HEALTH WEALTH CAREER

ECONOMIC AND MARKET OUTLOOK 2019 AND BEYOND

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The global economy performed well again in 2018 after the strength seen in 2017. However, as the year progressed the recovery became less synchronized, with growth in the US strengthening further while falling away in most other countries, as the strong US dollar and rising trade tensions undermined activity in some economies.

We expect the global economy to weaken a little from the growth rates seen in 2018. We also believe the period of US exceptionalism is likely to fade with US growth softening and the risk of a more material slowdown in the US in 2020 rising.

A resolution of the trade tensions could lead to stronger growth, especially in emerging markets (EM), whereas a further escalation would have the opposite impact.

Although we expect the US economy to slow somewhat, we believe it will continue to grow at a decent pace, pushing the unemployment rate below 3.5% and toward the lowest level since the 1960s. Strong household income growth, on the back of both job and wage growth, should support consumption, and high business confidence should support strong business investment. However, we expect the boost from the Trump administration's tax cuts and spending increases to fade, and higher interest rates should also dampen economic activity. In Europe and Japan, we expect economic growth to be sufficiently strong to lead to a further reduction in their unemployment rates.

The outlook for the Chinese economy is highly uncertain, with much dependent on whether the trade tensions stabilize, deteriorate or improve. While we believe eventually a deal will be reached that will lower or eliminate the tariffs applied by the US in 2018, we do not have a strong view on whether this will be late in 2018, in 2019 or beyond. Assuming things get a bit worse before they get better, we would expect Chinese export growth to weaken, though it would be partially offset by looser monetary and fiscal policy. Elsewhere in EM, we expect growth to continue at roughly the same pace, with the possibility of stronger growth when trade tensions ease.

Inflation rose in 2018 as the strong global economy started to weigh on supply chains and low unemployment finally prompted companies to raise wages. We expect inflation to rise modestly above the Federal Reserve's (Fed) 2% target and stay there as wage growth increases on the back of shortages for both skilled and unskilled labor; any further tariffs could also lead to higher prices. Inflation is also likely to rise in both Japan and the eurozone as wage growth picks up. However, it is unlikely that inflation in these regions will reach their respective central banks' 2% target.

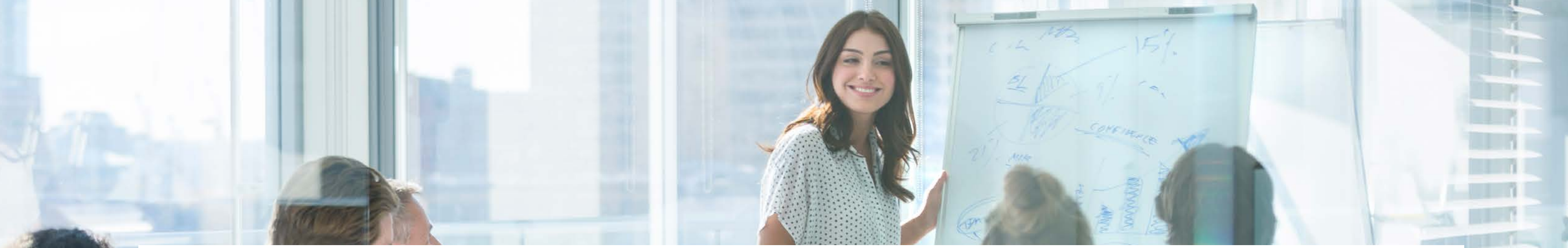
After the strength seen in 2017, equity markets were more mixed in 2018, despite very strong corporate earnings growth, especially in the US. EM and European equities fell, undermined by their faltering economies and concerns over trade tensions with the US. In 2019, we expect global equities to produce positive returns, although an improvement or worsening in trade tensions could lead to more substantial gains or losses. Equities are likely to be supported by positive earnings growth, particularly in comparison to the poor returns that may be seen elsewhere. However, rising bond yields may be a headwind, especially if coupled with higher inflation.

We expect inflationary pressures to continue building up on the back of tight labor markets, solid GDP growth, tight supply chains and possibly import tariffs in the US leading to higher consumer prices. In the US, this should allow the Fed to continue to increase interest rates at its current steady pace. The European Central Bank (ECB) will remain cautious, although it should also gradually move in the direction of tightening policy, whereas the Bank of Japan is likely to remain on hold for some time. On balance, we expect this to lead to higher bond yields.

Despite the negative market sentiment toward EM during 2018, we remain cautiously optimistic about both EM equities and EM debt. We are of the view that, broadly speaking, the emerging world is at the earlier stages of the business cycle, whereas a number of developed economies (particularly the US) are now at the later stages. In addition, emerging market debt and equities both seem relatively attractively valued. All of these factors should lead to asset outperformance for EM over the medium term, on the back of sound economic fundamentals and more favorable cyclical dynamics — whereby economies are growing without facing significant capacity constraints.

A key risk to financial markets is trade tensions between the US and China. If the situation escalates further, it may lead to a material slowdown in global economic growth, especially if it lowers business confidence and, thus, investment spending. The International Monetary Fund cut its global growth forecasts, citing trade war concerns. Although we have little visibility, we believe that President Trump ultimately just wants to make a deal, although it is unclear when this will happen.

