WorldView 3Q | 2015

The Fed, Europe after Greece and seeking value in Emerging Markets

IN BRIEF

- The Federal Reserve (Fed) is expected to start raising its policy rate before the end of the year. Factors undermining U.S. economic growth in the first half of 2015 are likely to be less of a problem going forward. Sluggish wage growth is likely to limit the pace of policy normalization, and hence any negative impact on financial markets is likely to be manageable. While fixed income remains an important part of any investor's portfolio allocation, elevated valuations imply the need for a more active and flexible approach.
- With the Greek debt tension calming, at least for now, we believe that there are more opportunities than headwinds in Europe for investors. Economic recovery and loose monetary conditions are facilitating an improvement in the region's corporate earnings. Meanwhile, the European Central Bank's (ECB) quantitative easing program is expected to keep European bond yields at low levels. Peripheral bond yields could also remain low if their governments persist with needed structural reforms.
- Investors are becoming increasingly nervous about the prospects for emerging markets due to recent weak economic growth, especially in China, the upcoming round of Fed tightening and a stronger U.S. dollar. We agree that these issues could pose challenges for emerging markets in the medium term, but believe that the impact will not be uniform across the asset class. Differentiation within the emerging world continues to be important, and investors will need to recognize that markets have already factored in some of these worries.

J.P.Morgan
Asset Management

WORLDVIEW

THE KEY TO SUCCESSFUL INVESTING is not seeing the future with some kind of mythical vision—it is seeing the present with clarity. This is more true today than ever, in a world recovering from financial crisis, rife with political discontent, extreme monetary easing and deep seated investor prejudice. In this quarterly publication, we strive to provide clarity by examining the key issues shaping the global investment landscape, while identifying risks and opportunities for investors.

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THE FED LOOKS SET TO RAISE RATES AS ECONOMIC EXPANSION CONTINUES

Samantha Azzarello, *Global Market Strategist, U.S.*

Introduction

With a long-awaited U.S. Federal Reserve (Fed) rate hike expected in September 2015, we analyze the potential impact of tightening on the equity and fixed income markets, and on investors' portfolios. We also discuss what could lie ahead for the U.S. economy in the second half of the year and beyond.

Many investors are anticipating Fed tightening with nervousness, which is understandable after seven years of near-zero rates.

Meanwhile, for the wider U.S. economy, we expect the overall trends seen over the last few years to continue: a slow and steady expansion, further improvements in the labor market and a moderate up-tick in inflation. We also expect the factors that dragged on the economy in the first half of the year to lessen in impact in the second half, but not to disappear.

VIEWPOINT

The Fed will likely raise rates in the second half of the year, with the odds in favor of a September liftoff on the back of steady labor market improvements. One key factor that could delay the Fed's move is disappointing wage growth.

Based on many of the Fed's key economic indicators, the economy no longer needs emergency measures in the form of near-zero short-term interest rates. The past few years have delivered impressive labor market growth. The strength of the economic expansion has enabled the economy to create, on average, an impressive 235,000 jobs per month, while bringing down the unemployment rate from a high of 10% in 2009 to its current level of 5.3%. This figure is on track to fall further, reaching 5% by the end of 2015. But one indicator that the Fed watches closely has so far been missing from this recovery. Wage growth has been lackluster at best, tracking core inflation and growing at about 2% per year.

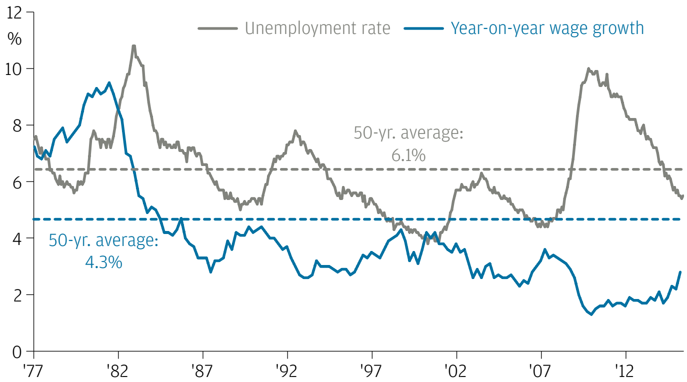
To put this into context, the 50-year average for wage growth is much higher at 4.3%. Normally, in a period of economic expansion, wages pick up significantly as the unemployment rate falls with tightness in the labor market pushing up wages (**Exhibit 1**).

WHY ARE WAGES FAILING TO RESPOND TO AN IMPROVING LABOR MARKET?

There are numerous interconnected reasons, related to the foundations of the economy, as to why wage growth has been low. First, productivity growth (defined as output per worker) has been low, with a declining trend. If labor is less productive, it does not necessarily justify higher wages in the eyes of employers. Second, an increase in the number of part-time workers in the labor force could be a factor. Median wage data shows that part-time workers experience less wage growth than their full-time counterparts. This could partly explain the drag on overall wage growth. Third, low inflation has reduced the need for wage growth: if overall prices are not rising, there is no corresponding imperative to raise wages. Another factor could be workers' loss of bargaining power as shown by the decline of private sector union membership from 16% in 1985 to 6.6% in 2014.

When unemployment comes down, wages should go up

EXHIBIT 1: CIVILIAN UNEMPLOYMENT RATE AND YEAR-ON-YEAR GROWTH IN WAGES



Source: BLS, FactSet, J.P. Morgan Asset Management. *Guide to the Markets – U.S.*, page 24. Data as of 30 June 2015. This graph and the graphs, charts and tables found herein are for illustrative purposes only.

Slow wage growth aside, the improvement of numerous indicators, from GDP growth to manufacturing purchasing managers' indices, show how far the U.S. economy has come since the depths of the recession. By this logic, near-zero interest rates – with negative real rates after accounting for inflation – are not appropriate for a growing economy no longer in crisis mode.

When the Fed begins to hike, we expect the path to be gradual. We do not expect a hike at every meeting, nor do we anticipate sharp increases, fast moves or surprises along the way. The Fed will be eager to show that it is not following a pre-ordained path, emphasizing the data and event dependent nature of the rate increases. Furthermore, the Fed will certainly have its eye on Greece, China and any other international developments through September and beyond. The central bank's Federal Open Market Committee (FOMC) currently expects two rate increases in 2015, four rate increases in 2016 and a long-run projection of the short-term rate at 3.75% (**Exhibit 2**).

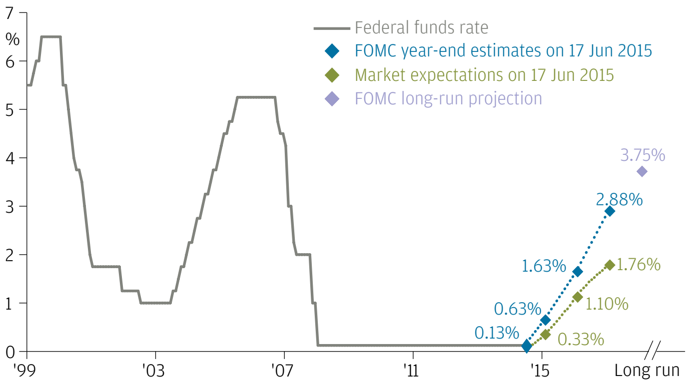
HOW IS THE FED GOING TO RAISE RATES?

This Fed hike cycle will be very different from previous ones. For example, the Fed now sets a target range for the federal funds rate, currently at 0-25 basis points (bps), with expectations for an increase to 25-50bps at the first hike. The effective federal funds rate (EFFR) will fall within this range, with the interest rate on excess reserves as the ceiling of the range and the overnight reverse repo rate as the floor of the range. The Fed will then conduct repo operations to drain liquidity from the system in order to raise the EFFR.

