2021 Global Alternatives Outlook

Alternatives: From optional to essential
Alternatives: from optional to essential

For more than 50 years, institutional investors have enjoyed the option of adding alternative investments to their portfolios. Today, whether seeking alpha, income or diversification, the optional has indeed become essential. In our 2021 Global Alternatives Outlook, we present a 12- to 18-month view for alternative assets and explore the most promising investment ideas from the CEOs, CIOs and strategists of our USD 150 billion alternatives platform. We hope these insights make a meaningful impact on your investment success.
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WHAT IS ESSENTIAL?

“Essential” may not have been chosen as Merriam-Webster’s 2020 Word of the Year, but it might have been. It was, after all, the year when we came to appreciate anew our essential workers, particularly our heroic frontline health professionals.

The year also led many of us to reflect on what was most essential in our own lives—family, health, home, friends and, of course, a good internet connection.

As investors, we saw that disciplined risk-taking was essential to success in 2020 as markets rewarded those with the confidence to lean in while the world was pulling back. Our own conviction to act on a range of market dislocations stemmed from our more than 50 years of alternatives investment experience and the unique cross-alternative asset class insights that we continually share. Lessons learned in 2008 and 2009, for example, convinced us that swift central bank action and fiscal stimulus would jump-start a V-shaped recovery. At the same time, real-time data exchange from our 14 investment engines and thousands of individual investments pointed to underlying consumer strength and resilient fundamentals.

So where does that leave us for 2021? What is essential in the year ahead? Alternatives, perhaps once considered optional in investors’ portfolios, have indeed become essential. Facing stretched valuations in traditional markets, limited correlation benefits between fixed income and equities, and persistently low bond yields with asymmetric risk, investors have made a decided turn to alternatives in the pursuit of alpha, income and diversification.

To guide our clients in these pursuits, in our 2021 Global Alternatives Outlook, we challenged our diverse group of CEOs, CIOs and strategists from our USD 150 billion alternatives platform to provide a 12- to 18-month outlook for their respective markets and explore their most promising investment ideas over that time horizon.

We hope you find it helpful, if not essential, in navigating 2021. Please let us know if we can be of help in implementing any ideas presented or if you need additional information from any of our contributors.

On behalf of J.P. Morgan Asset Management, thank you for your continued trust and confidence.

Anton Pil
Global Head of Alternatives
Why the recovery has only just begun

David Lebovitz, Global Market Strategist

WE EXPECT 2021 TO BE A YEAR OF GLOBAL RECOVERY AND GROWTH, WITH LOW INFLATION AND EASY MONETARY POLICY. EXPLORE OUR 2021 MACROECONOMIC OUTLOOK.

Economic and investment outlooks often have short shelf lives. In 2020, however, year-ahead outlooks were rendered useless by the end of February. At the start of last year, few market participants took the potential for a global pandemic as seriously as perhaps they should have, nor did anyone anticipate the robust and coordinated policy response that followed. Fiscal and monetary policies seem to have built a bridge to the other side of this pandemic, and with effective vaccines now in distribution, it appears that better times lie ahead.

That said, we are not yet out of the woods. Although the U.S. economy finished 2020 with a decent amount of momentum, that was not the case for the global economy. The European economy contracted during the final quarter of the year as a second wave of COVID-19 spread rapidly and lockdowns were put in place. In emerging markets, China has rebounded strongly, but elsewhere the picture is more mixed. Still, we believe that 2021 will be a year of recovery. In other words, the current business cycle has only just begun.

GROWTH

In early 2021, the global economy will likely pause to catch its breath, with the duration of the pause determined by the path of the virus and subsequent policy response. We expect that policy will continue to help the economy heal during, and through, the pandemic: In Europe, austerity seems to be off the table, and in the U.S. additional fiscal stimulus was delivered in December. These policy supports will help bolster economic activity in the short term. Critically, too, they will prevent more permanent economic damage.

As populations around the world are vaccinated gradually during the first half of the year, economic activity should begin to accelerate. Goods and manufacturing bounced back strongly in 2020, but services remained under pressure due to social distancing (EXHIBIT 1). As the threat of the virus fades, we expect a material acceleration in the pace of services sector activity amid pent-up demand for restaurant dining, entertainment, travel and other services impacted by the pandemic. This suggests a surge in economic activity during the second half of 2021 and into the beginning of 2022. We expect it will be accompanied by a strong increase in corporate profits, particularly for the hardest-hit sectors.
Against this backdrop, inflation should remain fairly tame. In the near term, a combination of elevated unemployment rates and output gaps should keep a lid on inflation. In the long term, high levels of corporate and government debt, coupled with structural trends like income inequality, continued technology adoption and aging demographics, will likely constrain price growth. However, inflation could surprise to the upside as economic growth picks up into the end of the year. If demand were to come roaring back when liquidity was still plentiful, we could well see an environment in which too much money was chasing too few goods.

In the near term, however, low rates of inflation should allow central banks to maintain an accommodative stance. The Federal Reserve (Fed) made a shift to average inflation targeting, suggesting that inflation above 2% will be tolerated for some time. Although the Fed may signal a tapering of its asset purchase program toward the end of the year, interest rates look set to remain at the zero bound for the foreseeable future. The European Central Bank (ECB) has extended its window for net asset purchases through March 2022, and for reinvesting maturing securities through the end of 2023. The bottom line: Until inflation picks up, monetary policy will remain easy.

INVESTMENT IMPLICATIONS

In general, 2021 should be a solid year for the global economy. As always, investors should understand the risks, particularly when everyone seems to be singing from the same song sheet. Any lack of fiscal support or abrupt change in the tone of monetary policy could undermine the recovery and cause capital markets to stumble. Challenges relating to the distribution of the vaccine and/or inoculation would almost certainly delay a complete economic recovery. And there is still a risk that the virus mutates in such a way that current vaccines become ineffective.

While these risks do not represent our base case, they need to be considered. At the same time, last year’s policy response pulled forward a great deal of return—particularly in the public markets—which will make investing increasingly difficult during the early stages of this expansion. We expect that investors will continue to shift their focus from public to private markets as they increasingly search for businesses that have experienced temporary disruption due to the pandemic but avoided long-term demand destruction for the goods and services they provide. This leads us to favor more cyclical assets in the short term even as we continue to recognize the need for growth, income and diversification over the long run. The pandemic may soon come to an end, but this economic cycle has only just begun.

Source: Markit, J.P. Morgan Asset Management. PMI is the Purchasing Managers’ Index; data as of December 31, 2020.

EXHIBIT 1: GLOBAL PMI FOR MANUFACTURING AND SERVICES
Alternatives bring AID (alpha, income, diversification) to the traditional asset portfolio

Jamie Kramer, CFA, Head of Alternatives Solutions Group
Pulkit Sharma, CFA, Head of Alternatives Investments Strategy & Solutions

It’s been a year marked by shortages: toilet paper, hand sanitizer, even flour. In 2020, we all learned that replacing paper towels with reusable kitchen rags is both efficient and sustainable. Faced with shortages, we look for items that have the potential to create similar and possibly better outcomes. Applying this concept to the markets today, investors can address shortages of alpha, income and diversification (AID) in traditional portfolios by adding alternatives. In this way, they can realize better investment outcomes.

