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JULY 2018

GLOBAL ASSET ALLOCATION VIEWPOINTS AND INVESTMENT ENVIRONMENT

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1 MARKET THEMES As of June 30, 2018

Trade Wars: Cease-Fire or Armageddon?

With trade wars escalating, markets are becoming more concerned about when and how it all ends. For now, the U.S. and China appear locked in a tit-for-tat escalation of tariffs, with the European Union and Canada joining the battle by retaliating with targeted tariffs on U.S. goods, and NAFTA undergoing renegotiation. While the U.S. economy is less reliant on trade than most of its trade partners, targeted tariffs could have significant impacts on certain U.S. sectors and companies. For certain, tariffs raise costs, can pressure margins and result in higher prices. While the U.S. may feel it has the upper hand given its trade deficits with China and the EU, tariffs are not the only weapons available—targeted actions on foreign companies, unwinding U.S. treasury holdings and currency manipulation do not seem out of scope. While it is difficult to gauge the impacts on markets given the current dynamics, things could certainly get a lot worse with battles opening on multiple fronts and the choice of weapons expanding.

A Scorching Summer Ahead for EMS?

Emerging markets debt, equity and currency markets are feeling the heat from a growing list of concerns. With the recent escalation in trade wars, investors are selling emerging markets assets as uncertainty over the outcome grows. Beyond trade wars, liquidity has fallen as developed market central banks—led by the Fed—unwind accomodation, the U.S. dollar has strengthened and interest rates are higher. Some emerging countries are already being forced to raise rates to defend their currencies. With several upcoming key elections, a resilient U.S. Fed and no end in sight on trade wars, it may be a scorching summer for a few emerging markets countries. On the bright side, the broad sell-off seems to have priced in much of the risks and some less vulnerable countries are looking attractive.

What Could De-throne Growth (Stocks)?

Continued strong relative performance in the technology and consumer discretionary sectors has helped advance a multi-year lead for growth relative to value stocks. Since the end of 2014, growth-oriented stocks in the U.S. are up nearly 50%, more than tripling the return of value stocks. Growth stocks have undoubtedly benefitted from the low growth economic environment where investors sought "durable growers" in lieu of more cyclical sectors, but they have also delivered vastly superior earnings growth. However, the advance has been primarily driven by a narrow list of technology-oriented companies that now hold elevated valuations. Trade wars may cause investors to question these elevated valuations, with technology supply chains vulnerable to escalation of the U.S.-China trade dispute.

FIGURE 1: U.S. TRADE BY COUNTRY/REGION
As of 31 May 2018

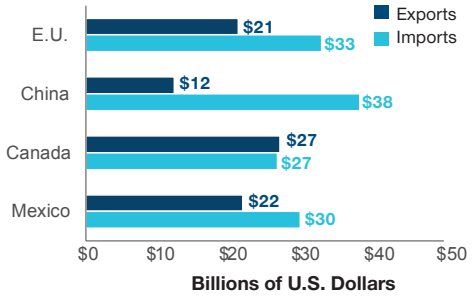


FIGURE 2: EMERGING MARKETS RETURNS[1]
As of 30 June 2018

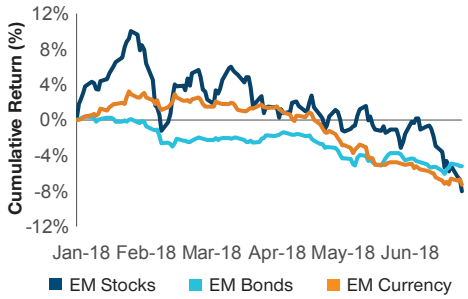
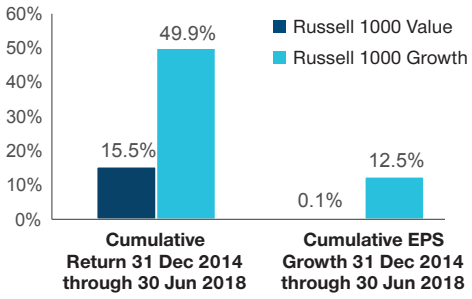


FIGURE 3: U.S. GROWTH VS. VALUE



Past performance is not a reliable indicator of future returns.
Sources: FactSet Research Systems, All Rights Reserved, J.P. Morgan, IMF/Haver Analytics.
[1] Indices used: EM Stocks = MSCI Emerging Markets Index, EM Bonds = JP Morgan EMBI Global Index, EM Currency = JP Morgan EM Currency Index

UNITED STATES

Macro-Economic

- In the later stages of the economic cycle, with recession risks low but rising
- Pro-cyclical policies of tax reform and deregulation offer near-term support, but late cycle stimulus may result in overheating
- Inflation gradually rising amid tighter labor markets, with added pressure from higher oil prices
- Aggressive trade policy poses a significant and growing risk, but may ultimately be limited in scope