The path of interest rates from the Fed: No spikes and no surprises

EXHIBIT 2: FOMC FED FUNDS RATE EXPECTATIONS

FOMC year-end estimates for the Fed funds rate



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. *Guide to the Markets – U.S.*, page 33. Data as of 30 June 2015.

VIEWPOINT

In the second half of the year, the U.S. economy is on trend to continue its expansion. We expect factors that dragged on growth in the first part of the year, including oil and the strong dollar, to lessen in impact. The U.S. consumer is also on course to be a major contributor to growth.

In the first half of the year U.S. economic growth was moderate, with an upwardly-revised first-quarter growth rate of 0.6% and a second-quarter growth rate of 2.3% — not stellar, but certainly not dismal. Growth was dragged down by the strong dollar, which weakened exports, and the decline of oil prices, which adversely affected business investment.

The dollar rose 18% in the second quarter year on year against a broad basket of other currencies. Much of the dollar run is likely already over and we would expect the drag on GDP to subside. However, this will only happen once the impact of current dollar strength has flowed through the global economy. For example, as the dollar becomes more expensive, it can take time for foreign companies to re-source their exports from a different country. This is one example of how the strong dollar may continue to impact GDP growth.

While the fall in energy prices is a net positive for the consumer through lower gasoline prices, it has had a negative impact on GDP growth through substantially decreased energy investment. Interestingly, oil and gas capital expenditures represent a tiny fraction (less than 1%) of the total economy. However, the severity of the decline meant it had a significant effect on GDP in the first half of the year. Rig counts are down 55% since their peak before the oil price decline. Research shows that, historically, rig counts bottom 25 weeks after a 10% decline from a peak — and we have now reached this point. While rigs account for only a quarter of energy investment expenditures, they track the overall expenditure movements very closely. This bottoming suggests a more muted drag on energy investment expenditures in the second half of the year.

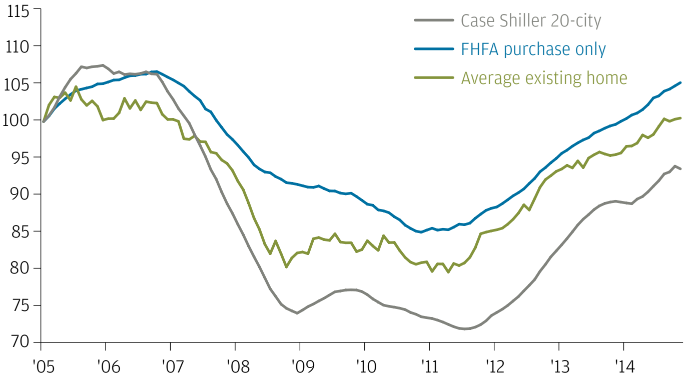
Two factors that could support growth through the second half of the year are the strength of the consumer and the strength of the housing sector. By many measures, U.S. consumers are in excellent financial shape. Household net worth has reached new highs, while the household debt service ratio — debt payments as a percent of disposable personal income - is at an all-time low. In addition, the steep decline in gas prices has added disposable income to consumers' pockets. While this has not yet led to a surge in consumer spending, the factors that are currently supporting the consumer should remain in place in the second half of the year and beyond.

Housing could also bolster second-half growth. While housing construction accounts for a small share of total GDP (approximately 3%), its ripple effects make it vital to the broader economy. For example, while gains in the stock market benefit the 42% of the population that holds equity (often indirectly through retirement accounts), this has less of an impact than the 64% of the population that owns a home and benefits from increased home equity (**Exhibit 3** on next page).

In recent years, lending standards for approved mortgage rate loans have been very high (**Exhibit 4** on next page). This indicates how tight conditions have been for consumer credit since the financial crisis, even with rates close to zero. Interestingly, banks may have a greater incentive to lend once rates increase. Locking in and lending money at such low rates - for example, through a 30-year mortgage - is not an attractive proposition for the banks with interest rates at such low levels. A rising-rate environment could spur increased credit growth, leading to higher consumer spending, including home purchases.

Home price increases help household balance sheets

EXHIBIT 3: HOUSE PRICES, INDEXED TO 100 AND SEASONALLY ADJUSTED

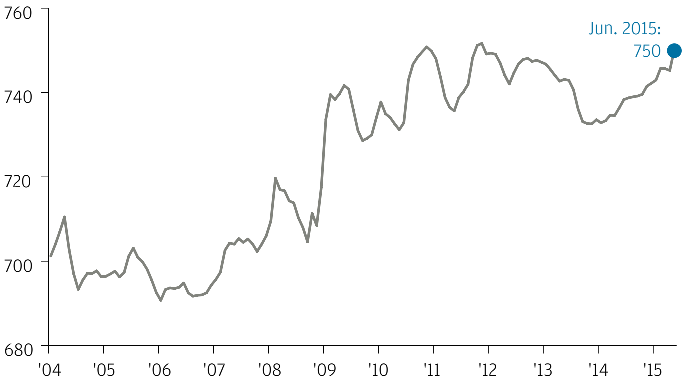


Source: FactSet, Federal Housing Finance Agency (FHFA), National Association of Realtors, Standard & Poor's, J.P. Morgan Asset Management. ***Guide to the Markets – U.S.***, page 21. Data as of 30 June 2015.

Ultra-low rates and super-tight lending standards

EXHIBIT 4: LENDING STANDARD FOR APPROVED MORTGAGE LOANS

Average FICO* score based on origination date



Source: McDash, J.P. Morgan Securitized Product Research, J.P. Morgan Asset Management. *FICO is a primary provider of credit scores in the U.S.. ***Guide to the Markets – U.S.***, page 21. Data as of 30 June 2015.

VIEWPOINT

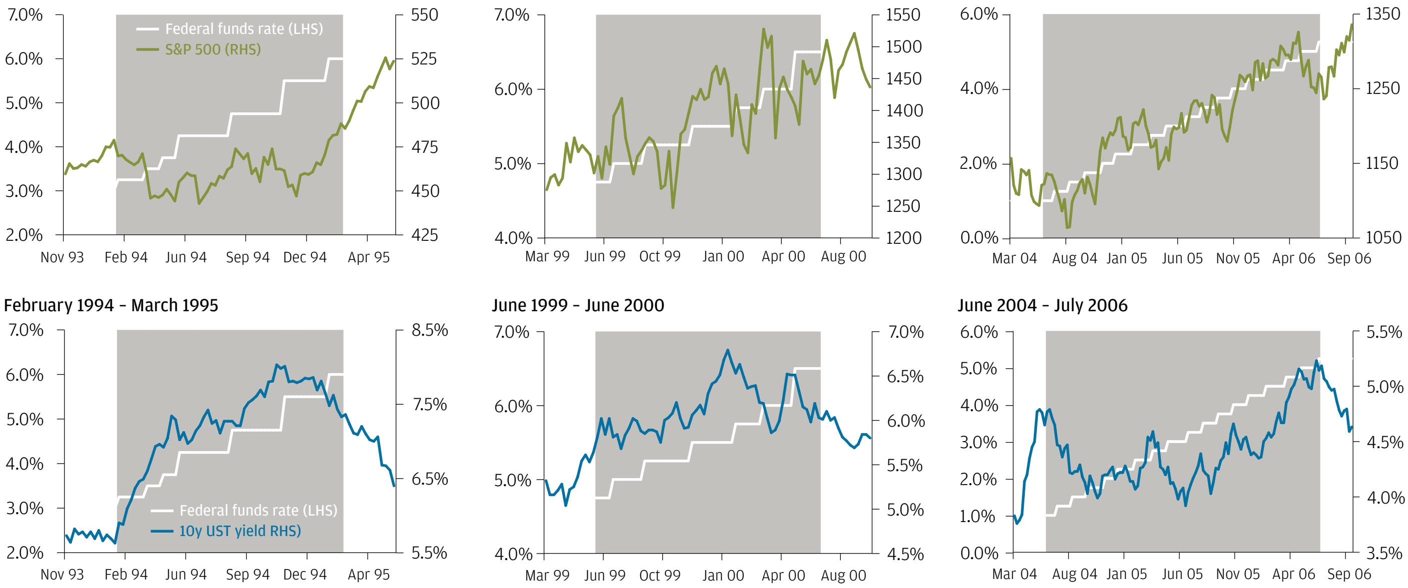
Historically, rate-tightening cycles have not been bad for equity markets, but the same cannot be said for fixed income markets. Nevertheless, fixed income will remain an important part of the long-term investor's portfolio. We believe investors would be well placed to expand their opportunity set by looking beyond the U.S.

