The Investment Outlook for 2020: A Midyear Review

Investing in the Shadow of COVID-19

IN BRIEF

- Social distancing measures to combat COVID-19 have plunged the global economy into the deepest recession since the Great Depression.
- Some success in slowing the spread of the disease and a recognition of the economic toll from social distancing are leading to a relaxation of social restrictions. However, a resumption of a normal economy will have to await the widespread distribution of a vaccine, hopefully in 2021.
- In the U.S., following a huge GDP decline in the second quarter, we expect to see a sharp bounce in the third. However, progress from then on should be slow until a vaccine is distributed. This suggests double-digit unemployment into 2021.
- Fiscal stimulus will support living standards through the pandemic but will add to the risk of higher inflation, higher interest rates and higher taxes within a few years.
- While Fed easing and the recession have generally reduced Treasury rates, massive QE does threaten higher inflation and higher rates down the road. Meanwhile, the recession is leading to a wave of corporate downgrades.
- While there are good reasons for U.S. equities to remain relatively resilient in the midst of the social distancing recession, the rebound in stocks from their March lows may be overdone, risking a correction in reaction to disappointment in economic data or medical progress.
- Although the entire world economy has slumped into the social distancing recession in a similar way, the paths out could be quite different, and those economies with more disciplined public health practices or deeper pockets could fare better in the rebound.
- The extraordinary events of the past few months serve as a reminder of the benefits of diversification as well as the importance of paying attention to valuations and maintaining a long-term perspective in investment strategy.
THE STATE OF THE PANDEMIC

Any analysis of the global economy and financial markets in the middle of 2020 needs to start with an understanding of the pandemic itself. As this article goes to print, COVID-19 has killed over 400,000 people worldwide and 110,000 in the United States. The good news (as shown in Exhibit 1) is that radical adoption of social distancing has caused a plateau and a decline in both the number of confirmed cases and fatalities in the United States, as is the case across most advanced economies. However, with some relaxation in social distancing, it is likely that this progress will stall, if not reverse, in the months ahead.

Exhibit 1: Change in confirmed cases and fatalities in the U.S.
7-DAY MOVING AVERAGE, AS OF JUNE 4, 2020

![Graph showing confirmed cases and fatalities in the U.S.]

Data are as of June 4, 2020.

It is also worth noting that we are very far away from "herd immunity," which in a disease of this virulence, may not kick in until over 60% of the population is immune. Analysis of mortality data in South Korea, Taiwan, Australia and New Zealand, where the disease has been essentially wiped out through intensive testing, contact tracing and quarantining, suggests that COVID-19’s true mortality rate is close to 1%. If this is the case, and allowing for the lag between infection and mortality, less than 5% of the U.S. or global population has been infected to this point.

This suggests that, while better treatments may reduce mortality, both governments and families will likely continue to practice social distancing until a vaccine is developed, manufactured and distributed, hopefully in 2021. This, in turn, implies that the global economy will continue to suffer from the effects of social distancing well into next year.

THE U.S. ECONOMY: A SLUMP, A BUMP, A CRAWL AND A SURGE

It is clear that the U.S. has fallen into its deepest recession since the Great Depression. What is less obvious is the shape that the recession is likely to take in upcoming quarters. Some argue for a V-shaped recession, some suggest a U-shaped downturn and others grimly prophesy an L-shaped depression.

If, however, we recognize the current partial relaxation of social distancing behavior, acknowledge that there can be no full resumption of “life as normal” until a vaccine is distributed and finally assume that this occurs in the second quarter of 2021, then a pattern emerges. This pattern, which should be visible across real GDP, employment, profits and inflation, consists of a slump, a bump, a crawl and a surge.

On real GDP, it now appears that output could fall by about 40% annualized in the second quarter following a 5% decline in the first. It should, however, bounce higher in the third quarter, perhaps rising by more than 15% at an annualized rate, as manufacturing, construction and auto and home sales move back to more normal levels. However, thereafter progress should slow. One reason for this is that there are wide swaths of the economy where it is very difficult to achieve social distancing or operate profitably with social distancing protocols in place. In particular, activity in restaurants, brick-and-mortar retailing outside of groceries, air travel, hotels, sporting events and all large-group activities should remain severely depressed until a vaccine is widely distributed. The collapse in energy investment spending (due to low oil prices) and widespread state and local government layoffs will likely also weigh on economic activity in the months ahead. Consequently, we expect real economic growth to average roughly 5% annualized in late 2020 and early 2021, before accelerating to roughly 10% annualized for a few quarters once a vaccine has been distributed.
The decline in jobs has also been extreme in this recession, with the unemployment rate rising from a near 50-year low at the start of the year to 14.7% in April, before falling back to 13.3% in May. We expect that the unemployment rate will only fall slowly in the second half of 2020, due, in part, to the fact that many low-wage workers in the most affected industries are actually earning more from unemployment benefits than they did when working. Overall, we expect the unemployment rate to remain in double digits throughout the rest of this year and still be close to 8% by the fourth quarter of 2021.

