Eye on the Market Outlook 2017

J.P. MORGAN SECURITIES

True Believers. Two groups of true believers are driving changes in the developed world. The first: single-minded central bankers who spent trillions of dollars pushing government bond yields close to zero (and below). While this unprecedented monetary experiment helped owners of stocks and real estate, its regressive nature did little to satisfy the second group: voters who are disenfranchised by globalization and automation, and who are on the march. What next? The fiscal experiments now begin (again). Prepare for another single digit portfolio return year in 2017.

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MARY CALLAHAN ERDOES
Chief Executive Officer
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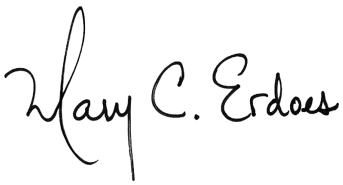
Expect the unexpected—that was the world's lesson from 2016. From the U.K.'s decision to leave the European Union to the U.S. presidential election's surprising results, citizens of the world voiced their desire for change. As investors, such major shifts require our reassessment of almost every assumption, from tax rates to inflation, to global trade, and all the subsequent spillover effects. Thinking through portfolios and any associated balance sheet borrowings are more important now than in many years past.

To that end, I'm pleased to share with you our ever thought-provoking 2017 Outlook. As depicted on the cover, Michael Cembalest and his team analyze the duality of pitchfork problems: the rise of anti-establishment parties around the world and the continued central bank attempts to shovel money at the problems of anemic growth. Both cause the need for a comprehensive portfolio review to ensure your assets are headed in the right direction.

We thank you for your continued trust and confidence in all of us at JPMorgan Chase.

Most sincerely,

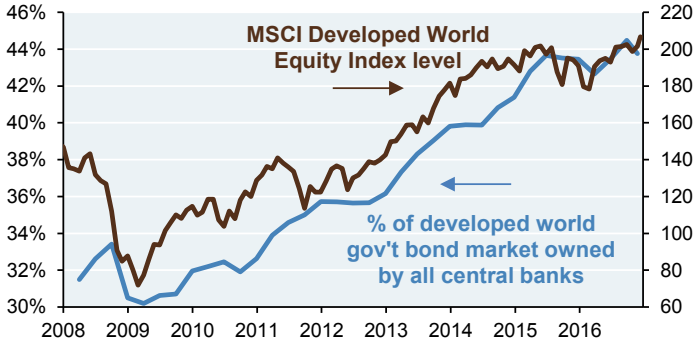


Executive Summary: True Believers

Political upheavals and unorthodox central bank actions persist, but it looks like more of the same in 2017: single digit returns on diversified investment portfolios as the global economic expansion bumps along for another year.

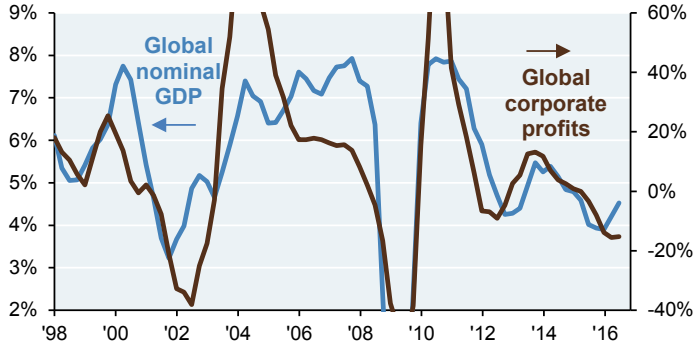
How we got here. By the end of 2014, central bank stimulus lost its levitating impact on markets, GDP and corporate profits, all of which have been growing below trend. Proxies for diversified investment portfolios[1] generated returns of just 1%-3% in 2015 and 6%-7% in 2016.

The fading impact of central bank government bond purchases on global equity returns



Source: National stats offices, Haver, MSCI, Bloomberg, JPMAM. Dec. 2016.

