2018 Global Outlook

J.P. Morgan Research
Global Outlook

- We believe that tax reform translates into a modest boost (0.25%-pts) to US growth for 2018, but could mean more for equity market returns.
- Government bonds, European credit and commodities are likely to deliver poor returns for beta investors in 2018.
- We forecast only 2% returns for US high grade, while US high yield and emerging markets credit should deliver returns in the 6-7% range, while equities continue to offer an almost 300bp valuation gap.

J.P. Morgan’s Global Research team forecasts sustained, synchronized above-potential global growth, for a second consecutive year, against a reflationary backdrop. Central bank tightening is still in its early stages, with US real policy rates outright negative and still relatively easy monetary policy elsewhere in the world. Our Global Research team forecasts global real GDP growth at 3.0% in 2018, comfortably above the 2.6% potential growth rate, while global CPI inflation should rise toward 2.5%. We believe that tax reform translates into a very modest boost (0.25%-pts) to US growth for 2018, but could mean more for equity market returns as tax cuts are positive for equities, while the reduction in interest expense deductibility is a negative for credit.

Given the record issuance, flows and strong market performance over the course of 2017 across asset classes, stretched valuations are of greater concern. We expect the gap between equity and fixed income market returns to likely widen further next year. Government bonds, European credit and commodities are likely to deliver poor returns for beta investors in 2018. Our strategists are forecasting only 2% returns for US high grade, while US high yield and emerging markets credit should deliver returns in the 6-7% range. Although equity multiples do not look cheap in absolute terms, equities continue to offer an almost 300bp valuation gap. We think 2018 could be the second year in a row in which earnings show further improvement, supporting equity markets. Our strategists expect US equities to deliver +5% in early 2018 while Europe to deliver +9%, Eurozone +12%, UK +7%, EM equities +18% and Japan +14% in full year 2018 total returns. We enter 2018 increasing our allocation to equities and have cut our Overweight in credit and commodities to zero.

Joyce Chang, Global Head of Research
Cross-Asset Strategy

- Expect a broadening bear market in fixed income, with Bonds to deliver negative returns (and underperforming cash) for the first time since 2013. European credit could return zero to -1%, for some of its worst returns of the EMU era. The best-performing FICC sectors should be EM Local and US High Yield.

- I expect lower returns than in 2018, but still much better than Bonds and Credit; 10%-15% price gains, from earnings growth rather than multiple expansion. Targets of S&P 3000, MSCI Eurozone 250, FTSE 7750, MSC’I EM 1300, TOPIX 2100. Macro/policy backdrop more consistent with twilight of the mid cycle rather than proper late-cycle, so defensive trade should be selective.

A backdrop of above-trend global growth and policy moves from the G3 central banks carries material consequences for fixed income, given serious valuation problems in some bond markets (Bunds, JGBs) and tighter-than-average spreads in US, European and Emerging Markets (EM) corporates. Although there is no commonly accepted definition of a bear market in bonds (unlike the -20% metric used in equities), 2017 was a losing year for German Bunds (-0.8%) and almost for JGBs (+0.2%). In 2018, losses probably broaden from Bunds to other Developed Markets (DM), in turn imposing flat, or negative, returns on some credit sectors. The chart below presents historical total returns with our strategists’ 2018 projections across the risk spectrum, so covering cash, government bonds (DM, EM), corporates (US, Euro, EM), real assets (commodities, inflation-linked bonds), currencies and equities. A 25-year average is used for benchmarking long-term returns, or since an index’s inception for newer markets like EM local and corporates.

J.P. Morgan 2018 projections – losses on DM Bonds and Euro Credit, average returns on EM fixed income, higher than average on Equities

J.P. Morgan Research total return projections for 2018 in local currency except for EM Local and MSCI EM long-run average

Source: J.P. Morgan 2018 year-ahead outlooks posted on webpage JPM 2018 Outlooks
Global cash is forecast to return 0.5% next year – its highest returns since 2012 – given Fed and BoE tightening and JPM GBI weights of approximately 40% US, 30% Euro area, 20% Japan and 7% UK. That outcome is still miserable, but it, nonetheless, improves on losses of -0.2% in 2016 and -0.3% in 2017.

DM government bonds could lose 3% (Bunds -2%, JGBs -4%, USTs -0.10%), which would mark only their fourth annual loss on a global index in over 30 years (local currency basis). Other losing years were 1994 (-3.5%) due to Greenspan’s surprise tightening cycle delivered; 1999 (-1.3%) due to a growth/commodity price rebound plus Fed tightening after the Asian Crisis; and 2013 (-0.4%) because of the taper tantrum.

Spread market returns should vary considerably next year – highest for EM assets and lowest for European corporates. EM local bonds could return about 7% (6% carry, 1% FX appreciation), so less than 2017’s 12%. Valuations are not as stretched as in DM or EM corporates (GBI-EM spreads to USTs are near their long-term average, while corporate spreads are well below their mean), but the fundamental tension between above-trend global growth and Fed tightening/slower global central bank balance sheet expansion limits capital gains. Robust earnings justify only modest US credit spread compression from today’s levels. Our credit strategists forecast another -15bp to 115bp on US High Grade and another -20bp to 395bp on US High Yield, implying returns of 2% and 5.5%, respectively (2017 delivered 6%-7%). EM sovereigns and corporates could also tighten 20bp and 30bp to 250bp on EMBIG and 200bp on CEMBI, so return 6-7%. With Quantitative easing ending in Europe, Euro High Grade probably widens 6bp and Euro High Yield by 70bp, implying 1% losses on High Grade, but 1% gains on High Yield given the forecast rise in short to intermediate German yields.

