MARKET INSIGHTS

Investment Outlook 2021

Bridge over troubled waters

UK | December 2020

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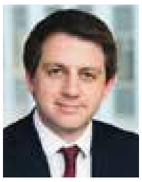

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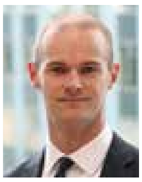

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IN BRIEF

- Government and central bank support appears to have carried economies through the worst of the Covid-19 crisis, and the vaccine provides hope that an end is in sight which should give policymakers the confidence to do more in the coming months.
- The extraordinary debt burden for companies and governments coming out of the pandemic is likely to result in an extended period of low interest rates and continued central bank asset purchases.
- In any rotation from winners to losers in markets, it will be important to discriminate between cyclical and secular headwinds and tailwinds.
- After a decade of US market dominance, it could be Asia's turn to shine. Not only has the region been more successful in containing the pandemic, but structural growth prospects are also in its favour.
- Momentum to tackle climate change looks set to increase in the year ahead. Governments are likely to use regulatory levers to put the onus on private capital.
- Extremely low government bond yields mean it's time to rethink the 60:40 approach to portfolio construction. Credit, real estate, infrastructure and macro funds could help provide income and diversification.
- Our central case for 2021 is a vaccine rollout in the first half of the year, followed by a robust recovery in the second half. However, there are risks to both sides of this scenario and investors should be particularly vigilant of the risk of a return of inflation.

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MONETARY AND FISCAL POLICY BRIDGED THE GAP IN ECONOMIC ACTIVITY

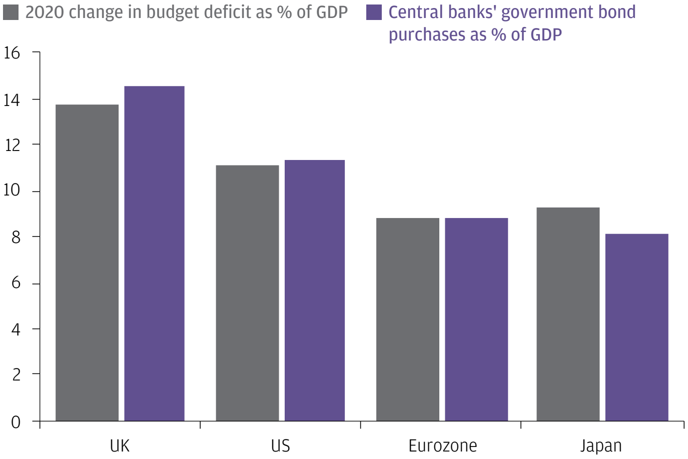
Policy makers have worked hard to build bridges over the tremendously troubled waters posed by the Covid-19 virus in 2020 (**EXHIBIT 1**).

Globally, governments issued trillions of dollars of debt to provide support to affected businesses and workers. Indeed, in the US, we estimate that roughly 75% of the workers that lost their jobs actually received more from enhanced unemployment insurance than they previously received from income in employment. This helped fuel the recovery when infections subsided in the summer.

Exhibit 1: Unprecedented monetary and fiscal coordination has supported activity

GOVERNMENT BUDGET DEFICITS AND CENTRAL BANK GOVERNMENT BOND PURCHASES

% of nominal GDP, 2020 estimate



Source: Bank of England, Bank of Japan, Bloomberg, European Central Bank, IMF, US Federal Reserve, J.P. Morgan Asset Management. Budget deficits as % of GDP are forecasts for 2020 from Bloomberg contributor composite. Central bank government bond purchases are J.P. Morgan Asset Management forecasts for 2020.
Data as of 17 November 2020.

However, much of the developed world is dealing with new waves of infections and new restrictions to contain the spread. It is certainly looking like a long and difficult winter.

As a result, European policymakers are busy extending their bridges. The US is likely to follow suit. Many of the effective fiscal initiatives in the US ran out in the summer and, with infection rates likely to curtail the recovery through the winter months, a new fiscal package is desperately needed. This may be delayed until after the 5 January run-offs, which will dictate who takes the Senate. But a new fiscal package is likely.

The bridges appear to be working

Support measures appear, on the whole, to be working (**EXHIBIT 2**). Despite an unprecedented plunge in activity, unemployment has risen relatively modestly in Europe and has fallen back sharply in the US. Corporate insolvencies have also been lower than might have been anticipated.

Exhibit 2: Relatively few corporate bankruptcies suggest policy support is working

UK AND US COMPANY BANKRUPTCIES

Number of companies per quarter

Source: Administrative Office of the United States Courts, Refinitiv Datastream, UK Insolvency Service, J.P. Morgan Asset Management. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates. Data as of 17 November 2020.

And with news of viable vaccines we can now see the land on the other side of the bridge. It may be some months away, depending on the speed at which the vaccines can be produced and distributed. But the fact that there's an end in sight should give policymakers the confidence to keep extending their bridges, and corporates sufficient hope to plough on through the difficult winter months.

Our expectation, therefore, is that activity in developed economies will remain depressed in the first quarter of the year, and potentially the second. However, from the second half we could see a meaningful bounce in activity, once the vaccines are rolled out, pent-up demand is unleashed and life starts to return to normal.

Bridges come at a future cost…for investors

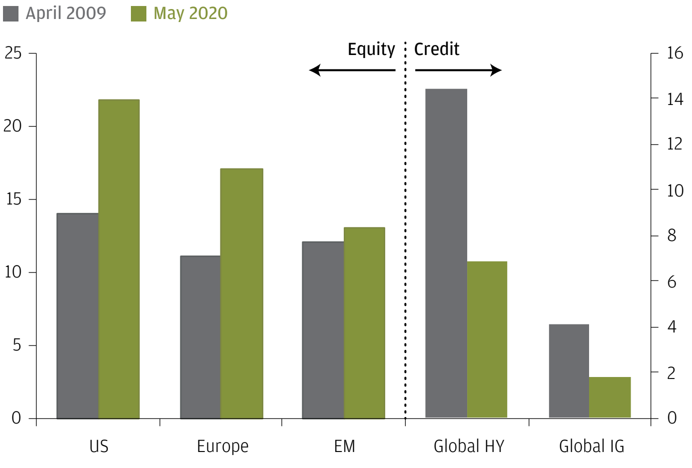
The extraordinary policy interventions have done a good job in supporting the economy. But they come at a price. The Institute for International Finance estimates that over the past year global government debt has increased by USD 8.4tn and non-financial corporate debt has increased by USD 6.0tn. Does this mean a return to government austerity and low business investment that will weigh on the recovery? Not necessarily. As we discuss in the chapter *The debt deluge*, we think the main consequence will be an extended period of low interest rates and continued asset purchases by the central banks. This will ease the burden of debt for issuers, but presents considerable challenges for the returns on high quality fixed income.

