Quarterly Perspectives

U.S. | 1Q 2016

J.P. Morgan Asset Management is pleased to present the latest edition of *Quarterly Perspectives*. This piece explores key themes from our *Guide to the Markets*, providing timely economic and investment insight.

THIS QUARTER'S THEMES

1. The Fed in 2016: Sticking to the dots?
2. Looking for investment opportunities abroad
3. Will U.S. earnings recover?
4. A bear market for fixed income?

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1 The Fed in 2016: Sticking to the dots?

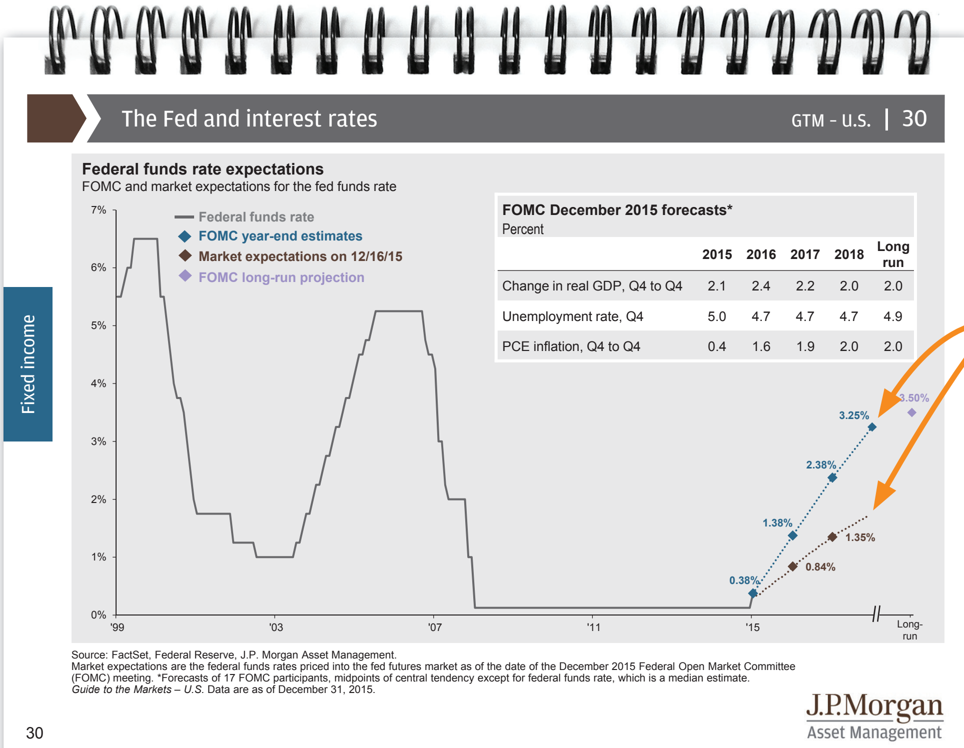
THE MARKET IS STILL MORE DOVISH THAN THE FED

In December, following seven years of near-zero short-term interest rates, the Federal Reserve (Fed) raised the federal funds rate from a range of 0%-0.25% to a new range of 0.25%-0.50%. With the first rate hike behind us, markets are now focused on the future speed of Fed tightening. Fed forecasts of 2.4% GDP growth and 1.6% inflation in 2016, combined with a fall in the unemployment rate to 4.7% by the fourth quarter, more than justify the FOMC's "dot-plot" projection of a 1% increase in short-term rates in 2016.

- During the last five rate hike cycles, the federal funds rate was raised at an average pace of 2.5% per year.
- In addition, the Fed's forecasts may be too conservative as 2.4% growth, if achieved, would likely reduce the unemployment rate below 4.5% by the fourth quarter, while any rebound in oil prices could push inflation above 1.6%.
- Meanwhile, markets appear priced for an even slower pace of tightening, suggesting some volatility and higher long-term interest rates if the Fed actually sticks to its "dots."

OVERVIEW

- After a first short-term rate hike in December, Fed officials are forecasting four more rate hikes in 2016, a faster pace of tightening than is suggested by futures markets.
- Economic growth could accelerate in 2016, reducing unemployment and adding to inflation pressures.
- If this occurs, the Fed may well stick to its "dot plot", delivering more monetary tightening than is expected by the market and putting some upward pressure on long-term interest rates.



FOMC December 2015 forecasts*
Percent

	2015	2016	2017	2018	Long run
Change in real GDP, Q4 to Q4	2.1	2.4	2.2	2.0	2.0
Unemployment rate, Q4	5.0	4.7	4.7	4.7	4.9
PCE inflation, Q4 to Q4	0.4	1.6	1.9	2.0	2.0

Futures markets point to just a 0.50% increase in short-term rates in 2016 compared to Fed expectations of 1.00%.

