Market Outlook | 2025

Navigating the IFs and BUTs in a promising year

The global economy is entering 2025 with decent momentum. Inflation is declining, thus enabling central banks to ease restrictive monetary policy. Historically, a U.S. economic soft landing and monetary policy easing have helped equities and fixed income to outperform cash (represented by U.S. short-term Treasuries). We believe this is still the most likely scenario.

However, the incoming Republican administration in the U.S. and the political changes in many developed economies suggest that significant policy shifts could impact the global economy and investment landscape in both the short and the long term. We highlight five factors covering the IFs and BUTs that investors could focus on.

I: Inflation resurging

F: Fiscal discipline

B: Borders and geopolitics

U: Unemployment and recessions

T: Trade and industrial policy

What's positive is that there are solutions to tackle these issues through allocation into equities, fixed income and alternative assets. In this **2025 Market Outlook**, we aim to address some of the key topics and themes investors should consider:

1. Can the U.S. economy maintain the soft landing ?
2. Central bank policy: In lockstep or dancing to different tunes?
3. Exchange rates: What could stop the rising U.S. dollar?
4. Is it time to take a fresh look at fixed income?
5. Trump's tariff plans: Accelerating an ongoing supply chain evolution
6. Embracing Asia's many opportunities despite the challenges
7. Why the building of AI infrastructure is a boon
8. What's the view on U.S. and developed market equities?
9. The importance of diversification amid portfolio construction

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1. Can the U.S. economy maintain the soft landing?

The fundamental outlook of the global economy is benign. Economies have survived the sharp rise in interest rates and inflation is decreasing. This enables central banks to ease restrictive monetary policy to safeguard growth. An extension of the U.S. economic cycle is still our core scenario because triggers for a severe recession, such as over-leveraged households or corporations, are not evident. We believe the current momentum from personal consumption and business investment should keep the U.S. economy expanding at trend growth going into 2025..

While there are good reasons to be optimistic, it is important to take note of the ifs and buts, or risk scenarios, when we think about portfolio construction for the new year. We use “IF” and “BUT” to label five risk factors, each with different probabilities of appearing and varying effects on the market.

I - Inflation resurging. High interest rates have achieved the goal of bringing down inflationary pressures. However, as we experienced in 2022, a resurgence of inflation could reignite the positive correlation between stocks and bonds, especially if central banks are compelled to reverse their policies. This could be driven by supply-side factors, such as a surge in commodity prices, or the direct impact of higher tariffs and other protectionist measures. Strict immigration policies that result in a tighter labor market could also increase inflationary pressure.

F - Fiscal discipline. We saw in September 2022 what poor fiscal discipline did to the UK government bond market in terms of impaired investor confidence. With the incoming Republican administration in the U.S. looking to extend the 2017 tax cuts, and possibly pushing corporate tax rates even lower, investors should pay greater attention to the long-term debt sustainability of the federal government. Elsewhere, achieving net-zero carbon emissions and the changing geopolitical landscape could force developed market (DM) governments to raise deficits.

B - Borders and geopolitics. Conflicts over the past three years have disrupted commodity supply chains and shipping routes. Still, these key economic pipelines remain vulnerable to unexpected conflicts. Furthermore, how the new Trump administration collaborates with North Atlantic Treaty Organization and Asian allies could lead many governments to prioritize defense spending more highly. Borders also represent immigration policy in the U.S. and Europe. We view immigration as crucial for sustaining long-term economic growth, but voters prefer more restrictive policies.

U - Unemployment and recessions. Economic growth typically does not just stop abruptly. Recessions are usually triggered by an economic shock. The key is to find the right strategy to safeguard our portfolio against this risk, especially when risk assets, such as equities and high-yield corporate bonds, are pricing in little risk of a recession.

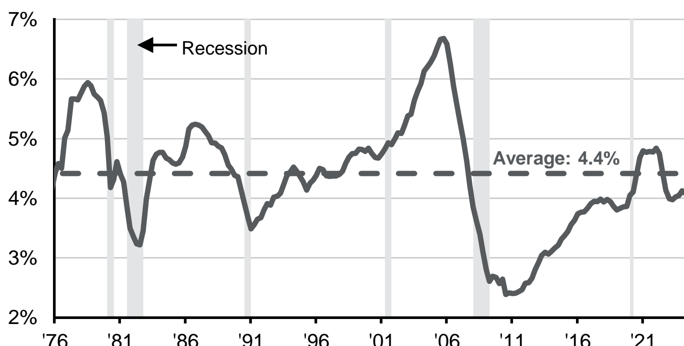
T - Trade and industrial policy. Tariffs are likely the most well known risk in this category. This could trigger a resurgence of inflation and ignite trade tensions, both of which are destructive to global growth.

Yet, we have also seen an increase in industrial policies supporting the domestic development of strategically important sectors, such as technology, artificial intelligence (AI) and renewable energy. A less globalized world is arguably less productive and more expensive.

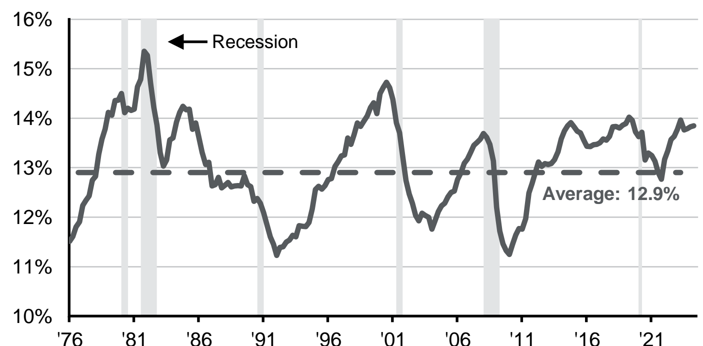
Macroeconomic data still point toward the soft landing of the U.S. economy, but we should keep in mind the risks that could challenge investors.

Exhibit 1: United States cyclical sectors

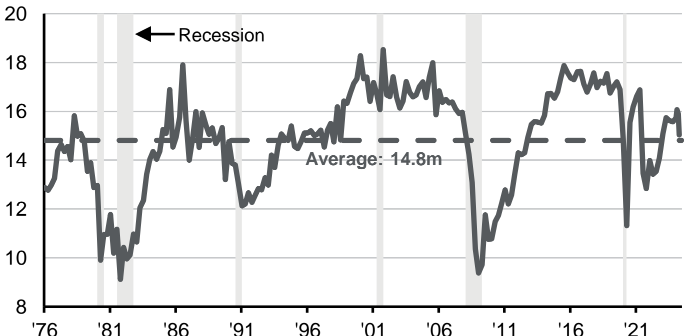
Residential investment as a % of GDP
Quarterly, seasonally adjusted



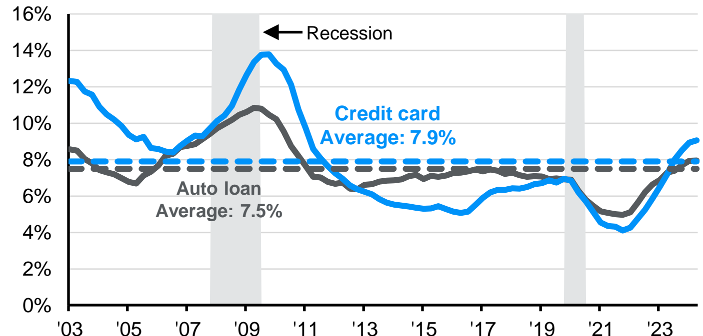
Business fixed investment as a % of GDP
Quarterly, seasonally adjusted



Light vehicle sales
Million vehicles, seasonally adjusted annualized rate



Flows into early delinquencies
Share of balance delinquent 30+ days



Source: Bureau of Economic Analysis, FactSet, U.S. Census Bureau, J.P. Morgan Asset Management. Data for light vehicle sales is quarterly apart from the latest monthly data point. *Guide to the Markets – Asia.* Data reflect most recently available as of 30/09/24.

