Investment Outlook 2024

Too early for a victory lap

Authors

Karen Ward
Chief Market Strategist for EMEA

Paola Toschi
Global Market Strategist

Tilmann Galler
Global Market Strategist

Vincent Juvyns
Global Market Strategist

Hugh Gimber
Global Market Strategist

Max McKechnie
Global Market Strategist

Natasha May
Global Market Analyst

Zara Nokes
Global Market Analyst

In brief

- As we head into 2024, a combination of solid activity and falling inflation has seen the market narrative increasingly shift towards the prospects of a soft landing.
- We are a little more sceptical. Even though Western economies may be less rate sensitive than in the past, we expect that the "long and variable lags" of monetary policy transmission are at least part of the better explanation for the economic resilience seen so far.
- We think it's too early for the central banks to declare outright victory over inflation, and anticipate that rate cuts in 2024 are unlikely to pre-empt economic weakness.
- We therefore think interest rates could be set to fall later than the market currently expects, but eventually they may also fall further than predicted.
- We believe investors should focus on locking in yields currently on offer in the bond market. Targeted alternatives could augment the role that bonds play as diversifiers against different risks. In equities, potential pressure on margins warrants a focus on quality and income.

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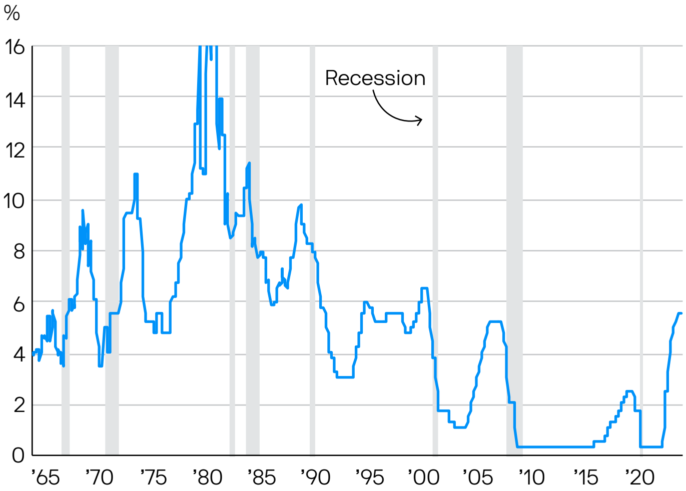
It is extraordinary how the market narrative swung over the course of 2023. Coming into the year the predominant view was that we were stuck in the grips of 1970s-style stagflation. With central banks slamming on the brakes it is no wonder so many, ourselves included, expected a recession. That is usually what happens when interest rates rise so sharply.

Exhibit 1: Usually monetary tightening causes recessions

US Fed funds rate



Source: Federal Reserve, LSEG Datastream, J.P. Morgan Asset Management. Periods of recession are defined using US National Bureau of Economic Research (NBER) business cycle dates. Data as of 15 November 2023.

However, economies have so far coped remarkably well with higher rates. Coupled with signs that pandemic-related inflation is easing, the market narrative has shifted towards the prospect of a soft landing. Bond markets are excited about rate cuts, spreads are at or below historical averages in most areas of credit, and equity analysts are forecasting double-digit earnings growth for 2024.

Were this to play out, it would represent an extraordinary success for central banks. But we would urge caution against taking a victory lap too early. It is the "long and variable lags" in monetary policy that so often plague economic forecasters. When consumer confidence turns, it turns quickly. Averaging the last 12 recessions, US GDP growth in the quarter prior to a recession was 3% in real terms and 7% in nominal terms. Forecasting the direction of economies is hard, but forecasting the timing of a recession is even harder.

Long and variable lags

Anyone forming a view for 2024 has to start with the following question: do interest rates still bite?

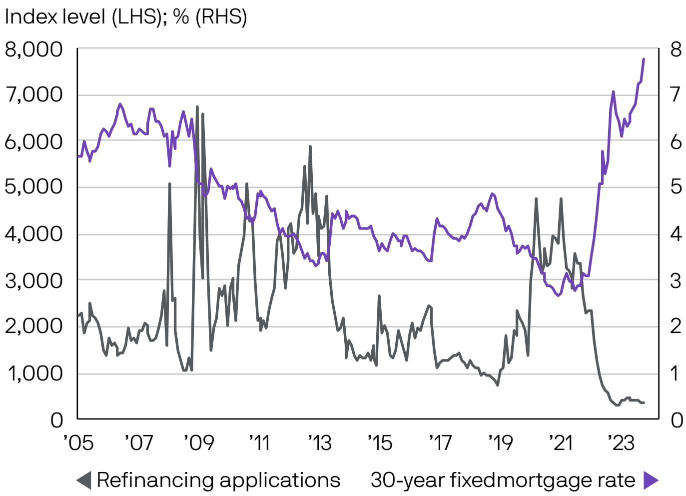
If economies can cope with higher interest rates, the impact on risk assets should be positive, but more trouble could be in store for core bonds given bond markets are still eagerly looking forward to lower rates. However, if what we have seen in 2023 is the usual "long and variable lags" in monetary policy transmission, then investors should be cautious about risk assets and instead focus their attention on the insurance provided by high quality bonds as expected rate cuts, and more besides, get delivered.

There are reasons Western economies are slightly less interest rate sensitive than in the past. Overall private sector debt is a little lower than the last time interest rates reached these levels. The big accumulation of debt in recent years has been by the government.

Existing mortgage debt has also been financed on longer-term interest rates. Many US households took advantage of the low interest rates on offer in the pandemic and the typical mortgage is locked for 30 years. Unless those households choose, or are forced, to move they are immune to what is going on at the Federal Reserve.

Exhibit 2: Many US households locked in low mortgage rates

US mortgage refinancing applications and 30-year mortgage rate



Source: Federal Home Loan Mortgage Corporation, LSEG Datastream, Mortgage Bankers Association of America, J.P. Morgan Asset Management. Data as of 15 November 2023.

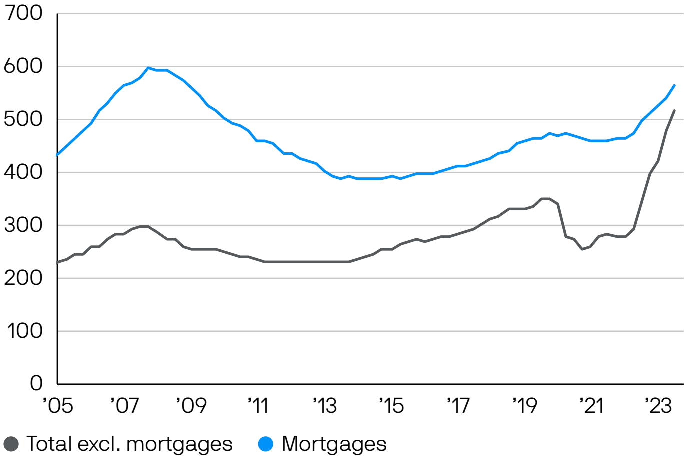
In Europe, households also made use of pandemic savings to pay down debt. A higher proportion of households in Europe are mortgage free relative to the US, and rates started rising from a much lower base. However, there are some regions where refinancing onto higher mortgage rates will still be a significant drag heading into 2024, notably in the UK.

The situation is not so benign when we look at non-mortgage debt, where rates are still largely variable. In the US, total spending on interest payments has picked up markedly in recent months and delinquencies on auto and credit card loans are the highest level in over 10 years.

Exhibit 3: The interest rates on non-mortgage debt are starting to bite

US personal interest payments

USD billions



Source: BEA, LSEG Datastream, J.P. Morgan Asset Management. Data as of 15 November 2023.

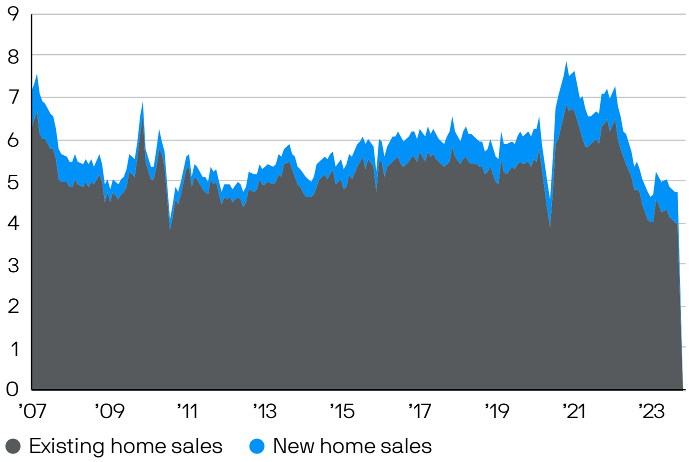
Corporates also took advantage of lower rates a couple of years ago. But the amount of corporate debt that will have to be refinanced at higher rates starts to pick up more substantially over the next two years (see Locking in Yields).

The cost of new loans is punitive. US homeowners now face a 30-year mortgage rate of nearly 8%, which based on current house prices would eat up around 26% of median income.[1] In the UK, the equivalent figures are 5% (for a 5-year fixed rate) and 38% respectively.[2] Given this, it is no wonder housing activity is depressed. US developers have been relatively successful in keeping activity going by offering their own discounted rates, but these incentives seem unsustainable. Construction and housing-related spending is likely to remain lacklustre.

Exhibit 4: The US housing market has stalled

US home sales

Millions, seasonally adjusted



Source: LSEG Datastream, National Association of Realtors, US Census Bureau, J.P. Morgan Asset Management. Data as of 15 November 2023.

Overall, we would be cautious about the idea that economies can easily cope with interest rates of 5% or more in the US and UK, and 4% in the eurozone. We would expect the damage of higher interest rates to become increasingly evident in the consumer and business spending data in the coming months.