Source: *Guide to the Markets - U.S.* 1Q 2016, page 30

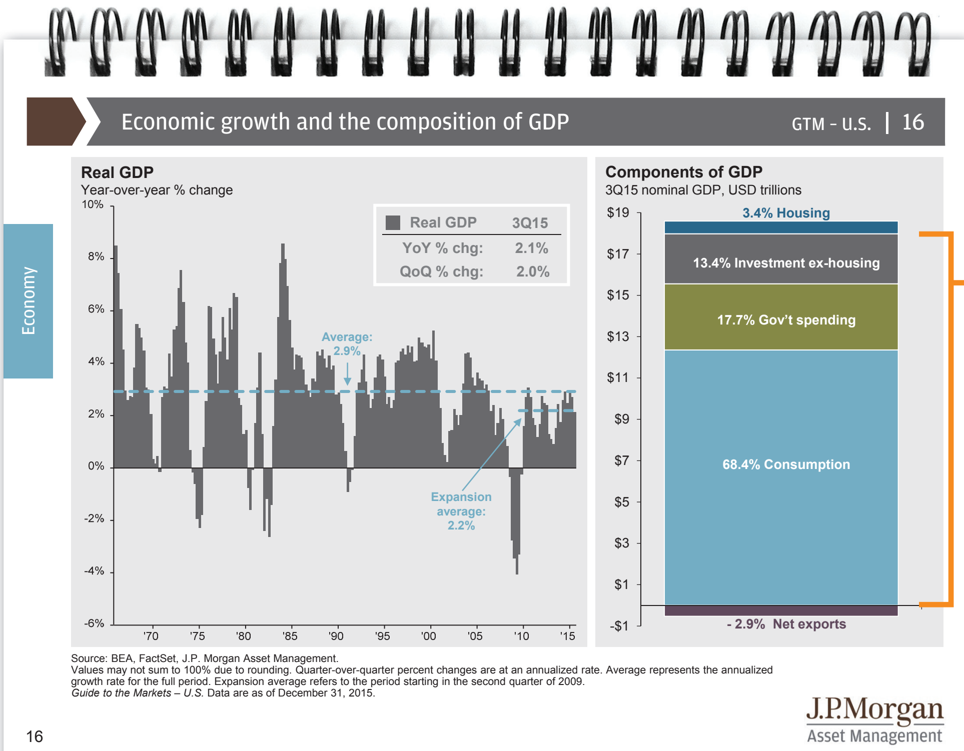
GROWTH SHOULD ACCELERATE DUE TO SOLID CONSUMER SPENDING AND SOME REVIVAL IN INVESTMENT

While slower-growing inventories, reduced spending on oil exploration and a worsening trade position should continue to weigh on growth, 2.0%-2.5% growth appears very attainable in 2016. In particular, growth prospects have brightened recently with the passage of key fiscal legislation in Washington, the impact of lower oil prices on consumers and the potential for increased interest income.

- The passage of a multi-year transportation bill and multi-year corporate tax breaks in December, along with the relaxation of sequester spending cuts, represent major fiscal stimulus and should help both consumer and business spending.

- 2016 will see a continuation of very low gasoline prices due to a global oil glut and massive over-production by OPEC. While this is a negative for capital spending on oil exploration, it is a major positive for consumer confidence and discretionary income.

- Consumers will also be aided by interest rate increases: first, because the consumer sector has far more interest-bearing assets than interest-bearing liabilities; second, because a much greater percent of their liabilities are fixed rate; and third, because long rates have not risen, so far, in response to higher short rates.



Fiscal stimulus and even cheaper oil should help consumption, investment and government spending in 2016.

Source: *Guide to the Markets – U.S.* 1Q 2016, page 16

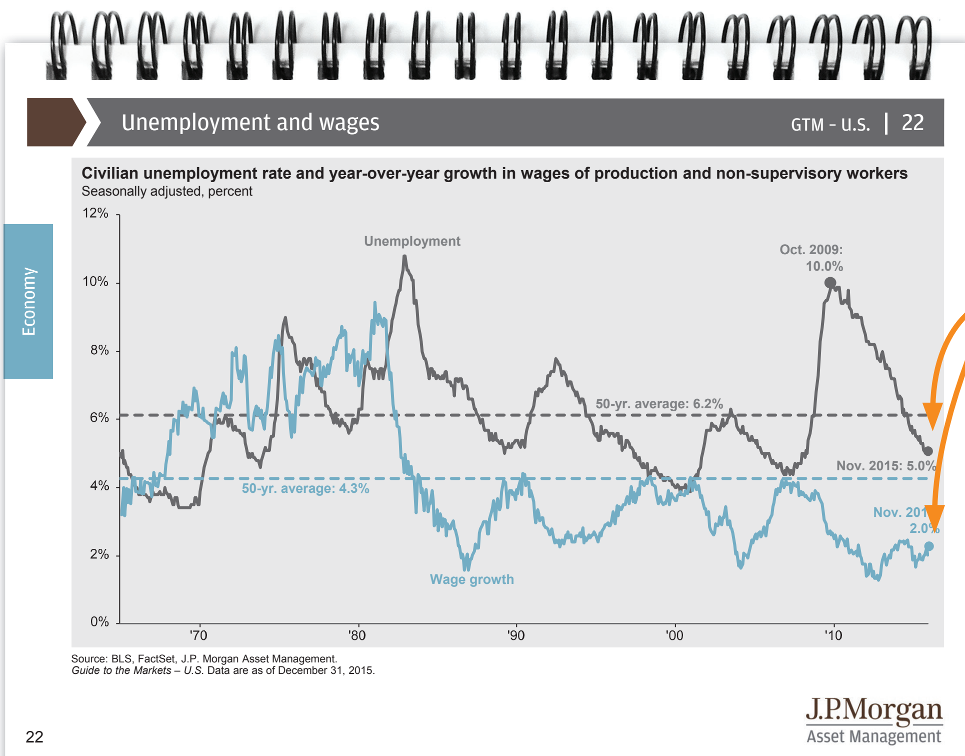
WEAK LABOR FORCE AND PRODUCTIVITY GAINS MEAN EVEN MODERATE GDP GROWTH SHOULD LEAD TO LOWER UNEMPLOYMENT AND FASTER WAGE GROWTH