Equities

We expect the second half of the year to bring both storm clouds and silver linings for the equity market. History shows that previous Fed tightening cycles caused no major lasting contractions in the equity market. In the three previous rate hike cycles, the S&P 500 rose between the first and the last rate hikes (**Exhibit 5**, top three charts). The market was only slightly up in the 1994-1995 cycle, and up significantly in the other two cycles.

Historical impact of rate increases

EXHIBIT 5: S&P 500 PRICE INDEX AND 10-YEAR U.S. TREASURY YIELD OVER THE LAST THREE RATE-HIKING CYCLES



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. ***Guide to the Markets – U.S.***, page 60. Data as of 30 June 2015.

While we still have a favorable view on the asset class, we expect that equity markets will be more volatile going forward and that this higher level of volatility could persist. Annual returns and intra-year declines for the S&P 500 show that, year to date, there has been a single pullback of 4%. Over the past 25 years, the average intra-year pullback has been 14% (**Exhibit 6**). Furthermore, a 5% pullback has occurred an average of four times per year, while a 10% pullback has happened once per year[1].

The S&P 500 forward price-to-earnings (P/E) ratio currently stands at 16.4 times, which is just above its 25-year average of 15.7 times. With the market at slightly elevated valuations, the effect of any earnings misses or bearish news can be amplified. This is a good reason to be selective within U.S. equities, building portfolios around those sectors that are poised to benefit from the continued expansion. Looking abroad, many international developed markets have attractive valuations. European equities are an example of better value coinciding with a compelling growth story.

Fixed income

As the Fed begins to raise rates, downward pressure will be exerted on fixed income prices. Previous Fed tightening cycles show that the 10-year yield rose in all three cycles, as one would expect (**Exhibit 3** on previous page). In practice, the path and pace of rate hikes will have the biggest effect on fixed income. A gradual path towards higher rates should not result in a panic scenario, and could even boost performance among certain assets. Yet while the Fed can raise short-term rates, it cannot control the shape of the yield curve. There are interesting global dynamics at play. For example, 10-year U.S. and German yields are highly correlated (with a correlation coefficient of 0.8), and German yields are at extremely low levels, dragging on U.S yields. Low inflation and demand for U.S. Treasuries are other factors that could suppress yields. These are some of the factors that will weigh on U.S. yields at the long end of the yield curve through 2015 and beyond, regardless of Fed action.

Fixed income is still an important source of diversification and safety within portfolios, but with the overall asset class looking expensive, attractive opportunities must be actively sought out. Investors should be well diversified in order to prepare for the range of potential outcomes as rates increase. Core holdings of Treasuries can provide diversification and capital preservation for a portfolio, while an income component can be garnered from higher-yielding credit securities. In addition, despite very easy monetary policies from developed country central banks, there are attractive yields scattered throughout global fixed income markets and active management can play a part in capitalizing on them.

[1] See ***Investing with Composure in Volatile Markets***, James Liu, J.P. Morgan Asset Management, February 2015.

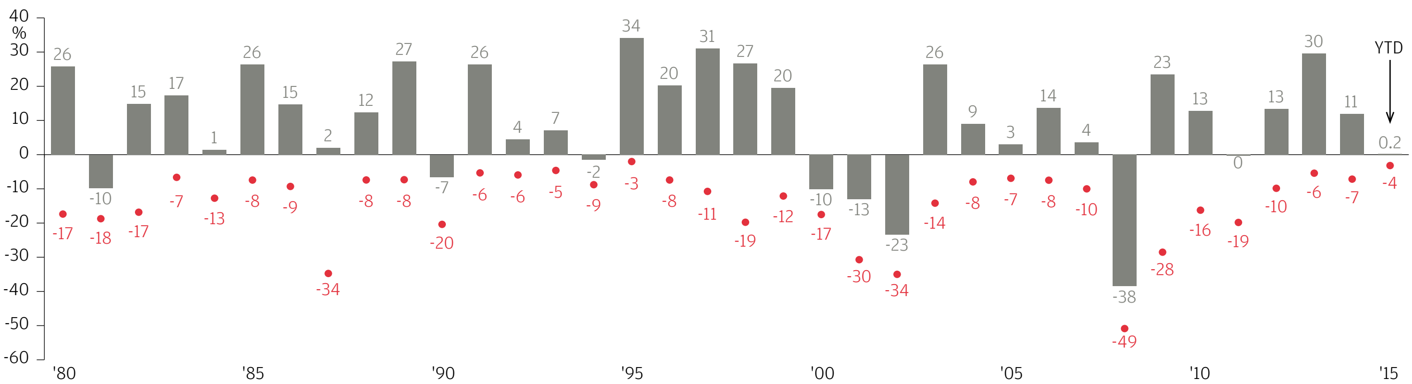
INVESTMENT IMPLICATIONS

Overall, trends seen throughout the economic recovery should remain in place in the second half of the year. The slow and steady expansion will be supported by further labor market improvements, low inflation and easy monetary policy. The first rate hike is unlikely to derail any of the positive economic momentum that has been building to date. U.S. equities may be more volatile, if history provides any guidance, but their outlook continues to be more constructive than for fixed income. Elevated valuation in fixed income will point to the need for an active and flexible approach to seek out opportunities.

U.S. equities might experience an up-tick in volatility

EXHIBIT 6: S&P 500 INTRA-YEAR DECLINES VS. CALENDAR-YEAR RETURNS

Despite average intra-year drops of 14.2%, annual returns have been positive in 27 of 35 years*



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. ***Guide to the Markets – U.S.***, page 13. Data as of 30 June 2015. *Returns are based on price index only and do not included dividends. Intra-year drops refer to the largest market drops from peak to trough during the year.

IMPROVING FUNDAMENTALS AND FALLING RISKS STILL FAVOR EUROPEAN ASSETS

Maria Paola Toschi, *Global Market Strategist, Europe*

Introduction

In the second quarter of 2015, European markets were focused on Greece. The last-minute bailout agreement reduced the risk of an immediate Greek exit (or Grexit) from the euro and shifted investors' focus back to European fundamentals, which are showing encouraging signs of improvement. With this in mind, we argue that there are more opportunities than headwinds for investors with exposure to European assets and that equities and bonds can play different roles in diversified portfolios.

The Greek deal has reduced systemic concerns but political risks remain

The unexpected last minute deal between Greece and its European government creditors avoided a messy exit by Greece from the euro – at least for the time being. With negotiations re-starting on the contents of a third bailout program, worth around EUR 86 billion, investors broadly welcomed the decision to step back from the brink.

