2024 Mid-Year Investment Outlook

A rising tide lifting most investment boats

Key takeaways

- The U.S. economy looks set to see a continuing gradual moderation in economic growth, jobs and inflation, providing a rising tide to support most long-term risk assets.
- International economic data have begun to inflect upwards, with further room to run given still below trend consumption and lower inflation. Positive economic surprises suggest peak pessimism about international. More progress in disinflation in some corners mean some central banks moving before the Fed, keeping the dollar elevated.
- Given the swift repricing in policy rate expectations that occurred in the first half of the year, we expect long term interest rates to generally stabilize for the remainder of this year. However, given the shallow path of expected rate reductions in the years ahead, the yield curve is likely to remain inverted for some time, suggesting active management around duration and credit are key.
- After a strong run in U.S. equities, the backdrop remains supported by healthy earnings growth, increased investment in AI and a wave of buyback announcements. Opportunities remain, but valuations are not cheap and return expectations should be more modest from here.
- U.S. concentration within global equities is extreme, but other markets have begun to catch up. A positive cyclical turn, combined with structural tailwinds and cheap valuations, suggest more strong performance to come, with a broadening out by company and region than seen thus far.
- Through diversification, inflation protection and alpha generation, opportunities in alternatives can help better prepare portfolios for challenges that may lie ahead.
- Despite significant uncertainty, the outlook for the rest of 2024 remains constructive, though investors would do well to broadly diversify across high-quality assets.

J.P.Morgan
ASSET MANAGEMENT

U.S. economy: Extending the expansion

The economic expansion, which started with a very swift rebound from the pandemic recession in April 2020, has now entered its fifth year. However, while growth remains a little stronger than expected and inflation a little hotter, the broad trend is of an extended expansion powered by voracious consumers, a surge in immigrant workers and competition suppressing inflation. The economy has now survived its cyclical fever and will likely continue on a path of mildly moderating growth and inflation unless and until it is hit by some unexpected substantial shock.

The first impression presented by recent GDP numbers is one of sharp deceleration, with real GDP growth falling from 4.9% annualized in the third quarter of 2023 to just 1.3% in the first quarter of 2024. However, first impressions can be deceiving and are in this case. Most of the measured slowdown was due to a sharp downturn in net exports and inventory accumulation, the two most volatile and, arguably, mismeasured components of GDP. Excluding these sectors and looking instead at final sales to domestic purchasers, real growth downshifted much more modestly from 3.5% in the third and fourth quarters of 2023 to 2.5% in the first quarter of 2024. Early estimates suggest real GDP growth of roughly 2.5% in the second quarter, continuing a growth trend that is well above the Federal Reserve's (Fed's) estimate of the long-run growth potential of the U.S. economy, currently pegged at 1.8%.

This growth is particularly remarkable given the widespread recession fears of a year ago and is mainly due to two factors. First, consumer spending has remained remarkably strong even in the face of dwindling pandemic savings. With an extended period of positive real wage growth and significant recent gains in wealth, consumer spending should continue to drive the expansion forward into 2025.

The other big surprise in the past year has been the resilience of investment spending in the face of higher interest rates and a credit crunch exacerbated by last year's mini banking crisis. This resilience largely reflected healthy corporate balance sheets, federal government incentives and a surge in demand for AI-related technology. This also should continue into 2025, providing the potential for continued moderate economic expansion in the absence of a major shock.

Labor markets have also shown some moderation in recent months with the unemployment rate edging up to 4.0% from a low of 3.4% set in April 2023. Still, the unemployment rate has now remained at or below 4% for two and a half years, the longest such stretch since the late 1960s. Job openings have continued to ease but remain above pre-pandemic levels. Remarkably, despite some modest deceleration in recent months, non-farm payrolls have climbed by almost 2.8 million over the past year, as labor force participation among those aged 18-64 has continued to rise and the labor force has been bolstered by a surge in new migrants. Equally remarkable, wage growth has continued to decelerate, with the year-over-year (y/y) change in average hourly earnings falling from 4.6% in May 2023 to 4.1% a year later.

This moderation in wage growth, perhaps reflecting both the long-term decline in unionization and a surge in relatively low-wage immigrant workers, is allaying fears of cost-push inflation. Still, progress toward lower inflation has stalled in recent months with a rebound in energy prices, only a very slow decline in shelter inflation and auto insurance rates still up by more than 20% y/y. We expect these impacts to gradually fade in the months ahead. However, we now expect CPI inflation to only fall from 3.3% y/y in May to roughly 2.9% by December. Equally importantly, we expect inflation as measured by the personal consumption deflator to ease only slowly from 2.7% in April 2024 to 2.5% by the end of this year and reach the Fed's target of 2% in the middle of 2025.

Overall, the slowdown in growth and inflation has been delayed in 2024, somewhat frustrating Fed officials who expected a swifter moderation. However, with solid economic growth, low unemployment and most of the journey back to 2% inflation completed, the U.S. economy should continue to provide a rising tide to support most investment boats for the rest of this year and into 2025.

Assessing the market impact of the 2024 presidential election

After a stretch of strong investment returns, the 2024 presidential election adds an extra element of uncertainty for investors. The contest marks the first presidential rematch since 1956 and will come into greater focus this summer as campaigning heats up. However, while elections can garner a significant amount of attention in American life, their impact on investment outcomes is often much more muted. This is because it is policy, not politics, that matter for investment outcomes.

