



Driving in a complicated landscape

2025 Mid-Year Outlook: Navigating change by broadening portfolios

The first half of 2025 has been dominated by dramatic policy changes. However, to understand their potential impacts, it is first necessary to appreciate the economic backdrop at the start of the year.

Economists often argue about whether the economy is “early cycle,” “mid cycle” or “late cycle.” However, a better description of the economy at the end of 2024 is that it was “post-cycle.”

The traditional business cycle starts with a surge in economic growth, which, in time, triggers higher inflation. This worries the central bank, which raises interest rates to cool economic growth and thereby subdue inflation. Typically, they succeed in this endeavor

but overdo it, and the economy is pushed into recession. They then cut interest rates to very low levels, which, with the help of fiscal stimulus and pent-up demand, restarts the economy and the cycle begins anew.

The business cycle that followed the pandemic followed this script at the start, as the economy bounced out of recession due to massive fiscal stimulus. This stimulus and supply-chain issues triggered inflation, which was amplified by the effects of Russia’s invasion of Ukraine. In March 2022, the Fed began to raise interest rates while CPI inflation hit a 40-year peak of 9.0% three months later. The Fed kept tightening for a further year, with the federal funds rate finally plateauing in a range of 5.25%–5.50% in July 2023.

Meanwhile, however, inflation had begun to retreat, with year-over-year CPI inflation falling to 3.1% in June 2023. Importantly, this was not accompanied by recession. The unemployment rate in June 2023 was 3.6%, exactly the same as it had been a year earlier.

Eighteen months later, in December 2024, the economy was in a similar position with year-over-year CPI inflation running at 2.9% and unemployment at 4.1%, following a year in which real GDP had grown by 2.5%. By December 2024, the expansion that had started in April 2020 was already in its fifth year and had turned into a healthy tortoise, advancing at a slow and steady pace with neither enough exuberance to trigger inflation or enough fear and imbalances to cause recession.

The impact of policy

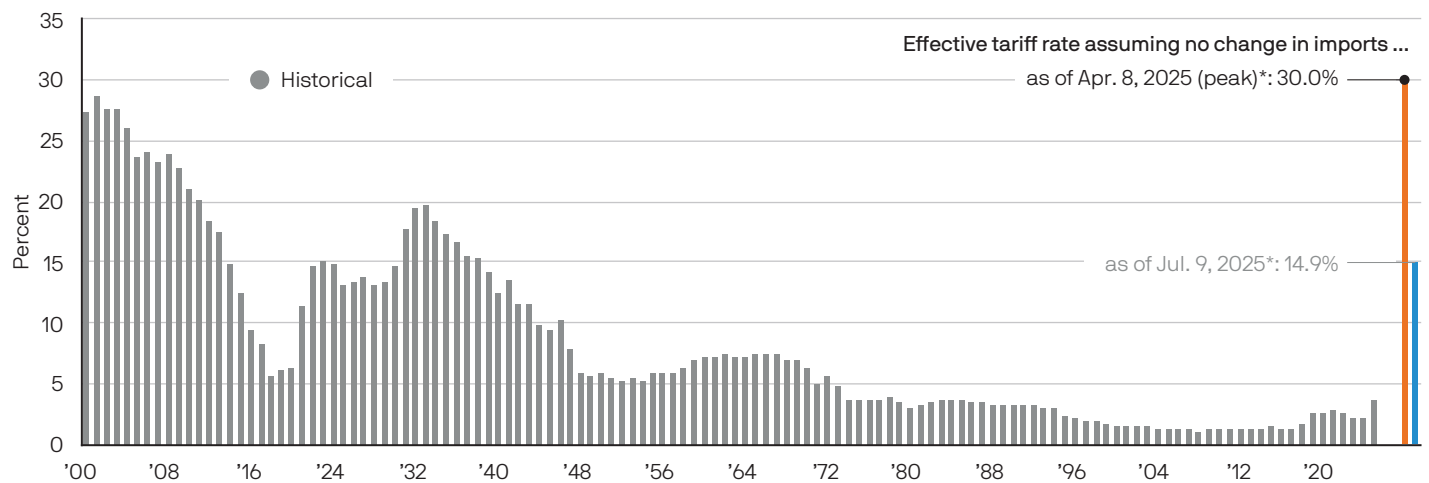
While economists and the Fed were happy with the economic numbers in 2024, the expansion had left many behind, contributing to a Republican sweep in November. This enabled the president to implement many of his campaign promises and, consequently, the last six months have seen some radical changes, particularly in the areas of tariffs, immigration and the budget.

While the Constitution grants Congress the exclusive right to impose tariffs, various laws passed in the 1960s and 1970s effectively transferred that power to the president when responding to a national emergency, a threat to national security or in negotiations to remove unreasonable foreign trade barriers. The president, taking an expansive view of his powers in this respect, has made many tariff announcements over the last six months with the most dramatic being the unveiling of so-called “reciprocal tariffs” on April 2. While some of these tariffs were paused, initially until July 9 and now until August 1, as of mid-July, the average tariff rate levied by the United States on imported goods is 14.9%, up from 2.5% at the start of the year.