Fiscal spending is back in vogue

One factor that has been cushioning the impact of higher rates is ongoing expansionary fiscal policy. In the US, a number of pandemic-related tax moratoriums, such as student loan repayments, persisted for much of 2023. Additionally, we have seen the introduction of multi-year, multi trillion dollar stimulus programmes in the form of the CHIPS and Science Act, the JOBS Act and the Inflation Reduction Act.

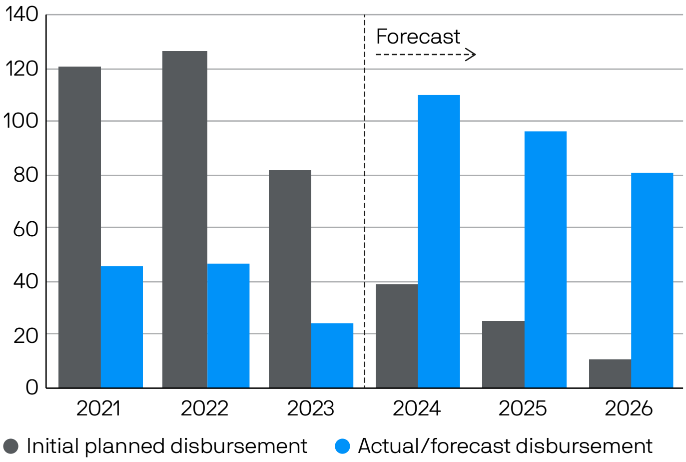
In Europe, fiscal spending is also currently far more supportive than it has been over the last decade, although not of the scale seen in the US. In the eurozone, the key fiscal package was the European Union (EU) Recovery Fund, but that is only slowly being put to work, with 65% of funds yet to be disbursed.

1 Calculated using the median existing single family home price and median family income, and assuming an 80% loan. Source: National Association of Realtors, J.P. Morgan Asset Management.
2 Calculated using the average first time buyer home price and the average post-tax earnings for a full-time adult worker, assuming a loan of 80%. Source: Nationwide, J.P. Morgan Asset Management.

Exhibit 5: Europe has not yet spent its Recovery Fund

EU Recovery Fund grants

EUR billions



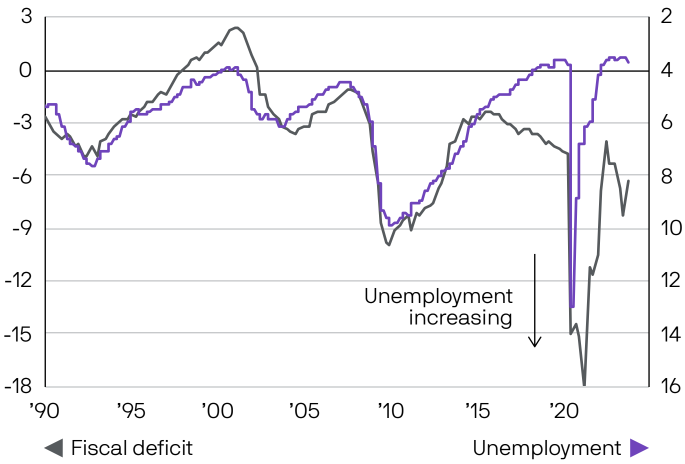
Source: European Commission, J.P. Morgan Asset Management. The grants disbursed in 2024-26 are based on JPMAM estimates. Data as of 15 November 2023.

While these infrastructure spending programmes will support economic activity for some time, governments will have to turn their attention to how they will balance the books at some point. A 6% budget deficit in the US at a time when unemployment is near a record low is simply not sustainable, particularly given the central banks are no longer buying government debt. A deficit at this level would also suggest that whoever ends up running for president in 2024 will not be doing so on the promise of major tax cuts.

Exhibit 6: Such a large US deficit is concerning given low unemployment

US fiscal deficit and unemployment rate

% of nominal GDP (LHS); % (RHS)



Source: Bloomberg, BLS, US Treasury, J.P. Morgan Asset Management. Data as of 15 November 2023.

Forecasting human beings

The final, but potentially most important, component of the resilience story is human behaviour. Having been forced to stay at home for prolonged periods in the pandemic, many people understandably had a strong desire to make up for the experiences and holidays that they missed.

These 'animal spirits' effects, coupled with pent-up savings, cannot be captured by historical data and are something that our models simply cannot forecast. The unpredictable way in which consumers switch from over-optimism to over-pessimism is one of the main reasons for the long and variable lags in monetary policy, and is why forecasting the timing of the business cycle is so very hard.

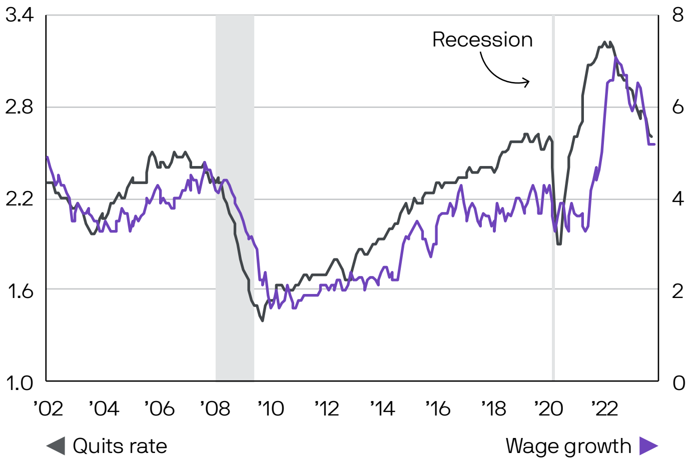
A prolonged central bank pause

While we see the current resilience in economic activity as somewhat transitory, the good news is that there are signs that inflationary pressures are moderating, not only at the headline level but also in wages. As the labour market cools and cost-of-living pressures become less intense, workers are not hot-footing off to new jobs with the promise of higher pay in the way they were a year ago. This change is most evident in the US, but Europe is likely to see a similar phenomenon as headline inflation, and hiring, falls.

Exhibit 7: The US labour market is cooling

US job quits and wage growth

%, three-month moving averages, wage growth is year on year



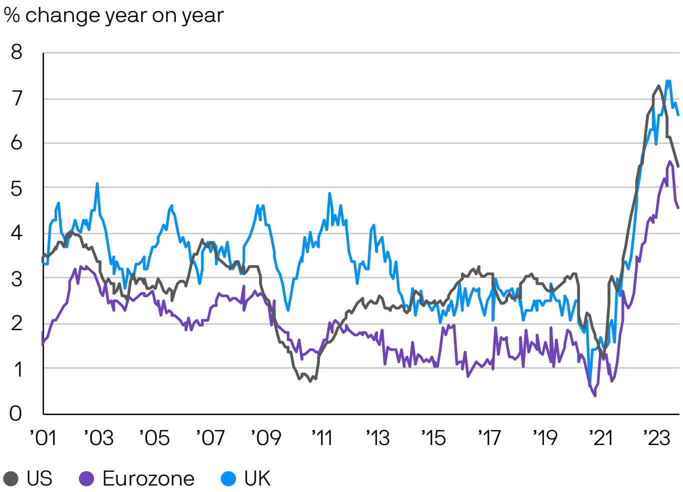
Source: BLS, Federal Reserve Bank of Atlanta, LSEG Datastream, J.P. Morgan Asset Management. Wage growth is the Atlanta Fed wage tracker. Periods of recession are defined using US National Bureau of Economic Research (NBER) business cycle dates. Data as of 15 November 2023.

Global inflation has also been helped by the lack of a bounce-back in China. This weakness looks entrenched as Beijing appears to be struggling to find a new economic engine that does not rely on exports or property excess. While the Chinese government has announced a number of stimulus measures, none equate to the large-scale programmes of the past, so China looks likely to grow at much lower levels than in recent decades.

Despite these positive signs, we think the central banks would be unwise to declare an early victory on inflation. We certainly do not buy the "goldilocks is back" narrative. It is fair to say, however, that the risk that inflation would stay stuck nearer 5% is meaningfully lower than it appeared to be earlier in 2023.

Exhibit 8: Services inflation still somewhat sticky, particularly in the UK

Core services inflation



Source: BLS, Eurostat, LSEG Datastream, ONS, J.P. Morgan Asset Management. Core services inflation excludes energy services. Data as of 15 November 2023.

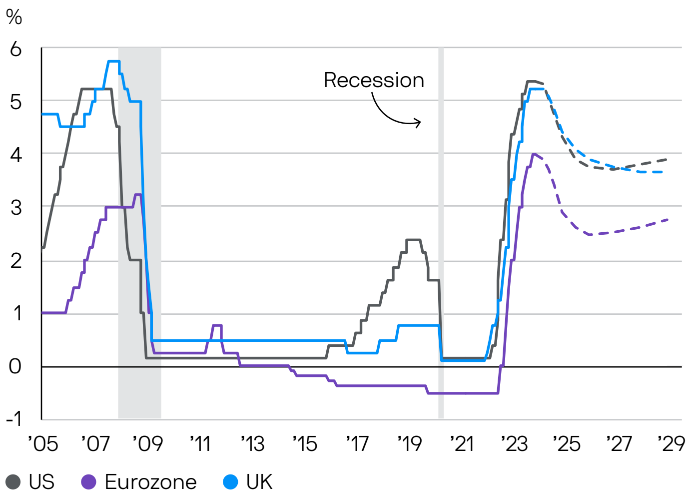
Importantly, if inflation is not stuck at a high level the central banks will have the freedom to cut rates, *if and when the economic data justify rate cuts*.

It seems very unlikely that the central banks would cut pre-emptively without a significant slowdown in activity. With inflation having been above target for much of the last three years, we expect they will rather err on the side of easing too late, rather than too early, to negate the risk of restoking the inflation problem they worked so hard to eliminate. Recent work by the International Monetary Fund[3] shows that there have been frequent episodes historically where central banks have made the mistake of celebrating prematurely, leading to inflation plateauing at an elevated level and then re-accelerating.

