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2019 SECOND QUARTER

Market Review & Outlook

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Q2 2019

Executive Summary

- **The US S&P 500 index achieved a new record high**. The Federal Reserve (Fed) did not cut interest rates at its June meeting but indicated that there might be rate cuts ahead. More economically-sensitive areas of the market generally performed strongly.
- **Shares in developed markets gained in Q2**, despite a steep fall in May due to concerns over the US-China trade war. Stock markets were supported by increasingly accommodative central banks and hopes of progress in trade tensions by the end of June.
- **Eurozone shares advanced**, with a sharp drop in May, sandwiched between gains in April and June. European Central Bank (ECB) President Mario Draghi hinted at further monetary policy easing if the inflation outlook fails to improve.
- **UK shares performed well over the quarter**, despite ongoing Brexit-related uncertainty and the resignation of Prime Minister Theresa May.
- **Japanese shares performed worse than the other major developed markets**. The yen strengthened, partly as a result of its reputation as a safe haven at times of geopolitical risk.
- **Emerging market shares lagged their developed market counterparts**. Trade uncertainty weighed on Chinese and South Korean stocks. South Africa, Indonesia, Turkey, and Argentina were the best performing countries.
- **Government bond yields fell markedly as prices rose**. Corporate bond markets delivered positive total returns and performed better than government bonds.

Macroeconomic & Asset Review

United States

US equity indices were broadly positive in Q2, and the S&P 500 set a new record high. Uncertainty surrounding the US' trade stance caused a mid-quarter market wobble. However, investors were broadly cheered by continued dovishness from the Federal Reserve and indications of progress in trade tensions by the end of June. Comments from President Trump that his administration could impose tariffs on Mexico's imports, and extend the suite of goods that are taxed on import from China, caused a sharp market sell-off in May. In June, signs emerged of progress in talks with China, with Trump also "indefinitely suspending" the Mexican tariffs.

Economic data was mixed. US gross domestic product (GDP), which measures the value of all the goods and services produced by an economy, grew 3.1% (quarter-on-quarter, annualized) in Q1, revised down from 3.2%, which was as expected. Employment data remained broadly encouraging despite slowing in June. The unemployment rate remained stable at a 49-year low of 3.6% while average hourly earnings climbed 3.1% from a year earlier, below expectation of a 3.2% gain.

However, consumer and business confidence indices weakened, and survey data indicate business activity is slowing. The Fed did not cut rates at its June meeting, but the "dot plot" signals easier policy ahead. The dot plot shows what level Fed policymakers think rates will be in the future.

More cyclical areas of the market, i.e., those that are most sensitive to the economic cycle, generally performed strongly. Financials, materials, and IT all generated robust gains. Healthcare remains challenged by potential changes to pricing legislation, and more defensive (i.e., less cyclical) areas of the market made modest gains. Energy stocks largely declined.

Risk assets, such as stocks and bonds rallied along with "risk-off" assets, such as developed market government bonds and gold. U.S. Growth stocks were the strongest individual asset class in Q2 of 2019 and commodities lagged. On the global side, MSCI Europe ex UK was the best performing index while Japan's TOPIX lagged (see charts below).