These higher tariff rates only apply to goods shipped after early April and, given the time necessary to ship them to the United States and then to distribute them to retailers, there was always going to be a considerable lag between the announcement of tariffs and their impact on consumer prices. This has particularly been the case in 2025, due to a surge in imports between December and March to try to get ahead of the tariffs. Some of the cost of these tariffs may be absorbed by foreign producers or U.S. importers. However, we expect that most of this cost will ultimately be borne by U.S. consumers.

Much higher tariffs should feed through to higher consumer inflation in 2025

EXHIBIT 1: AVERAGE TARIFF RATE ON U.S. GOODS IMPORTS FOR CONSUMPTION (DUTIES COLLECTED/VALUE OF TOTAL GOODS IMPORTS FOR CONSUMPTION)



Source: Goldman Sachs Investment Research, U.S. International Trade Commission, J.P. Morgan Asset Management. For illustrative purposes only. The estimated weighted average U.S. tariff rate includes the latest tariff announcements. Estimates about which goods are USMCA compliant come from Goldman Sachs Investment Research. Imports for consumption: goods brought into a country for direct use or sale in the domestic market. The estimate does not consider non-tariff barriers, such as value-added taxes. *Figures are based on 2024 import levels and assume no change in demand due to tariff increases. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections or other forward-looking statements, actual events, results or performance may differ materially from those reflected or contemplated.

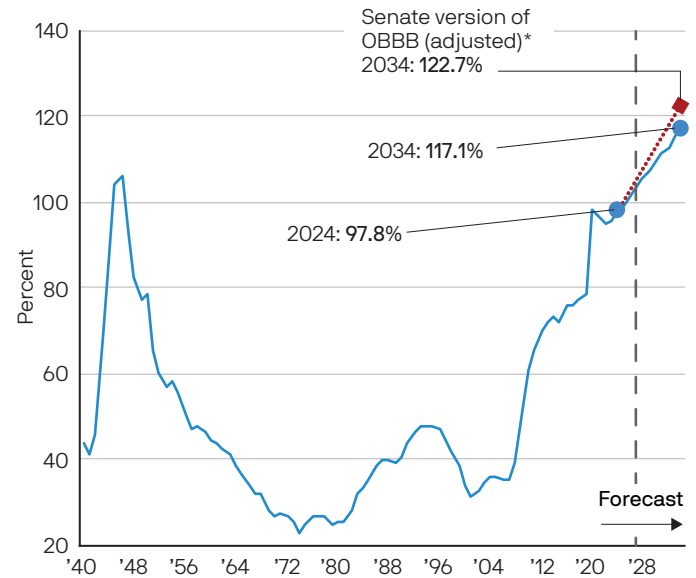
The easiest way to calculate the impact of this on inflation is to look at tariff revenue. In 2024, total U.S. goods imports were \$3,295 billion. A 10-percentage-point increase in the effective tariff rate would thus raise \$330 billion annually, assuming no change in import volumes. If consumers paid 60% of this, then new tariffs would increase the cost of goods by \$198 billion. In the fourth quarter of 2024, nominal consumer spending on goods and services was \$20,256 billion annualized, so, assuming that the impact of tariffs is fully felt by the fourth quarter of this year, a 10-percentage-point increase in tariff rates should add almost exactly 1% to year-over-year inflation as measured by the personal consumption deflator. And, as this is being written, the increase in average tariff rates looks more likely to exceed 10% than fall short of that number.

The first half of 2025 has also seen dramatic changes in immigration. Illegal immigration across the southern border has collapsed, with border encounters falling from an average of over 100,000 per month in the fourth quarter of 2024 to just 12,000 per month between February and May 2025. Arrests of unauthorized immigrants have also risen, with 56,000 in detention as of June 15, up from 40,000 in mid-January and, while the administration has not released recent data on daily deportations, a surge in deportation flights in June suggests this is also picking up. Overall, we expect the number of deportations in fiscal 2025 to exceed 2024's total of 271,000, and this number should continue to grow sharply given the dramatic increase in funding for immigration enforcement in the just-signed reconciliation bill.

There has also been a sharp decline in immigrant visas issued by U.S. embassies, down 16% year-over-year in April and down 20% year-over-year in May. If this continues, then given the shutdown of illegal immigration and the rise in deportations, net U.S. immigration could fall to an annual pace of just a few hundred thousand, compared to over a million per year since the start of the century. This, combined with the continued aging of the Baby Boomers, would result in a significant decline in the working age population, particularly over the next five years. Indeed, Census Bureau projections from 2023, show that in a low immigration scenario, the population aged 18–64 would fall by an average of 140,000 per year, over the next five years.

Federal debt is still on track to surge after OBBBA

EXHIBIT 2: FEDERAL NET DEBT (ACCUMULATED DEFICITS) AS A % OF GDP, 1940–2034, CBO BASELINE FORECAST, END OF FISCAL YEAR



Source: BEA, CBO, Treasury Department. J.P. Morgan Asset Management. Estimates are from the Congressional Budget Office (CBO) January 2025 An Update to the Budget Outlook: 2025 to 2035. OBBB refers to the “One Big Beautiful Bill Act.” *Adjusted by JPMAM to include estimates from the CBO June 2025 report “Estimated Budgetary Effects of an Amendment in the Nature of a Substitute to H.R. 1, the One Big Beautiful Bill Act.” Figures are also adjusted to include JPMAM estimates of tariff revenues and the estimated cost of extending expiring tax cuts beyond 2028, based on CBO estimates prepared for the version of the OBBB proposed by the House of Representatives on May 22, 2025. Forecasts are not a reliable indicator of future performance. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections or other forward-looking statements, actual events, results or performance may differ materially from those reflected or contemplated.