Corporate profits should see a more accentuated pattern over the next two years. However, provided economic growth rebounds in 2021 and is accompanied by relatively low wage growth and interest rates, profits could set a new all-time high in 2022.

Finally, on the economy, inflation has already fallen as the recession has taken hold and could drift down further. However, because social distancing is constraining the supply of goods and services as well as demand for them and because of the unusual degree of government aid for consumers in the pandemic, inflation may not fall as much as some suspect in the recession and could well rebound in 2021 as the economy begins to regain its health.

In the midst of all of this, the federal government will likely continue to provide dramatic support for the U.S. economy. Four relief packages to date have carried a price tag of roughly 2.4 trillion USD. Despite partisan bickering, it is possible that further packages could be passed this summer and after the election with the potential to add another 2 trillion USD to the national debt. We do not believe this extraordinary level of fiscal stimulus will precipitate a near-term fiscal crisis. However, it is possible that, as the economy strengthens in 2022 and beyond, today’s extraordinary fiscal actions will result in higher inflation, higher interest rates and higher taxes.

Source: BEA, FactSet, J.P. Morgan Asset Management. Quarter-over-quarter percent changes are at an annualized rate. Average represents the annualized growth rate for the full period. Guide to the Markets – U.S. Data are as of June 4, 2020.
THE PANDEMIC AND THE 2020 ELECTION

Since the start of the year, the backdrop for the 2020 election has shifted dramatically, as the next administration’s policies will shape the economic recovery and build the foundation for the next expansion.

Historically, incumbent presidents have won reelection unless there was a recession during their term. Now, amidst a deep recession and the highest unemployment rate since the Great Depression, President Trump will either have to convince voters he has managed this crisis appropriately, driving the reopening of the economy, or rely on his signature issues such as immigration, trade protectionism and infrastructure. While signature issues may resonate with his fiercely loyal base, economic realities could be more decisive in swing states (Exhibit 4).

Exhibit 4: Unemployment rates in 10 states with tightest election races in 2016
APRIL 2020, SEASONALLY ADJUSTED

<table>
<thead>
<tr>
<th>State</th>
<th>Unemployment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Michigan</td>
<td>22.7%</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>23.4%</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>15.1%</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>14.1%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>14.1%</td>
</tr>
<tr>
<td>Florida</td>
<td>8.1%</td>
</tr>
<tr>
<td>Minnesota</td>
<td>10.6%</td>
</tr>
<tr>
<td>Iowa</td>
<td>10.6%</td>
</tr>
<tr>
<td>Arizona</td>
<td>12.2%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>12.2%</td>
</tr>
</tbody>
</table>

Source: BLS, J.P. Morgan Asset Management. Tightest races are defined by spread of popular vote between candidates. Organized left to right by tightest race, Michigan, to tenth tightest race, North Carolina. Data are as of June 4 2020.

Meanwhile, presumptive Democratic nominee Joe Biden is likely to emphasize his experience as vice president in the aftermath of the financial crisis, campaigning on helping the average American worker and reducing inequality by enhancing the Affordable Care Act (while maintaining private options), alleviating portions of student debt and proposing a corporate tax hike to 28% from 21% currently.

One issue both appear to agree on in principle, although perhaps not in implementation, is being tough on China, which is supported by both Republican and Democratic voters, as highlighted in Exhibit 5. This could lead to an even tougher trade stance, diverting supply chains, reducing investment and imposing restrictions on technology.

Exhibit 5: Percent of Republicans and Democrats who say they have an unfavorable opinion of China

The first half of the next presidential term will be squarely focused on rebuilding the economy. Infrastructure investment, which has bipartisan support, could be a key part of this. However, once the economy stabilizes, the government will have to tackle massive federal debt and a deep budget deficit, which, in conjunction with easy monetary policy, could cause an inflation spike, forcing higher rates and making debt expensive to service. Unpopular decisions may have to be made to raise taxes or cut spending to restore federal finances.

