Bracing for the Cold

Preparing portfolios for a cooler market climate

After nearly 10 years of relatively warm, sunny conditions, the forecast is turning colder and grayer for investors. To be clear, we haven’t yet reached the end of the cycle. While no blizzards loom on the immediate horizon, we’ve already begun to prepare our global portfolios for harsher weather ahead.

Economic growth prospects are cooling

We’ve said all along that any imbalances within U.S. and global economies could usher in the end of the current business cycle. So what are we seeing these days?

United States. The labor market continues to tighten. The unemployment rate has fallen to 3.7%, a level that we associate with full employment (see chart).1 As a result, the Federal Reserve seems set to continue raising interest rates to cool down the labor market.

“We firmly believe our preparations for slowing economic growth will help clients optimize their portfolio performance until it’s summertime once again for markets.” – Andrew Goldberg, Global Head Of Client Investment Strategy, J.P. Morgan Private Bank

Falling unemployment, rising wages

The U.S. economy may start to cool as interest rates continue rising in an attempt to slow down wage growth and inflation pressures.

Left: Unemployment rate, Right: Wage inflation (year-over-year)

Source: BLS, Haver. Data is as of October 31, 2018.

As the cost of capital continues to rise and the boost from fiscal stimulus wears off, the U.S. economy is likely to slow as we approach 2020. However, we’d need to see several more boxes checked off before assuming the end of the cycle is close at hand.

**Europe.** Major European economies are starting to slow. Missed expectations early in 2018 were widely blamed on inclement weather, but it appears that weakness has spilled over into the second and third quarters of the year (see chart). We’re keeping an especially close eye on political turmoil, which has contributed to deteriorating sentiment and may continue to impact economic growth, corporate profits and stock values going forward.

**A slowdown in Europe**

After steady growth throughout much of 2016 and 2017, European economic activity has decelerated in 2018. (Purchasing Manager Indices > 50 = expansion)

![Chart showing Purchasing Manager Indices for Services, Composite, and Manufacturing from December 2014 to June 2018](source: IHS Markit, Haver Analytics, October 2018.)

**Asia.** China’s economy is facing stiff headwinds from clampdowns on shadow banking, declining infrastructure spending and negative business sentiment due to mounting trade tensions. In response, the country is now injecting fiscal stimulus and easing monetary policy—moves that some believe could boost economic growth by as much as 1% within the next year. But despite such efforts, China’s weakness has spread to many of its trading partners, including Japan, South Korea, Taiwan, Singapore and even the Philippines.

**Emerging markets.** We’re seeing weakness in Turkey and Argentina along with pessimistic forecasts in places like South Africa, the Czech Republic, Ecuador, Uruguay and Venezuela. Emerging countries that carry a lot of dollar-denominated debt are feeling the negative effects of higher U.S. interest rates. In addition, trade tensions are limiting some nations from exporting their goods and services to America.

**Turning up the heat on interest rates**

The lowest U.S. unemployment in 49 years gives the Federal Reserve plenty of reason to continue boosting short-term interest rates. We expect the Fed to increase rates by another 1.25% through the end of 2019. That should push corporate borrowing costs closer to the point of exceeding the potential returns on investment spending. When this happens, companies are incentivized to save rather than invest—and economic growth suffers as a result.

---

2 Global Data Watch, November 8, 2018.
Winterizing our clients’ portfolios

At J.P. Morgan, we’re taking the following steps to adjust portfolios in light of our latest economic and market outlooks:

- **Gradually extending duration** with longer-term bonds as U.S. interest rates inch closer toward their peak.

- **Investing in higher-quality bonds**—for example, by moving from high yield to investment grade or from investment grade to municipal bonds. The goal is to insulate portfolios from increased risks in a slowing economy.

- **Gradually shifting stocks** out of cyclical sectors (materials, financials, industrials) and into sectors with more exposure to long-term secular trends (healthcare, technology). Companies in those sectors could be better suited for the later stages of a market cycle.

What does it all mean for you?

Although we think winter is approaching for investors, current U.S. imbalances don’t appear to be as severe as what we saw before the financial crisis. With that in mind, we firmly believe our preparations for slowing economic growth will help clients optimize their portfolio performance until it’s summertime once again for markets.

“We expect the Fed to increase rates by another 1.25% through the end of 2019.”

— **Andrew Goldberg**, Global Head Of Client Investment Strategy, J.P. Morgan Private Bank
The views and opinions expressed in this material are those of the featured J.P. Morgan Chase & Co. (“J.P. Morgan”) employee and do not necessarily reflect the policies or positions of JPMorgan Chase & Co. The material is provided for informational purposes only and is designed to provide general market commentary. It does not constitute J.P. Morgan research nor should it be considered a recommendation of a particular investment strategy or an offer or solicitation for the purchase or sale of any financial instrument. Opinions and estimates offered constitute the featured J.P. Morgan employee's judgment as of the date of this material and are subject to change without notice as are statements of financial market trends, which are based on current market conditions. J.P. Morgan believes the information provided here is reliable, but do not warrant its accuracy or completeness. References to future returns are not promises or even estimates of actual returns a client portfolio may achieve. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation for any particular action.

Investing involves market risk, including the possible loss of principal. Investments in international or emerging markets can be more volatile and involve a greater degree of risk. Not all investments or strategies are suitable for all investors and there is no guarantee that a particular investment objective will be achieved. You should speak to your financial advisor before making any investment decisions.

The price of equity securities may rise or fall due to the changes in the broad market or changes in a company's financial condition, sometimes rapidly or unpredictably. Equity securities are subject to “stock market risk” meaning that stock prices in general may decline over short or extended periods of time.

In general, the bond market is volatile, bond prices rise when interest rates fall and vice versa. Longer term securities are more prone to price fluctuation than shorter term securities. Any fixed income security sold or redeemed prior to maturity may be subject to substantial gain or loss. Dependable income is subject to the credit risk of the issuer of the bond. If an issuer defaults no future income payments will be made.

Past performance is not a guarantee of future results. Diversification does not ensure a profit or protect against a loss.

J.P. Morgan and its affiliates do not provide legal, tax or account advice so you should seek professional guidance if you have questions.

JPMorgan Chase Bank, N.A. and its affiliates (collectively “JPMCB”) offer investment products, which may include bank managed accounts and custody, as part of its trust and fiduciary services. Other investment products and services, such as brokerage and advisory accounts, are offered through J.P. Morgan Securities LLC (JPMS), a member of FINRA and SIPC. Annuities are made available through Chase Insurance Agency, Inc. (CIA), a licensed insurance agency, doing business as Chase Insurance Agency Services, Inc. in Florida. JPMCB, JPMS and CIA are affiliated companies under the common control of JPMorgan Chase & Co. Products not available in all states.

© 2018 JPMorgan Chase & Co.