Another key risk to financial markets is the Fed being more hawkish than expected. We believe that as long as the rate hikes occur in conjunction with strong growth, risk assets should continue to do well. If, however, global growth slows and inflation continues to rise, a more hawkish Fed might spark a significant risk-off reaction. As 2019 unfolds, our usual quarterly dynamic asset allocation reports will provide you with our updated assessment of opportunities and risks.



GLOBAL ECONOMIC OUTLOOK

Economic growth in 2018 was strong but less broad-based than in 2017. The US led the pack on the back of solid economic fundamentals, for both the household and the corporate sector, and a boost by the tax cuts and spending increases. Economic growth elsewhere was more mixed, with regions like the eurozone losing momentum. We expect global economic growth in 2019 to weaken slightly. The period of US exceptionalism is likely to fade as growth in the US slows from the highs seen in 2018, but growth should remain at decent levels elsewhere. Globally, consumer spending should continue to be supported by improving labor markets, rising wages and still-elevated confidence levels. Business confidence is also high, and this should continue to support capital expenditures — one of the key underpins of long-term economic growth.

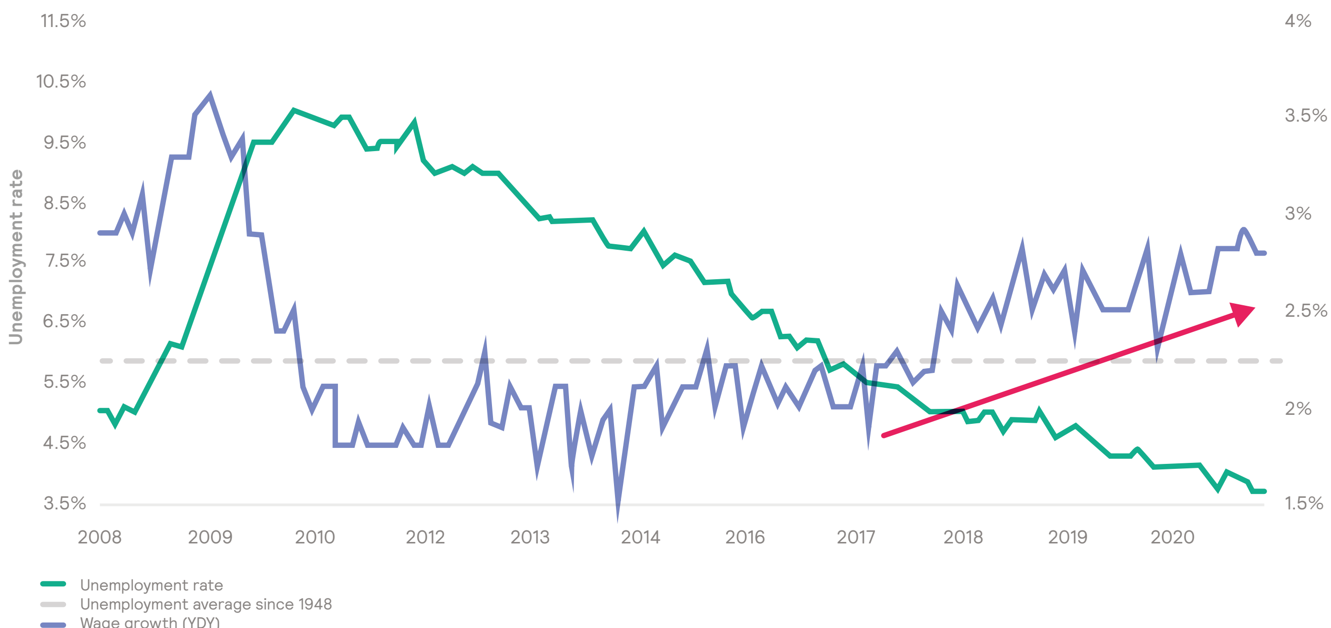
The US economy had a strong year in 2018, driven by strong consumption, decent capital expenditure and looser fiscal policy. As noted earlier, the impact of the tax cuts is likely to fade in 2019 and the high GDP growth numbers are likely to moderate in 2019. Consumer and business spending, however, should continue to support the economy.

Inflation in the US rose in 2018 on the back of firmer commodity prices, higher wage growth and rising producer prices. Having started the year at 1.6%, inflation (Personal Consumption Expenditure measure) reached the Fed's 2% target. We expect this measure of inflation to edge higher over the next 12 months, especially if the labor market continues to be tight with an unemployment rate at 3.7%, the lowest since the late 1960s (see Figure 1). We note that the short-term inflationary pressures may be battling the long-term deflationary forces from globalization and technology.

Economic growth in the eurozone, following a particularly strong 2017, was disappointing in 2018, with growth forecasts being cut throughout the year. Trade tensions, political problems in Italy and Brexit were among the key factors weighing on the outlook for the currency union. Going forward, we believe that growth in the eurozone should be decent, as it will be supported by robust global aggregate demand and strong European consumer spending. Political risk remains high, especially with the recent announcement by Angela Merkel not to seek re-election in 2021, but it is unclear whether this will weaken growth. The unemployment rate fell over the year to 8.1%, well below the 12.1% reached in 2012 and only a bit above the 7.3% seen before the financial crisis. As the economy continues to create jobs, we believe the unemployment rate is likely to fall further in 2019. This could place some pressure on wages, particularly in countries like Germany, where the labor market has nearly full employment. Inflation in the eurozone remains below the ECB's 2% target. We expect core inflation to increase modestly in 2019.

