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MARKET INSIGHTS

Quarterly Perspectives

Asia | 1Q 2019

J.P. Morgan Asset Management is pleased to present the latest edition of ***Quarterly Perspectives***. This piece explores key themes from our ***Guide to the Markets***, providing timely economic and investment insights.

THIS QUARTER'S THEMES

1. The global economy: From great to good
2. Focus on volatility given lower expected returns
3. Fixed income: Growth momentum key to allocation
4. What would spur a rise in Asian equities?

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The global economy: From great to good

UNITED STATES: LEVERAGE - *page 4*

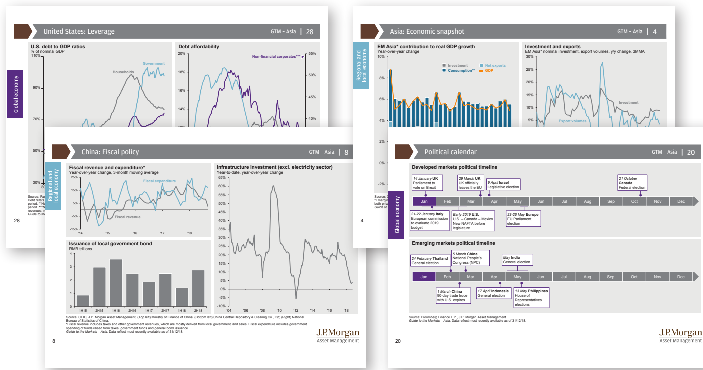
CHINA: FISCAL POLICY - *page 4*

ASIA: ECONOMIC SNAPSHOT - *page 5*

POLITICAL CALENDAR - *page 5*

OVERVIEW

- Global economic growth momentum is expected to ease in 2019 from above-trend to trend growth, curbed by dwindling spare capacity, trade uncertainties and monetary policy normalization.
- The U.S. Federal Reserve is expected to keep raising policy rates toward neutral, but China is switching to an easing bias to support growth.
- As investors adjust their asset allocation when the economy moves deeper into the late cycle, volatility could rise. Still, this should allow investors to take a balanced approach toward risk assets such as global equities, corporate credit and emerging market (EM) debt entering 2019.



INVESTMENT IMPLICATIONS

- Global growth at trend suggests investors should enter 2019 with a continued balanced approach to risk assets, such as global equities, corporate credit and emerging market debt. As economic growth slows in the next 18-24 months, investors should gradually rotate to a more defensive allocation.
- An internationally diversified equity portfolio would be appropriate following a year of U.S. equity outperformance. If our expectation of a weakening of the U.S. dollar proves correct, Asian and EM equities could benefit.
- High yield corporate debt is still supported by fundamentals, while EM debt offers attractive value opportunities. Investors will likely gear toward U.S. Treasuries later as the cycle draws to a close.
- In the long run, cash underperforms both equities at times of growth and U.S. government bonds in a bear market.

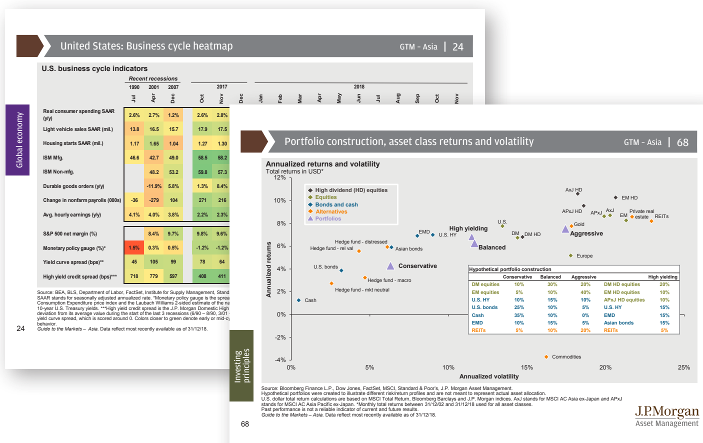
Focus on volatility given lower expected returns

UNITED STATES: BUSINESS CYCLE HEATMAP - *page 6*

PORTFOLIO CONSTRUCTION, ASSET CLASS RETURNS AND VOLATILITY - *page 7*

OVERVIEW

- The outlook for global growth has become slightly more uncertain. Recent economic data releases are not pointing toward an imminent recession, but the U.S. economy is moving deeper into the late cycle. Returns from equities are likely to be modest compared with the past 10 years; managing portfolio volatility should gradually become the priority. Having a plan to deal with the next downturn is crucial in order to ease investor anxiety. This plan should include greater emphasis on U.S. government bonds and high dividend equities.



INVESTMENT IMPLICATIONS

- Global growth remains positive, but investors are becoming more mindful of downside risks to the global economy. Their greater risk sensitivity could increase market volatility.
- This scenario warrants a game plan to position investor portfolios for a downturn and avoid panic when it comes. The plan should involve a rotation to less volatile asset classes or those with less cyclical sensitivity, potentially including fixed income or high dividend equities that can provide a total return cushion for portfolios.

