Market Insights

Quarterly Perspectives

Peak rates, moderating growth

Asia | 4Q 2023

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Peak rates, moderating growth

Overview

- The global economy is set to decelerate as we go into 2024. Europe's growth momentum is already weakening on the back of higher rates. We believe the U.S. could follow suit in 2024 if the Federal Reserve (Fed) insists on keeping interest rates higher for longer. Meanwhile, China's economic recovery continues to be held back by the real estate sector.
- With the interest rate cycle expected to peak in most economies, the coming months will be a key window of opportunity to lock in higher rates via fixed income. The looming conclusion of the U.S. hiking cycle could drive investors to increase duration in both fixed income and equities.
- In fixed income, this implies extending duration via longer-dated government bonds and investment-grade corporate credits. Meanwhile, high yield corporate debt could be temporarily undermined by credit spread widening. For equities, growth and technology stocks tend to benefit from falling yields.
- Despite slowing growth momentum, the U.S. economy is likely to remain relatively more resilient versus Europe and other developed economies. This would allow for U.S. equities to outperform in relative terms. Domestic demand in Asia remains robust, contributing to earnings growth, especially in Japan, India and ASEAN. A pick-up in the electronic cycle could eventually benefit markets such as Taiwan and South Korea, in our view.

Investment Implications

- Peaking policy rates could nudge investors in the direction of long duration assets, including government bonds, growth stocks and gold.
- In our opinion, locking in yields should be a priority for investors as government bond yields could move lower in 2024 amid the end of the U.S. hiking cycle.
- Among developed market equities, U.S. stocks are likely to continue to lead the way. For Asian equities, we believe a more diversified approach across the region is important to capture domestic recovery opportunities. With potentially lower bond yields and cash returns, high dividend equities in Asia could become more appealing to investors once again.

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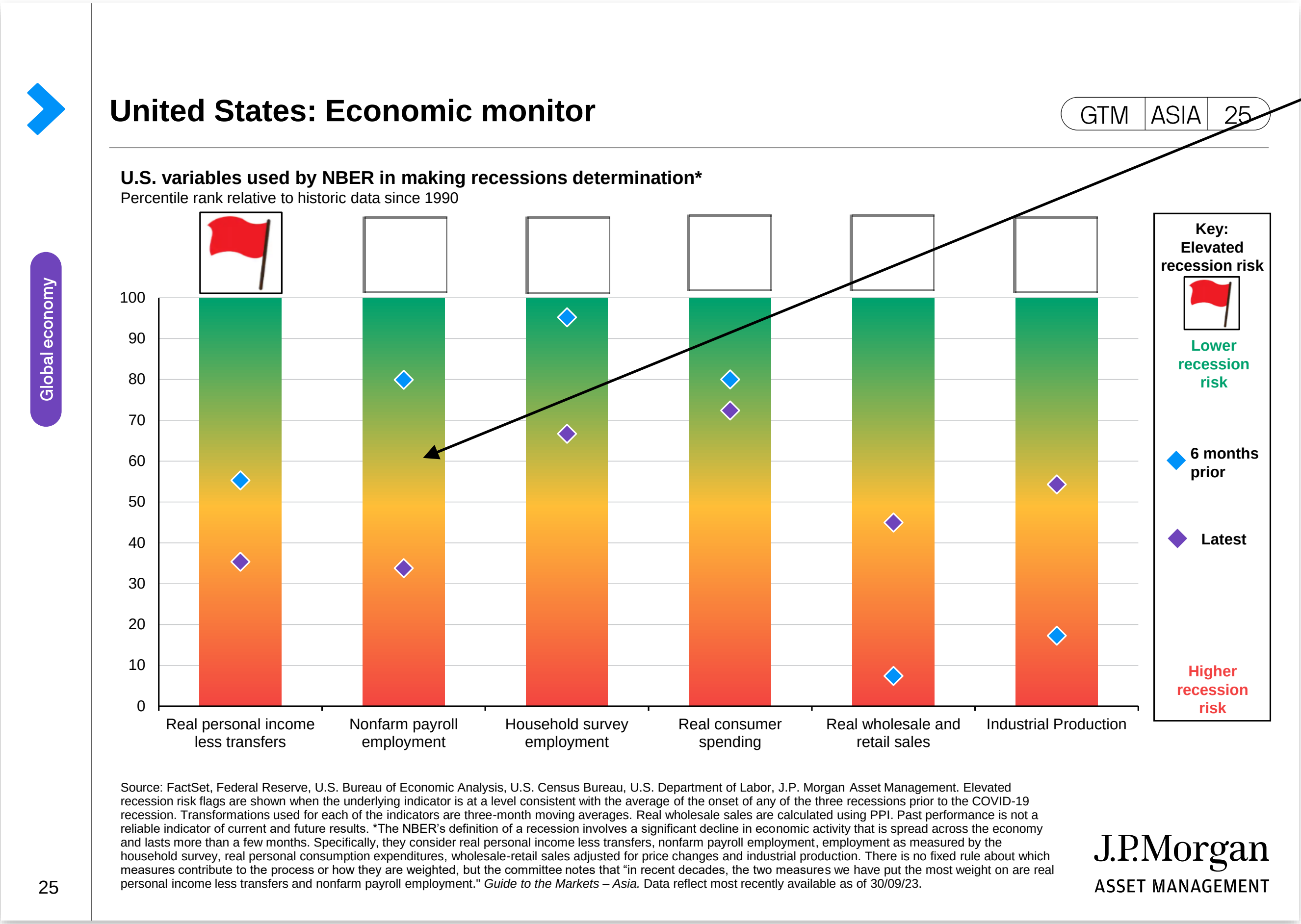