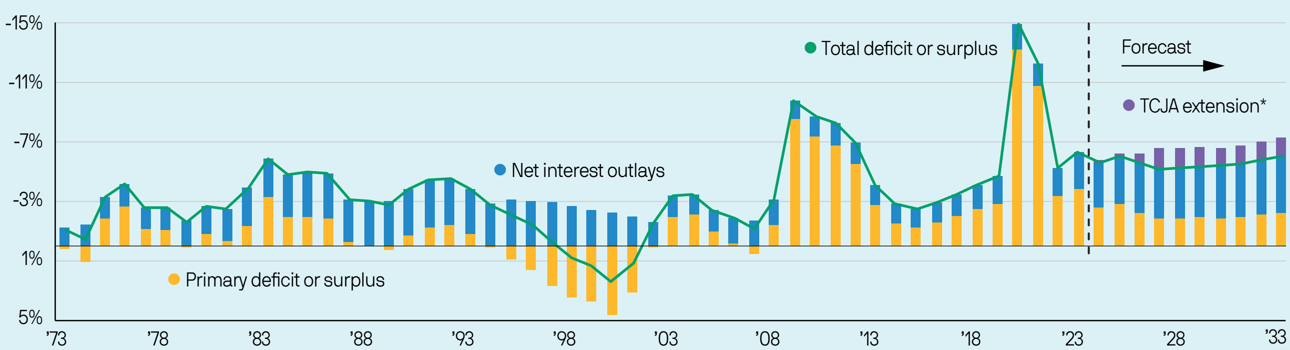
As such, which policy issues should investors be mindful of? First, taking center stage of the fiscal debate will be the decision of whether to extend tax cuts from the 2017 Tax Cuts and Jobs Act (TCJA). The challenge here is two-sided for both candidates: either extend the tax cuts and increase the debt or allow the tax cuts to expire and hurt growth. So far, Biden has proposed a partial extension of the tax cuts and expanded tax credits with potentially higher taxes on wealthy households and corporations. Whereas Trump has pledged to make the individual and estate tax cuts of the TCJA permanent, partially offset with spending cuts. Under either candidate, deficits are likely to widen (primarily due to rising interest costs) and discretionary spending is likely to be cut, creating a modest headwind for growth and some upside risk for yields.

Outside of taxes, immigration and U.S./China trade policy will also be key issues. In either outcome, immigration is set to slow after a period of significant border crossings boosted net immigration to an estimated 3.3 million in 2023.[1] Many economists believe this boost in labor supply has enabled the goldilocks combination of strong growth and declining wage inflation, with continued improvements expected as migrants are integrated into the workforce. New restrictive measures could limit this effect. On trade, both candidates have reflected a "tough on China" stance with renewed attention placed on tariffs. However, the secular trend of friend-shoring and diversification from China will likely continue and the effect of tariffs and supply chain realignment on inflation and U.S. profit margins has so far been muted.

The campaign season will surely see many bold promises to implement major change, but their translation to real policy change is hardly straightforward, and even less so to investment outcomes. Instead, economic context is the more powerful driver of market performance. As such, investors would do well to maintain a disciplined approach to investing, avoiding the pitfalls that could potentially derail portfolios from their long-term goals.

Under either election outcome, deficits will likely widen

Exhibit 1: Federal deficit and net interest outlays. % of GDP, 1973-2034, CBO Baseline Forecast



Source: CBO, J.P. Morgan Asset Management. Estimates are based on the Congressional Budget Office (CBO) February 2024 An Update to the Budget Outlook: 2024 to 2034. *Adjusted by JPMAM to include estimates from the CBO May 2023 report "Budgetary Outcomes Under Alternative Assumptions About Spending and Revenues" on the extension of TCJA provisions. Assumes the following provisions from the TCJA are extended: changes to individual income tax provisions, higher estate and gift tax exemptions, changes to the tax treatment of investment costs and maintaining certain business tax provisions going into effect in 2023. Guide to the Markets – U.S. Data are as of May 31, 2024.

[1] Brookings, "New immigration estimates help make sense of the pace of employment," March 7, 2024.

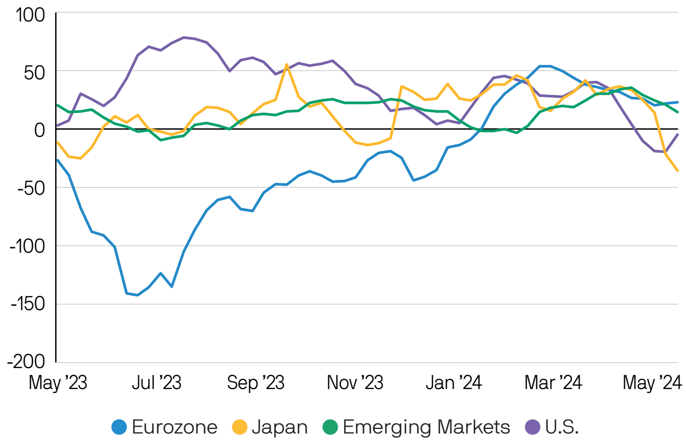
International economy: Growth convergence, but central bank divergence

Entering 2024, we expected continued resilience in the global economy, but with less divergence beneath the surface. Last year, the U.S., Japan and pockets of emerging markets (EM) excluding China surprised positively, while the eurozone, UK, Canada and China ended up disappointing. Consumers are at the heart of the story. While U.S. and Japanese consumer goods spending has surpassed pre-pandemic trends, this has not been the case in the eurozone, UK and China, with spending still 6%, 10% and 19% below trend, respectively. In Europe, the energy price shock unleashed by the war in Ukraine dampened consumer confidence and spending, while China's "Zero COVID Policy" and housing market slump left households cautious. Some of this divergence is now diminishing.

In the eurozone and UK, consumer confidence has been increasing consistently since October due to solid real income gains for households as inflation has finally decreased. This should power consumption moving forward. Additionally, the region is heavily exposed to manufacturing, which is now stabilizing, propelling Europe's composite PMIs higher by 6 points since last year's low. In China, the upturn in consumption should remain gradual given the continued weakness in the housing market. However, late last year's pro-growth turn by Chinese policymakers has continued into this year. Fiscal policy continues to support infrastructure and advanced manufacturing – and has turned more forcefully toward housing in May – which should stabilize China's growth rate at around 5%. Elsewhere in Asia, early signs of a global recovery in technology-related exports should benefit the big exporters, such as Korea and Taiwan. Lastly, India's strong growth momentum should continue, as the election outcome still implies continuity of major economic reforms. Encouragingly, economic surprises have turned positive in the eurozone and emerging markets while those in the U.S. have turned negative (**Exhibit 2**). This suggests that we may have passed peak optimism about the U.S. economy and peak pessimism about the rest of the world.