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Fixed income: Growth momentum key to allocation

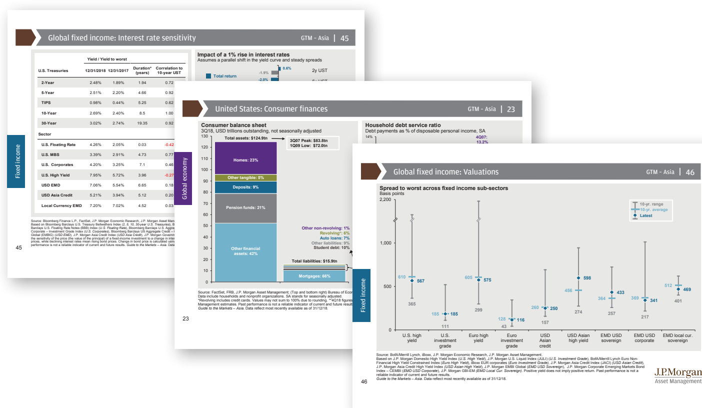
GLOBAL FIXED INCOME: INTEREST RATE SENSITIVITY - *page 8*

UNITED STATES: CONSUMER FINANCES - *page 8*

GLOBAL FIXED INCOME: VALUATIONS - *page 9*

OVERVIEW

- Fixed income has been a challenging market for investors in 2018. We expect fixed income performance to improve in 2019, but the asset class may come under added pressure relative to equities as major central banks continue to normalize monetary policy and as interest rates and bond yields move higher. However, as growth momentum slowly wanes, investors will likely become more conservative in their allocations and adopt a more agile approach, marked by diversification among the different types of fixed income assets.



INVESTMENT IMPLICATIONS

- Steady global growth continues to benefit high yield corporate debt and hard currency EM debt.
- The very tight labor market, rising incomes and still-low interest rates continue to provide a solid foundation for U.S. consumer asset-backed securities credit trends.
- A sustained slowdown in global momentum in the medium term would warrant an investor rotation toward long duration U.S. government bonds.

What would spur a rise in Asian equities?

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CHINA: CREDIT AND LEVERAGE - *page 11*

APAC EX-JAPAN: EQUITIES SNAPSHOT - *page 11*

OVERVIEW

- Heightened trade tension, U.S. dollar strength and worries over the Chinese economy created a challenging environment for Asian equities in 2018. The reversal of some of these negatives is essential if Asian equities are to again outperform developed market equities. We believe the resumption of U.S. dollar depreciation, economic stimulus from Beijing and some stabilization in U.S.-China trade tensions would be important catalysts to renew investor confidence in Asia's stock markets. Relatively attractive valuations, and the continuing expansion of the global trade cycle that has provided crucial support to corporate earnings, would be further positives.

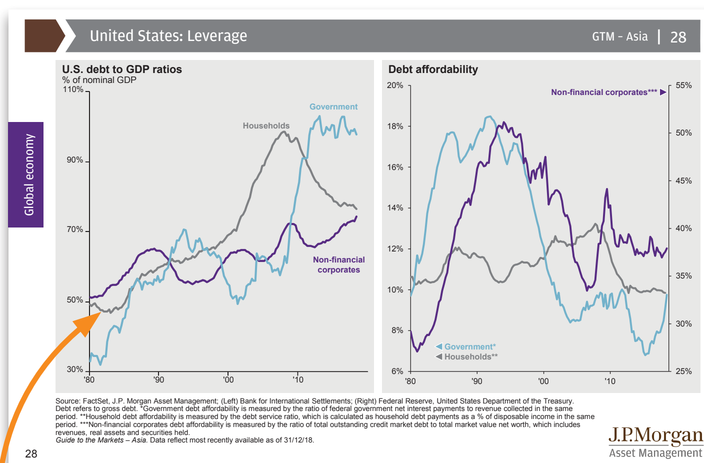
INVESTMENT IMPLICATIONS

- We have a stronger conviction on the U.S. dollar depreciating and on Chinese economic stimulus stabilizing investor confidence. Trade tension between the U.S. and China is unlikely to ease significantly, but for now, avoiding any deterioration is arguably good enough for investors.
- In addition, steady earnings fundamentals and reasonable valuation should encourage investors to include Asian equities as part of their asset allocation and contribute to return performance.

1 The global economy: From great to good

OVERVIEW

Global economic growth momentum is expected to ease in 2019 from above-trend to trend growth, curbed by dwindling spare capacity, trade uncertainties and monetary policy normalization. The U.S. Federal Reserve (Fed) is expected to keep raising policy rates toward neutral, but China is switching to an easing bias to support growth. As investors adjust their asset allocation when the economy moves deeper into the late cycle, volatility could rise. Still, this should allow investors to take a balanced approach toward risk assets such as global equities, corporate credit and emerging market (EM) debt entering 2019.