On the heels of unprecedented, pandemic-driven fiscal and monetary policy intervention, our 2021 Long-Term Capital Market Assumptions forecast an annual 4.2% return from a 60/40 portfolio over the next 10 to 15 years. Today, at the start of a new cycle, public markets are challenged by yields at all-time lows and stretched valuations—a highly unusual occurrence. In this context, alternatives and active management stand out as the two sources of AID investors need to succeed, in both the near term and the long term.

CYCLE-AWARE ALLOCATIONS CAN ENHANCE ALPHA, INCOME AND DIVERSIFICATION

Utilization of this AID requires precision and discipline. Too often, investors assemble a collection of alternative assets without giving enough consideration to how the allocations will work together in a portfolio. This lack of foresight can prove damaging in portfolio construction. We believe that a strong alternatives framework is essential to building resilient portfolios. Alternative asset portfolio construction should be a holistic process with an emphasis on investment attributes. Focus on what assets do rather than what they’re called. For instance, as shown in EXHIBIT 1, the alternatives core foundation provides stable income with lower volatility. Core complements provide added diversification and/or differentiated returns. And return enhancers deliver just what the name implies. Similarly, fixed income-like and equity-like alternatives on the left and right, respectively, solve for enhanced outcomes vs. those public markets. Hybrids represent all-season asset classes (such as hedge funds and real assets) that have both fixed income and equity-like attributes.

Our 2020 outlook emphasized that we were in the late stages of the previous market cycle. (Of course, we did not imagine that a global pandemic would spark widespread lockdowns and a sharp recession.) Last year, we highlighted the use of all-season hybrids that either provide resilience via core real assets or capture dislocation via hedge funds and special situations. We pointed to core foundation credit as a source of added protection and private equity as a return enhancer that would position investors to benefit when the cycle turned. All of these positions held up well vs. lower quality credit, or non-core hard assets, which were de-emphasized (EXHIBIT 1A).
Early in the pandemic (EXHIBIT 1B), we made the case for allocating new capital to fixed income-like alternatives at both the higher quality and the distressed ends of the spectrum, where we saw considerable dislocation. We also liked actively managed low volatility core equity such as hedged equity and all-tranche REITs, while maintaining an emphasis on all-season hybrids in the form of hedge funds and special situations, which benefit from volatility and dislocation.

2021: CURRENT EARLY-CYCLE POSITIONING

In November, news of successful COVID-19 vaccine trial results led us to our post-pandemic 2021 view (EXHIBIT 1C), which coincidentally looks like the Red Cross first aid symbol. An AID approach may be especially helpful in today’s market environment, when investors’ need for alpha, income and diversification is more pronounced.

Post-pandemic alpha: All segments of the core complements look well positioned to deliver enhanced returns. Those returns may come from spread and yield compression in the less trafficked, disrupted segments of alternative credit. Or we may see normalization-driven risk premia compression in value-add real assets or in return-enhancing special situations plays focused on the service economy. Rising volatility, dispersion and ESG (environmental, social and governance) integrated diligence could continue to create a “Goldilocks” environment for hedge fund alpha generation.

Post-pandemic income: In essential assets such as core real assets, investors can find stable income streams generated by long-term contractual cash flows that can, in most cases, grow with inflation. With traditional fixed income yields at all-time lows, core real assets look mispriced vs. fixed income, as their yields have held up well in the pandemic. Normalization should compress their risk premia further. High quality core real estate globally looks especially attractive in this environment.

Post-pandemic diversification: Today, many segments of fixed income have become less effective as volatility dampeners and diversifiers. In such an environment, hybrid asset classes such as hedge funds and real assets can boost diversification. Hedge funds, with their ability to short, can be quite effective when quality, sector and regional dispersion is on the rise. As a result, they are well suited to provide uncorrelated return streams that benefit from equity volatility. Tangible hybrid high quality assets, such as core real assets, offer exposure to local uncorrelated economic factors, underpinned by stable income, with the potential to grow those income streams. They provide another important tool investors can use for public equity diversification.
CONCLUSION

When paper towels were nowhere to be found, kitchen rags came to our rescue. A similar sort of flexibility powers the growing use of alternatives in multi-asset portfolios. Indeed, the AID from alternatives is accelerating their transition from optional to essential portfolio components. Alternatives can be used for both re-risking and de-risking, and today alternative assets offer very attractive risk premia across the board. We encourage investors to use this early-cycle window to take advantage of the alpha opportunities arising from pandemic dislocation, while building in income, diversification and portfolio resilience. A strong investment framework will include outcome-driven insight and analytics-based allocations. That will bolster investors as they look to alternatives for the alpha, income and diversification they need.
Momentum for growth, despite COVID-19

Jamie Kramer, CFA, Head of Alternatives Solutions Group
Yazann Romahi, Ph.D., CFA, Chief Investment Officer, Quantitative Solutions
Shrenick Shah, Head of Macro Strategies
Paul Zummo, CFA, Chief Investment Officer, J.P. Morgan Alternative Asset Management

Our hedge fund investors see strong opportunities in 2021. We expect a rich environment for growth, even with most pandemic-related dislocation behind us and generally elevated valuations. The macro backdrop is broadly supportive, with continuing fiscal stimulus, expected above-trend growth and, most of all, rebounding economies. Given ultra-low interest rates, we believe hedge funds can serve as a quite valuable portfolio complement.

We’ll be investing in global megatrends—sustainability, emerging market consumers and technology (including health care tech, such as telemedicine). We believe consumer and corporate technology adoption is at an inflection point, creating opportunities in cloud computing, software, cybersecurity, payments, semiconductors and biotech. We also see opportunities in special purpose acquisition companies (SPACs), where transaction volume is mushrooming. We also favor undervalued high quality and value equities, which should benefit as vaccination campaigns help economies normalize.

SPECIAL PURPOSE ACQUISITION COMPANIES

Issuance in SPACs, which have proven to be a more efficient means for some companies to go public, boomed in 2020. (At publication time, 282 SPACs were seeking a deal or had a deal in progress. The amount raised through SPACs surged from USD 13.6 billion in 59 SPACs in 2019 to USD 82.8 billion raised by 248 SPACs in 2020.) Over time, the quality of sponsors, stakeholders and deal structure has improved. Yet from an investment standpoint, SPACs remain quite inefficient, providing strong investment opportunities for us. Strategies include participation in SPAC sponsor shares, initial unit formation, late-stage SPACs and volatility trading.

A REVIVAL OF FUNDAMENTAL FACTORS

Many stocks were hurt by pandemic-driven market volatility, which reflected shifts in sentiment more than company fundamentals. Cheap, high quality companies’ stocks look inexpensive on a forward-looking basis and may well fare better in 2021 if economies and markets normalize. We could see a rewarding recovery of value and quality stocks, underpinned by strong fundamentals, as companies begin to trade relative to one another rather than on broader shocks and trends. Value’s temporary pickup when vaccine approvals were first announced was one sign of this potential tailwind.

Our other hedge fund teams expect to find opportunities in securities that display strong value and growth characteristics.