Equity Fundamentals

- Valuations above historical averages, with significant bifurcation between winners and losers
- Earnings are very strong, but current pace of growth unlikely to be sustainable
- Margins could face headwinds from higher rates, wages and input costs
- Earnings disappointments are beindrg harshly punished

Interest Rates

- Short-term rates rising in unison with Fed rate increases, could extend into 2019
- Longer rates volatile, but biased higher over the long term amidst improving growth, rising inflation expectations, expanded budget deficit, and Fed balance sheet unwind

Currencies

- Stabilization of global growth, tighter monetary policy outside the U.S. and valuations are likely headwinds to the medium-term outlook for the dollar
- The dollar has continued its strong performance of late, partly driven by softer growth outside of the U.S. Higher relative yields in the U.S. also remain supportive

DEVELOPED EUROPE

Macro-Economic

- Eurozone growth moderating, but expected to stabilize and remain above potential
- Rising trade protectionism is a significant risk, most notably for Germany given its export focus
- While off their highs, Italian yields remain elevated after the formation of the government, as the market awaits its economic policies

Equity Fundamentals

- Valuations are modestly attractive relative to the U.S.
- Operating leverage provides for further earnings upside potential, with the recent uptrend in earnings expected to continue
- European banks showing significant weakness both on an absolute basis and versus other sectors

Interest Rates

- Sustained growth, recent euro weakness, and further evidence of rising inflation could gradually push rates higher
- Recent Italian political events, the lack of progress/acceptance of the Macron reforms to reinforce the Eurozone, and the tension over immigration have re-introduced concerns regarding the sustainability of the E.U.

Currencies

- Political risks, ECB policy, and still lackluster data flow, continue to restrain the euro versus the U.S. dollar
- Valuations remain attractive from an exchange rate perspective, and the medium-term economic and ECB policy trajectories remain positive, albiet weakened, drivers

CHINA

Macro-Economic

- We continue to expect the economic momentum to slow down throughout 2018: recent activity data missed expectations although leading manufacturing indicators help up reasonably well due to inventory rebuilt
- Trade war concerns and anticipated economic slowdown should keep macro policies supportive in the short term. Growth is slowing but remains actively controlled

Equity Fundamentals

- The MSCI inclusion of A-share should be driving some flows to the equity markets, although positioning in Chinese stocks are already relatively high
- Recent performance, now officially in contraction territory, provides support for a rebound from a valuation perspective
- We might have to wait for the trade talks to be behind us before we experience this short term rebound though

Interest Rates

- Policy is easing through a reserve requirement ratio cut, in response to the weakening macro data and the trade war concerns
- On the other hand, onshore defaults is likely to mildly tighten financial conditions

Currencies

- Recent policy easing put pressure on the RMB. However, the weakening of the RMB has been mainly against the US dollar for this year, while it has appreciated against a basket of currencies
- We expect the same pattern to continue for now, followed by a slight appreciation bias of the RMB over the medium term

JAPAN

Macro-Economic

- The economic slowdown continued although some confidence metrics and leading manufacturing indicators are pointing to a rebound. Japanese economy might experience a short term rebound, absent any external shock
- Wage inflation was as significant as expected despite an extremely tight labor market. However, wage growth is required to alleviate some of the concerns on the soft domestic demand
- Significant rebound in Prime Minister Abe's approval ratings suggest a stable macro policy outlook for now

Equity Fundamentals

- In the short term, domestic stocks should continue to be volatile on the back of international developments around trade policies
- Long term supports for the domestic equity market remain in place: attractive relative valuation, solid earnings growth and above all, corporate governance improvement

Interest Rates

- The Bank of Japan continues to re-affirm its accommodative policy. No change expected in the near term. Current levels of inflation and wage growth are not satisfactory yet
- The rise in global yields may impact the long end of the curve

Currencies

- We expect the Yen to remain range bound in the near future, with a modest appreciation bias
- The risk remains that international developments precipitate a larger Yen appreciation which would hit domestic equity markets if that occurs

AUSTRALIA

Macro-Economic

- Economic activity improved from last year: net exports and government spending were the main contributors in the first quarter
- The largest domestic risk is the fallout of the Royal Bank Commission. Banks might tighten lending standards which could trigger a prolonged decline in house prices and consumer confidence

Equity Fundamentals

- Price multiples are getting stretched on the back of the solid gains recently. But, the local market still remains attractively valued compared to international peers
- Earning revisions continue to be better than average despite a recent drop

Interest Rates

- RBA is pushing further away any rate increase. Wage growth remains subdued which supports this forecast even if the unemployment rate stabilized

Currencies

- In the near term, the Australian dollar should remain in the same range it has been since 2016, mostly driven by external factors (namely the direction of the US dollar). Any escalation in the trade dispute between China and the US could exacerbate the recent drop in the Aussie dollar