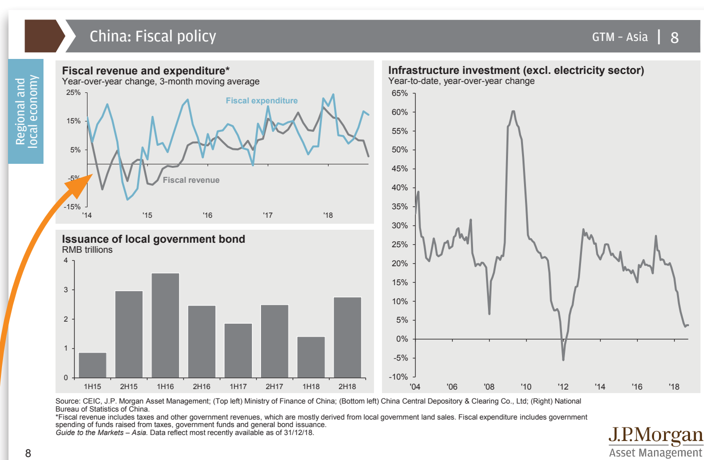


Source: *Guide to the Markets – Asia*, page 28

- **Strong household balance sheets to support consumption; corporate leverage deserves monitoring.**

U.S. fiscal and monetary policy to temper growth

- A strong job market and relatively healthy household balance sheets are supporting U.S. consumers. The corporate debt-to-GDP ratio has reached a post-global financial crisis peak, but relatively low financing costs and strong profits are helping to sustain capital expenditure growth.
- Fiscal and monetary policies are likely to bring U.S. economic growth back to trend following a strong 2018. The boost from tax reform is expected to fade in 2019, and fresh fiscal stimulus is unlikely with a Democrat-controlled House of Representatives. Two more hikes in 1H 2019 would bring the policy rate to 2.75%–3.00%, consistent with the Fed's long-run forecast. This would be a modest rate in real terms, but the prospect of Fed hikes beyond this level could prompt companies to be more cautious about capital investments.



Source: *Guide to the Markets – Asia*, page 8

- **Fiscal policy to provide quick relief to the Chinese economy.**

China shifting toward more stimulus

- The Chinese economy has decelerated due, in part, to two years of corporate deleveraging, as well as uncertainties surrounding trade tensions with the U.S. in 2018. In response, Beijing's economic policy priority is shifting from addressing excess leverage to stabilizing growth. While remaining attentive to financial risk mitigation, the government's monetary policy bias in 2019 will likely tilt toward reinforcing business and consumer confidence.
- Expansive fiscal policy, especially infrastructure spending, should provide quick relief to the Chinese economy. Tax cuts could boost business earnings and/or prompt private sector investment. Monetary easing, however, could be limited, both to prevent another debt-fueled boom and because it is a relatively slow and uncertain mechanism for stimulating the economy.

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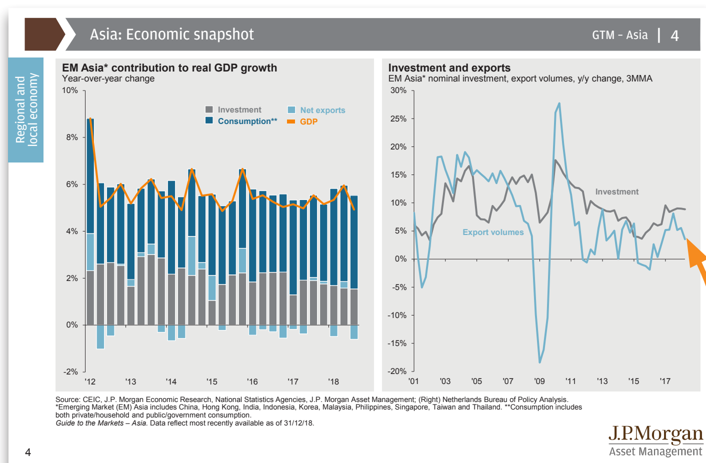
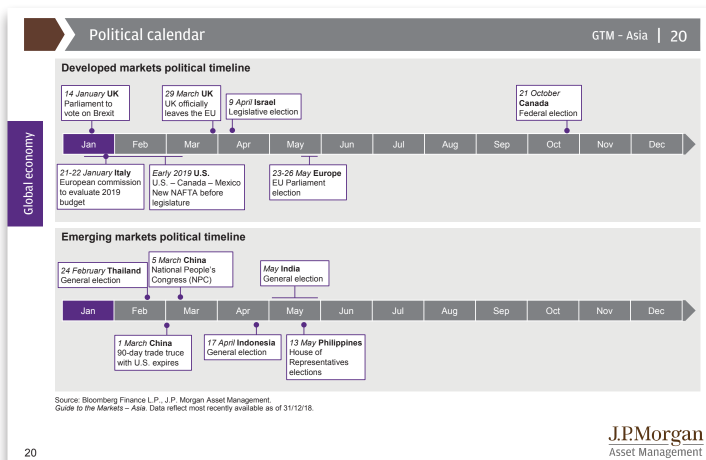


Source: *Guide to the Markets - Asia*, page 4

- **Asian export volumes still expanding at around 5% annually.**

Asia trade cycle is key to earnings and sentiment

- Despite the ongoing trade dispute between the U.S. and China, the Asian export volume continues to grow by about 5% annually. While some attribute this decent performance to efforts by Chinese exporters to ship products ahead of further tariff increases, demand from consumers around the globe remains robust. The depreciation of Asian currencies in 2018 has also helped to enhance the competitiveness of Asian exports.
- Asian authorities would need to mobilize greater domestic demand to help offset the downside risk in the global economy over the next 18-24 months. However, policy rates in most Asian countries are already low. Room for rate cuts in India and Indonesia, where rates were raised in 2018 to stabilize local currencies, remains limited until the U.S. dollar weakens.