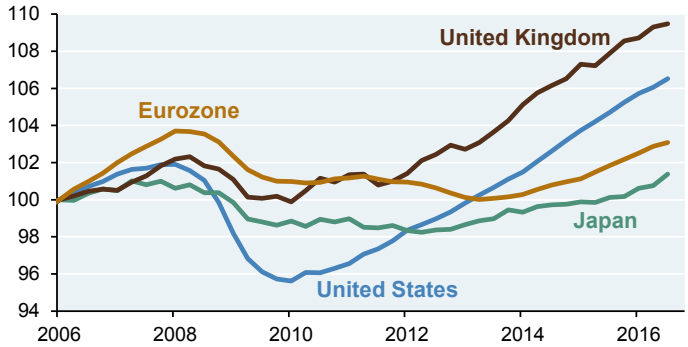
A slow growth world
Y/Y % change (both axes)



Source: J.P. Morgan Securities LLC. Q3 2016.

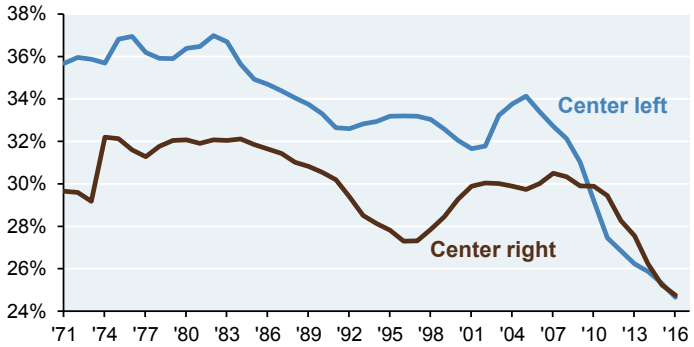
The biggest experiment in central bank history ($11 trillion and counting as of November 2016) helped employment recover in the US and UK, and more recently in Europe and Japan. Across all regions, however, too many of the benefits from this experiment accrued to holders of financial assets rather than to the average citizen. As a result, the political center of a slow-growth world has begun to erode, culminating with the election of a non-establishment US President with no prior political experience, and the UK electorate's decision to leave the European Union. The market response to **Trump's** election has been positive as investors factor in the benefits of tax cuts, deregulation and fiscal stimulus and ignore for now potential consequences for the dollar, deficits, interest rates, trade and inflation (see US section on the "American Enterprise Institute Presidency").

Employment growth in the developed world
Index (Q1 2006 = 100)



Source: National statistics offices, Haver Analytics. Q3 2016.

Erosion of the political center
Vote share, average of developed world countries

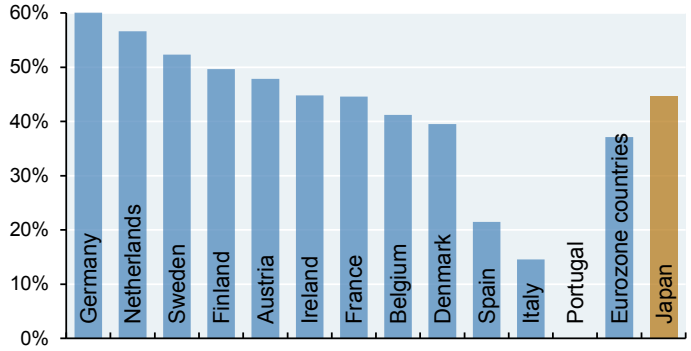


Source: Barclays Research. October 2016.

[1] Weights and indices used for diversified portfolio proxies: 60% equities (using the MSCI All-Country World Equity Index, including emerging markets), and 40% fixed income (using the Barclays US Aggregate for US$ investors, and the Barclays Global Aggregate hedged into Euros for Euro investors).

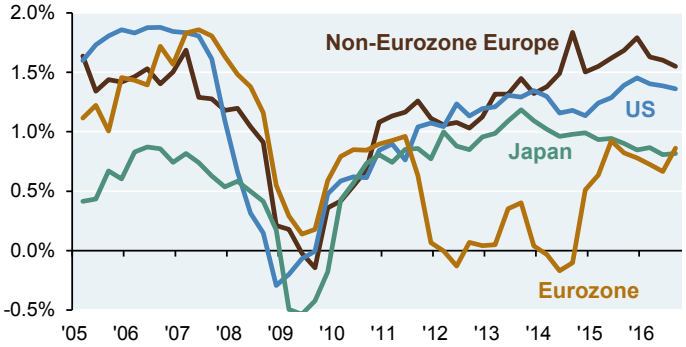
"True Believer" central banks have created unprecedented distortions in government bond markets. Bond purchases and negative policy rates by the ECB and Bank of Japan led to negative government bond yields. Whatever their benefits may be, they also resulted in profit weakness and stock price underperformance of European and Japanese banks. The poor performance of European and Japanese financials was a driver of lower relative equity returns in both regions in 2015/2016[2].