2. Central bank policy: In lockstep or dancing to different tunes?

Global central banks have begun their monetary policy easing cycles. However, the differing characteristics of each economy's inflation and growth path will dictate the pace and magnitude of easing .

Despite the Federal Reserve's (Fed) slightly larger cut at the start of its monetary rate-cutting cycle in September, future policy decisions will be guided by evolving economic conditions, particularly in the labor market. Incoming data suggests the labor market is on a stable footing, reducing the likelihood of a deeper-than-expected rate-cutting cycle.

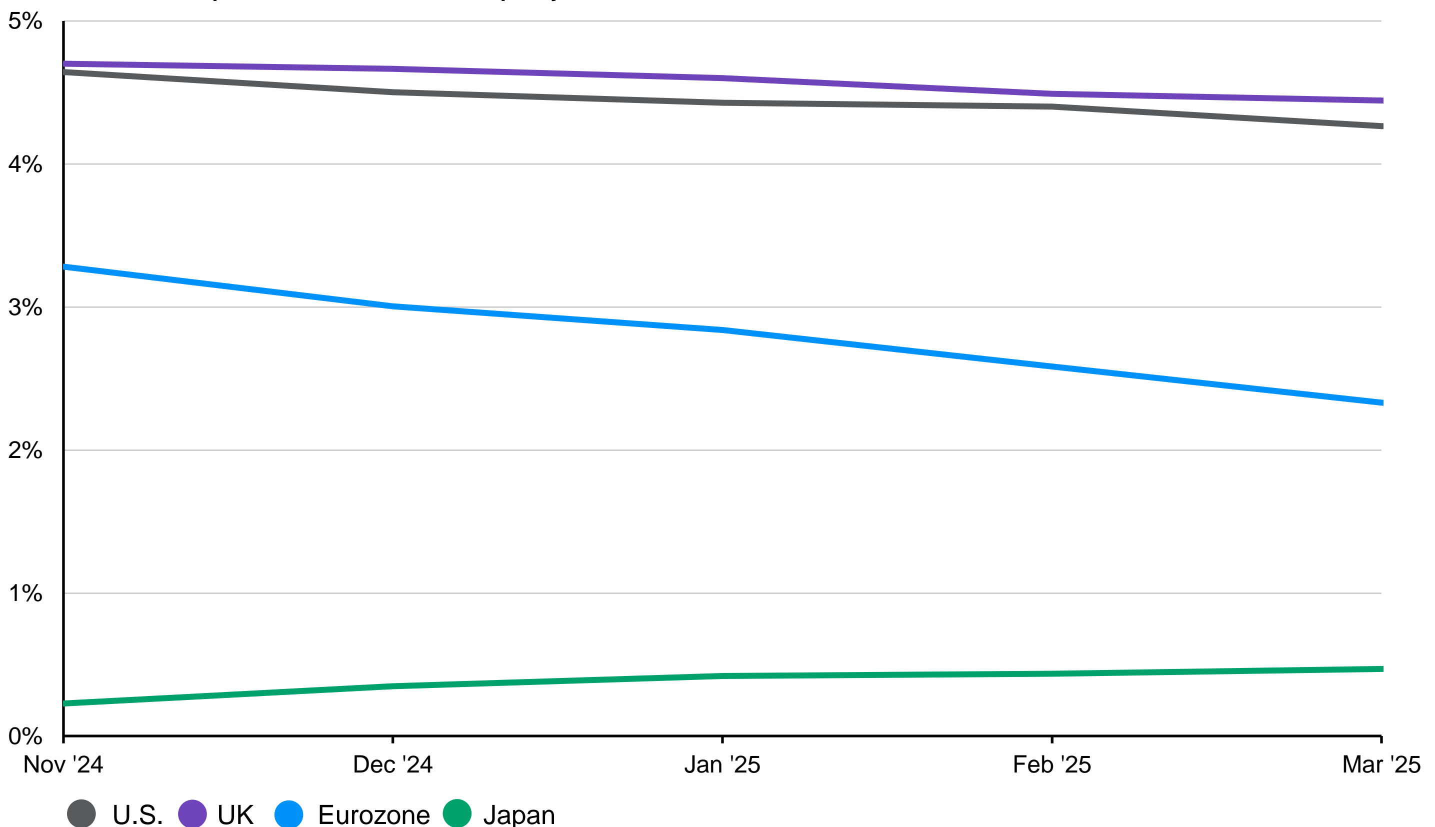
In Europe, however, a series of downward data surprises has raised concerns over the health of the economy, prompting expectations of a deeper and faster easing cycle by the European Central Bank (ECB) despite persistent stickiness in services inflation. With the disinflationary process on track, however, the ECB can address the weaker growth environment and continue to adjust monetary policy settings accordingly.

Given the drastically different growth backdrops, we see a higher risk of dovish surprises from the ECB compared with the Fed. Meanwhile, the Bank of Japan is likely to raise the policy rate gradually as rising wage costs are increasingly affecting services price inflation.

Earlier in 2024, shifting expectations for the Fed's rate cuts and a strong U.S. dollar (USD) prompted emerging market (EM) central banks to balance financial stability, growth and inflation. With the Fed rate-cutting cycle underway, concerns about financial stability linked to weaker currencies have lessened. This has allowed EM central banks to focus on domestic conditions. With supporting structural growth factors, the level of monetary policy easing by Asian EM economies is expected to be less than the U.S.

Still, the trajectory of the central banks' policy easing could be challenged by factors such as a severe U.S. growth shock or trade policy changes that may slow the global goods cycle. These shocks could affect developed and emerging economies differently, leading to varied interest-rate-cutting cycles globally. This, in turn, can present investors with a wider range of opportunities for global rates allocation.

Market expectations for future policy rates in the G4 economies, based on overnight index swap rates.
Exhibit 2: Market expectations* for central bank policy rates



Source: Bank of England, Bank of Japan, European Central Bank, U.S. Federal Reserve, J.P. Morgan Asset Management; Bloomberg L.P. *Expectations are based on overnight index swap rates. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – Asia. Data reflect most recently available as of 19/11/24.

3. Exchange rates: What could stop the rising U.S. dollar?

The USD experienced a volatile year in 2024, peaking on robust economic and inflation data in April, then bottoming out as recession fears resurfaced later in September.