For real assets, TIPS (+1.2 %) should outperform Euro linkers (-2%) but underperform commodities (+3%) due to oil’s strength. The US should generate more inflation than Europe next year, and Treasuries carry less duration risk than Bunds. A commodity index could gain about 3% if the OPEC-Russia accord lifts oil prices to the high $60s/bbl, but base metals fall on slower Chinese demand and precious metals move down in H1 then up in H2 with US real yields.

For equity investors worried that bond markets threaten equity valuations through a higher risk-free rate or a feedback loop to weaker earnings, here’s the good news: real US cash rates have been at least +2% before US recessions, and will barely be positive in H2 2018; and only one bond bear market of the past 30 years has also been associated with negative annual returns on global equities (1994, when MSCI World fell 2.5%).
For the S&P500, J.P. Morgan’s year-end target of 3000, implying 13% price gains. For international Equities: MSCI Eurozone 250 (10% price gains); FTSE 7750 (4%); TOPIX 2100 (17%); and MSCI EM in USD terms 1300 (16%). Add another 2% for current dividend yields to all markets, but the UK (where it’s 4%), and the total return range runs from 8% on the FTSE to 19% on the TOPIX. All represent smaller gains than in 2017, but still above their long-run averages of closer to 10% for most markets and 3% on Japan.

Are these reasonable, bottom-up return projections? As a top-down cross-check, the chart below shows the average quarterly return for six asset classes over four phases of the US business cycle, based on five episodes since 1975. Recession quarters are defined by the NBER’s business cycle dates; we then call early the first four quarters after a recession, late the last four quarters before recession, and mid all quarters in between. Equities tend to generate above average returns early-cycle, average returns mid-cycle, below average returns late-cycle and their worst returns during recessions. Stocks also underperform cash and bonds late-cycles and obviously in recessions. So our 2018 forecasts of above-average returns are optimistic, whether one labels 2018 as mid- or late-cycle.

**J.P. Morgan projections more consistent with mid than late cycle**

Average quarterly returns by phase of US business cycle; 1975-2017 sample

Source: J.P. Morgan

We consider next year to be the mid-cycle’s twilight. Yes this expansion is very old (8.5 years), but inflation and real policy rates are too low to think it will end in the next few quarters, in turn generating low absolute returns on stocks or underperformance versus bonds. But to hedge the possibility that expansion-ending shocks emerge early in 2018 rather than later, we are long markets typically associated with late-cycle stress (oil, inflation breakevens, USD/JPY vol). We are also underweight one cyclical asset where policy support is fading (Euro Credit, due to ECB tapering).

**John Normand, Head of Cross-Asset Fundamental Strategy**
Global Economics

- We forecast global real GDP growth at 3.0% in 2018 and global CPI inflation should rise toward 2.5%
- We see four Fed hikes during 2018, and we also expect the Fed balance sheet to fall by $400 billion
- We expect the US unemployment rate to fall to 3.7% next year
- We did not expect a turbulent political backdrop to determine the contours of the global business cycle this year and continue to place political change in the background of the 2018 outlook

The 2018 global economic outlook reflects stronger growth and tighter labor markets, while forecasting higher core inflation. A combination of time, balance sheet healing and extraordinary monetary policy accommodation is promoting a more traditional dynamic, where a positive feedback loop linking growth to supportive financial conditions and rising sentiment delivers sustained, synchronized above-potential global growth for a second consecutive year. We forecast global real GDP growth at 3.0% in 2018, comfortably above the 2.6% potential growth rate, while global CPI inflation should rise toward 2.5%. A rebound in profits and business sentiment suggests that a long-awaited recovery in global capital expenditure (capex) will fuel 2018 growth and sustained strong growth points to further labor market tightening and higher core inflation. We expect the US unemployment rate to fall to 3.7% next year, more than a percentage point below our non-accelerating inflation rate of unemployment (NAIRU) estimate and the Euro area rate to slide to 8%.

Central bank policy guidance is likely to diverge even with strong growth, as the juxtaposition of negative real policy rates, tight labor markets and rising core inflation will pressure central banks to normalize their stances. We believe the US will be the prime catalyst for higher global rates next year as the Fed is on the march toward a neutral policy stance and should nudge its 2018 dot plot closer to four moves. This is in line with our forecast of four Fed hikes during 2018, and we also expect the Fed balance sheet to fall by $400 billion. However, the ECB should reaffirm its low-for-long stance, signaling that it will maintain its -0.4% deposit rate through end-2018. We expect a $700 billion increase by the ECB and BoJ to offset the Fed balance sheet unwind and the average policy rate to rise by only 4bp through the end of next year. Other central banks will be in hiking mode, and we expect four hikes from the Bank of Canada, two from
the Bank of England, two from Riksbank and rate hikes from EM central banks in seven countries although Asian heavyweights, China and India, are on hold, and Brazil and Russia are still easing.

