, they are probably most important to consider in the later stages of economic and market cycles. Being “late cycle” may invoke troubling memories of 2008; however, fundamentals suggest that today’s financial environment is quite different. Indeed, this late-cycle period could be long, sticky and drawn out, just like the broader cycle. Calling the end would be a fool’s errand, and could result in missed opportunities.

Thinking of a light dimmer can be helpful. The jarring experience of turning a light on in a dark bedroom after (hopefully) eight hours of restful sleep is less than ideal. Equally, at night, plunging a room into darkness can be disquieting as your eyes adjust. However, dimmers, which gradually ease a light on and off, can avoid these displeasures.

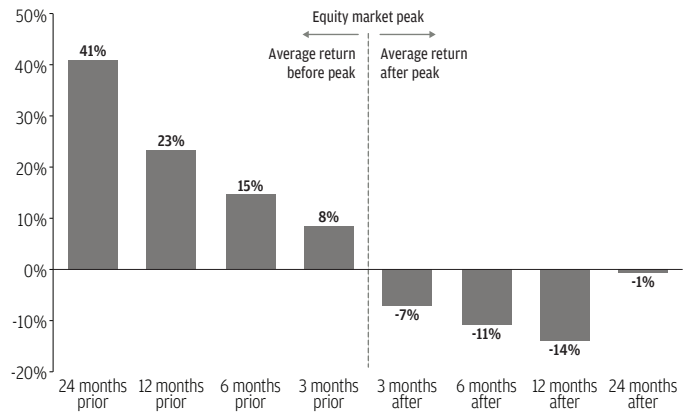
Risk exposure in an investment portfolio can be viewed the same way. While the financial press often speaks of being “in” or “out” of the market, we know that’s the equivalent of our jarring light switch. Dimming the dials, which tune our exposure in portfolios, makes for a better investor experience as the investment landscape shifts.

For 2019, we are dialing up good quality fixed income exposure (the tried and true diversifier in a downturn) and dimming down credit risk. We are maintaining equity exposure. However, given the outperformance of the U.S. throughout most of the bull market and depressed valuations abroad, investors should consider dialing up international back to a neutral position. Lastly, we are staying diversified. As we move closer to the next recession, volatility is likely to remain elevated. Having a well- thought out plan can prevent behavioral biases from taking a hold and hurting returns.

It’s telling to note that late-cycle returns tend to be substantial, as shown in **Exhibit 6**. While the nature of, and end to, each cycle differs, since 1945, the average return for the U.S. equity market in the two years preceding a bear market has been about 40%; even in the six months preceding the onset of a bear, that return has averaged 15%. This suggests that exiting the market too early may leave considerable upside on the table. Moreover, timing the exit also requires timing re-entrance. Few can make one good timing call correctly. Making two is harder still and in the long run, timing mistakes tend to significantly hurt returns.

Average return leading up to and following equity market peaks

EXHIBIT 6: S&P 500 TOTAL RETURN INDEX, 1945-2017



Source: FactSet, Robert Shiller, Standard & Poor’s, J.P. Morgan Asset Management. Chart is based on return data from 11 bear markets since 1945. A bear market is defined as a decline of 20% or more in the S&P 500 benchmark. Monthly total return data from 1945 to 1970 is from the S&P Shiller Composite index. From 1970 to present, return data is from Standard & Poor’s. *Guide to the Markets* – U.S. Data are as of October 31, 2018.

While diversification will continue to be key in 2019, in any one year a diversified portfolio is never the best performer. However, its benefit truly shows over the long run, as shown in **Exhibit 7**. Over the last 15 years, a hypothetical diversified portfolio had an average annual return of just over 8%, with a volatility of 11% – an attractive risk/return profile. The last six years have marked the outperformance of U.S. large cap stocks. However, gradually rising wages and interest costs and fading fiscal stimulus in the U.S. suggest that next year’s performance will likely be lower. With that in mind, a well-balanced diversified approach is warranted and over time has shown to be a winning strategy for long-run investors.

Investors should be especially thoughtful in managing their money in a late-cycle environment. Some good rules to follow include: using a “dimmers” approach to asset allocation; employing strategies to participate in the upside, while trying to mitigate downside risk through hedging; avoiding big directional calls, concentrated positions or risky bets; retaining good quality fixed income, even if recent performance is disappointing; have a bias to quality across asset classes; prioritize volatility dampening; and take capital gains where it makes sense. Most importantly, rebalance, stick to a plan and remember: get invested and stay invested.

Asset class returns

EXHIBIT 7

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	2003-2017	
																Ann.	Vol.
EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Large Cap 3.0%	EM Equity 12.7%	EM Equity 23.0%
Small Cap 47.3%	EM Equity 26.0%	Comdty 21.4%	EM Equity 32.6%	Comdty 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Cash 1.4%	Small Cap 11.2%	REITs 22.3%
DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. 25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	Small Cap -0.6%	REITs 11.1%	Small Cap 18.8%
REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty 11.8%	Small Cap 14.6%	REITs -0.9%	Large Cap 9.9%	Comdty 18.8%
High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Asset Alloc. -2.3%	High Yield 9.6%	DM Equity 18.4%
Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Fixed Income -2.4%	DM Equity 8.6%	Large Cap 14.5%
Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	High Yield -2.4%	Asset Alloc. 8.3%	High Yield 11.3%
Comdty 23.9%	Comdty 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty -4.1%	Fixed Income 4.1%	Asset Alloc. 11.0%
Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty 1.7%	DM Equity -8.9%	Cash 1.2%	Fixed Income 3.3%
Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty -1.1%	Comdty -9.5%	Comdty -17.0%	Comdty -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -15.4%	Comdty -0.3%	Cash 0.8%

Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.

Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Barclays Global HY Index, Fixed Income: Bloomberg Barclays US Aggregate, REITs: NAREIT Equity REIT Index. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg Barclays US Aggregate, 5% in the Bloomberg Barclays 1-3m Treasury, 5% in the Bloomberg Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period of 12/31/02 - 12/31/17. Please see disclosure page at end for index definitions. All data represents total return for stated period. Past performance is not indicative of future returns. *Guide to the Markets* - U.S. Data are as of October 31, 2018.

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