VIEWPOINT

The Greek crisis has highlighted deep divisions between France and Germany and caused some European leaders, for the first time, to openly discuss the possibility that Greece could leave the euro. These developments may have long-term consequences for the region but they are unlikely to derail the economic recovery in the short-to-medium term.

More important than the details of the Greek compromise deal was the message it sent about Europe's increased capacity to respond to systemic risk. Europe's leaders did not emerge from the situation particularly well, but it is worth noting that the financial safeguards introduced since 2012 were broadly effective in limiting market contagion. Among these safeguards, the European Financial Stability Facility (EFSF) confirmed its importance by providing the bridging loan to Greece. The European Central bank (ECB) also played a crucial role supporting Greek banks through the Emergency Liquidity Assistance (ELA), while it helped support the eurozone sovereign bond market by undertaking a massive program of bond purchases.

There is still uncertainty around Greece. The Greek government could find it hard to implement the entire set of reforms that it has signed up to as part of the bailout deal, including the difficult process of privatizations. Votes on some crucial decisions, such as higher taxes on farmers and the removal of the baby retirement plan, were postponed. The International Monetary Fund (IMF) has suggested that it cannot participate in the new support program for Greece without a significant restructuring of Greek sovereign debt. This could complicate the passage of any deal through the German Bundestag, which is broadly opposed to debt relief but is also not keen to move forward without support from the IMF.

Even if the Greek saga takes another difficult turn in the fall, Greece accounts for barely 2% of eurozone GDP and, in our view, does not pose a major risk to Europe's recovery. In December, a general election in Spain will draw attention to Podemos, a left-wing party that draws inspiration from Syriza. However, polls suggest that the debacle of the Greek prime minister, Alexis Tsipras, has reduced the popularity of Podemos and Syriza while strengthening support for traditional parties in Greece and Spain. The fact that Spain is now enjoying a robust recovery offers further support for the case that reforms can help growth.

Investors can continue to benefit from exposure to European assets, especially in countries where growth is now firmly back on track, but further ahead we do need to see that this reduction in systemic risk is accompanied by the commitment of governments to deeper economic integration and structural reform.

VIEWPOINT

One positive outcome from the Greek saga has been that the safeguards introduced by Europe since 2012 have been broadly effective. Markets can benefit from this reduction in eurozone systemic risk but governments must remain focused on long-term reforms.

Europe's economic recovery is on track

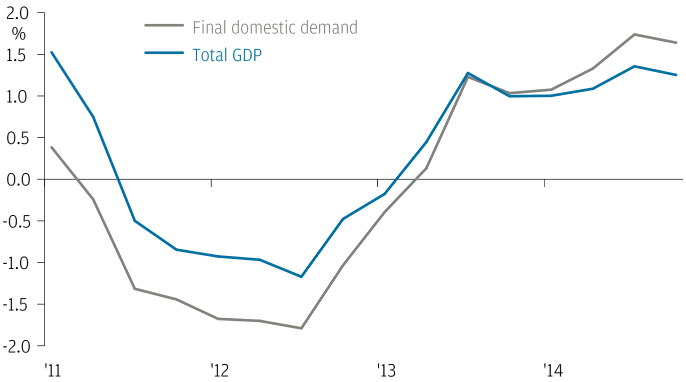
The prolonged turmoil in Greece did not derail the economic upturn in Europe that has been taking place since the beginning of the year. Europe's recovery also continued despite the weaker news out of the U.S. and many emerging economies. In the first quarter, eurozone GDP grew at a 0.4% rate quarter-on-quarter, with France and Italy returning to expansion and Spain continuing to show strong momentum. The flash release for euro area GDP for the second quarter confirmed a trend of expansion with 1.25% quarter-on-quarter growth. Inflation remains low but the risk of deflation has receded, and there are signs that the ECB's quantitative easing program has revived the transmission of monetary policy to the real economy. By 10 July, the Euro-system had bought bonds totaling EUR 215 billion and the ECB president, Mario Draghi, has reaffirmed the Governing Council's intention to continue the program until at least September 2016.

The significant weakening of the euro that we have seen over the last nine months or so has been helpful for the eurozone, which has run a positive current account balance since 2012 thanks to support from its big export-oriented economies – Germany, Italy and France. But it is important – and encouraging – to note that the economic recovery we have seen in 2015 has not been driven by exports. Disappointing demand from Europe's leading trading partners, particularly the U.S. and China, has countered the positive impact of a more competitive currency, but there has been a marked pick-up in domestic demand (**Exhibit 1**).

A pick-up in domestic demand has supported the ongoing eurozone recovery

EXHIBIT 1: EUROZONE TOTAL GROWTH VS. FINAL DEMAND

Year-on-year change



Source: Eurostat, FactSet, J.P. Morgan Asset Management. Data as of 7 August 2015. This graph and the graphs, charts and tables found herein are for illustrative purposes only.

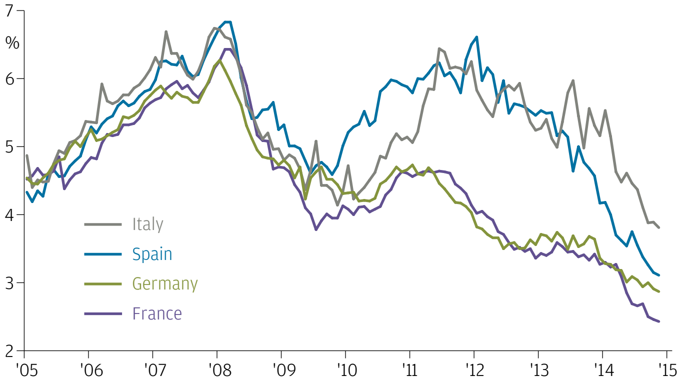
Consumption is the main driver of this recovery thanks to better labor market conditions, the lower oil price and reduced fiscal tightening. At more than 11%, the eurozone average unemployment rate is still high, but it is moving in the right direction. Aggregate retail sales and car registrations grew by 1.1% quarter-on-quarter in the first quarter, and were especially strong in Spain and Germany.

It is also very encouraging that the improvement in lending conditions for ordinary businesses and households has continued (**Exhibit 2**), despite the market jitters around Greece and the sell-off in sovereign bond markets in the early summer. The ECB bank lending survey for the second quarter has also showed an improvement in credit dynamics (**Exhibit 3**). The cumulative components of retail and corporate demand have reached a record high, surpassing the pre-crisis peak of 2006. This is vital for Europe's recovery because corporate capital spending in the region is overwhelmingly financed by bank lending rather than the capital markets.

Corporate lending rates have declined and converged

EXHIBIT 2: CORPORATE LENDING RATES

Non-financial corporations, new businesses lending up to €1 million, 1-5 years

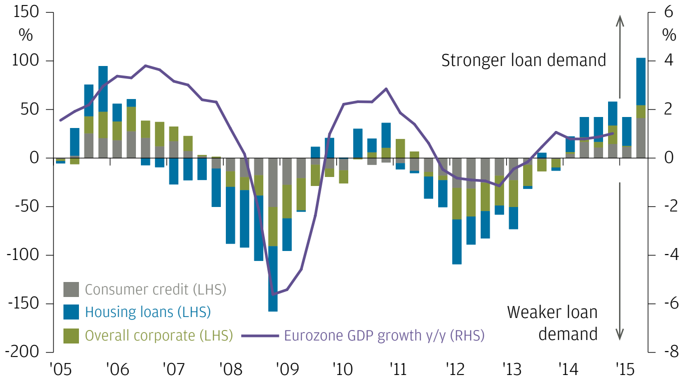


Source: ECB, Thomson Reuters Datastream, J.P. Morgan Asset Management. ***Guide to the Markets – UK***, updated page 18 / ***Guide to the Markets - Europe***, updated page 7. Data as of 7 August 2015.