Economic growth in the UK was decent in 2018, despite the ongoing Brexit uncertainty. Unemployment fell to the lowest level since the 1970s, and overall activity remained solid. The outlook for 2019 is heavily dependent on whether the UK and the EU pass the Withdrawal Agreement (WA), which, among other things, allows for a 21-month transition period, during which the economic relationship between the UK and the EU will remain largely unchanged. If an agreement

Figure 1. Tight US Labor Market — Wage Growth Picking Up



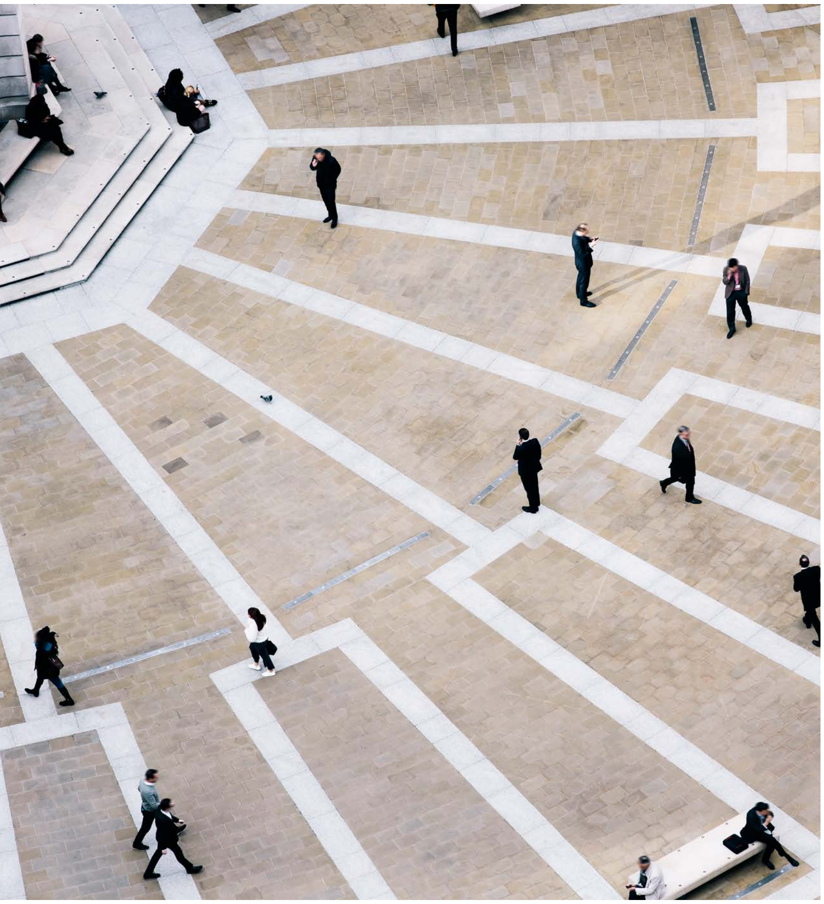
Source: Bloomberg, Bureau of Labor Statistics

is reached, the UK and the EU are expected to negotiate what the future trade relationship will look like and, in particular, whether it will be a soft (frictionless trade) or a hard (trade-restricted) Brexit. Failure to pass the WA could lead to a severe economic disruption in April 2019, as the UK will leave the EU on March 29, regardless of whether the WA is passed, and the entire legal basis for trade as it currently stands will fall away.

Our best guess (and it is only a guess) is that after significant political tension in the UK, the WA will be passed. However, we also believe it is possible that the Article 50 process could be extended and that the UK's departure date could be pushed back by a few months to give more time for negotiation. Although that would require unanimous agreement by all EU governments, it may be seen as preferable to the UK leaving the EU in March without any kind of deal. Such a departure could lead to a collapse in EU/UK trade, damaging both sides.

On the assumption that an agreement is reached, the UK economy might feel a modest boost as some of the uncertainty is removed. However, a large amount of uncertainty will remain, as it will not be clear for some time whether the final trade relationship will be "hard" or "soft."

Growth in Japan has been mixed in 2018, with a contraction seen in the first quarter and a subsequent rebound in the second. There are some encouraging signs, though, with a significant pickup in capital spending by companies — an integral driver of long-term economic growth. The labor market is in a very good shape, with unemployment at 2.4% — a 25-year low that is slowly but noticeably applying pressure to wage growth. Japanese headline inflation has picked up over the year; however, much of that was related to the rise in energy prices, and the core inflation measure remains close to 0%. For the Bank of Japan to reach its inflation target of 2%, the Japanese economy needs to perform



significantly above trend and wage growth has to pick up sharply — something we view as unlikely, at least during 2019. Growth in 2019 and the early parts of 2020 may also come under pressure from the scheduled increase in the VAT from 8% to 10% in October. To avoid a repeat of significant weakening in the aftermath of the 2014 hike, authorities will implement a series of measures to offset the initial impact, but it is not clear how effective this will be.