Asset classes and style returns in local currency

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD	2Q 2019
MSCI EM 62.8%	REITS 27.6%	REITS 7.3%	REITS 20.1%	Small cap 35.8%	REITS 27.1%	Growth 6.5%	Value 15.1%	MSCI EM 31.0%	Global Agg -1.2%	Growth 21.0%	Growth 5.1%
Small cap 40.8%	Small cap 24.4%	Global Agg 5.6%	Small cap 18.4%	Value 29.7%	Growth 11.5%	Small cap 2.8%	Small cap 14.5%	Growth 24.5%	REITs -4.1%	REITs 18.8%	DM Equities 3.8%
Growth 29.4%	Cmdty 16.8%	Value -4.9%	MSCI EM 17.4%	DM Equities 29.6%	DM Equities 10.4%	DM Equities 2.6%	Cmdty 11.8%	Small cap 19.1%	Growth -5.1%	DM Equities 17.1%	Global Agg 3.3%
REITS 27.4%	MSCI EM 14.4%	DM Equities -5.0%	Growth 16.5%	Growth 29.5%	Value 9.2%	REITS 2.3%	MSCI EM 10.1%	DM Equities 19.1%	DM Equities -6.9%	Small cap 15.9%	Value 2.5%
DM Equities 26.5%	Growth 12.7%	Growth -5.1%	DM Equities 16.4%	MSCI EM 3.8%	Small cap 6.7%	Value -1.2%	DM Equities 9.6%	Value 14.1%	Value -8.7%	Value 13.2%	REITs 1.8%
Value 23.6%	DM Equities 10.6%	Small cap -8.7%	Value 16.3%	REITS 3.2%	MSCI EM 5.6%	Global Agg -3.2%	REITs 9.3%	REITs 9.3%	MSCI EM -9.7%	MSCI EM 10.2%	Small cap 1.7%
Cmdty 18.9%	Value 8.4%	MSCI EM -12.5%	Global Agg 4.3%	Global Agg -2.6%	Global Agg 0.6%	MSCI EM -5.4%	Growth 4.4%	Global Agg 7.4%	Cmdty -11.2%	Global Agg 5.6%	MSCI EM 0.3%
Global Agg 6.9%	Global Agg 5.5%	Cmdty -13.3%	Cmdty -1.1%	Cmdty -9.5%	Cmdty -17.0%	Cmdty -24.7%	Global Agg 2.1%	Cmdty 1.7%	Small cap -12.2%	Cmdty 5.1%	Cmdty -1.2%

Source: Barclays, Bloomberg, FactSet, FTSE, MSCI, J.P. Morgan Asset Management. DM Equities: MSCI World; REITs: FTSE NAREIT All REITs; Cmdty: Bloomberg UBS Commodity Index; Global Agg: Barclays Global Aggregate; Growth: MSCI World Growth; Value: MSCI World Value; Small cap: MSCI World Small Cap. All indices are total return in local currency. Past performance is not a reliable indicator of current and future results. Data as of 30 June 2019.

World stock market returns in local currency

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD	2Q 2019
MSCI Asia ex Japan 67.2%	MSCI Asia ex Japan 15.6%	US S&P 500 2.1%	Japan TOPIX 20.9%	Japan TOPIX 54.4%	US S&P 500 13.7%	Japan TOPIX 12.1%	UK FTSE 100 19.1%	MSCI Asia ex Japan 35.9%	US S&P 500 -4.4%	US S&P 500 18.5%	MSCI Europe ex UK 4.9%
MSCI EM 62.8%	US S&P 500 15.1%	UK FTSE 100 -2.2%	MSCI Europe ex UK 20.0%	US S&P 500 32.4%	Japan TOPIX 10.3%	MSCI Europe ex UK 9.1%	US S&P 500 12.0%	MSCI EM 31.0%	UK FTSE 100 -8.7%	MSCI Europe ex UK 18.1%	US S&P 500 4.3%
MSCI Europe ex UK 29.0%	MSCI EM 14.4%	MSCI Europe ex UK -12.1%	MSCI Asia ex Japan 19.7%	MSCI Europe ex UK 24.2%	MSCI Asia ex Japan 7.7%	US S&P 500 1.4%	MSCI EM 10.1%	Japan TOPIX 22.2%	MSCI EM -9.7%	UK FTSE 100 13.1%	UK FTSE 100 3.3%
UK FTSE 100 27.3%	UK FTSE 100 12.6%	MSCI EM -12.5%	MSCI EM 17.4%	UK FTSE 100 18.7%	MSCI Europe ex UK 7.4%	UK FTSE 100 -1.3%	MSCI Asia ex Japan 6.4%	US S&P 500 21.8%	MSCI Europe ex UK -10.6%	MSCI Asia ex Japan 11.0%	MSCI EM 0.3%
US S&P 500 26.5%	MSCI Europe ex UK 5.1%	MSCI Asia ex Japan -14.6%	US S&P 500 16.0%	MSCI Asia ex Japan 6.2%	MSCI EM 5.6%	MSCI Asia ex Japan -5.3%	MSCI Europe ex UK 3.2%	MSCI Europe ex UK 14.5%	MSCI Asia ex Japan -12.0%	MSCI EM 10.2%	MSCI Asia ex Japan -0.6%
Japan TOPIX 7.6%	Japan TOPIX 1.0%	Japan TOPIX -17.0%	UK FTSE 100 10.0%	MSCI EM 3.8%	UK FTSE 100 0.7%	MSCI EM -5.4%	Japan TOPIX 0.3%	UK FTSE 100 11.9%	Japan TOPIX -16.0%	Japan TOPIX 5.2%	Japan TOPIX -2.4%

Source: FactSet, FTSE, MSCI, Standard & Poor's, TOPIX, J.P. Morgan Asset Management. All indices are total return in local currency. Past performance is not a reliable indicator of current and future results. Data as of 30 June 2019.

