Topics: US technology IPOs; Rising risks of Trumpism as China exhausts its welcome in DC; and a look at Progressive Democratic policy proposals given Senator Warren’s rise

The struggles of some US technology companies in the IPO market and in the pre-IPO market have gotten a lot of headlines recently. What’s lost in the shuffle: most real technology IPO’s are doing just fine, as shown below. “Tangential tech” companies included in the broad tech category but which are not pure tech are for the most part the ones that are struggling. Many companies on the right side of the chart also fail the simple “rule of 40%” test on the sum of revenue growth and free cash flow margins (in the case of Uber, Arlo, Eventbrite and Pivotal, the rule of 40% test yields a negative number, and for Zuora and Upwork, the rule of 40% test yields a positive number but one that is below 20%).

What’s wrong with the performance of 2018/2019 tech IPOs?
Not much, as long as what you’re buying is actually a real technology company

Performance relative to IPO price (or direct listing price)

Sources: Bloomberg, Company financials, Stratechery.com, JPMAM. Oct 4, 2019. The companies above are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell. The use of the above companies is in no way an endorsement for J.P.Morgan Asset Management investment management services.

Additional comments on IPOs and the tech sector:

- **Diversified multi-sector IPO investing since 2010 hasn’t done much for investors.** The latest study, we’ve seen takes two approaches. The first is a portfolio that owns 200 IPOs, with proceeds to buy each new IPO sourced from selling the worst performers. Since 2010, its relative performance has been flat to the market. The second looked at relative performance of IPOs since 2010 assuming a 2-year hold. Median IPO performance was 20% below the market. Average returns were better but still just matched market returns, benefitting from the 2% of IPOs that delivered returns > 200%. IPO underperformance can be attributed to healthcare, the largest issuing and worst performing sector in the US IPO market since 2010.

- Not directly related to the chart above, but I think it’s worth pointing out: **Moore’s law** improvements in computer processing power have slowed to just a few percent per year, and there has been no improvement in clock (microprocessor) speed since 2004. Components may have reached atomic dimensions which now act as a natural limit to further improvements due to the end of a phenomenon known as Dennard Scaling.

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The latest on the Trade War as China wears out its welcome in DC

As we wrote in the Labor Day *Eye on the Market*, we believe that US equity markets are now range-bound by Trumpism, and that the upper end of that range is ~3,000 on the S&P 500. The latest news on the trade war includes Senator Rubio’s proposals to delist Chinese companies that do not comply with US accounting and securities regulations (par for the course: a 2013 agreement allowing US regulators to request audit working papers in China has not been effectively implemented), and a proposal to ban Federal retirement accounts investing in products with China exposure. At this point, the most important chart on the Trade War may be the second one below. With almost two decades elapsed since China joined the World Trade Organization, China is still the most mercantile country in the world, with few friends in Washington on either side left to defend them and with many detractors in the private sector as well. The best outcome I can imagine for now is a narrow deal based on mutually beneficial agricultural trade, particularly since China is considering a release of its strategic frozen pork reserves after the death of 100 mm pigs.

Last week, the WTO authorized the US to apply tariffs on certain European products as recompense for unfair EU subsidies to Airbus. The US trade representative said it would impose tariffs starting October 18, with 10% on jetliners and 25% duties on whiskies/wine/cheeses. The maximum amount of goods that can be tariffed is very small ($7.5 billion), but it could lead to retaliation by the EU.
The impact of the trade war is growing, as indicated by weakness in US manufacturing surveys and CEO confidence, no growth in US corporate profits in Q2/Q3, and falling global cross-border capital spending and M&A activity. US capital spending has also weakened from 5.5% growth to around 2%, but this appears to be more a reflection of Boeing aircraft drags and a declining rig count in the oil sector. So far, the US consumer and related services are holding up much better (vehicle sales, retail sales, employment, confidence, etc). **Trump is playing with fire here, since the gap between the two cannot be sustained indefinitely.** In fact, last week the US service sector survey declined, a possible sign that the gap may already be closing. I expect a modest growth and earnings rebound in the months ahead as a recession is avoided, but the Trumpism trading range shown on the prior page still holds.