1 Value companies’ plunge followed several down years, during which a massive gap arose between value stocks and expensive growth stocks, amid a surge in growth stocks on investor exuberance.
IN SUSTAINABLE INVESTING, SOCIAL ADVANCES AND THE CARBON TRANSITION GET UNDERWAY

We called sustainability a driver of growth in last year’s outlook; today, that momentum is picking up speed. We are well positioned to identify and take advantage of hedge funds, and the other companies in which we invest, becoming more aware of advancing environmental, social and governance (ESG) issues. We see the focus broadening in a healthy way from the environment and governance to social issues, accelerated by the racial and socioeconomic disparities in COVID-19’s impact on society—in health, income and educational access—and the revitalized civil rights movement in the U.S. Many companies, and hedge funds themselves, have begun to understand the importance of a diverse workforce.

We will use proprietary metrics to track and rank our target investments’ staff diversity, and a raft of other ESG factors, to help us invest in ESG winners and avoid or short the losers. The proliferation of relevant data should make the process more reliable than ever.

The carbon transition—away from fossil fuels to mitigate climate change—should also create investment opportunities, among them renewable power, transport and energy efficiency. Over time, we expect the set to expand as more companies find profitable climate-friendly business models. European firms are today’s leaders, but the U.S. should move forward under the Biden administration. Meanwhile, China recently adopted aggressive decarbonization targets (EXHIBITS 1A and 1B). Across regions, we will look for sustainable companies poised to gain market share. Quantitative investors will access and analyze Big Data to help design and enhance these strategies in 2021.

THE EMERGING MARKET CONSUMER

Middle-class consumers in emerging markets are key drivers of global demand. We favor, for example, consumer discretionary and financial services in India and Indonesia, where working-age urban populations are growing in size and wealth, and businesses and consumers are taking on more credit. We’re searching for tech opportunities in Asia, particularly China, and Latin America, where consumers are adopting technology at accelerated rates. We also like health care in China—biotech, generics, innovative therapeutics and pharmacy networks.

CONCLUSION

The wide dispersion of performance we expect—among sectors, strategies, stocks and hedge fund managers—should help us generate alpha and allow hedge funds to complement traditional stock and bond holdings at a time of ultra-low rates. Hedge funds’ volatility profiles are in some cases similar to fixed income portfolios’ yet have the potential, we believe, for far more upside.

As governments worldwide seek to mitigate climate change by reducing fossil fuel emissions, there are opportunities in the shift to renewable energy sources.

EXHIBIT 1A: EMISSIONS TARGETS (MTCO2E/YEAR)

EXHIBIT 1B: GLOBAL ENERGY MIX (SHARE OF PRIMARY ENERGY)

Source: ClimateActionTracker, J.P. Morgan Asset Management; data as of October 31, 2020. MTCO2e is metric tons of carbon dioxide equivalent, a standard emissions measure. Past performance and forecasts are not reliable indicators of current and future results.
How core is your core infrastructure?

Nicholas Moller, Investment Specialist, Infrastructure Investments Group

Before anyone had heard of COVID-19, many institutional investors shrugged off the distinction between lower risk (core) and higher risk private infrastructure assets. Capital flowed into assets traditionally seen as higher risk due to their volumetric and/or commodity exposures (airports, ports, toll roads, energy, etc.). Some even described such assets as having a core risk profile. Many investors expected higher returns without an undue level of risk compared with relatively “expensive” traditional core infrastructure assets (regulated and long-term contracted assets for essentials like water, heat and electricity); 2020 put this thesis to the test. When pandemic lockdowns hit, many (but not all) higher risk infrastructure assets struggled on a relative basis, highlighting the very different risk profiles of the asset types (EXHIBIT 1).

The experience of 2020 has reaffirmed the role of private core infrastructure equity as a lower-risk, more forecastable source of diversification, inflation protection and yield in multi-asset portfolios. It also has pointed the way to opportunities to be found in 2021. In particular, the past year has underscored the benefits of an integrated ESG (environmental, social and governance) approach, with a focus on governance and stakeholder engagement, in core infrastructure investments.

THE POWER OF CONTROL AND STAKEHOLDER ENGAGEMENT

On the governance front, we saw clearly that owning a controlling stake in a business often provides the tools required to manage a crisis. A majority owner can make needed changes—and move with the requisite speed. In the “batten down the hatches” second quarter of 2020, control positions allowed investors to work hand in hand with their companies and management to quickly resolve any issues they were facing. This proved key to mitigating risk during a very tumultuous period.

The COVID-19 crisis also emphasized the importance of proactive stakeholder engagement. For example, in the early weeks of the pandemic shutdowns, regulated utilities agreed not to disconnect any customers for nonpayment. That was both the right thing to do and exactly what regulators were looking for. Proactive engagement with key customers and communities on the challenges they were facing was also critical for contracted businesses.

AN ACCELERATED ENERGY TRANSITION

Turning to the “E” in ESG, the COVID-19 crisis certainly accelerated focus on the transition to a low carbon economy. That will in turn impact infrastructure investment in the coming years. Many governments (and prospective governments) pledged commitments to a “green recovery,” promising environmentally friendly stimulus to mitigate the effects of the coronavirus recession.
Only time will tell what deal might be struck between the incoming Biden administration and Congress with respect to long-discussed infrastructure legislation. Whatever happens in Washington, the build-out of solar and wind energy capacity will continue to accelerate. Utilities will further shift from more traditional fossil fuels to renewables, as they have been doing for the last few decades since the energy transition began, often complemented by less carbon intensive and non-intermittent natural gas generation. Facilitating this transition and its acceleration will continue to provide investment opportunities.

We also anticipate that there will be necessary complementary investments in electricity transmission and utility electric grids.

OPPORTUNITIES AND RISKS IN 2021

How might the infrastructure investing environment change over the coming year, and what are the risks to our outlook? By their nature, investments in private core infrastructure are expected to be relatively cycle-agnostic, given they represent essential services. If we do see a post-COVID-19 surge in economic growth and a material recovery in risk assets, private core infrastructure will likely benefit relatively less than other assets. However, this would be entirely consistent with the diversification objectives of the asset class and the lower relative drawdown that was seen during the coronavirus crisis. Remember too that infrastructure is an inflation-sensitive asset class with opportunity for upside participation given the pass-through structure of many contracts. To the extent an economic recovery creates more normalized levels of inflation, it would be a positive for asset class returns.

We do expect that very accommodative monetary policy will keep bond yields extremely low for at least the near to medium term. As investors have a tough time finding income, we expect the relatively attractive yield of infrastructure will stand out. Indeed, more and more yield-centric investors are allocating to private infrastructure. Even if bond yields were to rise, the higher yields available in infrastructure should provide some cushion, especially if rising rates are coupled with rising inflation.

Non-U.S. investors (especially those in Australia, Canada, Europe, Japan and the UK) were early adopters of core private infrastructure investment, given that they have had fewer fixed income options, and they continue to invest. In part as a result of the effects of COVID-19 on higher risk infrastructure investments, and in part due to depressed rates, we have recently seen increased flows from U.S. investors into core infrastructure. Like real estate 20 or 30 years ago, private core infrastructure is fast becoming a standard part of institutional asset allocation.
Green tech: A key driver for transport investments

Andrian R. Dacy, Chief Investment Officer, Global Transportation Group

The future of transportation will differ from its past in a crucial way: The sector will be led by larger, more stable players with access to a more selective capital base and a drive toward environmental sustainability.