Our 2018 global economic outlook is built on the view that the long shadow cast by the global financial crisis (GFC) has finally lifted (see Global outlook 2018: The return of the business cycle). Twice this expansion, upward momentum was short-circuited GFC aftershocks— the Euro area sovereign crisis in 2011-12 and the EM credit tightening in 2014-16. GFC post-traumatic stress also has held back business spending and dampened households’ response to improving labor markets and financial conditions. If we are right, a combination of time, balance sheet healing, and extraordinary monetary policy accommodation is promoting a more traditional dynamic, where a positive feedback loop linking growth to supportive financial conditions and rising sentiment delivers sustained, synchronized above-potential global growth for a second consecutive year in 2018.

Alongside the recent pickup in global demand growth, supply side performance has strengthened with both productivity and labor force growth rebounding. However, we believe that the past decade’s global supply slide will persist even as GFC drags fade. Aging populations remain a powerful dampening force on labor supply growth and productivity. In addition, global investment shares remain depressed (ex. China) and depreciation shares have trended higher. These developments suggest that the global capex upturn we project will not restore productivity growth to its earlier trend.

A return to more normal demand dynamics alongside sustained weaker potential growth points to further labor market tightening and higher core inflation. These moves are likely to be led by the Developed Markets (DM), which we believe is already operating at full employment. We expect the US unemployment rate to fall to 3.7% next year, more than a percentage point below our NAIRU estimate. With the Euro area rate expected to slide to 8%, DM unemployment rates should drop to their lowest levels since 1980. We expect tight DM labor markets and a recovery in global goods pricing power to lift DM wage inflation and push DM core inflation up 0.4%-pts next year.

Experience shows that strong global growth phases tend to end with a shock or with rising interest rates tightening financial conditions. While our projected 1.8% DM core inflation rate should not raise inflation concerns for markets or central banks, DM policy rates currently average 0.6%. With growth strong, the juxtaposition of negative real policy rates with
tight labor markets and rising core inflation will pressure central banks to normalize their stances. We believe the US will be a prime catalyst for higher global rates next year as we expect its fiscal policy to ease, the Fed to tighten 125bp (including a move this December), and the Fed balance sheet to fall by $400 billion.

We did not expect a turbulent political backdrop to determine the contours of the global business cycle this year and continue to place political change in the background of the 2018 outlook. We look for only modest US fiscal ease and do not see NAFTA or Brexit negotiations or important 2018 elections in Europe and Latin America impinging on the outlook.

Bruce Kasman, Chief Economist
US Economics

- We see growth close to 2% in 2018
- If tax reform is approved, we see a modest boost to 2018 US GDP growth of only 0.25%-pts
- Expenditures (PCE) moving only slowly back toward the Fed’s 2% goal and we expect four rate hikes in 2018 given the decline in the unemployment rate

The prospects for the economy at the end of 2017 look about as favorable as they have at any point in this expansion. The animal spirits of both consumers and businesses appear energized; the ever-present global headwinds of the last half decade have turned to a tailwind; and the domestic fiscal austerity that has acted as a drag on growth since 2011 may now be turning to profligacy. The only sticking point is that by many measures the economy already appears to be operating at capacity. This is the fundamental tension in the outlook: does continued above-trend growth tighten labor and product markets enough to threaten higher wage and price inflation, or does growth slow enough to limit strains on the rate of resource utilization? Our outlook balances these outcomes.

We see growth close to 2% in 2018; while that is somewhat below what we expect will be realized for 2017, it is still about 0.5%-point above our estimate of sustainable trend growth. If tax reform is approved by year’s end, we see a modest boost to 2018 US GDP growth of only 0.25%-pts. This should be enough to push the unemployment rate down into the high 3’s (see first chart) If our forecast is realized, the expansion will enter its tenth year in the second half of 2018 and will become the second longest US expansion on record.

Unemployment rate and nonfarm payroll growth

Source: BLS, J.P. Morgan forecast
Inflation has been mysteriously absent this year, but historically it has not been long before unemployment below 4% began to generate firmer wage and price pressures. We expect that to be the case next year as well. Fortunately for the outlook, this will take place from a starting point in which cost pressures are relatively low, so some firming in inflation trends is not to be feared. Even with core Personal Consumption Expenditures (PCE) moving only slowly back toward the Fed’s 2% goal, we expect the Federal Open Market Committee (FOMC) to maintain a fairly steady cadence of rate hikes next year. As widely expected, the Fed hiked the target range for the funds rate by 25 basis points to 1.25-1.50% at the December meeting; the fifth hike this cycle and the third this year. While the median participant continues to look for three hikes next year, we still feel that four hikes is more likely given the ongoing surprising decline in the unemployment rate.