European business surveys are weaker than in the US given its higher reliance on exports. On **China**, a one-year measure of coincident growth has fallen from 7% in January 2018 to just 4% in August 2019.

### China activity coincident tracker

<table>
<thead>
<tr>
<th>Year</th>
<th>2%</th>
<th>3%</th>
<th>4%</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
<th>9%</th>
<th>10%</th>
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<td>2013</td>
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Includes: electricity production, fiscal revenue, real exports, port throughput, retail sales, financial services proxy, air/rail/highway traffic

Warren Peace: Progressive Democrats battle the status quo

Given Senator Warren’s rise in the polls and in betting markets, it’s time to review proposals advanced by Senator Warren and by other candidates whose ideas she might also adopt if she becomes President.

On the next few pages, I included some charts and tables that review these policies. This exercise is a political Rorschach test, since some people will like most of the things that they see, and others won’t. One thing is clear: the breadth of current progressive proposals are in line with a chart we first showed last December. Senator Warren occupies a place on an empirically derived political spectrum that is considerably to the left of 20th century Democratic Presidents, and to the left of Democrats who aspired to become President as well.

Political ideology of Presidential administrations, and a look at 2020

UCLA Voteview Liberal-Conservative scores, derived from Congressional voting histories
Filled circles = administration aggregates, unfilled circles = losing candidate scores

Source: Voteview Congressional Roll-Call Votes Database, JP Morgan Asset Management. 2019. See page 11 for details on how this chart was constructed, including a list of politicians with Congressional voting histories that were included in each administration’s aggregate score.
Progressive Policy Review

The table outlines progressive proposals on taxation, the corporate sector, labor, energy, healthcare, investment and student debt, most of which have been put forward by Senator Warren. We take a closer look at a few of them on pages 6-10. For many of these proposals to be adopted, Democrats would have to take control of the Senate and not just the White House, and the new Senate Majority Leader would have to agree to put these proposals on the docket, and Democrats might have to end the filibuster. However, in the wake of recent precedents (Trump unilateral actions on environmental, trade and border issues), some could be enacted through Executive Action and regulation rather than through legislation.