Expecting too much good news in the U.S. and bad news abroad

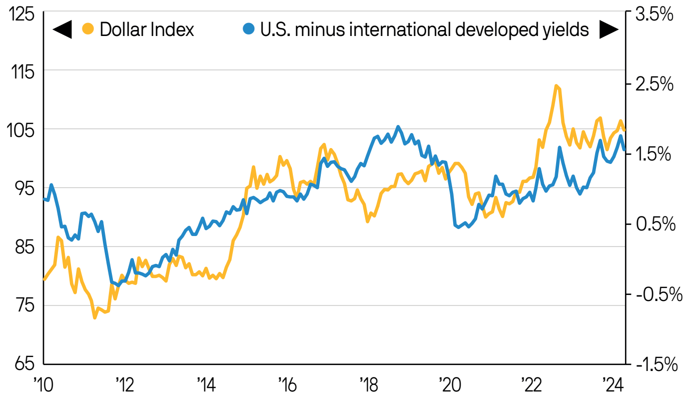
Exhibit 2: Citi Economic Surprise Index, weekly



Source: Citi, FactSet, J.P. Morgan Asset Management. Data are as of May 31, 2024.

The U.S. dollar should stay strong but may be topping out

Exhibit 3: DXY Index, U.S. and intl. dev. interest rate differentials, monthly



Source: Bank of Canada, FactSet, Federal Reserve Economic Data (FRED), Ministry of Finance of Japan, MSCI, OECD, Standard & Poor's, J.P. Morgan Asset Management. The dollar index (DXY Index) is a nominal trade-weighted index of major trading partners' currencies. Major currencies are the British pound, Canadian dollar, euro, Japanese yen, Swedish kroner and Swiss franc. DM is developed markets, and the yield is calculated as a GDP-weighted average of the 10-year government bond yields of Australia, Canada, France, Germany, Italy, Japan, Switzerland and the UK. Past performance is not a reliable indicator of current and future results. Data are as of May 31, 2024.

On the other hand, progress on disinflation has become more uneven, leading to divergent paths for central banks. Since December, year-over-year U.S. core inflation has moved down 30bps, compared to 80bps in the eurozone and 90bps in the UK. While expectations of Fed rate cuts have been pushed back and reduced, they have been pulled forward for the European Central Bank and the Bank of England – with European central banks now likely to cut rates first. For EM central banks, the delay in Fed cuts has led to slower or delayed rate-cutting cycles in response to currency pressure. Two important exceptions remain: China, continuing its stimulative monetary policy, and Japan, which finally embarked on a very gradual rate-hiking path.

Instead of decreasing, the U.S. rate differential with the rest of developed markets has increased again this year, by 16bps so far **(Exhibit 3)**. As a result, the U.S. dollar has not depreciated as expected. Going forward, stabilizing interest rate differentials and narrowing growth differentials may put a lid on the dollar, keeping it strong (but not stronger) for longer. The U.S. election is a risk, as tariff discussions heat up again, especially for currencies of major trading partners.

Supply chain relocations unlock opportunities for key beneficiaries

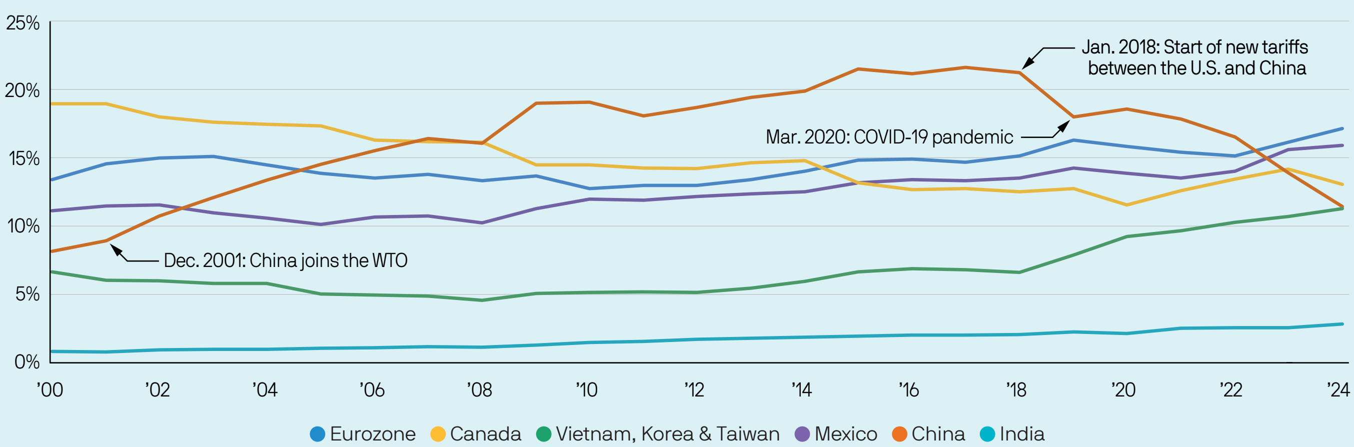
Disruptive events, such as COVID-19, ongoing trade tensions between the U.S. and China and elevated geopolitical risks, have brought supply chains into focus. Companies are now seeking to diversify their production locations, while nations are increasingly favoring trade with allies. The shift is already evident, with China losing its status as the U.S.'s top trade partner since the implementation of tariffs in 2018. China represented 22% of U.S. imports just five years ago but now accounts for only 12%.

Other countries have stepped in to fill the gap. Some Asian countries, such as India, Vietnam and Taiwan, are poised to benefit from friendshoring due to their cost competitiveness, integration in global supply chains, favorable industrial and corporate policies and rising middle-income consumer bases. Within Latin America, a key beneficiary of nearshoring has been Mexico, thanks to its existing manufacturing hubs and low wages.

While nearshoring is gaining momentum, it will take time, as China remains an important trade partner for most countries and is uniquely positioned in key industries. Nevertheless, as we transition to a multipolar world, investors can participate in this trend by further diversifying their equity exposure with a focus on the potential beneficiaries.

Key beneficiaries from supply chain shifts are ramping up imports to the U.S. and filling in the void left by China

Exhibit 4: U.S. goods imports by location, % of total imports, yearly



Source: FactSet, U.S. Census Bureau, J.P. Morgan Asset Management. WTO = World Trade Organization. Data are as of May 31, 2024.

Fixed income: A slow dance downward

After the strong performance from bonds to end 2023, it appeared the worst of the bond market rout was in the rearview. Inflation had fallen consistently since the middle of 2022, Fed Chairman Jerome Powell had hinted at the possibility of reducing interest rates this year, and while growth accelerated and unemployment remained low, leading indicators signaled moderation in 2024. However, inflation proved sticky and job growth remained robust to start the year, leading to a swift and dramatic repricing for fewer rate cuts, pushing long term interest rates higher **(Exhibit 5)**.