Over the past decade, the output per worker of the U.S. economy has increased by just 0.9% per year, suggesting that the Fed's expected 2.4% rise in GDP growth over the next year would require a 1.5% increase in employment. Moreover, the labor force has grown by just 0.4% per year over the past five years and a continuation of this trend would cut the unemployment rate to 4.1% by the fourth quarter of 2016.

- While some cyclical bounce in participation rates and productivity may slow its fall, we still expect the unemployment rate to fall further than the Fed expects in 2016.
- Wage growth, which has been subdued so far in this expansion, could accelerate in the face of even tighter labor markets.
- Stronger wage growth, combined with even a modest increase in energy prices, could leave inflation firmly on the path to 2.0%, even using the Fed's preferred measure of inflation, which tends to run low. This should put pressure on the Fed to stick to its projected tightening for 2016.

INVESTMENT IMPLICATIONS

- Solid demand growth in the economy, combined with weak labor force and productivity gains, should lead to continued declines in unemployment and a rise in wage growth.
- Because of this, the Fed may well stick to its expected pace of tightening, despite market skepticism and its own dovish tendencies.
- A 1% increase in short-term rates in 2016 would represent very moderate tightening by historical standards and should not hurt the economy or the stock market.
- However, given very low yields at the start of the tightening cycle, investors should expect some modest increase in long-term interest rates over the course of 2016.



Solid demand and weak supply should push unemployment down and wage growth up in 2016.

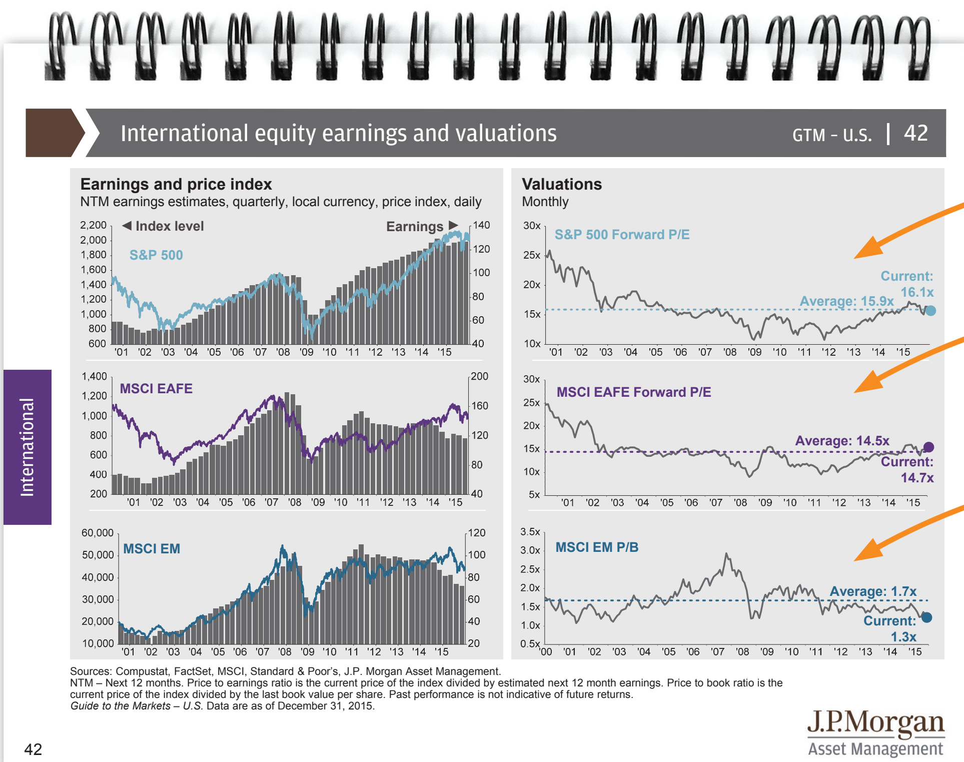
Source: *Guide to the Markets - U.S.* 1Q 2016, page 22

2 Looking for investment opportunities abroad

INTERNATIONAL EQUITY MARKETS PRESENT GROWTH OPPORTUNITIES AS U.S. MARKETS ARE EXPECTED TO PROVIDE LOWER RETURNS

With U.S. equity valuations near fair value and many expecting a slower (and bumpier) ride, a look at opportunities abroad may be fruitful. But being selective is still key, as there are many differences amongst these individual markets.