Demand for loans is rising across the continent

EXHIBIT 3: CREDIT DEMAND AND EUROZONE GDP GROWTH

Net % of banks reporting positive loan demand, GDP growth



Source: ECB, Eurostat, FactSet, J.P. Morgan Asset Management. ***Guide to the Markets – UK***, updated page 18 / ***Guide to the Markets - Europe***, updated page 7. Data as of 7 August 2015.

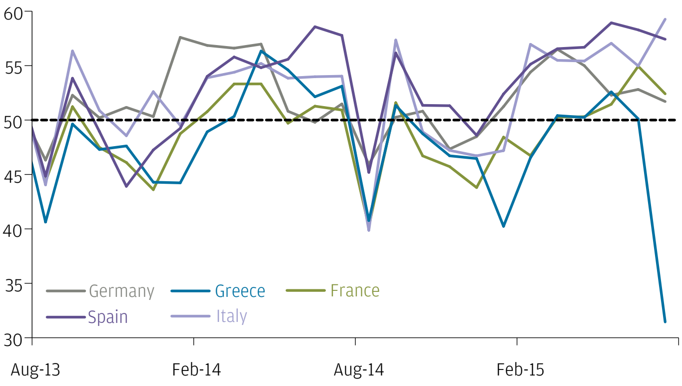
Quantitative easing can help to revive growth, but as ECB president Mario Draghi has emphasized, structural reforms are needed to transform an economic bounce-back into a sustainable long-term expansion. In the past year countries such as Spain, which have pressed ahead with reforms to introduce more flexibility to labor market and revive competitiveness, have significantly outperformed countries that have been slower to make these kinds of changes. According to IMF estimates, GDP growth in Spain could reach 3% this year, double the eurozone average. At 22.4%, unemployment is still too high but has declined from its peak of 26.3% in March 2014. Italy could yet follow Spain's example thanks to a wide program of reforms currently being pursued by the government in Rome, though it is early days yet.

Looking ahead, we see the European economy continuing to improve in the second half of 2015. The July manufacturing and services purchasing managers' indices, at 52.2 and 53.8 respectively, point to a continuation of the cyclical recovery (**Exhibit 4**). We would also expect the ECB to continue to support the market as long as inflation remains very low. The consumer price index grew by only 0.2% in the year to June and with oil prices falling again, we would expect inflation to be subdued for some time to come. This further decline in energy prices offers big benefits to Europe as a major net importer of oil. The expected bounce-back in the U.S. economy and the prospect of higher U.S. interest rates could also trigger a further round of euro weakening.

Strengthening manufacturing data supports the cyclical upturn

EXHIBIT 4: PURCHASING MANAGERS' INDICES FOR MANUFACTURING

Index level



Source: Markit, J.P. Morgan Asset Management. ***Guide to the Markets – UK***, updated page 17 / ***Guide to the Markets - Europe***, updated page 6. Data as of 7 August 2015.

VIEWPOINT

The European economy has continued to move forward in 2015 despite weaker news from other parts of the world. This is due to a welcome revival in domestic demand — linked to easier financial conditions and cheap oil — which we expect to continue.

There are many reasons to keep exposure to European assets

2015 has been a big year for flows into Europe, but we believe improving fundamentals and reduced headwinds continue to support the case for investing in European assets. Equities are well placed to deliver decent returns if the recovery in corporate earnings continues. Bonds can also offer opportunities for investors in search of income (in the periphery) or in search of stability (in core countries) – though investors should be aware that there is likely to be further bond market volatility in the second part of the year if expectations of a U.S. rate rise are realized.

Equities can still provide decent returns

At the end of June the MSCI Europe Index stood 13.3% higher year to date, after a limited correction of 3.0% in the second quarter. Equities are no longer cheap: forward price-to-earnings (P/E) ratios are now broadly in line with their long-term averages. We do believe that equities can offer positive returns at these valuations, but support from earnings growth will be crucial.

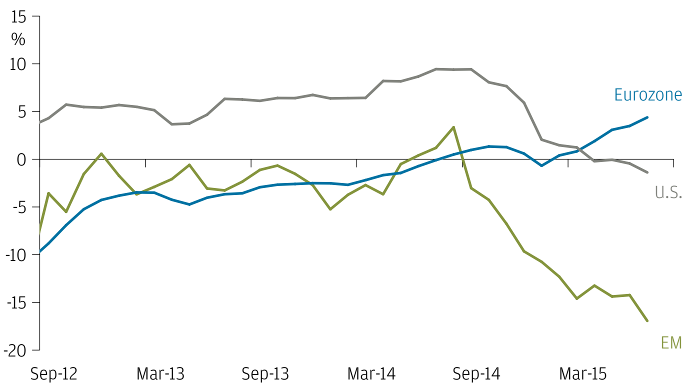
The most recent earnings season is encouraging, with aggregate earnings for companies listed in the Euro Stoxx 600 Index growing by around 9-10% in the last two earning seasons for the fourth quarter of 2014 and first quarter of 2015. The increase was driven by a wide range of sectors and the main positive contributors were industrials and financials. The energy sector produced a limited drag. However, all countries in the eurozone contributed positively.

Many of the positive factors that pushed earnings higher persist. The long trend of earnings downgrades appears to have halted and there are signs that a reversal is in place, as seen in **Exhibit 5**. We see cyclical sectors benefiting from this improved economic momentum – and banks could be especially favored by the reduced need for provisions and by the reduction in write-offs in their credit portfolios. The plunge in oil prices is a challenge for some regions, but for Europe this is largely an opportunity.

Eurozone earnings momentum is on the up

EXHIBIT 5: EARNINGS MOMENTUM

12-month forward EPS growth, year-on-year change



Source: FactSet, MSCI, J.P. Morgan Asset Management. Data as of 7 August 2015.

European bonds can play a big role in fixed income portfolios

In the second half of the year and in early 2016 investors are likely to be concerned about the first rate hikes by the U.S. Federal Reserve and the Bank of England - even though very low global inflation and record low oil prices suggest that tightening will be gradual. The upshot is that two big investment themes for the remaining part of the year will be to find fixed income asset classes that can provide some income, but also some protection from rising rates. European fixed income assets offer the potential to deliver on both fronts.

The long-term spread between Italian and Spanish sovereign bonds and German Bunds can decline further if the Italian and Spanish governments confirm their dedication to implement economic reforms. At the same time, we believe the support offered by the ECB's bond purchase program could inject stability to fixed income portfolios at a time of increased volatility. This is not always going to be the case, as demonstrated by the extreme volatility in the German Bund market in May and June. Volatility can still affect markets and will most likely depend on how inflation and inflation expectations react to quantitative easing. The presence of a portion of sovereign bonds with negative yields, now estimated at 16% of the overall eurozone bond market, could also make markets nervous. But, even with bouts of volatility, we believe that the increased divergence in monetary policy between the ECB and the U.S. will favor eurozone bonds for some time to come.