From an investment standpoint, the election itself should not change how investors are approaching the market. Although typically returns are lower and volatility is higher in election years, this is skewed by recessions and market events, such as the tech bubble in 2000 and the financial crisis in 2008. Returns and volatility in 2020 will almost certainly be attributable to COVID-19, not the political campaigns quietly existing alongside it.
U.S. FIXED INCOME: HEDGING RISKS WHILE MAINTAINING QUALITY

Core bonds performed well through the first half of 2020 as pervasive risk-off sentiment amidst a global recession and the reintroduction of quantitative easing (QE) domestically weighed heavily on long-term U.S. bond yields. Moreover, sharp reductions in policy rates to effectively zero and forward guidance from the Federal Reserve (Fed) should keep front-end yields near zero over the medium term.

While yields have moved lower, as highlighted in Exhibit 6, previous rounds of QE suggest—perhaps counterintuitively—that long rates tend to rise following the first few months of asset purchases and settle at a higher level even while purchases may be ongoing. There are three reasons that might explain this:

- **Fiscal stimulus**: In most instances, previous rounds of QE, similar to today, have been met with expanding budget deficits. Indeed, massive Treasury issuance to fund government spending plays a factor in the supply/demand balance within the market.

- **Money supply**: Large scale asset purchases increase the money supply, therefore increasing the risk of higher inflation. As a result, nominal yields may adjust in order to compensate for that risk.

- **Forward guidance**: Clear policy expectations set by the Fed help in supporting growth and inflation expectations, both of which are fundamental drivers of nominal bond yields.

**Exhibit 6: Long bond yields tend to rise during periods of QE**

CHANGE IN U.S. 10-YEAR TREASURY YIELD DURING PREVIOUS ROUNDS OF QE, BPS

Massive amounts of Treasury debt issuance and Fed buying could potentially lead to higher inflation as the economy recovers, pushing yields higher into 2021. Still, while yields may grind higher, uncertainties around the outlook are likely to limit just how much higher they can actually go. Therefore, fixed income investors should be balanced for the remainder of the year, maintaining an allocation to high-quality duration as a hedge against equity risk, while also positioning for slightly higher yields via assets like floating-rate bonds.

CREDIT: DOWN, DOWN, DOWNGRADES

Country-wide lockdowns have led to a collapse in corporate revenues and a subsequent wave of corporate downgrades. While both monetary and fiscal stimulus will partially offset the severity, the credit outlook looks quite bleak. As highlighted, through May 2020, 11% of investment-grade (IG) bonds have been downgraded: 7.5% have been within the IG space while 3.6% have been from IG companies falling into high yield (fallen angels). Notably, this is the fastest pace of net downgrades (9.6%) over the past decade. Moreover, net downgrades are expected to reach 13%-15% by year-end with acute pain being felt across the auto and energy sectors, suggesting there is more pain to be felt.

2020 is shaping up to be a brutal year for corporate downgrades, suggesting the need for careful security selection within fixed income and a tilt toward quality.

**Exhibit 7: Non-financial net IG-credit rating downgrades**

<table>
<thead>
<tr>
<th>Year</th>
<th>% rising stars</th>
<th>% fallen angels</th>
<th>% upgraded within HG</th>
<th>% downgraded within IG</th>
<th>Net downgrades/upgrades</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>-1%</td>
<td>-3%</td>
<td>6%</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>2008</td>
<td>2%</td>
<td>-2%</td>
<td>4%</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>2009</td>
<td>6%</td>
<td>-2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>2010</td>
<td>0%</td>
<td>-6%</td>
<td>0%</td>
<td>0%</td>
<td>-6%</td>
</tr>
<tr>
<td>2011</td>
<td>-4%</td>
<td>-9.6%</td>
<td>0%</td>
<td>0%</td>
<td>-9.6%</td>
</tr>
</tbody>
</table>

U.S. EQUITIES: UNREASONABLE RESILIENCE?

Investors have been caught flat-footed by the uninterrupted bounce back in equity markets from the March 23 lows. In general, this rally is driven by three things — a slowdown in case growth, the fiscal and monetary policy response and the expectation of a V-shaped recovery in corporate profits.

We acknowledge that case growth has slowed and the policy response has been significant, but doubt that S&P 500 earnings per share will hit a new all-time high next year. The majority of the weakness in 2020 profits will come during the second quarter. That said, markets are inherently forward looking. While we acknowledge that earnings growth will improve in 2021, it seems like a V-shaped recovery will be difficult to achieve. Historically, it has taken about three years for earnings to reach a new all-time high following a drawdown, and the economic recovery looks set to be somewhat muted. The sectoral mix of the equity market is far different from that of the economy, but it is still important to recognize the relationship between nominal GDP and earnings.