As markets repriced rate cuts, interest rate volatility remained elevated. While this backdrop of higher interest rate volatility and policy rate uncertainty has weighed on bond market performance this year, the adjustment higher in interest rates has dramatically improved the current income from owning U.S. Treasuries and other fixed income instruments like corporate bonds. Moreover, higher coupons should offset price losses if interest rates move modestly higher from here.

To be clear, we expect long-term interest rates as measured by the U.S. 10-year Treasury yield to stabilize between 4.00%-4.75% through the end of the year. Thereafter, we expect long rates to modestly decline to a range of 3.50%-4.00%, as the Fed gradually reduces interest rates, and growth and inflation trend to more normal levels.

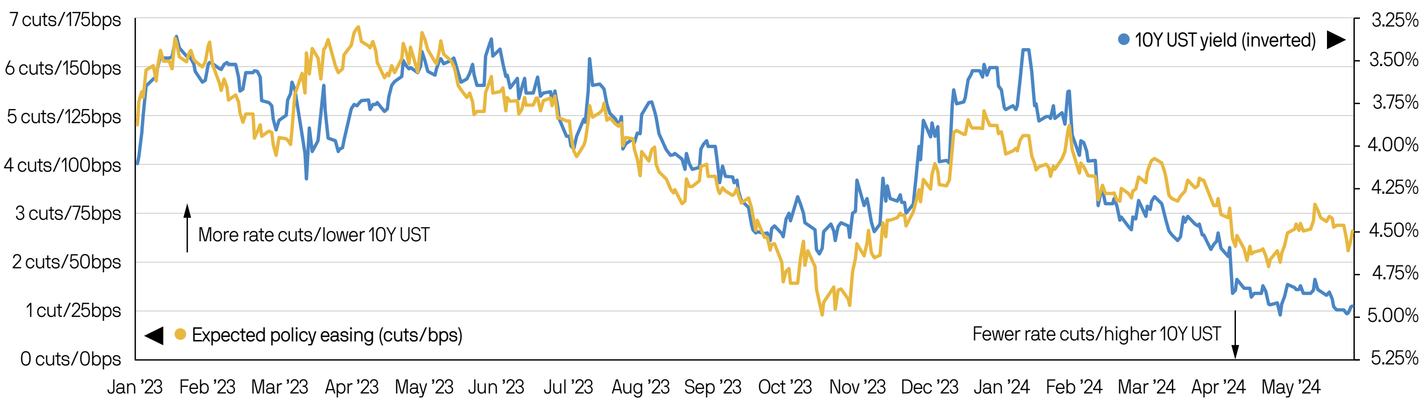
A few factors will likely contribute to this corridor for long-term rates in the near term:

Rate ceiling:

- Any upward pressure on rates should be limited given our expectation that year-over-year growth will moderate to 2% by the fourth quarter and real personal consumption deflator inflation should fall to 2% by the middle of 2025.
- The wind down of the Fed's quantitative tightening (QT) program suggest the Federal Reserve could become a net buyer of U.S. Treasuries by the end of the year, likely containing any meaningful move higher in rates.[2]

Shifting policy expectations have been tightly correlated with long rates

Exhibit 5: Federal funds futures, expected rate cuts in 2024, U.S. 10-year Treasury yield (inverted)



Source: Bloomberg, CME, J.P. Morgan Asset Management. Market expectations for policy easing are derived from federal funds futures contracts for December 2023 and 2024. Data are as of May 31, 2024.

[2] The committee announced it will reduce the cap on Treasuries maturing from $60bn to $25bn/mo. and maintain the $35bn cap on MBS paydowns beginning in June 2024. Using the 2019 QT experience as a guide, the committee could end QT in 4Q2024. If the Fed allows maturing mortgage-backed securities (MBS) to be reinvested into Treasuries, in order to keep the balance sheet level the Fed would become net buyers of Treasuries by the end of the year.

Rate floor:

- Long rates are likely to remain supported given the shallow path of rate reductions through 2026 and rising estimates of the perceived "neutral" policy rate or r-star[3] for the U.S. economy.
- Technical dynamics in the Treasury market, i.e. more Treasury bond supply given increased borrowing from the federal government, should also provide a floor on rates.

Turning to short-term rates, we anticipate the Fed will reduce rates 1-2 times by the end of the year and provide four more 25 basis point rate reductions in 2025. Thereafter, growth and inflation dynamics will largely dictate policy rates. Of course, should a recession occur, the Fed will likely respond by cutting rates aggressively, but likely not to zero like in the last cycle.

Investing during inversions

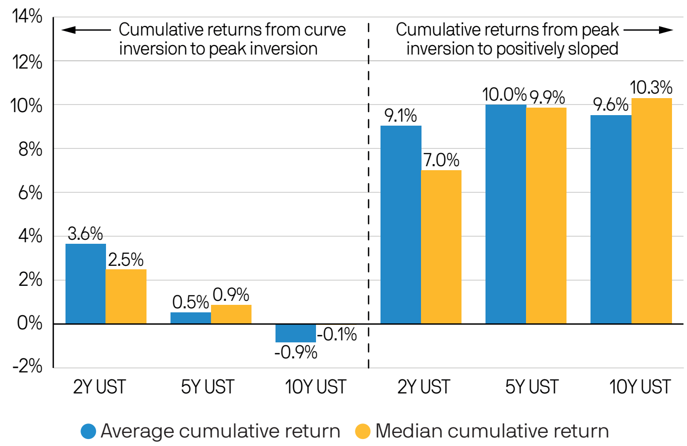
The yield curve has confounded many economists and market participants. A once reliable indicator of recession—specifically an inverted yield curve where short-term rates are higher than long-term rates—has potentially presented a false positive signal; while it has been inverted for almost two years, the economy has not fallen into recession.

That said, our rate forecasts suggest that while the curve could be positively sloped by the end of 2025 it is likely to remain inverted at least through the end of this year. Given this, investors should consider how bonds have performed under previous inversion cycles.

As shown in **Exhibit 6**, the initial inversion and further flattening driven by policy tightening creates a difficult backdrop for bonds, but generally maintaining a shorter duration posture is most suitable. Thereafter, as a combination of looser policy and/or slowing growth and inflation allows the curve to steepen, gradually extending duration has best served investors. That said, the shallow path for rate cuts driven by normalizing growth and inflation suggests investors may be best suited embracing a barbell approach by generating still attractive yields at the front end, while owning some duration as a portfolio hedge.