Investors will also have to work hard to make sure the equities in their portfolios are generating the returns they need. We start this new economic cycle with valuations that are higher than is normal coming out of a recession (**EXHIBIT 3**). The fall in real rates has supported valuations. With interest rates closer to their nominal floor, such a repeated boost looks unlikely in the years ahead. More than ever, the emphasis will have to be on identifying the regions, sectors and companies that have the strongest underappreciated earnings prospects.

Exhibit 3: Valuations are richer today than coming out of the last recession

EQUITY AND CREDIT VALUATIONS AT THE START OF THE CYCLE

x, multiple (LHS); % point option-adjusted spread (RHS)



Source: Bloomberg Barclays, ICE BofA, MSCI, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. April 2009 and May 2020 mark the start of the last two US cycles as defined by the trough in earnings per share estimates. US: S&P 500; Europe: MSCI Europe; EM: MSCI EM; Global HY: ICE BofA Global High Yield; Global IG: Bloomberg Barclays Global Aggregate – Corporates. Data as of 17 November 2020.

Investors will have to look across geographies and asset classes to enhance returns

Being ahead of potential sectoral and style shifts might help enhance returns. Assuming the news about vaccine efficacy and production capacity continues to be constructive, markets may look through near term economic weakness. Covid-19 generated considerable dispersion between the stock prices of those companies that facilitated the shift to life at home and those vulnerable to a need for social distancing. The valuation premium between global growth and value reached the highest level since the dotcom boom. As we discuss in our chapter *Winners and losers*, we should be cautious about the idea of an outright switch into value from growth. Instead, we would advocate picking apart the secular story from the cyclical one within both styles, and focusing on areas where current valuations are justified by the outlook for earnings growth.

Regional shifts in allocation are also worth considering. China has evaded the experience of recurrent waves seen elsewhere, seemingly thanks to the sophistication of its internal test and trace system and the robustness of external border controls. As a result, it has bounced back remarkably quickly to pre-crisis levels of activity. The government's recent five-year plan builds on this cyclical bounceback with a convincing structural programme that aims to transition the economy to consumer driven, internally generated growth. Add in the fact that the capital markets are maturing and we believe this could be *Asia's decade* for market performance, much like the way the US dominated the last cycle.

Investors should also be increasingly mindful of how their portfolios screen on environmental, social and governance factors. President-elect Joe Biden is expected to increase the momentum behind tackling climate change, as we discuss in our chapter *Global momentum towards tackling climate change*. Policymakers will be pulling on many different policy and regulatory levers to ensure that public and private capital provides a solution to climate change.

Identifying reasonably valued opportunities for strong earnings growth is imperative – but not an unusual challenge for investors. What is more novel is the challenge we now face in constructing a balanced, resilient portfolio. Core government bonds hold little appeal at such deeply negative real interest rates, but abandoning them altogether could leave investors with a much more volatile portfolio. In *Rethinking 60:40* we consider some ideas for portfolio construction.

And finally, after such an unprecedented year, we should not underestimate the risks. In our final chapter, we provide an overview of our *Central projections and risks*, in terms of both macro scenarios and portfolio ideas. The key upside risk is that the recovery takes hold more quickly and is more synchronised across regions than we have in our base case. The downside risk that has us most concerned is if it is inflation rather than growth that returns with gusto. Central banks would be forced to outline an exit strategy from their current stance much more quickly than the market expects. This would trouble the economic outlook but the challenges for the markets may be more acute, as we saw in the taper tantrum of 2013.

THE DEBT DELUGE MEANS LOWER INTEREST RATES FOR EVEN LONGER

Companies and governments have been forced to borrow trillions of dollars to cover revenue shortfalls during the period in which Covid-19 has restrained activity. Borrowing on such a large scale might have been expected to put upward pressure on global interest rates. This was prevented by the extraordinary interventions of the central banks. In the developed world, the central banks absorbed the entire new issuance of governments this year (**EXHIBIT 1**).

Interventions were not limited to government bonds. The willingness of the Federal Reserve to buy even high yield credit gave investors the reassurance needed to search for yield in credit markets. This underpinned prices across the fixed income space.

Central banks are unlikely to withdraw this support any time soon. Structural inflation challenges in Europe and Japan suggest negative interest rates and ongoing asset purchases are likely to continue through 2021 at least.

In the US, the Federal Reserve's (Fed's) new average inflation target paves the way for it to maintain easy monetary policy for some time. Aiming for a period of above-target inflation essentially delays the point in the expansion at which the Fed might begin removing support, and this will create a ceiling for 10-year Treasury yields. In time, we expect other central banks to adopt a similar framework.

The long and short of it is that interest rates are likely to stay at these levels for a considerable period of time. Indeed, we suspect we will see a more muted version of the experience of the post-war period, in which the combination of yield curve control and financial repression held interest rates down despite the acceleration in nominal activity. This enabled governments to grow out of their debts relatively easily (**EXHIBIT 4**).

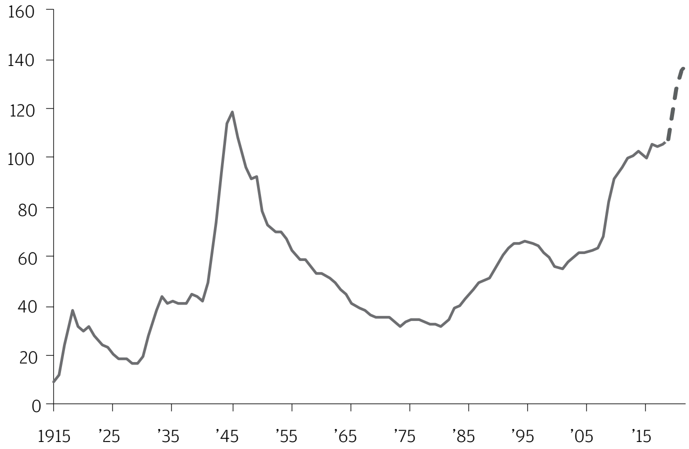
As long as inflation stays benign this should be relatively straightforward for policymakers to deliver. But problems will arise if inflation returns with more gusto than it did in the last expansion. We don't dismiss this risk. In the last expansion, the central banks faced a considerable headwind given both banks and governments came out of the recession focused on a multi-year period of deleveraging. The central banks had their foot on the accelerator, while the commercial banks and governments had their feet on the brake. We suspect governments will be much more relaxed about deficit reduction this time around.

Despite this we remain fairly confident that inflation in the euro-zone and Japan will remain stuck at low levels. Their structural disinflationary problems appear to have become more entrenched in 2020.