This year has been very challenging for emerging market economies, as a number of them have been hit by currency crises (Turkey, Argentina and, to a more limited extent, Brazil and South Africa), while China has been involved in an escalating trade dispute with the US. China, the powerhouse of the emerging world, also has been slowing, with the government striving to contain the shadow banking sector and ease financial imbalances. Consumption has remained solid, however. Going forward, we expect EM growth in 2019 to remain roughly at the current pace, with some pickup expected in 2020.

MONETARY POLICY OUTLOOK

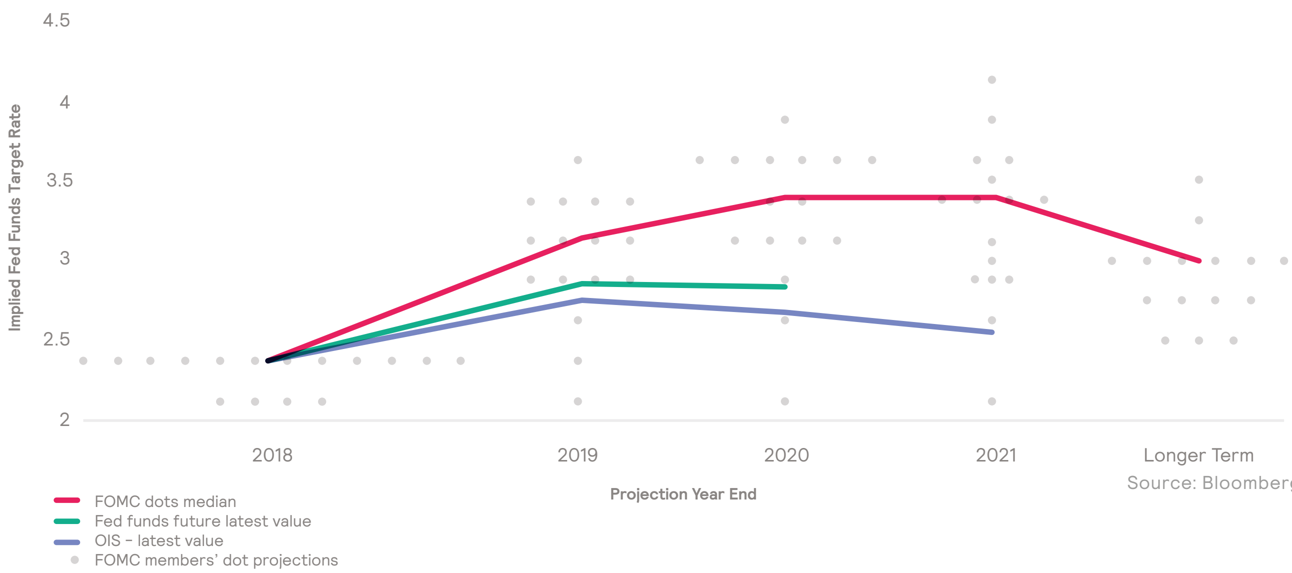
In last year's economic outlook, we noted that global interest rate policy had been rather dull for quite some time and that the years ahead would be much less predictable and have more significant implications for financial markets. We saw some of that in 2018, with a slightly more hawkish Fed, the ECB moving to end any additional net purchases of bonds and the Bank of England raising interest rates twice.

We believe that we are at the early stages of monetary policy normalization, as central banks slowly withdraw unconventional support measures, such as quantitative easing and negative interest rates. Although the impact of prolonged loose monetary policy is too early to judge conclusively, so far, it seems to have helped the global economy recover from one of the greatest financial and economic meltdowns in history and has set it on a path of self-sustaining expansion. As noted earlier, the US is the most advanced in normalizing its monetary policy, as the Fed is gradually raising rates and reducing the size of its balance sheet.

In addition to higher interest rates, we expect bond yields to rise. However, we believe that monetary policy normalization does not necessarily mean that rates and yields will return to the levels seen in recent decades. Less favorable demographics and ongoing deflationary pressures from new technologies may keep yields lower than before, although we remain alert to populist pressures moving yields in the other direction.

In the US, we expect the Fed to raise interest rates three to four times in 2019 and to continue to reduce the size of its balance sheet. Figure 2 shows the Fed's Dot Plot. The Dot Plot sets out where individual Federal Open Market Committee members believe interest rates will be in the future. The average and median of these forecasts are just over 3% for the end of 2019 and just below 3.5% for the end of 2020. The market, however, does not seem to believe that (at the time of writing), with both 2019 and 2020 forecasts just under 3%. As noted previously, the ECB is likely to stop purchasing bonds by the end of 2018, with the first hike expected sometime in 2019, while the Bank of Japan is expected to continue its accommodative monetary policy for the foreseeable future.