In the decade leading up to the global financial crisis (GFC), capital poured into the transportation sector. Amid ample and low cost liquidity, orders for new assets piled up. These excesses occurred in aviation, rail and shipping. For example, shipping’s global order book had swelled to historical highs by 2008 (EXHIBIT 1). When the GFC hit, lenders pursued a “flight to quality,” and the industry entered a period of overcapacity and reduced earnings. Capacity growth was more measured in aviation, given the natural limitations of just two major global aircraft manufacturers. However, the shocks of the GFC and, more recently, COVID-19 have led to a constrained aviation demand environment and the departure of many opportunistic investors.

The last 10 years have also seen the impact of post-GFC regulatory changes, particularly on traditional lenders’ leasing activity. In the wake of post-GFC regulations as well as market pressures, banks retreated from leasing and focused on lending to an increasingly small group of strong borrowers. The result: “smoother” ordering cycles (particularly in shipping), an improved supply-demand balance and a more stable transportation sector led by increasingly large players. And as COVID-19 recedes in 2021, we expect to see that the cohort of well-capitalized airlines will have taken market share from their weaker brethren.

Supply-demand balance has improved in the past decade

EXHIBIT 1: GLOBAL ORDER BOOK AS % OF FLEET

CRITICAL NEED FOR CAPITAL

Financial strength has always been important in this capital-intensive sector. Access to capital is critical for participation, particularly in the long-duration leasing segment, where assets can cost up to USD 200 million each. An estimated USD 3.5 trillion in capital is needed to fund aviation and shipping over the next decade. Depreciation and the finite useful lives of transportation assets create the need for ongoing replacement and associated...
financing (assets typically depreciate at 3%-4% per annum). But capital strength is even more critical now, given the pressing need for investment in environmentally sustainable technology. Indeed, all industry stakeholders (owners, end users, regulators, investors and financiers) are increasingly focused on sustainability.

Companies with ample access to capital will be better positioned to make the necessary investment in clean technology solutions. That technology is expensive, reinforcing the need for additional capital to replace aging assets. Moreover, the link between capital strength and environmental sustainability will be self-reinforcing as financing and leasing opportunities in the industry become linked to environmental, social and governance (ESG) performance. Just as banks prefer to lend to well-capitalized owners with strong sustainability records, end users (global conglomerates, utilities, energy companies, etc.) seeking to lease transportation assets for long periods prefer to work with large, stable lessors with robust ESG credentials.

To make the sector more sustainable, various technology solutions are under development. One overarching goal: to improve engine technology and reduce emissions. Progress is underway through the development of carbon-reducing propulsion methods such as liquefied natural gas (LNG), hydrogen and various low emission synthetic fuels.

We note one recent success in the ESG transportation sphere: the global adoption of ballast water treatment systems within the shipping industry. These systems “clean” the stabilizing ballast water in commercial vessels by neutralizing biological organisms in a vessel’s ballast tanks. In this way, they prevent the spread of organisms that can become invasive species—an increasingly important environmental consideration.

SEARCH FOR SCALABLE AND SUSTAINABLE TECHNOLOGY SOLUTIONS

How realistic are the new technologies in the transportation sector? That remains to be seen. Engines powered by hydrogen or ammonia could be an option for ships but will require a global fueling infrastructure. As we’ve discussed, it will be the larger, better-capitalized companies that will be able to fund these improvements, likely accelerating industry consolidation. Similar issues challenge long-haul aviation, where synthetic fuels or biofuels are the most likely alternatives.

Renewable power generation presents both a challenge and an opportunity. While wind farm generation can be unpredictable, small-scale hydrogen or syngas plants can be positioned along transmission lines to use off-peak power (when it would otherwise not be utilized). Similar solutions are under development for excess solar power transmission. With battery storage improvements, energy storage options will expand, providing further flexibility to future carbon-free power generation for transportation.

OPTIMISTIC OUTLOOK: A COORDINATED PUSH FOR CARBON REDUCTION

What technologies will be relevant in the future? Who will be able to afford to make the necessary investments for the industry to become more sustainable? Those are the central questions the industry faces. Certainly, it helps that banks are prioritizing the financing of ESG-oriented initiatives, backed by large, well-capitalized industry participants. Indeed, a virtuous circle is starting to emerge in which banks, bigger asset owners and high quality end users are all focused on cooperating to reduce carbon reduction and promote sustainability.

What are the risks to our generally hopeful outlook? The reemergence of undisciplined capital, recalling the early 2000s, could reintroduce overordering and potentially set back sustainability initiatives. A low oil price could lead to delays or variations in regional adoption of carbon-neutral strategies. However, emerging markets have notably demonstrated a recent commitment to sustainability. This bodes well for the long term. On balance, we believe investors can find good opportunities in a transportation sector increasingly adopting sustainability goals and providing attractive, predictable, long-term returns.
As we enter 2021, investors are fleeing low yield public credit markets in favor of private debt. We expect this to be an accelerating trend due to an outlook for persistently low public market yields (EXHIBIT 1). Between new capital to deploy, a rebound in economic data and optimism for post-vaccine business prospects, lenders are gaining confidence and offering gradually improving terms to borrowers. In certain markets, this is starting to push spreads in from crisis highs, but yields remain well above pre-pandemic levels. And we continue to see especially compelling income and total return opportunities in a number of private debt and credit markets where this phenomenon is not yet occurring.

Simply put, opportunity persists where the central banks missed. This includes a few spots in less-trafficked public markets, such as mid cap convertible debt. We also see a wide array of opportunities in private debt markets. While returns will be highly dispersed across diverse economies, geographies, industries and individual assets, we see consistently wider spreads and higher yields in private credit than in public credit, along with more protective covenants for lenders than a year ago. Additionally, private credit can potentially lower portfolio volatility while adding diversification.

With higher yields hard to find elsewhere, two thirds of investors surveyed intend to increase investment in private credit (EXHIBIT 1).

Across asset-backed and corporate lending, two themes dominate our views this year:

- **Disruption doesn’t mean destruction.** Disruption is temporary. We’re finding assets and companies that should return to normal (or bounce back stronger) as the world normalizes after COVID-19. We will be especially selective, looking to steer clear or sell companies and assets whose long-term decline has been accelerated by new trends or shifts in behavior.

- **Defaults aren’t done but delayed.** Heroic central bank actions successfully rescued public credit markets from a tidal wave of distress in 2020. But those policy actions did not eliminate defaults—they dispersed a giant wave into smaller future ripples, creating several years of distressed investing opportunities.

**ASSET-BACKED LENDING, ESPECIALLY MORTGAGES, TAKES THE INCOME SPOTLIGHT**

We like asset-backed property lending for income and expect to continue to originate loans at better spreads and terms than pre-pandemic—and given the low cost of borrowing, we like using modest leverage to enhance income. Our asset-backed investing should be strengthened by the stability of the underlying assets, which, beyond mostly core commercial properties, include critical new digital and green infrastructure.