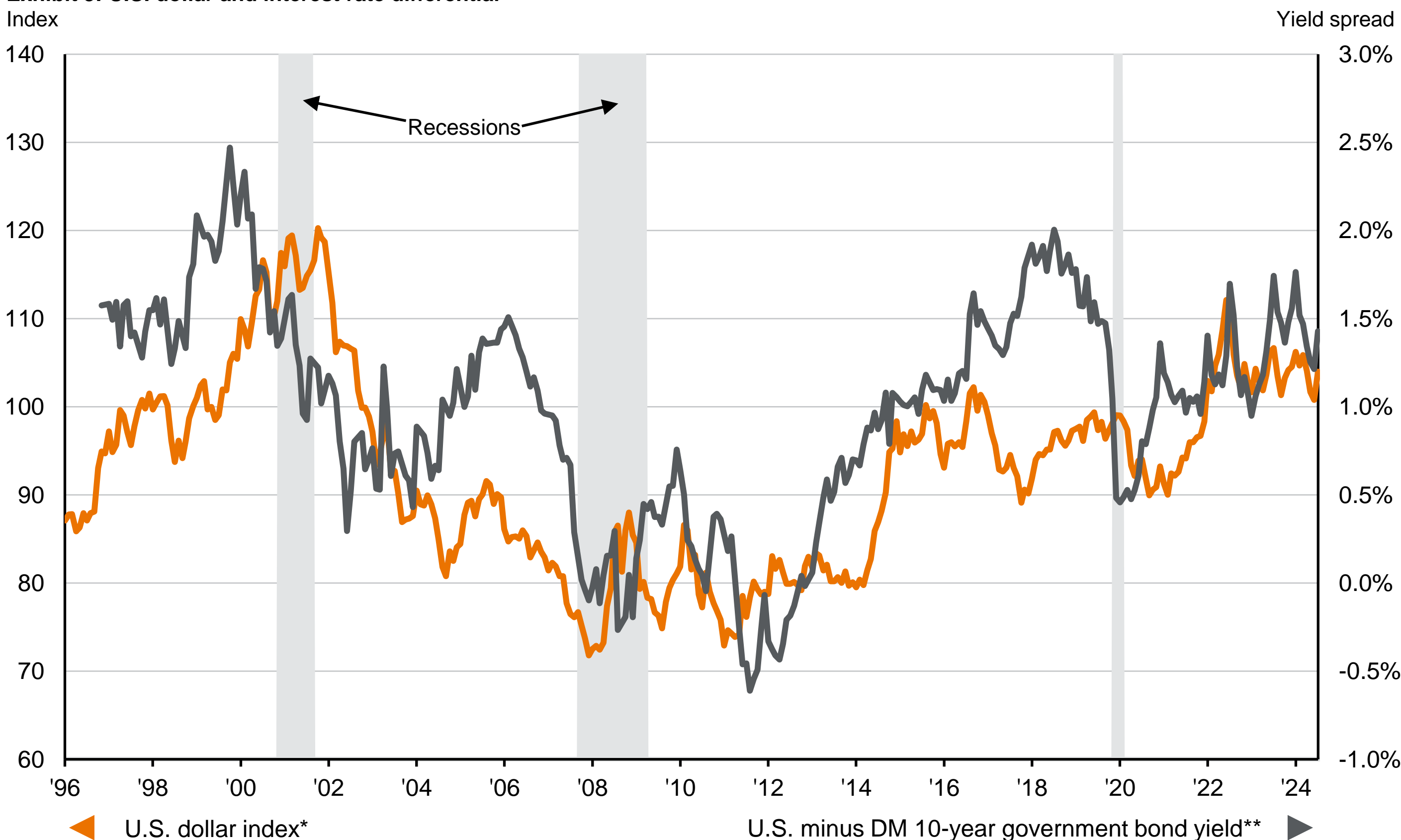
Cyclically, U.S. economic growth remains resilient, supported by strong domestic demand. The possibility of policy changes may pose a challenge for the Fed since tariffs can heighten inflationary pressure. With growth expected to slow only modestly, and the risks of "no-landing" reflationary growth re-emerging, the Fed may not cut interest rates as much as the market anticipates. This could support the near-term dynamics of the USD. U.S. growth is likely to remain relatively resilient compared with other DMs, suggesting potential for further capital inflows into the U.S. In short, the USD could remain stable rather than decline.

Meanwhile, factors such as heightened geopolitical tensions could increase demand for safe-haven assets such as the USD or U.S. Treasuries, serving as a defensive allocation in risk-off environments. Additionally, the expanding federal budget deficit could lead to increased U.S. Treasury bond issuance, resulting in persistently high long-term yields. Together, these factors support the view of a stronger USD in the medium term.

Though not part of our base case, there are scenarios where the USD could see a softer run. Domestically, if the U.S. labor market or household balance sheets deteriorate rapidly, leading into a sharper growth slowdown compared with the rest of the world, larger Fed rate cuts could occur, narrowing the interest rate differential with other currencies. Alternatively, if China's stimulus measures gain momentum, they could bolster its economy and the broader Asian region, supporting a gradual shift into Asian currencies. In addition, as Japan's positive wage growth and services prices gather momentum, policy normalization will remain a key theme with the Bank of Japan, one of the few central banks to raise interest rates, supporting the Japanese yen.

The balance ultimately depends on the outlook horizon. Interest rate differentials and other cyclical factors are likely to support a strong USD in the near term. However, as structural factors start to be priced in by markets and considering its current valuation, longer-term risks lean toward a gradual moderation of the USD. Investors may consider this an opportunity to rotate into a globally diversified portfolio of equities. Japanese equities' unique negative correlation to its currency strength also sets it as a worthwhile consideration in portfolios, especially noting its undemanding valuation.

The performance of the USD represented by the trade-weighted USD index and the interest rate differential between the U.S. and a weighted average of major DMs.
Exhibit 3: U.S. dollar and interest rate differential



Source: FactSet, OECD, Tullett Prebon, WM/Reuters, J.P. Morgan Asset Management. *The U.S. dollar index shown here is a nominal trade-weighted index of major trading partners' currencies. Major currencies are the British pound, Canadian dollar, euro, Japanese yen, Swedish kroner and Swiss franc. **DM is developed markets and the yield is calculated as a GDP-weighted average of the 10-year government bond yields of Australia, Canada, France, Germany, Italy, Japan, Switzerland and the UK. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – Asia. Data reflect most recently available as of 19/11/24.

4. Is it time to take a fresh look at fixed income?

After an eventful close to 2024, U.S. Treasury yields have risen back to July levels, with a steepened curve. On the short end, even though the Fed has started lowering interest rates, initially with a surprise 50 basis points (bps) cut, the pace of future cuts is expected to slow substantially as the next U.S. administration's pro-growth focus could keep inflation elevated.