Source: Factset, Bloomberg, S&P, JPM

Eurozone

Eurozone equities (shares) advanced in Q2 with a sharp drop in May sandwiched in between gains in April and June. Top performing sectors included information technology (IT), consumer discretionary, and industrials. The lack of any further escalation in the trade wars in June helped the market to recover after May's pull-back. The real estate sector fell after Berlin's city government proposed a five-year freeze on residential property rents from 2020.

Quarter 1 GDP growth for the eurozone was confirmed at 0.4% quarter-on-quarter. Annual inflation for June was stable compared to May at 1.2%. European Central Bank President Mario Draghi hinted that further monetary policy easing, such as new bond purchases, could be on the way if the eurozone inflation outlook fails to improve.

Forward-looking surveys painted a mixed picture. The flash composite purchasing managers' index (PMI) reached a seven-month high of 52.1 in June. Any reading of the index above 50 indicates improving conditions, while readings below 50 indicate a deteriorating economic circumstance. However, the index has service and manufacturing elements, and the latter remained at a level that indicates it is shrinking.

United Kingdom

UK shares also performed well. Areas of the market perceived to offer superior and defensible earnings growth extended the run of outperformance they have experienced since the beginning of 2019. Conversely, many of the market's domestically-focused sectors underperformed amid renewed Brexit and political uncertainty.

Theresa May resigned as UK prime minister, taking a caretaker role as of 7 June. The Conservative Party began the process of selecting its new leader, who will also become prime minister. Despite a further extension of the Article 50 deadline to 31 October, there remains considerable uncertainty as to the path a new leader might wish to take.

Meanwhile, the negative impact of the original 31 March Article 50 deadline on the UK manufacturing sector became clearer. While GDP grew by 0.5% in Q1, in line with expectations, the Office for National Statistics (ONS) revealed that the economy shrank by 0.4% in April (by more than forecast) and primarily due to a sharp fall in car production related to Brexit uncertainty.

Japan

Japanese shares performed worse than the other main developed markets in the second quarter. The total return for the three months was -2.4%, primarily as a result of weakness in May. The yen strengthened against other major currencies, driven partly by its perceived safe-haven status at times of geopolitical risk, and partly as a result of changing interest rate expectations for the US.

The main development during the quarter was the continued escalation of trade issues, notably the announcement in May of sharp increases in US tariffs on imports from China. For most of the quarter, this issue exacerbated the reaction to a slowdown in corporate earnings growth, which was evident in the results for the final quarter of the fiscal year. Meanwhile, the direct bilateral trade talks between the US and Japan took a backseat, and any substantive announcements seem to have been delayed until August, safely after Japan's Upper House elections in July.

Economic data was mixed, with the largest positive surprise seen in Japan's growth rate for Q1 2019. This showed real GDP grew at an annualized rate of 2.1% whereas consensus expectations had called for a decline. Although the detailed breakdown was not particularly encouraging for the domestic economy, it does mean that in the short term Japan is likely to avoid a technical recession, which is when an economy shrinks for two quarters in a row. The Bank of Japan left monetary policy, and the associated language, unchanged in the quarter.

Asia (ex Japan)

Asia ex-Japan shares posted modest losses in the second quarter as markets in the region recorded mixed performances. The Asian index of stock markets (the MSCI Asia ex-Japan index) underperformed the global equivalent (the MSCI World index).

Trade tensions and economic risks played on the minds of investors, while global monetary policy was another key focus. In particular, the US-China trade war escalated in May after the US raised tariffs on US$200 billion worth of Chinese imports and added Chinese telecommunications group Huawei to a trade blacklist. China countered with retaliatory tariffs on US goods. Both countries subsequently agreed to a truce and will resume trade negotiations following a meeting between their leaders in June.

