**MARKET INSIGHTS**

The Investment Outlook for 2021: A Midyear Review

The Evolving Expansion

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**IN BRIEF**

- The U.S. economic expansion has accelerated in 2Q and should continue at a strong pace for the rest of the year, generating a near full recovery in employment and higher inflation.

- International growth was uneven early in the year but should broadly accelerate as vaccines are distributed. A cycle ahead with stronger international economic growth should push the U.S. dollar lower.

- Strong growth and rising inflation should prompt the Fed to taper bond purchases in late 2021/early 2022 and begin to raise short-term rates in late 2022/early 2023, pushing long-term interest rates higher.

- In 1H21, value has beaten growth and small caps have beaten large caps; we expect this will continue in 2H21.

- Using earnings as a guide will increase in importance against a backdrop of rising rates, as higher yields will pressure equity valuations.

- International equities should benefit from a falling dollar and lower valuations relative to the U.S., with different regions offering a mix of cyclicality, inflation hedge and structural growth themes.

- Sustainable investing, measured by ESG factors, is likely to be a decade-defining theme and can enhance portfolios by mitigating risk and harnessing the opportunities that come from growth and change, particularly environmental and social shifts.

- More investors are turning to alternatives — both public and private — as a solution in a world of low rates and meager expected returns.

- Commercial real estate is healing, there is plenty of momentum in private equity markets and the outlook for hedge funds will depend on the path of volatility.

- As the global economy continues to recover, it will be important to identify cyclical positioning to find the best opportunities for growth and value.

- In a post-pandemic environment, investors will need to think outside the box, including allocations to international equities and alternatives.
INTRODUCTION

The American economy can best be understood as a living organism — not just one that expands and contracts but one that is in a constant state of evolution, usually growing but also being distorted by, and adapting to, a variety of shocks and changes in policy.

This is a particularly important reality to grasp today. At a superficial level, the economy is simply in the midst of a powerful recovery from a deep recession. However, a closer look at the data shows many sectors that remain far from a full recovery as well as many that have positively thrived in the pandemic environment. Moreover, both the economy itself and government policy will forever be changed by the pandemic. While a full recovery remains likely, the full-employment economy of 2022 will be very different from the full-employment economy of 2019 — and the differences may have important implications for investors.

TOP-LINE PROGRESS ON THE ROAD TO RECOVERY

The broad story on the U.S. economy remains one of very strong recovery. Real GDP numbers for the first quarter showed strong 6.4% annualized growth. However, April data for consumer spending, inventories and durable goods orders reinforced our view that this growth is accelerating and that second quarter growth could be over 10%. Even with a moderation in the growth rate in the second half of the year, real output by the fourth quarter of this year could be up by roughly 7.5% year-over-year and by 5% relative to the fourth quarter of 2019, essentially marking a full recovery from the pandemic recession, even accounting for normal trend-like GDP growth.

The labor market tells a similar story with the economy producing a net gain of 559,000 jobs in May, with the unemployment rate falling from 6.1% to 5.8%. While this was a marked improvement from April’s disappointing report, it still understates the potential for major job gains in the months ahead. Survey data confirm that many businesses are hungry to hire workers and that workers recognize the strength of labor demand. However, employment growth continues to be restrained by lingering pandemic worries and by generous federal unemployment benefits.

Thankfully, as more Americans have gotten vaccinated, the pandemic has receded and should be a much less significant drag on the labor market in the months ahead. In addition, 25 states, accounting for more than 40% of U.S. workers, are ending supplemental unemployment benefits by early July, while these benefits will expire for everyone else by September 6. In combination, these trends should eliminate most of the current distortions in the labor market, potentially allowing the unemployment rate to fall below 5% by the fourth quarter of this year.
THE EVOLVING EXPANSION

However, while a super-fast economic recovery remains on track, a detailed look at April consumer spending reveals the distortions wrought by the pandemic and massive fiscal aid.

Some areas clearly remain depressed. Compared to April 2019, real consumer spending in April 2021 was down 16% for dentists, 17% for flights, 30% for taxis, 38% for hotels, 46% for hairdressers, 65% for spectator sports and 89% for movie theatres. Presumably, most of this spending will fully recover by the end of the summer, as pandemic restrictions fade.