Exhibit 4: Low interest rates will help governments grow into their debts

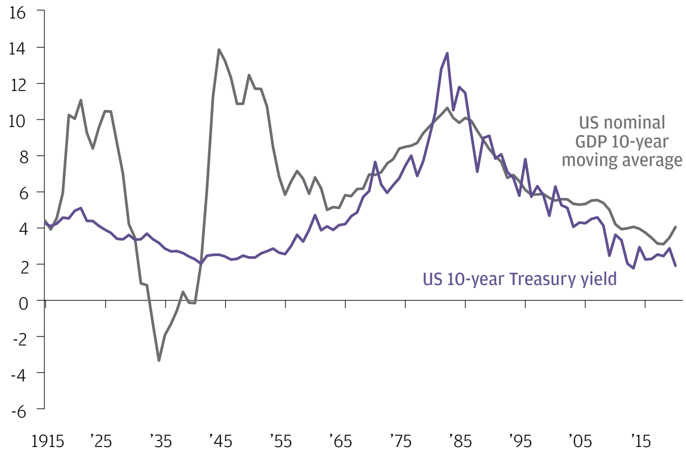
US FEDERAL DEBT OUTSTANDING

% of nominal GDP, by fiscal year



US NOMINAL GDP GROWTH AND 10-YEAR TREASURY YIELD

%, nominal GDP growth is % change year on year



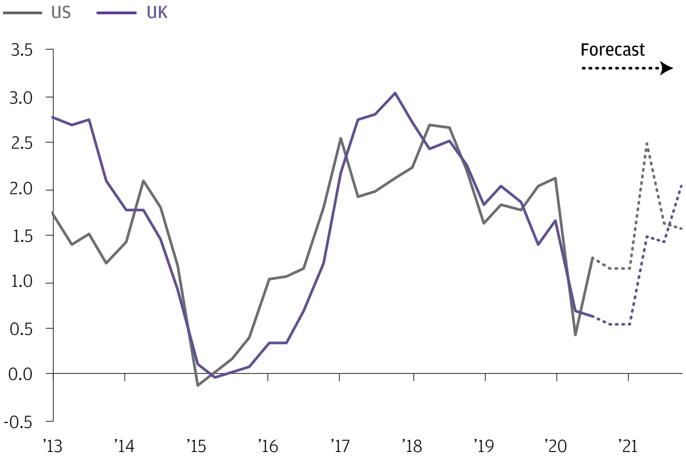
Source: (Top) Haver Analytics, US Office of Management and Budget, J.P. Morgan Asset Management. JPMAM forecast from 2020 onwards. (Bottom) BEA, Haver Analytics, Robert Shiller, J.P. Morgan Asset Management. Data as of 17 November 2020.

The US and UK may deserve greater scrutiny particularly when the base effects become less favourable in the spring (**EXHIBIT 5**).

Exhibit 5: Inflation may become a greater topic of conversation when the base effects turn

UK AND US HEADLINE INFLATION WITH FORECASTS

% change year on year



Source: BLS, ONS, J.P. Morgan Securities Research, J.P. Morgan Asset Management. Forecasts are from J.P. Morgan Securities Research and are from Q4 2020 onwards. Data as of 17 November 2020.

This leaves us with an aversion to government bonds. But we are not of the view that they should be abandoned entirely. If interest rates do not normalise over the coming years then at the next economic shock, whatever causes it, central banks such as the Bank of England and Federal Reserve may have little choice but to use negative interest rates. A moderate allocation to long duration government bonds still seems sensible as downside insurance given the returns that could be achieved in such a shift to negative interest rates. Of course these bonds stand to suffer if the economic performance is more robust, but in this scenario we would expect other assets in the portfolio, such as stocks, to compensate.

However, the role that Treasuries, Gilts and other developed market government bonds played in a portfolio may increasingly be played by investment grade and high-quality emerging market sovereigns. We return to this issue in our chapter *Rethinking a 60:40 portfolio*.

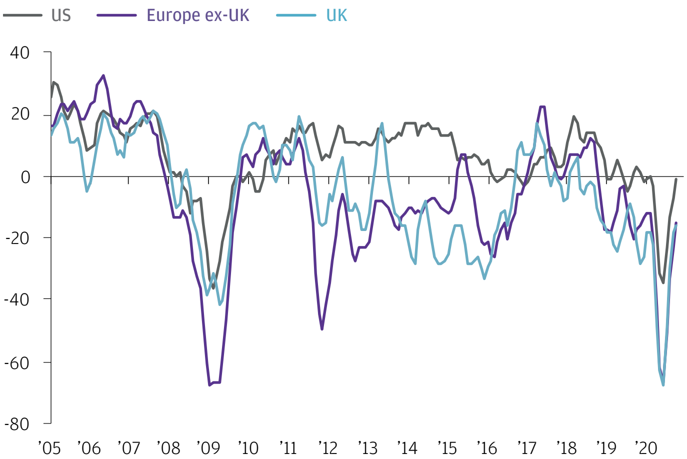
Income-hungry investors will also be more dependent on the stocks in their portfolio to provide them with dividend income. Of course, in 2020, dividends were cut alongside interest rates, although the experience has varied across regions. UK and continental European markets have been in the eye of the storm, while lower payout ratios and higher usage of buybacks (which are generally halted before companies alter dividend policy) have made for a much more resilient income stream from US stocks.

Again, there is light at the end of the tunnel (**EXHIBIT 6**). In Europe, analyst revisions for future dividends have seen an especially strong bounceback after having bottomed in the summer. Meanwhile, industry flow data shows investor appetite for dividend-focused strategies globally improving steadily since August. Valuations are also attractive, with high dividend stocks in developed markets trading at around two standard deviations below their long-term average valuation relative to growth stocks. From a sector perspective, financials and energy have historically been two key sources of payouts. Following the ban on bank dividends across the UK and eurozone in 2020, generally robust capital positions should allow bank payouts to restart at some point next year when regulators allow, while a recovery in oil prices would also improve the outlook for energy. Yet we would caution against relying on history to identify the strongest dividend payers. Resilient dividends in areas such as utilities look well placed to maintain steady growth, while some more cyclical areas including housebuilders are seeing a strong recovery – all of which points to a broader mix of dividend contributions going forward.

Exhibit 6: The outlook for dividends is improving

DIVIDEND REVISION RATIOS

% net upgrades as proportion of total dividend estimate revisions, three-month rolling average



Source: IBES, MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Data as of 17 November 2020.