Turning to the budget, the recently signed OBBB Act should counteract some of the short-term effects of higher tariffs and lower immigration on economic growth, while amplifying their impacts on inflation.

In particular, while many spending cuts are postponed until 2027, new tax cuts for households, including a higher standard deduction, higher child tax credits, the elimination, under certain conditions, of taxes on tips and overtime, the deductibility of auto loan interest on domestic vehicles, the increased deductibility of state and local taxes and new \$6,000 deduction for senior citizens, are all backdated to January 1, 2025. Since most of these tax cuts don’t trigger an automatic adjustment to income tax withholding schedules, early 2026 will see a bumper crop of income tax refunds.

Because of this refund surge, we expect these tax cuts to boost disposable income by \$6 billion per quarter in the second half of 2025, \$76 billion per quarter in the first half of 2026, and then \$26 billion per quarter in the second half of 2026. If new tariff revenue equals \$75 billion per quarter from the fourth quarter on, and consumers end up paying 60% of that, or \$45 billion per quarter, then the drag on consumers from higher tariffs will exceed the value of new tax breaks in late 2025 and late 2026 but not in the first half of 2026.

Finally, it is important to recognize the impact of the OBBB Act on the federal debt. Entering 2025, if Washington had simply extended the 2017 tax cuts, federal finances were already on a path of serious deterioration, with the debt-to-GDP ratio projected to rise to roughly 130% of GDP by 2035 from 98% in 2034. However, starting with the CBO’s estimate of the impact of OBBB tax and spending cuts, assuming that new temporary tax cuts become permanent but also adding in new tariff revenue, the outcome would be better on a static analysis than a simple extension of the 2017 tax cuts. That being said, if policy changes on tariffs and immigration slow economic growth and raise inflation, or if budgeted spending cuts fail to materialize, the fiscal outcome may well be close to that of a straight TCJA extension. It should be stressed that any of these outcomes would still imply very fast-rising federal debt.

The economic outlook

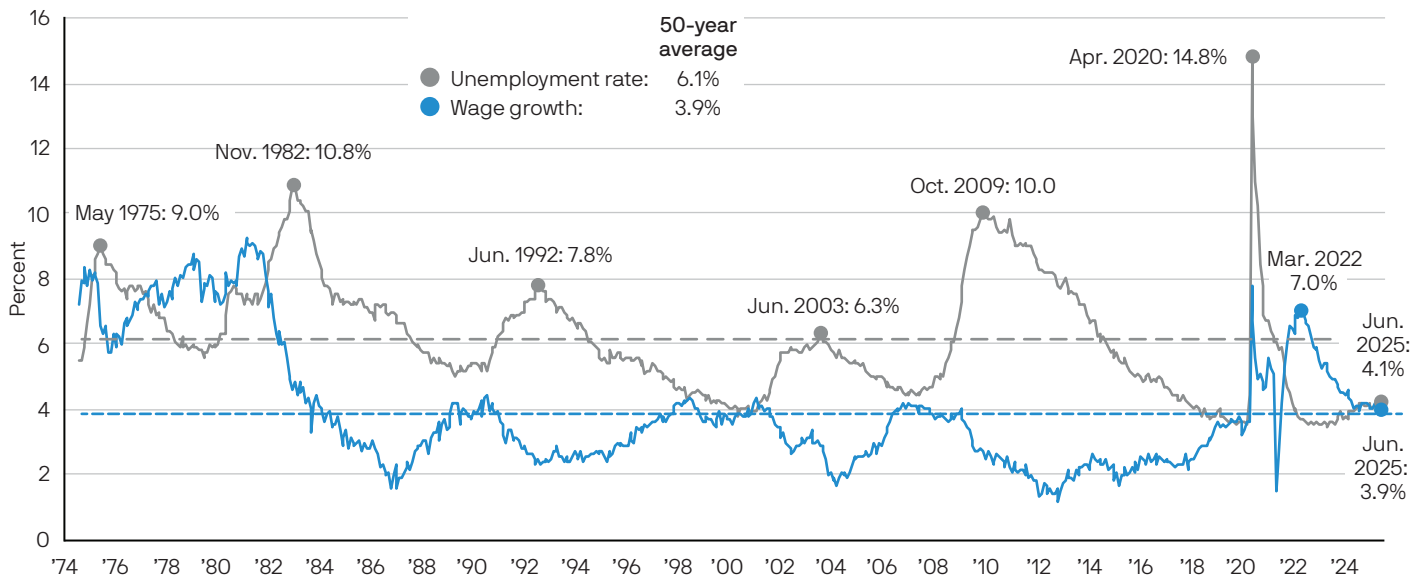
The aggregate effects of higher tariffs, lower immigration and delayed fiscal stimulus should result in slower growth for the rest of 2025, a pick-up in activity in the first half of 2026 and then a further slowdown later next year. This pattern should be most evident in consumer spending. Outside of consumption, international trade numbers will likely improve somewhat, as imports fall more than exports, and business fixed investment could benefit from more favorable tax treatment and the rush to develop AI. However, higher tariffs will likely result in less inventory accumulation, federal cutbacks should drag on government spending and high mortgage rates, combined with very low population growth, should keep housing stagnant.