Although a more cautious approach would mean that rate cuts come later than the market currently expects, we suspect the central banks will eventually cut further than predicted. Hence, we are not worried that bond yields may continue to move higher, since the data will signify this is a timing, rather than direction of travel issue.

Exhibit 9: Central banks are likely to cut later but by more

Market expectations for central bank policy rates



Source: Bank of England, Bloomberg, European Central Bank, Federal Reserve, J.P. Morgan Asset Management. Expectations are calculated using OIS forwards. Data as of 15 November 2023.

[3] International Monetary Fund, "One Hundred Inflation Shocks: Seven Stylized Facts", IMF Working Paper 23/190 (September 2023).

On top of these macro uncertainties, there are numerous political and geopolitical uncertainties that are hard to forecast at this stage. Wars are still raging on multiple frontiers that have the potential to deliver further commodity price shocks through the global economy. Hard fought elections will take place in the US and UK, while elections elsewhere, such as in Taiwan, may also be in focus given Chinese tensions (see Navigating the Political Calendar).

In the chapters that follow, we highlight the investment implications of this macro view. Being humble about the risks and preparing for all scenarios is key.

We believe investors should focus on locking in yields currently on offer in core bond markets. Although these yields are below current cash rates, investors should view this situation as an insurance premium that will pay out handsomely if the recession does happen with greater force than many anticipate (see Locking in Yields). Generally, we think investors should resist the temptation of optically attractive cash rates, which we see as a mirage (see Cash Rates are a Mirage).

Equities are not expensive, but they also are not cheap, particularly when we account for both a more cautious earnings outlook and the fact that the difference between the earnings yield on stocks and corporate bonds is the lowest it has been in over 10 years (see Equities: Problems at the Margins). Given there are upside scenarios, investors probably would not want to overly reduce their equity exposure, but instead focus attention on quality stocks and income payers.

Structurally, we also believe investors need to recognise that the relationship between the price of stocks and bonds will not be as reliably negative as it has been in the past, particularly when the global economy is subject to cost shocks that may be a more common feature of a more fragmented world. Certain assets found in the alternatives space, as well as commodities, could augment the role that bonds play in providing shelter from many different kinds of economic weather (see Targeted Alternatives for Targeted Risks).

Navigating the political calendar

2024 is a big year for national elections, with 40 nations scheduled to go to the polls. This includes four of the world's five most populous countries, and in total elections are set to cover over 40% of both the world's population and GDP. See details on the elections in the appendix.

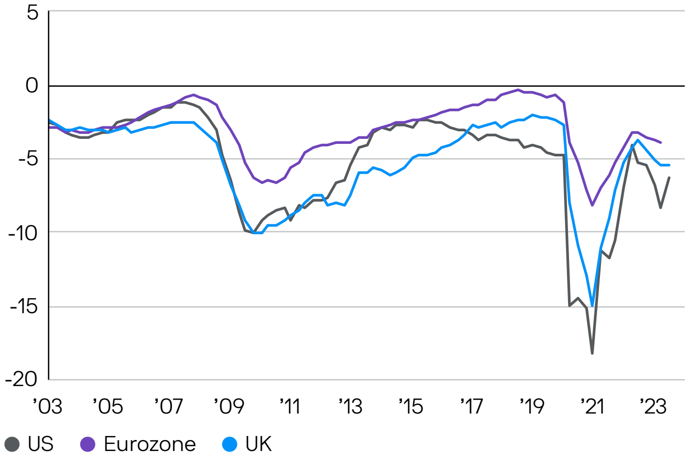
Of the elections that could have global market implications, Taiwan's presidential elections will be the first to come into focus in January. The successful candidate's stance towards China will be the key element for investors to watch. India goes to the polls in April where Prime Minister Narendra Modi will be pushing to secure a third term. European Union parliamentary elections will take place over the summer, ahead of the US presidential election that will take place in November. In the UK, the election date is currently unknown but an election must be called by 17 December 2024 at the latest.

The fiscal promises of the successful party are often key to how markets react. For example, tax cuts enacted by President Trump in 2017 fuelled a strong rally in the stock market given the wave of earnings upgrades that followed. In 2024, however, limited fiscal headroom in both the US and the UK will likely make it difficult for any party to deliver further tax cuts or major spending programmes. With interest costs rising and deficits already more than 6% and 5% of GDP in the US and UK respectively, the economic differentiation between right- and left-leaning parties looks set to be smaller than normal.

Exhibit 10: Large deficits limit the prospects of fiscal giveaways

Public sector budget balance

% of nominal GDP



Source: Bloomberg, Eurostat, ONS, US Treasury, J.P. Morgan Asset Management. Data as of 15 November 2023.

Candidates in both the US and the UK will also be scrutinised for their position on climate change, as well as their foreign policy stance. In particular, this includes the role the US will play in what look to be lengthy conflicts in both Ukraine and the Middle East.

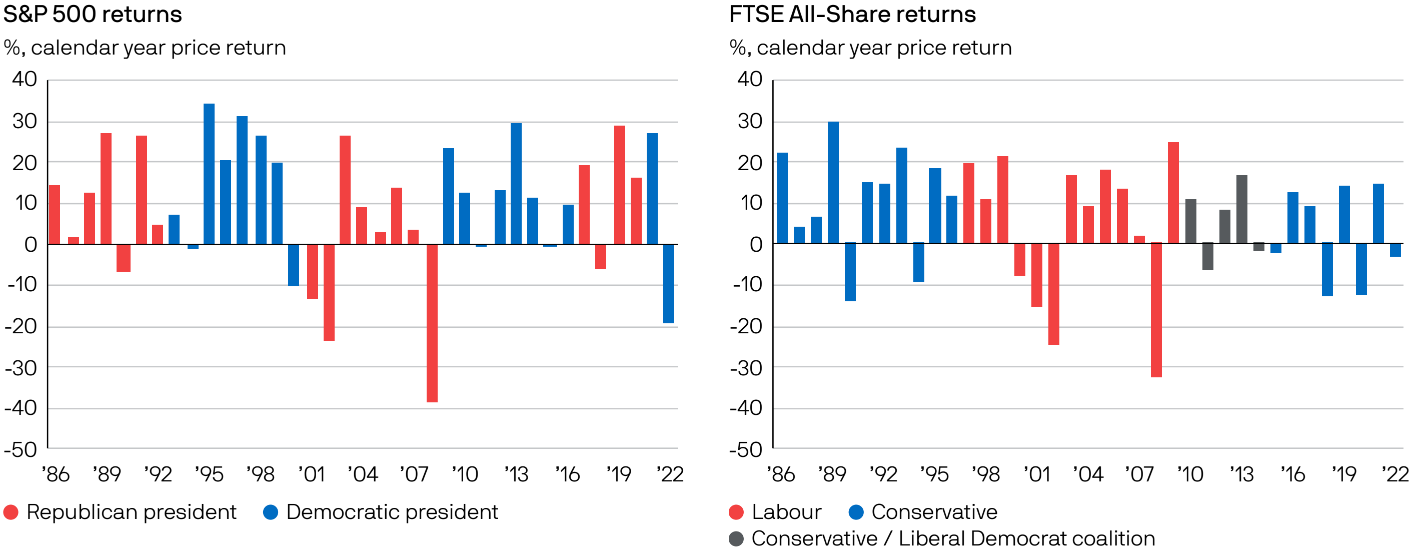
Three factors, however, should temper our inclination to shift portfolio positioning due to political events.

First, predicting the outcome of elections has in recent years been incredibly challenging. Polls provide a less than ideal guide, though it is unclear why; potentially voters are unwilling to reveal more populist leanings to pollsters.

Second, it is by no means a given that campaign promises will make it into law. Over the last three US elections, the successful candidates made a combined 700 campaign promises. But so far less than half of these have made it into law according to data from Politifact, in large part due to Congressional opposition.

Finally, it is worth remembering that over the long run, there is no clear correlation between governing party and market performance. Key events in the economy – such as the bursting of the tech bubble or the financial crisis – tend to have much more of an impact on the average returns under different governments than the governments do themselves.

Exhibit 11: There is little relationship between ruling parties and stock performance



Source: FTSE, LSEG Datastream, S&P Global, J.P. Morgan Asset Management. The shading represents who was in power for the majority of each year. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

Locking in yields

Bond yields have been on a rollercoaster ride over the past few years. The US 10-year yield even breached 5% for the first time since 2007. As we look to 2024, we feel more confident that both short and long-term interest rates have peaked and that investors should take the opportunity to lock in yields on high-quality fixed income.

Bond vigilantes

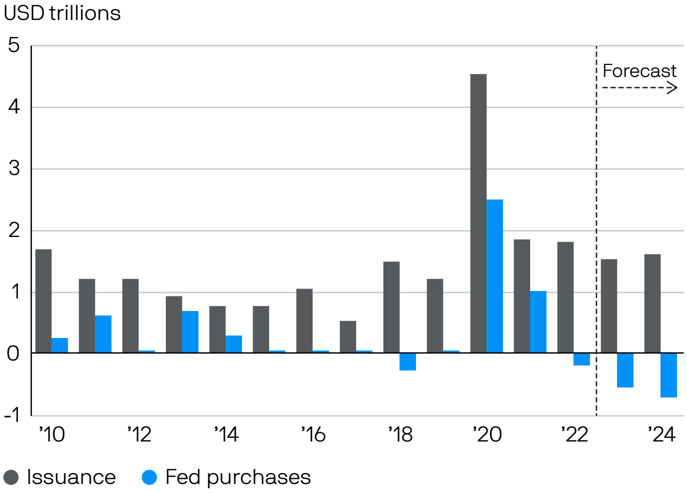
Why did bond yields spike? One explanation is that there is a supply and demand mismatch in government bond markets, particularly for US Treasuries. With a considerable amount of US government spending already legislated for, the concern is that issuance of government debt is overwhelming bond demand now that the Federal Reserve is no longer buying Treasuries.