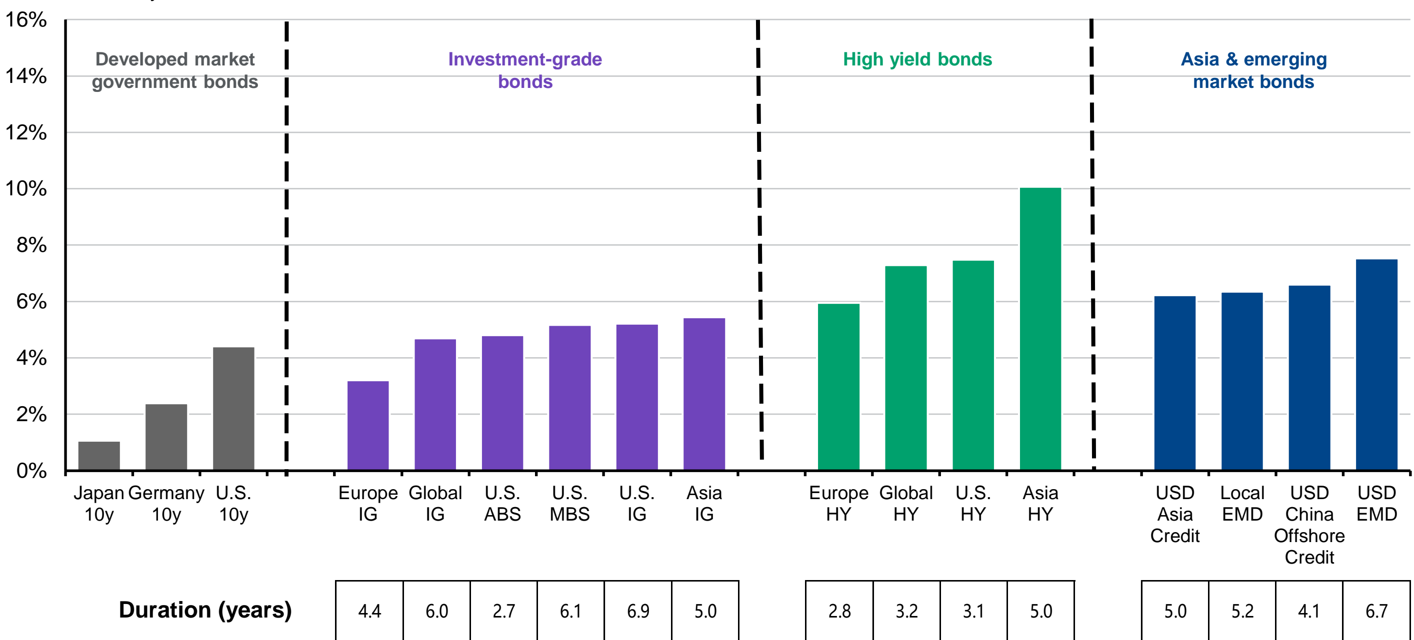
While markets are still pricing in just over 50 bps of cuts for 2025, it is a sharp contrast from the Fed's recent projection of 100 bps. On the long end, an increased risk of a worsening fiscal deficit has also pushed yields higher. While the steepening curve has created opportunities for positive carry on long U.S. duration, the expected increase in Treasuries supply and the Fed's continued reduction of its Treasury holdings suggest that long-term yields could stay high for some time.

Duration in other DMs such as Europe appears more attractive. The ECB has been cautious with rate cuts, but incoming economic data suggesting weaker domestic growth and softer inflation could lead to more aggressive monetary easing. With growth risks leaning downward, Europe is likely to surprise with dovish policies, making European bonds potentially more favorable than U.S. bonds as their yields may drift lower.

Beyond duration, credit spreads for both U.S. investment-grade (IG) and high-yield (HY) bonds are currently on the tighter side compared to historical norms. In similar previous situations, where the U.S. economy experienced a soft landing and credit fundamentals were strong, credit spreads have stayed tight for an extended period. While there is limited room for spreads to tighten further, the risk of them widening significantly is low, especially with a proposed pro-growth tax cut on the horizon. Overall, all-in yields remain attractive, and corporate bonds are likely to benefit from stable spread returns and changes in short-term rates.

For Asian EMs, the Fed's easing cycle has temporarily reduced pressure on domestic currencies, enabling some central banks to start lowering interest rates. However, renewed expectations for U.S. reflation and higher rates could stall this progress, keeping domestic currencies under pressure. Despite this, a more disciplined fiscal approach in certain markets, especially those with stronger fundamentals, should provide better support for local bonds compared with U.S. Treasuries, presenting a boost to Asian fixed income.

All-in yields for U.S. IG, HY and EM bonds appear more attractive compared to U.S. Treasuries.
Exhibit 4: Fixed Income yields
Yield to maturity



Source: Bloomberg, FactSet, ICE BofA Merrill Lynch, J.P. Morgan Economic Research, J.P. Morgan Asset Management. Based on Bloomberg U.S. Aggregate Credit – Corporate Investment Grade Index (U.S. IG), Bloomberg Euro Aggregate Credit – Corporate (Europe IG), J.P. Morgan Asia Credit Investment Grade Index (Asia IG), Bloomberg Global Aggregate – Corporate (Global IG), Bloomberg U.S. Aggregate Credit – Corporate High Yield Index (U.S. HY), Bloomberg U.S. Aggregate Securitized – Asset Backed Securities (U.S. ABS), Bloomberg U.S. Aggregate Securitized – Mortgage Backed Securities (U.S. MBS), Bloomberg Pan European High Yield (Europe HY), J.P. Morgan Asia Credit High Yield Index (Asia HY), ICE BofA Global High Yield (Global HY), J.P. Morgan GBI-EM Global Diversified (Local EMD), J.P. Morgan EMBI Global (USD EMD), J.P. Morgan Asia Credit Index (JACI) (USD Asia Credit), J.P. Morgan Asia Credit China Index (USD China Offshore Credit). Duration is a measure of the sensitivity of the price (the value of the principal) of a fixed income investment to a change in interest rates and is expressed as number of years. Spread durations are shown for Asia IG, Asia HY, USD EMD, USD Asia Credit and USD China Offshore Credit. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. Yields are not guaranteed, positive yield does not imply positive return. Past performance is not a reliable indicator of current and future results.
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5. Trump's tariff plans: Accelerating an ongoing supply chain evolution

The COVID-19 pandemic and the Russia-Ukraine conflict exposed supply chain weaknesses, leading to more friendshoring and industrial policies globally. President-elect Trump's victory and his tariff plans could accelerate these changes. While any new trade laws would require congressional support, the President can impose tariffs for unfair trade practices or national security reasons. However, tariffs are often negotiation tools, and the actual levels may be lower or more limited than initially proposed due to their impact on U.S. inflation and growth.

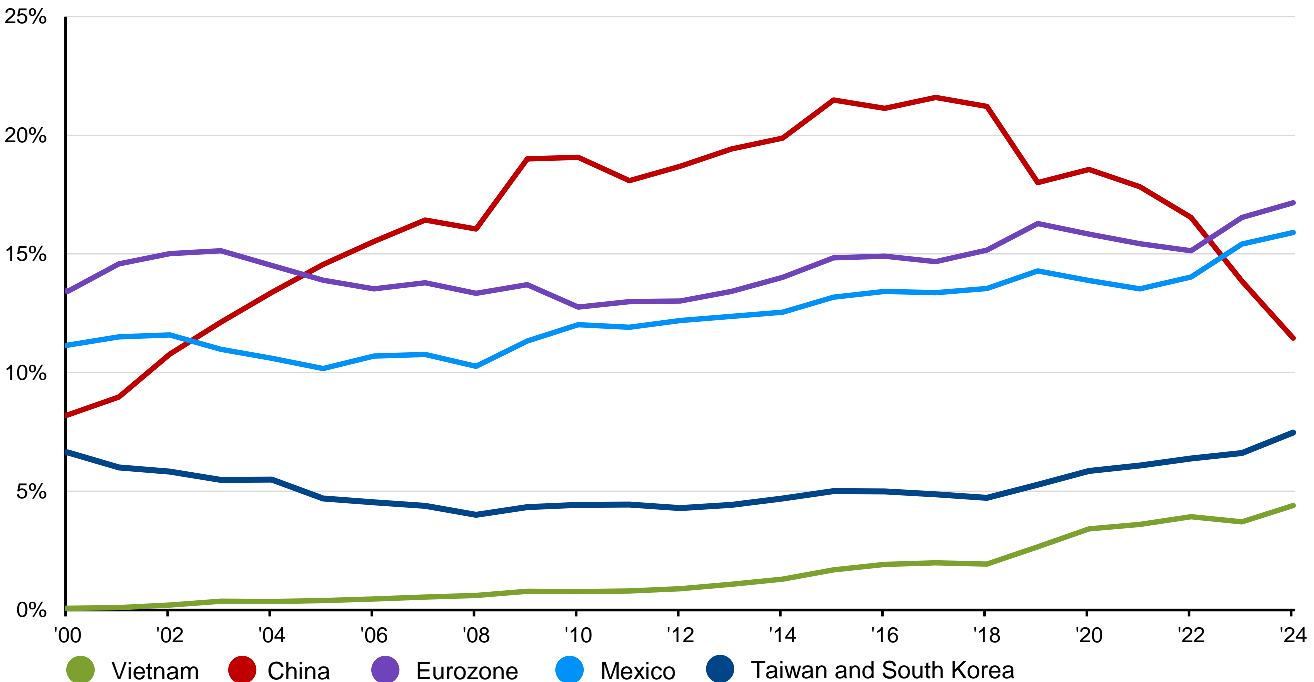
A 60% U.S. tariff on Chinese goods could lower China's real gross domestic product (GDP) growth by 2 percentage points over the next 4-6 quarters, assuming all other factors remain constant, according to J.P. Morgan Economic Research (as of November 2024). Exports, investments and consumption will face direct negative impact, alongside the spillovers from reduced business confidence. To offset this impact, China's government will likely increase fiscal support and may respond with retaliatory tariffs and currency depreciation.