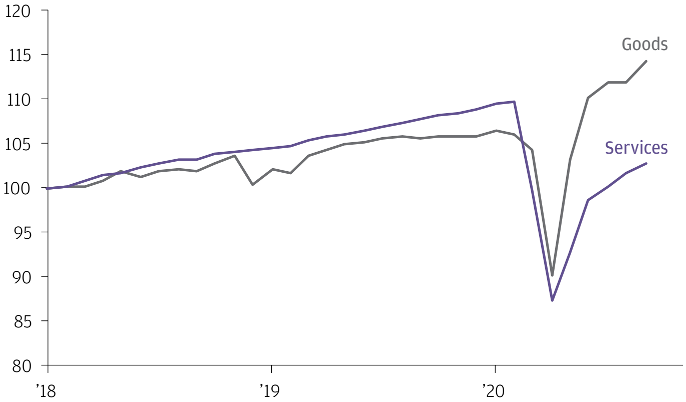
THE COVID WINNERS/LOSERS NARRATIVE COULD CHANGE

The highly unusual nature of the Covid-19 recession has created stark differences between winners and losers. From a macro perspective, service sectors have suffered disproportionately from social distancing restrictions. But this misfortune has benefited some manufacturers as households have diverted spending from experiences to goods (**EXHIBIT 7**). This has also affected regional performance as countries with a high weight to services, and tourism in particular, have generally lagged their more manufacturing-heavy counterparts.

Exhibit 7: People have spent where they could

US GOODS AND SERVICES CONSUMER SPENDING

Nominal index level, rebased to 100 in January 2018



Source: BEA, Refinitiv Datastream, J.P. Morgan Asset Management.
Data latest available as of 17 November 2020.

Market performance was similarly bifurcated for much of 2020, as companies with a technology/online tilt benefited not only from their ability to grow earnings when most other sectors saw huge pressure on profits, but also from the decline in the discount rate used to calculate the present value of those future earnings streams (**EXHIBIT 8**). In the summer, the gap in valuations between growth and value stocks reached levels not seen since the technology bubble.

Progress towards a vaccine has already changed this narrative as we move into 2021. On the day that the news broke of an effective vaccine, global value stocks experienced their best day relative to growth stocks since records began. The key question for next year is how confident we can be that this shift from the winners to the losers will be sustained.

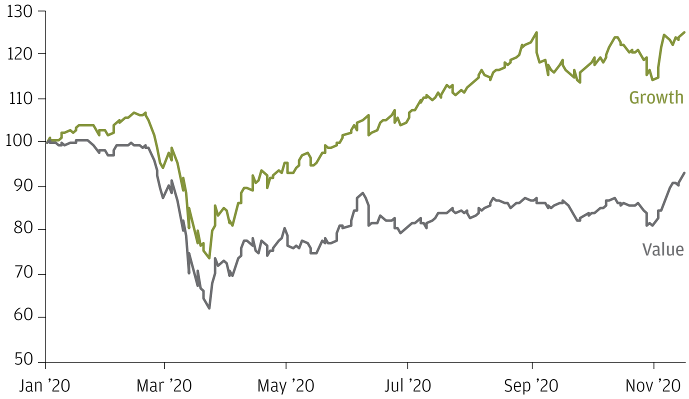
Valuations alone might suggest there is more room for this rotation to run. Despite the very strong bounce in 2020's laggards, such as financials and energy, since the vaccine announcement, both sectors still lag broad indexes substantially year to date. Cheaper valuations are also seen in regions such as the UK and Europe that are more tilted towards value sectors, while US indices look relatively more expensive given the 'big tech' tilt.

There may come a point at which we are looking at a more meaningful outperformance of value vs. growth. But a precursor to that, in our view, would be higher interest rates and a steeper government bond yield curve, which would be a headwind to growth stocks and would help financials within the value style. This scenario would require a greater acceleration in nominal GDP and a more rapid tapering of central bank asset purchases than we have in our core scenario.

Exhibit 8: Growth stocks benefitted from the shifts in spending in 2020

MSCI WORLD GROWTH AND VALUE PRICE RETURNS

Index level, rebased to 100 in January 2020



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management.
Data as of 16 November 2020.

With interest rates capped by the burden of debt, we see this outcome as an upside risk rather than our central projection.

For now, we believe the key to successful allocation across equity market sectors – and therefore across regions – will be to differentiate between secular and cyclical tailwinds and headwinds. For growth sectors, the Covid-19 recession has been the catalyst for many years of technological advancement and adoption to be condensed into a few quarters. We are confident that companies will allocate a greater portion of their resources towards technology going forward, and see many beneficiaries from this secular shift, including areas profiting from advancements in semiconductor technology and the adoption of cloud computing. In other cases, though, growth stock valuations appear to assume that behaviours will permanently reflect a Covid-constrained environment. Investors must ensure that the price they are paying for any company reflects an earnings outlook and market share that can be achieved in a post-Covid world, not just the highly unusual environment of this past year.

The same debate of cyclical vs. secular can be used when assessing the opportunities in value. In very simple terms, we expect companies and countries that have suffered most during the pandemic to be the biggest beneficiaries of a vaccine. Yet medical developments cannot remove all of the headwinds for every company. Take the energy sector, for example. An improvement in the economic outlook should clearly help to put upward pressure on oil prices as demand normalises, and energy stocks should benefit accordingly. But secular headwinds remain as the world transitions away from dependence on fossil fuel towards renewables (see *Global momentum towards tackling climate change*). Careful stock selection will still be required.

In sum, progress towards a vaccine requires a much more balanced approach across styles, sectors and regions for next year. We expect the significant pressures on the Covid-19 laggards to ease, which in turn should catalyse a rotation across markets. But just as we avoided advocating an 'all-in' approach to growth in 2020, we do not see the year ahead as the time to allocate indiscriminately towards only the cheapest stocks. A vaccine will be a major step forward, but it will not cure all ailments.

ASIA'S DECADE

For investors, the last decade was dominated by US market performance. The period brought 10 years of standout returns from US assets and an appreciating US dollar. In our view, the next decade may be the Asian markets' time to shine.

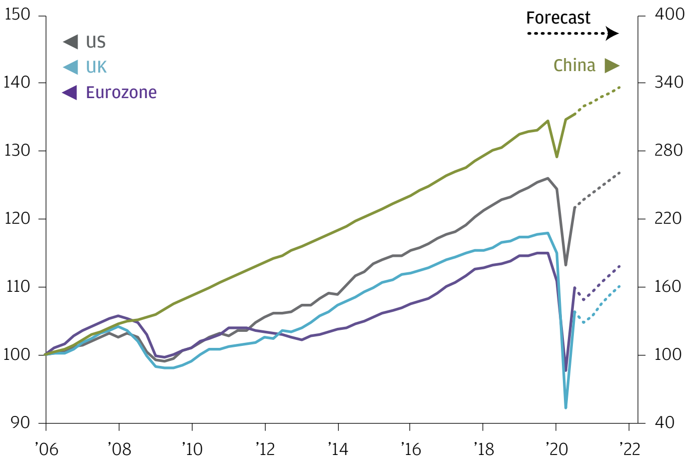
Crises often lead to secular shifts in market performance. The end of the dotcom boom in 2000 marked the end of US growth outperformance, and was followed by a period of strong performance for value, emerging markets and European equities. After the global financial crisis, the pendulum swung back in favour of the US.