Exhibit 2: Consumer spending has changed materially in the pandemic

PERCENT CHANGE IN REAL CONSUMER SPENDING FROM APRIL 2019

<table>
<thead>
<tr>
<th>Category</th>
<th>Change from April 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>New light trucks</td>
<td>66%</td>
</tr>
<tr>
<td>Computer equipment</td>
<td>58%</td>
</tr>
<tr>
<td>Televisions</td>
<td>53%</td>
</tr>
<tr>
<td>Alcohol consumed at home</td>
<td>36%</td>
</tr>
<tr>
<td>Food consumed at home</td>
<td>19%</td>
</tr>
<tr>
<td>Tobacco</td>
<td>19%</td>
</tr>
<tr>
<td>Jewelry</td>
<td>9%</td>
</tr>
<tr>
<td>Hairdressers</td>
<td>-16%</td>
</tr>
<tr>
<td>Flights</td>
<td>-17%</td>
</tr>
<tr>
<td>Taxis and ride-share</td>
<td>-19%</td>
</tr>
<tr>
<td>Nail salons</td>
<td>-30%</td>
</tr>
<tr>
<td>Dentists</td>
<td>-38%</td>
</tr>
<tr>
<td>Hotels</td>
<td>-46%</td>
</tr>
<tr>
<td>Spectator sports</td>
<td>-66%</td>
</tr>
<tr>
<td>Movie theatres</td>
<td>-65%</td>
</tr>
</tbody>
</table>


Other areas have thrived through the pandemic. Again compared to April 2019, real consumer spending in April 2021 was up 9% for food consumed at home, 18% for lottery tickets, 19% for alcohol consumed at home, 28% for jewelry, 36% for televisions, 53% for games and toys, 58% for computer equipment and 66% for new light trucks. Some of this will likely fade in the months ahead, as consumers devote more of their money to services and return to their physical workplaces in greater numbers. However, some of it reflects a surge in household wealth from a booming stock market and in income from generous federal aid, and these areas should continue to drive consumer spending even as the pandemic winds down.

More importantly, both the pandemic and massive fiscal stimulus have changed the economic landscape.

• How and where we work will likely be permanently altered:
  Multiple recent surveys1 have shown that most employees who were forced to switch to remote work by the pandemic feel the change has largely been productive and would prefer a remote or hybrid model going forward. While maintaining motivation and a corporate culture requires some in-person interaction, particularly for younger employees, the forced adoption of work-from-home technology will likely permanently reduce the demand for office space. This could also alleviate peak-hour traffic congestion and the need for new physical infrastructure. A similar argument can be made for business travel, which will likely be permanently reduced by the adoption of virtual technology.

• Cheap labor will become increasingly scarce: While Federal Reserve (Fed) officials might argue otherwise, there is clear evidence that a tightening U.S. labor market was adding to wage growth prior to the onset of the pandemic. A very quick recovery from the pandemic will mean much less time for labor market slack to erode wage growth as, of course, will generous unemployment benefits. In addition, a sharp decline in immigration, even before the pandemic, is limiting U.S. labor supply, and the highly political nature of the immigration debate suggests that this trend may continue for some time. All of this points to stronger wage growth in the wake of the pandemic. Conversely, very easy monetary policy could continue to fuel investment in labor-saving technology, such as robotics and artificial intelligence. This could herald the arrival of stronger productivity growth across the economy.

• The risks of higher inflation and interest rates have increased: The failure of monetary stimulus to generate either stronger economic growth or higher inflation in the last expansion has resulted in even more dovish Fed policies. Meanwhile, political populism on both the right and left has reduced concerns about rising government debt. Both of these trends suggest that debt will increase and monetary policy will remain very easy until inflation is steadily above the Federal Reserve’s 2% long-run target for the personal consumption deflator. Indeed it is worth noting that the personal consumption deflator posted a 3.6% year-over-year increase in April. If prices, by this measure, rise by just 0.2% per month for the rest of the year, inflation will still be 3.2% year-over-year by the fourth quarter of 2021.

There is now a very good chance that real economic growth will be stronger and inflation will be higher in the fourth quarter of 2021 than in current Federal Reserve projections. As we note in our comments on fixed income, this could well force the Fed to taper bond purchases in late 2021 or early 2022 and raise the federal funds rate in late 2022 or early 2023.