Curve inversions are challenging for bond returns, but as the curve steepens to positively sloped, duration tends to perform a bit better

Exhibit 6: Difference between the U.S. 10 year Treasury yield and the U.S. 2 year Treasury yield



Source: FactSet, Federal Reserve, Haver Analytics, J.P. Morgan Asset Management. Analysis includes seven yield curve inversion episodes since 1968. It does not include the current inversion period. *From January 1962 to May 1976, short-term bond is U.S. 1-year note, and from June 1976 onwards the short-term bond is the 2-year note due to lack of data availability. Returns are total returns. As of June 2024, the yield curve has been inverted for 23 full months without a recession. Data are as of May 31, 2024.

Barring an idiosyncratic shock or deterioration in economic conditions and labor markets, our base case view of moderating growth and gradually cooling inflation suggests that investors who continue to hold excess cash should begin deploying capital further out on the curve. Moreover, under this benign economic backdrop, credit spreads across investment grade and high yield could remain tight, particularly given low default rates and attractive all-in yields keeping credit markets supported. Overall, as the Fed eventually begins reducing rates, core high-quality intermediate bonds should prove to be an equity diversifier and ballast in client portfolios once again.

[3] R-star is considered the federal funds target rate range that is neither accommodative nor restrictive on economic activity over the long run.

U.S. equities: An extended, more inclusive bull market

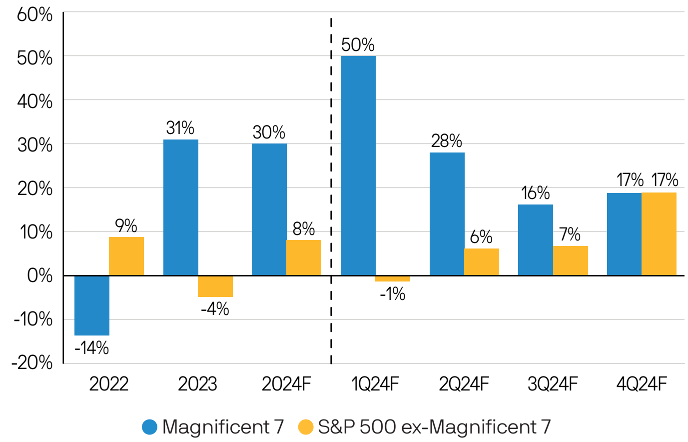
Equity markets have had a strong start to the year, shrugging off a hawkish repricing in monetary policy expectations and a 5% pullback in April to set 25 new all-time highs. In contrast to last year, market strength has been accompanied by breadth, as solid economic fundamentals have supported a broader earnings recovery and improved investor sentiment. Looking ahead, return expectations should be more modest, but healthy earnings growth and wide valuation dispersion suggest the environment remains positive for equity performance with opportunities for alpha generation.

Corporate America had a strong showing in the first quarter earnings season, posting 5% year-over-year EPS growth with wide participation in earnings surprises. Among the sectors, consumer discretionary, communication services and technology drove the biggest overall gains and most companies within the "Magnificent 7" continued to dominate. Notably, the first quarter should also mark a low point for the year, with every other quarter on track to deliver both sequential and annual growth. If this trend persists, all 11 S&P 500 sectors could see earnings grow on a year-over-year basis by the fourth quarter, a feat that has not been achieved since the second quarter of 2021. Much of this strength owes to success in defending margins (12.4% in 1Q24), with the combination of stronger-than-expected economic growth and easing labor pressures allowing corporates to retain pricing power.

Strong earnings have also helped fuel a return of buybacks. Whereas last year many companies slowed debt issuance amid an uncertain outlook for rates, this year issuance has rebounded, allowing for a renewed wave of buyback announcements. Some estimates suggest buybacks could reach $1 trillion for the year, a +13% annual gain, led by many of the mega-cap tech names. Many of these same companies are also investing heavily into AI. Consensus expects the five major AI "hyperscalers"[4] to spend nearly $200 billion on capex this year (**Exhibit 8**), corresponding to +36% year-over-year and over 8x growth in the last decade, while S&P 500 capex more broadly accelerated at an estimated 9% year-over-year pace in the first quarter.

A broadening out in earnings growth is underway

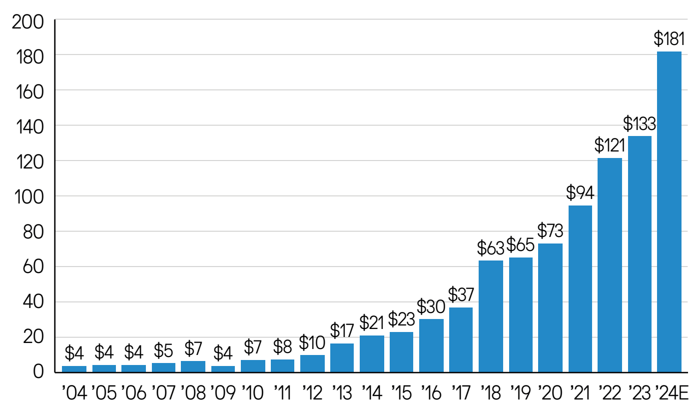
Exhibit 7: Earnings growth



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. *Magnificent 7 includes AAPL, AMZN, GOOG, GOOGL, META, MSFT, NVDA and TSLA. Earnings estimates for 2024 are forecasts based on consensus analyst expectations. Guide to the Markets – U.S. Data are as of May 31, 2024.

Capex has ramped up quickly and is expected to continue

Exhibit 8: Capex from the "Hyperscalers" – Microsoft, Meta, Amazon (AWS), Oracle and Alphabet, USD billions



Source: Bloomberg, J.P. Morgan Asset Management. Figures include estimates from the J.P. Morgan U.S. Growth investment team. Capex for Amazon (AWS) is estimated by excluding logistics and other non-AWS tech investments, while total capex is shown for Microsoft, Meta, Oracle and Alphabet. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections and other forward statements, actual events, results or performance may differ materially from those reflected or contemplated. Data are as of May 31, 2024.

[4] Hyperscalers refers to large tech companies that own and operate AI data centers, providing scalable cloud and storage resources required to run generative AI tools. The major five companies referenced are Amazon (AWS), Microsoft (Azure), Meta, Oracle and Alphabet (Google Cloud).