**Commercial real estate debt**

Commercial mortgage loans (CMLs) and mezzanine debt are areas of extremely high conviction. Since the onset of COVID-19, CMLs and mezzanine debt on top-tier U.S. properties have yielded more than traditional investment grade credit equivalents with comparable duration. While our investors may have varying targets for returns and loan-to-value levels, the high quality of the collateral and our ability to properly structure the loans—with lender-friendly covenants, strong underwriting metrics and lower leverage—should drive value. We also expect higher spreads. Since the pandemic, fewer lenders are active in the space and many borrowers’ liquidity and capital market access has dried up. In 2021, the normal capital needs of commercial real estate—a levered asset class that requires continuous flows of financing—may be unmet. We expect to selectively fill the void.

Though office demand has waned during the pandemic, we continue to believe in the asset class; we expect a rebound in select markets as early as 2H 2021. We like mezzanine debt backed by stabilized (long-term leased) office buildings in primary and secondary markets and with solid collection from tenants, as spreads have widened disproportionately in this sector and leverage has remained modest. We are also enthusiastic about loans lower in the capital stack, with returns enhanced by selectively employing leverage.

U.S. housing continues to be a bright spot, with some consumer balance sheets in better shape than the average U.S. company following the corporate debt binge. We favor U.S. multifamily housing commercial lending because occupancy and rent have held up despite the pandemic. While many younger renters fled some cities to move back in with their families, we expect that trend to reverse in 2H 2021. Other residential mortgage debt strategies include investing in loans and pools of securitized loans.

One strategy, targeting 5.0%-6.0% gross returns, mostly from income, involves primarily floating-rate U.S. mortgage loans to expert, well-capitalized sponsors. Another strategy, aiming for 7.0%-9.0% gross returns on lower leverage subordinate and mezzanine debt, targets institutional grade real estate and sponsors. Short duration should limit the impact of interest rate moves, and our deal structures provide equity cushions. We also expect many opportunities in retail and lodging properties, the sectors most impacted by COVID-19.

**Residential mortgage debt**

Home prices, a leading driver of performance, have been buoyed by low interest rates, limited supply, strong household formation despite the hardships, and people moving from cities to suburbs. Buyers and renters who came through 2020 strong have been making payments, and mortgage forbearance measures reduced delinquencies, helping stem defaults, both commercial and residential.

Other favored strategies include credit risk transfer (CRT) deals—CRTs are niche but liquid publicly traded securities that assume the credit risk of agency mortgages originally held by Fannie Mae and Freddie Mac. We also like nonqualified mortgages and new issue nonagency mortgage-backed securities. We may also acquire loans in the private market and exit via the public credit markets through securitizations.

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1 Defaults as of November 30, 2020, were at a 10-year high of 6.2%, according to J.P. Morgan Asset Management.

2 Banks adjusting to meet risk-weighted capital regulations, many participants in the commercial mortgage-backed securities market, mortgage REITs, hedge funds and other levered debt funds have all retrenched.

3 Loans made at below replacement (construction) cost mean that if a building must be taken back, it could be run more competitively than new construction.
Infrastructure debt

Infrastructure assets provide essential services and are characterized by stable, long-term cash flows, often from contracts with premier-tier counterparties, including governments. Senior secured infrastructure debt, an implicitly investment grade asset class, offers another income opportunity, targeting yields of 200 to 300 basis points over risk-free rates.

Investment highlights are renewable solar and wind power generation and evolving energy efficiency. For example, we favor green energy credits in the U.S., particularly up-and-running solar power purchase agreements with investment grade counterparties where there is a high degree of cash flow visibility and attractive pricing. We also like conservation projects (smart grids, smart metering, smart storage), which are driven by government policy to combat climate change. Digital infrastructure will also attract a larger investment allocation: The COVID-19 crisis has revealed the internet’s centrality as an essential service. New investment will include the build-out of super-fast broadband networks and construction of new data storage.

CORPORATE LENDING OFFERS POCKETS OF YIELD, COMPELLING TOTAL RETURN OPPORTUNITIES

Corporate credit has been on a roller coaster the past year. Many direct lenders stepped out of the market in 1Q 2020 when the outlook was at its worst. Since then, the market’s recovery, through stimulus capital, has allowed many loans to begin performing again and some lenders to return. Still, a shortage of capital remains, though rescue lending programs make our opportunity set smaller than was originally expected, and dispersed more through time.

Direct lending

COVID-19 burst a years-long bubble in direct lending, making the area an interesting one for us again. We now see better terms for lenders, including stronger covenants and lower leverage. We particularly like sectors insulated from the pandemic or with a greater disconnect between supply and demand, such as health care, renewable energy and software as a service. The opportunities in areas such as airlines and healthcare are enriched due the specialist skills needed to analyze them. The uncertainty of the pandemic outlook means caution is still required and underlines the importance of manager selection.

Stressed, distressed and special situations

The temporary disappearance of revenue for very high quality companies has dramatically broadened the investment universe for our special situation investment teams. Many loans are still performing, but companies are finding revenue loss challenging; post-default recovery rates are close to an all-time low in both high yield and leveraged loans.

Many travel and leisure, transportation (e.g., airlines), hospitality and consumer discretionary companies—otherwise great long-term credits—will likely need short-term help. An example of a typical transaction would be a sale leaseback or a secured loan against an aircraft for an airline with liquidity constraints. We will continue providing customized capital market solutions, likely with more lender-friendly terms than previously achievable.

We see high levels of idiosyncratic, stressed and distressed credit opportunities in the U.S. and Europe. We believe longer-duration capital will allow investment in much higher returning opportunities compared with public markets over the next several years.

We expect to originate opportunities at deep discounts to intrinsic value and transact bespoke secondary market deals with smaller, off-the-beaten-path private companies. In many cases, these borrowers are overleveraged. These circumstances can create opportunities to negotiate high coupon rescue loans or negotiate term loans for refinances, debt consolidation or M&A.

Public and secondary markets

While we’ve spoken at length about how private yields are compelling vs. comparable public market yields, some areas in public markets offer interesting opportunities. We see value in less trafficked public markets, such as mid cap convertible debt, where spreads remain wide vs. the prior year, and high yield bonds. We also like another less followed area of public markets: the now-discounted “orphaned” credits of underserved, overlooked or misunderstood middle-market publicly traded companies. We also expect to see opportunities in purchasing whole portfolios of

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4 For example, the European Green Deal aims for a climate-neutral Continent by 2050. The European Commission has proposed cutting greenhouse gas emissions by at least 55% by 2030 vs. 1990 levels, mainly through clean energy and energy efficiency, according to the European Union’s Climate Target Plan 2030 (as of September 2020).
downgraded high yield credits and direct loans whose owners are forced sellers for regulatory reasons. Another increasingly attractive option with public market spreads so tight: shorting public credit, particularly by using credit default swaps.

RISKS

Risks to private credit investments broadly include limited stimulus measures that hamper economic recovery, delays in widespread vaccination and/or tighter lockdowns. The rapid tightening of spreads in a market would also make a private credit investment relatively less attractive.