INTERNATIONAL ECONOMY: A DELAYED, NOT DERAILED, RECOVERY

The global economy continues to make progress in moving on from the pandemic, but with still uneven regional trends. Countries in North Asia continue to be at the front of the pack, with China already in its fifth consecutive quarter of growth. Its focus has now turned squarely to its priorities for the expansion ahead: passing the baton back to the consumer and normalizing its fiscal and monetary policies. Perhaps exactly because it did not need vaccines for life to return to normal domestically, its population has not felt the same urgency for vaccinations as in other regions. Improvement on this front will be important in order for the region to reopen its borders and permanently move on from the threat of localized lockdowns. The pickup in daily vaccination rates in China in May is encouraging.

In contrast, other regions have disappointed expectations relative to the turn of the year, primarily due to renewed national restrictions on activity and a slower-than-expected vaccination pace. The eurozone is a prime example, with an unexpected contraction in activity in the first quarter. This disappointment contrasted with positive surprises in the U.S.; however, the tables have begun to turn. Optimism toward the U.S. recovery might be nearing a peak, while it has begun to lift off the floor across the Atlantic. Since April, countries in Europe, like Germany and France, have substantially improved the daily pace of inoculation, now vaccinating a higher percentage of their populations on a daily basis than the U.S. As a result, green shoots have begun to emerge in the data, with the eurozone composite PMIs rising 3.7 points from March to May. One additional catalyst awaits Europe in the second half: the beginning of the disbursement of funds from the EU Recovery Fund, which sets up a much more even playing field for periphery countries in the cycle ahead. In order for Japan to join Europe in its own acceleration, it will be key for the country to improve its lagging vaccination rate.

In emerging market (EM) regions outside of North Asia, such as Southeast Asia and Latin America, news around the pandemic has been worse than expected, with powerful second waves causing likely activity contraction in the second quarter. While the pace of vaccinations remains slow, even in these regions, the pandemic is expected to wind down, although perhaps by relying more heavily on the population acquiring natural immunity to the virus.

While the expected synchronized global recovery has been delayed, it has not been derailed. Looking ahead, it is reasonable to expect a fully recovered global economy 18 months from now, with above-trend growth in between. The waves of enthusiasm will roll from region to region, with the timing of such changes impossible to get exactly right. Rather, long-term investors should keep their eyes on the horizon.

Exhibit 3: Daily vaccination rates have picked up in Europe and China

These moves will be felt in the U.S. dollar, with the initial disappointment having caused the dollar to strengthen 1.3% in the first quarter, while building international enthusiasm has caused the dollar to weaken -0.6% since March. Ultimately, the more even global economic cycle ahead continues to suggest a weaker dollar path, albeit with short-term bumps along the way. This expected depreciation of the U.S. dollar should provide a currency boost to international returns for U.S. dollar-based investors.

As activity picks up, global headline and core inflation have perked up, moving up from 2020’s low of 1.1% and 1.3% to April’s 2.7% and 1.9%, respectively. While some effects are likely temporary, the change in fiscal policies in regions such as Europe and countries like the UK suggests more upside risk to developed market ex-U.S. inflation in the cycle ahead. Within emerging markets, the focus will remain on raising interest rates to combat unwanted increases in inflation, as central banks continue to work on their policy credibility.
Exhibit 4: With a strong international economy up ahead, the U.S. dollar should weaken

REAL GDP GROWTH: U.S.-INTL. (5-YR. MOVING AVG.)
U.S. DOLLAR: 100 = 1984

Source: IMF, J.P. Morgan Global Economic Research, J.P. Morgan Asset Management. Global GDP growth is based on GDP at market exchange rates as weights versus the prior year-end. U.S. dollar is the J.P. Morgan Global Economic Research real broad effective exchange rate (CPI), calculated as year-end moves. Data are as of May 31, 2021.

FEDERAL RESERVE: SAME DOVISH TUNE WITH MORE HAWKISH MELODIES

Inflation will likely continue to dominate the market narrative through the remainder of the year, particularly as both headline and core inflation run above the Fed’s 2% target. For investors, the most consequential issues will be the Fed’s reaction function to higher inflation and strong economic growth and how bond yields respond.