<table>
<thead>
<tr>
<th>Progressive Democratic Agenda</th>
<th>Taxation</th>
<th>Corporate</th>
<th>Labor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Double capital gains tax rate on earners over $1mm</td>
<td>Curb or prohibition on stock buybacks (see p.6)</td>
<td>Ban on state ‘right to work’ laws, ‘fair share’ fees to allow unions to collect fees from non-members</td>
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<tr>
<td>Eliminate step-up in basis on death</td>
<td>Break up big banks, reverse Trump dereg. on capital/liquidity, impose financial transaction taxes</td>
<td>Eliminate secret ballots in worker union elections</td>
<td></td>
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<tr>
<td>Tax unrealized capital gains (see p. 8)</td>
<td>Break up big tech, reinstate Net Neutrality</td>
<td>Worker election of 40%+ of board members (co-determination)</td>
<td></td>
</tr>
<tr>
<td>Treat cap gains and dividends as ordinary income for tax purposes</td>
<td>Federal charter required by public companies with revenues &gt;$1bn, must produce “material public benefit”… and “material positive impact on society” to obtain charter from Dep’t of Commerce</td>
<td>Industry-level sectoral bargaining</td>
<td></td>
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<tr>
<td>Wealth tax of 2% over $50mm</td>
<td>“Office of US Corporations” and State Attorney Generals can sue to revoke charters</td>
<td>Reduced classification of independent contract workers</td>
<td></td>
</tr>
<tr>
<td>Top estate tax rate of 77%</td>
<td>“Office of US Corporations” and State Attorney Generals can sue to revoke charters</td>
<td>Penalties for Federal contractors with gender pay disparities</td>
<td></td>
</tr>
<tr>
<td>New payroll tax of 12.4% &gt; $250k in income</td>
<td>Political expenditures subject to 75% approval by all shareholders</td>
<td>NLRB penalties on companies and executives for violating worker rights and wrongful termination</td>
<td></td>
</tr>
<tr>
<td>Eliminate corporate tax cuts, surtax on corporate profits over $100mm (see p.7)</td>
<td>Private equity firms must guarantee repayment of debt and pensions of acquired companies</td>
<td>Increased protections for striking workers</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Healthcare</th>
<th>Energy</th>
<th>Student debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medicare for All with no deductibles or copays</td>
<td>Ban hydraulic fracturing on private land and fracturing/drilling on federal land (see p. 9)</td>
<td>Reduce student debt for 95% of Americans with student debt (45 million people)</td>
</tr>
<tr>
<td>Ban private health insurance</td>
<td>Ban fossil fuel exports, no new nuclear power plants</td>
<td>Wipe out student debt entirely for 75% of students with debt</td>
</tr>
<tr>
<td>Drug price caps, gouging penalties, and reimportation allowances</td>
<td>Repeal traditional energy friendly tax provisions</td>
<td>Universal free public college education</td>
</tr>
<tr>
<td>Allow HHS to manufacture/sub-contract generic drugs</td>
<td>$1 trillion over 10 years to subsidize transition to 100% clean energy</td>
<td>Estimated cost = $955 billion</td>
</tr>
</tbody>
</table>

Source: Cornerstone Macro Research, CNBC, warren.senate.gov. 2019
Redistribution, equity market sector risks and a ban on stock buybacks

Before getting into the details, a brief comment on redistribution. I don’t think redistribution is inherently positive or negative for the economy; it depends on a lot of factors, such as the impact of higher tax rates on propensities to invest and consume at different income levels, the efficiency with which the Federal government allocates tax revenue to productive/unproductive programs, the impact of redistribution on consumer and investor sentiment, and the degree to which Federal revenue-raising targets are affected/circumvented by changes in corporate or individual behavior. Even so, I do think that the broader a redistribution agenda is, the greater the chance that it adversely impacts the private sector in unanticipated ways. In our June 2019 analysis of Nordic countries, we found that in some ways, Nordic countries are even more business-friendly than the US; that their tax systems rely primarily on consumer (VAT) and payroll taxes to finance entitlements; and that their healthcare systems generally require both co-pays and deductibles to manage cost. In other words, even the most progressive countries need a vibrant private sector and incentives for citizens to invest in new businesses and capital projects in order to afford redistribution in the first place.

Equity market sector implications. When thinking about potential implications of a Democratic sweep, it seems to me that the greatest valuation risks would be in store for the following, in alphabetical order: banks (large and mid-sized), biotech, chemicals, energy E&P, healthcare managed payers/service providers, independent power producers, integrated oil & gas, medical devices, megacap internet, payment processors, branded specialty pharmaceuticals and specialty/consumer finance. With respect to healthcare, while a lot of negative sentiment is priced in already, many proposals are essentially based on eliminating private sector rents in the healthcare system, so I could imagine additional downside risk depending on the details.

While there is little evidence that companies pursue stock buybacks instead of hiring and capital spending, there appears to be broad progressive Democratic support for stock buyback restrictions or an outright ban. The chart on the right shows the sectors most reliant on buybacks as a contributor to investor returns.