At face value, this demand-supply mismatch has merit. Central banks absorbed a lot of the government debt issued in recent years and now seem firmly committed to reducing their balance sheets. It is also true that in the absence of quantitative easing the bond market is ‘free’ to tell governments when it perceives spending programmes to be too much. In other words, the bond vigilantes are back, as former UK Prime Minister Liz Truss learned only too well.

However, if private investors were worried about the uncontrollable profligacy of government spending, one might have expected the rise in yields to have been driven at least in part by higher inflation expectations. Instead, the move through the second half of 2023 has been almost entirely driven by real yields.

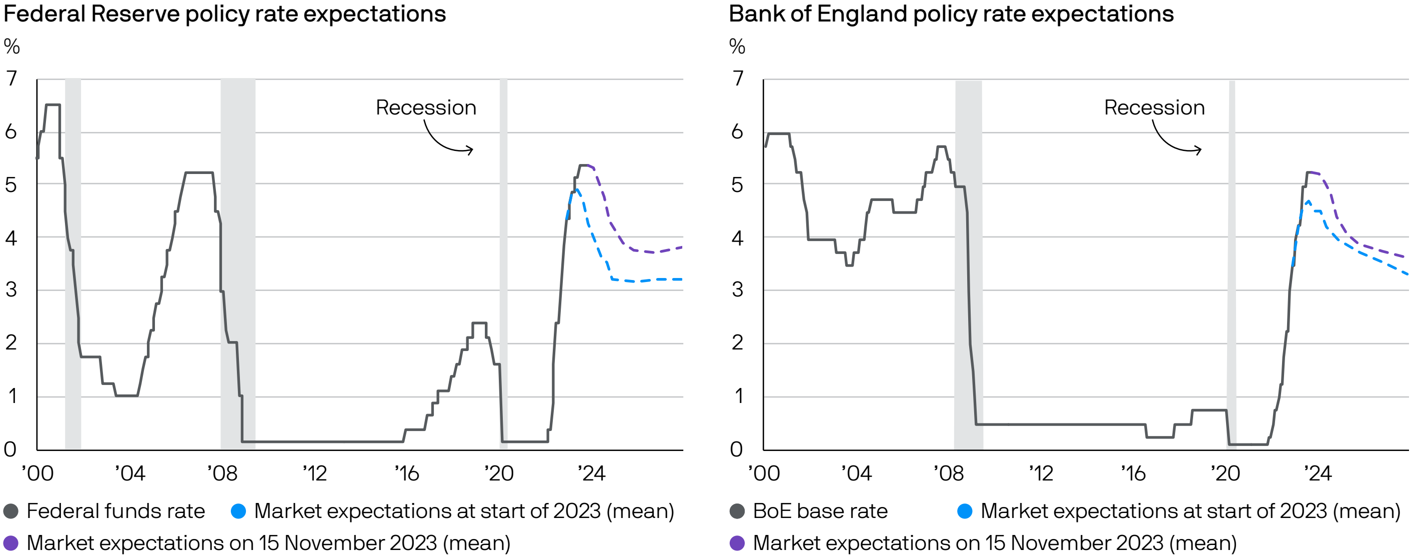
Exhibit 12: Central banks are no longer absorbing government issuance

US government debt issuance and Fed purchases



Source: CBO, US Treasury, J.P. Morgan Asset Management. Data as of 15 November 2023.

Exhibit 13: Markets have repriced for ‘higher for longer’



Source: Bank of England, Bloomberg, Federal Reserve, J.P. Morgan Asset Management. Market expectations are calculated using OIS forwards. Data as of 15 November 2023.

The explanation for higher bond yields that we find more compelling is that the US economy has simply proved more resilient to higher interest rates than was previously expected. Thus, the market has had to re-evaluate perceptions of what the sustainable or 'neutral' interest rate is. The neutral rate is sometimes referred to by economists as R-star. It is the interest rate that would prevail when the economy is at full employment and inflation is stable such that monetary policy is neither expansionary nor contractionary.

R-star gazing

Whether bond yields rise further depends on what we learn about R-star in the coming months. If economies remain resilient, and/or inflation is not showing signs of returning to 2%, then the rate cuts that are currently priced in will have to be removed – or even further hikes will need to be priced – which could put upward pressure on yields.

If, however, the economy shows signs of cracking under current policy rates as per our base case, then attention will turn to when and how much the central banks will cut. Relative to pricing in the middle of November, we expect central banks to cut later but by a greater amount. This would send bond yields lower and potentially release a sizeable capital gain – a 200bp decline in the US 10-year Treasury yield over the next 12 months would result in a total return of 21%.

In short, core bonds offer not only attractive income levels for investors but also potential capital gains in a recessionary scenario. The opportunity to lock in yields at current levels looks compelling, even if bond volatility is likely to remain elevated for some time.

Being selective with fixed income

An element of selectivity will still be required. In Europe, we see the risk that some governments in the periphery will not be able to resist the temptation of expansionary fiscal policy in 2024. The 10-year bond yield spread between Italy and Germany is below 200bps. As a result, we think higher quality core European sovereigns look more attractive than their peripheral counterparts.

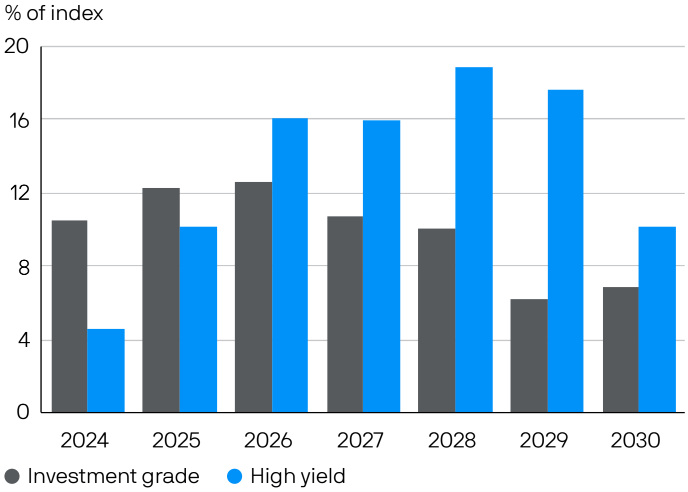
Globally, investors will also probably favour sovereign bond markets where monetary policy prospects are the most favourable. While in the US and Europe, we – like many other investors – believe that policy rates have peaked, this is not the case in Japan. With the Bank of Japan set to normalise policy further in 2024, upward pressure on long-term Japanese bond yields looks set to remain.

Refinancing needs warrants a step up in quality

In corporate bond markets, both investment grade and high yield bond spreads have held in well this year thanks to a combination of relatively resilient growth and relatively little refinancing. The wall of refinancing to much higher interest rates is, however, coming. At face value it looks like 2024 maturities should be perfectly manageable, but corporates tend to look a year ahead when assessing capital needs, making the step up in maturities in 2025 a problem that will need to be addressed in 2024.

Exhibit 14: The wall of refinancing

Global credit maturity schedule



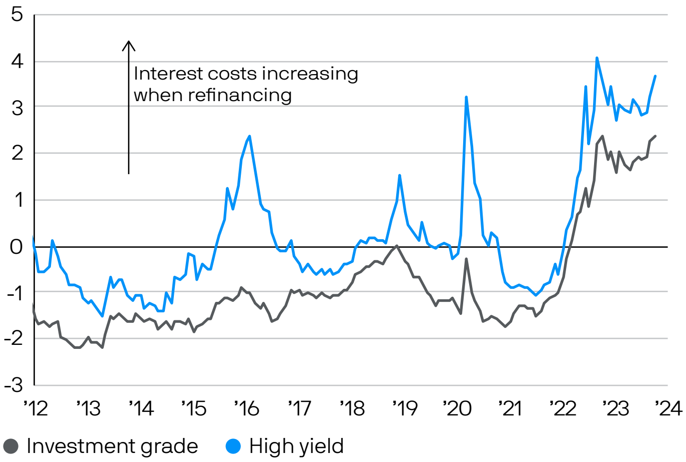
Source: Bloomberg, BofA, J.P. Morgan Asset Management. Global Investment Grade: BofA Global Corporate Index; Global High Yield: BofA Global Developed Market Non-Financial High Yield Constrained Index. 2024 maturities include bonds that have now dropped out of the index given less than one year until maturity. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

The situation is likely to be more problematic in high yield than it is in investment grade. While imminent maturities in high yield markets are not as large as investment grade counterparts, the gap between the current coupon and index yield is wider, suggesting a bigger jump in interest costs when corporates have to issue debt at higher rates.

Exhibit 15: Those refinancing face higher costs

Global corporate refinancing costs

% point difference between current yields and average coupon



Source: BofA, LSEG Datastream, J.P. Morgan Asset Management. Global Investment Grade: BofA Global Corporate Index; Global High Yield: BofA Global Developed Market Non-Financial High Yield Constrained Index. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

This outlook leaves us with a preference for investment grade over high yield, where total returns could also benefit from higher rate sensitivity if government bond yields start to fall.