Government bonds trading below 0% yield
% of total government bonds by market value



Source: J.P. Morgan Securities LLC, JPMAM. December 15, 2016.

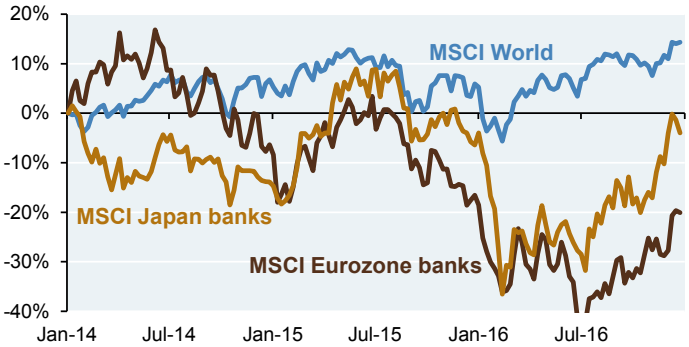
Bank earnings in the developed world
Trailing 12-month earnings as a % of risk-weighted assets



Source: Bloomberg, JPMAM. Q3 2016.

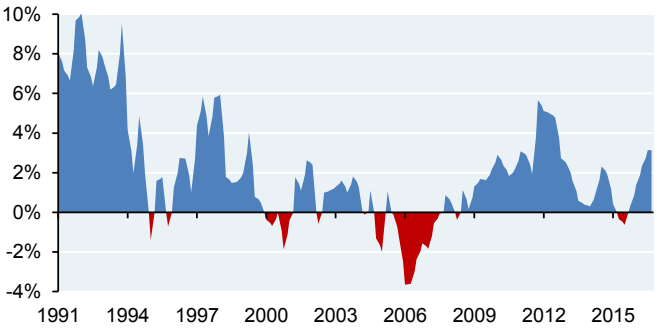
For the last few years, I have written about a preference for an equity portfolio that's overweight the US and Emerging Markets, and underweight Europe and Japan[3]. This has been one of the most consistently beneficial investment strategies I've seen since joining J.P. Morgan in 1987 (see chart below, right). It worked again in 2016, and despite the negative consequences of rising interest rates and a rising dollar for US and EM assets, I think it makes sense to maintain this regional barbell for another year as Europe and Japan once again snatch defeat from the jaws of victory.

Eurozone and Japanese banks have underperformed
Cumulative total return, US$



Source: Bloomberg, MSCI. December 28, 2016.

Benefits of overweighting US/EM, underweighting Europe/Japan, 3-year rolling out (under) performance



Source: Bloomberg, J.P. Morgan Asset Management. Dec. 15, 2016.
Portfolio is quarterly rebalanced and assumes no currency hedging.

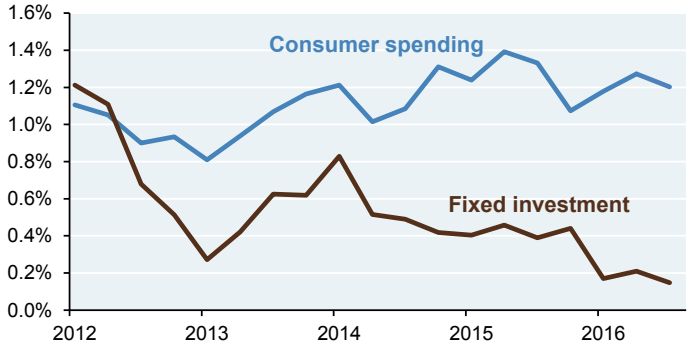
[2] **Eurozone and Japanese bank stocks** rallied sharply in Q3 2016, mostly a reflection of steepening yield curves which portend improved bank profitability. As the ECB gradually slows bond purchases in 2017, Eurozone bank stocks could rise further. However, the rest of the Eurozone markets might suffer with less stimulative conditions.