Source: *Guide to the Markets - Asia*, page 20

- **U.S.-China trade tension remains the most potent risk for 2019.**

Risk factors to watch out for:

- U.S.-China trade tension remains the most potent risk factor for 2019, given the potential economic repercussions around the world. The agreement established during the 2018 G20 Leaders' Summit to delay further tariff escalation is a plus, but a sustained resolution is unlikely, given the growing rivalry between Beijing and Washington.
- Tensions in the Middle East, 2019 elections in India and Indonesia, political uncertainties within the European Union and a no-deal Brexit could also raise market anxiety. Some of these factors are not expected to have material global impact; investors should stay calm and assess worrisome headlines rationally.

INVESTMENT IMPLICATIONS

- Global growth at trend suggests investors should enter 2019 with a continued balanced approach to risk assets, such as global equities, corporate credit and emerging market debt. As economic growth slows in the next 18-24 months, investors should gradually rotate to a more defensive allocation.
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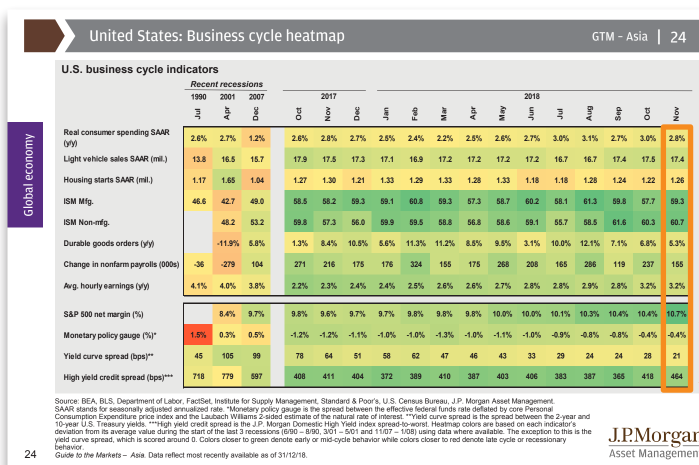
2 Focus on volatility given lower expected returns

OVERVIEW

The outlook for global growth has become slightly more uncertain. Recent economic data releases are not pointing toward an imminent recession, but the U.S. economy is moving deeper into the late cycle. Returns from equities are likely to be modest compared with the past 10 years; managing portfolio volatility should gradually become the priority. Having a plan to deal with the next downturn is crucial in order to ease investor anxiety. This plan should include greater emphasis on U.S. government bonds and high dividend equities.



United States: Business cycle heatmap — GTM – Asia | 24

Global economy

U.S. business cycle indicators

	Recent recessions			2017			2018										
	1990 Jul	2001 Apr	2007 Dec	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
Real consumer spending SAAR (y/y)	2.6%	2.7%	1.2%	2.6%	2.8%	2.7%	2.5%	2.4%	2.2%	2.5%	2.6%	2.7%	3.0%	3.1%	2.7%	3.0%	2.8%
Light vehicle sales SAAR (mil.)	13.8	16.5	15.7	17.9	17.5	17.3	17.1	16.9	17.2	17.2	17.2	17.2	16.7	16.7	17.4	17.5	17.4
Housing starts SAAR (mil.)	1.17	1.65	1.04	1.27	1.30	1.21	1.33	1.29	1.33	1.28	1.33	1.18	1.18	1.28	1.24	1.22	1.26
ISM Mfg.	46.6	42.7	49.0	58.5	58.2	59.3	59.1	60.8	59.3	57.3	58.7	60.2	58.1	61.3	59.8	57.7	59.3
ISM Non-mfg.		48.2	53.2	59.8	57.3	56.0	59.9	59.5	58.8	56.8	58.6	59.1	55.7	58.5	61.6	60.3	60.7
Durable goods orders (y/y)		-11.9%	5.8%	1.3%	8.4%	10.5%	5.6%	11.3%	11.2%	8.5%	9.5%	3.1%	10.0%	12.1%	7.1%	6.8%	5.3%
Change in nonfarm payrolls (000s)	-36	-279	104	271	216	175	176	324	155	175	268	208	165	286	119	237	155
Avg. hourly earnings (y/y)	4.1%	4.0%	3.8%	2.2%	2.3%	2.4%	2.4%	2.5%	2.6%	2.6%	2.7%	2.8%	2.8%	2.9%	2.8%	3.2%	3.2%
S&P 500 net margin (%)		8.4%	9.7%	9.8%	9.6%	9.7%	9.7%	9.8%	9.8%	9.8%	10.0%	10.0%	10.1%	10.3%	10.4%	10.4%	10.7%
Monetary policy gauge (%)*	1.5%	0.3%	0.5%	-1.2%	-1.2%	-1.1%	-1.0%	-1.0%	-1.3%	-1.0%	-1.1%	-1.0%	-0.9%	-0.8%	-0.8%	-0.4%	-0.4%
Yield curve spread (bps)**	45	105	99	78	64	51	58	62	47	46	43	33	29	24	24	28	21
High yield credit spread (bps)***	718	779	597	408	411	404	372	389	410	387	403	406	383	387	365	418	464