Putting it all together, after some wild tariff-related swings in the first half of 2026, we expect year-over-year real GDP growth to fall to 1% by the fourth quarter of 2025 and then rebound to about 2% by the fourth quarter of 2026.

Slower economic growth is already impacting job gains, with payroll employment rising by 130,000 per month in the first half of 2025 compared to 168,000 in 2024. This could slow further in the months ahead, with the distinct possibility that an upcoming jobs report could

Less immigration should cut job gains but hold down unemployment and sustain wage growth

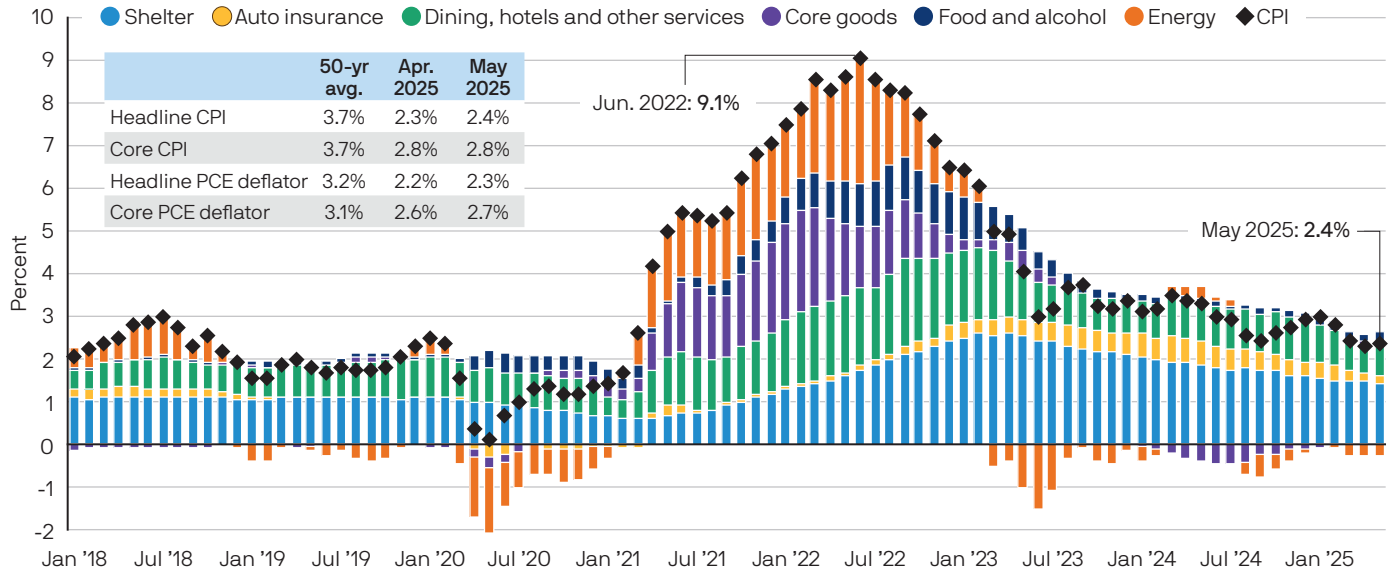
EXHIBIT 3: CIVILIAN UNEMPLOYMENT RATE AND YEAR-OVER-YEAR WAGE GROWTH (PRIVATE PRODUCTION AND NON-SUPERVISORY WORKERS, SEASONALLY ADJUSTED)



Source: BLS, FactSet, J.P. Morgan Asset Management. Private production and non-supervisory jobs represent just over 80% of total private non-farm jobs.

Tariffs and fiscal stimulus should delay a return to 2% inflation until late 2026

EXHIBIT 4: CONTRIBUTION TO Y/Y % CHANGE IN CPI, NON-SEASONALLY ADJUSTED



Source: BLS, FactSet, J.P. Morgan Asset Management. Contributions mirror the BLS methodology on Table 7 of the CPI report. Values may not sum to headline CPI figures due to rounding and underlying calculations. "Shelter" includes owners' equivalent rent, rent of primary residence and home insurance.

show a monthly decline. Despite this, we expect unemployment to rise only moderately to 4.5% in the fourth quarter from 4.1% in June, as less immigration cuts into labor supply. Job growth should edge up and the unemployment rate should edge down later in 2026, in a delayed reaction to fiscal stimulus.

A still-tight labor market should result in resilient wage growth and this, combined with the lagged effect of higher tariffs and a falling dollar, should boost inflation. We expect the personal consumption deflator inflation rate to rise from 2.4% year-over-year in May 2024 to 3.2% by the fourth quarter of this year. This inflation could be sustained in the first half of 2026 by the stimulative impact of tax cuts. However, by the second half of the year, the stimulus from income tax refunds should wear off, allowing the inflation rate to finally drift back down to the Fed's 2.0% target.