**S&P 500 healthcare versus S&P 500 valuations**

![S&P 500 healthcare versus S&P 500 valuations graph](source: Bloomberg, October 4, 2019)

**Quarterly buyback yield by S&P 500 sector**

![Quarterly buyback yield by S&P 500 sector chart](source: RBC Capital Markets, October 2019)
Repeal of the 2017 corporate tax bill and additional windfall taxes on the corporate sector

In 2016, the US had the highest marginal effective corporate tax rate within the G-7 and within the 34 countries in the OECD. The 2017 tax bill lowered US corporate tax rates to be in line with other countries. As a result, a repeal would push effective US corporate tax rates back to where they were before: higher than most other developed and developing nations.

Reducing corporate tax rates used to be a Democratic agenda item as well. President Obama’s Bipartisan Commission on Fiscal Reform in 2010 proposed a switch to a territorial system (from a Roman worldwide system), as did the President’s Export Council, the President’s Manufacturing Council, and the President’s Jobs Council, with the Fiscal Commission writing that “the current system puts US corporations at a competitive disadvantage against foreign competitors. A territorial tax system should be adopted to help put the US system in line with other countries, leveling the playing field”. A shift to higher corporate taxes would be a marker of changing economic views within the Democratic Party.

Marginal effective tax rate
% effective tax rate on new investment in manufacturing & services

<table>
<thead>
<tr>
<th>Region</th>
<th>Marginal Effective Tax Rate</th>
</tr>
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<tbody>
<tr>
<td>US (Prior)</td>
<td>35%</td>
</tr>
<tr>
<td>Asia-Oceania</td>
<td>30%</td>
</tr>
<tr>
<td>Europe</td>
<td>15%</td>
</tr>
<tr>
<td>Canada</td>
<td>10%</td>
</tr>
<tr>
<td>Mexico</td>
<td>0%</td>
</tr>
<tr>
<td>US (Current)</td>
<td>20%</td>
</tr>
<tr>
<td>Africa</td>
<td>5%</td>
</tr>
<tr>
<td>M. East &amp; N. Africa</td>
<td>5%</td>
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Source: University of Calgary School of Public Policy, Mintz & Bazel. Corporate tax rates are GDP weighted. December 17, 2017.

In terms of the impact on markets, the corporate tax cuts boosted S&P earnings on a one-time basis by 8%-10% in 2018. Assuming a 17.5x multiple, a corporate tax cut repeal could in isolation reduce the fair value of the S&P 500 by the same amount. This assumes a complete repeal of the corporate tax cuts, but does not include proposals by Senator Warren to impose an additional 7% windfall profit tax on earnings over $100 mm to finance a renewable energy transition. Sectors that benefitted the most from tax cuts in terms of declines in effective tax rates: communication services, consumer discretionary and financials.

From a corporate finance perspective, the 2017 tax bill reduced incentives for corporate inversions (expatriations) by narrowing the tax gap with the rest of the OECD. On top of that, US companies that had already inverted actually suffered from the new bill. A repeal of the 2017 act could result in a renewed spike in inversions, the history of which is shown above. As a reminder, before the new tax law, no company ever inverted into the US, which was a sign of a non-competitive US corporate tax system.

On financial transactions taxes, a Georgetown finance professor released a paper which you can read if you’re interested. The primary conclusions: FTTs have often not been very successful (and have often been repealed) in other jurisdictions due to location-switching (much less revenue raised than projected); also, costs tend to be passed along to consumers, taxpayers and investors rather than being absorbed by the financial system. Source: “Financial transactions taxes: A tax on investors, consumers and taxpayers”, James Angel, Georgetown University, 2019.

