Overview

2020 has been an exceptional year, largely due to the onset of COVID-19 and the global economic fallout from the pandemic. Central banks and governments reacted quickly and aggressively, devising strategy as they learnt more about the virus. These policies have helped markets recover from one of the sharpest bear markets in modern history. Still, they have also created challenges for investors going forward.

As we look forward to 2021, not only are we hoping for a better year with a gradual return to some normality, but also we are contemplating the investment advice that would be appropriate for such an unusual economic and policy environment. In the spirit of our weekly publication, “On the minds of investors”, we address nine questions that our clients are asking, or should be asking, regarding 2021.

1. What will economic recovery in 2021 look like?
2. Is inflation a problem? Are we likely to see higher government bond yields?
3. What are the risk factors that investors should monitor?
4. Is the U.S. dollar (USD) on a depreciation path?
5. What is the key message on asset allocation in 2021?
6. Have equities already priced in all the good news?
7. Can Asia continue to outperform? What strategy should investors adopt?
8. How can investors find protection amid low developed market (DM) government bond yields?
9. Why should investors invest in corporate credit and emerging market debt (EMD)?
1. What will economic recovery in 2021 look like?

The COVID-19 pandemic will continue to dominate the economic landscape in 2021. And the speed with which governments can suppress it will, to a large extent, determine the economic winners and losers of the year ahead. China’s ability to contain the pandemic has enabled businesses and consumers to return gradually to normality. This is already reflected in its economic rebound since Q2 2020. We expect China to continue to lead the global economic recovery in 2021. For other East Asian economies, such as Hong Kong, Taiwan, Korea and Singapore, their competence in managing the pandemic will need to combine with a rebound in the global trade cycle to facilitate a stronger recovery.

In the U.S. and Europe, we believe that economic recovery could improve if their governments can strike a better balance between controlling the pandemic and maintaining economic momentum. These economies do have sufficient domestic demand to facilitate a rebound once policymakers find that balance.

Fiscal and monetary policies have been doing the heavy lifting in 2020 and should remain supportive. We shall discuss their outlook in subsequent questions. However, these policies have already done as much as they can in 2020, and we would expect a gradual pull back in fiscal stimulus as governments are burdened by growing debt. They will need to be more selective and smarter on distributing fiscal resources. With policy rates already at zero, if not negative, DM central banks are not in a position to make material cuts in policy rates. Even if they can step up asset purchases, the net impact on boosting growth could diminish.

Moreover, vaccine development and distribution, combined with accurate and efficient tests, should help to accelerate recovery. However, this may not impact the real economy until H2 2021 at the earliest, considering the amount of time that is needed to manufacture and distribute the vaccines. Additionally, not every economy will have the same access to vaccines in the early days. This means the pace of global recovery is likely to be uneven.

Positive growth to return, but not all economies can return to pre-pandemic GDP by end 2021

**EXHIBIT 1: REAL GDP GROWTH FORECAST
% GROWTH, ANNUALIZED**

<table>
<thead>
<tr>
<th>Country</th>
<th>2020</th>
<th>2021</th>
<th>2021 relative to 2019</th>
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<tbody>
<tr>
<td>U.S.</td>
<td>-3.6%</td>
<td>2.8%</td>
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<tr>
<td>Eurozone</td>
<td>-7.2%</td>
<td>4.5%</td>
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<tr>
<td>UK</td>
<td>-10.9%</td>
<td>6.0%</td>
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<tr>
<td>Japan</td>
<td>-4.7%</td>
<td>3.1%</td>
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<tr>
<td>Australia</td>
<td>-6.4%</td>
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<tr>
<td>Thailand</td>
<td>-6.2%</td>
<td>3.0%</td>
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<tr>
<td>Singapore</td>
<td>-5.7%</td>
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<tr>
<td>Hong Kong</td>
<td>-6.1%</td>
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<td>Malaysia</td>
<td>-8.0%</td>
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<td>Philippines</td>
<td>-9.0%</td>
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<tr>
<td>India</td>
<td>-2.2%</td>
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<td>Indonesia</td>
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<td>China</td>
<td>8.6%</td>
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Data reflect most recently available as of 31/10/20.
2. Is inflation a problem? Are we likely to see higher government bond yields?