Our expectation that we may see a similar shift this time is based on our macro outlook and structural changes that are taking place as Asia's capital markets mature. The north Asian economies (China, Korea, Taiwan), which represent the bulk of the investable universe in Asia, have been more successful in containing the pandemic than the rest of the world. New daily Covid-19 cases per million people, even at peak infection rates were just a fraction of those in other regions. Due to the limited outbreaks and the ability to keep track of infections, these economies appear to have put Covid-19 behind them. While Europe and the US still face significant restrictions to contain the spread of the virus, China is already back to pre-crisis levels of activity (**EXHIBIT 9**).

Exhibit 9: China's bounceback has been extraordinary

REAL GDP LEVELS

Index level, rebased to 100 at 1Q 2006



Source: BEA, Bloomberg, Eurostat, National Bureau of Statistics of China, ONS, J.P. Morgan Asset Management. Forecasts are from Bloomberg contributor composite. Data as of 17 November 2020.

Despite the fast-growing consumer base, the Asian economies and markets are still highly dependent on the dynamics in global manufacturing and trade. But what has been a disadvantage for the region in the recent years of trade conflict has been a relative strength recently as the global consumer diverted its spending from services to goods.

The yield opportunity

Due to the success in controlling the outbreak, the fiscal and monetary response to the Covid-19 crisis was significantly smaller in Asia than in Europe and the US. As a consequence, central bank balance sheets are less bloated and bond yields fell less than US Treasuries.

Structural changes in the region's bond market are further increasing its appeal for global bond investors. In the past, restricted access and limited currency convertibility prevented Asian bond markets from playing a major role for global investors. But with the rising financing needs of the region, this is changing rapidly. Following the opening of the USD 15 trillion local renminbi bond market to overseas buyers, yield-starved international bond investors now have the opportunity to invest in Chinese government bonds with yields north of 3%. As well as offering higher yields, local renminbi bonds have a relatively low correlation to developed market bonds and zero return beta to global equities, potentially boosting portfolio diversification and enhancing risk-adjusted returns.

In the past 12 years, monthly return correlations between renminbi bonds and global developed market bonds have been 0.1. With China's early success in containing the Covid-19 pandemic knocking its economic cycle out of sync with the rest of the world, we would expect correlations to remain low for the time being. The fact that the renminbi remains to some degree managed by the authorities, reducing currency volatility, also increases the appeal.

The growth opportunity

North Asian equity markets outperformed many of the developed world indices in 2020, in large part thanks to their economic outperformance and relatively high weighting of tech and online companies. We expect this outperformance to continue for two reasons. In the near term, the outperformance reflects the fact that developed world activity will remain constrained until the vaccines are widely distributed and life can return to normal.

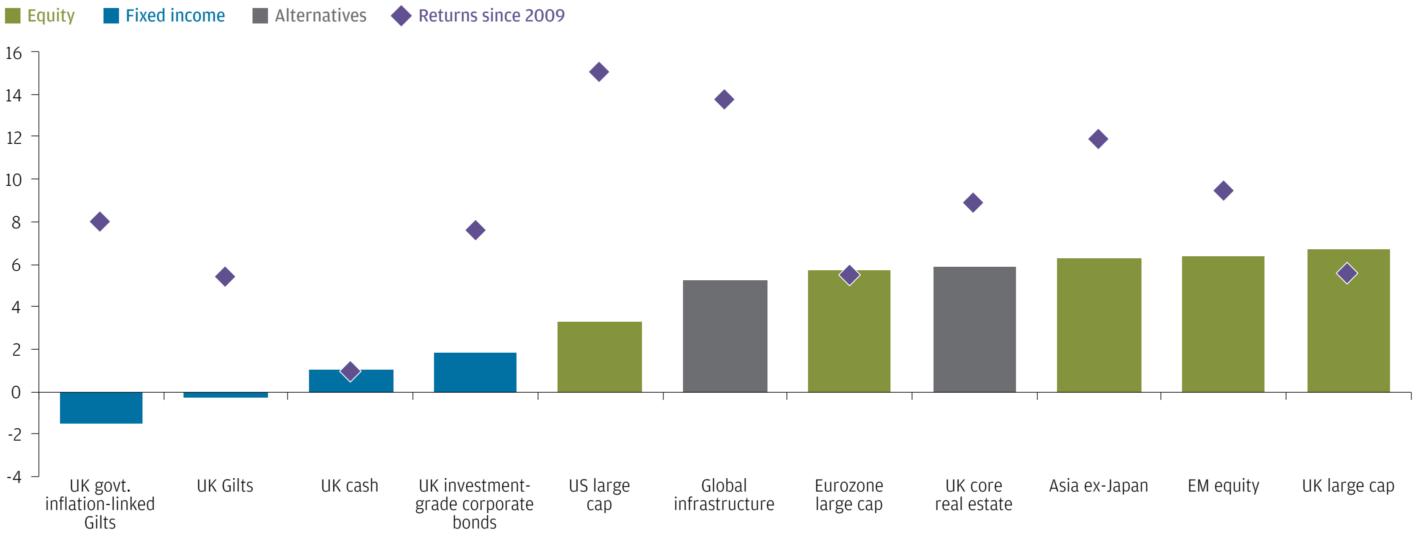
In the longer term, structural growth prospects in Asia are underpinned by urbanisation and the growth of the middle class. These trends are set to continue in the next decade in three of the most populous countries in the world – China, India, and Indonesia – creating large domestic and consumer-led markets. The new free trade agreement (Regional Comprehensive Economic Partnership) covers 10 ASEAN countries and China, Japan, Korea, Australia and New Zealand. These 15 nations represent almost a third of global GDP. This should further support the long-term growth outlook. The agreement is expected to eliminate 90% of tariffs between the trading partners if all components of the product are manufactured inside the free trade area. This rule of origin provision could deepen the supply chains inside the region since it incentivises the signatories to build the full supply chain inside the new free trade zone.

As a result, Asian companies will be provided with plenty of opportunities to grow in the coming years. China's push to move further up the value chain, presented in the latest five-year plan, should facilitate its transition to a high-income economy and help it to weather the negative impact of deteriorating demographics. Asian equities had a strong run in 2020; nevertheless, our 2021 Long-Term Capital Market Assumptions suggest Asian equities still have the potential to outperform developed markets by 2.2% a year over the next 10 to 15 years (**EXHIBIT 10**). Mounting signs that the 10-year-old US dollar bull market is fading further reinforce our view that the next 10 years might go down as the Asian decade.

Exhibit 10: Asian stocks look favourable on our long-term projections

2021 LONG-TERM CAPITAL MARKET ASSUMPTIONS EXPECTED RETURNS IN COMING 10-15 YEARS

%, annualised returns in GBP



Source: *2021 Long-Term Capital Market Assumptions*, J.P. Morgan Multi-Asset Solutions, J.P. Morgan Asset Management. Returns are nominal and in GBP. Past returns are calculated from the start of 2009 up to the end of October 2020, or the most recent available data. The projections in the chart above are based on J.P. Morgan Asset Management's proprietary long-term capital market assumptions (10-15 years) for returns of major asset classes. The resulting projections include only the benchmark return associated with the portfolio and do not include alpha from the underlying product strategies within each asset class. The assumptions are presented for illustrative purposes only. Data as of 31 October 2020.