Trade tensions are a familiar challenge for Chinese exporters. While their share of U.S. imports has fallen by 5 percentage points since the end of 2017, their share of global exports has increased. Chinese exporters have been managing geopolitical risks by diversifying export destinations and increasing production capacity in other EMs to counter tariff measures. They have become less dependent on the U.S. and are better equipped to handle tariff escalations compared with 2018.

Products from the Association of Southeast Asian Nations (ASEAN) and Mexico have increased their share of U.S. imports since 2018, partially offsetting the shortfall from China. ASEAN has mostly replaced China in light-manufacturing products like textiles, Mexico in the automotive sector, and Taiwan and Korea in electronics. Whether this trend continues will depend on future tariff levels, the specific products targeted and any transshipment restrictions, such as those related to Mexico-manufactured autos. Several factors will determine the winners in the reshoring trend: cost competitiveness, supportive government policies, close substitutes for Chinese products and integration into existing supply chains, as well as adequate infrastructure and capacity to meet additional demand. Evidence from 2018-2019 suggests these beneficiaries not only re-exported Chinese goods, but also increased value-added production and exports to economies beyond the U.S. This was likely due to expanded capacity allowed for economies of scale and new trade opportunities with other economies.

In conclusion, supply chain diversification has been underway for years, and higher tariffs on China could accelerate this process, especially for strategically important goods like semiconductors, solar cells and critical metals. This shift will benefit other low-cost manufacturers, but if the Trump administration raises tariffs on all imports, reallocation could slow and lead to higher costs. While U.S.-China trade connections will become less direct, a complete decoupling is unlikely in the near term. Firstly, the exact scope and magnitude of tariffs remain uncertain. Secondly, China remains an attractive manufacturing hub due to its competitive advantages, economies of scale and sunk costs that firms must weigh against the benefits of reshoring. Additionally, Chinese companies are better positioned to cope with higher tariffs than they were before.

Mexico and several Asian markets have increased their share of U.S. imports since 2018, partially offsetting the shortfall from China.
Exhibit 5: U.S. goods imports by market
Share of total U.S. goods imports



Source: FactSet, U.S Census Bureau, J.P. Morgan Asset Management.
Guide to the Markets – Asia. Data reflect most recently available as of 30/09/24.

6. Embracing Asia's many opportunities despite the challenges

Growth in most Asian economies slowed in 3Q 2024, notably in Hong Kong, South Korea and Taiwan. This slowdown aligns with the recent decline in export momentum across Asia, which is driven by cyclical weaknesses in the global manufacturing sector and a gradual moderation in semiconductor export growth.

However, semiconductor exports from North Asia are expected to increase in the near to medium term, supported by ongoing structural strength in AI-related products and high-performance computing (HPC) demand. AI-driven technology upgrades broadening to mobile phones, personal computers and other consumer tech products could also sustain this cycle.

Inflation in Asia has generally remained weak, even though India's inflation surprisingly rose recently, driven by higher-than-expected food prices. However, India's core inflation remains soft. Asian central banks are likely to maintain their easing bias, but the pace and timing may be limited if tariff risks create currency pressures. Additionally, changes in U.S. rates may also prompt Asian central banks to focus on defending their currencies rather than cutting rates to support their domestic economies.

In late September 2024, China announced a series of coordinated monetary, fiscal and property easing measures to support its economy. Early signs of improvement are starting to emerge. However, recovery of the real estate market will be slow because of excess inventory and cautious buyer expectations. With the new U.S. administration, investors may worry about potential higher tariffs and geopolitical uncertainties.

The U.S. viewing China as a competitive rival isn't new, and trade concerns are well known and likely already priced in. Most Chinese companies listed in the A-share market generate revenue domestically, and so local demand is crucial. While severe U.S. tariffs may impact China's exports, domestic policy measures to support the economy are likely to be a more significant driver for Chinese equities. In a slow growth environment, high-dividend and defensive stocks like banks, energy and state-owned enterprises have performed well.

However, if China's economic momentum improves in 2025, we see value opportunities in Chinese equities, especially for private sector companies that have enhanced their profit margins and corporate fundamentals. Improved market sentiment toward China could also attract more capital flows back into Asian markets.

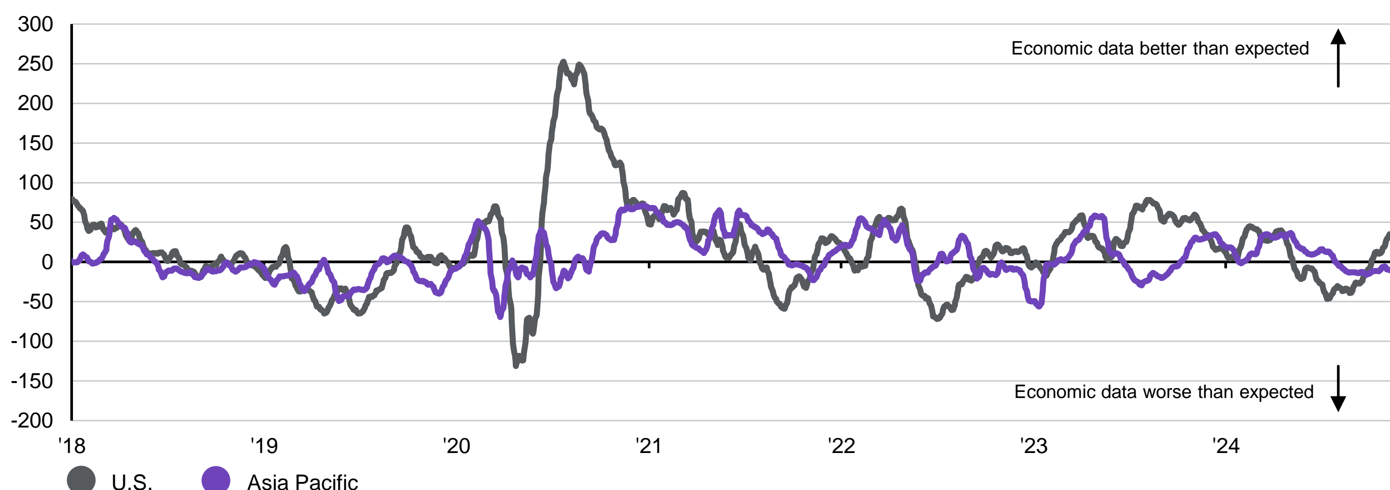
In India, the recent moderation in growth momentum should improve as (1) consumer demand picks up during the upcoming festive season; (2) government spending picks up; (3) private capital expenditure moves from announcements to actual investments; and (4) the central bank starts easing.