Global inflation fell on the back of the COVID-19 recession. This sets up a low base for 2021, which could see headline inflation rise, especially if energy prices rebound from exceptionally low levels in H1 2020. However, central bankers will likely be more forward looking when considering their policy options. We believe demand-side inflation is unlikely to pick up momentum in 2021. This is echoed by the markets’ inflation expectations derived from inflation-linked bonds.

In terms of economic activity, most DM economies are only expected to return to the pre-pandemic level of real gross domestic product (GDP) in mid- to late-2021. Unemployment rates are also expected to stay above average. Therefore, these economies could continue to expand for longer before inflationary pressure sets in, despite aggressive stimulus.

Economic recovery in 2021, especially if boosted by safe and effective vaccines and tests, should lift government bond yields higher. Nonetheless, DM central banks will need to find a balance between allowing the bond market to reflect growth and inflation expectations, while limiting the interest costs of governments in the wake of the recent surge in government debt.

We think it is very unlikely that DM and Asian central banks will raise their policy rates in 2021. As we mentioned above, demand-side inflation is not an imminent threat. The U.S. Federal Reserve has now adopted an average inflation targeting strategy, which means the core personal consumption expenditure (PCE) deflator would need to run above its 2% target for some time before it would raise short-term rates. Therefore, we could see some upside risks to government bond yields in 2021, but this should be capped by easy central bank policy. We assume the net issuance of government debt by the major G4 governments (Eurozone, Japan, the UK and the U.S.) in 2021 will continue to be largely offset by net government bond purchases by their respective central banks. If governments opt for smaller fiscal support, this could also prompt their central banks to step up in monetary stimulus.

G4 central banks to support government fiscal spending with asset purchases

**EXHIBIT 2: G4 BANK PURCHASES AND GOVERNMENT ISSUANCE**

USD TRILLIONS

3. What are the risk factors that investors should monitor?

The COVID-19 pandemic continues to be the biggest uncertainty facing investors in 2021. A resurgence of infections and prolonged disruption in economic activity could put companies, even those with the strongest balance sheets and fundamentals, under pressure. This could be partly offset by further monetary policy easing and fiscal programs.

The relationship between the U.S. and China should also stay on investors’ radars. The new Biden administration may put trade tariffs on the back burner and be willing to work with Beijing on climate change and public health issues. Still, it could continue to pressure China on intellectual property rights protection, geopolitics over the South China Sea and cross-strait relations with Taiwan. However, these potential points of friction should not have a major impact on global trade and economic growth.

A lack of fiscal discipline could become a greater concern as the global economy gradually recovers. While the markets are pragmatic about governments running massive deficits to support their economies from the fallout of COVID-19, investors may be less forgiving if any government uses this as an excuse to abandon fiscal discipline. Governments’ handling of the pandemic in 2020 also led to growing discontent by the public, forcing early elections or demands for regime change.

Recovery in 2021 should be supportive of risk assets, including equities, high yield corporate debt and EM fixed income