Figure 2: The US Fed's Dot Plot



Source: Bloomberg

MARKET OUTLOOK

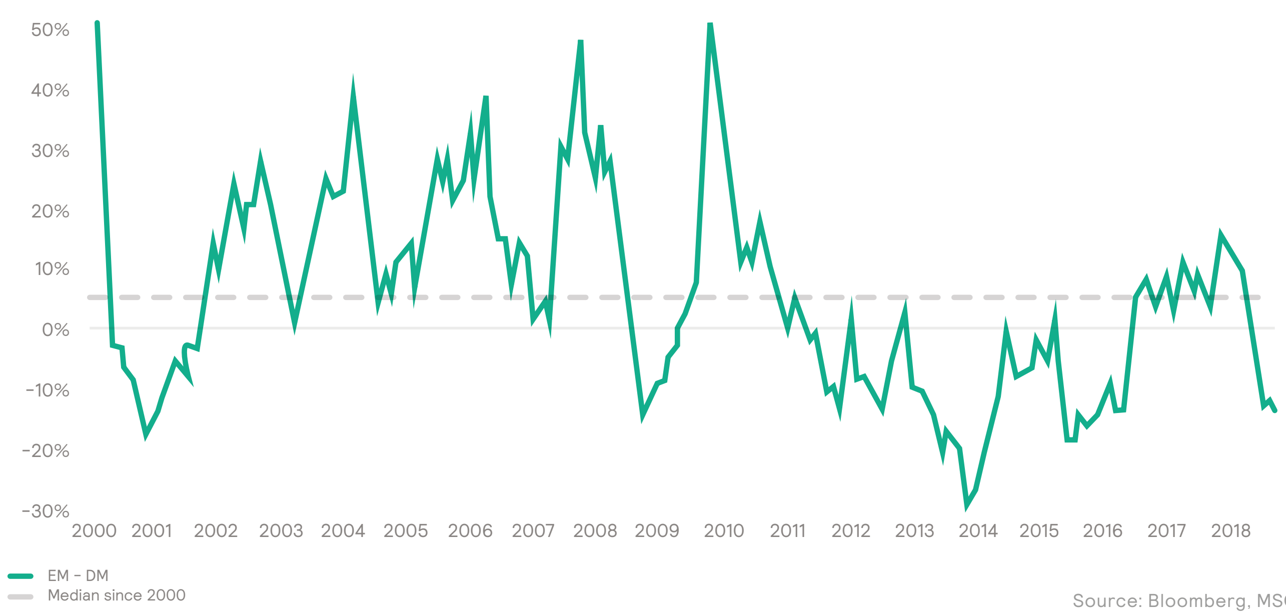
EQUITIES

Equities have had a volatile and regionally divergent year. As noted in the economic outlook section, 2018 was the year of US exceptionalism, with the S&P 500 index up 3% year to date (as at October 31, in USD, total return) and the broader market down 3.5%. EMs were especially weak, with the broad market index down 16% year to date (in USD, total return; see Figure 3). Broadly speaking, tighter liquidity conditions to control the financial imbalance and trade war fears were the key reasons behind the selloff. What kept US equities afloat was share buybacks and particularly strong earnings growth, courtesy of the tax cuts at the beginning of the year.

Going forward into 2019, we believe a case can be made for a rise in equity prices. We remain constructive on global economic growth, which should support earnings growth. The outperformance of US equities, however, is likely to fade. US valuations remain slightly stretched, whereas the rest of the world is much more reasonably priced. An end to the US's trade dispute could lead to much stronger returns, but a deterioration would have the opposite impact. The broader sentiment on equities is slightly negative (at the time of writing), with October being one of the worst months since 2012 — the MSCI World Total Return in USD fell by 7.3%.

From a longer-term perspective, it is difficult to imagine how the next five years for equities can be as good as the past five years, particularly in the US. To put it simply, if you buy when the

Figure 3. Emerging Markets and Developed Markets (One-Year Rolling Returns in USD)