Feeling the pinch from higher rates?

- As we approach the end of 2023, the U.S. economy continues to exhibit relatively healthy growth momentum. Despite early signs of a slowdown, the U.S. consumer and labor market remain largely resilient. This is the result of households and corporates locking in cheaper borrowing costs before the hiking cycle began in earnest in early 2022.
- Inflation is coming off and is likely to continue to decline, even if it takes about 12-18 months to approach the Fed's 2% target.
- Should the Fed keep interest rates high for much of 2024, the buffers that have helped corporates and consumers ride out a period of higher rates may eventually wear out. This could lead the economy to a weaker growth path. As a result, an economic recession cannot be ruled out. Much will depend on the Fed's policy outlook, especially amid a time when fresh fiscal stimulus is unlikely due to a divided Congress ahead of the 2024 presidential election.

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Global economy

United States: Monetary policy

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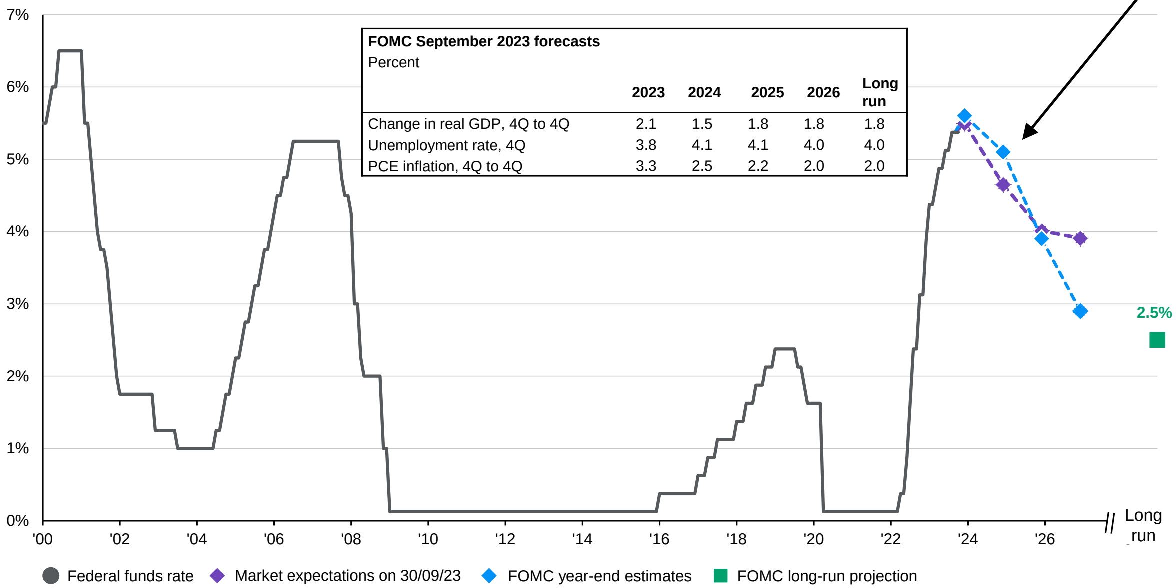
Federal funds rate expectations