| EXHIBIT 3: RISK SCENARIOS AND ASSET ALLOCATION IMPLICATIONS |
|---|---|---|---|
| Scenario | Upside | Core | Downside |
| **Trigger** | Vaccine development and distribution accelerated; significant improvement in U.S.-China relationship | Steady progress in vaccine development (distribution begins in H2 2021) | Significant delay in vaccine development; material deterioration in U.S.-China relationship |
| **Bond yields** | 10-year U.S. Treasury yield could rise above 1% as the Federal Reserve (Fed) is comfortable with recovery leading rates higher | 10-year U.S. Treasury yield in a range of 0.6%-1% with the Fed’s quantitative easing (QE) limiting the upside | 10-year U.S. Treasury yield could push below 0.5% as the Fed steps up support via QE |
| **Equities** | A more rapid rotation toward 2020 laggards; rapid USD depreciation and commodity rebound should see EM ex-Asia markets leading the way | A gradual rotation toward 2020 laggards (materials, financials, discretionary, Europe, ASEAN) as global recovery becomes more comprehensive | Broad correction in equities as 2021 earnings expectations are revised lower; U.S.-China trade tension would pressure China and Asian markets |
| **Fixed income** | High yield corporate debt and local currency EM fixed income could outperform | High yield corporate debt and local currency EM fixed income could outperform | U.S. Treasuries, due to falling yields, and investment-grade corporate debt could outperform |
| **U.S. dollar** | Accelerated depreciation with strong risk appetite | Gradual depreciation | Appreciation due to risk aversion |

Source: J.P. Morgan Asset Management.
Data reflect most recently available as of 31/10/20.
4. Is the USD on a depreciation path?

Cyclical support for the USD is weakening alongside some structural challenges. U.S. fiscal and current account deficits are high and rising—negative factors for any currency. Cyclical support for the USD includes interest rate differentials and growth outperformance. USD interest rate differentials against major currencies have collapsed during the pandemic, and U.S. economic outperformance against other developed economies has also disappeared. Admittedly, if U.S. Treasury (UST) yields move higher, then the yield differential advantage could return. However, this would take place in a global recovery scenario, which is typically negative for the USD. Finally, a more predictable trade policy under a Biden administration should also support risk appetite and help to soften the USD. This also implies a more constructive environment for Asian and emerging market (EM) assets, which typically outperform developed markets in a weak USD environment.

Investors should note not all currencies can benefit to the same degree in a weak dollar scenario. Selected EM currencies do have very competitive valuations but some are due to poor policy credibility or other structural issues. Active management in selecting the right markets remains essential. Non-Asian EM currencies may offer a stronger upside potential given their competitive valuations, but they are also likely to experience higher volatility relative to Asian currencies. The Chinese yuan is expected to appreciate modestly in 2021, which would attract international investors to increase participation in the onshore China equity and fixed income markets.

Narrowing interest rate differential between the USD and other major currencies could push the USD weaker

EXHIBIT 4: U.S. DOLLAR AND INTEREST RATE DIFFERENTIAL
INDEX

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.

5. What is the key message on asset allocation in 2021?

The COVID-19 pandemic has triggered a very unusual recession. The economic downturn and rebound were sharp and short. We reached the trough of the cycle in less than three months, and recovered a large part of the output lost within one quarter. Nonetheless, the first half of 2021 can still be considered as the early phase of the economic cycle.

In 2021, we should be in an early growth phase, which historically has been particularly positive for risk assets, such as equities and corporate credit as well as EM fixed income. A sustained medical solution to the pandemic could unleash a fresh round of risk-on rallies, with many of the worst-hit sectors again becoming more compelling to investors because of their low valuations. Accommodative monetary policy should also maintain this pro-risk bias, both in terms of liquidity and the willingness of central banks to support the economy at any cost.

Diversification helped investors to get through the pandemic; we expect equities to be the key return generator in 2021