[3] Computations are based on an all-equity portfolio that is overweight the US by 10%, underweight Europe by 10%, overweight EM by 5% and underweight Japan by 5%. All overweights and underweights are expressed relative to prevailing MSCI index weights.

We had a single digit portfolio return view for 2015 and 2016 (which is how things turned out), and we're extending that view to 2017 as well. There are some positive leading indicators which I will get to in a minute, but first, the headwinds:

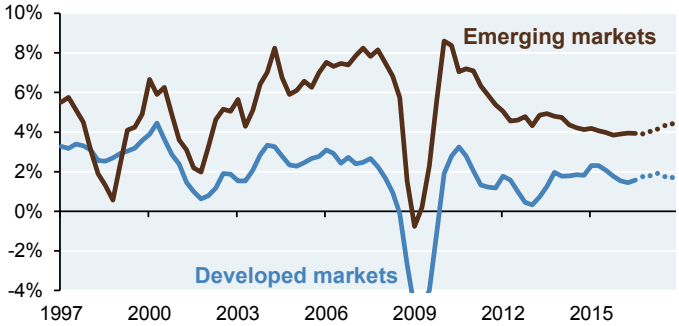
- While global consumer spending has held up, global business fixed investment remains weak, in part a consequence of the end of the commodity super-cycle and slower Chinese growth
- We expect the emerging market recovery to be gradual, particularly if Trump policies lead to substantially higher interest rates and a higher US dollar
- We expect a near-term US growth boost (amount to be determined based on the composition of tax cuts, infrastructure spending and deregulation), but trend growth still looks to be just 1.0% in Japan and 2.0% in Europe

Components of global real GDP
Percentage point contribution to Y/Y real GDP growth



Source: J.P. Morgan Securities LLC. Q3 2016.

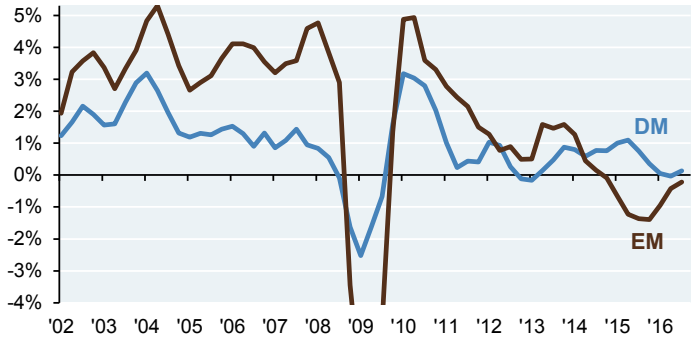
Stable, slow global growth
Y/Y real GDP growth



Source: J.P. Morgan Securities LLC. Q3 2016. Dotted lines show GDP growth estimates through Q4 2017.

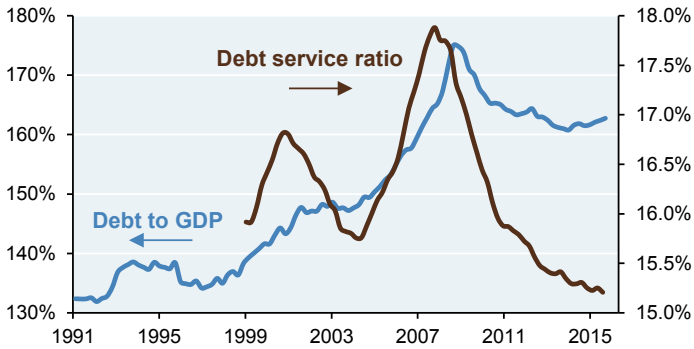
- The global productivity conundrum continues, leaving many unanswered questions in its wake[4]
- Even though private sector debt *service* levels are low, high absolute *amounts* of debt may constrain the strength of any business or consumer-led recovery

The global productivity slowdown
Productivity proxy (change in output per unit of employment)



Source: J.P. Morgan Securities LLC. Q3 2016. EM excludes India and China.