Source: Bloomberg, MSCI

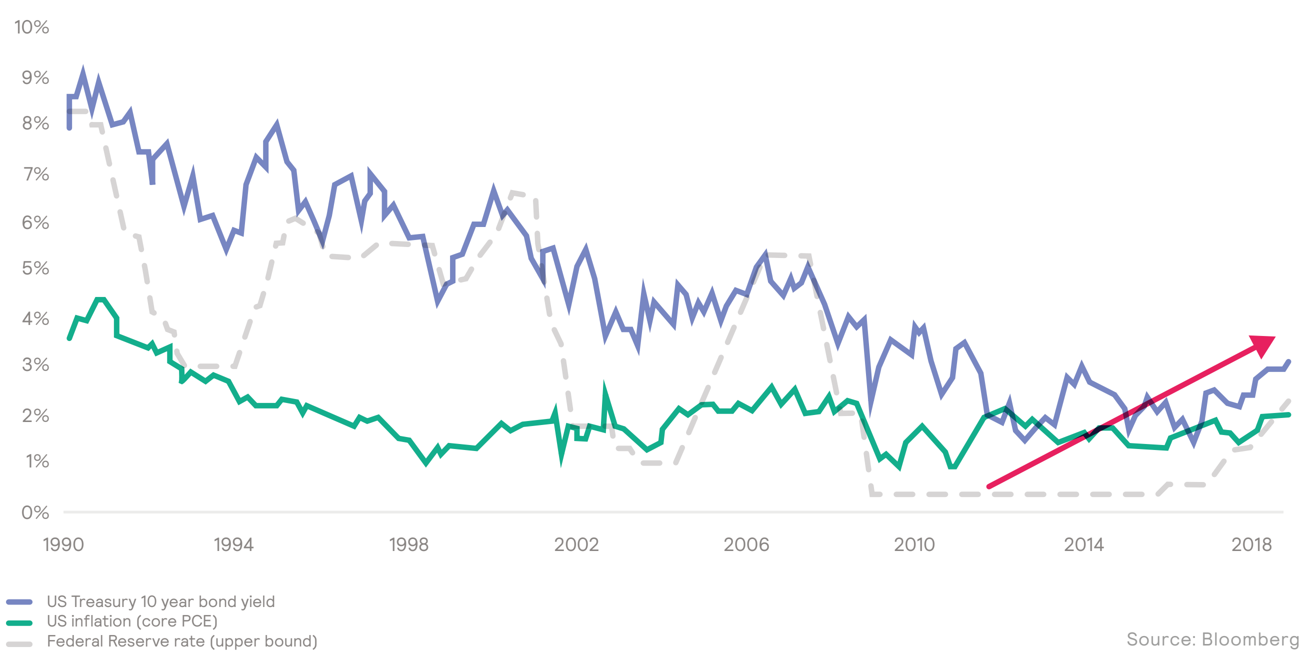
stocks are cheap — that is, price to the cyclically adjusted earnings (CAPE) is low — you are more likely to make money than if you buy stocks when they are expensive. At present, the US CAPE is around 30, suggesting real returns over the next decade are likely to be low. This is by no means a forecast — especially since the other equity markets, such as EM, are much cheaper and have good potential; we are merely suggesting that an equity investor starting today is less likely to achieve lucrative returns than if he or she had begun five years ago.

As noted earlier, we believe emerging market equities are likely to outperform developed market equities for a number of reasons. First, they are cheaper, which leaves more room for expansion before we get to the expensive territory. Second, emerging economies are in the earlier stages of their business cycles and are likely to grow at a strong pace over the next five years, which should act as a tailwind to earnings growth. Finally, the negative sentiment on the asset class, driven by trade tensions and stronger US dollar, had caused a substantial outflow from EM — providing an opportunity from a contrarian standpoint.

GOVERNMENT BONDS

Global government bond yields rose overall in 2018 — some places had higher yields than others as monetary policies diverged. Yields rose in the US (Figure 4) and the UK, largely due to the Fed and the Bank of England raising rates — the former likely to hike four times by the end of 2018 while the latter is likely to finish the year having hiked once. Japanese and eurozone government bonds were largely unchanged for the year, as their respective central banks did not make any surprising moves.

Figure 4. Higher Inflation, Rates and Yields



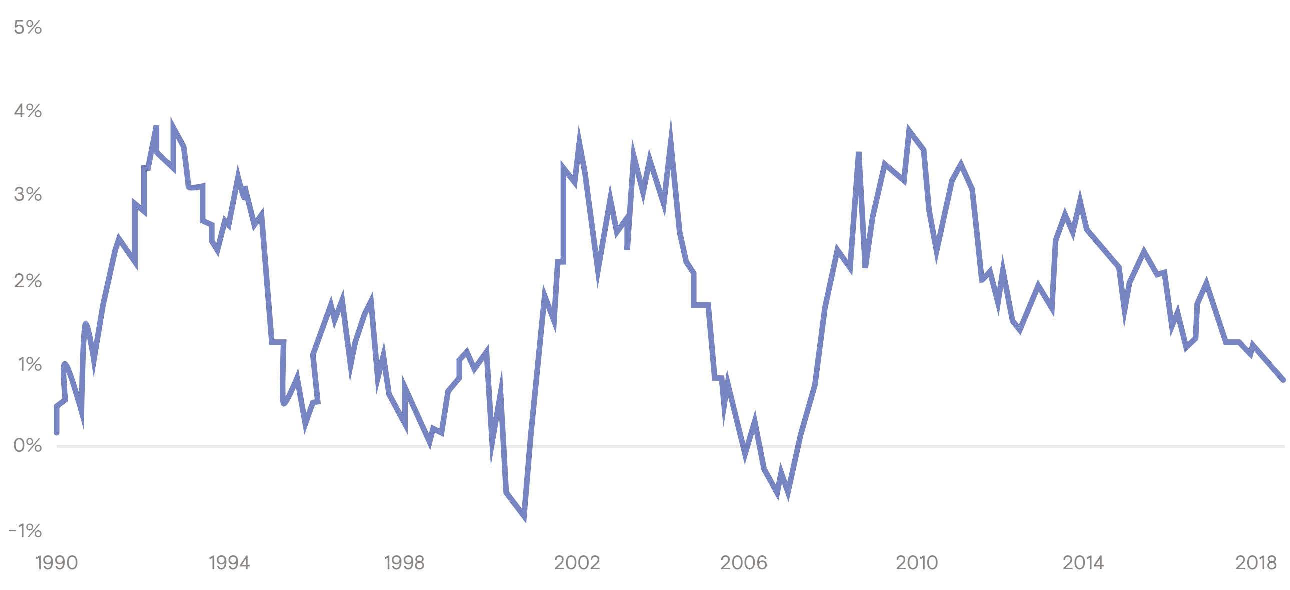
Source: Bloomberg

Importantly, in the US, long-dated bond yields rose by much less over the year, leading to a further flattening of the yield curve (Figure 5).