**EXHIBITS: Asset Class Returns**

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<td>27.1%</td>
<td>57.3%</td>
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<td>U.S. IG</td>
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<td>6.1%</td>
<td>7.4%</td>
<td>-5.8%</td>
<td>13.4%</td>
<td>0.5%</td>
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<td>DM Equities</td>
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<td>U.S. IG</td>
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<td>22.3%</td>
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<td>18.3%</td>
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The "Diversified" portfolio assumes the following weights: 20% in the MSCI World Index (DM Equities), 20% in the MSCI AC Asia Pacific ex-Japan (APAC ex-JP), 5% in the average of the MSCI EM Latin America and MSCI EM EMEA Indices (EM ex-Asia), 10% in the J.P. Morgan EMBIG Index (EMD), 10% in the Bloomberg Barclays Aggregate (Global Bonds), 10% in the Bloomberg Barclays Global Corporate High Yield Index (Global Corporate High Yield), 15% in J.P. Morgan Asia Credit Index (Asian Bonds), 5% in Bloomberg Barclays U.S. Aggregate Credit Corporate Investment Grade Index (U.S. IG) and 5% in Bloomberg Barclays U.S. Treasury – Bills 0-3 months (Cash). Diversified portfolio assumes annual rebalancing. All data represent total return in U.S. dollar terms for the stated period. 10-year total return data is used to calculate annualized volatility (Ann. Vol.) and reflects the period 31/10/10–31/10/20. "Peak-to-trough" data reflect the period for each respective market between January and March 2020, except for cash which reflects the period from the peak and trough of the S&P 500 YTD. **Since trough data reflect the period from each respective market’s trough to the latest data available, except for cash which starts from the trough of the S&P 500 YTD. Please see disclosure page at end for index definitions. Past performance is not a reliable indicator of current and future results.

Data reflect most recently available as of 31/10/20.
6. Have equities already priced in all the good news?

While equity markets have made impressive gains since the trough in March 2020, this recovery has been uneven across sectors and regions. For example, at the end of October, markets in the Association of Southeast Asian Nations (ASEAN), Europe and Japan were still down relative to the start of 2020. The U.S. equity recovery has mostly come from technology and health care, which are expected to see positive earnings growth for both 2020 and 2021. We believe the relative performance of equity markets around the world has factored in a steady earnings recovery in 2020 and 2021. This suggests equity returns in 2021 could normalize relative to the sharp rebound of the last six months.

Sustained medical solutions to the pandemic could also prompt a sector rotation from the leaders to the laggards. Even though it will take time to manufacture and distribute vaccines, markets are likely to price in such information early before it becomes reality. This would imply a more constructive environment for sectors such as consumer discretionary, travel, materials and energy, industrials and financials. The same could apply to regions such as Europe and ASEAN. These are reflected by their valuations. Traditionally, a rise in bond yields would also be constructive for value stocks. However, central banks’ policy biases may limit this market driver in 2021.

Overall, investors could consider U.S., Asia and China equities as the core of their equity allocations, especially as we work through the pandemic, but be ready to diversify globally into Europe, Japan and EM ex-Asia to capture the opportunities generated from a broader global recovery.

A more comprehensive recovery could boost earnings expectations in the energy, financials and consumer discretionary sectors.

**EXHIBIT 6: S&P 500 EARNINGS GROWTH ESTIMATES**

*Year-over-year change*

Source: FactSet, Standard & Poor’s, J.P. Morgan Asset Management; *Energy sector earnings are expected to increase by 493% in 2021.

Guide to the Markets-Asia. Data reflect most recently available as of 31/10/20.
7. Can Asia continue to outperform? What strategy should investors adopt?

Asian assets, and especially Chinese assets, are in a strong position to outperform in 2021. Similar to the U.S., the Asian equity market has been driven by technology and health care, and this trend could continue until the economic challenges from the pandemic are resolved. Those sectors and markets in Asia that have lagged in recovery could benefit from a more comprehensive global rebound. In addition to vaccine or testing development, discussion over travel bubbles and measures to restore mobility would help. An acceleration in global trade growth can also boost overall earnings performance in Asia. These cyclical improvements can add to the structural growth factors and strengthen the investment case for Asian equities.

The search for yield continues to attract international capital into Asian fixed income, considering the interest rate differential between DM fixed income and their Asian counterparts. In particular, the onshore China bond market is opening up to international investors, and this broadens active investing opportunities in Chinese government and corporate bonds.

Source: FactSet, MSCI, J.P. Morgan Asset Management. Sector indices used are from the MSCI AC Asia Pacific ex-Japan index. Consensus estimates used are calendar year estimates from FactSet. Past performance is not a reliable indicator of current and future results.
8. How can investors find protection amid low DM government bond yields?