Developed world private sector debt
Debt to GDP | Debt service to income

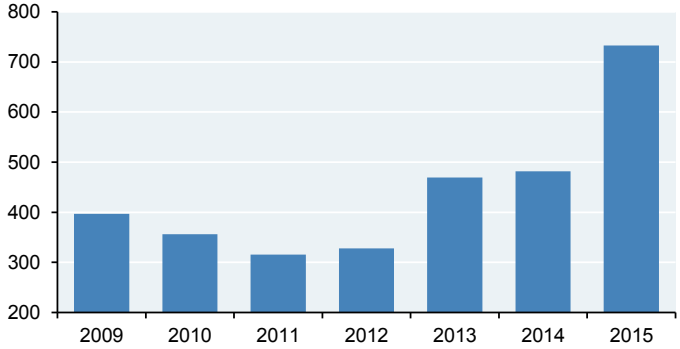


Source: J.P. Morgan Securities LLC, BIS, IMF. Q2 2016.

[4] **Is productivity mis-measured since economists can't measure benefits of new technology?** This is a complicated question, but the short answer is "I don't think so". I read two papers on the subject in 2016, one from the Fed/IMF and the second from the University of Chicago. In the first paper, the authors state that "we find little evidence that the [productivity] slowdown arises from growing mismeasurement of the gains from innovation in IT-related goods and services". And in the second, the authors conclude as follows: "evidence suggests that the case for the mismeasurement hypothesis faces real hurdles when confronted with the data". One smoking gun: the productivity slowdown is similar across countries regardless of the level of their ICT penetration (information and communication technology).

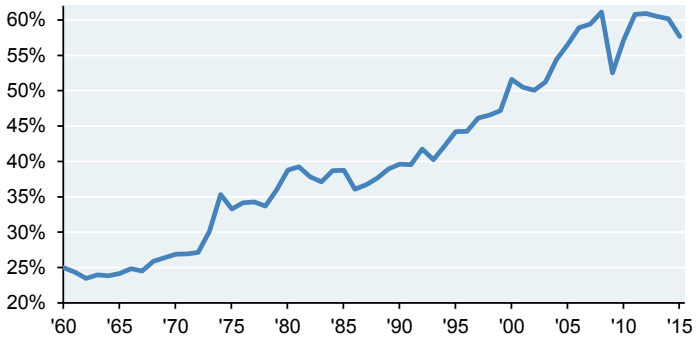
- And finally, even before Trump takes office, we're already seeing a rise in protectionism as global trade stagnates. The degree to which Trump follows through on campaign proposals on trade is a major question mark for 2017

Global rise in trade protectionism
# of discriminatory trade measures



Source: Center for Economic and Policy Research. July 2016.

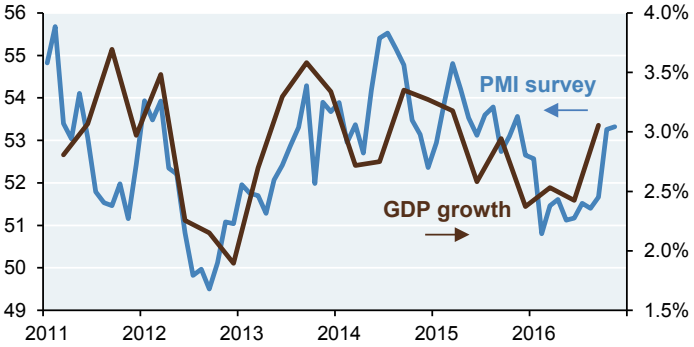
Global trade stagnant for the last decade
% of world GDP



Source: World Bank. 2015.

So, with all of that, why do we see 2017 as another year of modest portfolio gains despite the length of the current global expansion, one of the longest in history? As 2016 came to a close, global business surveys improved to levels consistent with 3% global GDP growth, suggesting that corporate profits will start growing at around 10% again after a weak 2016. More positive news: a rise in industrial metals prices, which is helpful in spotting turns in the business cycle (see Special Topic #8).