Our investors will continue relying on long-standing partnerships with companies, asset owners, lenders, sponsors and other stakeholders, and differentiated deal-sourcing capabilities. Our experience and expertise in fundamental analysis should serve us well. We will also lean into the insights of our broad alternatives investing platform. Outside the firm, we will turn to proprietary information networks to aid underwriting, access quality transactions and reduce execution risk.

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5 Through Q3 20, USD 748 billion of outstanding high yield debt, and USD 493 billion of leveraged loans, have been downgraded. Source: Fitch Ratings, Moody’s Investors Services, S&P Global Ratings, J.P. Morgan Securities LLC; data as of October 31, 2020.

6 Some structured corporate credit investors, including collateralized loan obligations (CLOs) and some trusts, have limited ability to hold distressed credits.
Three considerations for a competitive market

Stephen Catherwood and Ashmi Mehrotra, Co-Heads, Private Equity Group

Overall, we continue to have a positive outlook for private equity (PE) despite an increasingly competitive market environment. Long-term trends, particularly in the area of technology and innovation, are creating opportunities for disciplined, experienced managers to generate attractive returns.

Deal activity, following a pandemic-induced standstill in Q2, rebounded strongly in Q3 and Q4, especially for durable businesses that proved resilient during an extremely difficult year. Debt financing continues to be available at attractive terms. Exits and distribution activity across both buyouts and venture capital have been strong.

Still, competition is high: Increased deal volume in the back half of 2020 helped absorb some of the industry’s dry powder, but substantial amounts of capital raised in recent years will remain a factor for the foreseeable future. As a result, valuations are elevated and deal processes can be highly competitive.

Robust valuation multiples bring great businesses to market that might not otherwise be for sale—but the same can be said for less desirable businesses at similarly elevated prices. Working with experienced managers that have navigated prior cycles and developed clear playbooks for value creation is more critical than ever.

We offer three considerations for private equity investors as they search for opportunities in this environment:

1. **BIG DEALS PRODUCE HEADLINES, BUT SMALLER DEALS CAN DELIVER DIFFERENTIATED RESULTS**

While the largest buyout deals tend to grab headlines, we see the most attractive opportunities among firms with revenues of USD 10 million to USD 100 million. Despite increasingly competitive markets, these businesses can generally be purchased at lower valuation multiples with transaction structures less reliant on leverage. Smaller, undermanaged companies, even when fundamentally sound, can often benefit tremendously from collaboration with experienced general partners (GP) that have the deep sector expertise to drive transformational change. Once a growth plan has been successfully implemented, these businesses can be sold at premium valuations and drive differentiated returns for investors.

We look for investment opportunities wherever they may arise rather than straining to fill prescribed allocation buckets. We believe this approach is particularly well-suited for a world experiencing varying degrees of pressure and recovery as a result of the coronavirus pandemic.

2. **CO-INVESTING CAN POTENTIALLY HELP INVESTORS REACH PE PROGRAM OBJECTIVES**

Co-investments offer limited partners (LPs) the opportunity to invest directly in individual private companies alongside a GP that leads due diligence and is ultimately responsible for executing the deal. Relative to other

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types of private investment opportunities, co-investments have the potential to provide:

- Return enhancement: Research shows that co-investment net returns to investors can enhance overall private equity portfolio performance (Exhibit 1). Selection, however, is critical as greater upside potential comes with a higher dispersion of outcomes.

- Attractive economics: For LPs, the majority of co-investments are made on a no-fee, no-carry basis.

- Increased visibility and discretion: Co-investments are offered as pre-identified opportunities, not on a blind pool basis, as is the case in PE commingled funds.

Today, a number of dynamics are supporting particularly attractive co-investment deal flow. Increased deal activity and transaction complexity have created a greater need for reliable co-investors—and investors are seeking these opportunities. Over time, sellers have become more confident in the ability of proven co-investors to execute deals. This is particularly notable in the small and middle market, where fund sizes had previously limited otherwise capable GPs from participating in desirable though somewhat larger transactions sourced within their networks. We expect this trend to continue to drive a greater opportunity set for the foreseeable future.

3. TECHNOLOGY AND INNOVATION CONTINUE TO DRIVE OPPORTUNITIES

Technology and innovation are transforming our lives, economies and businesses—and driving substantial return-enhancing opportunities in venture capital and private equity. In many cases, the COVID-19 environment has accelerated technology adoption and benefited technology-focused businesses.

Not all innovative ideas, however, translate into sustainable, profitable businesses. Identifying the likely winners, ensuring that a detailed value-creation plan is in place and executed—and that downside risks are understood—requires a seasoned GP with deep sector knowledge and specialized skills. We highlight opportunities in two areas as examples in today’s market:

Software-as-a-service (SaaS) refers to web- or cloud-based software for which a customer pays a recurring subscription fee for access. SaaS solutions can be expediently installed, cost-effective alternatives to customized installations on in-house servers. They allow enterprises to rapidly adopt a wider range of software tools that can have a significant impact on productivity and efficiency. These flexible solutions can grow with business and production needs to quickly become a vital part of a company’s day-to-day operations. This accelerated innovation and end-user demand are fueling high levels of growth at earlier stages, making these SaaS providers attractive to venture capital firms, while more mature businesses are appealing targets for buyout firms.

Health care demand is growing, driven largely by long-term demographic shifts. At the same time, the sector is catching up in its adoption of software applications. Attractive investment opportunities take many forms, including online platforms designed to connect independent medical practices and provide economies of scale, and services supporting patient adherence to medication and therapy programs. We see increasing opportunities for technology-based solutions that can help providers deliver better care to patients, with better outcomes and at lower costs.

In short, while the private equity market continues to be competitive, we believe significant opportunity remains for disciplined, experienced investors.
Opportunities as megatrends accelerate

David Chen, Chief Investment Officer, Real Estate Asia Pacific
Tony Manno, President and Chief Investment Officer, Security Capital Research & Management, Inc.
Pete Reilly, Chief Investment Officer, Real Estate Europe
Doug Schwartz, Chief Investment Officer, Real Estate Americas
Alan Supple, Head of Global Real Estate Securities

A series of megatrends—the growth of e-commerce, advances in technology and connectivity, population and migration shifts—are gradually transforming how and where we live and work. In the process, they are shaping the very nature and form of real estate investing.

The COVID-19 pandemic has accelerated these megatrends, with repercussions across all real estate sectors—from positive for industrial/logistics to perhaps most disruptive for traditional retail. The opportunity set is shifting. In the current environment, informed asset selection is more important than ever in building diversified real estate allocations.

The implications vary regionally as well, depending on the progression of these megatrends, the current economic cycle and the pandemic experience in each region. These are important considerations for real estate investing.

What’s more, near-term visibility has been clouded by the pandemic—at least, until more transactions and lease renewals take place. Some properties may become obsolete while the more flexible and adaptive will survive and thrive. As a result, bottom-up analysis of individual properties and an informed view of sector and regional drivers of income and return are critical.

With that backdrop in mind, we look at opportunities within the major real estate sectors (industrial/logistics, retail, office and residential), including extended sectors, and identify the differentiated trends and resulting investment implications and opportunities our regional specialists are seeing in their respective markets.