Michael Feroli, Chief US Economist
US Treasuries

- We forecast the Fed will hike four times in 2018, and there is room for front-end yields to reprice higher: we project 2-year yields should reach 2.10% by mid-year and 2.55% by 4Q18

- Long-end yields should be better supported by a low neutral funds rate and are not expected to rise materially until the Fed funds rate is above 2%. We project 10-year yields will reach 2.55% by 2Q18, and 2.70% by 4Q18. Against this backdrop, we recommend focusing shorts at the front end and also favor long-end flatteners

- We expect $1.303 trillion in net issuance in 2018. We find a 3:1 mix of front-end and intermediate vs. long-end auction size increases would stabilize WAM alongside growing bill supply

- Foreign demand should rebound further, driven by official institutions. Commercial bank demand should turn positive, and pension and insurance demand should remain robust

- Ongoing tax reform and recessionary risks could add to an already-wide deficit and drive yields higher over the long term

- We think rising import prices and a tight labor market should bias core inflation higher: we expect core CPI to reach 2.2% y/y by YE 2018. This increase in core CPI should fuel a modest widening in breakevens, and higher nominal yields and tighter credit spreads should also be supportive: we target 10-year breakevens to reach 200bp in 2Q and 205bp by year-end. We expect the real yield curve to flatten in line with the nominal curve; look for the 5s/10s real yield curve to reach 0bp

We think the backdrop is bearish for Treasuries in 2018, and the curve has bear flattened in recent weeks as markets are pricing in a faster pace of rate hikes over the coming year. Over the past month, the Treasury curve has bear flattened with the 2s/30s curve falling 24bps to about 98bp, fueled by higher yields in the front end and belly of the curve. The market should be more willing to price in this shift in monetary policy, implying there is room for front-end yields to reprice higher. However, a low neutral Fed funds rates as well as traditional tightening cycle dynamics suggest the long end should be more anchored until the funds rate rises above 2%. This flattening bias is further exacerbated by our expectations for increased coupon issuance to be concentrated in the 2- to 5-year sector. Although we think front-end duration shorts and long-end flatteners are likely
to be profitable in the coming months, we recommend waiting for more advantageous levels before initiating these trades.

We think a combination of wider deficits in the coming years and System Open Market Account (SOMA) redemptions will add to Treasury’s funding needs, requiring increases in nominal coupon auction sizes. Given Treasury’s desire to normalize bill supply and stabilize weighted-average maturity (WAM) at current levels, we find that a 3:1 mix of auction size increases at the front end and intermediates versus the long end best achieves this, and expect Treasury to increase auction sizes in accordance with this ratio at the February, August, and November refundings. As a result, net issuance of Treasuries to the public would total $1.303 trillion in 2018, with $847 billion allocated to coupons. However, there is some downside risk to this forecast if the upcoming debt ceiling debate results in a shorter-term resolution that hinders normalization of the cash balance to operationally prudent levels.

The demand picture in 2018 looks somewhat challenging due to additional supply, and foreign investors, commercial banks, as well as pension funds and insurance companies will need to absorb additional duration, likely requiring higher yields. FX reserve growth should support foreign official demand while private demand should moderate as FX-hedged yield pickup has declined from 2013-2014 peaks. Commercial bank demand should turn positive as banks seek High-Quality Liquid Assets (HQLA) replacements for reserves, while pension and insurance demand should remain robust as equities and credit continue to rally, partially offset by curve flattening.

Jay Barry, US Fixed Income Strategy
Phoebe White, US Treasuries and Agencies Strategy
Securitized Products Group Outlook

Most securitized products sectors have tightened in 2017, with many approaching record tight levels. Fundamentals remain strong, as the consumer has de-levered meaningfully since the financial crisis, thanks in part to a tighter credit box; consequently, we do not expect the next credit shock to be consumer-driven. Corporations, on the other hand, have used the low rate environment to add leverage, in a change from the conditions leading to the crisis. With limited spread tightening potential going forward, we highlight sectors that offer the best carry and rolldown. We adjust for risk level through two different frameworks, first by using spread duration but second by adjusting for which sectors would widen the most in a “credit shock”, calibrated to repricings observed since the financial crisis.

Our carry/rolldown framework, adjusted for credit shock risk, finds the best value in FFELP, CLOs, agency CMBS and CRT. Finally, while a number of risks could threaten securitized products next year, we believe most are exogenous to the sector and macro in nature. We look for overall issuance to slow to $1.5 trillion, mainly owing to a decline in agency MBS issuance. While it’s difficult to identify the catalyst for spread widening, possible candidates include a shrinking footprint of global central banks’ balance sheets, negative yields across $10tn in sovereign debt, or most likely, some sort of policy disappointment in tax or regulation.

Please see our 2018 Securitized Products Outlook for a full discussion.”

Matthew Jozoff, Head of Securitized Products Research
Global FX

- We expect US dollar strength in the first half of the year (+0.9%) as the Fed proves the only major central bank adjusting policy.
- We forecast narrower dollar weakness with EUR/USD at 1.23 (USD index ends 2018 net 1.2% lower) as the dollar increasingly sees late-cycle fatigue.
- USD will see some further strength in early 2018 followed by a resumption of trend-weakness.