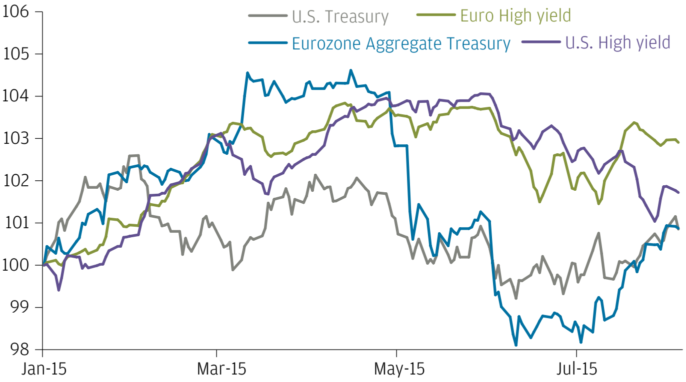
Corporate bonds are also appealing. The European high yield market is still small compared to the U.S. but it has become larger and more liquid in recent years, rising to around EUR 400 billion from EUR 90 billion in 2008. The quality of these markets also compares favorably with the U.S. high yield market thanks to a big portion of BB and B rated issuance, low default rates and a very limited presence of energy issuers – which has been such a concern to investors in the U.S.

High yield markets have not been untouched by the recent sell-offs in European bond markets but they have provided more insulation from the market's ups and downs than many other assets and outperformed many other forms of fixed income assets since the start of the year (**Exhibit 6**).

European high yield bonds have outperformed so far in 2015

EXHIBIT 6: FIXED INCOME TOTAL RETURNS

Indexed to January 2015



Source: BofA/ML, Barclays, J.P. Morgan Asset Management. Data as of 6 August 2015. Indices shown are Barclays US Aggregate Government - Treasury, Barclays Euro Aggregate Government - Treasury, BofA Merrill Lynch Euro High Yield Constrained, BofA Merrill Lynch US High Yield Constrained. Data as of 7 August 2015.

INVESTMENT IMPLICATIONS

The key takeaways for investors are that Europe's fundamentals continue to improve – in stark contrast to other parts of the world, whose economies have largely disappointed since the start of the year. Political risks remain and elections in Spain and possibly Greece in the final months of 2015 could create further bouts of volatility. But ultimately we believe that the improvement in economic and financial conditions we have seen in 2015 will prove-self-sustaining and can offer continued support to European markets.

Equity markets are no longer cheap but can still provide decent returns if earnings continue to grow and investors follow active, bottom-up, strategies. We also believe that European bonds can add income and flexibility to investors' bond portfolios, with peripheral bonds offering the potential for further capital gains and high yield bonds offering some protection against higher U.S. rates.

LOOKING FOR VALUE IN EMERGING MARKETS

Tai Hui, *Chief Market Strategist, Asia*

Introduction

Investors have become more cautious towards emerging markets recently due to mediocre earnings over the past three years and a challenging outlook. The Federal Reserve's (Fed) normalization of its monetary policy, a strong U.S. dollar, weak commodity prices and slower growth in China are all reasons for investors to favor developed over emerging markets. Nonetheless, differentiation across the emerging world and an understanding of domestic idiosyncratic factors can still help investors to achieve respectable returns, while also meeting the objective of diversification.

Emerging markets have hit a speed bump

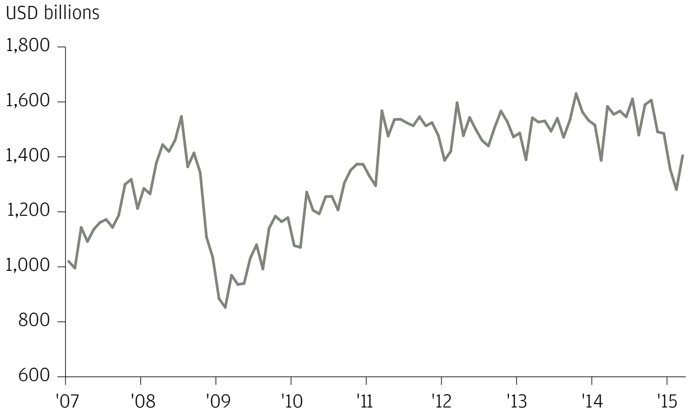
Strong economic growth in emerging markets has come under pressure in recent years for a number of reasons. First, China's three decade-long growth miracle is showing signs of aging. Given that the size of China's economy is about one-third of emerging markets, and that its demand for commodities drives the growth of many other emerging markets, its economic performance is critical. The maturing Chinese economy and slowing population are putting more limitations on headline growth. Corporate debt accumulation in recent years is also limiting the amount of additional monetary stimulus that can be deployed by its central bank to support growth. We believe an economic hard landing in China is unlikely, since Beijing still has sufficient policy options, especially on fiscal policy, to protect growth if needed. Nonetheless, we anticipate China's headline growth numbers will gradually drift lower towards 5%-6% in the medium term, with greater volatility as market forces become more dominant.

Second, global trade has slowed down. **Exhibit 1** shows that global trade recovered to the pre-financial crisis level of around USD 1.6 trillion per month in 2014, but then declined by 9.9% year-on-year in the first quarter of 2015. This is partly explained by the decline in commodity prices, in particular oil and industrial metals. However, the weak performance is not limited to commodity exporters. For markets that are strong in the manufactured goods space, such as China, Singapore, South Korea and Taiwan, the gradual recovery in the U.S. and Europe has provided little lift to their export performance. Subsequently, domestic investment has slowed down as local companies have become cautious in their business outlook.

Finally, domestic factors, including a rise in household debt in countries such as Malaysia, South Korea and Thailand, mean that consumption growth is facing more constraints. Geopolitical events in Russia and central and eastern Europe have also undermined economic growth.

Global trade bounced back to pre-crisis levels before declining again in Q1

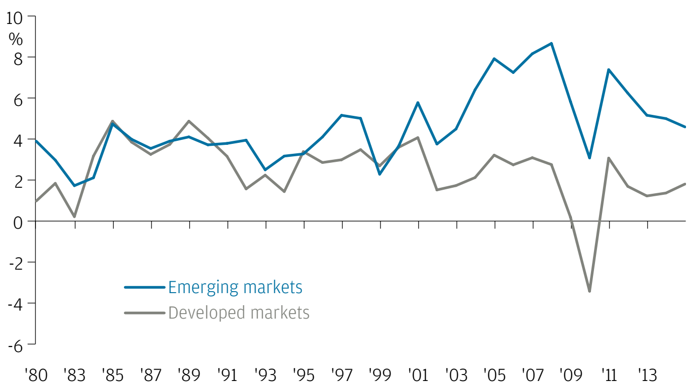
EXHIBIT 1: GLOBAL TRADE



Source: IMF, J.P. Morgan Asset Management. Data as of 31 July 2015. This graph and the graphs, charts and tables found herein are for illustrative purposes only.

As a result, developed markets are catching up with emerging markets in terms of economic growth. **Exhibit 2** shows that in the 2000s, emerging markets typically enjoyed growth that was 4 to 5 percentage points higher than that of developed markets. This difference declined to just 2.8 percentage points in 2014, according to data from the International Monetary Fund (IMF), as developed market economic growth picked up modestly while emerging market growth decelerated. This convergence has coincided with a period of strong corporate earnings growth in the U.S. and a notable recovery in Europe and Japan. Corporate earnings growth in emerging markets and Asia, in contrast, has been lagging. The IMF expects this gap in GDP growth to remain small in 2015 and 2016. Some investors believe that developed markets have a more constructive investment outlook relative to emerging markets as a result of this convergence in performance.

EXHIBIT 2: ANNUAL GDP GROWTH OF EMERGING VS. DEVELOPED MARKETS



Source: IMF, J.P. Morgan Asset Management. Data as of 31 July 2015.