Market expectations for the fed funds rate



FOMC September 2023 forecasts

Percent

	2023	2024	2025	2026	Long run
Change in real GDP, 4Q to 4Q	2.1	1.5	1.8	1.8	1.8
Unemployment rate, 4Q	3.8	4.1	4.1	4.0	4.0
PCE inflation, 4Q to 4Q	3.3	2.5	2.2	2.0	2.0

Source: Bloomberg, FactSet, U.S. Federal Reserve, J.P. Morgan Asset Management. Market expectations are derived from market implied policy rates as of 30/09/23. Federal Reserve projections shown are the median estimates of Federal Open Market Committee (FOMC) participants.
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The Fed will need to be more balanced

- A strong labor market and above-target inflation could continue to keep Fed officials hawkish. Even if we are at the tail end of the hiking cycle, policymakers appear committed to keeping rates elevated in 2024 to fully quash inflation.
- In addition to the policy outlook for the next 12-18 months, the recent Jackson Hole central bank symposium discussed various factors that may affect policy making in the long run, such as climate change, supply chain shifts and the Russia-Ukraine conflict. One possible outcome is that the neutral rate—the interest rate that keeps the economy on an even keel—could be higher than before.
- The Fed's hawkish attitude stands in contrast to softening economic indicators, including tighter bank lending standards, cautious business confidence and slowing construction activities. This could imply an eventual bullish steepening of the U.S. Treasury (UST) yield curve amid peaking policy rates. While the Fed might be determined to keep rates higher for longer, it will eventually need to adopt a more balanced view in managing the trade-offs between controlling price pressures and avoiding an outright recession.