- The positive trend in S&P 500 earnings was interrupted in 2015 due to falling oil prices and a stronger dollar. While we expect earnings growth to resume in 2016, it will likely be at a slower pace.
- Looking at MSCI EAFE, the continuation of the consumer-led pickup in Europe looks positive for European equities – especially cyclical domestically-oriented sectors. However, the picture is murkier for Japan, where it remains unclear if Bank of Japan (BoJ) easing will continue to support Japanese equities to the same degree.
- Emerging markets (EM) are clearly the most attractive region on a valuation basis, but some areas are cheap for a reason. The theme of continued weakness in commodity producers and exporters could persist, with additional pressure coming from a stronger U.S. dollar for some countries. In contrast, many commodity importers are experiencing a reprieve, and investors have found some success stories in the services sector.



Source: *Guide to the Markets - U.S.* 1Q 2016, page 42

U.S. equities are near fair value, with earnings growth expected to resume in 2016.

European and Japanese equity markets are marching to very different beats despite full blown monetary easing.

EM valuations look attractive, but it is tough to see a catalyst for earnings to improve on the whole in the near term. Instead, it will be important to identify winners and losers along the commodity importer-exporter divide.

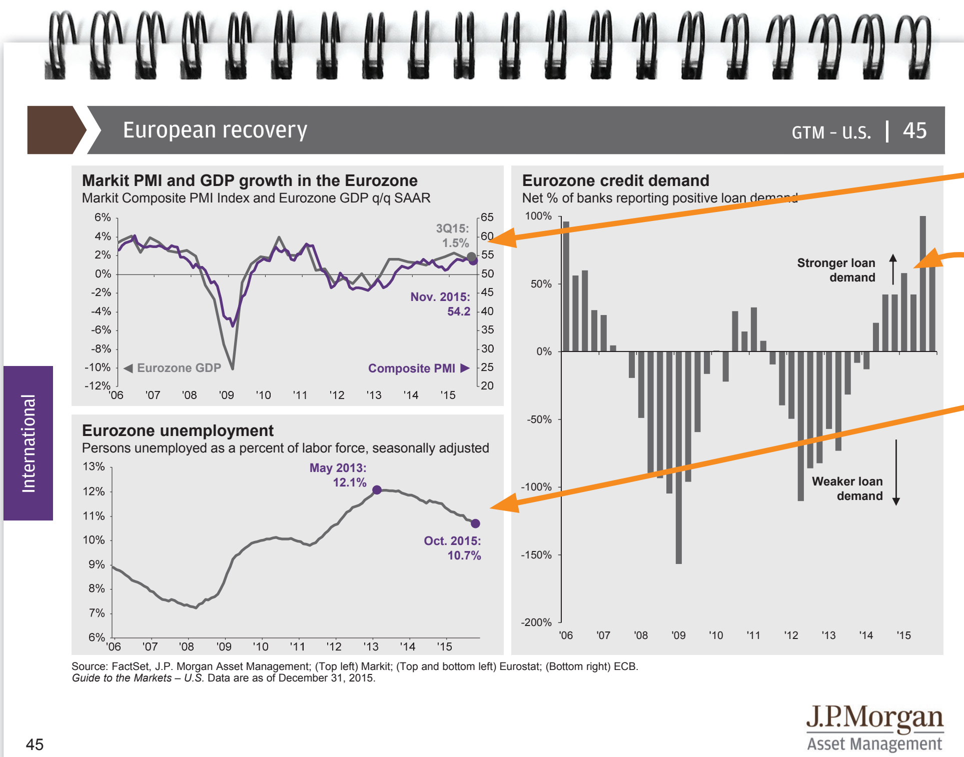
OVERVIEW

- While U.S. equity markets have had attractive returns over the last 7 years, forward returns may be more muted. Going forward, looking outside the U.S. for value and earnings growth may present opportunities.
- Early stages of a European economic recovery could provide opportunities in the equity market. With growth starting to trend in the right direction in the eurozone, equity market earnings should benefit.
- Challenges remain for emerging markets as a whole in 2016, even though the asset class's valuations are now well below average. However, investors should remember that the term "EM" encompasses a diverse array of regions and sectors, necessitating a selective approach.

COMPELLING REASONS TO BE POSITIVE ON EUROPE

Easy monetary policy, a falling euro and low energy prices are all positive drivers for Europe. However, further economic recovery will depend on the continued implementation of structural reforms aimed at fostering more efficient government, greater labor mobility and friendlier credit conditions.

- After the financial crisis of 2008, the U.S. began to slowly recover while Europe was hit with a double-dip recession. This meant that while the U.S. economy and equity markets have had time to heal from the aftermath of 2008, Europe has only more recently begun this process.
- GDP growth in the eurozone is finally trending in the right direction, unemployment is falling and corporate profits have stabilized.
- The weaker euro should support European companies exporting to the U.S.
- Credit conditions are at the heart of the eurozone recovery. After a period of almost frozen credit — no demand and no lending — we now see loan growth and demand thawing. Stronger loan demand and supply is an important driver for growth in the region.