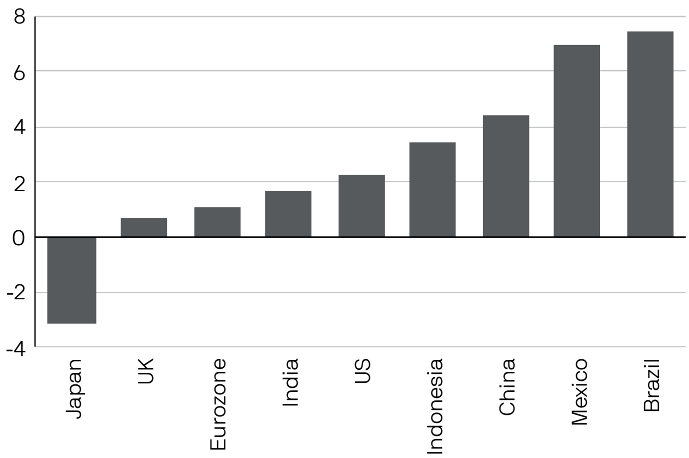
Emerging market debt

Local currency emerging market debt was a standout performer in 2023, given an environment of rapidly falling inflation and stable domestic currencies. High real rates and a shift to more dovish central bank policy – particularly in Latin America and Eastern Europe – provided plenty of tailwinds for these local markets. Going forward, the outlook is less straight forward. Geopolitical concerns raise the risk of a stronger US dollar, although further room for central bank easing should still provide a duration tailwind for local bonds.

Exhibit 16: EM central banks have more scope to cut given positive real rates

Real rates

%



Source: Banco Central Brasil, Banco de Mexico, Bank Indonesia, BLS, BoE, BoJ, ECB, Eurostat, Federal Reserve, IBGE, INEGI, India Ministry of Statistics & Programme Implementation, Japan Ministry of Internal Affairs & Communication, LSEG Datastream, National Bureau of Statistics of China, ONS, People's Bank of China, Reserve Bank of India, Statistics Indonesia, J.P. Morgan Asset Management. Real rates are calculated by deducting the headline inflation rate from the policy rate. Data as of 15 November 2023.

Tight US credit conditions are currently a headwind for hard currency emerging market debt, but possible monetary easing from the US Federal Reserve and a subsequent easing of credit conditions could improve the outlook for the sector in the second half of 2024. Finally, in an environment where we generally aim to focus on higher quality assets, it is worth noting that emerging market fundamentals continue to improve as reflected by the growing share of A and AA rated countries in the universe.

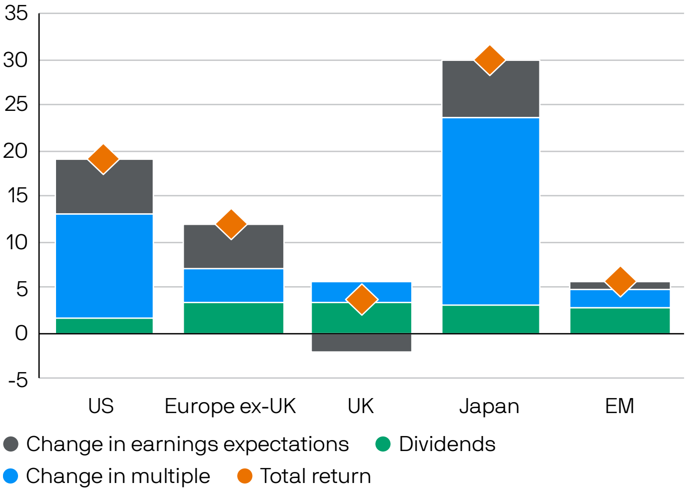
Equities: Problems at the margins

The resilience demonstrated by the global economy in 2023 helped to deliver positive returns for equity indexes in all major regions, but the drivers of these returns have varied significantly. Japan is the standout in local currency terms (although much less so in sterling or euro terms), benefiting from a significant re-rating.

Exhibit 17: Earnings resilience has helped stocks in 2023

Return decomposition year to date

Sources of equity market return, %



Source: FTSE, IBES, LSEG Datastream, MSCI, S&P Global, J.P. Morgan Asset Management. MSCI indexes used for Europe ex-UK, Japan and EM. US is S&P 500 and UK is FTSE All-Share. Returns shown in local currency, with the exception of EM which is in US dollars. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

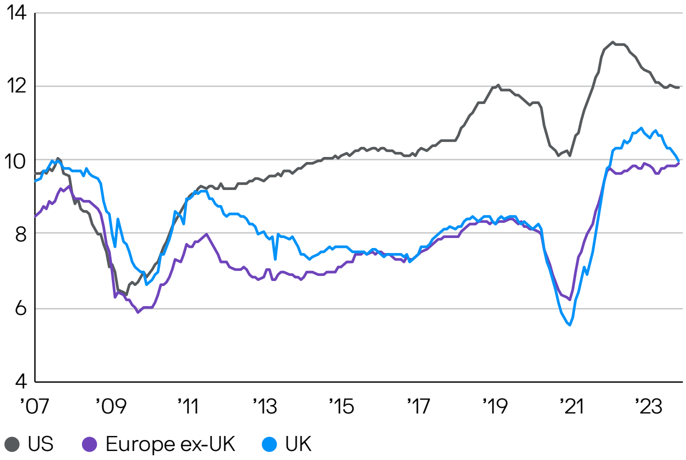
These moves leave most major equity markets looking neither cheap nor expensive heading into 2024. The US continues to trade at a major premium to others, but this is primarily driven by the megacaps, some of which have continued to deliver on what had appeared to be elevated earnings expectations. When stripping out the top 10 names, S&P 500 multiples move from 19x 12-month forward earnings to a more reasonable 17x.

The question is whether these valuations are flattered by overly optimistic earnings expectations. Looking at 2024 consensus forecasts, the 11% earnings growth currently expected for the US market stands out as high. Margins are our key concern, as firms are unlikely to have the pricing power they did in times of bumper consumer demand. Yet current analyst forecasts see US margins rising back towards record highs in 2024, and staying close to record highs in the UK and Europe.

Exhibit 18: There could be margin pressure as activity slows

Profit margins

%, margins of 12-month trailing earnings relative to sales



Source: FTSE, IBES, LSEG Datastream, MSCI, S&P Global, J.P. Morgan Asset Management. US: S&P 500, Europe ex-UK: MSCI Europe ex-UK, UK: FTSE All-Share. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

The picture for stocks looks more challenging on a relative basis versus credit. Over the past 10 years, developed market equity earnings yields have on average been around 300 basis points higher than the yield available on developed market, BBB-rated corporate credit. Today, that gap is less than 30 basis points.

Exhibit 19: The equity market faces stiff competition given bond yields

Equity and credit yields

% yield

Source: BofA, IBES, LSEG Datastream, MSCI, J.P. Morgan Asset Management. Developed market equities: MSCI World, Global BBB credit: BofA Global BBB Corporate Index. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

Identifying opportunities

Our highest conviction view across equity markets is a focus on higher quality stocks – those with robust balance sheets, proven management teams and a stronger ability to defend margins. Naturally some of these will be found in the technology sector, but there are also good examples in more cyclical sectors such as industrials and financials, as well as more traditionally defensive sectors such as healthcare.

We see merit in a balanced approach between growth and value styles. Market dynamics on this front in 2023 have been fascinating. A rising yield environment typically favours value sectors over their longer duration growth counterparts, and this has played out in Europe, Japan and emerging markets. The US is the only major market where growth has beaten value this year, making the outperformance of megacap tech that much more remarkable but also raising some questions about the sustainability of this trend. If a more benign macro scenario prevails, we would expect this to be relatively more positive for value-tilted sectors.

Income strategies are another component of an equity strategy with firmer foundations. Despite potential downgrades to earnings expectations ahead, we think that low payout ratios and solid balance sheets should still leave management plenty of room to return cash to shareholders.

From a regional perspective, European stock valuations look reasonable in absolute terms but compelling relative to the US, with a 30% discount to the S&P 500 – equivalent to levels last seen in the aftermath of the financial crisis. This is not just down to sector composition: European companies trade at an above average discount across many sectors at present.

While the European macro environment has clearly been weaker than the US this year, it does appear that much of this negativity is now reflected in prices, particularly when considering that European indices only generate 40% of their revenue domestically. Conversely, for the US market to deliver another year of outperformance versus its European counterparts, a lot will be riding on the "super 7" largest stocks, who will need to deliver on elevated earnings expectations.

The bull case for the UK is unlikely to be anchored around a major re-rating – the market is indeed cheaper than many others but this has been the case for some time and the catalysts for a turnaround are not obvious. Instead, the relative attractiveness of the UK is likely in its defensive characteristics. The FTSE 100 has the highest dividend yield of any developed market, UK stocks offer a relatively low beta to global stocks, and a high weight to the energy sector could prove a useful diversifier if higher oil prices challenge the disinflation narrative.

Japanese benchmarks have been helped by surging buybacks and hopes that the Japanese economy is out of its low growth, low inflation funk. However, the currency outlook remains the key risk as the Bank of Japan edges further away from yield curve control. Given the extent of the rally to date, we are cautious on the prospect of further significant upside from here.

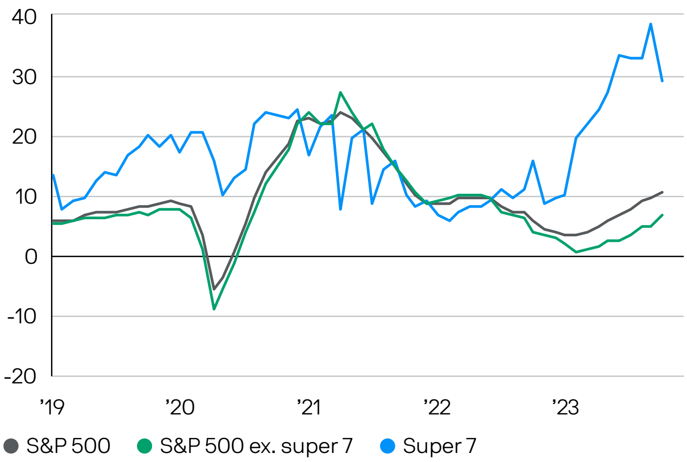
In China, recent fiscal stimulus should help to put a floor under the growth outlook, supporting consumer confidence and earnings. From a valuation perspective, again it appears that much of the negative macro newsflow is well reflected in prices, with multiples having completed a round trip over the past 12 months. In the absence of a big stimulus package, worries about the property sector and/or the geopolitical outlook will likely need to ease for the market to re-rate.