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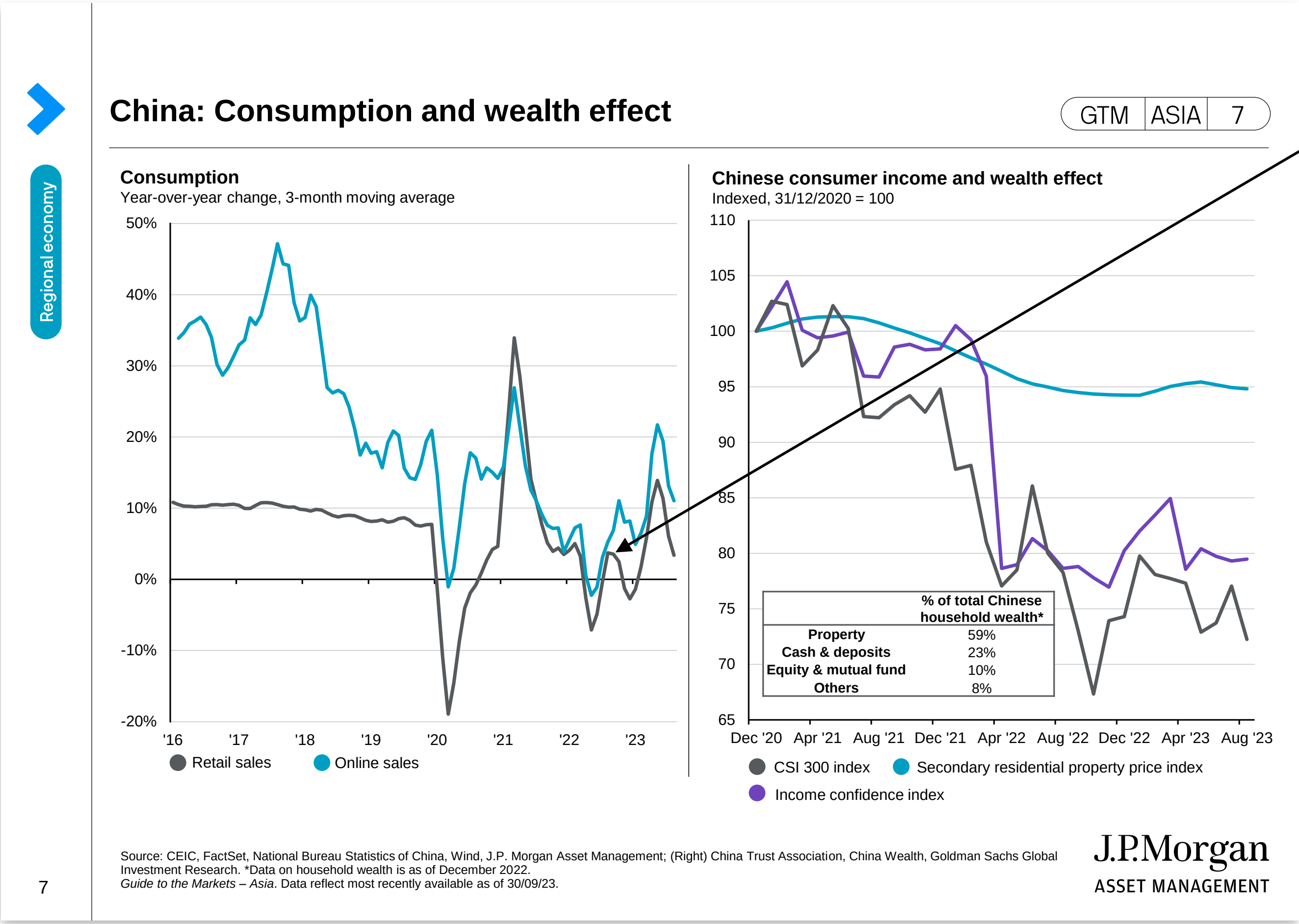

Stronger confidence needed to accompany stimulus efforts

- China's economic recovery has hit a snag with the real estate market still in the doldrums. Private sector investment remains weak, and consumer spending growth in home-related items, such as electric appliances and furniture, was constrained by weaker-than-expected home sales. Meanwhile, the contraction in exports reflects broader challenges facing Asian exporters.
- The authorities have introduced various measures to support the economy, including cutting interest rates and relaxing home purchase restrictions for selected cities. However, boosting home sales and construction activities will require policies that are more specifically directed at improving market expectations on property prices. Beijing will need to delicately balance improving confidence with maintaining housing affordability.
- The banking sector, especially the larger state-owned banks, has adequate capital and loan loss provisions to buffer against a potential rise in non-performing assets. This could help mitigate broader systemic risk. Meanwhile, developers' financial stress could continue for some time as home sales take time to recover.

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United States: Last rate hike and market performance