Growth is the eurozone is picking up slowly but steadily.

Improving credit conditions and a weaker euro should support further economic growth.

The unemployment rate in the eurozone is slowly coming down, highlighting the room for progress in the region.

Source: *Guide to the Markets - U.S.* 1Q 2016, page 45

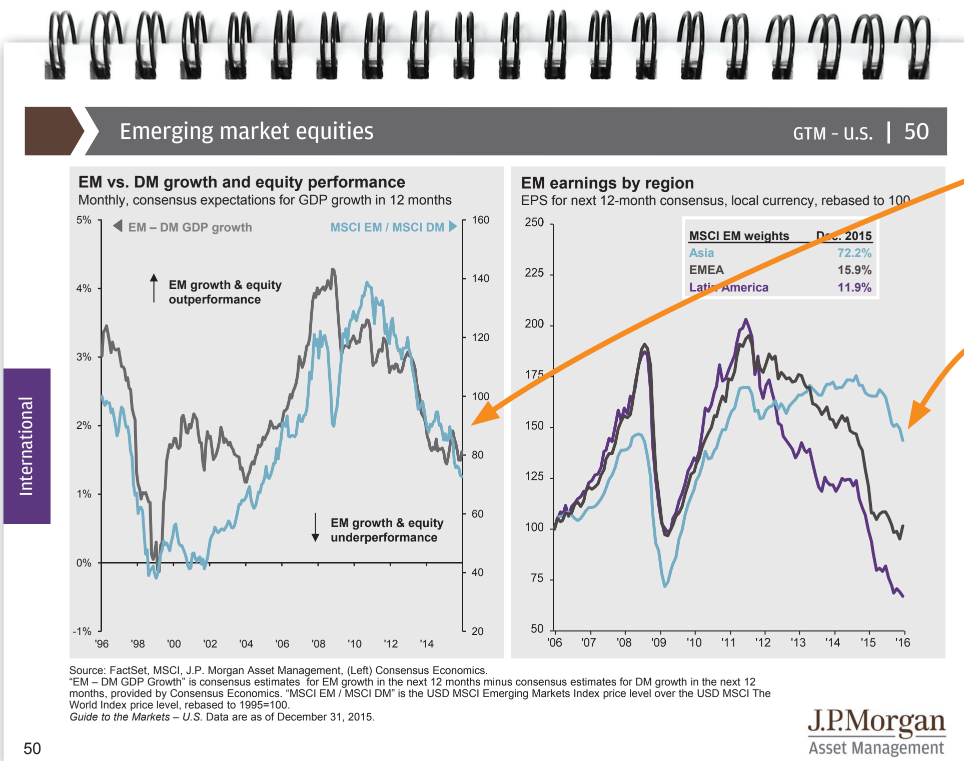
EM CHALLENGES AND OPPORTUNITIES

Emerging market equities have underperformed those in developed markets (DM) for the past few years. This poor relative performance is linked to the waning gap between EM and DM growth. In the last decade, it was normal for the gap between EM over DM growth to be widening; that is, EM countries grew at a much faster rate than DM countries. But in the few years since the commodity super cycle peak, the tables have turned and the growth differential has been steadily shrinking.

- Emerging market equities have become an unloved and relatively cheap asset class. The relative price-to-book valuation between DM and EM is now below its 10-year average. However, valuations are still above the late 1990s crisis period, suggesting that things could worsen before they get better.
- In order to become more constructive on the asset class as a whole, we would need to see three things: a turnaround in the expectations for the EM and DM growth differential, a stabilization of EM currencies and upward revisions of earnings.
- However, investors should remember that the term "emerging markets" encompasses a multitude of different economies and markets. Within the asset class, there are still opportunities, like in places where there are improving growth stories, such as Northern Asia, or where valuations have already become historically cheap, such as Russia.

INVESTMENT IMPLICATIONS

- Opportunities remain within U.S. equities; however, future returns may be more muted going forward compared to the past few years.
- Investors may want to consider value and growth opportunities outside of the U.S.
- Selectivity will be increasingly important in both developed and emerging markets.



EM equities have underperformed DM over the past few years as the growth gap between the two has shrunk.

Not all economies have been affected the same way, with Latin America and EM Europe suffering more than EM Asia given their greater dependence on commodities.