The dollar is ending 2017 with a rebound on renewed expectations of Fed tightening and hope for tax reform, yet it is still net 5% lower, marking the first down year since 2012 as repricing outside of the US was more significant than within. Similar dynamics should play out in 2018, where progression in rest-of-world policy normalization combined with an increasingly mature US cycle drives an ongoing low-vol dollar bear market, though not without intra-quarter backups in the dollar of the nature that we’ve see in the final quarter of 2017. We expect US dollar strength in the first half of the year (+0.9%) as the Fed proves the only major central bank adjusting policy. In the second half of the year, US dollar weakness could play out as policy normalization elsewhere comes into focus through European Central Bank (ECB) balance sheet normalization and a possible hike in the BoJ yield target. We forecast narrower dollar weakness with EUR/USD at 1.23 (USD index ends 2018 net 1.2% lower) as the dollar increasingly sees late-cycle fatigue. We are forecasting USD/JPY lower at 112 in end-2018, one of the weaker currencies globally. The same factors that drove JPY underperformance in 2017, suppressed nominal and real yields due to BoJ’s Yield Curve Control (YCC) policy, and alongside domestic and carry-trade funded JPY selling, carryover into 2018.

On a pairwise basis, local factors in several of the majors reinforce the idea that the USD will see some further strength in early 2018 followed by a resumption of trend-weakness. For example, EUR weakens to 1.14 (Italian elections and ECB autopilot) in the first quarter of 2018 and resumes higher to 1.23 year-end (continuation of ECB normalization) and CAD weakens to 1.30 (North American Free Trade Agreement, or NAFTA, risks) in the first quarter of 2018, but recovers to 1.21 year-end (ongoing quarterly BoC hikes). Even though GBP continuously grinds weaker versus EUR, versus USD sterling also follows this profile weakening to 1.30 in the first quarter, but reaching 1.34 year-end. On the other hand, the Antipodeans
more persistently weaken with year-end AUD to 0.72 and NZD 0.64 (inactive monetary policy). Meanwhile in Emerging Markets (EM), USD/CNY should be stable in a range with a mid-year low of 6.56 rebounding to 6.60 year-end. This keeps the EM Asia bloc also range-bound with a similar profile of more strength in the first half of 2018 and some retracement in 2H. On the other hand idiosyncratic factors drive large divergences across EMEA EM and Latin American FX. Among these two blocs, the weakest currencies include TRY (4.35 year-end), MXN (weakest in 2Q at 21.0), and ZAR (15.0 in 1Q before retracing stronger); strongest are those EUR-linked European EM currencies positively geared to euro strength, so CZK (year-end 19.92), PLN (3.33) and HUF (247).

For FX, the flow of QE seems to matter more than the stock. The ECB taper still supports a shallow upswing for EUR/USD.

Eur/Usd vs annual change in Fed balance sheet minus ECB, % of GDP.

Source: J.P. Morgan

John Normand, Head of cross-asset fundamental strategy
Paul Meggyesi, Head of FX strategy
Jonny Goulden, Head of EM Local Markets and Sovereign Debt Strategy
International Rates Outlook

- In 2018 we expect less stimulus from global central banks, delivered at uneven pace
- We broadly expect long-dated rates will drift higher
- In EUR we favor steepeners in money markets and at the long end of the German curve
- In GBP we recommend bearish duration exposure only via options given Brexit risks
- We expect political risk to be more muted than in 2017 and a minor market driver
- In Japan we expect the market to start pricing eventually an upward revision to 10Y YCC

In 2018 the global economy will continue to expand at an above-trend pace, albeit with some modest cooling from the recent torrid pace. US inflation will rise amid tight labor markets and building wage pressures, whereas rises in core inflation in the Euro area and Japan will be more modest. This dynamic will be broadly supportive of higher yields, albeit with various country-specific idiosyncrasies given ongoing monetary policy divergence. The ECB and BoJ will leave official rates unchanged but they will gradually reduce the pace of asset purchases.

In the Euro area, we expect long-dated rates will drift higher in 2018 on the back of solid global growth, increasing confidence that Phillips curves are not hopelessly flat and the end of QE purchases. We see higher intermediate yields and steeper curves in 2018, and target 10Y Bunds at 65bp by mid-2018 and 85bp by 4Q18. We recommend bearish duration exposure via outright shorts in 10-30Y Bunds or steepeners in 5s/30s and reds/15Y in Germany and EUR swaps respectively. We are also biased for a steeper money market curve, expressed via greens/blues and blues/golds EONIA steepeners.

We see intra-EMU spreads as range-bound, with relative Spain outperformance and Italy underperformance. We see modest widening in early 2018 due to political risk, followed by a tightening in the spring. From there on, we see modestly wider spreads in 2H18 as the prospect of an end to ECB QE draws closer and the Fed continues to tighten. Spain is expected
to outperform other peripheral countries. We recommend underweight Italy into early next year on politics and heavy supply.

The outlook for UK markets for next year will be shaped by the potential path for Brexit. UK rates in 2018 are highly dependent on the path of Brexit, with the outlook best thought of as a baseline scenario with increasingly fat tails given we see the probability of an either accidental or intentional “no-deal” transition as 25%. We recommend bearish duration exposure only via options given Brexit risks. Cross market hold longs 10-year gilts versus 10-year USTs over 1Q18.

Japan, markets should start pricing some possibility of tweaks to the BoJ’s yield curve control. While we expect yields to remain range bound in the next few months, we see the market increasingly pricing in a chance that the parameters of the BoJ’s yield curve control will be adjusted if core inflation drifts higher, with an upward revision to the 10-year YCC (to 25bp first and to 50bp eventually by the end of 2018). We expect 20Y JGB to underperform on the curve.