In recent press conferences and testimony, Fed Chair Jay Powell made it clear that, if a tension emerged between the Fed's inflation and employment goals, they would look at how far the economy was from those goals and how long it might take to achieve them. In their June Summary of Economic Projections, FOMC participants said that they expected, in the long run and under appropriate monetary policy, that the unemployment rate would be 4.2% and that consumption deflator inflation would be 2.0%. It now looks like, by the end of

the year, inflation will be further above its target than the unemployment rate, with fiscal stimulus likely to sustain above-target inflation into the first half of 2026. This being the case, we may only see one rate cut, if any, by the end of 2025 and no change in early 2026. If, however, inflation falls in the second half of 2026, the Fed could cut rates in both the third and fourth quarters, ending the year with a funds rate between 3.50% and 3.75%.

Asset allocation: Policy back to being a chronic not acute issue for markets

Entering the second half of 2025, policy has transitioned from an acute to a chronic issue for markets. It no longer drives day-to-day activities but still requires attention due to its side effects. Since the April 90-day pause of "reciprocal tariffs," the impact of U.S. policy announcements on global markets has diminished. The worst-case scenarios were avoided, recession risks receded and a new policy equilibrium emerged — a supportive backdrop for risk assets. However, having recouped their losses, U.S. equities and credit may be more prone to a (normal) correction if disappointment arises. In addition, policy impacts are still to be felt on a company-by-company basis. Quality is key as the "soggy" economic backdrop amid elevated rates is a good enough one for risk assets, but not one that benefits cyclical, speculative and levered areas of the market.

Long-term structural themes have taken back the baton as day-to-day drivers of market performance and investor decisions. Many previous themes have been further turbocharged by U.S. policy changes: AI adoption, automation, “friendshoring” of supply chains, rising electricity demand, higher defense spending, fiscal activism and the global economy leaving the post-GFC period firmly behind. While the themes may be similar, their investment implementation is ever evolving. We expect the winners to further broaden out within U.S. and global equities and across public and private markets. This leaves plenty of room for active management to add value.

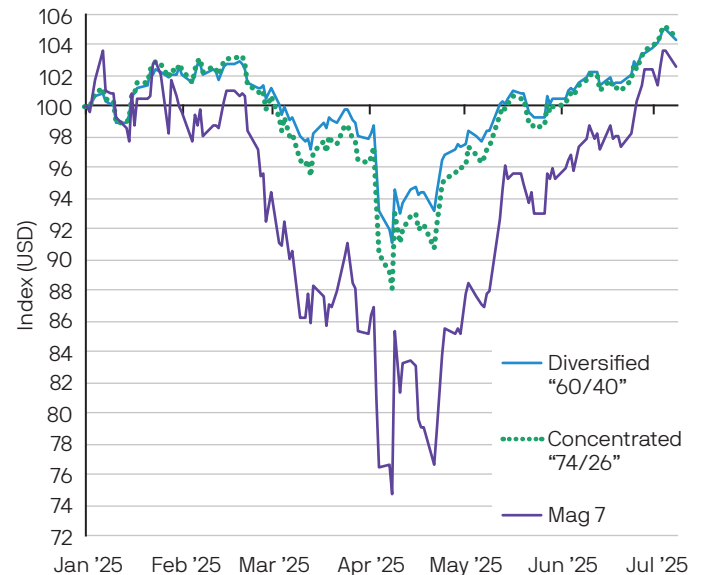
Investors should not forget this year’s lessons: diversification made a triumphant return after being proclaimed dead in 2022–2024. At the bottom of the U.S. stock market on April 8, duration proved its worth as a recession diversifier with the U.S. Aggregate up 1.9% (beating cash up 1.1%), international equities outperformed U.S. equities by 1,200bps and U.S. Value outperformed Growth by 700bps. Additionally, investment basics mattered again, including taking valuations and expectations into account and avoiding concentration, with over-owned areas of the market like the Magnificent 7 selling off the most.

The main action call for investors is not to predict the second half of the year with precision, but to rebalance likely unbalanced portfolios. Incremental shifts involve rebuilding a core allocation in fixed income (some duration and quality corporate and securitized credit), equally weighting U.S. Value and Growth and closing international underweights.

By having offsets in other parts of portfolios, investors would have had the staying power to hold on and not miss the stock market’s return to all-time highs (Exhibit 5). History shows that diversification’s worth may be questioned again in the future, but its results win out. Since 1995, a 60/40 has outperformed cash 80% of the time over a 3-year period, 91% of the time over a 5-year period and 100% of the time over a 10-year period. It’s a “60/40 with a twist”: adding private markets to boost portfolio resilience, including the offense (private equity and private credit secondaries) and the defense (infrastructure, real estate, absolute return hedge funds).

Embracing diversification and avoiding concentration paid off this year

EXHIBIT 5: 2025 PERFORMANCE OF DIFFERENT THEORETICAL PORTFOLIOS (JANUARY 1, 2025 = USD 100)



Source: Bloomberg, FactSet, MSCI, Standard & Poor’s, J.P. Morgan Asset Management; data are as of July 2, 2025. The 60/40 portfolio consists of 12.5% Large Cap Value (Russell 1000 Value Index), 12.5% Large Cap Growth (Russell 1000 Growth Index), 12.5% Small Cap Value (Russell 2000 Value Index), 12.5% Small Cap Growth (Russell 2000 Growth Index), 10% International Equity (MSCI All Country World ex-U.S. Index), 30% U.S. IG Fixed Income (Bloomberg U.S. Aggregate Index) and 10% Global High Yield Fixed Income (Bloomberg Global High Yield Index). The 74/26 portfolio represents a 60/40 portfolio that had not been rebalanced from Jan. 1, 2019 to Dec. 31, 2024. Mag 7 includes AAPL, AMZN, GOOGL/GOOG, META, MSFT, NVDA and TSLA. The 60/40 and 74/26 returns are total return in USD, while the Mag 7 is price return.