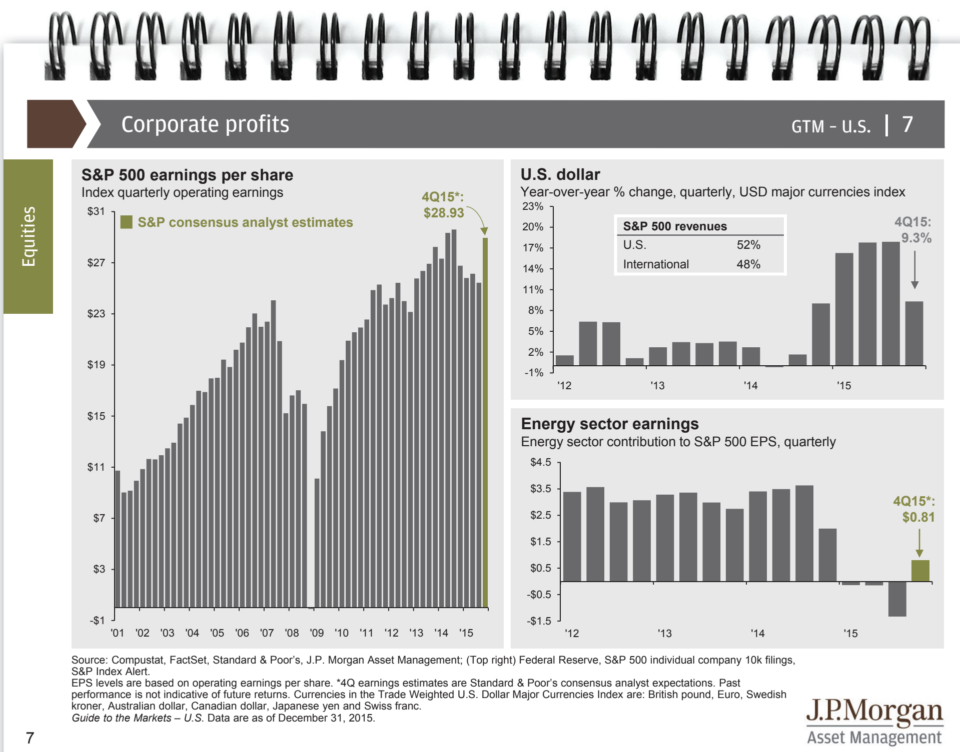
Source: *Guide to the Markets - U.S.* 1Q 2016, page 50

3 Will U.S. earnings recover?

EARNINGS GROWTH TOOK A PAUSE IN 2015, BUT MACROECONOMIC HEADWINDS SHOULD FADE THIS YEAR

S&P 500 earnings stumbled in 2015, owing mostly to the plunge in commodity prices and surging U.S. dollar. This, along with other global macroeconomic concerns, resulted in weak performance for the stock market. However, as these headwinds fade, we expect corporate earnings to recover in 2016.

- The dollar was nearly 18% higher in the third quarter of 2015 compared to the prior year. Since nearly half of corporate revenues come from overseas, this acted as a drag on profitability.
- The energy sector, which has historically contributed over $3.00 per share to overall S&P 500 earnings, actually *detracted* from profitability in 2015.
- These headwinds should prove temporary in nature, and as companies adjust to the higher dollar and lower price of oil, earnings should stabilize. With nominal GDP growth of roughly 4%, we see the potential for overall S&P 500 earnings to grow in 2016 by roughly 5%-7%.
- Excluding the energy and materials sectors, corporate earnings continue to show resilience, growing by 8% in 2015.



Source: *Guide to the Markets - U.S.* 1Q 2016, page 7

OVERVIEW

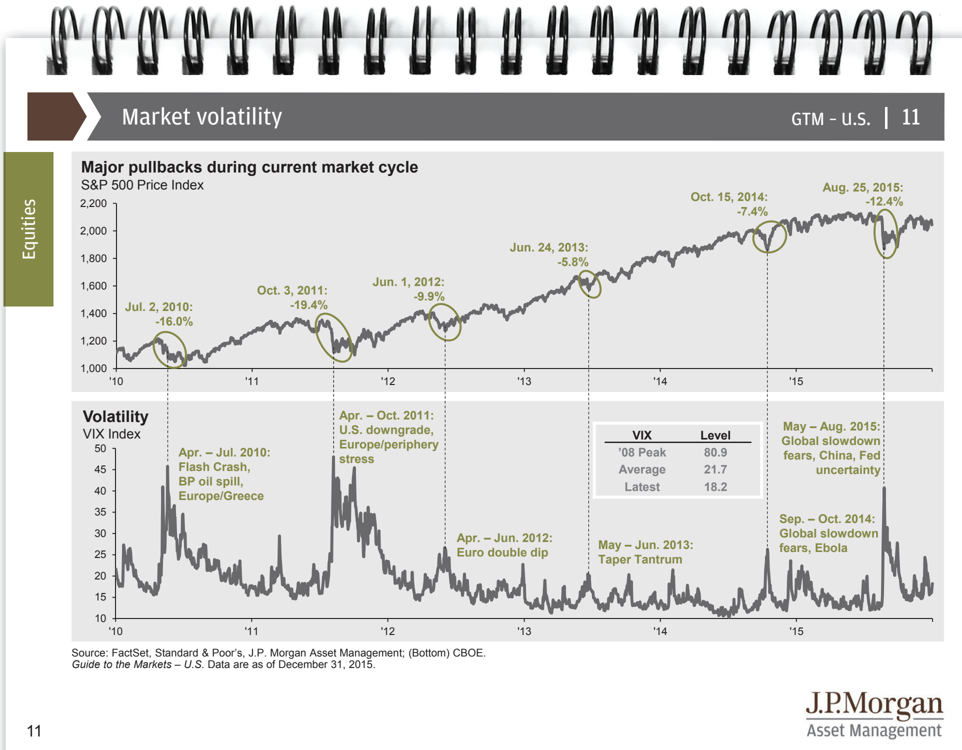
- Unexpected macroeconomic headwinds, such as the stronger U.S. dollar and weak commodities prices, reduced corporate earnings growth in 2015. Earnings should rebound as these drags abate.
- Stock market volatility is likely to remain elevated in 2016 as we enter the later stages of the cycle.