VIEWPOINT

The growth outperformance of emerging markets over their developed counterparts has been undermined by a slowing China, weak global trade growth and idiosyncratic factors such as rising household debt and politics.

Emerging markets' reaction to Fed rate hike more likely to mirror that of December 2013

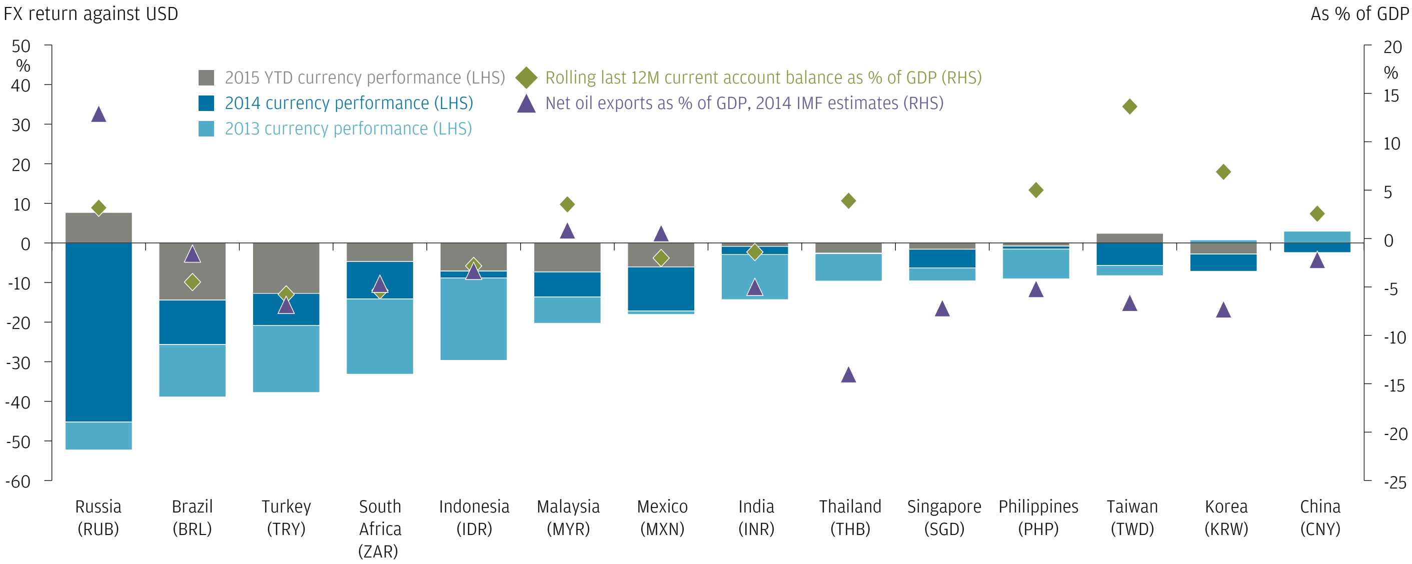
In addition to the headwinds facing emerging market growth, investors are also mindful of the potential impact from the impending normalization of policy rates by the Fed. They are concerned that higher U.S. interest rates could lead to capital outflows from emerging markets and add to the funding costs of companies issuing debt in U.S. dollars. A stronger U.S. dollar, partly the result of higher U.S. interest rates, could also lead to a sharp depreciation in emerging market currencies and force central banks to raise interest rates to protect their external balances. The recent Chinese yuan devaluation has also exacerbated concerns of competitive devaluation in emerging markets, even though we believe such risk is low.

In the second quarter of 2013, when former Fed chairman Ben Bernanke warned that the central bank would need to think about reducing its asset purchases, investors responded with a "taper tantrum," which led to sharp depreciation in some emerging market currencies. **Exhibit 3** shows that Brazil, Turkey, South Africa, India and Indonesia were the worst hit during the importance of taper tantrum. It is also worth noting that some emerging market currencies escaped relatively unscathed, such as Korea, Mexico, Singapore, Taiwan and China. This highlights the differentiation within emerging markets. The currencies that suffered the most from the taper tantrum are those economies with large current account deficits, a low level of foreign exchange reserves and unfavorable inflation dynamics. **Exhibit 3** also shows that in 2014 and 2015, commodity exporters have experienced sizeable currency depreciation as investors expect their export receipts to fall due to lower commodity prices, leading to deterioration in their current account positions.

Despite the turbulent experience of emerging market currencies in 2013 and 2014, we believe that the impact of the Fed's upcoming interest rate increase should be less damaging. The Fed has already been preparing the market in recent months for the first rate rise by carefully adjusting its language in its Federal Open Market Committee statements, so few investors should be surprised when the liftoff finally comes. The upcoming rate rise cycle is also expected to be gentle relative to previous Fed rise cycles. Therefore, we believe the market's reaction could be similar to December 2013, when the Fed finally announced the start of quantitative easing (QE) tapering, instead of May 2013, when Bernanke shocked the market by first bringing up the topic. Moreover, other major central banks, such as the European Central Bank and the Bank of Japan, are still engaging in their own versions of QE. These two central banks alone are expected to print around USD 1.3 trillion-1.4 trillion over the next 12 months. This would help to prevent an excessive tightening of global liquidity.

The taper tantrum had the biggest impact on economies with large current account deficits

EXHIBIT 3: EMERGING MARKET CURRENCY PERFORMANCE VS. CURRENT ACCOUNT POSITION FOR NET EXPORTERS OF OIL

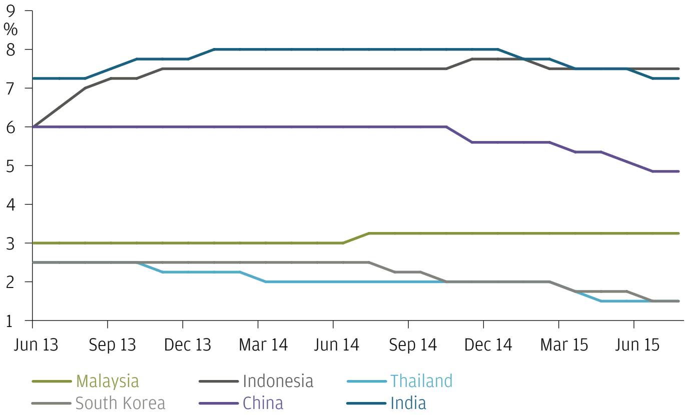


Source: CEIC, FactSet, IMF, J.P. Morgan Economics, J.P. Morgan Asset Management. *Guide to the Markets – Asia*, updated page 59. Data as of 31 July 2015.

In addition to the Fed's communication, we believe that some countries have also made an effort to mitigate the potential impact on their currencies (**Exhibit 4**). India is a good example, as its current account position has improved considerably, from 4.8% of GDP in 2012 to 1.4% in 2014. It is inevitable that some central banks would have to raise interest rates in reaction to the Fed's policy, but this is likely to be limited to a selection of emerging markets with weak external balances as mentioned above, rather than a comprehensive tightening across emerging markets as a whole. In fact, some countries, such as Thailand, China and South Korea, are still looking at the possibility of further monetary easing to support their growth.

India and Indonesia raised rates in 2013 to limit impact from taper tantrum

EXHIBIT 4: EMERGING MARKET POLICY RATE TRENDS



Source: FactSet, J.P. Morgan Asset Management. Data as of 31 July 2015.

VIEWPOINT

The Fed's management of market expectations, along with QE in Europe and Japan and an improvement in the balance of payments for some emerging market countries, should help to limit the potential negative effect from interest rate rises in the U.S. Countries with high current account deficits or those dependent on commodity exports could face a tougher time and may need to raise interest rates to maintain currency stability.