GLOBAL MOMENTUM TOWARDS TACKLING CLIMATE CHANGE

For much of the last few years, tackling climate change appeared to be just a European priority. European policymakers have certainly led the charge: even before the US's withdrawal from the Paris Agreement, the EU had set more ambitious reduction targets and had made more progress towards meeting them. Moreover, their efforts have intensified in 2020 with the Commission's commitment to step up its green investments as part of its Green Deal and spend 30% of the EU's flagship recovery fund on green initiatives.

As we look to 2021, we see an increase in global momentum on tackling climate change which could be formalised during the 26th United Nations Climate Change Conference, also known as COP26, which will take place in Glasgow on November 2021. This could have far reaching implications for the way we live, produce and consume, which will affect the investment landscape.

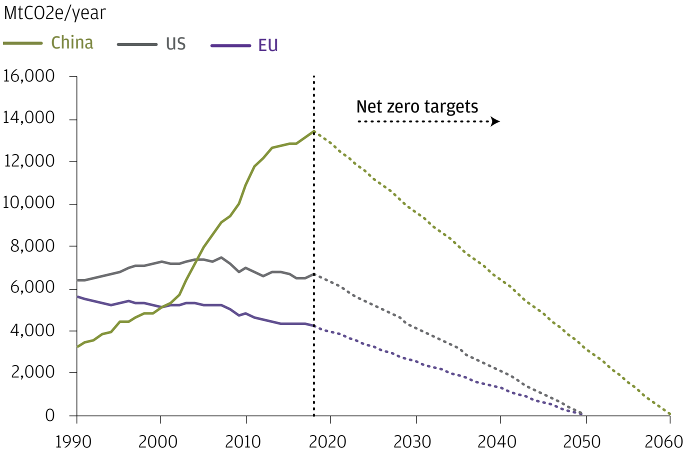
The election of Joe Biden in the US is an important contributor to our expectations of increased momentum. The president-elect has stated that rejoining the Paris Agreement will be a day one priority. In addition to adopting and leading a multilateral approach on climate change abroad, Biden has ambitions to address climate change at home with the signature of a series of executive orders to ensure that 'the US achieves a 100% clean energy economy and reaches net-zero emissions no later than 2050'. However as Joe Biden will more than probably have to govern the country with a divided congress he will need to focus on fiscal 'carrots' to achieve its climate objectives goal instead of 'sticks' (such as use of relevant taxes) in order to win Republicans' support.

China has also stepped up its intent this year as it prioritised sustainable growth as part of its new five-year plan, and has set out a target to become carbon-neutral by 2060. While this may seem less ambitious than the EU's and Biden's 2050 target it would imply a significant step change relative to the trajectory China has been on so far. More focus will be placed on the quality over quantity of economic growth – with increasing measures to address carbon emissions and environmental protections.

EXHIBIT 11 shows how far the EU, US and China currently are from these emissions objectives they have set themselves. Efforts will have to intensify meaningfully in the coming years. For governments, this provides an opportunity to kill two birds with one stone – to both green and revive their economies. High levels of public debt may restrain spending ambitions, but that is likely to mean policymakers use regulatory levers to ensure private capital is a core part of the solution. Again, this is something investors need to understand.

Exhibit 11: All regions will have to intensify efforts to meet their climate objectives

EMISSIONS TARGETS

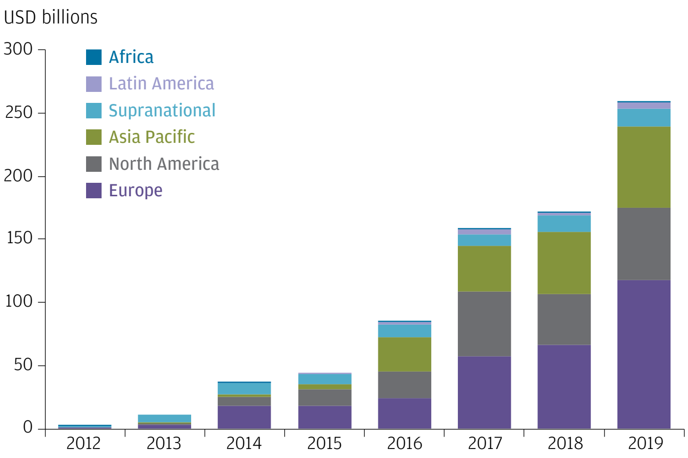


Source: ClimateActionTracker, J.P. Morgan Asset Management. MtCO2e is metric tons of carbon dioxide equivalent. Data as of 31 October 2020.

The expected flood of green infrastructure projects in the next few years, to the tune of several trillion dollars, presents significant opportunities for investors in equity, fixed income and real assets. The relatively young green bond market and its rapidly growing issuance globally provide a useful indicator of how this opportunity may evolve (**EXHIBIT 12**). Demand for green bonds is likely to remain supported by regulatory levers. Central banks, such as the ECB, which increasingly see climate change as part of their mandate, are also discussing the role of green bonds in their broad monetary policy operations, which may give a relative price advantage to green bonds over other bonds with similar ratings and maturities.

Exhibit 12: Green bond issuance is expected to continue growing strongly

GREEN BOND ISSUANCE BY REGION



Source: Climate Bonds Initiative, J.P. Morgan Asset Management.
Data as of 17 November 2020.

RETHINKING THE 60:40 PORTFOLIO

Government bonds used to provide both an income and the prospect of strong positive returns during a recession. Balancing equity exposure with significant government bond exposure therefore became a core tenet of portfolio construction. But today, with such low starting yields, government bonds offer little income or upside potential, forcing investors to rethink their approach to both diversification and income generation.

In the next decade, a traditional UK market 60:40 stock-bond allocation is expected to earn only around 4% a year (2021 LTCMA estimate). But many investors require higher yields and higher returns than that from their portfolios.

Seeking higher income

EXHIBIT 13 shows a range of fixed income asset classes offering income and their correlation with global equities. While higher yields are available to investors prepared to look beyond developed market government bonds, the challenge is building a fixed income portfolio with sufficient yield without uncomfortably increasing the correlation with equities.

Investors may be comfortable shifting a higher proportion of their fixed income allocation towards credit, on the assumption that any downside will be capped by central bank intervention. However, we caution against abandoning a focus on fundamentals. Given the ongoing near-term uncertainties, investors making their first steps out of government bonds into the credit markets may benefit from focusing on the highest-quality segments. We are also mindful that the dependence on central bank support gives rise to risks of taper tantrum-style events of the type seen in 2013.