The U.S. dollar and the energy sector were drags on corporate earnings. Earnings should rebound as these drags fade.

EXPECT THE UNEXPECTED

Despite the anticipated improvement in fundamentals, investors should continue to expect increased volatility, lower returns and greater dispersion as we approach the later stages of this market cycle. Below are a few key points to consider around volatility:

- There have been multiple pullbacks of 5% or more this cycle. These have mostly been associated with geopolitical concerns and central bank actions.
- Even so, market volatility was relatively muted compared to history. The largest pullbacks from 2012 to 2014 were all less than 10%, well below historical averages.
- Despite these pullbacks, the market continued to grind higher on improving fundamentals. So while we should expect lower returns and higher volatility, we still favor U.S. equities in 2016.



Source: *Guide to the Markets – U.S.* 1Q 2016, page 11

INVESTMENT IMPLICATIONS

- Despite a weak earnings year, profits should rebound as macroeconomic headwinds fade.
- We continue to favor U.S. equities in this environment. However, investors should expect higher market volatility as we approach the later stages of the cycle.

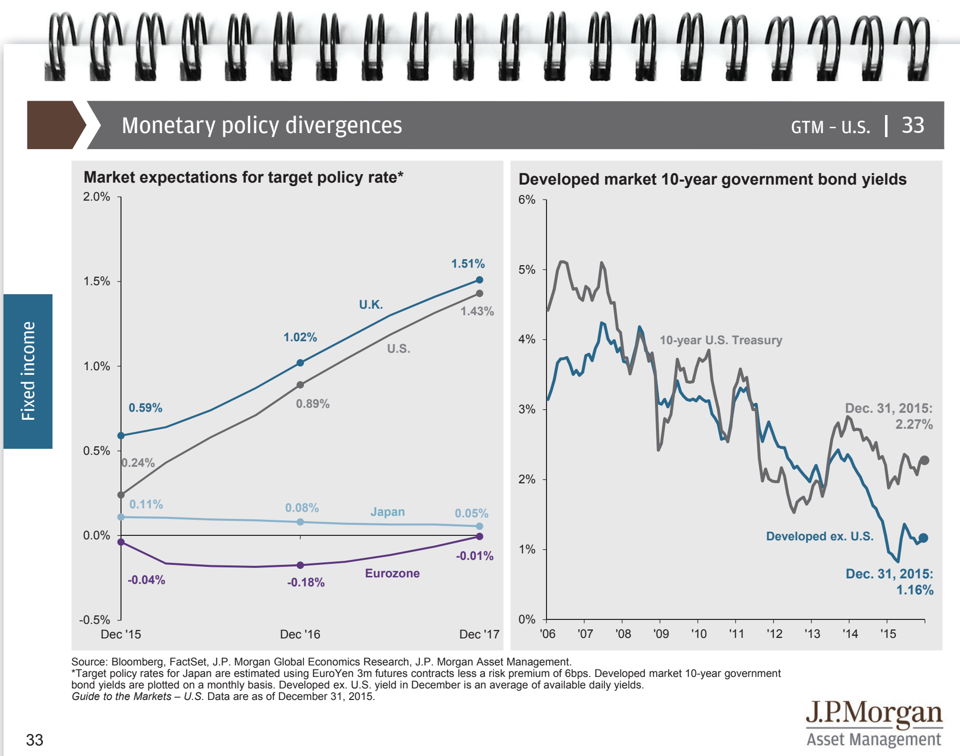
There have been several large pullbacks during this cycle. Despite these setbacks, the market has grinded higher on the back of strong fundamentals.

4 A bear market for fixed income?

DIVERGING MONETARY POLICY

In December, the Fed moved to raise rates to 0.25%-0.5% from 0% for the first time in 7 years, while the European Central Bank (ECB) cut its deposit rate to -0.3%. In contrast to the Fed, the ECB and BoJ are not expected to raise rates until at least 2017. The ECB also extended its quantitative easing (QE) program through March of 2017, which should keep rates across Europe very low.

- A bear market in fixed income requires a sharp, fast and unexpected move in rates (similar to 1994), none of which are expected. Instead, we believe rates will gradually rise over the next few years.
- Investors should remember two things: coupons are much lower today than in prior hiking cycles, and the Fed may surprise the market by hiking faster than is currently priced in. A Fed surprise would translate into higher short-term yields, but easy monetary policy outside of the U.S. should continue putting downward pressure on long-term U.S. yields.
- Outside of New Zealand and Australia, the 10-year U.S. Treasury is the highest yielding developed market sovereign bond. Institutional demand for high-quality long-term assets and the lack of yield in Europe should help keep long-term rates well anchored.