2020 was a year where UST lost their shine in protecting investors against market volatility. Not only have yields fallen below 1%, and therefore do not generate adequate income for investors, but their traditional negative correlation against equities also weakened considerably. One reason could be because of the high valuations of UST. For now, UST can be likened to a pair of old running shoes that have lost their bounce.

So where else should investors look for diversification against volatility in equities and other risk assets? Securitized assets, such as asset-backed securities and mortgage-backed securities, also have low correlations with equities but provide slightly better yields than UST. Investors with long-term investment horizons could also consider alternative assets, such as real estate, infrastructure and transportation assets, which can also generate relatively attractive income streams with low correlation to global equities.

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**Exhibit 8: Yields and Correlations of Fixed Income Returns to Equities**

*Yield, 10-Year Correlation Between Monthly Total Returns*

![Diagram showing correlation between different fixed income assets and equities]


Based on Bloomberg Barclays U.S. Treasury (UST) Bellwether 2y & 10y (2y & 10y UST), Bloomberg Barclays Treasury Inflation-Protected Securities (TIPS), ICE BofAML Country Government (1-10y) (France, Germany, Japan & UK (1-10y)), Bloomberg Barclays U.S. Aggregate Credit–Investment Grade & High Yield (U.S. Aggregate, IG & HY), Bloomberg Barclays U.S. Floating Rate (U.S. Floating Rate), Bloomberg Barclays U.S. Aggregate Securitized–Mortgage-Backed Securities (U.S. MBS), Bloomberg Barclays Pan-European High Yield (Europe HY), J.P. Morgan GB-EM Global (Local EMD), J.P. Morgan EM Global (USD EMD), J.P. Morgan Asia Credit (JACI) (USD Asia Credit), J.P. Morgan Asia Credit (JACI)–High Yield (USD Asia HY), J.P. Morgan Asia Credit China Index (USD China offshore credit), J.P. Morgan CEMBI (USD EMD corporates), J.P. Morgan Asia Diversified (LADE) (Local Asia). *Correlations are based on 10 years of monthly returns.

*Guide to the Markets—Asia.* Data reflect most recently available as of 31/10/20.
9. Why should investors invest in corporate credit and EMD?

The investment case for corporate credit and EMD remains compelling. Our strong conviction that central banks will maintain ultra-accommodative monetary policy would support these fixed income assets. Should there be a delay in the development of a sustained medical solution or a more sluggish economic recovery, the risk of credit spread widening could be offset by more fiscal and monetary stimulus.

The prevailing low-yield environment could also encourage global investors to take additional risks to generate income to meet their financial objectives. This could be in the form of credit risk in corporate credit or currency risk in local currency EMD. The latter could look particularly attractive when the USD is under depreciation pressure. The current valuations of these assets are in line with their long-term averages. Their relatively high coupons also provide better protection against any rise in risk-free rates relative to investment-grade corporate debt, especially when default rates probably have peaked.

With the diverging sector performance in the economy, sector rotation could also occur in the corporate bond market. A more comprehensive recovery from the pandemic could see investors rotate into sectors under higher default pressure. This would include retail, travel, energy and materials.

The demand for income, reasonable valuations and a weaker USD should support global high yield and Asian fixed income.

**EXHIBIT 9: SPREAD TO WORST ACROSS FIXED INCOME SUB-SECTORS**
BASIS POINTS, LAST 10 YEARS


**Conclusion**

We expect 2021 to be a year where the global economy gradually recovers from the pandemic. How COVID-19 unfolds will be pivotal to growth, policy and sector performance. Uneven market returns in 2020 and uneven recoveries in 2021 would imply the need for more active management in asset allocation, equity and fixed income selection. This does not mean investors should speculate and try to time the market. Instead, they should review their portfolios regularly and be ready to re-balance. They should also adjust their exposure depending on how the pandemic develops in coming months.
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