In 2019, we expect the Fed to raise rates three or four times, as growth remains robust, the labor market continues to tighten and inflation remains at or slightly above target. The Fed is also likely to continue unwinding its balance sheet. All of this, coupled with the expansion of US fiscal deficits following tax cuts and increased spending, will likely lead to higher yields in the US at all maturities. Although the shape of the curve is difficult to forecast, the prevailing market opinion is that the short-dated yields may eventually exceed longer-dated yields; in other words, the US yield curve may invert. Some may interpret such a phenomenon as a signal that the US economy is due to fall into recession in the short to medium term. We have some sympathy with the view that yield curve inversion is a leading indicator of recessions; however, the timing varies. As noted earlier, we believe growth is likely to weaken slightly in 2019 but still remain at decent levels, and the risk of a more material slowdown — or even recession — in 2020 or 2021 is rising.

Government bond yields outside the US are expected to rise. In the eurozone, the ECB is likely to stop expanding its balance sheet and eventually hike rates (perhaps in late 2019), which should put a mild upward pressure on the bond yields. The Bank of Japan is likely to remain largely accommodative, unless inflation has a meaningful pickup. The actions by the Bank of England are largely unpredictable. On the one hand, the UK labor market is tight, inflation is above target and the economy is doing reasonably well, which are enough reasons for the central bank to take a less accommodative stance. On the other hand, we have Brexit, which, especially in a no-deal scenario, may slow down the economy and subsequently cause the central bank to at least stay on pause.

Figure 5. Curve Flattening US 10-Year Yield (US 3-Month Yield)



Source: Bloomberg

CORPORATE BONDS

The performance of corporate bonds depends on the performance of government bonds and the behavior of the credit spread (the difference in yield between the government and corporate bond). As we have a negative view on government bonds, we believe corporate bonds are likely to perform poorly, too. The tightening or widening of the credit spread will depend largely on the outlook for the global economy. If investors believe the economic growth will remain at decent levels, the default rates are likely to remain low and credit spreads are likely to tighten — leading to the outperformance of corporate bonds relative to government bonds. If, on the other hand, investors begin to pre-empt the turn in the credit cycle and start to price in a recession, credit spreads are likely to widen — causing corporate bonds to underperform.

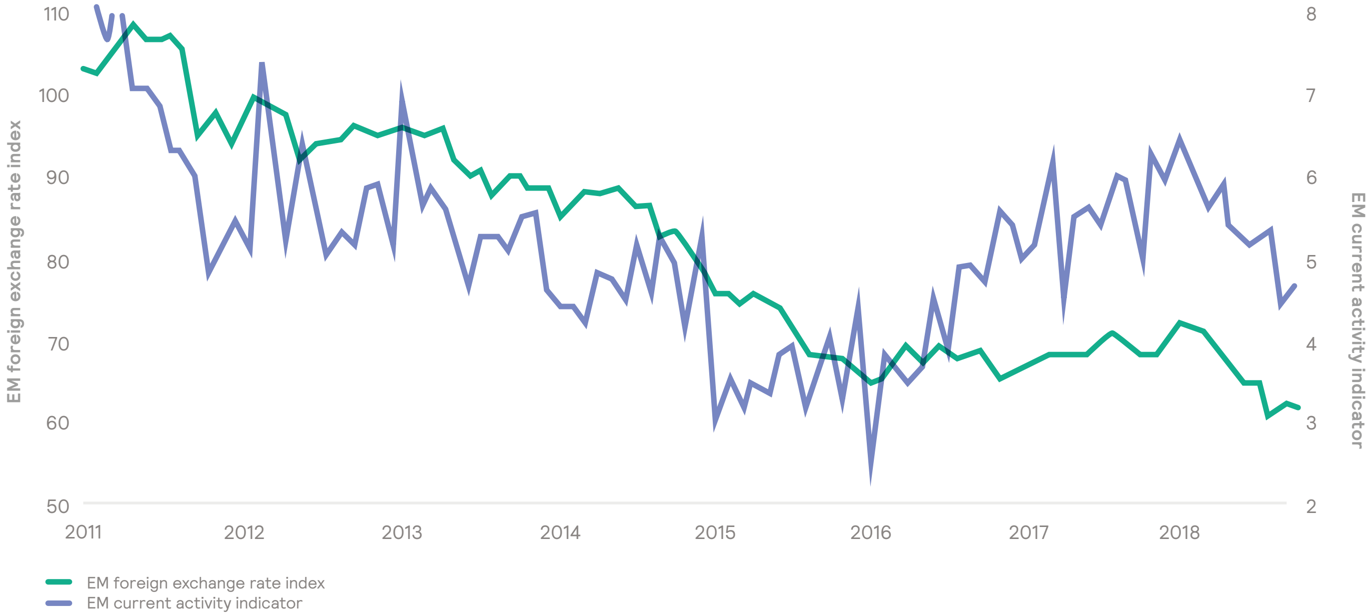
Figure 6. Global Aggregate Credit Spread

Source: Bloomberg, Goldman Sachs, J.P. Morgan

LOCAL CURRENCY EMERGING MARKET DEBT

Returns in emerging market local currency debt are driven by two factors: the return that bonds generate in their local currency terms and the performance of those currencies against developed market currencies. Following a turbulent 2018, when emerging market debt sold off, mostly due to the weakness of emerging market currencies against the US dollar, we view the asset class favorably because the yield is attractive and the currencies that were oversold (Figure 7) are perhaps due a rebound. Also, the inflation outlook is reasonably positive for emerging market bonds, as economies are likely to grow without facing significant capacity constraints and labor markets have plenty of room to tighten without causing wage growth pressures. For this sequence of reasons, we believe emerging market local currency debt will be one of the most attractive of main growth fixed income assets over the coming year.