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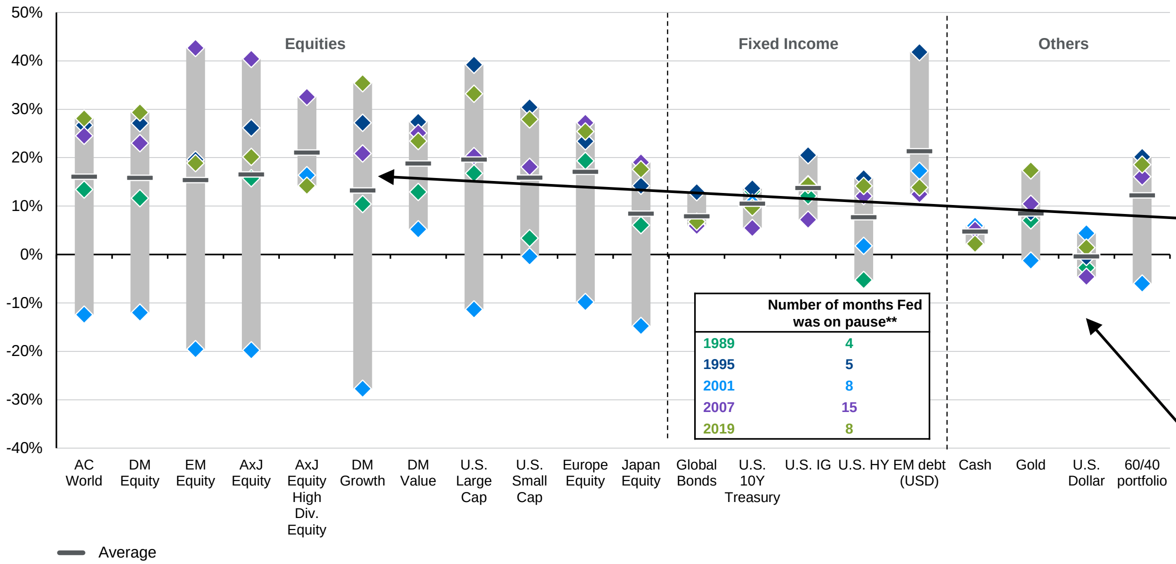
Other asset classes

Asset class returns following the end of rate hikes

Average returns* a year after the past five rate hike cycles ended



Source: FactSet, U.S. Federal Reserve, J.P. Morgan Asset Management. Based on MSCI AC World Index (AC World), MSCI World Index (DM Equity), MSCI Emerging Markets Index (EM Equity), MSCI Asia Pacific ex-Japan Index (AxJ Equity), MSCI Asia Pacific ex-Japan High Dividend Yield Index (AxJ Equity High Div. Equity), MSCI World Growth Index (DM Growth), MSCI World Value Index (DM Value), S&P 500 Index (U.S. Large Cap), Russell 2000 Index (U.S. Small Cap), MSCI Europe Index (Europe Equity), MSCI Japan Index (Japan Equity), Bloomberg Global Aggregate (Global Bonds), Bloomberg U.S. Treasury Bellwethers 10Y (U.S. 10Y Treasury), Bloomberg U.S. Corporate Investment Grade Index (U.S. IG), Bloomberg U.S. Credit Corporate High Yield (U.S. HY), J.P. Morgan EMBI Global (EM Debt USD), Bloomberg U.S. Treasury Bills 1-3M (Cash), Gold New Spot price (Gold), U.S. dollar index (U.S. dollar), 60% AC World and 40% Global Bonds (60/40 portfolio). *Total returns in local currency are used, unless otherwise specified. **Refers to the duration between the last rate hike and the first rate cut, specifically Feb '89 - Jun ‘89, Feb '95 - Jul ‘ 95, May '00 - Jan ‘01, Jun '06 - Sep ‘07, Dec '18 - Aug ‘19.

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Long duration assets shine as yields peak

- The possible end to the U.S. hiking cycle could be constructive for both equities and fixed income. The broader asset allocation decision between equities and fixed income largely hinges on an investor’s risk profile. The macroeconomic and policy backdrop will likely determine the allocation decisions within asset classes, as opposed to across asset classes.
- For example, the peak in rates typically coincides with a bullish steepening of the UST yield curve. This means yields could fall more at the short end of the yield curve than the long end. Lower yields historically benefited stocks with higher valuations. Typically, this is constructive for growth-style equities, such as technology stocks.
- Peaking cash rates could potentially persuade investors to take a closer look at deploying cash for investments. Money market funds could be useful on account of their flexibility and liquidity versus a fixed time deposit, in our view.