Overall, we believe that with careful, diligent asset selection across regions and sectors, both traditional and extended, real estate investing can provide the alpha, income and diversification investors are seeking in this environment of persistently low rates (EXHIBIT 1).

INDUSTRIAL AND LOGISTICS: OPPORTUNITY—WITH A PANDEMIC BOOST

The industrial/logistics sector appears to be the greatest beneficiary of accelerating megatrends. The continuing shift to e-commerce, along with technological leaps in connectivity, cloud computing and the internet of things (IoT), is creating demand not only for traditional industrial assets (EXHIBIT 2) but also for specialized core assets, including data centers, cold storage and truck terminals. The pandemic, with its social restrictions, distancing and adaptive work from home (WFH) practices, has amplified that demand. In a low rate environment, this expanding opportunity set can offer long-duration, stable cash flows and the potential for yield enhancement over core bonds.
Real estate can be a stable source of income and yield in a continuing low interest rate environment

EXHIBIT 1: REAL ESTATE VS. BOND YIELDS

<table>
<thead>
<tr>
<th>Asset Class Yields (%)</th>
<th>Global REITs</th>
<th>APAC real estate</th>
<th>Europe real estate</th>
<th>U.S. real estate</th>
<th>Australia 10-year</th>
<th>U.S. 10-year</th>
<th>U.K. 10-year</th>
<th>Japan 10-year</th>
<th>Euro Govt. (7-10-year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate</td>
<td>4.8</td>
<td>4.3</td>
<td>4.1</td>
<td>4.1</td>
<td>0.9</td>
<td>0.7</td>
<td>0.3</td>
<td>0.0</td>
<td>-0.1</td>
</tr>
<tr>
<td>Fixed income</td>
<td></td>
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</tbody>
</table>


U.S.

As e-commerce accelerates, our U.S. team prefers infill warehouses (within a close drive to consumers) to those located farther from high density points of final consumption (and more susceptible to increasing supply). Our specialists are strategically focused on sectors where value is driven largely by the land component of a site vs. building improvements and special tenant amenities. Truck terminals and outdoor storage yards look particularly attractive. These long-leased properties require relatively low capital expenditures, are readily adapted to specific tenant needs and can generate stable cash flows.

Europe

E-commerce penetration has progressed more slowly in Europe vs. the U.S. and the UK, but the pace is picking up. That is driving demand for modern warehouses, which are in short supply. Online businesses need efficiently designed, well-located warehouses to be competitive—and they are investing capital to fit out these spaces to meet their specific needs. Given supply-demand dynamics, rental agreements are becoming more attractive from an investment perspective, with longer terms, inflation links, stronger covenants and high renewal rates. We see the potential for upward pressure on rental values over time.

Asia-Pacific (APAC)

The growth of industrial/logistics assets at the expense of retail is not new, but has been fast-tracked by the pandemic.

EXHIBIT 2: NFI-ODCE INDEX ALLOCATION BASED ON GROSS ASSET VALUE

The growth of the industrial/logistics sector in APAC’s key gateway cities is evident in warehousing, as well as in cold storage and data centers. This growth story is not just about e-commerce expanding at the expense of traditional retail, but about economic growth and a rising middle class. Warehouse stock is old, and an acute land shortage is driving a distinctly vertical build-out in many markets. Among the region’s supply chain modernization opportunities our APAC experts highlight:

- Japan, with its low e-commerce penetration and the highest ratio of warehouse demand growth to economic growth among major markets in APAC.¹
- China, with over 90% of warehousing stock in need of modernization² and spending power in its top-tier cities expanding strongly.

¹ Oxford Economics, Jones Lang LaSalle; growth rate from 2015 to 3Q 2020.
Global REITs

While our REITs team remains positive on the traditional industrial sector, we focus here on the compelling opportunities team members see in data centers. As with traditional warehouses, this fast-growing extended core sector can rapidly scale by leveraging the specialized skills, efficient service platforms and access to public markets that best-in-class REITs can offer. In Europe, our specialists highlight opportunities in, for example, Frankfurt and Paris as the shift to a hybrid cloud model accelerates. APAC (e.g., Singapore, Tokyo and Osaka) is likely to provide the greatest development returns, though land acquisition remains difficult, driving up returns but limiting opportunities. That said, the key listed players with established teams on the ground are well positioned to capitalize in this space.

Retail: Down but Not Out

Retail properties have suffered significantly as COVID-19 has hastened the trend toward online purchases. In our view, it is not time to abandon the sector but rather to take a more discerning look at its variety of property types and to be laser-focused on diligent asset selection.

Retail property types have varying levels of susceptibility to online shopping. Generally, “necessity” retailers have fared better than those considered discretionary. Additionally, e-commerce penetration varies by regional market (EXHIBIT 3), as do retail property supply-demand dynamics.

We see significant opportunity for operators that can reimagine and develop spaces in line with emerging retail models—models driven not by consumers’ pandemic-constrained behavior but by how people prefer to procure items, from groceries to big-ticket luxury purchases, in a more normal environment. The showroom aspect of retailing is expected to thrive as digitally native brands compete to establish their images and reach customers.

U.S.

Given the oversupply of retail outlets in the U.S., consolidation is inevitable, providing opportunities for survivors to become stronger and more dominant. As our U.S. team sees it, the winning retail model will not aim to physically reach as many customers as possible (suggesting that generic “big box” stores are more likely to succumb to online retailing). Instead, the victors will have created highly differentiated spaces targeting specific market segments, with a carefully curated, synergistic collection of businesses—stores, services, restaurants and entertainment—that together drive demand and support the image retailers want to establish. In a post-pandemic world, entertainment and leisure will again thrive as a key driver of retail demand.

Europe

Much of the European retail sector cannot currently be viewed as core, given the impact of excess supply and changing demand dynamics on both rental and capital values. Our European team views this period of uncertainty and transition as a potential opportunity to selectively acquire non-core properties that can be developed and delivered to the core market as the new core retail model emerges.

Online retail penetration varies across regional markets

EXHIBIT 3: GLOBAL ONLINE SALES’ SHARE OF TOTAL RETAIL SALES

Source: Australian Bureau of Statistics, Centre for Retail Research (Germany, France, Italy, Spain), Korean Statistical Information Service, METI (Japan), National Bureau of Statistics (China), ONS (UK), Statistics of Singapore, U.S. Census Bureau, J.P. Morgan Asset Management. Online retail sales estimates are as of 3Q20, except European countries are 2020 forecast and Japan which is as of 2019.
Asia-Pacific (APAC)

While situations vary intraregionally, the APAC region as a whole appears to be leading the COVID-19 recovery globally. Oversupply of mall space is not as significant a headwind relative to other regions, and distressed properties are fewer. Here, much of the pain has been due to tighter social distancing measures and a loss of tourist demand, which should rebound when travel restrictions are lifted. Retail sales have bounced back to the pre-pandemic levels of 2019.3

Global REITs

Some REITs with retail portfolios have issued equity at a discount—for redevelopment purposes and/or to shore up balance sheets in the current storm. While potentially detrimental to current investors, these offerings could be an attractive entry point for new investors seeking a certain risk profile. Selection is critical: Our team looks for portfolios of sound assets likely to survive the pandemic and participate in a recovery rally, guided by a top-notch management team that can effectively employ new capital to reconfigure existing properties.