Against such a backdrop, stock markets from countries in ASEAN (Association of Southeast Asian Nations) outperformed. Thailand and Singapore notched the biggest gains in the region. The Philippines was helped by strong advances in communication services and consumer staples stocks. Indonesia, where President Joko Widodo was re-elected, also fared well.

In Greater China markets, Hong Kong benefited from the rally in financial stocks, while investors also cheered the suspension of a contentious extradition bill. Taiwan edged up as gains in consumer staples and industrials stocks outweighed declines in the healthcare sector. Conversely, Chinese stocks fell and were among Asia's worst performers, though losses were pared in June thanks to easing trade tensions and hopes of further stimulus measures.

Indian stocks posted slim gains as Prime Minister Modi's Bharatiya Janata Party was re-elected with a stronger mandate. Separately, the central bank cut its benchmark interest rate twice to spur growth. Elsewhere, South Korean stocks retreated, weighed down by poor corporate earnings.

Index Returns for June 2019 (as a percentage)

INDEX	GBP	USD	JPY	EUR	LOC
Equities (MSCI)					
MSCI World Index	5.6	6.6	5.8	4.3	5.9
MSCI USA	6.0	7.0	6.2	4.7	7.0
MSCI Europe ex UK	6.4	7.4	6.6	5.1	4.9
MSCI United Kingdom	4.0	5.0	4.2	2.7	4.0
MSCI Japan	2.8	3.8	3.0	1.5	3.0
MSCI AC Asia ex JP	5.6	6.7	5.8	4.4	5.4
MSCI EM Latin America	5.2	6.2	5.4	3.9	3.8
MSCI EM (Emerging Markets)	5.3	6.3	5.5	4.0	4.7

Source: MSCI, Factset & JPM Economic Research

Emerging Markets

Emerging market shares recorded a slight gain in a volatile second quarter. US-China trade tensions were rekindled in May as talks unexpectedly broke down, and both sides implemented new tariffs. However, hopes for a resumption of talks post the G20 summit in June, and rising expectations that the US Fed will cut interest rates proved supportive later in the period. The MSCI Emerging Markets Index gained but underperformed the MSCI World.

Those markets most sensitive to changes in global liquidity performed well, in particular, Argentina, where political developments also boosted sentiment. In advance of presidential elections in October, the leading candidates appeared to adopt a more centrist stance. South Africa, Indonesia, and Turkey were among the best performers.

Russia also performed better than the average country in the index, due in part to a strong rally from state-controlled oil company Gazprom. Meanwhile, the Russian central bank cut interest rates by 25 basis points (bps) to 7.25% in June and signaled the potential for further easing this year.

By contrast, China and South Korea finished in negative territory, impacted by global trade uncertainty. After trade talks broke down, the US increased tariffs on $200 billion of Chinese goods imports from 10% to 25% and blacklisted Chinese telecoms company Huawei. It also threatened to levy tariffs on the remaining $300 billion of goods imported from China. China retaliated by raising tariffs on $60 billion of US goods imports from an existing 5-10% range to a maximum of 25%. However, following the G20 Osaka summit, which took place at the end of June, further tariff hikes have been paused. The US has also eased some export controls against Huawei.

Global Bonds

It was a positive quarter for financial markets with both riskier assets and government bonds making gains. Broadly, this reflected expectations that central banks would keep monetary policy loose, including the possibility of US rate cuts. At their meetings in mid-June, comments from the Fed and ECB confirmed the growing dovishness among policymakers, with both clearing the way for further policy measures if needed.

Government bond yields fell markedly as prices rose. The 10-year US Treasury yield was over 40 basis points (bps) lower over the period and the 10-year German Bund yield over 25bps lower at -0.33%. There was a pronounced move in the Spanish 10-year yield, which fell 65bps to just above 0.40% as the April general election removed political uncertainty. The UK 10-year yield underperformed, falling by about 17bps.