Government and regulatory policies are aimed at sustaining growth through incentives for new sectors while curbing excesses. This will likely expand India's economic growth beyond traditional sectors, like financials, information technology and consumer staples, to other sectors, such as consumer discretionary and new-age disruptive businesses tailored for the local market.

Additionally, the ongoing supply chain reorganization suggests growing demand for infrastructure as India develops into another global manufacturing hub, competing with China and ASEAN. This will likely benefit transport and infrastructure assets. India's long-term strengths, such as demographics and growth potential, remain robust. It is no surprise that Indian equity market valuations are high, reflecting strong earnings expectations. However, with time and continued profitability growth, this optimism should be justified.

Besides India, ASEAN markets are also likely to gain from the ongoing shift in supply chains. Like India, earnings growth in ASEAN should be supported in the medium term by structural factors such as favorable demographics, a growing middle class and increasing consumption. However, with ASEAN valuations at 13.7x in mid-November, matching their 15-year average, they are more attractive compared to India. Active bottom-up selection is crucial due to the wide variation in macroeconomic and stock fundamentals across ASEAN. The regional grouping's higher dividend payout ratios make it appealing for income-seeking investors, further enhancing its long-term investment appeal.

Growth in most Asian economies slowed in 3Q 2024, aligning with the recent decline in export momentum across Asia.
Exhibit 6: Citi Economic Surprise Indices
Index, 7-day moving average



Source: Citi, J.P. Morgan Asset Management.
Data reflects most recently available as of 19/11/24.

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7. Why the building of AI infrastructure is a boon

The rise of AI has been a major theme in global stock markets. In the U.S., where tech leadership has been most pronounced, stock markets have rallied a stellar 60% over the past two years. Most of these gains have been concentrated in the stocks of seven mega-cap tech or tech-related companies, which collectively have risen by 113% during this period[1].

Interestingly, despite the rise in stock prices, valuations have actually declined and are lower today than they were during the 2020-2021 market rally. This is partly because, unlike previous tech booms, the AI wave has been driven by highly profitable tech incumbents. Take the hyperscalers[2], for example; these large-scale cloud service companies are uniquely positioned to manage and host AI workloads. They are ramping up capital expenditures[3] (capex) by over 50% in 2024 to around USD 200billion, with continued growth expected in the next few years (see **Exhibit 7**). While the return-on-investment may take several quarters or even years to materialize, this spending is backed by significant cash flow generation.

As such, the elevated valuations of mega-cap U.S. tech companies should be supported by their quality, cash flow generation and growth potential. However, significant spending increases the risk of capital misallocation and overly optimistic growth expectations, which investors will scrutinize more closely as monetization becomes a greater focus. With substantial returns, investors have ended up with large allocations into just a few tech names, warranting careful attention to the competitive and regulatory risks that could curb growth expectations.

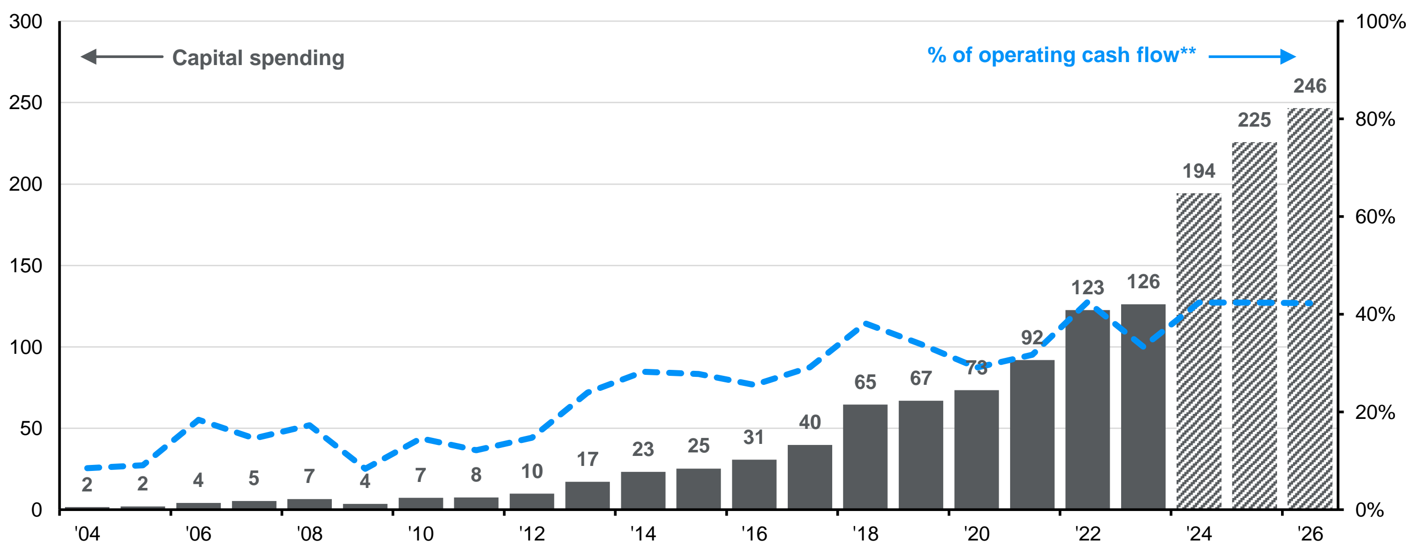
The capex boom is broadening the range of AI beneficiaries, presenting investors with diverse opportunities to invest in AI. One company's capex becomes another company's revenue, and the AI infrastructure value chain has revealed beneficiaries across both value and growth sectors, spanning small, mid and large-cap companies globally.

In the U.S., spending is expected to benefit market sectors like data center real estate, engineering and construction, nuclear and renewable power, energy transmission, gas-powered electricity, cooling technologies and the electrical components that connect these systems.

In Northeast Asian markets, the dominance in the AI semiconductor supply chain continues to benefit manufacturing powerhouses in South Korea and Taiwan. Japan, which has an edge in semiconductor manufacturing equipment, also stands to benefit. While many Asian exporters may be affected by escalating U.S.-China tensions, it is unlikely the U.S. can completely reduce its reliance on Asian chipmakers anytime soon. Demand for chips is expected to remain robust from both the U.S. and China.

Overall, we continue to view AI as a long-term investment opportunity that is still in its early stages. However, the heavy emphasis of mega-cap U.S. tech stocks in portfolios suggests a need for more diversification. This can be achieved by broadening investments to include a wider range of AI-related opportunities across various markets.

The major AI infrastructure companies are significantly increasing their investment spending, and they have the cash flows to support this expansion.
Exhibit 7: Capex from the major AI hyperscalers*
USD billions; Alphabet, Amazon (AWS), Meta, Microsoft, Oracle



Source: Bloomberg, J.P. Morgan Asset Management. Data for 2024, 2025 and 2026 reflects consensus estimates. Capex shown is company total, except for Amazon, which reflects an estimate for AWS spend (2004 to 2012 are J.P. Morgan Asset Management estimates and 2012 to current are Bloomberg consensus estimates). *Hyperscalers are the large cloud computing companies that own and operate data centers with horizontally linked servers that, along with cooling and data storage capabilities, enable them to house and operate AI workloads. **Reflects cash flow before capital expenditures in contrast to free cash flow, which subtracts out capital expenditures.
Guide to the Markets - U.S. Data are as of November 7, 2024.