In sum, with still elevated uncertainty around the path for the economy in 2024, a regionally diversified approach appears prudent. In the US, mega cap tech will need to continue to beat an ever-higher bar when it comes to elevated earnings expectations. A softer landing for the economy is likely to benefit more cyclical regions such as Europe and emerging markets, while in the event of a deeper downturn, the more defensive characteristics of the UK market may come to the fore.

Exhibit 20: The megacaps have a high earnings bar to beat

12-month forward earnings expectations

% change year on year



Source: IBES, LSEG Datastream, S&P Global, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2023.

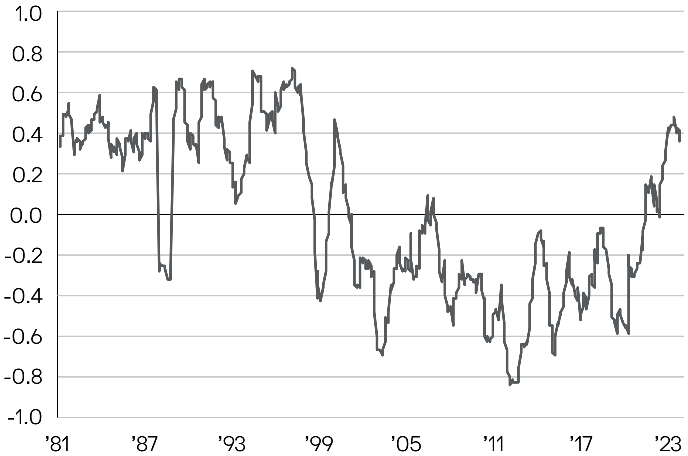
Targeted alternatives for targeted risks

Negative correlation between stock and bond prices has been a key pillar of portfolio construction for much of the past two decades. The resurgence of inflation flipped this relationship in 2022, with both bonds and equities losing ground as the market priced in higher policy rates to deal with ongoing price pressures. While inflation has declined substantially this year, stock/bond correlations have remained stubbornly positive, creating challenges for investors looking to build diversified portfolios.

Exhibit 21: The stock-bond correlation is unlikely to be reliably negative in the coming decade

S&P 500/US 10-year Treasury correlations

Rolling one-year correlation based on weekly returns



Source: LSEG Datastream, S&P Global, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

Looking ahead, we do expect the stock-bond correlation to return to negative territory in our base case scenario for the economy next year. We see weaker growth ultimately bringing inflation much closer to target, which in turn should eventually create room for central banks to cut rates to support the economy.

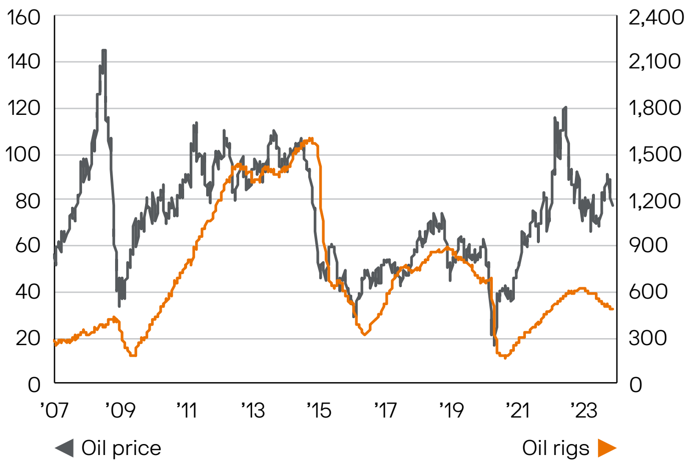
While this outcome would make diversification easier to come by in 2024, it's also important to note that we anticipate more volatility in the stock/bond correlation in the coming years, mainly because we think inflation volatility will also remain higher in the medium term.

Climate change is already leading to more food price volatility, with the summer droughts in India one of several recent examples. The pace of the energy transition is likely to receive greater attention as a result, yet despite many wind and solar sources now being cheaper than fossil fuel equivalents, significant price swings are still likely given the intermittency of renewable power. Meanwhile, the role that US suppliers have played in oil markets over the past decade to dampen price volatility – by increasing production as prices rose and vice versa – is no longer as prominent.

Exhibit 22: Oil and climate events may create cost shocks

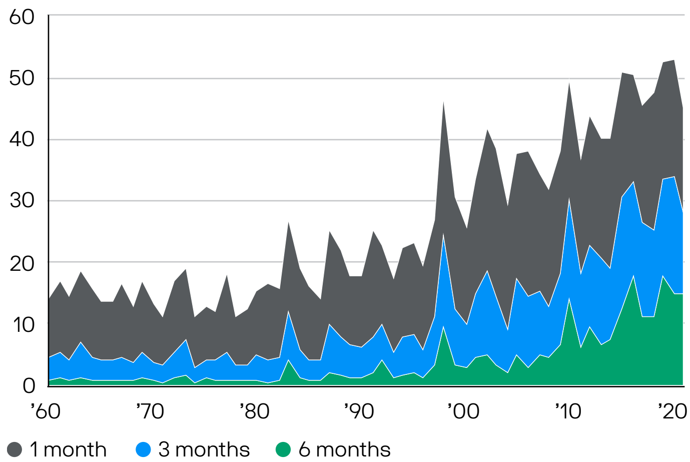
WTI crude oil price and US rig count

USD per barrel (LHS); number of rigs (RHS)



Land affected by droughts

% of global land affected by droughts per year



Source: (Left) Baker Hughes, Bloomberg, J.P. Morgan Asset Management. (Right) Global Standardised Precipitation-Evapotranspiration Index Database, 2021. Beguería, S et al., The Lancet Countdown on Health and Climate Change: 2022 Report, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

All of these shifts seem likely to increase inflation volatility, and therefore the unpredictability of the stock/bond correlation.

For investors, a less uniformly negative stock/bond correlation reinforces the need to use different assets to diversify against different risks. Fixed income will still be the key tool to diversify against disinflationary recessions, when central banks are able to ride to the rescue. But when it's too much inflation that's the worry, rather than too little growth, a broader toolkit of diversifiers will be required.

We therefore see an increased role in portfolios for real assets, such as private infrastructure and timber.

These asset classes historically have exhibited a low correlation to traditional assets, as 2022 demonstrated, and thus can often diversify against the inflation shocks that lead to periods of positive stock/bond correlation.

For investors that don't have access to private market vehicles, other diversifiers are on offer. Some public market alternatives – for example, real estate investment trusts – have disappointed recently as rising yields have resulted in equity-like volatility. But commodity strategies and hedge funds (which often benefit from higher levels of market volatility) could also help protect portfolios when both stocks and bonds are falling.

Exhibit 23: Look across alternatives for uncorrelated assets

Public and private market correlations

Correlations based on quarterly returns

	2008–2023	Global bonds	Global equities
Financial assets	Global Bonds	1.0	
	Global Equities	0.4	1.0
Global real estate	U.S. Core RE	-0.3	0.0
	Europe Core RE	-0.2	0.1
Real assets	Commodities	-0.2	0.0
	Global Core Infra	-0.1	0.1
	Transport	-0.2	0.0
	Timber	-0.2	-0.1
Private markets	Direct Lending	0.1	0.7
	Private Equity	0.3	0.9
Hedge funds	Equity Long/Short	0.3	0.9
	Macro	0.0	0.3

Source: Bloomberg, Burgiss, Cliffwater, FactSet, HRFI, LSEG Datastream, MSCI, NCREIF, J.P. Morgan Asset Management. Global equities: MSCI AC World Index; Global bonds: Bloomberg Global Aggregate Index; US core real estate: NCREIF Property Index – Open End Diversified Core Equity; Europe core real estate: MSCI Global Property Fund Index – Continental Europe; Direct lending: Cliffwater Direct Lending Index; Global infrastructure: MSCI Global Quarterly Infrastructure Asset Index (equal-weighted blend); Timber: NCREIF Timberland Total Return Index; Commodities: Bloomberg Commodity Index. Private equity is time-weighted returns from Burgiss. Hedge fund indices are from HFRI. Transport: returns are derived from a J.P. Morgan Asset Management index. All correlation coefficients are calculated based on quarterly total return data for the period 30/06/2008 – 31/03/2023. Returns are denominated in USD. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

Cash rates are a mirage

With short-term interest rates at their highest level since 2008, it is easy to sympathise with the view that cash looks tempting. If investors can get 4-5% with no risk of capital loss, why engage with stocks? And with no additional yield on offer from longer-term bonds, why is there any need to take on more interest rate risk?

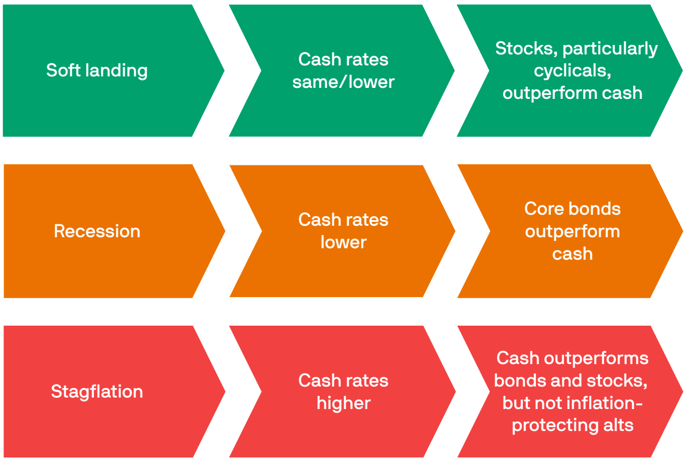
But today's cash rates are a mirage. They are likely to disappear as we get closer to a recession. If they stay high, it will be because the whole investment landscape has changed.