Source: *Guide to the Markets – U.S.* 1Q 2016, page 33

OVERVIEW

- The period of widest monetary policy divergence in 20 years between U.S. and Europe started in December.
- Fed rate hikes do not spell a bear market in all fixed income; while short-end rates are vulnerable to Fed surprises, U.S. long-end rates are supported by global monetary policy divergence and institutional demand.
- ECB QE provides a tailwind for European credit assets.

The Fed started its rate hiking cycle in December, but the ECB and BoJ are not expected to follow until at least 2017.

Ongoing QE in the developed world is keeping long-term rates low relative to the 10-year U.S. Treasury.

THE IMPORTANCE OF GOING GLOBAL

The Fed tightening cycle generally dents the prospects for U.S. bond market returns, but not all fixed income is created equal and some parts, like U.S. high yield, can still deliver positive results. Moreover, opportunities exist globally as developed market monetary policy remains extremely accommodative.

- If the ECB's increase to their QE program holds down long-term U.S. yields, it should have a positive impact on European bond markets as well.
- The tailwinds of QE should be especially supportive for European high yield. Low yields across the sovereign space create demand for higher yielding assets. Unlike U.S. high yield, however, Europe's high yield has little exposure to energy. But, despite this low energy exposure, spreads on European high yield have widened as well.
- Wider spreads present an attractive entry point for investors, as current pricing is not in line with underlying fundamentals.

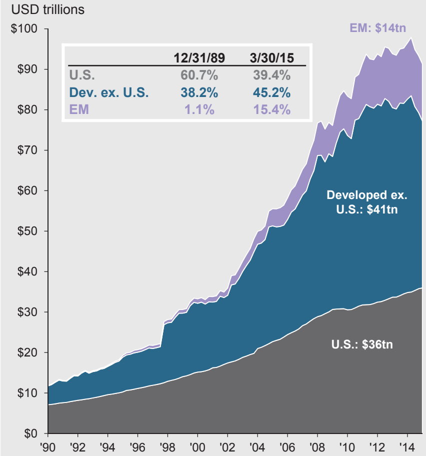
Global fixed income

GTM – U.S. | 35

Fixed income

			Yield		2015 Return	
Aggregates	**Correl to 10-year**	**Duration**	**12/31/2015**	**9/30/2015**	**Local**	**USD**
U.S.	0.86	5.7 years	2.59%	2.31%	0.55%	0.55%
Gbl. ex. U.S.	0.30	7.2	1.29%	1.29%		-5.30%
Japan	0.49	8.6	0.36%	0.42%	1.08%	0.74%
Germany	0.15	5.9	0.67%	0.69%	1.43%	-8.94%
U.K.	0.21	9.3	2.17%	2.03%	0.54%	-4.97%
Italy	-0.02	6.7	1.15%	1.32%	4.62%	-6.08%
Spain	0.01	6.1	1.17%	1.26%	1.56%	-8.82%
Sector						
Euro Corp.	0.09	4.9 years	1.42%	1.59%	-0.56%	-10.73%
Euro HY.	-0.39	4.0	5.37%	5.46%	2.92%	-7.61%
EMD ($)	0.15	6.5	6.39%	6.32%		1.18%
EMD (LCL)	0.02	4.8	7.13%	7.09%	3.28%	-14.92%
EM Corp.	-0.02	5.3	6.42%	6.25%		1.30%

Global bond market
USD trillions



Source: J.P. Morgan Asset Management; (Left) FactSet, Barclays Capital; (Right) BIS.
Fixed income sectors shown above are provided by Barclays Capital and are represented by the global aggregate for each country except where noted. EMD sectors are represented by the J.P. Morgan EMBIG Diversified Index (USD), the J.P. Morgan GBI EM Global Diversified Index (LCL), and the J.P. Morgan CEMBI Broad Diversified Index (Corp). European Corporates are represented by the Barclays Euro Aggregate Corporate Index and the Barclays Pan-European High Yield index. Sector yields reflect yield to worst. Duration is modified duration. Correlations are based on 7 years of monthly returns for all sectors. Past performance is not indicative of future results. Global bond market regional breakdown may not sum to 100% due to rounding.
Guide to the Markets – U.S. Data are as of December 31, 2015.

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Source: *Guide to the Markets – U.S.* 1Q 2016, page 35

INVESTMENT IMPLICATIONS

- The start of a rate hiking cycle is typically bearish for bonds, but this rate hiking cycle is characterized by the greatest period of policy divergence between U.S. and Europe in 20 years.
- Investors should be cautious on the short-term part of the yield curve where any Fed surprises could be reflected the most. Investors should look for marginally higher 10-year U.S. Treasury yields as growth and inflation rise, but these yields are likely to *drift* higher, rather than *shoot* higher.
- The search for yield is still ongoing. This time, the tailwinds of QE should benefit European high yield, while U.S. high yield ex-energy also stands out with wider spreads but low expected default rates.

The tailwinds of QE in Europe should be supportive for European high yield.

Opportunities exist in global fixed income markets as developed market monetary policy remains extremely accommodative.

Quarterly Perspectives

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