Many investors are questioning the sustainability of market valuations. Our research shows that a 50bp decline in the 10-year U.S. Treasury yield should add around 1x to the market multiple; with the 10-year down about 100bps from earlier this year, this helps to explain some of the increase in valuations during recent months. At the same time, however, falling earnings estimates have corresponded with a market rally, putting further upward pressure on valuations.

That said, it is important to remember that valuations are not a good short-term indicator, and stocks can get more expensive before they get cheaper. Markets seem to care much more about the direction of the data, rather than the level, and the gradual reopening of the economy seems to be commanding the majority of investors’ attention at the current juncture. However, plenty of risks still remain, and investors will be watching closely for any signs of a reacceleration in case growth, or alternatively a signal that policymakers are considering closing the stimulus taps. As such, markets may trend higher in the short-run, but will likely be range bound until a medical solution has been developed and made available. The silver lining to all of this is that markets may be able to grow into the elevated valuations we are observing at the current juncture.

INTERNATIONAL ECONOMY: SAME SHOCK, DIFFERENT PATHS OUT OF IT

Over the next few quarters, the global economy will begin to recover from its COVID-19 induced deep recession. Global activity will likely turn positive in the third quarter, as most countries will have rolled back their most severe social distancing restrictions. However, the recovery will be slow until a vaccine is distributed globally, most likely in 2Q21. From then on, a surge in activity is likely to follow for a few quarters as pent-up demand is unleashed. 2020 will be remembered as the year with the largest contraction in global economic output since 1946; 2021 will likely be remembered as the opposite, with the fastest growth since 1976.
No part of the world has been immune to the effects of COVID-19, but the timing and pace of the recovery from it will vary by sector and region. Given the need for caution until a vaccine is distributed, the recovery will be led by industries that can function while some social distancing is practiced (manufacturing and construction) and lagged by industries that have to operate below normal (social distancing-impacted services sectors). Regionally, the recovery will be led by countries that were able to efficiently deal with the health issue (several countries in Asia) or by countries that have deep pockets to provide fiscal support for households and corporations during a lengthier battle with the disease (Europe). Countries that fail to do one or the other will lag behind, with a slower recovery in 2021 (Latin America and EMEA).

The IMF estimates 9 trillion USD of fiscal measures across the G20; however, stark differences exist beneath the surface (Exhibit 9). Developed countries have provided significantly larger support than emerging ones, which have feared the consequences in bond and currency markets. With its faster reopening, Asia did not need large fiscal responses, but it will be sorely missed in other emerging market (EM) regions. Given the initially slow pace of economic recovery and low oil prices, inflation will likely remain low over the next 18 months. As a result, central banks in both developed and emerging markets will keep interest rates near record lows, liquidity ample and credit flowing. Rate hikes and discussions around normalizing central bank balance sheets will likely be deferred until 2022. This will continue to facilitate spending on fiscal relief packages, especially in developed countries.

Thinking beyond the initial aftermath of COVID-19, it is worthwhile to consider whether some things may change during the next cycle, as we move from recovery to expansion in 2022 and beyond. Some may not, such as low economic growth in developed markets versus a sizable growth alpha in emerging markets, led by India and China. However, once this next cycle truly gets under way, we might finally see higher inflation and higher interest rates in developed markets given the large fiscal measures of 2020.

### Exhibit 9: Fiscal support has been much larger in developed countries

**FISCAL RESPONSE TO COVID-19 PANDEMIC, % OF GDP**

<table>
<thead>
<tr>
<th>Country</th>
<th>Loans, equity and guarantees</th>
<th>Spending and revenue measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Africa</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>India</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>Mexico</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>Russia</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>Turkey</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>Argentina</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>China</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Brazil</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>Korea</td>
<td>11%</td>
<td>11%</td>
</tr>
<tr>
<td>Canada</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>Spain</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>United States</td>
<td>19%</td>
<td>19%</td>
</tr>
<tr>
<td>Australia</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>France</td>
<td>34%</td>
<td>34%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>34%</td>
<td>34%</td>
</tr>
<tr>
<td>Japan</td>
<td>34%</td>
<td>34%</td>
</tr>
<tr>
<td>Italy</td>
<td>34%</td>
<td>34%</td>
</tr>
<tr>
<td>Germany</td>
<td>34%</td>
<td>34%</td>
</tr>
</tbody>
</table>