The Fed continues to assert that the rise in inflation as the pandemic winds down is transitory and therefore should not prompt any changes to interest rate policy. While long-run inflation expectations have risen above 2% and the perceived “stickiness” of higher inflation will continue to be hotly debated, on balance, the market appears to be in agreement with Fed officials. As highlighted in Exhibit 5, the inflation curve, as measured by CPI swap rates, has deeply inverted. In other words, markets are expecting meaningfully higher inflation over the next two years, than over the next five years.

While transient inflation and labor market slack should support the Fed’s near zero policy rate stance at least until sometime in late 2022/early 2023, a rapidly improving economy will likely cause a change of tune regarding its bond purchase program sometime this summer. In fact, based on minutes from its April meeting, “a number of participants suggested that if the economy continued to make rapid progress toward the Committee’s goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases.” Given this, we expect the committee to lay the groundwork for tapering this summer, and announce a timeline at its September meeting. Regarding rates, the FOMC is likely to strike a more hawkish tone through its updated economic projections and “dot plot” later this month. We expect the median dot to reflect one rate hike sometime in 2023 and for modest upgrades to its inflation and growth forecasts this year and next.

Exhibit 5: Markets expect high inflation to be transitory

5-YR. INFLATION SWAP RATE - 2-YR. INFLATION SWAP RATE, DAILY, BASIS POINTS

Source: J.P. Morgan Investment Bank, J.P. Morgan Asset Management. An inflation swap is when one party pays a fixed rate cash flow on a notional principal amount while the other party pays a floating rate linked to headline CPI. Inflation swap rates provide a fairly accurate estimation of what the market considers to be the “break-even” inflation rate over that time period. Data are as of May 31, 2021.

One of the more perplexing developments in recent weeks has been the stability in long-term bond yields as inflation and growth expectations continue to move higher. One theory is bond markets have already priced in much of this strong data. Going forward, it may be the case that economic data will need to surprise to the upside relative to expectations for yields to break out of their trading range. As shown in Exhibit 6, changes in long-term yields closely track the magnitude of economic surprises. Earlier this year, the economy was handily beating expectations and nominal yields rose as a result. Since then, however, yields have remained range bound as economic surprises have moderated.

2 Based on 5-year, 5-year forward inflation break-even rates, Guide to the Markets, page 38.
Exhibit 6: Data in line with expectations translates to less rate volatility

ROLLING 3-MO. CHANGE IN 10-YR. UST YIELD (BPS) AND CITI ECONOMIC SURPRISE INDEX


So, what could cause the next leg higher in yields? We think a shift in the Fed’s tone around tapering the balance sheet could be an initial catalyst. In addition, as the labor market recovery picks up steam again, particularly in the fourth quarter as enhanced federal unemployment benefits expire and elevated job openings and higher wages attract workers back into the labor force, yields should grind higher. Moreover, as further fiscal stimulus is passed, increased borrowing at the same time the Fed is easing up on Treasury purchases should also act as a headwind for bond prices. All things considered, we expect the 10-year Treasury yield to end the year between 2.0% and 2.25%.

Overall, navigating fixed income markets will be challenging over the next 12-18 months as nominal yields grind higher and robust economic activity keep credit spreads tight. Investors should maintain a below-benchmark duration profile, while adding to extended sectors like credit and emerging market debt as the global recovery gains momentum.

Exhibit 7: Earnings in value sectors are more sensitive to economic growth

S&P 500 SECTOR EARNINGS CORRELATION TO REAL GDP, 1Q09-4Q20

Source: FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management. Growth is represented by the Russell 1000 Growth Index and Value is represented by the Russell 1000 Value Index. Beta is calculated relative to the Russell 1000 Index. *Communication services correlation is since 3Q13 and based on backtested data by JPMAM. Guide to the Markets – U.S. Data are as of May 31, 2021.

The return differential between growth and value since the March 2020 low has primarily been a function of differences in earnings growth; nearly 25% of the return of the Russell 1000 Growth has been driven by earnings, versus 13% for the Russell 1000 Value. Put simply, growth stocks saw earnings rise sharply last year, while earnings on the value side struggled. Given our expectation for vigorous economic activity during the second half, we believe that value stocks will resume their outperformance on the back of robust profitability.
More broadly, using earnings as a guide will increase in importance against a backdrop of rising rates. Our work shows that rates and equities should be able to rise together until the 10-year U.S. Treasury yield approaches 3.5%; importantly, the primary channel through which rising rates pressure equities is valuations. This means that story stocks, meme stocks and some of the other, frother parts of the equity market will likely come under pressure as rates continue to move higher.