Fixed income: Settling in at high rates and low spreads

Despite March and April’s policy-induced spike in bond market volatility, the backdrop for bonds has not changed dramatically versus the start of the year: the Fed is still biased to cut (not hike) rates gradually, fiscal deficits and debt issuance are still on a worsening trend and the economy is still humming along keeping corporate and household default rates low. The direction of travel is still the same: 1) settling in at elevated rates, with a very modest move lower in yields versus last year, 2) continued steepening of the yield curve led by the short end and 3) low corporate credit spreads becoming the norm.

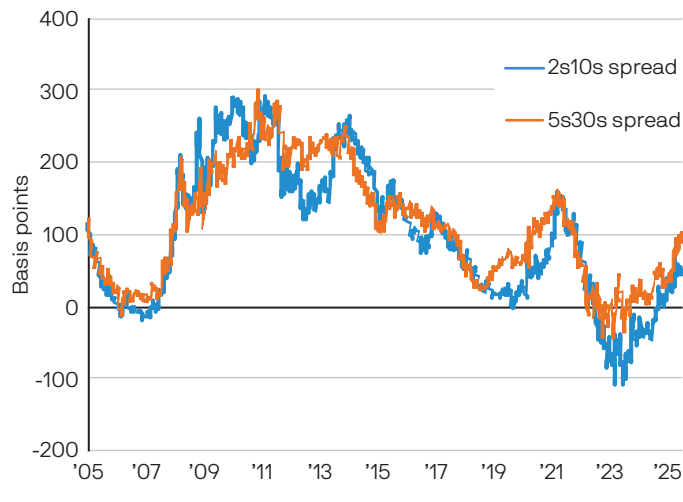
The 2025 fixed income playbook remains:

- **Extend duration (a little) out of cash, “just in case”:** After two years of inversion, the yield curve (the 2s10s) has steepened by 100bps since late 2023

– and the trend is toward further normalization (Exhibit 6). A step out of cash-like instruments is more attractive again, as an “insurance policy” for recession risk and to minimize reinvestment risk. However, elevated deficits plus inflation uncertainty provide a floor for long-end yields until the next recession arrives. The short-to-intermediate part of the curve is a sweet spot for investors.

U.S. Treasury curve should continue to steepen

EXHIBIT 6: U.S. TREASURY CURVE STEEPNESS (BASIS POINTS, JAN. 1, 2005–TODAY)



Source: FactSet, U.S. Treasury Department, J.P. Morgan Asset Management; data as of July 15, 2025.

- **Embrace credit for the yield, not the spread:** After briefly spiking by 177bps and 43bps respectively, high yield (HY) and investment grade (IG) spreads are once again lower than at the start of the year. While spreads are low, so are corporate defaults — and we do not see a reason for them to spike given good enough corporate and household fundamentals and lower recession odds. Investors should stop waiting for cheaper spreads and instead embrace the attractive all-in yields across the corporate credit space (especially IG and HY) and securitized markets (agency MBS and asset-backed securities). Investors should be wary of reaching for too much yield, with areas like leveraged loans and direct lending showing very early signs of stress after years of elevated rates.
- **Use the whole fixed income universe to your advantage:** While a passive index like the Bloomberg U.S. Aggregate does a fair job benchmarking the core fixed

income space, it leaves out attractive pockets: only 10% of securitized and other agency markets are captured. In addition, municipal bonds are not included — and even its dedicated index only captures 40% of the tax-exempt universe. This is one area where there is still value even compared to last year: with steep curves across the AAA and BBB tax-equivalent space, plus strong state and local fundamentals.

In the second half, the main question is not if but how the curve steepens from here: led by the short end or by the long end? This will depend on the tug-of-war between growth and inflation — and the FOMC’s response. We still believe the yield curve is biased to steepen led by the ultra-short end, as the Fed gradually lowers rates and remains sensitive to a “break” in the labor market. However, the risk for bond investors is that the long end leads the way, likely due to higher inflation worsened by a Fed that’s too quick to lower rates.

U.S. equities: Unchanged themes but not an unchanged market

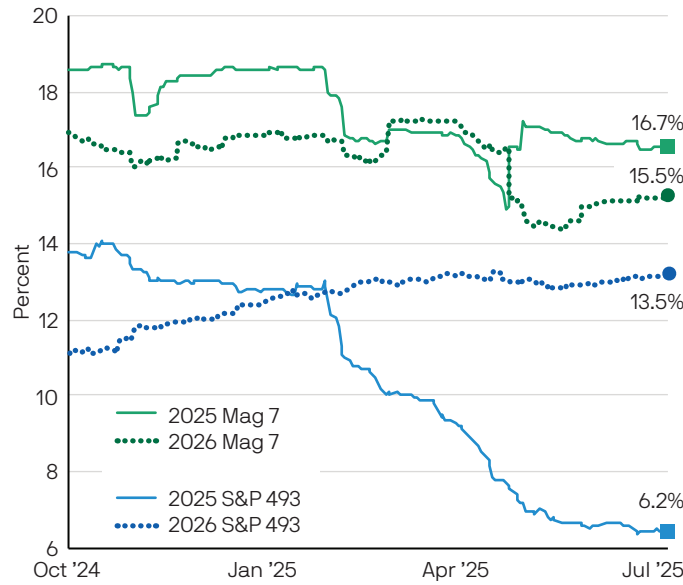
After a near bear market in early April, U.S. large cap stocks have resumed their bull market. More all-time highs are expected, as strength begets more strength in a context of positive nominal economic growth and positive earnings growth. That said, valuations are now higher than at the start of the year, with the S&P 500 price-to-earnings ratio at 22x, leaving the market vulnerable to any disappointment. However, unless the policy and macro-economic base case changes significantly, future corrections should remain in the “normal” zone (-5 to 10%).