Source: BEA, BLS, Department of Labor, FactSet, Institute for Supply Management, Standard & Poor's, U.S. Census Bureau, J.P. Morgan Asset Management. SAAR stands for seasonally adjusted annualized rate. *Monetary policy gauge is the spread between the effective federal funds rate deflated by core Personal Consumption Expenditure price index and the Laubach Williams 2-sided estimate of the natural rate of interest. **Yield curve spread is the spread between the 2-year and 10-year U.S. Treasury yields. ***High yield credit spread is the J.P. Morgan Domestic High Yield index spread-to-worst. Heatmap colors are based on each indicator's deviation from its average value during the start of the last 3 recessions (6/90 – 8/90, 3/01 – 5/01 and 11/07 – 1/08) using data where available. The exception to this is the yield curve spread, which is scored around 0. Colors closer to green denote early or mid-cycle behavior while colors closer to red denote late cycle or recessionary behavior.

24 *Guide to the Markets – Asia.* Data reflect most recently available as of 31/12/18.

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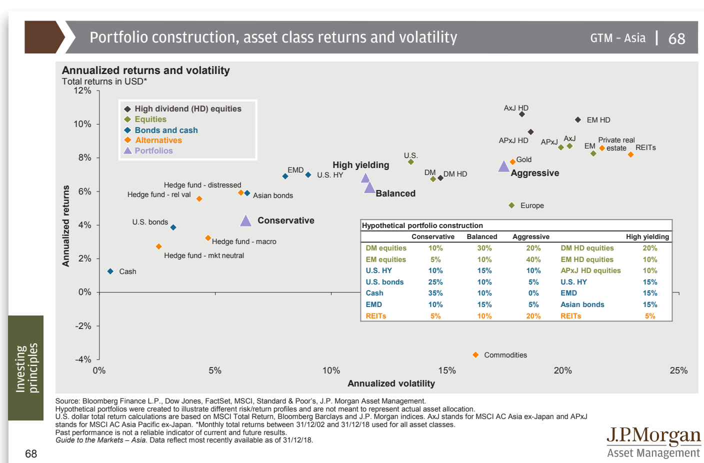
Source: *Guide to the Markets - Asia*, page 24

- **Indicators are not signaling imminent recession, but rather, time for caution.**

Time for some caution

- The U.S. expansion is now in its 10th year and the Fed is set on a tightening path for interest rate policy, albeit a slow one. The global economy is still positioned such that a slowdown in the U.S. will mean a slowdown for the rest of the world. While there is always uncertainty about the exact timing of a cycle turn, higher frequency U.S. cyclical economic indicators show that a recession or significant slowdown does not appear imminent. The late stage of the cycle can still last for some time, despite the pressures we are seeing from multiple directions.
- However, the potential risks suggest that investors may want to start focusing more on volatility management than on capital gains. It takes time for a portfolio to recuperate from a drawdown. Not every investor will be at a stage of life where they have the luxury of time to wait for their investments to recover.



	Conservative	Balanced	Aggressive		High yielding
DM equities	10%	30%	20%	DM HD equities	20%
EM equities	5%	10%	40%	EM HD equities	10%
U.S. HY	10%	15%	10%	APxJ HD equities	10%
U.S. bonds	25%	10%	5%	U.S. HY	15%
Cash	35%	10%	0%	EMD	15%
EMD	10%	15%	5%	Asian bonds	15%
REITs	5%	10%	20%	REITs	5%

Source: *Guide to the Markets – Asia*, page 68

- **Heed risk and return trade-offs; go beyond cash and bonds.**

No need to panic if you have a game plan

- Paying attention to risk is healthy. As the global economy progresses deeper into the late cycle, investors are right to prepare for the downturn. Having a plan in place can help reduce panic when recession eventually arrives.
- Still, shifting all investments to a more defensive stance could be a bad idea. On average, expansions have lasted much longer than contractions. Being risk-off the majority of the time tends to be detrimental to returns, despite the difficulty of perfectly timing a downturn. A slow rotation from an aggressive to a more defensive portfolio is likely the more suitable answer.
- A common defensive move to consider is shifting toward a greater allocation to bonds. Fixed income assets have struggled over the past year, but they are less volatile and more defensive during a slowdown. Those that are less sensitive to higher interest rates and offer more attractive yield can help during times of poor market performance.
- Income generation from high dividend-yielding equities can also provide some cushion in the event of a slowdown. A portfolio comprised of only high dividend indices and higher yielding fixed income appears to have had quite a favorable risk and return profile over the past 15 years.