Source: IMF, J.P. Morgan Asset Management. Data are as of June 4, 2020

### INTERNATIONAL MARKETS: SURVIVING 2020 TO THRIVE IN 2021 AND BEYOND

Like the economy, global earnings are likely to see a plunge in the first half of 2020, a slow recovery in the second half and a surge in 2021. Beneath the surface, cyclical sectors like energy, industrials, financials and consumer discretionary are seeing the biggest earnings contractions. Regionally, these are sectors with larger representations in EMEA, Latin America, Japan and Europe (Exhibit 10). This helps to explain why international equities (MSCI ACWI ex-U.S.) have underperformed U.S. equities by 900bps year-to-date. EM Asia has been significantly more resilient than other regions, given its faster domestic recovery, as well as its heavier weighting toward a COVID-19 beneficiary sector like technology at 21% of its index.

Going forward, investors should ask themselves: 1) Which markets will be more geared toward the eventual global recovery? And 2) Which markets may be more geared toward the next cycle’s themes? Once a stronger economic recovery begins, cyclical sectors and regions will see a stronger earnings rebound. This suggests stronger performance up ahead for regions such as Europe, Japan and emerging markets. In addition, emerging markets are exposed to one of the next decade’s biggest growth stories: the emergence of the EM middle class, which benefits sectors like financials and consumer discretionary and a region like EM Asia in particular. Lastly, should inflation pick up and rates move higher over the next cycle, value-oriented regions, like Europe, would benefit.
The COVID-19 shock has created a better entry point for investing in the global recovery and positioning for the next cycle’s global themes. The MSCI ACWI ex-U.S. discount to the U.S. now sits at 27% versus the 20-year average discount of 8% (trailing price-to-earnings ratio). In addition, currencies have depreciated 8% versus the U.S. dollar, making the dollar even more expensive and prone to a greater depreciation cycle.

Turning to international bonds, while the recovery is slow and uncertain, interest rates will remain capped and quality will remain top of mind for investors, leading to outperformance of core developed market government bonds over those in emerging markets, and of investment-grade over high yield issuers. However, opportunity has been created in riskier areas of the bond market, such as EM corporate and sovereign debt. Spreads have widened significantly since the beginning of the year, retracing only 40% of March’s widening and remaining about 200bps higher than on December 31. These levels suggest the potential for double-digit returns over the next two years, if investors can select the companies and countries that will survive 2020.

Exhibit 10: Cyclical exposure varies by region

Cyclical sectors include energy, materials, financials, industrials and consumer discretionary. Data are as of June 4, 2020.

ALTERNATIVE INVESTMENTS: DIVERSIFICATION IN A DOWNTURN

High-quality fixed income provides you with protection, but no income. Risk assets increasingly provide you with growth, but no protection. In a world where real rates are negative, and taking on equity beta is the only way to generate yield, adding alternative investments to a portfolio is emerging as a way of solving for diversification, income and growth.

In real estate, the COVID-19 induced downturn likely accelerates trends that were already in place before the virus began to spread. This means that headwinds to retail properties have strengthened, tailwinds for industrial properties have been reaffirmed and the office sector will remain in a state of flux. That said, we still see value in direct real estate as a source of income, and more broadly, as a portfolio diversifier. On the public side of real estate, REITs provide exposure to more forward-looking sectors like data centers, and simultaneously allow for a more liquid access point to the asset class.

Turning to infrastructure, assets that exhibit less sensitivity to the business cycle are looking increasingly attractive, as much of the prior expansion saw investors chase highly cyclical assets in an effort to obtain private equity-like returns. At the current juncture, however, a focus on regulated utilities and contracted assets, where cash flow is the more significant driver of returns, seems prudent.

Private equity funds may not struggle the same way they did coming out of the financial crisis. With financing much more readily available through a number of different channels, general partner (GPs) may be better able to take advantage of depressed valuations. Deal activity will slow, but gradually rebound as the outlook stabilizes, and preferences for technology, health care and anything tied to e-commerce will be reinforced.

Private credit has long been an area of concern. Funds that are in the process of returning capital will take a hit, as a significant share of direct lending is comprised of COVID-19 exposed sectors. There is an evolving opportunity for distressed managers, as well as direct lenders that can provide financing for companies that may be unable or unwilling to tap into Fed facilities. That said, caution is still warranted given uncertainty around the duration of this downturn.