Investors should rightfully celebrate leaving peak policy uncertainty behind, but policy changes do matter beneath the surface. Subsequent earnings seasons this year will show whether analysts have lowered their earnings expectations sufficiently. 2025 earnings expectations have been cut in half for the S&P 493 group of companies but not significantly declined for 2026 or for the Magnificent 7 (Exhibit 7, next page).

- **Impact of higher tariffs will differ company-by-company:** Outside of utilities, no sector is immune from elevated tariff rates. The magnitude will depend on exposure to foreign suppliers and foreign revenues, as well as pricing power. Equity investors should cheer some inflation as a sign that companies are able to pass on higher tariff costs and preserve margins.

2025 earnings expectations have been cut in half for the S&P 493, but not others

EXHIBIT 7: MAGNIFICENT 7* EARNINGS EXPECTATIONS (CONSENSUS EPS GROWTH ESTIMATES, YEAR-OVER-YEAR)



Source: FactSet, S&P Global, J.P. Morgan Asset Management; data as of July 15, 2025.

*Mag 7 includes AAPL, AMZN, GOOGL/GOOG, META, MSFT, NVDA, and TSLA

- **Backdrop is still for modest growth and elevated rates:** This should continue to pressure results of cyclical and rate-sensitive companies like small caps, retail, materials, some industrials, autos and homebuilders. Our preference remains for large cap stocks and the quality factor.
- **Policy winners always emerge:** Large banks are the clearest example of tangible changes to regulation already benefiting earnings expectations — and attention will be on how much loan growth picks up and how much deal activity rebounds. Other policy winners include companies involved in automation and robotics, which will get an accelerated boost from higher domestic input costs.

Investors should also cheer the room to refocus attention on long-term investment themes, but the implementation of the themes has changed:

- **AI is still the main U.S. market theme, but the Mag 7 isn't the best way to express it:** The Magnificent 7 group of companies has only contributed 20% to year-to-date returns versus 55% last year and 63% the year before. Investors have focused on the monetization of the AI capex (and personnel) costs borne by hyperscalers

and are better differentiating within the group. While the Mag 7 earnings surprise rose again in 1Q, it has been on a decelerating trend since 3Q23, suggesting more up and down volatility ahead. Its high voltage was present this year as the group sold off 26% during the February-April sell-off, while the remaining 493 companies were down 11%.

- **“New new AI winners” emerge:** “Deep Seek Monday” was a reminder that disruption is a feature not a bug of rapid innovation. Winners include a broader group: companies involved in the digital and physical infrastructure buildout and AI adoption more broadly, including companies as diverse as cybersecurity, software, industrials and utilities. The related themes of automation and rising electricity consumption are key to incorporate.
- **Environment ripe for active management:** A broadening market, a focus on micro over macro drivers, plus still-elevated stock valuation dispersion is a solid environment for stock pickers. While at index level valuations are elevated again, there is still a 17x difference in valuations between stocks in the 20th and 80th percentiles.

A risk for investors to keep in mind are signs of overly risk-on behavior, including cyclicals leading defensives, SPACs fundraising again and profitless small companies outperforming profitable ones. While there's room for upside surprise with animal spirits, the best expression of that would be through quality companies.

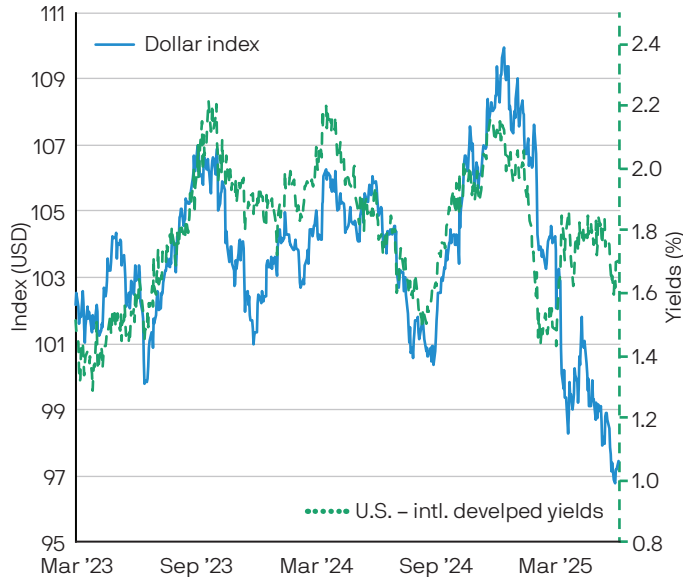
International equities: More room to run as U.S. exceptionalism normalizes

International equities have outperformed U.S. equities by 1,200bps year-to-date — the best first half of the year since 2009. Interestingly, both developed and emerging markets outperformed the U.S. during the February–April sell-off and did not give back their outperformance after the United States market recovered. This year's 11% move lower in the U.S. dollar has been a key but not sole contributor to returns, especially in Europe, China and the rest of emerging markets as multiple expansion has been strong.