Exhibit 8: Stocks come under pressure when rates approach 3.5%

Going forward, investors should ask themselves: 1) Which markets are more geared toward the global recovery?, 2) Which markets are more geared toward the next cycle’s themes, like inflation, technology and the rise of the EM middle class? and 3) Where is the valuation starting point most favorable for the recovery and expansion ahead?

The strongest international earnings growth is occurring in cyclical sectors like energy, financials, industrials and materials, which are the most exposed to the improvement in the real economy. As a result, earnings this year are expected to be particularly strong in regions that have the most exposure to these cyclical sectors, namely Europe and Japan, where cyclical sectors make up 55% of the market. In addition to providing investors the biggest cyclical recovery bang for their buck, these international markets also offer investors a hedge against inflation, a topic of debate that will likely continue to characterize the expansion ahead. In particular, financials and materials can offer an inflation hedge, as the banking sector benefits from steepening yield curves and the mining sector benefits from rising commodity prices.

So far this year, regional equity performance has been a tale of two quarters. In 1Q, MSCI Europe ex-UK underperformed the S&P 500 by 250bps, while it has outperformed by 360bps in 2Q as the wave of enthusiasm about the recovery has rolled over the Atlantic. As a result of the previous decade’s underperformance versus the U.S., European equity valuations are still at a steep discount versus the U.S. at 18% compared to a 20-year average discount of 12%.

For emerging markets, this is a different beginning to a new cycle. With China now making up nearly 40% of the MSCI Emerging Markets Index, combined with technology-heavy Taiwan and Korea making up an additional 25% of the index, emerging markets now has only 44% of its index represented by cyclical sectors versus 63% in 2009. As a result, it is not unexpected for emerging markets to be underperforming in a year characterized by growth underperformance over cycicals. Instead, emerging markets offer investors access to the most powerful structural growth themes of the expansion ahead: technological innovation and the rise of the EM Asia middle class. Compared to the start of the year, EM multiples have moved down 7%, offering investors a better entry point to themes that will likely come back into favor once investors look past the initial early cycle economic growth surge.

INTERNATIONAL MARKETS: A MIX OF CYCLICALITY, INFLATION HEDGE AND STRUCTURAL GROWTH

Like the economy, international earnings have begun to recover from the pandemic hit, which caused earnings for the MSCI All Country World Index ex-U.S. to contract 28% in 2020. Given the expected surge in nominal international growth, international earnings are expected to grow 37% this year.
Exhibit 9: International equities offer a mix of cyclicality and growth

**GLOBAL EARNINGS GROWTH, CALENDAR YEAR CONSENSUS EXPECTATIONS**

![Chart showing earnings growth expectations for various regions/countries.]

Source: FactSet, MSCI, Standard & Poor’s, Thomson Reuters, J.P. Morgan Asset Management. *Cyclical sectors include consumer discretionary, financials, industrials, energy and materials. The Internet and direct marketing subsector has been removed from the cyclicals calculation. In our judgement, companies in this space do not yet fit into the cyclical category, as they are still in a transitional growth phase and are not being directly impacted by the business cycle. Earnings use MSCI indices for all regions/countries, except for the U.S., which is the S&P 500. All indices use IBES aggregate earnings estimates. Data are as of May 31, 2021.

**THE SUSTAINABLE DECADE**

Sustainability is likely to be a decade-defining theme, and momentum is building from all of the major actors in the global economy. Global policymakers are strengthening commitments to net zero carbon emissions. Many consumers are opting for more sustainable choices particularly in transportation, energy and food consumption. Companies are responding to changing consumer preferences by adapting products, services and supply chains. Investors are flocking to sustainable investment strategies, measured by ESG (environmental, social, governance) factors. Nearly $205 billion has flowed into ESG strategies globally year-to-date, bringing AUM to $2.1 trillion. Regulators are taking note as well, with the EU imposing sustainability-related disclosures on financial services firms. With momentum coalescing around sustainability, it can create powerful opportunities for portfolios.