A full corporate tax reversal would raise rates back to 35% and also narrow the corporate tax base, since the 2017 bill broadened the base through interest expense limitations. An increase to 28% with no change in the base could be similar economically to a full repeal.
“Treat Wealth Like Wages”: how the Federal government might tax unrealized capital gains each year

Since Senator Warren’s wealth tax proposal could be subject to constitutional challenges (that we discussed here), I would not be surprised if her campaign eventually adopted the proposal by Senator Wyden (D-OR, ranking member of the Senate Finance Committee) to tax existing and future unrealized capital gains on an annual basis. Here are the things you need to know about the “Treat Wealth Like Wages” proposal:

- It would tax all capital gains as ordinary income
- Wealthy taxpayers would have to use “anti-deferral accounting rules” that require mark-to-market taxation of gains and losses on publicly tradable securities, and lookback taxation of non-tradable assets
- Who qualifies as “wealthy”? Anyone with income over $1 mm or assets over $10 mm in 3 consecutive years, with both figures adjusted annually for inflation
- What counts towards the asset threshold? Cash, stocks, partnership interests, bonds, futures, options and other derivatives; real property; acquired patents, copyrights and intangibles; and also collectibles
- How do the rules work for tradable securities? Taxes on unrealized gains (or deductions on losses) are paid (received) yearly. The year-end market-to-market value establishes the basis in the asset for the next year
- How do the rules work for non-tradable assets? The proposal recognizes the administrative complexities of annual appraisals of non-tradable assets for which no market price is available. Instead, taxpayers would be subject to a lookback charge when they do sell the asset that would be intended to eliminate the benefit of having deferred the income tax. One possible approach: an interest charge on the deferred tax, similar to penalties applied to taxpayers filing late
- Exemptions: The first combined $2 mm of primary and secondary residences would not count towards the $10 mm asset threshold and would be exempt from the lookback charge. The first $5 mm of the combined value of family farms would also be exempt. In addition, the first $3 mm of retirement account assets would not count towards the $10 mm asset threshold, and no amount in any retirement account would be subject to the mark-to-market or lookback charges
- Would mark-to-market and lookback rules apply to current unrealized capital gains? Yes. All capital gains, even those that accrue before enactment of this proposal, would be captured by year-end mark-to-market or lookback charges. Because this may result in very large tax bills in the first year, the proposal would include transition rules allowing taxpayers to pay the tax over several years
- For pass-through entities, rules apply at the partner or shareholder level. The pass-through entity will be responsible for reporting shares of mark-to-market gains/losses and lookback charges. The rules do not apply to publicly-traded C corporations, but the proposal acknowledges that the plan will have to include anti-abuse rules to prevent taxpayers from using private C corporations to circumvent them
- Unlike Warren’s wealth tax, Wyden’s plan works within the framework of the existing tax system. While there may be court challenges as to whether unrealized gains really constitute taxable “income”, the current tax code already imposes mark-to-market taxation of some unrealized gains. Examples include mark-to-market on certain derivative contracts under §1256, mark-to-market accounting for securities dealers under §475, and the “exit tax” on expatriates under §877A. Similarly, precedent for the lookback charge on non-tradable assets exists in the passive foreign investment company excess distribution rules under §1291. By using a lookback charge for gains on non-tradable assets, Wyden’s proposal would also avoid many of the complexities inherent in Senator Warren’s plan, which would require annual valuations of such assets

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4 The progressive Institute on Taxation and Economic Policy had an idea as to how non-tradable real estate could be taxed under an annual wealth tax regime. Legislation creating a federal wealth tax could instruct that whenever a taxpayer challenges an assessment of real estate by the IRS, the Treasury Department would provide the taxpayers’ own appraisal of their real estate to any state or local government that could then acquire the property through eminent domain and claim they are paying “just compensation”. Yes, this is really what they wrote.
The impact of an immediate ban on hydraulic fracturing

Hydraulic fracturing now accounts for 60%-80% of US oil, natural gas and natural gas liquid (NGL) production. As a result, domestically produced oil and gas derived from hydraulic fracturing also accounts for an enormous 40% of total US primary energy consumption. While US renewable power generation is growing, the pace is almost certainly not fast enough to immediately abandon fractured natural gas and oil given US goals of decommissioning aging coal and nuclear power plants, and of reducing reliance on foreign oil. In the absence of an interconnected, nationwide electricity grid and cheap energy storage (see 6th chart below), natural gas is a critical complement to intermittent renewable energy.
Anti-trust and the tech sector