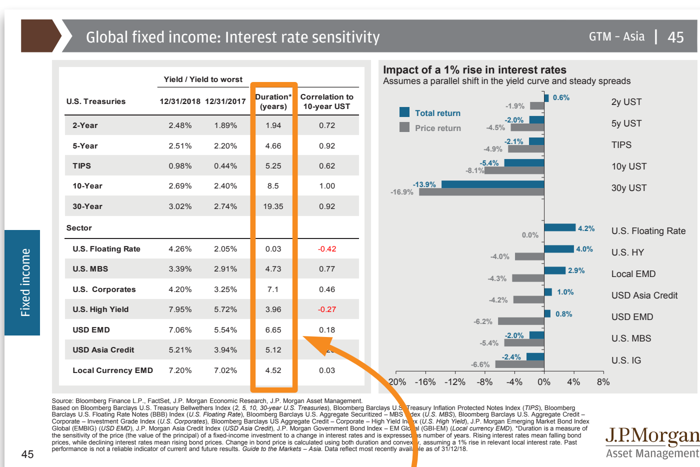
INVESTMENT IMPLICATIONS

- Global growth remains positive, but investors are becoming more mindful of downside risks to the global economy. Their greater risk sensitivity could increase market volatility.
- This scenario warrants a game plan to position investor portfolios for a downturn and avoid panic when it comes. The plan should involve a rotation to less volatile asset classes or those with less cyclical sensitivity, potentially including fixed income or high dividend equities that can provide a total return cushion for portfolios.

3 Fixed income: Growth momentum key to allocation

OVERVIEW

Fixed income has been a challenging market for investors in 2018. We expect fixed income performance to improve in 2019, but the asset class may come under added pressure relative to equities as major central banks continue to normalize monetary policy and as interest rates and bond yields move higher. However, as growth momentum slowly wanes, investors will likely become more conservative in their allocations and adopt a more agile approach, marked by diversification among the different types of fixed income assets.



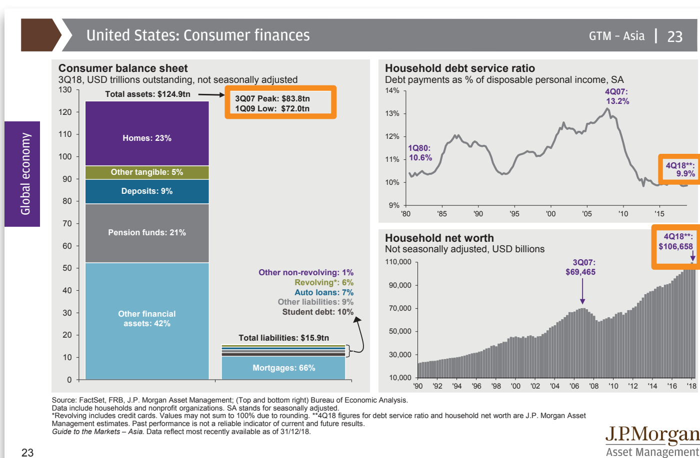
U.S. Treasuries	Yield / Yield to worst 12/31/2018	Yield / Yield to worst 12/31/2017	Duration* (years)	Correlation to 10-year UST
2-Year	2.48%	1.89%	1.94	0.72
5-Year	2.51%	2.20%	4.66	0.92
TIPS	0.98%	0.44%	5.25	0.62
10-Year	2.69%	2.40%	8.5	1.00
30-Year	3.02%	2.74%	19.35	0.92
Sector				
U.S. Floating Rate	4.26%	2.05%	0.03	-0.42
U.S. MBS	3.39%	2.91%	4.73	0.77
U.S. Corporates	4.20%	3.25%	7.1	0.46
U.S. High Yield	7.95%	5.72%	3.96	-0.27
USD EMD	7.06%	5.54%	6.65	0.18
USD Asia Credit	5.21%	3.94%	5.12	[illegible]
Local Currency EMD	7.20%	7.02%	4.52	0.03

Source: *Guide to the Markets – Asia*, page 45

- **Investors can consider adding back some duration to fixed income portfolios.**

Add back duration as downside risks materialize

- We anticipate that the G4 (the U.S., the UK, the eurozone and Japan) central banks will continue policy normalization in 2019. As such, we expect those countries' government bond yields to remain skewed higher, suggesting a short duration bias in portfolios.
- However, the moderating outlook for rates and increasing speculation of a turn in the cycle as economic data weakens further over the next 18-24 months should drive more capital into longer duration bonds. Gradually increasing exposure to government debt, and slowly adding back some duration, could help buffer investors against growth concerns and bouts of risk aversion.