Consider the three most likely paths ahead for the global economy:

In a soft-landing scenario, where economies prove more resilient than we expect but inflation is not troublesome, cash may be a better option than government bonds, with central banks not needing to deliver on the interest rate cuts that are currently priced. Yet in this scenario, parts of the stock market would likely see some uplift as recession risk diminishes, outperforming cash. That upside could be substantial in cyclical parts of the market like small caps where valuations are currently modest.

In a mild recession, currently our base case, interest rates eventually bite. Consumer spending runs out of steam, businesses pull back on investment and weakening labour markets lead to a mild recession that helps to bring inflation back towards target. In this scenario, the attractive cash rates available today will no longer be available in a year's time, as central banks, convinced that their work is done, finally start to ease off the brakes. Sitting with large cash allocations therefore entails significant reinvestment risk. We would expect core bonds to outperform, as they have done in the two years at the end of each US rate hiking cycle since the mid-1980s.

Exhibit 24: Cash is unlikely to be the best option



Source: J.P. Morgan Asset Management, as of November 2023.

Stagflation, the final scenario, where the economy rolls over but interest rates are not cut, is arguably the most difficult and where cash has its appeal. Central banks could be forced to hike rates even further in a desperate bid to retain credibility and to keep inflation expectations anchored. Stocks would come under pressure due to a much weaker earnings outlook, while bonds would fall as investors repriced the path ahead for interest rates.

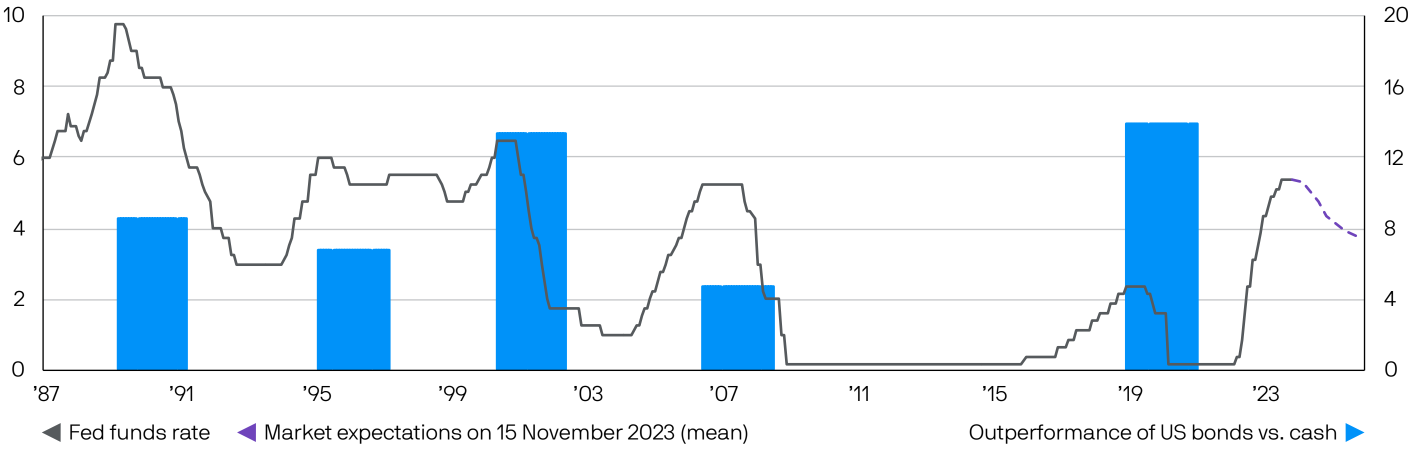
However, there are still options that we would expect to outperform cash, in both nominal and real terms. The best cash-beating solutions would be those in the private markets, with real assets such as infrastructure and timber well positioned to repeat their strong performance of 2022. Liquid solutions include commodity stocks and hedge fund strategies.

Over a much longer time horizon, cash looks even less attractive. $1 invested in 1900 in money markets would have amounted to just $2 by 2022 in real terms, i.e. adjusted for inflation. Bonds would have returned $9 over the same period. By far the best performer on a real basis was equities, returning $2,600. Hunkering down in the safety of cash is never the right investment strategy over a longer time frame.

Exhibit 25: Bonds outperform cash beyond peak rates

Relative performance of US bonds vs. cash after interest rate peaks

% (LHS); % points, two-year relative performance of US Aggregate bonds vs. cash (RHS)

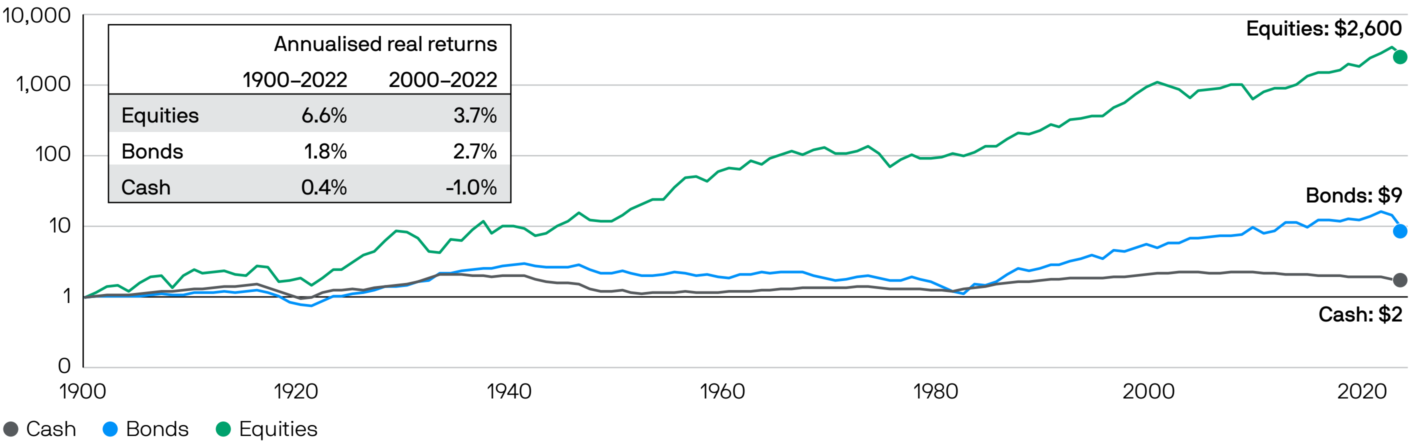


Source: Bloomberg, Bloomberg Barclays, Federal Reserve, ICE BofA, J.P. Morgan Asset Management. Market expectations are calculated using OIS forwards. Cash: ICE BofA 3-Month Treasury Bill Index; US bonds: Bloomberg Barclays US Aggregate Index. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

Exhibit 26: Cash is never king over the long term

Total return of $1 in real terms

USD, log scale for total returns



	Annualised real returns	
	1900–2022	2000–2022
Equities	6.6%	3.7%
Bonds	1.8%	2.7%
Cash	0.4%	-1.0%

Source: Bloomberg, Bloomberg Barclays, FactSet, Shiller, Siegel, S&P Global, J.P. Morgan Asset Management. Pre-2010 returns: Shiller, Siegel; from 2010: Equities: S&P 500; Bonds: Bloomberg Barclays US Treasury 20+ year Total Return Index; Cash: Bloomberg Barclays US Treasury Bills Total Return Index. Past performance is not a reliable indicator of current and future results. Data as of 15 November 2023.

Scenarios and risks

Our macro "base case" on a 12-month horizon expects mild recessions ahead. A productivity boom is central to the goldilocks environment, while the 'soft landing' scenario looks most closely aligned to current market pricing across both equities and fixed income. Stagflation is likely the most challenging scenario for most investors, but we would expect selected alternatives and commodity strategies to outperform cash.

Mild recessions (base case)

Macro: Developed market economies slip into mild recessions. Weaker growth helps to push inflation back towards central bank targets. Interest rates are eventually cut, albeit reactively rather than proactively, and to levels still well above pre-pandemic lows.

Markets: Moderate downside for stocks, with higher quality and income strategies outperforming. Positive environment for core fixed income, as yields are supported by markets pricing in further rate cuts ahead.

Goldilocks

Macro: Global growth reaccelerates while inflation continues to moderate, thanks to a combination of stronger productivity growth and rising labour participation helping to ease labour market pressures. Interest rates are lowered slightly, but significant cuts are not required given healthy levels of activity.

Markets: Strongest scenario for stocks, with higher beta and less highly valued areas such as small caps outperforming. Core bonds provide healthy income streams but yields remain largely rangebound.

Soft landing

Macro: Growth remains close to, or modestly below, trend across developed markets, while inflation falls back towards 2%. Interest rates are gradually lowered back towards "neutral", but more substantial rate cuts are not required.

