MARKET INSIGHTS

Economic Update

July 30, 2018

Dr. David Kelly, CFA | *Chief Global Strategist for J.P. Morgan Funds*

This weekly update provides a snapshot of changes in the economy and markets and their implications for investors.

Growth

The preliminary estimate of 2Q18 economic growth came in at 4.1% q/q annualized, slightly below consensus. Strong retail sales and an improving trade position helped to boost growth to above-trend levels, though falling inventories and weak housing were net drags on the economy. Moving forward, growth should continue to be strong for the next few quarters before slowing in the second half of 2019, reflecting fading fiscal stimulus and higher interest rates.

Jobs

In June, the unemployment rate rose to 4.0% due to a 601,000 increase in the civilian labor force rather than job losses. In addition, 213,000 new payroll jobs were added and the prior two months were revised upward by 37,000 jobs. Average hourly earnings for production and non-supervisory workers rose 2.7% year-over-year, slightly down from the initially reported 2.8% for May. On balance, the employment report showed continued labor market strength. As strong consumer demand clashes with weak labor demographics, this should lead to wage growth acceleration, rising labor force participation and productivity growth and, eventually, slowing economic growth.

Profits

With 248 companies having reported (62.6% of market cap), our current estimate for 2Q18 S&P 500 operating EPS is $39.02 ($31.68 ex-financials), representing a 27.9% y/y growth rate. We expect particular strength in energy, technology, health care and telecom, though all sectors are currently forecasted to have positive earnings growth. So far, 84% of companies have beat on earnings, a new record, while 60% have beat on revenue. Margins continue to be a major driver of earnings growth this quarter and are set to expand to 11.8%, their highest level on record. This margin growth has been driven by tax reform and a focus on efficiency, which has led to an increase in operating income without a significant rise in costs.

Inflation

June inflation data came in strong, with headline CPI up 2.9% y/y and core up 2.3% y/y. Both figures were higher than May's numbers, continuing a gradual trend of rising inflation. In addition, the Fed's preferred inflation measure, PCE, rose 2.3% y/y in May, with core PCE rising 2.0% y/y. The Fed acknowledged rising prices by increasing its inflation outlook for 2018 and 2019, which further supports the backdrop for two additional hikes this year and three next year.

Rates

As expected, the Federal Reserve raised its target for the federal funds rate to a range of 1.75%-2.00% at its June meeting. Both the language in its statement and economic projections were slightly more hawkish than in previous meetings. The committee raised both economic growth and inflation forecasts and cut the unemployment rate forecast for this year and next. In addition, the slightly more hawkish view was enough to increase the median forecast to four rate hikes in 2018 and maintain its March forecast of three in 2019. With interest rates set to continue rising on the back of firmer inflation and stronger growth, bonds will face continued headwinds, and investors will need to be more selective in fixed income investing.

Risks

- Danger of extensive fiscal stimulus in a full employment economy could lead to overheating.
- Elevated asset prices and valuations are pressured as rates move materially higher.
- Trade tensions and political turmoil result in a slowdown in global growth.

Investment Themes

- Increasing earnings growth, coupled with slowly rising interest rates, still make stocks look attractive in relative terms.
- High yield bonds look more attractive than Treasuries, but a diversified approach to fixed income investing seems appropriate given Fed tightening.
- International exposure is warranted given growth prospects abroad, and a weaker dollar can enhance foreign returns.

■ Denotes updated information

J.P.Morgan Asset Management

Data are as of July 30, 2018

Past performance does not guarantee future results.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

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