There’s a vigorous debate as to whether tech giants are adversely affecting consumers, and/or if they are adversely impacting potential competitors. We will not debate that here; the regulatory table below shows that after a 50 year decline in anti-trust investigations (particularly on the tech sector), many politicians now believe that the answer to one or both of these questions is “yes”. To the extent that this negatively impacts the tech sector, it could have an adverse impact on investors since tech has almost doubled the return on the rest of the stock market since 2010 (3rd chart), and since the largest tech companies have been very active acquirers of both revenues and intellectual capital (4th chart).

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The consultancy Oliver Wyman wrote a piece in 2018 (reportedly funded by Facebook) that argued that Facebook, Google and Amazon do not have a material impact on overall VC markets. Critics argued that when narrowing the analysis to companies that compete directly with Facebook, Google and Amazon, there is in fact a “kill zone” of reduced venture capital activity (e.g., Oct 2018 report from Ian Hathaway, non-resident senior fellow at Brookings).
Our political spectrum pendulum chart

Each administration’s score is based on politicians we selected (see list below), which include members of its Executive Branch with Congressional voting histories, and prominent members of Congress that supported major legislative initiatives of that administration, and/or defended its political and governing principles. The degree of liberalism/conservatism for each politician is based on Voteview data, which essentially reflects how frequently each politician voted with their respective bloc. Voteview data has been used in peer-reviewed studies of polarization and Congressional history since the 1980’s, and includes ideological scores for all Congressional politicians since the first Congress in 1789. The project began with pioneering work done by Keith Poole at the University of Georgia and Howard Rosenthal at NYU/Carnegie Mellon (“The Polarization of American Politics”, 1984), and is now maintained by UCLA’s Department of Political Science. We first discussed this chart in our December 10, 2018 Eye on the Market (which you can find [here](#)), where we also illustrated how the decline in moderate politicians coincided with a decline in US long-term growth.

Who’s included in each administration’s score:

- Trump admin: Cotton, Graham, Hatch, McCarthy, Meadows, Paul, Perdue, Ryan, Scalise, Sessions
- Obama admin: Biden, Durbin, H. Clinton, Kennedy, Kerry, Obama, Pelosi, Reid, Waxman
- GW Bush admin: Ashcroft, Blunt, Cheney, DeLay, Kyl, McConnell, Santorum
- Clinton admin: Bentsen, Carper, Chiles, Gephardt, H. Ford, Nunn, Robb
- Reagan/Bush admin: Baker, Bush, Dole, Kemp, Latta, Laxalt, Lugar, Michel
- Carter admin: Bayh, Byrd, Hawkins, Mondale, O’Neill, Wright
- Nixon/Ford admin: Ford, Lott, Percy, Rhodes, Sandman, Scott, Wiggins
- JFK/LBJ admin: Bolling, Humphrey, JFK, Johnson, Mansfield, McCarthy, McCormack
- Eisenhower admin: Dirksen, Dulles, Flanders, Nixon, Saltonsall, Smith, Taft
- FDR/Truman admin: Barkley, Black, Byrns, Garner, Guffey, McCormack, Robinson, Sabath, Truman
- Coolidge/Hoover admin: Curtis, Hawley, Longworth, Moses, Tilson, Watson

Acronyms of the week

- **B2B** Business to Business
- **DoJ** Department of Justice
- **E&P** Exploration and Production
- **EU** European Union
- **FAANG** Facebook, Amazon, Apple, Netflix, Google
- **FTC** Federal Trade Commission
- **FTT** Financial Transactions Tax
- **FX** Foreign exchange
- **IP** Intellectual property
- **IPO** Initial public offering
- **IRA** Individual Retirement Account
- **NLRB** National Labor Relations Board
- **OECD** Organization for Economic Cooperation and Development
- **VAT** Value Added Tax
- **WTO** World Trade Organization
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