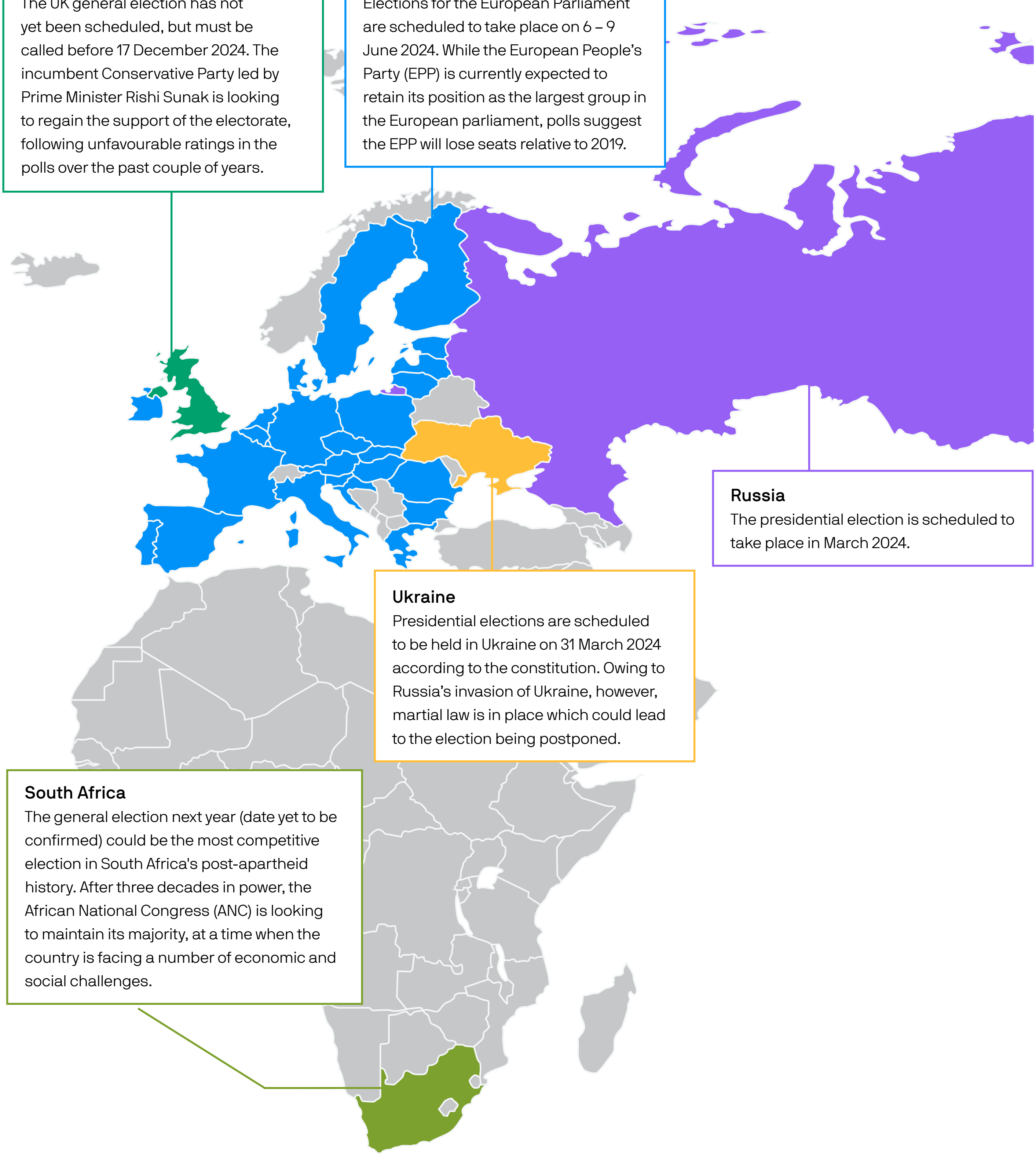
Markets: This scenario appears most aligned with current market pricing across both stocks and bonds. Core fixed income delivers coupon-like returns, while stock markets are largely rangebound.

Stagflation

Macro: Sticky inflation forces central banks to hike further into restrictive territory as policymakers fear a loss of credibility. Despite the damage this does to the global economy, rates are held in restrictive territory given elevated inflation pressures, resulting in a deeper recession.

Markets: Very negative environment for stocks, with pressure on both earnings and multiples. Rising yields on core fixed income lead to losses as stock/bond correlations remain positive. Real assets and commodity strategies outperform cash, while hedge funds that can benefit from higher volatility also perform well.

Appendix - EMEA



UK
The UK general election has not yet been scheduled, but must be called before 17 December 2024. The incumbent Conservative Party led by Prime Minister Rishi Sunak is looking to regain the support of the electorate, following unfavourable ratings in the polls over the past couple of years.

EU
Elections for the European Parliament are scheduled to take place on 6 – 9 June 2024. While the European People's Party (EPP) is currently expected to retain its position as the largest group in the European parliament, polls suggest the EPP will lose seats relative to 2019.

Russia
The presidential election is scheduled to take place in March 2024.

Ukraine
Presidential elections are scheduled to be held in Ukraine on 31 March 2024 according to the constitution. Owing to Russia's invasion of Ukraine, however, martial law is in place which could lead to the election being postponed.

South Africa
The general election next year (date yet to be confirmed) could be the most competitive election in South Africa's post-apartheid history. After three decades in power, the African National Congress (ANC) is looking to maintain its majority, at a time when the country is facing a number of economic and social challenges.

Appendix - Americas

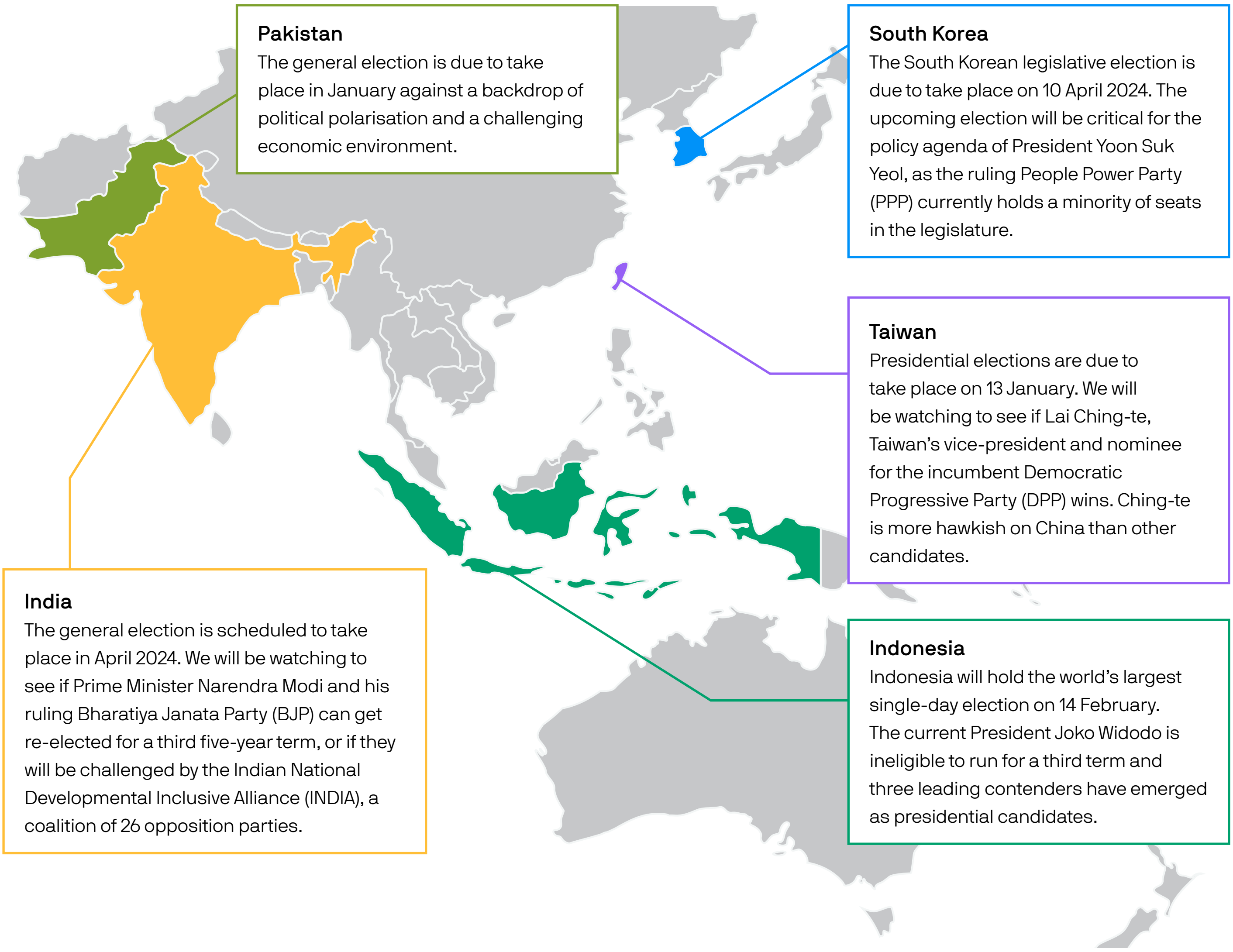
USA

The US presidential election is scheduled for 5 November 2024. If Biden and Trump go head-to-head, this would mark the first presidential rematch since 1956. The outcome of the election will impact global affairs given the differing stance between Republican and Democrats on a number of issues, including the war in Ukraine and climate action.

Mexico

A general election is scheduled to be held on 2 June 2024. The incumbent president Andrés Manuel López Obrador is ineligible to run for re-election. Four other candidates have emerged as potential replacements.

Appendix - APAC



Pakistan

The general election is due to take place in January against a backdrop of political polarisation and a challenging economic environment.

South Korea

The South Korean legislative election is due to take place on 10 April 2024. The upcoming election will be critical for the policy agenda of President Yoon Suk Yeol, as the ruling People Power Party (PPP) currently holds a minority of seats in the legislature.

Taiwan

Presidential elections are due to take place on 13 January. We will be watching to see if Lai Ching-te, Taiwan's vice-president and nominee for the incumbent Democratic Progressive Party (DPP) wins. Ching-te is more hawkish on China than other candidates.

India

The general election is scheduled to take place in April 2024. We will be watching to see if Prime Minister Narendra Modi and his ruling Bharatiya Janata Party (BJP) can get re-elected for a third five-year term, or if they will be challenged by the Indian National Developmental Inclusive Alliance (INDIA), a coalition of 26 opposition parties.

Indonesia

Indonesia will hold the world's largest single-day election on 14 February. The current President Joko Widodo is ineligible to run for a third term and three leading contenders have emerged as presidential candidates.

Authors

Karen Ward
Chief Market Strategist for EMEA

Paola Toschi
Global Market Strategist

Tilmann Galler
Global Market Strategist

Vincent Juvyns
Global Market Strategist

Hugh Gimber
Global Market Strategist

Max McKechnie
Global Market Strategist

Natasha May
Global Market Analyst

Zara Nokes
Global Market Analyst

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