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Global equities: Earnings expectations

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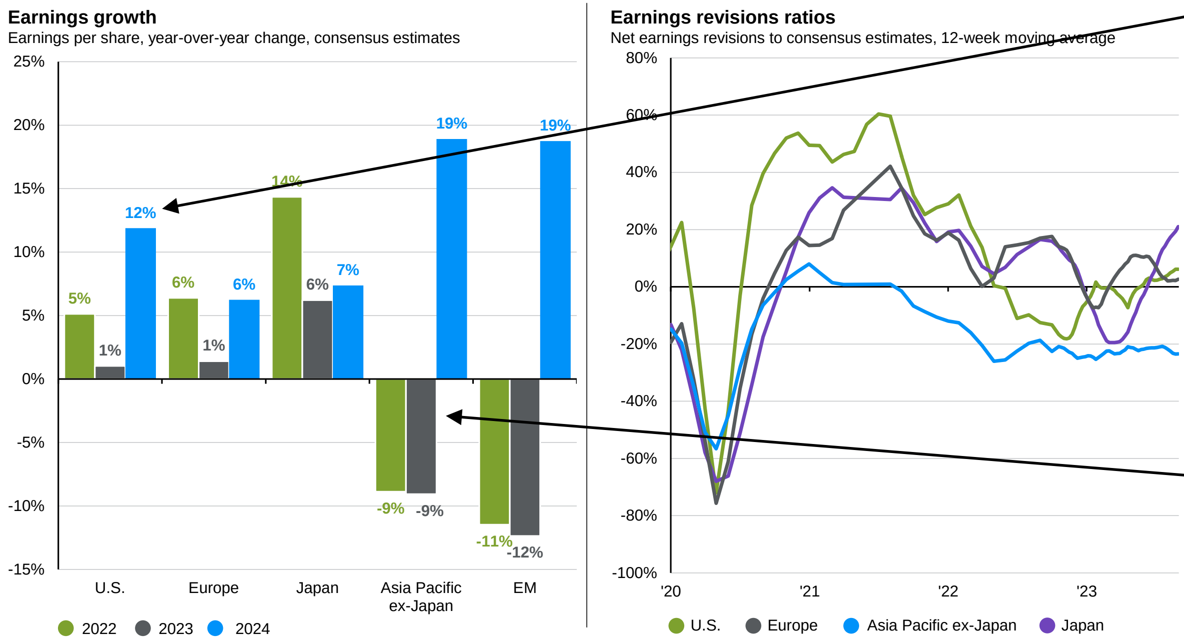
Equities



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. Asia Pacific ex-Japan, emerging markets (EM), Japan, Europe and U.S. equity indices used are the MSCI AC Asia Pacific ex-Japan, MSCI Emerging Markets, MSCI Japan, MSCI Europe and S&P 500, respectively. Consensus estimates used are calendar year estimates from FactSet. Revisions are based on the current unreported year. Net earnings revisions is (number of companies with upward earnings revisions minus number of companies with downward earnings revisions) divided by the number of total companies. Past performance is not a reliable indicator of current and future results.
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U.S. growth and Asian high dividend stocks could see tailwinds from lower yields

- The U.S. has avoided an earnings recession so far, given its economic resilience. That said, with interest rates likely staying higher for longer and growth momentum waning, the current 2024 earnings per share growth forecast of 12% seems optimistic.
- Nevertheless, given the higher risk of an economic recession in Europe and slower recovery in China, U.S. equities could still lead the way, especially if there are further breakthroughs in artificial intelligence that could fuel investors' optimism.
- There are still ample opportunities in Asia. Stronger domestic growth momentum across the region, especially in India, Japan and ASEAN, continues to support corporate earnings. With relatively lower bond yields and cash rates across the region, high dividend equities could become appealing to Asian investors once again.