Figure 7. EM Economic Activity and Currencies



Source: Bloomberg, Goldman Sachs, J.P. Morgan

FOREIGN EXCHANGE

The US dollar rose gradually in 2018, having appreciated by *c.*4% (end of October) against a basket of developed market currencies. It is not a standout move in a historical context, however. For example, during the 2014–2015 period, the US dollar rallied by *c.*24% (Figure 8). Large or not, the recent rally was likely supported by a number of factors, such as the Fed, higher growth in the US than elsewhere and a few market shocks throughout the year that led to rallies in safe-haven currencies.

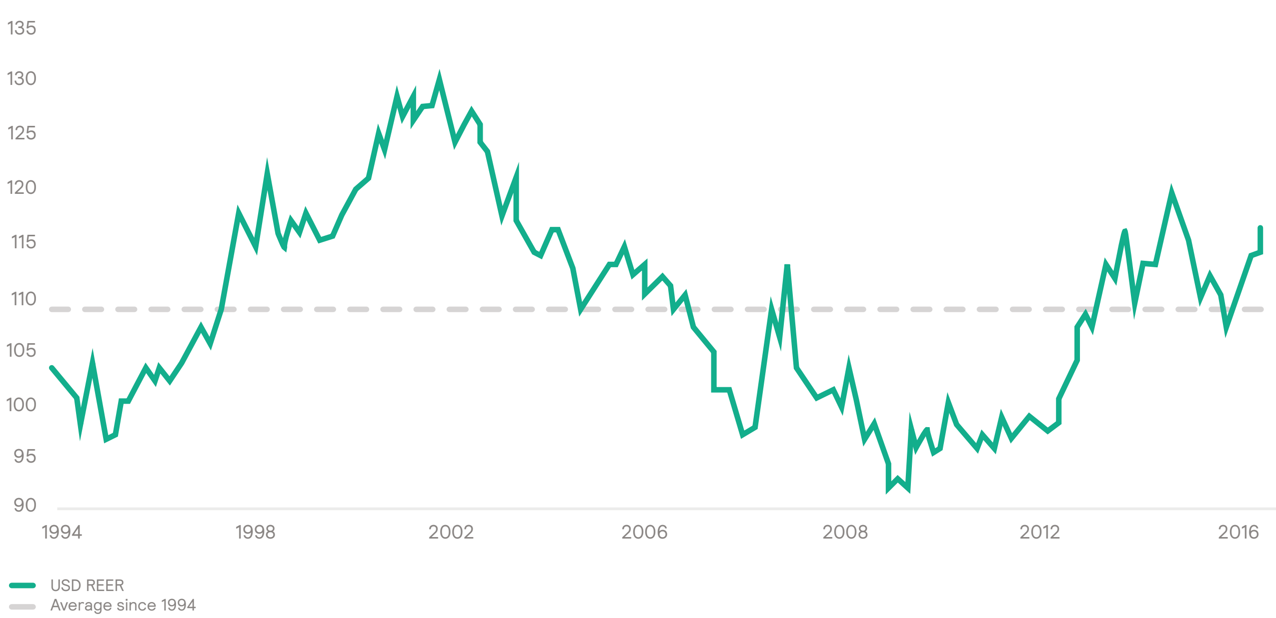
Going forward, we do not have high-conviction views on the directions of the major currencies. Although interest rate differences between the US and the rest of the developed world should support the US dollar, it is getting slightly overvalued. In addition, the slowdown of growth in the US compared to the rest of the world may provide an additional headwind.

While the euro has the potential to appreciate on the less accommodative ECB, that may be offset by the political uncertainty with regard to Italy and Germany and the mixed growth outlook for the currency union. Sterling remains at the mercy of Brexit, and its future direction will likely be wholly dependent on the progress of negotiations. Fundamentally, sterling looks cheap, and absent any significant progress in Brexit, it may remain cheap for a while.

Monetary policy divergence between the Fed and the Bank of Japan may prompt some yen weakness, but the balance of risks may be slightly tilted toward a stronger yen. The yen is undervalued on a number of long-term measures, while Japan's relatively large current account surpluses and the yen's safe-haven properties may see demand grow.

Although we do not have a strong view on developed market currencies, we are constructive on emerging market currencies for valuation and cyclical reasons. As noted earlier, we believe emerging economies are at the earlier stages of the economic cycle and are likely to grow at a decent pace for a long period without facing significant capacity constraints. This should be supportive of their currencies over the medium term.

Figure 8. US Dollar Real Effective Rate



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