Corporate bond markets delivered positive total returns and outperformed government bonds. Credit drew support from falling yields (bond prices rise when yields fall). Higher quality bonds (i.e., investment grade (IG)) saw better returns than high yield (HY) as they tend to benefit more from falling yields. Emerging market (EM) bonds had a positive quarter. EM debt denominated in local currencies performed particularly well as the US dollar weakened in June. Across US dollar-denominated and corporate EM bonds, IG produced stronger returns than HY.

Fixed income sector returns in local currency

2013	2014	2015	2016	2017	2018	YTD	2Q 2019
Euro HY 8.8%	Euro Treas. 13.1%	Euro Treas. 1.6%	US HY 17.5%	EM Debt 9.3%	Euro Treas. 1.0%	EM Debt 10.6%	Global IG 3.9%
US HY 7.4%	EM Debt 5.5%	EM Debt 1.2%	EM Debt 10.2%	Global IG 9.1%	US Treas. 0.9%	US HY 10.1%	EM Debt 3.8%
Euro Treas. 2.2%	Euro HY 5.5%	US Treas. 0.8%	Euro HY 10.1%	IL 8.7%	US HY -2.3%	Global IG 8.2%	Euro Treas. 3.4%
Global IG 0.3%	US Treas. 5.1%	Euro HY 0.5%	Global IG 4.3%	US HY 7.5%	Global IG -3.6%	Euro HY 7.5%	US Treas. 3.0%
US Treas. -2.7%	IL 3.4%	Global IG -3.6%	IL 3.9%	Euro HY 6.1%	Euro HY -3.6%	IL 6.2%	US HY 2.5%
IL -3.2%	Global IG 3.1%	US HY -4.6%	Euro Treas. 3.2%	US Treas. 2.3%	IL -4.1%	Euro Treas. 6.0%	IL 2.2%
EM Debt -6.6%	US HY 2.5%	IL -5.0%	US Treas. 1.0%	Euro Treas. 0.2%	EM Debt -4.6%	US Treas. 5.2%	Euro HY 2.2%

Source: Barclays, BofA/Merrill Lynch, FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management. IL: Barclays Global Inflation-Linked; Euro Treas: Barclays Euro Aggregate Government - Treasury; US Treas: Barclays US Aggregate Government - Treasury; Global IG: Barclays Global Aggregate - Corporates; US HY: BofA/Merrill Lynch US HY Constrained; Euro HY: BofA/Merrill Lynch Euro Non-Financial HY Constrained; EM Debt: J.P. Morgan EMBIG. All indices are total return in local currency. Past performance is not a reliable indicator of current and future results. Data as of 30 June 2019.

Source: Barclays, JPM, Bloomberg

Commentary

In talking to others in my position, the big debate we are having is whether the flattening yield curve is a sign of impending recession, as many market watchers believe. I have sat as a fixed income trader, and portfolio manager for over 25-years and my experience tells me historically when shorter-term Treasurys are yielding more than their longer-term counterparts, its an indication that something is not quite right with the (global) economy.

While unsettling, in my opinion, a recession is far from imminent. Part of the reason for the flat curve may stem from fears of a global slowdown. However, the U.S. bond market must be put into a global context. Simply put, would rates have fallen the way they have this year if Japanese and European bonds (Germany’s 10Y Bund at negative 30 bps) were not sporting negative interest rates? Considering that there is half a trillion dollars worth of corporate paper in Europe and $11 trillion in overall debt on the continent sporting negative rates, it's understandable why the demand for Treasurys that are yielding a number greater than zero remains high.

That said, the reality is that the yield curve is flat. As a result, the game gets complicated when it comes to fixed income. Go short without a hedge, and rates are likely to fall, and so will your income. Go long, and you are not getting paid a real return for the duration and maturity risk and investor should make — quite the conundrum for investors who want safe returns.

As for equities, market returns have been solid during the first half of this year. With the “Powell Pivot” and a Fed who turned remarkably dovish in a short period, success was a function of being invested. I believe this is set to change as uncertainty on trade policy, conflict in the middle east, lowered earnings expectations, and high equity valuations will capture the attention of investors. Moreover, as growth slows and profits reset, investors will have to once again contemplate their place in the business and market cycle. Whether rebalancing to tactical weights or banking gains on large positions, portfolio grooming is the order of the day. The benefit of working with your Lakeview Capital Advisor or Lakeview Institutional Advisor has never been more important.

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