In Australia and New Zealand, we are bullish on the front-end outright and cross-market versus US, and hold a steepening bias on the curve. We see both the RBA and RBNZ on hold with a dovish bias and expect front-end yields to outperform forwards in both markets. We have a preference for cross-market longs in reds (1Yx1Y) AUD swaps and 5Y NZD swaps vs. USD, given the divergence in Antipodean monetary policy compared to the Fed.

In Scandinavia, we recommend earning front-end carry in Sweden and Norway into 1Q18, while favouring medium term short in 10Y Swedish duration and money market curve steepeners in Norway.

In the inflation space, we see more value in trading cross market views and hold longs in 5-year US breakevens versus 5-year EUR breakevens given our relative inflation forecasts.

Fabio Bassi, Head of European Rate Strategy
Francis Diamond, European Rates Strategy
Global Commodity Outlook

- **Energy:** We expect Brent to average $58/bbl in 2018 on the back of an extended OPEC-NOPEC production cuts.
- **Base and precious metals:** We continue to prefer exposure only to metals with supply tailwinds and maintain our long aluminum trade recommendation.
- **Agricultural commodities:** 2018 presents a more conducive environment for Agricultural commodity prices.

The key theme for **2018 Global Commodities Outlook** is around tactical opportunities in 2018 due to fluid fundamentals driving large price swings intra-year. The first half of 2018 could still deliver losses, however (-8.8%) due to seasonal weakness in crude prices, weak Chinese demand’s impact on base metals prices, and the Fed tightening’s impact on gold. In Energy, we expect Brent to average $60/bbl and WTI to average $54.9/bbl in 2018 to factor in the commitment on the inclusion of Libya and Nigeria in the revised OPEC. Note that forecasts are below the futures curve given money managers’ record length and the possibility of both US production growth in H1 and a mild winter. For H2 2018, we take a bullish view as markets move through seasonally tighter quarters and US supply growth stabilizes. We assume that in the absence of market balance, OPEC will agree in June, or possibly in November, to extend the cuts through to the end of 1Q19 as the current agreement is originally designed to expire at the end of 1Q18. The end of quarter targets for Brent are now $56/bbl in Q1, $58/bbl in Q2 (from $62), $62/bbl in Q3 (from $59) and $65/bbl in Q4 (from $56). We stay long on Brent Dec’19 risk reversal trade on the expectations of tighter markets by end-2018. In products, we stay tactically long Mar’18 Heating Oil call and short Apr’18 put.

In the North American Natural Gas Market, the lack of increased storage capacity amid growing baseload demand in the US is a recipe for increased price volatility and seasonality. The 2018 price forecast has remained fairly stable, now averaging $3.08/MMBtu, while price appreciation through increased export demand is expected to impact the 2019 price.

In Base & Precious Metals, we are confident that the global expansion could be sustained through next year, but we see Chinese growth moderating, presenting tactical opportunities. We continue to prefer exposure only to metals with supply tailwinds. In precious metals, given solid...
economic growth, a possible bottoming out in inflation and the potential further Fed repricing US real rates should rise pushing prices lower. We stay tactically short gold.

In Agricultural commodities, 2018 presents a more conducive environment for agriculture commodity prices to push off the recent lows and for volatility to rise. Price forecasts are lowered for the grains in 4Q17 before markets gradually edge off the lows through 2018. Weather risks also cloud the outlook on the production side, after consistent record large crops in the US and Brazil have built a degree of supply-side comfort. We stay long the J.P. Morgan Commodities Agriculture Excess Return (non-Front Month) Index.

Abhishek Deshpande, Commodities Strategy
Global Equities

- Positives still outweigh the negatives, stay Overweight equities
- Growth momentum might have peaked, but activity is still likely to remain above trend with further earnings support

Global equities had a very strong run in 2017, up 21%. It is tempting to turn bearish given the big move, the likely peaking in activity momentum and an upcoming turn in liquidity conditions. However, we believe the positives still outweigh the negatives, and stay Overweight equities into 2018 as the alternatives are uninspiring. Relative to credit, equities score the best compared to prospective total returns that other assets offer. Growth momentum might have peaked, but activity is still likely to remain above trend with further earnings support, while central bank tightening is still in early stages with US real policy rates outright negative at present. None of the last eight downturns started with real rates below 2%. The yield curve is flattening, but is unlikely to invert until at least the second half of 2018, and crucially, equities have never peaked before the yield curve becomes outright inverted.

Regionally, we believe EM (Neutral) will consolidate versus the Developed Markets entering 2018, post the big rally – we had tactically cut our Overweight EM versus DM in September. At time of publishing, our strategists expect US equities to deliver +5% in early 2018 while Europe to deliver +9%, Eurozone +12%, UK +7%, EM equities +18% and Japan +14% in full year 2018 total returns. We are Overweight Japan on continued BoJ accommodation. Eurozone (OW) is a beneficiary of a potential repricing higher in bond yields and less pressure from the Euro, at least in the first half of 2018. We expect 12% total return upside for Eurozone in 2018, driven by 10% EPS growth. We remain Underweight UK despite its poor run. UK’s growth-policy trade-off is unappealing and political risks remain.