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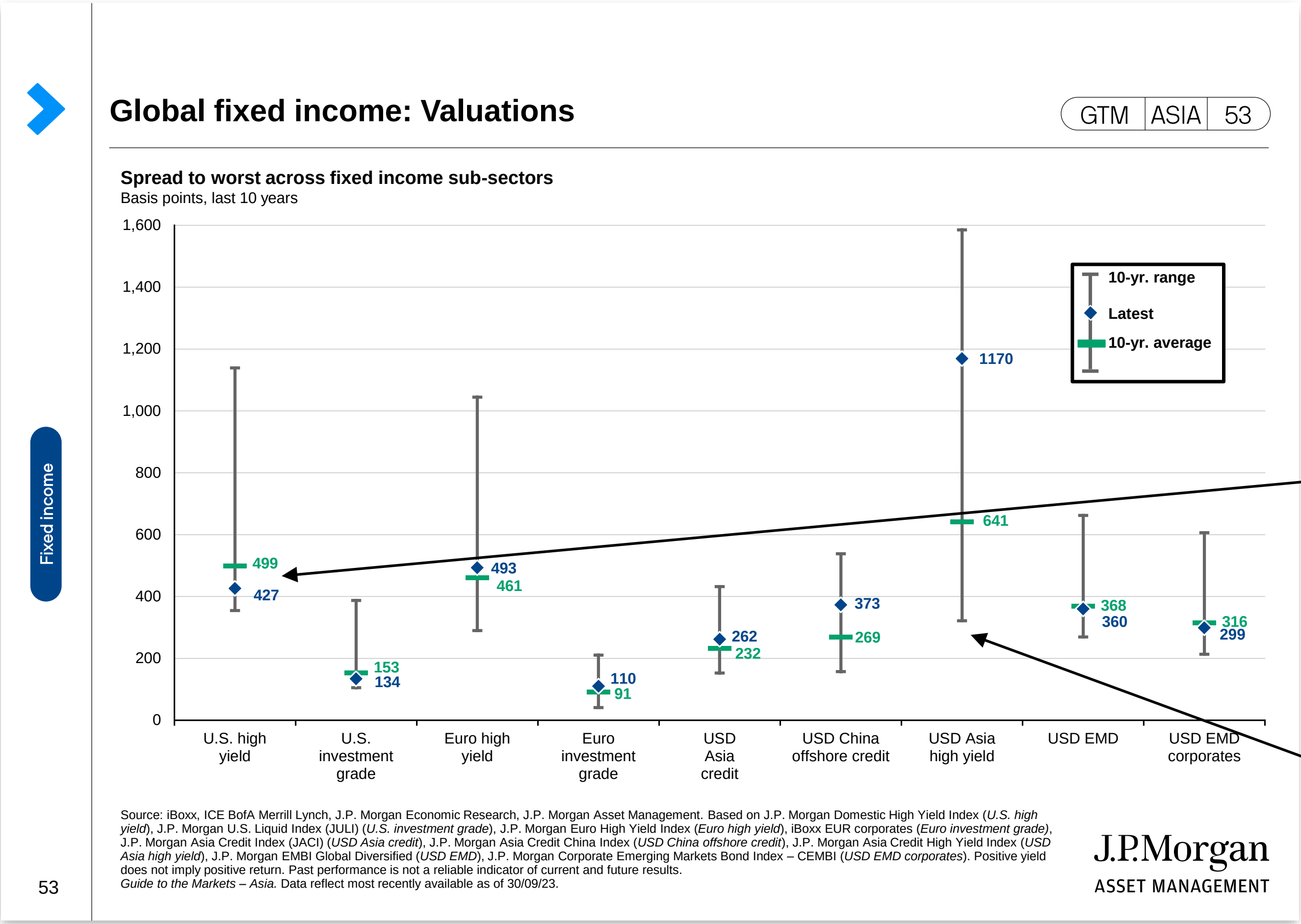

Leaning on quality fixed income in the short term

- The Fed's hawkish stance, resilient labor market data and softening inflation have benefited the short end of the UST yield curve. We view in the coming months, the eventual confirmation of the end of the hiking cycle should see short end rates decline, causing the UST yield curve to steepen or become less inverted. As a result, the long end of the curve could potentially outperform on a total return basis.
- As growth momentum in the U.S. slows, investors' focus could shift to the possible rise of default rates in the high yield space, leading to a widening of credit spreads and lower bond prices. This could result in high yield corporate bonds temporarily underperforming investment-grade corporate debt.
- We believe Chinese high yield corporate debt remains challenged on account of weak home sales in China. That said, we expect the economic and corporate fundamentals of other Asian and emerging market corporate bonds to be more constructive. The U.S. dollar could also weaken as we reach the end of the U.S. hiking cycle, which presents an additional tailwind for Asian and emerging market fixed income.

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