Global business surveys (PMI) point to higher growth
Output PMI, 50+ = expansion | Q/Q % change, annualized



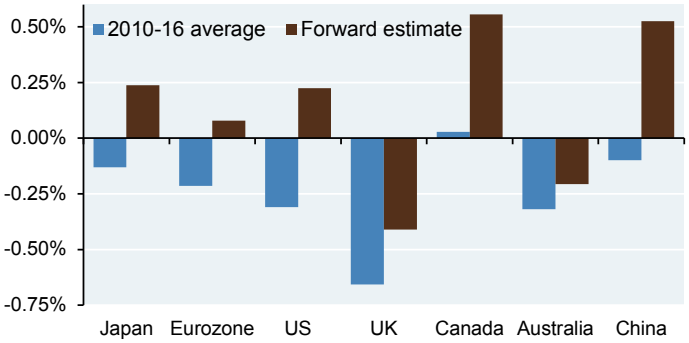
Source: J.P. Morgan Securities LLC, Haver Analytics. November 2016.

Industrial metals prices are stabilizing
Index level

Source: Bloomberg. December 15, 2016. Index tracks aluminum, copper, zinc, nickel and lead.

Furthermore (and I understand that there's plenty of disagreement on the benefits of this), **many developed countries are transitioning from "monetary stimulus only" to expansionary fiscal policy as well**. Political establishments are aware of mortal threats to their existence, and are looking to fiscal stimulus (or at least, less austerity) as a means of getting people back to work. The problem: given low productivity growth and low growth in labor supply, many countries are closer to full capacity than you might think. If so, too much fiscal stimulus could result in wage inflation and higher interest rates faster than you might think as well. That is certainly one of the bigger risks for the US.

Fiscal policy projected to ease
Government impact on growth



Source: Bridgewater Associates. August 2016.

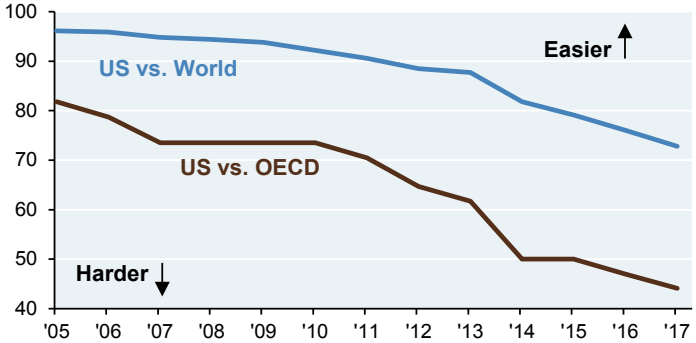
US, Europe and Japan equity valuations
Combined price-to-sales ratio on MSCI US, Europe and Japan equities, ex-financials and energy

Source: IBES, Datastream, Bloomberg, JPMAM. December 15, 2016.

So, to sum up, here's what we think 2017 looks like:

- A modest growth bounce in the US from some personal and corporate tax cuts, deregulation and infrastructure spending, with tighter labor markets, rising interest rates and a stronger dollar eventually taking some wind out of the US economy's sails. If I'm underestimating something, it might be the potential increase in confidence, spending and business activity resulting from a slowdown in the pace of government regulation (see chart, right, and page 13)

"Ease of starting a new business": in the US, getting less easy, US percentile rank relative to world and OECD



Source: World Bank Doing Business, JPMAM. October 2016. N = 189.

- A little better in Europe and Japan in 2017, but no major breakout from recent growth trends
- China grows close to stated goals, supported by multiple government bazookas firing at once
- Emerging markets ex-China continue recovering after balance of payments adjustments; while countries with high exposure to dollar financing will struggle, overall risks around a rising dollar have fallen markedly since 2011
- The world grows a little faster in 2017 than in 2016, but as shown above, a lot of that is already in the price of developed market equities. So, another single digit portfolio year ahead

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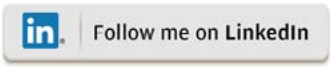

2017 Eye on the Market Outlook: Table of Contents

Chapter links

Brief videos of Michael discussing each of these special topics are available on the True Believers webpage.

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