OFFICE: A BRIGHTER THAN CONSENSUS VIEW

Some are calling for the pandemic-induced demise of the office sector. We are more optimistic. Working from home has accelerated under COVID-19 and proven its technological feasibility. But an optimal, sustainable home/office balance depends on economics and human nature—and may vary across businesses and regions. Here are some of the dynamics supporting our more constructive outlook:4

- Collaboration is essential to productivity, especially in industries for which innovation is a competitive necessity.
- The share of office-using jobs is growing, and those jobs’ share of wages is growing even faster (EXHIBIT 4).
- Spending fewer days in the office doesn’t necessarily imply a commensurate reduction in space needs. Companies have to plan for peak usage.

We believe that employers’ needs to attract the most productive workers to performance-enhancing, collaborative spaces in dynamic locations continue to drive a large and viable investment opportunity.


U.S.

Our U.S. team continues to favor central business district (CBD) vs. suburban offices, despite recent CBD underperformance and market concerns about a potential departure of jobs from urban centers. The de-urbanization trends following 9/11 reversed sharply and quickly, the team points out. Another positive sign for the CBD sector: manageable new supply and occupancy costs prior to the pandemic-induced recession, compared with those in the periods preceding the tech and global financial crises.5

Submarkets where innovation companies (tech, biotech and other heavily collaborative enterprises) reside should fare well. Even during the pandemic, some of these companies have made sizable commitments to new space (e.g., Facebook within midtown Manhattan). We remain bearish on suburban offices due to the lack of a cluster effect, and on those CBDs where the demand is not driven by innovation companies but, rather, dominated by traditional users (e.g., law, insurance and banking).

Europe

In Europe as in other regions, WFH practices were underway prior to the pandemic and have accelerated with COVID-19, weakening demand for office space. In the core space, higher quality properties—those in accessible and vibrant locations, able to provide flexibility, technology and connectivity in an environment conducive to productive, in-person collaboration—should be more resilient to WFH trends. Selection will be critical.

5 Ibid.
At the country/city level, our team is relatively optimistic on Germany, given its more positive supply-demand balance and fewer economic and pandemic-related headwinds. The team is taking a more cautious approach to the UK in the face of rising vacancy rates and Brexit uncertainties. Regardless of the Brexit outcome, relatively high real estate and bond yields suggest that London could benefit from yield compression and, therefore, greater short-term capital value protection from occupier market weakness—with opportunities for both core and non-core investors.

Asia-Pacific (APAC)

The COVID-19-induced recession has impacted the APAC office market as well, tempering demand, increasing competition for tenants and pressuring rents. Cyclical supply-demand dynamics, coupled with greater uncertainty around the timing of the recovery, requires increased scrutiny of markets, asset characteristics and tenant profiles. What’s more, given tighter living quarters in many markets and less historical adaptation to, and perhaps less cultural acceptance of, WFH, the trend has progressed more slowly and the return to the office has been generally swifter.

Our team sees particular opportunity in Osaka, Japan’s second largest city by GDP, with vacancy rates below 2% at the end of 3Q 2020, new supply expected to be limited and white-collar and office-based employment growing at a stable pace. Identification of modern, energy-efficient buildings with flexible floor plates, the amenities tenants demand and few expiring leases will be critical.

Global REITs

Our REITs team sees potential near-term pricing opportunities in office space but cautions that visibility will be limited and selectivity critical until more new leases are signed and/or renewed. Team members are generally more constructive on offices in selected European markets (e.g., Paris and Madrid) and Japan (e.g., Tokyo), where pandemic-induced declines in office demand are less likely to be exacerbated by too much supply. In the U.S., they see potential opportunities in Sunbelt markets (Charlotte, Atlanta, Austin), where leases are still being written. These nongateway cities, offering many of the attractions of major urban areas but with lower costs and taxes, are drawing corporate headquarters and an aging millennial workforce.

RESIDENTIAL: LONGER-TERM POPULATION DYNAMICS CONTINUE TO DRIVE THE OUTLOOK

Opportunities within residential real estate around the globe are being driven primarily by population trends in place prior to the pandemic. COVID-19 may be impacting the speed of these trends, largely through work-from-home dynamics and limited access to the dining, shopping and cultural experiences that make urban centers vibrant, desirable places to live. The pandemic’s effect on demand is being felt unevenly across geographies, but we believe it is likely to be relatively short-lived.

U.S.

Millennials starting families and retirees moving to the Sunbelt continue to drive opportunities in multifamily and purpose-built single-family rentals, helped at the margin by COVID-19.

Despite the exodus from urban centers in the U.S. during COVID-19, 3Q 2020 rent collections for our Real Estate Americas platform were back near pre-pandemic levels. What’s more, nearly 60% of renters leaving New York City during COVID-19 put their belongings in storage, suggesting potential for a fairly rapid snapback in urban multifamily rentals and selective investment opportunities.

Europe

The European/UK market is attractive but complicated by the potential for government regulation and controls. Our regional team sees opportunity in the UK purpose-built rental (PBR) sector, which is leading to the creation of institutional-quality assets in what has traditionally been a market dominated by specialists in Europe and small players and individual homeowners in the UK. These rental housing communities are supported by demand-side growth, given the high price of homeownership. Developers can realize economies of scale in developing and managing these properties, which have the potential to generate attractive cash flows.

Asia-Pacific (APAC)

Asia’s residential markets have shown resiliency in the face of COVID-19. Long-term regional migration trends persist, and most urban centers have not seen the outflows experienced in other regions.

6 Estimates according to Oxford Economics, as of December 2020.

7 Single-family homes built specifically for rental, generally in a community setting and providing apartment-like services and amenities.

Japan’s multifamily sector continues to stand out, led primarily by Tokyo and Osaka. Net migration growth rates may slow slightly in 2021 but should continue to provide a substantial tailwind. Rental units, particularly for single-person to small households, located near mass transportation should continue to see strong demand. Newer multifamily properties, from our experience, achieve high rental collection (currently near 100%), retention and renewal rates, and are expected to contribute to stable income streams. Yield spreads over bonds remain attractive.

Global REITs

Our Global REITs team sees particular opportunity in the institutionally managed multifamily rental sector in Europe, though government regulations to control rent could pose a challenge. In Germany, some of Europe’s largest listed multifamily companies are taking advantage of a still-fragmented market to assemble portfolios and build scale. Focused on the affordable end of the rent spectrum, these companies have had a stable collection experience during COVID-19 and have the potential for steady growth and solid income generation.

CONCLUSION

Once considered the most traditional of non-traditional asset classes, real estate is undergoing a transformation, driven by megatrends and fast-tracked by the pandemic. Some assets are set to benefit; others may not keep pace. Quality assets will adapt and thrive. With diligent asset selection, global real estate’s evolving opportunity set can continue to provide the alpha, income and diversification investors need.

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9 Based on J.P. Morgan Asset Management—Real Estate Asia-Pacific experience across approximately 5,500 units; as of December 31, 2020.
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