Solid growth and a renewed focus on shareholder return provide a further layer of support beneath the bull market, but at 20x forward P/E, the market isn't cheap. Consensus earnings expectations for the year currently point to 11% growth, but our top-down earnings model suggests headwinds from a stronger U.S. dollar and slowing nominal growth could lead growth to undershoot those expectations. Profit margins have so far been resilient, but if growth were to slow more materially, firms' pricing power would come under greater pressure. Finally, while the emphasis on AI may be justified, the concentration of returns amongst a few AI leaders suggests some vulnerability for markets as adoption speeds are still highly uncertain and sentiment has been ebullient.

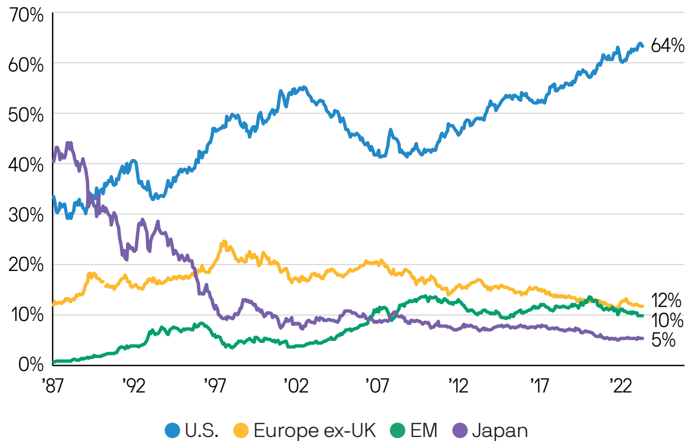
Overall, despite recent strong equity performance, the end of monetary tightening combined with strong nominal GDP growth provide a constructive backdrop for U.S. equities over the remainder of the year. We continue to favor quality across asset classes, leading us to prefer large and mid caps over small caps, a balance of both value and growth and an emphasis on stock selection to identify the attractive companies with resilient profits, solid balance sheets and favorable relative valuations.

International equities: The rest of the world's comeback

For over a year, financial commentators have frequently discussed the concentration of U.S. equities in just seven names, but rarely the extreme concentration of global equities in the U.S. Never has the U.S. share of global equities been this large at 64% (**Exhibit 9**). Recent trends suggest that upward trend has run its course – and the rest of the world is starting to catch up. Over the past two years, performance in international equity markets has been strong, especially in Europe, Japan and EM excluding China. The contribution to returns has been healthy, with equal heavy lifting being done by multiple expansion, earnings growth and dividends. The one sore spot, especially this year, has been the currency drag. In 2024, pockets of strong performance have continued, with Chinese equities joining the rebound. Beyond the regional view, single stock performance has been particularly strong, with 74% of the 50 best-performing companies being listed overseas (**Exhibit 10**).

U.S. concentration in global equity indices has never been so extreme

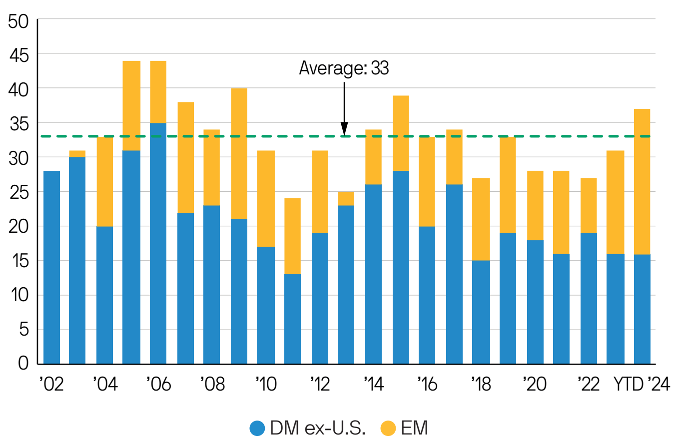
Exhibit 9: % weight in the MSCI All Country World Index, USD, monthly



Source: FactSet, MSCI, J.P. Morgan Asset Management. Countries are represented by their respective MSCI index. Data are as of May 31, 2024.

On any given year, about 33 of the 50 best performing companies are listed abroad

Exhibit 10: Top 50 performing companies globally, # of companies listed internationally, MSCI All Country World Index



Source: MSCI, J.P. Morgan Asset Management. Graph was made by ranking all the companies in the MSCI All Country World Index by performance on a yearly basis and determining the top 50 performers using their total return in USD. Companies are listed in no particular order. Excluded companies whose market capitalization does not make up at least 0.01% of the MSCI All Country World Index in the year listed. Data are as of May 31, 2024.

Going forward, multiple expansion can still provide some support, especially compared to the U.S. (with double the normal discount to the U.S. at 34%). Importantly, on a sector-by-sector basis, the discount for quality companies listed overseas versus in the U.S. persists. This abnormally large discount is no longer warranted for international developed markets given substantial macro- and microeconomic changes, such as the return of inflation and positive rates, end of fiscal austerity and addition of buybacks to the already healthy dividend yields these companies have traditionally paid. In Europe, the turn in economic sentiment and manufacturing activity should support earnings and performance ahead. In Japan, corporate governance reform momentum should generate additional multiple expansion – a once-in-a-generation re-rating opportunity for investors. The Value style will likely continue to lead returns in Europe and Japan, as they often do during environments when Treasury yields hover between 3% and 5%. Lastly, the worst of the currency drag (especially in Japan) should be behind us – but is unlikely to turn into a substantial boost to U.S. dollar-based returns just yet.

In emerging markets, unsurprisingly China has been leading, due to depressed valuations, sentiment and positioning going into the year. The better economic momentum in parts of the economy, combined with more fiscal policy easing, should continue to result in a tactical rebound for a bit longer driven by multiple expansion. However, for Chinese equities to break out of their multi-year range, investors need to be significantly more confident in a domestic demand recovery – which seems unlikely this year, given limited demand-side stimulus and rising geopolitical tensions going into the U.S. election. As a result, we expect other EM markets to take back the baton as the year progresses, especially other EM Asian markets. For Korea and Taiwan, the turn in the electronics cycle, coupled with the AI-generated boost in semiconductors, should continue to generate strong earnings growth and market returns. In addition, Indian equities should regain their footing once the uncertainty about the election passes and as the tactical rebound in China loses steam, given strong earnings growth fueled by robust economic momentum.