Emerging markets reward long-term investors who look for value

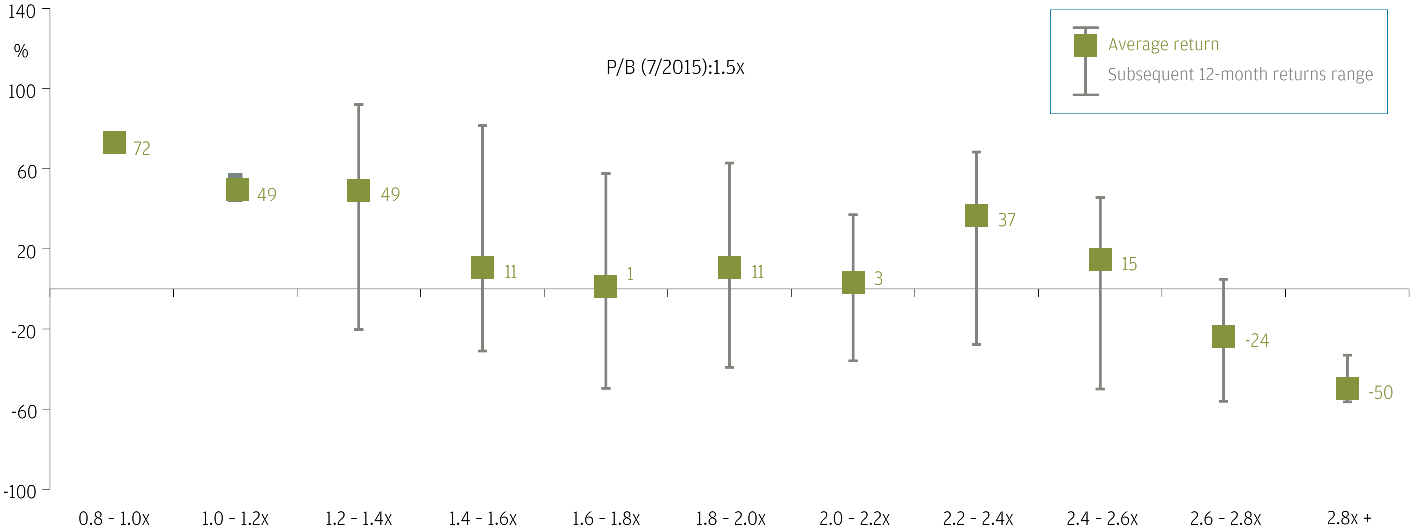
The economic and financial environment surrounding emerging markets could remain challenging in the near term. However, we still believe that investors should not abandon this asset class.

Emerging market equities enjoy relatively low valuations compared with developed markets as well as with history. At a trailing price-to-book (P/B) ratio of 1.5x, the MSCI Emerging Markets Index is close to one standard deviation below its 20-year average. It is also trading at a 30% discount relative to the MSCI World Index on a price-to-book basis. Taking into account the considerable variation in valuations among emerging markets, we believe that some of the bad news of growth headwinds, fragility towards higher interest rates in the U.S. and a strong U.S. dollar are at least partially reflected in current valuations.

Emerging market equities are currently attractively valued on a P/B basis

EXHIBIT 5: MSCI EMERGING MARKETS TRAILING P/B VALUATION ANALYSIS

Subsequent 12-month performance



Source: China Securities Index, FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. The total sampling size since September 1995, data permitting, included in the analysis are 238 months for MSCI Emerging Markets. *Guide to the Markets – Asia*, updated page 38. Data as of 31 July 2015.

Exhibit 5 (previous page) shows the 12-month return of the MSCI Emerging Markets Index as investors invest at different valuation levels. The average 12-month return when investors buy the MSCI Emerging Markets Index between 1.4 to 1.6x P/B ratio is around 11%. This is likely to be a potential point of attraction to investors as the U.S. equity rally has been ongoing for four years and investors are becoming increasingly wary of its relatively high valuation. Moreover, if investors were to wait for a notable improvement in earnings, they could be too late to enjoy the full extent of the market rally.

VIEWPOINT

Despite economic headwinds and potential volatility from the Fed's policy change, some of these challenges are at least partially reflected in equity valuations. Moreover, relatively high dividend yields mean that investors are rewarded for investing for the long term.

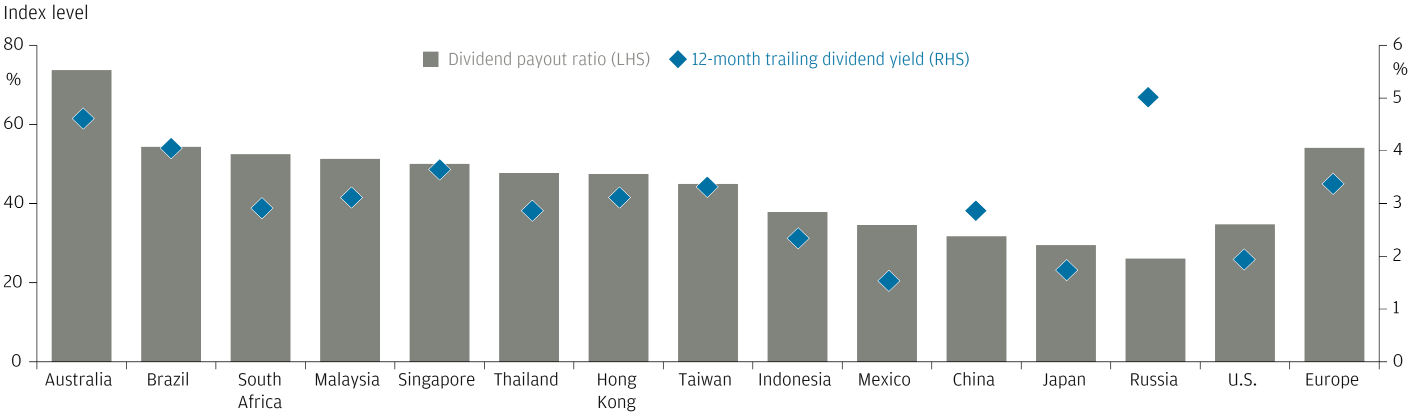
Another important aspect of emerging market equities is that, despite relatively high volatility, investors can get rewarded for holding onto emerging market equities. **Exhibit 6** shows the dividend payout ratio and dividend yield for selected emerging markets, the U.S. and Europe. There is a growing number of emerging market companies that are more willing to increase their dividend payout ratio. This has resulted in a respectable dividend yield that is 3% or higher in markets such as Brazil, China, Hong Kong, Russia, Singapore and Taiwan. This concept of income is increasingly important to investors who are receiving less yield from traditional fixed income investment and are looking for alternative sources of income. Of course, these investors will need to have a stronger risk appetite, given emerging market volatility, as well as a relatively long-term investment horizon.

INVESTMENT IMPLICATIONS

There are some clear structural and cyclical challenges facing emerging markets in the medium term. However, given the importance of diversification, we believe that abandoning emerging market equities is not the optimal strategy. Current emerging market equity valuations reflect the fact that the market is well aware of these challenges, and investors will need to clearly differentiate within emerging markets to benefit from some of the positive long-term trends. We also believe that emerging markets can reward long-term investors willing to search for value, via a high dividend yield.

Emerging market equities offer an attractive dividend yield

EXHIBIT 6: DIVIDEND PAYOUT RATIO & YIELD ACROSS THE WORLD



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. ***Guide to the Markets – Asia***, updated page 44. Data as of 31 July 2015.

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