In sum, investors should look to core real assets for uncorrelated sources of income, private equity for growth and idiosyncratic opportunities in private credit. As always, however, manager selection will remain of the utmost importance.
TACTICS AND TIMETABLES: ASSET ALLOCATION FOR THE RECESSION AND BEYOND

When considering asset allocation today, tactics depend on timing. Investors must consider if they are positioning themselves for the short term — the trough of the recession and any modest pre-vaccine recovery — or the longer term — the post-vaccine resurgence in global economic activity and the growth thereafter. Doing so will determine the amount of risk justifiable in a portfolio.

So long as COVID-19 remains a major public health concern (as in, before a vaccine is widely available), investors should position themselves defensively.

Central bank policy easing has pushed bond yields to near-record lows, and stress in credit markets created by cash flow concerns has added further complications to the hunt for yield. Given this, investors should be generally underweight bonds and use them primarily as ballast: quality is key, suggesting sovereigns, investment-grade corporates, agency MBS and high-quality municipal debt; and given the risk of an equity market correction or medical disappointment, which could push yields lower, duration can hedge returns. Moreover, the favorable U.S. yield environment relative to the rest of the developed world suggests a domestic bias.

Being underweight bonds necessitates being overweight stocks, which may seem antithetical to the idea of defensive positioning. However, as within fixed income, a tilt toward quality eases some of these concerns. A focus on larger-cap stocks is warranted given their better profitability and lower debt loads, while certain sectors — namely technology, consumer staples and health care — provide both a quality tilt and take advantage of current social distancing-related trends.

In addition, the global nature of this pandemic and the reemergence of trade tensions suggest that another global flight to quality — as witnessed in the first quarter — may come later this year; a domestic tilt would protect against this.

For investors looking beyond the immediate crisis, however, portfolios do not need to be as defensive. Global yields are likely to rise alongside stimulus-related inflation, improving the income prospects of bonds but making duration less appealing. In addition, while some of the near-term equity market winners may continue their winning streak — namely technology and health care — investors can expand their allocations to take advantage of more cyclical trends as well, like the return of consumer discretionary names and financials.

The ability to take risk also allows investors to move down the market cap spectrum, as small caps typically outperform in recoveries, and focus more on international assets, with high growth opportunities in the emerging world, especially Asia, and valuation and income-related tailwinds in certain developed markets like Europe and Japan.
COMMON SENSE IN UNCOMMON TIMES

Timeless investing principles are especially relevant in the current recession given the heightened uncertainty and volatility. As the world recovers from COVID-19, investors must follow common sense principles in uncommon times, including remaining diversified, having an investment plan, and staying invested in equities. Diversification remains essential even with rates at historic lows, as good quality fixed income will serve as a ballast if the economy suffers another shock. Having an investment plan is key, and investors should create sustainable and diverse income streams from equities and alternatives. For instance, realizing capital gains can support income streams in a low yield environment. Additionally, a heightened focus on quality in portfolios will be essential to many investment plans. Finally, equities remain the powerhouse in portfolios, and staying invested and avoiding the urge to time the market is more important than ever. Being a long-run investor improves investment outcomes; historically, the value of equities, fixed income and 50/50 portfolios increase and the range of potential returns shrinks over a five-year, 10-year or 20-year period (Exhibit 12).

Exhibit 12: An intense focus on the next year is warranted but keep an eye to the longer run

RANGE OF STOCK, BOND AND BLENDED TOTAL RETURNS, ANNUAL TOTAL RETURNS, 1950-2019

<table>
<thead>
<tr>
<th>1-yr.</th>
<th>5-yr. rolling</th>
<th>10-yr. rolling</th>
<th>20-yr. rolling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks</td>
<td>47%</td>
<td>28%</td>
<td>19%</td>
</tr>
<tr>
<td>Bonds</td>
<td>13%</td>
<td>13%</td>
<td>19%</td>
</tr>
<tr>
<td>50/50 portfolio</td>
<td>15%</td>
<td>1%</td>
<td>9%</td>
</tr>
</tbody>
</table>

Annual avg. total return:
- Stocks: 11.3%
- Bonds: 5.9%
- 50/50 portfolio: 8.9%

Growth of $100,000 over 20 years:
- Stocks: $844,684
- Bonds: $313,758
- 50/50 portfolio: $555,161


The current downturn highlights how quickly things can change, as nobody could have predicted the current economy at the start of the year. While uncertainty remains elevated, more clarity will come as the economic situation evolves, and the new cycle will have different characteristics and investment themes. While an intense focus on the current “uncommon” situation is justified, it should not come at the expense of preparing for the recovery and “common” times ahead.
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