EMERGING MARKETS

Macro-Economic

- Growth is slowing but not collapsing, likely to stabilize in the latter half of 2018
- Trade protectionism a growing risk, but real impact should be limited as long as the dialogue between U.S. and China continues
- Trade war concerns and anticipated economic slowdown should keep Chinese macro policies supportive in the short term. Growth is slowing but remains actively controlled
- Idiosyncratic and political risks remain elevated in several key countries— including Mexico, Brazil, Argentina, Venezuela, Malaysia and Turkey

Equity Fundamentals

- Valuations considerably more attractive, as equities have sold off on trade concerns, U.S. dollar strength, and elevated country-specific risks
- Demand for exports is healthy but fading
- Earnings growth remains broadly strong, with ROEs broadly improving

Interest Rates

- Interest rates trending higher as financial conditions tighten in response to rising inflation and higher U.S. rates
- Many central banks have shifted from accommodative/neutral to a tightening bias

Currencies

- EM currency valuations have cheapened due to a stronger USD, idiosyncratic factors and notable outflows
- U.S. rate policy, global growth, politics and trade will continue to be the major areas of focus for EM

3 ASSET ALLOCATION COMMITTEE POSITIONING

As of 30 June 2018

Underweight — Neutral — Overweight

▼ or ▲ Month Over Month Change

		Change	These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.
ASSET CLASS	Equities	▼	Valuations remain elevated against a backdrop of receding global liquidity, rising rates, an aging economic cycle in the U.S., and rising trade protectionism
	Bonds	▲	Upward trend in rates may be tempered by demand for yield, still modest growth expectations and increased volatility surrounding trade policies
	Cash		Yields more attractive as Fed advances rate hikes. Cash can provide a buffer against extended stock and bond valuations
EQUITIES	**Regions**		
	U.S.	▲	Valuations slightly elevated to history, but market leadership has been very narrow. Earnings growth is very strong but likely peaking
	Global Ex-U.S.	▼	Attractive valuations relative to U.S., stable economic growth, and positive earnings trends. Increased risks from trade wars and weakness in European financials
	Europe		Modestly attractive relative valuations and earnings upside from operating leverage, offset by rising political risks, moderating economic growth, and banking system weakness
	Japan		Valuations remain attractive, but dependence on global trade a headwind as global growth momentum has peaked and trade war concerns looming
	Emerging Markets		Attractive relative valuations and positive earnings trends are offset by U.S. dollar strength, rising rates, hawkish trade policies, and country-specific risks
	Style		
	U.S. Growth		Expect secular growers to continue to benefit in structurally low growth environment, but valuations are elevated, leadership has been narrow with tech supply chains possibly at risk
	U.S. Value		Valuations neutral, amidst still modest growth. Tax reform, higher rates, and higher oil prices could be supportive for cyclicals, financials, and energy
	Global Ex-U.S. Growth	▲	Relative valuations are above historical averages, particularly within cyclically sensitive areas, most notably industrials
	Global Ex-U.S. Value	▼	Relative valuations are attractive, but fundamentals have weakened, most notably within European financials
	Capitalization		
	U.S. Large-Cap		Valuations still above historical levels, although less expensive on stronger earnings growth. Tailwind from weaker dollar is fading and trade policy remains a threat
	U.S. Small-Cap		Reasonable valuation. Less vulnerable to trade policy and could benefit from tax-related capex spending, and a pick-up in mergers and aquisitions
	Global Ex-U.S. Large-Cap		Valuations are attractive relative to small-cap, with earnings upside due to depressed margins. Cautious on trade policy risks and fading global growth
	Global Ex-U.S. Small-Cap		Valuations have become more challenging and may be susceptible to fading liquidity, while domestic growth trends are moderating
	Inflation-Sensitive		
	Real Asset Equities		Energy supply/demand imbalances and fading Chinese metals demand remain headwinds. REITs valuations and fundamentals are relatively attractive but vulnerable to rising rates
BONDS	U.S. Investment Grade		Yields more attractive since start of the year, with risk moderated due to limited upside from growth and infaltion
	Developed Ex-U.S. IG (Hedged)		Expanding short-rate differential between U.S. and other developed markets has made hedged U.S. dollar yields more attractive, but durations remain extended
	Inflation-Linked		Inflation expectations have reset higher, making valuation less compelling. Higher oil prices and tight labor markets are supportive, offset by Fed tightening
	Global High Yield		Limited upside potential from current valuations. Despite late stage of credit cycle, fundamentals remain broadly positive with low near term default expectations
	Floating Rate Loans		Fundamentals supportive and rate-reset feature could offer defense against rising rates. However, loan terms have weakened and strong flows have crowded a less liquid sector
	EM Dollar Sovereigns		Yields are attractive, but offset by tightening monetary policy (both in developed and emerging markets), U.S. dollar strength, and rising country-specific risks
	EM Local Currency		Yields are attractive versus investment grade with potential upside from select currencies. However, volatility is likely to be elevated

ADDITIONAL DISCLOSURES

Certain numbers in this report may not equal stated totals due to rounding.

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