As momentum has been building around ESG investing, the philosophy behind it has also been evolving. Simply said, sustainable investing is about risk mitigation (governance) and harnessing the opportunities that come from growth and change, particularly environmental and social shifts.

Although risk mitigation has long been a key tenet of any successful investment strategy, with valuations high and pockets of froth in the markets, investors should ensure the companies they invest in have viable business models, realistic growth prospects and operational excellence. External threats companies face are also being amplified by technological advances. Robust cyber security has become critical not just for technology companies, but also financial firms, retailers and even energy and utilities companies.

On the environmental front, world leaders will convene at the U.N. Climate Change Conference (COP26) in November, aiming to cement details of the Paris Agreement, strengthen commitments to net zero carbon emissions and mobilize financing. Tackling climate change will require major innovation and investment from both the public and private sectors, but presents lucrative opportunities for the companies and countries that succeed. In fact, there could be significant economic and strategic benefits to being the leader in these new industries, which, in turn, can create opportunities for growth in portfolios.

Environmental change often takes the spotlight, but there is significant social change afoot. The pandemic not only revealed the global health challenges that persist, but also the disparate outcomes for lower income, minority or underserved communities. This has sparked demand for improved and more accessible medical solutions and investment in housing, health care and education. Even the Fed has acknowledged full employment includes a more diverse workforce.

Sustainability encompasses many of the solutions and innovations that countries, companies and consumers demand for the future, which should translate to attractive long-term opportunities for portfolios.

Exhibit 10: Fund flows suggest investors are warming up to sustainable investing

**AUM IN SUSTAINABLE INVESTMENT STRATEGIES, BILLIONS**

![Chart showing fund flows.]

Source: Morningstar, J.P. Morgan Asset Management. AUM for global mutual funds (40 Act and UCITS) and ETFs through April 30, 2021. Data are as of May 31, 2021.
OUTCOMES MATTER, AND SO DO ALTERNATIVES

In the first quarter of this year, the 10-year U.S. Treasury yield increased 82bps, its largest quarterly increase since 4Q16. This led the Barclays U.S. Aggregate Index to fall by 3.37%, its worst quarter since 3Q81. Rate volatility has subsided, but equity valuations remain elevated and long-term return expectations are muted. So what is an investor to do?

More and more clients are turning to alternatives — both public and private — as a solution in a world of low rates and meager expected returns. As we have written before, any allocation to alternatives should be outcome-oriented; first, investors need to identify the problem they are trying to solve, and then determine the asset or strategy that will provide a solution.

Commercial real estate is finding its footing. Although some questions around the office and retail sectors remain, the reopening of the economy this summer will begin to provide some insight as to how these sectors might evolve going forward. It seems that offices will increasingly become places for collaboration, rather than individual work, and success in the retail sector will be driven by properties that are oriented toward the consumption of services and experiences, rather than goods. Core real assets broadly can provide uncorrelated streams of income and inflation protection, helping to address some of the challenges posed by the bond market.

Exhibit 11: Tenant mix matters for retail properties

% CHANGE IN NUMBER OF RETAIL ESTABLISHMENTS, 3Q10-3Q20

<table>
<thead>
<tr>
<th>Sector</th>
<th>Change in Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>17.7%</td>
</tr>
<tr>
<td>Goods-producing</td>
<td>19.5%</td>
</tr>
<tr>
<td>Service-providing</td>
<td>23.7%</td>
</tr>
<tr>
<td>Department/discount</td>
<td>22.3%</td>
</tr>
<tr>
<td>Personal care/services</td>
<td>15.6%</td>
</tr>
<tr>
<td>Restaurants/bars</td>
<td>15.5%</td>
</tr>
<tr>
<td>Pharmacies and person care</td>
<td>15.5%</td>
</tr>
<tr>
<td>Grocery/liquor</td>
<td>3.9%</td>
</tr>
<tr>
<td>Automobile dealers</td>
<td>3.5%</td>
</tr>
<tr>
<td>Gas stations</td>
<td>3.0%</td>
</tr>
<tr>
<td>Clothing</td>
<td>-10.2%</td>
</tr>
<tr>
<td>Furniture/furnishings</td>
<td>-11.9%</td>
</tr>
<tr>
<td>Electronics/appliances</td>
<td>-12.8%</td>
</tr>
<tr>
<td>Entertainment goods</td>
<td>-17.5%</td>
</tr>
</tbody>
</table>

Source: Bureau of Labor Statistics, J.P. Morgan Asset Management. Personal care/services include nail salons, barber shops, etc. Entertainment goods include sports equipment, games, musical instruments and book stores. Industrial and retail establishments data is as of 3Q20. Industrial property vacancy rate is as of 4Q20. Data are as of May 31, 2021.