Investors have already started to notice the improved performance overseas, with international equity exposure in global equity portfolios at a 12-month high*. However, this comes from a very low starting point. As always with international, there is a lot more opportunity than meets the eye, and with valuation spreads near record highs, active managers have a chance to uncover it.

*Based on advisor portfolios analyzed by the J.P. Morgan Asset Management Portfolio Insights team.

Alternatives: Embracing the alternative advantage

The first half of 2024 exposed the difficulties of creating a stable portfolio using just routine allocations to traditional assets. In an uncertain investing environment in which inflation protection, stable income and outsized returns are difficult to source from public markets, alternatives look increasingly attractive.

After a steady wave of disinflation in 2023, more persistent price pressures this year underscore the risks of structurally higher inflation. As noted in our 2024 Outlook, real estate tends to act as an inflation hedge since higher costs can be passed on through higher rents. However, opportunities here extend beyond just inflation protection. Outside of office, other segments of commercial real estate are seeing renewed fundamental tailwinds. Limited home affordability and favorable demand dynamics, such as low unemployment, solid wage growth and immigration, should bolster the already solid renter base for multi-family. Meanwhile, specialized sectors, such as industrials, that are well positioned for a post-pandemic world should see strong demand.

Thanks to worries about reaccelerating inflation, stocks and bonds remained positively correlated. In a world where traditional markets have shown an increased propensity to move together, hedge funds can offer a solution. Hedge fund returns tend to benefit from higher short-term interest rates and elevated volatility; against the backdrop of a longer-than-expected Fed pause, this dynamic, along with their ability to go short, should provide both diversification and return.

Bonds proved once again that they can be unpredictable during periods of heightened inflation uncertainty. That said, transportation and infrastructure assets have established strong track records of dependable income and low volatility, allowing both asset classes to satisfy the need for stability within portfolios.

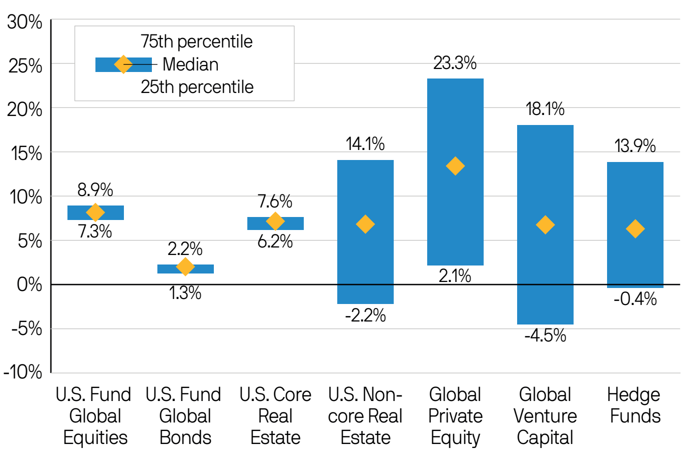
Against a backdrop of elevated public equity valuations and still-low yields relative to history, private markets can help generate outsized capital appreciation and income. Within private equity, middle market companies that derive the bulk of their returns from value creation instead of financial leverage should do well despite higher-for-longer rates. Private credit can offer attractive yields, although a pick-up in amend-and-extend activity and defaults call for a focus on quality.

As traditional private market exit activity remains subdued, opportunities in the secondary market can give investors exposure to seasoned assets at discounted valuations.

In a lagged reflection of public markets, repricing across private markets is still underway, but some sectors are moving faster than others. Prospects in real estate look brighter. Office remains an issue, but valuations in other segments are stabilizing, and managers with available liquidity can acquire quality assets at attractive prices. After valuations came down in 2023, private equity purchase price multiples retraced higher in early 2024 and are holding up well. However, a rebound in exit activity may force sellers to realize lower multiples. The rerating in private credit is still in its early stages, although rising default risk and the increased likelihood of higher-for-longer interest rates suggest that a more marked adjustment may be forthcoming.

Manager selection is critical in alternatives

Exhibit 11: Public and private manager dispersion. Based on returns over a 10-year window*



Source: Source: Burgiss, J.P. Morgan Asset Management, Morningstar, NCREIF, PivotalPath. Global equities and global bonds are based on the world large stock and world bond categories, respectively. *Manager dispersion is based on annual returns over a 10-year period ending 1Q24 for Hedge Funds, U.S. Core Real Estate, U.S. Fund Global Equities and U.S. Fund Global Bonds. Non-core Real Estate, Global Private Equity and Global Venture Capital are represented by the 10-year horizon internal rate of return (IRR) ending 4Q23. U.S. Fund Global Equities and Bonds are comprised of U.S.-domiciled mutual funds and ETFs. Data are based on availability as of May 31, 2024.

Nonetheless, there are plenty of attractive opportunities waiting for investors across the alternatives landscape. Much like an investor should focus on finding high-quality assets, asset allocators should strive to invest in high-quality managers. Indeed, manager dispersion is particularly wide in private markets, making investing with a good manager a key element of the allocation process **(Exhibit 11).**

Asset allocation: (Continue to) expect the unexpected

After a year of surprises, wise investors entered 2024 expecting the unexpected. Now, almost halfway through the year, this approach to investing is still relevant.

For many, the U.S. economy continues to surprise. Despite tighter lending standards, higher prices, elevated borrowing costs and a dwindling supply of eligible workers, employment and consumption data remain strong and inflation persistently sticky at higher-than-expected levels. Even with the slowdown in the first quarter, a recession is still unlikely through the rest of the year.

This economic optimism comes despite myriad challenges to the “peak rates” narrative at the start of the year, with a combination of central bank speak and hot economic data forcing markets to accept that “higher for longer” will be around a bit longer than initially thought. Still, the hurdle for the Fed to raise rates from here is significant, and the bias toward cutting in 2024 is still evident. A lower federal funds rate will have broad – and generally positive – implications across capital markets and economies, both in the U.S. and around the world. Nonetheless, a busy year for global politics has the potential to inject temporary volatility.

In other words, investing remains a challenge, and asset allocation must reflect the inherent uncertainty of a world very clearly in flux.

Given the changing outlook for interest rates this year, bond investors should embrace shorter duration instruments, gradually extending duration while having confidence that attractive coupons will act as a “cushion” in portfolios if the rate view unexpectedly changes further. They should also shore up quality, which should prove to be an effective portfolio ballast, to account for tighter-than-expected credit spreads and protect against unpredicted economic risk.