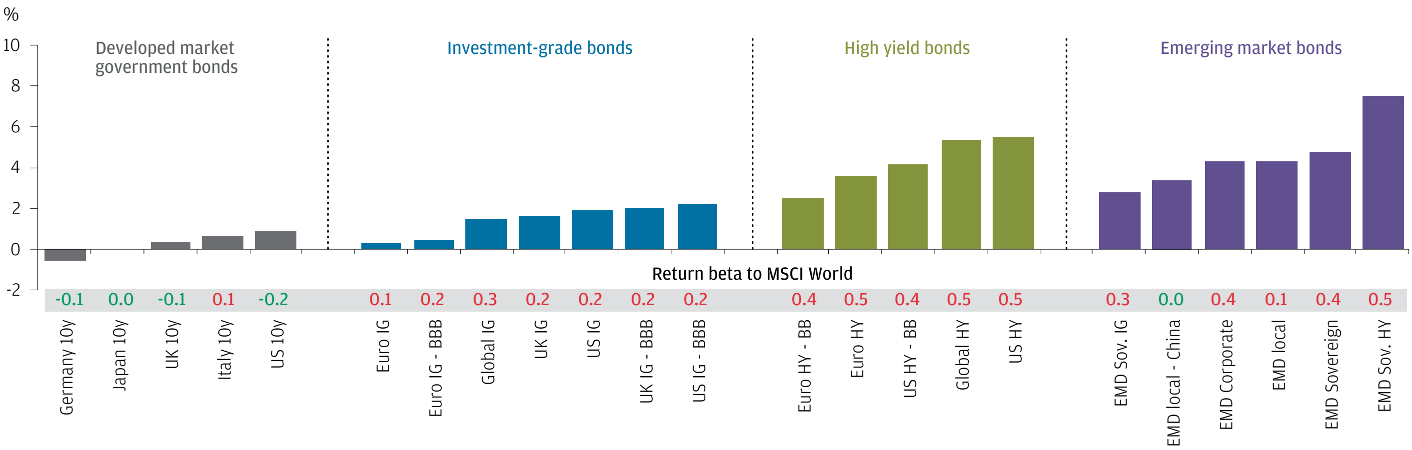
Chinese government bonds offer one potential solution, with a 2-3% yield depending on duration, next to no correlation with global equities and the potential for long-term currency appreciation. Flexible fixed income strategies with an absolute return objective could also help.

Outside of fixed income, real assets such as real estate and particularly infrastructure can offer more attractive yields in return for low liquidity. While real estate has clearly come under pressure because of Covid, we don't believe people will be working from home forever, given that one of the key benefits of offices – having everyone in the same place at the same time – cannot easily be replaced. Given office floor space requirement is driven by peak demand, say on a Monday, post-pandemic demand may prove more robust than some fear. Nor will all shopping be done online; however, just as the rise in online shopping creates a challenge for some retail properties, it also creates an opportunity in warehouses.

Core infrastructure has demonstrated remarkably consistent and defensive income streams both during this recession and during the last financial crisis. Given yields close to 7% and the ability to access reliable contracted or regulated cash flows with the potential for capital upside and inflation protection, infrastructure could play an increasingly important part in investor portfolios for those who can access it and are comfortable with the lack of underlying liquidity.

Exhibit 13: Investors will need to look across the piste to get the best balance of yield and risk

FIXED INCOME YIELDS



Source: Bloomberg, Bloomberg Barclays, ICE BofA, J.P. Morgan Economic Research, Refinitiv Datastream, J.P. Morgan Asset Management. Beta to MSCI World is calculated using monthly total returns since 2008. Indices used are as follows: Euro IG: Bloomberg Barclays Euro-Aggregate – Corporate; Global IG: Bloomberg Barclays Global Aggregate – Corporate; UK IG: Bloomberg Barclays Sterling Aggregate – Corporate; US IG: Bloomberg Barclays US Aggregate – Corporate; Euro HY: ICE BofA Euro Developed Markets Non-Financial High Yield Constrained Index; Global HY: ICE BofA Global High Yield Index; US HY: ICE BofA US High Yield Constrained Index; EMD Corporate: CEMBI Broad Diversified; EMD local: GBI-EM Global Diversified: EMD local – China: GBI-EM China: EMD Sovereign: EMBI Global Diversified; EMD Sov. IG: EMBI Global Diversified IG; EMD Sov. HY: EMBI Global Diversified HY. Yield is not guaranteed and may change over time. Data as of 17 November 2020.

Seeking diversification

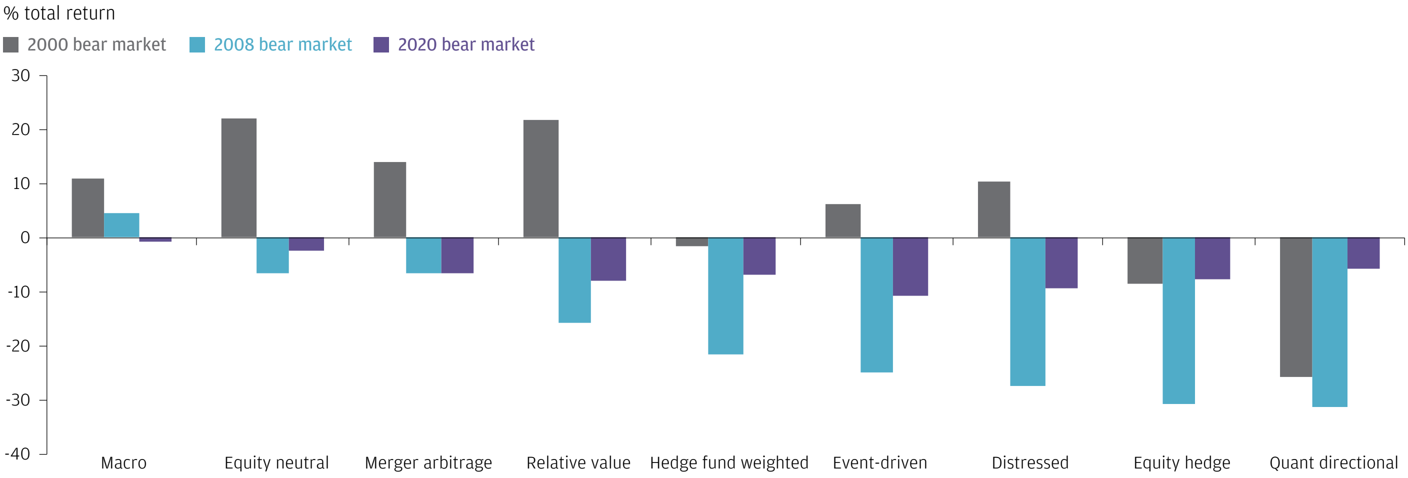
While adding higher yielding credit, real estate and infrastructure to a portfolio can help replace some of the income that government bonds used to offer, while still providing some diversification from equities, investors may need to look elsewhere for the kind of downside protection traditionally offered by government bonds.