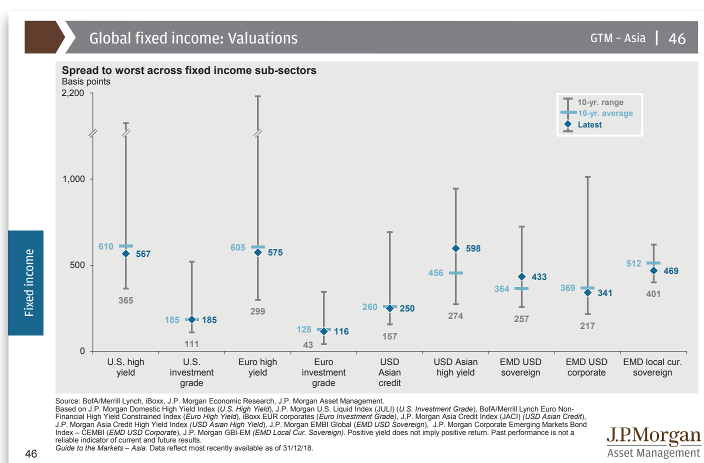


Source: *Guide to the Markets – Asia*, page 23

- **U.S. consumers' financial health much improved vs. a few years ago.**

Upcoming market conditions favor consumer ABS

- Our base case for 2019 remains one of positive economic growth in the U.S., albeit at a slower pace compared to 2018. Admittedly, recession risks are on the rise, but the very tight labor market, rising incomes and still-low interest rates continue to provide a solid foundation for U.S. consumer asset-backed securities (ABS) credit trends.
- Market volatility will likely increase this year, which tends to benefit high-quality, stable ABS sectors. Meanwhile, relatively strong lending conditions are likely to reduce concerns about the near-term credit performance of most ABS sectors. In particular, U.S. consumer balance sheets are still looking healthy with households' aggregate debt burden, as well as credit card and auto loan charge-offs, all remaining at low levels.



Source: *Guide to the Markets - Asia*, page 46

- **Hard currency EM debt and high yield corporate debt are looking attractive.**

Value arises for credit investors to buck the trend

- Credit markets saw sharp price moves in 2018. After a volatile year, EM debt has been among the underperformers, with spreads for EM corporates and EM sovereigns at their widest levels since 2016. Even more pronounced has been the underperformance in the U.S. and European high yield markets.
- A number of factors drove the credit market volatility, among them: rising interest rates, reduced earnings growth expectations, uncertainties in the energy sector due to oil prices' recent fall and trade tensions between the U.S. and China, as well as a possible slowdown in global growth.
- Although the risk-off environment may persist in the short term, valuations are starting to look more attractive. Moreover, we do not believe the rise in spreads is a sign of a looming recession or an indicator to sell out of the market, especially as fundamentals remain reasonable.
- Taking into account relative credit spreads, and the fact that BBB-rated bonds make up a rising share of the investment-grade bond segment, high yield corporate debt, in our view, still offers a better risk/reward trade-off than investment-grade debt.
- Investors may find this an appropriate time to look at fundamentally sound names within high yield corporate debt and hard currency EM debt that have been grounded by indiscriminate selling.

INVESTMENT IMPLICATIONS

- Steady global growth continues to benefit high yield corporate debt and hard currency EM debt.
- The very tight labor market, rising incomes and still-low interest rates continue to provide a solid foundation for U.S. consumer ABS credit trends.
- A sustained slowdown in global momentum in the medium term would warrant an investor rotation toward long duration U.S. government bonds.

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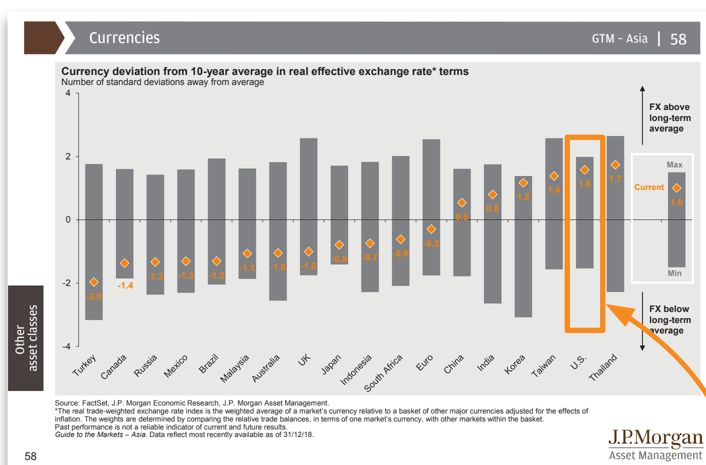
4 What would spur a rise in Asian equities?

OVERVIEW

Heightened trade tension, U.S. dollar strength and worries over the Chinese economy created a challenging environment for Asian equities in 2018. The reversal of some of these negatives is essential if Asian equities are to again outperform developed market equities. We believe the resumption of U.S. dollar depreciation, economic stimulus from Beijing and some stabilization in U.S.-China trade tensions would be important catalysts to renew investor confidence in Asia's stock markets. Relatively attractive valuations, and the continuing expansion of the global trade cycle that has provided crucial support to corporate earnings, would be further positives.



Source: *Guide to the Markets - Asia*, page 58

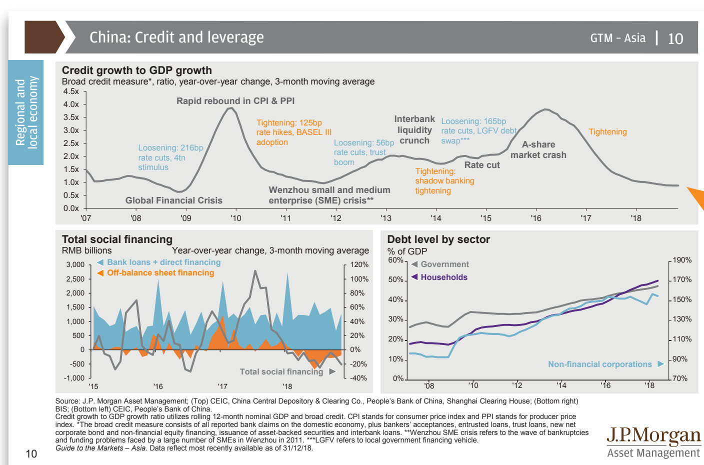
- **The USD REER is significantly above its long-term average.**