From an equity perspective, the first quarter U.S. earnings season was likely a window into the rest of the year: strong profit growth with broad participation in earnings surprises. Even so, the market is modestly rich and earnings expectations are likely too aggressive. As a result, a bias toward active management and quality, balanced between growth and value and skewed toward larger names, remains prudent. Outside the U.S., discounted markets should allow for multiple expansion to support performance, and the significant currency drag should abate, especially as the Fed looks to ease through the back half of the year.

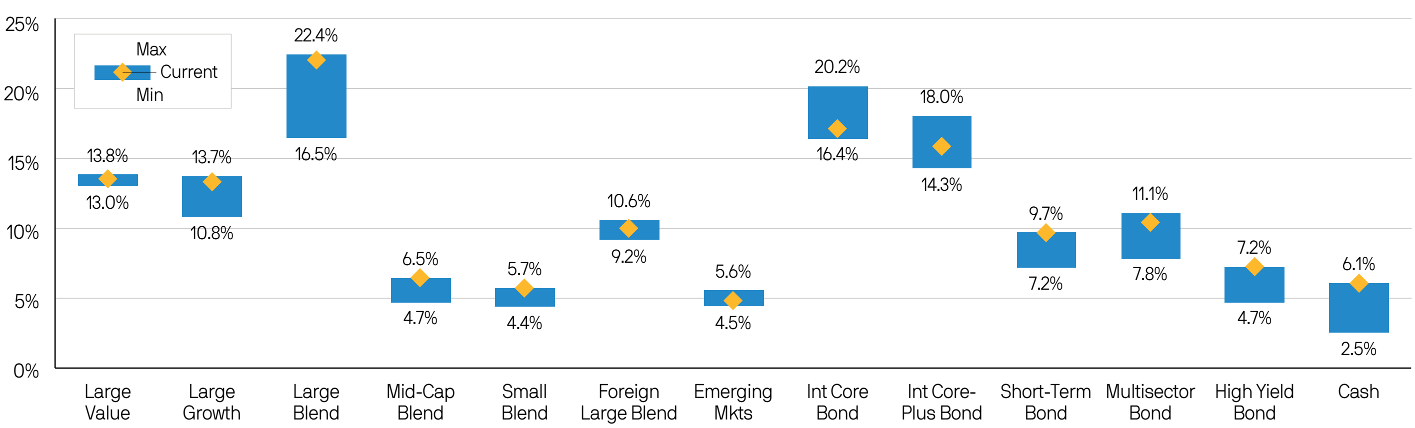
This backdrop is also supportive of alternative assets. Infrastructure investments can dampen portfolio volatility, particularly with a renewed interest in expansive industrial policy; real estate can protect against structurally higher inflation and prospects have improved; and private equity and hedge funds can thrive if the beta trade weakens. Against this, however, investors should recognize that a repricing in private markets is still underway, underscoring the need for careful manager selection.

Looking at portfolio positioning, this outlook has only partially been implemented. Within fixed income, appetite for higher-quality, extended-duration bonds has increased since the start of the year. Within equities, growth investing is back in vogue, likely a reflection of investors chasing momentum given this year's surprise rally; this has somewhat unwound the shift toward value that had occurred earlier in 2023 and has driven up duration in stock allocations. Meanwhile, interest in non-U.S. stocks has increased since the beginning of the year, albeit mostly through passive vehicles, with investor allocations trending higher than the historical average despite a hazy geopolitical horizon. Finally, investors are still broadly overweight cash, a continued weight on returns this year, as had been the case in 2023.

All told, the investing landscape remains volatile. Investors would therefore do well to diversify and lean on active management, stepping out of cash and into risk assets to take advantage of the anticipated changes ahead.

Investors are fairly well positioned to take advantage of market opportunities

Exhibit 12: Average allocations in moderate models, last 12 months



Source: J.P. Morgan Asset Management. "Moderate models" are defined as a 60% stock/40% bond portfolio. Note average allocations will not sum to 100 as not all categories are represented in each portfolio analyzed. Data are as of May 31, 2024.

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Index Definitions

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not include fees or expenses.

The **Composite PMI future output index** is a gauge of economic growth and can provide valuable insights into GDP, service sector growth and industrial production trends well ahead of official data.

The **Bloomberg Euro Aggregate Corporate Index** is a benchmark that measures the corporate component of the Euro Aggregate Index. It includes investment grade, euro-denominated, fixed-rate securities.

The **Bloomberg Pan-European High Yield Index** measures the market of non-investment grade, fixed-rate corporate bonds denominated in the following currencies: euro, pounds sterling, Danish krone, Norwegian krone, Swedish krona, and Swiss franc. Inclusion is based on the currency of issue, and not the domicile of the issuer. The index excludes emerging market debt.

The **Bloomberg U.S. Aggregate Treasury Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar denominated, fixed-rate taxable bond market. This includes Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities and collateralized mortgage-backed securities.

The **ICE BofA MOVE Index** tracks fixed income market volatility.

The **J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI Broad Diversified)** is an expansion of the J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI). The CEMBI is a market capitalization weighted index consisting of U.S. dollar denominated emerging market corporate bonds.

The **J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified)** tracks total returns for U.S. dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds. The index limits the exposure of some of the larger countries.

The **J.P. Morgan GBI EM Global Diversified** tracks the performance of local currency debt issued by emerging market governments, whose debt is accessible by most of the international investor base.

The **J.P. Morgan Leveraged Loan Index** is designed to mirror the investable universe of U.S. leveraged loans.

The **MSCI ACWI (All Country World Index)** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

The **MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The **MSCI Europe Index** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe.

The **MSCI Pacific Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the Pacific region.

The **MSCI World with USA Gross Index** measures the performance of the large and mid-cap segments across 23 Developed Markets (DM) countries. With 1,540 constituents, the index covers approximately 85% of the global investable equity opportunity set.

The **Russell 1000 Index**® measures the performance of the 1,000 largest companies in the Russell 3000.

The **Russell 1000 Value Index**® measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The **S&P 500 Index** is widely regarded as the best single gauge of the U.S. equities market. The index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. The **S&P 500 Index** focuses on the large-cap segment of the market; however, since it includes a significant portion of the total value of the market, it also represents the market.

The **U.S. Treasury Index** is a component of the U.S. Government index.

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