In the fourth quarter we argued entering that the market will witness a rotation into Value and Financials (OW), away from Growth and Tech (Neutral), and believe that this move might have legs in 2018. Banks and Insurance benefit if J.P. Morgan’s call for higher rates comes through. Cyclicals (Neutral) are likely to consolidate, post the very strong run, peaking in activity momentum and stretched valuations – we recently cut the group from Overweight. We remain Underweight Defensives, but have a preference for Euro utilities. Our pecking order into 2018 is: Overweight Financials, Neutral Cyclicals and Neutral Tech, Underweight Defensives.

Mislav Matejka, Global Equity Strategy
US Equities

- Strong global growth, reflationary backdrop, and still relatively easy monetary policy have driven global equities sharply higher in 2017 and we believe the strong momentum is likely to spill into next year
- We recommend investors remain Overweight sectors that would benefit from global reflation dynamics and declining regulatory burden

Our US equity strategists see the S&P 500 reaching 3,000 by the end of 2018, and the earnings forecast (including tax reform) is $153, implying 13% price gains. In our view, strong global growth, reflationary backdrop, and still relatively easy monetary policy have driven global equities sharply higher in 2017 (S&P 500 +16%, MSCI World ex-US +19%, and EM +34%). We believe the strong momentum is likely to spill into next year, especially with a positive outcome for corporate tax reform and continued growth out of EM/China. While the S&P 500 P/E has re-rated by two turns over the last two years, we expect S&P 500 companies to deliver performance in line with earnings growth (9-10%) with upside tied to tax reform.

The business portion of the tax plan could increase S&P 500 EPS up to ~$12/share, in our view. Half of the earnings upside (~$10) is due to tax reform, and the other half due to top line growth (~$7), margin expansion (~$1.50) and buybacks (~$2.50). However, industry pricing power should be the primary determinant of how much of this upside is retained by shareholders versus competed away and passed down to end-users. This catalyst for the market should drive significant rotations with elevated dispersion across style, sector, and size.

We now advocate fully rotating into Value from Growth as Value companies should see the greatest EPS benefit from the tax reform given that they have the highest domestic revenue at 76.9% (of total revenue) and carry the highest effective tax rate of 30.3% relative to other styles. We recommend investors remain Overweight sectors that would benefit from global reflation dynamics and declining regulatory burden (Financials, Energy, Materials, and Industrials) and Underweight interest rate-sensitive bond proxies (Staples, Utilities, REITs) and multinational growth such as Technology.

Dubravko Lakos-Bujas, Head of US Equity and Global Quantitative Strategy

Marko Kolanovic, PhD, Global Head of Macro Quantitative and Derivatives Strategy
Emerging Markets Equities

- We forecast robust inflow of funds into EM equities ($70bn) and stable EM FX
- We are currently Neutral on EM equities (versus global) as near-term dollar flattening into year-end could cap upside in the near term

We think Emerging Markets equities will deliver double-digit appreciation in 2018 (our MSCI EM target for 2018 year-end is 1,300, implying USD+18% upside), driven by earnings growth and modest room for multiple expansion (see EM Equity Strategy – Upside remains, despite a bumpier road). The EM growth premium likely will increase as we advance into 2018 and J.P. Morgan forecasts robust inflow of funds into EM equities ($70 billion) and stable EM FX. The bull/bear case range is 1,450/900, with the biggest risk coming from Fed hikes and inflation dynamics, which will remain under heavy scrutiny. The macro outlook supports our views as EM equities should continue to benefit from synchronized global growth and benign EM domestic dynamics via a sustained rise in private sector confidence, and the EM credit impulse turning positive.

The EPS growth premium to Developed Markets (DM) remains attractive (2018 EPS +12%), with modest optionality on re-rating (EM equities forward P/E is at a 30% discount to US equities). While rates are moving higher in DM, EM fundamentals are strong. Our key calls are Overweight China, Korea, Brazil, Russia, Peru, Information Technology, Financials, Consumer Discretionary and Materials, and Underweight South Africa, Mexico, Turkey, Colombia, Utilities, Consumer Staples, Telecom, Industrials and Energy. Cyclically, investors should ride insurance rates and rising Asian bank NIMs as a result. Our long views are focused on secular growth opportunities in IT and price support for commodities. On a tactical basis, J.P. Morgan is currently Neutral on EM equities (versus global) as near-term dollar flattening into year-end could cap upside in the near term.

Pedro Martins Junior, Emerging Market Equity Strategy
Global Credit

- Higher spread dispersion in a less-correlated world
- US spreads to tighten a little, Euro spreads to widen
- High Yield to decompress versus High Grade

As far as credit markets are concerned, we foresee a decidedly less-correlated world in 2018; that is, in market parlance, we expect to see more dispersion – cross-market and both inter- and intra-sectoral – as central banks gradually roll back accommodation. This is reflected in the distribution of our 2018 spread and total return forecasts (see table). These have been out there for 3-4 weeks now and, while it is perhaps premature to mark our year-ahead views to market, it’s a case of so far, so good.

Spread and Return Forecasts Globally

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Source: J.P. Morgan Global Credit Research.

We highlight six factors which will potentially shape the contours of the 2018 global credit market outlook, some global, some regional.