When the U.S. dollar bear wakes from hibernation

- We expect the U.S. dollar to face more downward pressure in 2019. U.S. economic and corporate earnings growth are likely to converge with the rest of the world's after an exceptional 2018. Speculation on when the Fed will stop raising interest rates would also hurt the greenback. Fundamentally, the rising current account deficit reflects strong U.S. domestic demand and an overvalued U.S. dollar. The real effective U.S. dollar exchange rate (USD REER) currently stands at 1.5 standard deviations above its 10-year average.
- A weaker U.S. dollar should allow Asian and EM central banks to run their monetary policies with greater autonomy and prompt more international capital to flow into the emerging markets and Asia. Overall, this should set up a more constructive environment for Asian assets.

U.S.-China trade tensions: Deal or no deal?

- U.S.-China tensions over tariffs are only part of the growing economic and geopolitical rivalry between the world's two largest economies. Hence, a resolution of the disputes over tariffs—and other protectionist measures—is unlikely. Nonetheless, a further escalation of the controversy over tariffs on Chinese exports to the U.S. may still be contained, based on discussions between U.S. President Donald Trump and Chinese President Xi Jinping during the 2018 G20 Leaders' Summit. Investors would likely see such containment as a large positive, given the potential damages to the U.S. economy and consumers should the list of Chinese exports subject to U.S. tariffs expand. President Trump would likely prefer to avoid actions that may dampen growth as he prepares his 2020 re-election bid.
- The battleground could easily shift from tariffs to export restrictions on sensitive technologies and on Chinese investment in U.S. technology companies. While this would be more sector specific, it would introduce uncertainties for the broader economy, especially in manufacturing.

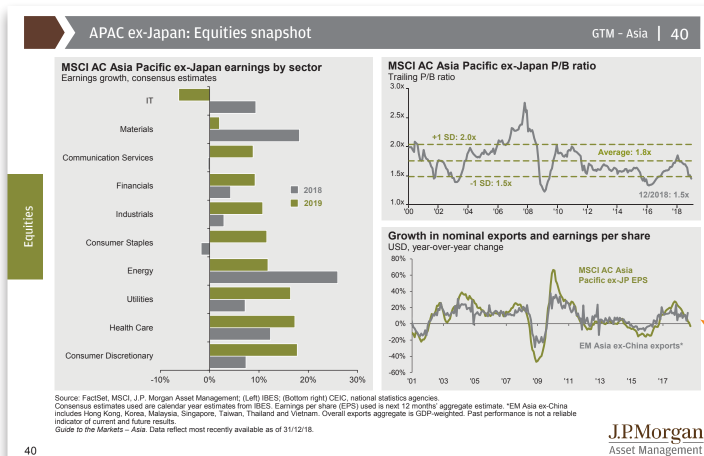


Source: *Guide to the Markets - Asia*, page 10

- **China's monetary easing is limited by worries of another leverage surge.**

China shifts from de-leveraging to growth

- Growth deceleration in 2018 due to de-leveraging and uncertainties surrounding U.S.-China trade tensions has prompted Beijing to shift its focus toward stimulating growth. This should improve market confidence in China and the region, especially as economic policy in the U.S. is slowly tightening. Government spending on infrastructure is likely to lead the way. Cuts to corporate value-added and individual income taxes are also in the cards.
- Monetary easing is tougher to execute. The People's Bank of China must be mindful not to restart another debt-fueled boom. The associated costs of excessive currency depreciation (capital outflow, additional pressure on U.S. dollar debt issuers, imported inflation) could also limit the magnitude of interest rate reduction, given the rise in U.S. dollar rates.



Source: *Guide to the Markets - Asia*, page 40

- **A healthy trade cycle is crucial to Asian corporate earnings.**

Trade supporting growth; valuations attractive

- While the U.S. dollar, trade war headlines and the Chinese economy have all weighed on investor sentiment, overall Asian economic fundamentals are solid. Export growth, closely correlated with overall corporate performance in the region, continues to expand steadily and is expected to remain positive in 2019, given strong consumer demand from the U.S. and the rest of the world.
- The valuation of Asian equities is also below its long-term average. The price-to-book ratio was at 1.5 times at the end of 2018, below the 10-year average of 1.8 times. This could attract long-term investors looking for value opportunities, especially since U.S. equities remain above their long-term average, both in price-to-earnings and price-to-book terms.

INVESTMENT IMPLICATIONS

- We have a stronger conviction on the U.S. dollar depreciating and on Chinese economic stimulus stabilizing investor confidence. Trade tension between the U.S. and China is unlikely to ease significantly, but for now, avoiding any deterioration is arguably good enough for investors.
- In addition, steady earnings fundamentals and reasonable valuation should encourage investors to include Asian equities as part of their asset allocation and contribute to return performance.

Quarterly Perspectives

Asia | 1Q 2019

NEXT STEPS

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Material ID: 0903c02a823a2b92