Momentum in private equity deal activity seems to have carried over to 2021. In the buyout space, purchase price multiples remain elevated, and this could very well remain the case. Robust demand for high yield debt has not only provided support for private credit markets, but may also allow more leverage to be applied in the deal process.

Exhibit 12: U.S. LBOs: Elevated multiples may stay elevated

U.S. LBO PURCHASE PRICE MULTIPLES, EQUITY AND DEBT OVER TRAILING EBITDA

The outlook for hedge funds will be dependent on the path of volatility. Retail investors seem to be returning to the stock market, and the economic reopening may create more questions than answers. As such, we see room for volatility to increase in the coming months, supporting hedge fund performance. Furthermore, with credit spreads at the low end of their range and equity valuation dispersion still wide, relative value and long-short strategies are particularly attractive.

At the end of the day, deciding which assets to allocate to is only the first step of the alternative investment process. Manager selection remains of the utmost importance. As we journey into a post-pandemic world, there will be more questions than answers — alternatives can play a role in providing income, enhancing return and managing risk.
CYCLICAL LOCATION AND ASSET ALLOCATION:
INVESTING FOR THE REST OF THE RECOVERY

As investors look into the back half of the year, perhaps the most important question to ask is: Where are we in the recovery? Positioning within the cycle can help to inform positioning within the portfolio, and given some of the higher-level headwinds present, having a firm grasp on the outlook will yield dividends, so to speak, in portfolio construction.

Following the recession in early 2020, U.S. economic growth snapped back unusually quickly. The recovery in earnings, while delayed relative to the broader economy, has also now manifested in an impressive way, with strong and positive EPS contributions from all sectors within the S&P 500 in 1Q21. These two forces were indications that the economy had entered into an “early-cycle” phase — categorized by an inflection in economic conditions, strong growth and improving credit conditions, leading to rapid margin expansion.

This unusual strength is something to be welcomed by investors, but it may also be an indication that a good portion of the “early-cycle” recovery may have been pulled forward. It could therefore be argued that the U.S. economy is already on the cusp of entering the “mid-cycle” — growth will slow but remain strong, profitability will stay healthy and monetary policy will become increasingly neutral. Moreover, the most recent economic indicators, including strong inflation prints and rising wage pressure, suggest even “mid-cycle” conditions may be fleeting, and that “late-cycle” conditions — peaking growth, rising inflation and tightening monetary policy — may be around the corner. All told, the U.S. may experience the entirety of a business cycle (excluding, hopefully, the recession phase) within less than two years.

The natural next question, then, is: How should investors be positioned relative to this changing world and hedge against the associated risks?

The gradual tightening of monetary policy in response to a warming economy means that investors would be wise to shorten up on duration, and could encourage additional risk taking in fixed income, either in lower-credit assets or foreign bonds.

Equities, though, are much more sensitive to business cycles, and the transition from “early” to “mid” to “late” could have a much more profound — and negative — impact on future returns. This suggests that within U.S. markets, investors should lean more on value-oriented sectors, which typically are more levered to strong domestic growth. It also suggests a need to look outside of the U.S., where business cycles are less mature given a delay in foreign vaccination campaigns.

This changing backdrop may also present challenges for investors looking to hedge portfolios, since rising interest rates alongside volatile equity markets could lead to a breakdown in traditional stock/bond correlations. This suggests the need for investors to consider a heartier allocation to alternatives, which are typically uncorrelated to public markets.

All told, the investing landscape continues to be both complex and changing. Given the speed of normalization and recovery, investors must be must be prepared for shifts in cyclical positioning, both domestically and abroad. For this reason, the best way to approach asset allocation is to broadly diversify and work with active managers.
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