**#1 US tax reform**: We continue to await final details (and actual passage), but, from what we know, we see impacts on both bond issuance and tax burdens. For High Grade companies, most of the impact will be on bond issuance. Companies with significant overseas cash, primarily in the Technology and Pharmaceuticals sectors, will likely issue fewer bonds. Their Treasury teams will also likely buy fewer short-dated bonds, potentially leading to a flatter spread curve. M&A is likely to rise next year, as 2017 M&A was light while companies awaited tax reform clarity, specifically the issue of interest expense deductibility. We do not expect much impact on capex spending, as most of this is driven by the commodity sector, where the key variable is the expectation of future commodity prices, with tax considerations secondary.
In High Yield, we do not see much impact on issuance from the tax bill, but there will be more dispersion between winners and losers with regard to changes in their tax burdens. The provision which limits the interest expense deduction to an amount up to 30% of EBITDA (the House proposal) or EBT (the Senate proposals) is the most uncertain at this point. If EBT is the threshold in the final bill then it will impact many more High Yield companies than if EBITDA is the threshold. Companies with significant capex (which becomes immediately deductible) will be relatively better off than those without. We will publish an updated set of estimates regarding the impact of tax reform once the final package has been agreed and passed.

**#2 The foreign demand for dollar spread product:** J.P. Morgan’s 2018 macro narrative means four more 25bp rate hikes versus a 35-40bp rise in Treasury yields. Against the backdrop of modestly tighter US High Grade spreads, it’s not clear investment grade corporate bond yields will fully offset the rise in FX hedging costs. This said, a related issue is whether all-in yields rise sufficiently to entice domestic buyers.

**#3 secured versus unsecured credit markets:** While securitized product fundamentals are solid, there will be $165 billion of Agency MBS which will need to find a home. Our SPG Research team thinks this will push option-adjusted spreads 20bp wider over the course of the next 12 months. Our assessment is that this should not be disruptive from the perspective of (unsecured) corporate bond spreads given that the High Grade Corporate-Mortgage Bond spread differential remains relatively wide.

**#4 increased business risk and disruption:** Some sectors which used to be regarded as defensive are seen as much less so today. ‘Disruption’ is highly relevant here. As some of the recent price action in the High Yield Cable and Technology sectors shows, markets can be very unforgiving in the case of large, liquid capital structures. Moreover, how companies respond or try to get ahead of disruption can have meaningful implications for creditors. CVS’s acquisition of Aetna is highly illustrative in this regard.

**#5 will we ever see a European credit cycle:** A standard operating assumption has been that there was always a 12-18 month lag between the US and Europe in credit cycle terms. Quite honestly, it feels like this lag has been extended for reasons which are not quite clear, not least given a best-in-memory operating environment and how central bank asset purchases have shifted the cost of debt relative to equity.

**#6 interest rates rubbing up credit markets the wrong way:** This week’s Fed and ECB meetings, at which both institutions formally raised their 2018
growth forecasts, once gain raise questions regarding the interaction between interest rates and credit spreads going forward. The Fed’s economic optimism supports the J.P. Morgan forecast of four rate hikes next year. The upward forecast revisions and Draghi’s press conference remarks that risks to the central bank’s Euro-area growth forecasts are tilted to the upside raise the risk that the ECB hits the brakes harder and earlier than currently expected. To the extent we can think of a credit spread as an option premium, what’s key here for credit markets is how this translates in interest rate volatility terms, with higher rate volatility implying potentially wider spreads.

*Stephen Dulake, Global Head of Credit Research*
EM Fixed Income

- With the global economy forecast above-potential growth, the gap between EM and DM growth is expected to widen.
- Risks to monitor for EM asset returns continue to be rising rates, particularly US rates.
- We forecast EM local markets returns of 6.7% from carry, with less than 1% from local duration and flat FX spot returns.

**Emerging Markets fundamentals support mid-to-high single-digit returns in 2018 despite rising Developed Markets rates.** EM fixed income assets will continue to be driven by the interaction between two strong cycles in 2018: EM growth and rising US rates. With the global economy forecast for another year of above-potential growth, the gap between EM and DM growth is expected to widen as EM GDP growth is expected to nudge higher. Risks to monitor for EM asset returns continue to be rising rates and US exceptionalism, particularly at points when rising US rates and a stronger USD will limit returns and raise questions of EM vulnerabilities. However, we see the asset class as much less susceptible to “tantrum” concerns given improvements in macro fragilities since 2013, but there are countries with weaknesses, and there will be times like in the past couple of months when returns could turn negative for local markets.

**Our base case for 2018 assumes that the interaction of higher EM growth and US rates cycles will still allow positive returns for EM fixed income, although rising rates will constrain these to around mid-single digits in USD terms.** We forecast EM local markets returns of 6.7% (for GBI-EM in USD), coming mostly from carry, with less than 1% from local duration and flat FX spot returns. 1Q18 is likely to see the weakest returns for EM local markets as FX returns could be negative due to a stronger USD as Fed hikes are delivered in the US and with a weaker EM-DM growth differential at the start of the year. For EM credit, we see 7% returns for EM sovereigns (EMBIGD) and 6% for EM corporates (CEMBI), coming from carry and around 50bp of spread tightening in both to counteract the impact of rising US rates.

*Luis Oganes*, Global Head of Emerging Markets Research

*Jonny Goulden*, Head of EM Local Markets and Sovereign Debt Strategy
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