[1]Price return from 10/31/2022 through 11/7/2024.
[2]The hyperscalers referred to are Microsoft (Azure), Meta, Amazon (AWS), Oracle and Alphabet (Google Cloud). Capex figures are company totals and not isolated to the cloud business.
[3]Aggregate capex is expected to climb from US$194 billion in 2024 to US$246 billion in 2026, while capex as a percentage of operating cash flow stays constant around 42%.

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8. What's the view on U.S. and developed market equities?

A concern for the U.S. market is that performance is focused in just a few companies. Over the past two years, the seven mega-cap tech or tech-related companies have been major drivers of the U.S. equity market. In 2024, their earnings are projected to grow by 36.2%, compared to just 3.1% for the rest of the index. However, the focus isn't solely on their earnings. These companies are heavily investing in AI and research & development, suggesting the tech sector and tech-related companies will likely stay prominent.

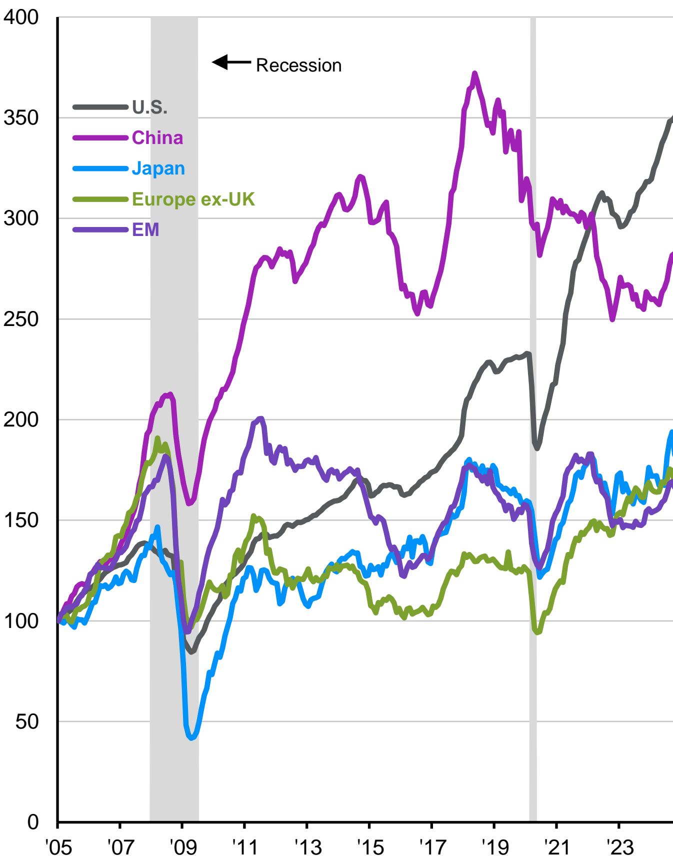
Still, there are signs of diversification into other areas. The contribution of the seven mega-cap tech-related companies to S&P 500 earnings per share (EPS) growth is decreasing, and their earnings growth rate is slowing, while it is accelerating for the rest of the index. Analysts expect the rest of the index will play a bigger role in 2024 and 2025. The rate-cutting cycle and resolution of election-related uncertainties should support a cyclical recovery in areas such as manufacturing, allowing less-favored sectors to benefit from tech-driven growth. This should help reduce concentration and valuation risks at the index level.

In Japan, corporate governance reforms have bolstered Japanese equities over the past year. However, this is a long-term structural theme that will contribute steadily over time. The current question for investors is whether there are other supportive factors. Japan's ruling coalition lost its majority in recent elections, complicating political governance and adding uncertainty. Despite this, the outlook for the Japanese equity market remains positive, driven by wage growth and relatively attractive valuations. The economic outlook in the U.S. and the USD/Japanese yen (JPY) exchange rate are crucial for Japanese equities. A soft landing in the U.S. could keep the JPY weak and boost stocks.

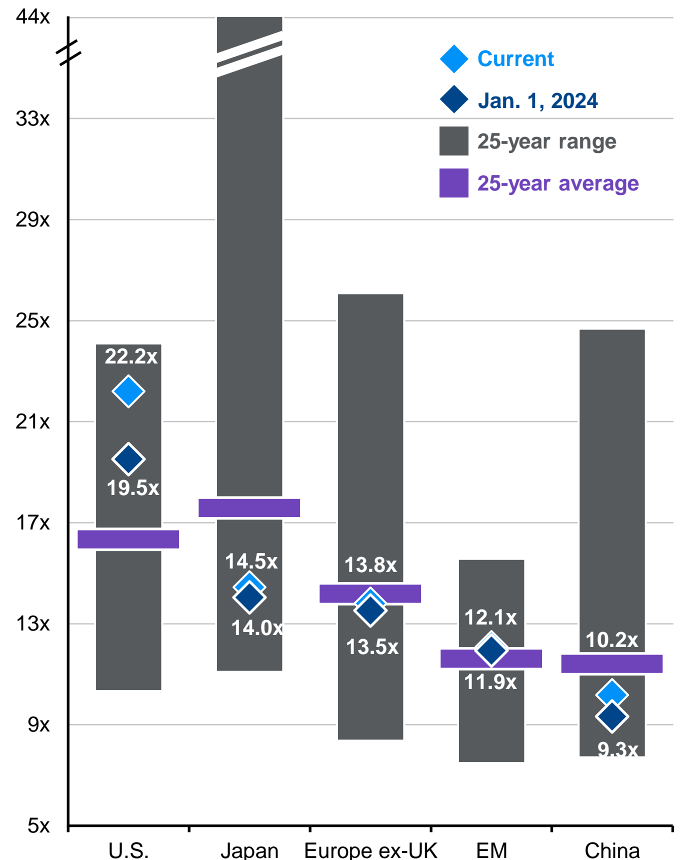
In Europe, the anticipated recovery has fallen short of expectations. Still, there are positive aspects for the region, and the modest rebound should persist. Faster interest rate cuts from the ECB, prompted by easing inflationary pressures and slower-than-expected growth should offer relief to manufacturers and support consumer spending. While challenges like potential new tariffs and trade tensions persist, ongoing real income growth is expected to gradually boost consumer confidence and consumption.

Conditions and fundamentals for positive DM outperformance are still in place.
Exhibit 8: Global equity earnings and valuations

Global earning estimates
Jan. 2005 = 100, next 12 months consensus, U.S. dollar



Global valuations
Current and 25-ear next 12 months price-to-earnings ratio



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. (Left) Next 12 months consensus estimates are based on pro-forma earnings and are in U.S. dollars. (Right) The purple bars for EM and China show 20-year averages due to a lack of available data. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of November 13, 2024.

9. The importance of diversification amid portfolio construction

2024 has been a remarkable year in financial markets. Global equities have reached new highs, driven by the strength of U.S. mega-cap stocks, while credit spreads are near historic lows due to robust corporate performance. Meanwhile, 10-year government bond yields are set to end the year higher, despite a global easing cycle by central banks.

Looking into 2025, the challenge in allocating across risk assets lies in the high starting point and the limitations that elevated valuations impose on expected returns, further complicated by economic uncertainty due to the change in U.S. government leadership.

However, our base case remains a steady expansion of the global economy, which should benefit risk assets like equities and credit. As such, the preference is to overweight equities compared to bonds and cash[4], and credit over government bonds within fixed income.

The challenge for asset allocators is to balance overweight positions in risk assets with effective diversifiers to hedge against both growth and inflation risks in the year ahead.