Of the hedge fund strategies available, macro funds have historically done the best job of consistently protecting portfolios during equity bear markets. While return expectations for macro funds as a whole are relatively low, good manager selection may help to boost returns during bull markets while still providing downside protection during bear markets (**EXHIBIT 14**).

In summary, while government bonds can still provide some diversification, they offer much less income and upside potential than they used to and are vulnerable to a potential pickup in inflation and/or growth. By adding real estate, infrastructure and macro strategies to portfolios, investors may be able to increase both their risk-adjusted income and returns relative to a traditional stock and bond portfolio (**EXHIBIT 15**).

Exhibit 14: Macro funds have tended to provide downside protection

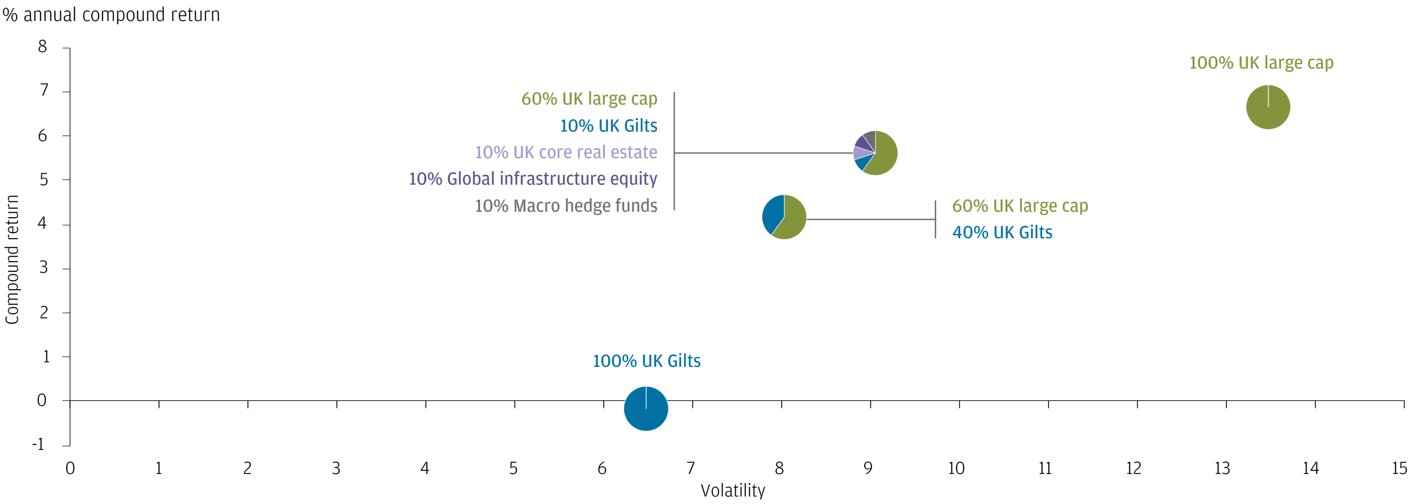
HEDGE FUND STYLE RETURNS DURING BEAR MARKETS



Source: Hedge Fund Research Indices (HFRI), Refinitiv Datastream, J.P. Morgan Asset Management. 2000 bear market is from 31 March 2000 to 31 October 2002, 2008 bear market is from 31 October 2007 to 28 February 2009, 2020 bear market is from 31 January 2020 to 30 April 2020. Hedge fund strategies are defined in the HFRI hedge fund strategy classification system. Data as of 17 November 2020.

Exhibit 15: Adding alternatives may help improve the risk/ return profile of a portfolio

EXPECTED RETURNS AND VOLATILITY FOR A GBP INVESTOR IN COMING 10-15 YEARS



Source: Long-Term Capital Market Assumptions, J.P. Morgan Asset Management Multi-Asset Solutions. Expected returns and volatility assumptions refer to the next 10-15 years. Past performance and forecasts are not a reliable indicator of current and future results. Data as of 31 October 2020.

CENTRAL PROJECTIONS AND RISKS

Our core scenario is for a relatively robust recovery in the second half of 2021. But given the unprecedented nature of both the shock and the policy reaction we should not underestimate the risks. In our view, the main upside risk is that the vaccine is rolled out more quickly and the recovery is stronger and more synchronised globally. Our downside risk is centred on an unexpected rise in inflation which forces a more rapid withdrawal of monetary stimulus than the market currently expects.

	DOWNSIDE	CENTRAL	UPSIDE
MACRO SCENARIO	**INFLATION/ TAPER TANTRUM** • Inflation rebounds more quickly than expected. • Central banks stop easing, turn more hawkish. • Yield curves steepen causing debt burden to rise. • Governments taper fiscal support. • Companies focus on deleveraging.	**H2 ROBUST RECOVERY** • Activity remains weak during winter months. Vaccine rolled out in H1 allowing full reopening of economy in Q3. Growth accelerates and broadens. • Central banks signal intent to keep interest rates low well into the cycle and continue asset purchases through H1 at least. (US 10yr Treasury yield to trade <1.5%). • Brexit deal and EU recovery fund ratified. • Governments do not revert to austerity but do not act as major source of new stimulus. • North Asian growth outperforms US/ eurozone.	**STRONG, SYNCHRONISED GLOBAL GROWTH** • Medical solution is quick and easy to distribute and facilitates quick reopening in H1. • Pent-up demand from consumers stronger than expected. • Fiscal authorities announce large-scale investment packages to spur growth and reduce inequality. • Inflationary pressures build but not enough to deter central banks from low-rate commitments. • Multilateral coordination to promote trade and investment to tackle climate change.
MARKET SCENARIO	• Equities fall and underperform government bonds. • Fixed income challenged as carry trades unwind. HY losses most significant but IG also affected by change in perception of central bank backstop. Index-linked bonds outperform. • EM underperforms across equities, fixed income and currencies. • Core infrastructure and real estate outperform. • Dollar strengthens.	• Overweight to equities. • Real returns in government bonds challenged. Fixed income opportunities limited to IG and selective high-quality HY and EMD. • Rotation of cyclical Covid winners/ losers (e.g. ecommerce to in-store retail). • Secular themes remain supportive for segments of growth and challenging for segments of value, preventing a full style rotation. • Asian equities and fixed income outperform. • Long-term opportunity for reasonably valued companies providing solutions to climate change. • Focus on companies that screen well on ESG characteristics. • Focus on alternative diversifiers and income-producing assets (macro funds, real assets). • Dollar weakens gradually on broad basis.	• Sizeable overweight to equities. • Real returns in core fixed income strongly challenged. Yield curve steepens. HY and EMD preferred. • Strong value and cyclical recovery, particularly financials. Small cap outperforms. • Europe/UK/ broader EM outperformance. • Dollar weakens materially on broad basis.

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