We expect this strong momentum in international equities to continue, with some laggards catching up in the second half including Japan and India. We also expect further depreciation of the U.S. dollar, given its elevated level and the clear shift in drivers (with interest

Since April, U.S. dollar no longer driven by interest rate differentials

EXHIBIT 8: DXY INDEX, U.S. – INTL. DEVELOPED BOND YIELDS



Source: BIS, FactSet, J.P. Morgan Asset Management; data are as of July 7, 2025. Currencies in the DXY Index are: British pound, Canadian dollar, euro, Japanese yen, Swedish krona and Swiss franc. Interest rate differential is the difference between the 10-year U.S. Treasury yield and a basket of the 10-year yields of each major trading partner (Australia, Canada, eurozone, Japan, Sweden, Switzerland and UK). Weights in the basket are calculated using the 10-year average of total government bonds outstanding in each region.

rate differentials taking a backseat) (Exhibit 8). The most powerful force now seems to be the global rebalancing of capital flows, especially on the equity side. Cycles of dollar weakness have tended to coincide with international outperformance — such as during 2001–2007 (an important parallel for investors to keep in mind).

Rather than the “end of U.S. exceptionalism,” we see it as a “normalization of U.S. exceptionalism” — more of a function of the starting point rather than the end point. U.S. equities handily outperformed for 15 years, leaving the U.S. premium and portfolio representation abnormally elevated: U.S. premium to international equities still stands at 35% (nearly double the 20-year average), the U.S. dollar is still elevated versus fundamentals, U.S. equities still represent 64% of global benchmarks, foreign investors still hold 18% of U.S. equities (a near 20-year high) and U.S. investors still exhibit a structural underweight to international equities.

The U.S. is still exceptional in its economic and earnings potential, but there’s room for further rebalancing in global valuations and portfolios:

- **“Push” from the U.S. side:** The Mag 7’s bear market earlier this year reminded global investors that there is a risk in being too concentrated in U.S. markets. The 4% depreciation of the U.S. dollar during the February–April sell-off was also a wake-up call for foreign investors to hedge or diversify currency exposure. Lastly, the uncertainty this year has stemmed from the U.S. policy and macro side amid elevated expectations.
- **“Pull” from international markets:** U.S. policy has prompted long-overdue international policy changes, especially in Europe with the largest change in German fiscal stance since WWII and a shift to public investment in defense and infrastructure across the continent. Further upside surprise in Europe could come from greater regional integration and a rethink of regulation. The pull remains strong in other regions as well, including corporate governance reforms in Japan and Korea and positive demographics and reforms in a high-quality market like India. Lastly, U.S. investors now have a reason to diversify currency exposure to diversify U.S. risk and as an added boost to returns.

Alternatives: Diversifying the offense and the defense

The inclusion of alternatives in high-net-worth individual portfolios continues to grow, propelled by valuation and diversification challenges in public markets. Within institutional portfolios, allocations are shifting with a rethinking of elevated private equity allocations and a focus on boosting non-correlated assets (like infrastructure). During the second half, these trends are set to accelerate as investors look to boost portfolio resilience:

- **Expanding the roster of portfolio “defenders”:** Duration worked as a diversifier to recession concerns this year, but this investing cycle comes with many other risks, including inflation and policy risks. Parts of private markets with a low to negative correlation to public markets include absolute return hedge funds, infrastructure, transportation and real estate.
- **Boosting portfolio “offense”:** Some alternatives can offer higher return or income and allow investors to participate in long-term themes: private equity

and venture capital offer access to fast-growing AI companies, private credit offers access to companies directly tied to the rise in public and private investment and infrastructure assets like power utilities tap into the themes of rising electricity demand and infrastructure needs.

- **Looking for value:** Areas of private markets have been dislocated over the past few years. One prime example is commercial real estate, where prices have adjusted lower in the rising rate environment. It's a good environment to be a real estate owner and investor, rather than a renter or first-time home buyer. In addition, the secondary markets in private equity and private credit offer discounted access to capital already deployed, as institutional investors have been forced to sell to shore up liquidity.

Conclusion

Looking ahead to the remainder of the year, the economic landscape will reflect the many policy changes enacted in the first half of the year. We expect the economy's resilience to still be evident, albeit with slightly slower growth, higher inflation and rates high for longer. We do not expect daily policy announcements to drive the day-to-day of the markets anymore, but their impacts will be felt beneath the surface across asset classes. Long-term themes like AI, automation, defense spending and shifting supply chains have taken back the baton as market drivers. However, with many markets back to previous highs, embracing quality and active management globally and across public and private markets is key. As investors navigate the long and winding road ahead, the focus should remain on rebalancing portfolios to increase portfolio resilience by diversifying both the offense and defense.

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PJCT-0625-AM-4124182-MI-MYO-WP

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