The rise in government bond yields means core government bonds can present a stronger buffer to downside portfolio risks, and we believe core government bonds will act as a credible hedge against a sharp economic growth shock.

The bigger concern may be that inflation starts to rise on U.S. fiscal policies and the impact of higher tariffs, leading to a repeat of 2022's "wrong way" correlation in markets. However, a negative correlation is not necessary for bonds to add diversification. Even bonds with zero correlation present benefits, though a more negative correlation provides stronger advantages.

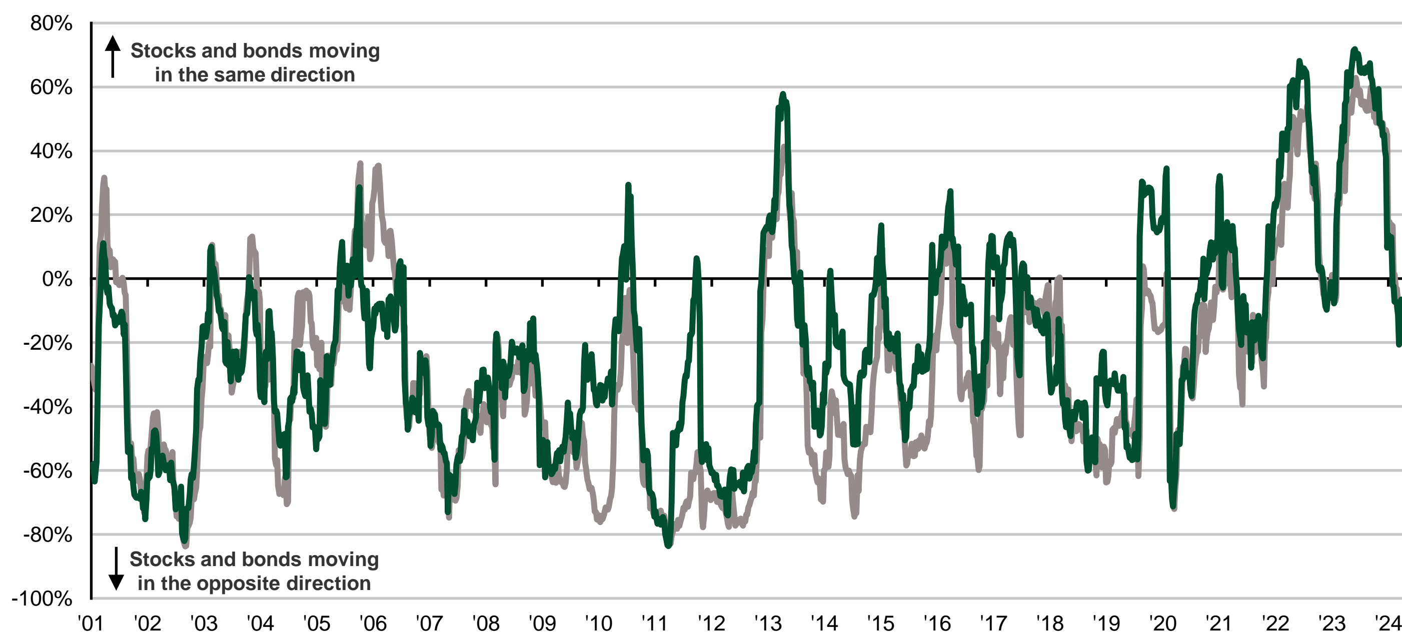
The rise in gold prices indicates investors are seeking assets to hedge against inflation and geopolitical risks or anticipating a decline in real yields due to central bank easing. Although gold is seen as a defensive asset, it is more effective for hedging against extreme events rather than general macroeconomic risks. Additionally, should the Fed opt for a shallower rate-cutting cycle, the carrying cost of holding gold could increase.

Building a resilient portfolio requires diverse assets and broader geographical diversification. Significant differences in sector returns and valuations across global equity markets support active management and stock selection.

The same applies to fixed income and adding duration to portfolios. Central bank policy paths, shaped by domestic conditions, create opportunities in government bond markets where growth is weaker, rate cuts are more substantial and yields may fall further on a relative basis.

Investors are increasingly allocating to alternative assets, particularly real assets like real estate, infrastructure and transport, to find income not available in public markets and to gain diversification due to their low correlation with public market assets. Recently, the inflation-hedging characteristics of real assets have been an additional draw. These assets are not only uncorrelated with public markets but also often uncorrelated with the economic cycle, with returns driven by steady income streams rather than capital gains.

The stock/bond correlation has been moving in the "right" direction but this trend will only persist if inflation falls.
Exhibit 9: Bonds can diversify growth shocks as stock and bond correlation becomes negative, but not inflation shock
Correlations between stocks and sovereign bonds
Weekly rolling six-month correlation of equities and sovereign bond prices*



Source: Bloomberg, FactSet, MSCI, J.P. Morgan Asset Management. *Rolling six-month pairwise correlations between weekly returns in equity (S&P 500 and MSCI All Country World Index price indices) and bonds (Bloomberg U.S. Aggregate Government Treasury and Bloomberg Global Aggregate Government Treasuries price indices) markets. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – Asia. Data reflect most recently available as of 19/11/24.

[4]Cash proxied by U.S. short term Treasuries.

Conclusion

With our core scenario of benign growth and policy easing, the outlook should be favorable to risk assets like equities and corporate credits. Despite high valuations, U.S. equities remain relatively attractive given a positive corporate earnings outlook and expectations of sustained tax cuts. Cyclically sensitive sectors could excel after several years of tech sector outperformance. For Asia, the tech export story remains strong, benefiting markets such as Taiwan and Japan, with Japan enjoying the boost from corporate governance reforms. For fixed income, DM corporate bonds strike a good balance between income generation and benefiting from the favorable economic environment.

Overlaying this favorable scenario is policy uncertainties. This is not only brought by the change in the U.S. government, but also the ongoing shifts in policy outlook with many western economies. Trade and industrial policies, including tariffs, could see considerable changes. Sectors or markets with lower exposure to trade in goods could benefit. This could be services such as selected technology, media and financial services. In Asia, India has a relative low share of trade in goods to GDP. ASEAN markets could gain in the longer run on changes in global supply chains. For alternative assets, transportation and infrastructure could benefit from expansion of supply chain diversification. More logistics infrastructure is needed to transport manufacturing products and more shipping capacity is required to handle complex shipping routes.

Governments opting for a higher fiscal deficit strategy may face a higher premium on their government bonds. A short duration strategy can help manage volatility in fixed income. Meanwhile, potential beneficiaries of a higher deficit could include corporates through tax cuts, which would then benefit the broader equity markets, or industrials that gain from increased government spending on defense or renewable energy.

Trade policies, fiscal deficits and geopolitical events could cause the soft-landing scenario to shift toward either rebounding inflation or a recession. For inflation rebounding, 2022 has shown that a traditional stock/bond portfolio may not be sufficient. Investors can turn to commodities, inflation-linked bonds and real assets with revenue indexed to inflation. In a recession, high-quality fixed income is the preferred asset class for safeguarding. A positive note is that relatively high government bond yields mean that using this hedge still presents investors with returns above inflation.

While it is not feasible to cover all possibilities and scenarios, this list aims to provide a sample of actions that can be taken to prepare for contingencies. Our ongoing recommendation to stay diversified remains valid even in a promising year with various IFs and BUTs. Investors will also need to be nimble to adjust their portfolios to account for these potential outcomes.

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