Quarterly Perspectives

J.P. Morgan Asset Management is pleased to present the latest edition of *Quarterly Perspectives*. This piece explores key themes from our *Guide to the Markets*, providing timely economic and investment insights.

**THIS QUARTER’S THEMES**

1. Diverging recoveries, diverging policies
2. Staying on course with the recovery playbook
3. Asia is lagging but not for long
4. Income beyond fixed income

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Diverging recoveries, diverging policies

COVID-19 vaccinations and infections - GTMA slide 24
United States: Inflation - GTMA slide 29
Global central bank policy rate changes - GTMA slide 19

Overview

- Variations in vaccination progress and economic stimulus have delayed synchronization of the global economic recovery. The U.S. is expected to lead the recovery in 2021, and Europe should follow. China’s economy has normalized and is expected to expand along its trend growth.
- Global inflation has accelerated as expected, but there is little clarity whether a series of one-off factors, such as supply-side bottlenecks, semiconductor shortages and commodity price volatility, could prolong this trend.
- Desynchronized recovery implies diverging paths for global monetary policy. Some smaller central banks have already become more hawkish. China has started to normalize with slower credit growth, and the U.S. is still being patient, despite a pick up in inflation. Meanwhile, the priority of most Asian central banks is to get through the latest wave of infections.

Investment Implications

- The economic recovery should continue to be positive for risk assets. However, the varying pace of the recovery implies Asian investors should take a more active approach when allocating by region.
- The U.S. and China are still leading in terms of economic performance, even though the strongest period of their rebound has probably passed. Europe is starting to benefit from a higher vaccination rate and the implementation of the European Recovery Fund.
- Asia’s domestic demand is still challenged by further waves of infections, but its export sector is posting strong demand.
- Ongoing inflation worries and future policy normalization could push bond yields higher, which require fixed income investors to be agile. Yet, higher inflation would raise demand for income and could push investors to other income-generating assets such as high-dividend stocks and alternatives, alongside high yield (HY) debt and emerging market (EM) bonds.

Staying on course with the recovery playbook

Asset class returns through the economic cycle - GTMA slide 67
United States: Interest rates and equity performance - GTMA slide 51
Global fixed income: Yields and duration - GTMA slide 53

Overview

- The ongoing recovery and rising yields still favor risk assets such as equities, corporate HY debt and EM fixed income.
- Recovery has peaked for the U.S. and China, and there is more in store for Europe, as well as Asia and other EM economies, as vaccination rates increase and infections recede. This implies relatively modest returns for equities at the index level, but ample opportunities among sectors.
- Higher U.S. Treasury (UST) yields still pose a challenge for fixed income. HY corporate bonds and EM debt remain viable sources of income generation.

Investment Implications

- Asian investors should continue to diversify their equity portfolios globally. Europe has enjoyed strong performance in 1H 2021, and we expect the ongoing cyclical sector rebound to provide more impetus.
- Asian equities have lagged this year due to policy normalization in China and new waves of infections in some of the region’s economies. Exports should still be well supported, while patience is needed for domestic demand to recover as current infections are being brought under control.
- In terms of sectors, cyclical should ride the economic tailwinds and the strength of the earnings outlook. Still, be mindful of rising raw material and wage costs. Higher inflation costs could add pressure to the profitability of downstream manufacturing industries in the near term.
- UST yields could consolidate in the near term but may push higher over the medium- to long-term trend. Investors should think short duration on fixed income while opting for higher-yielding debt.
Asia is lagging but not for long

**APAC ex-Japan equities: Exports and earnings - GTMA slide 42**

**Global equities: Input prices and profit margins - GTMA slide 36**

**APAC ex-Japan equities: Performance drivers - GTMA slide 40**

**OVERVIEW**

- Hopes of a quick recovery in Asia are being dashed by a resurgence of COVID-19 cases and the slow vaccination rollout across the region. Recent spikes in infections remind us that even locations that have done well in controlling the pandemic previously are not immune in the absence of higher vaccination rates.
- The U.S. and Europe may be ahead in vaccination rates, but we expect their recovery to benefit Asia as global demand rises.
- The recovery has been uneven and this could likely continue. China should lead the way, but other Asian economies will follow as they benefit from pent-up consumer demand and the fading impact of the pandemic.

**INVESTMENT IMPLICATIONS**

- We remain positive on Asian equities. Diverging intra-region performance could likely continue. China and other locations involved in electronic supply chains, or with an electronic product bias, should gain from increasing global demand. Although the share of U.S. and European demand for Asia’s goods is not as high as it once was, it remains an important driver.
- Earnings are expected to improve. Profit margins are rising despite worries over inflation and higher input costs.
- Asian equity valuations are not extremely attractive from a historical perspective, but relative to the U.S. and other major regions, they are undemanding.

Income beyond fixed income

**China bonds - GTMA slide 65**

**APAC ex-Japan equities: Dividends - GTMA slide 41**

**Alternative sources of income - GTMA slide 76**

**OVERVIEW**

- The struggle to find income is not new, but is currently complicated by expectations of rising government bond yields and heightened inflation, creating risks for holders of core government bonds or longer duration assets.
- The strengthening economic recovery has bolstered the earnings outlook. This should lead to a recovery in dividends as companies return capital through higher dividend payouts.
- For those looking for potentially more stable income streams, with a lower correlation to equities, alternatives, such as real estate and infrastructure, present predictable inflation-linked income options.

**INVESTMENT IMPLICATIONS**

- Some segments of the bond market can still be tapped to provide income in portfolios, such as HY bonds and EM debt. However, investors will increasingly have to look beyond the bond market for income.
- The strength in earnings growth means companies can reward shareholders with higher dividends as well as reinvest for growth. Higher-yielding equity markets are trading at elevated valuations, and this is an option that should be considered.
- For investors who can allocate to illiquid assets, the stable cash flows from real assets, such as infrastructure, transport and real estate, may be a viable source of reliable income and bond-like portfolio diversification.
Diverging recoveries, diverging policies

OVERVIEW

• Variations in vaccination progress and economic stimulus have delayed synchronization of the global economic recovery. The U.S. is expected to lead the recovery in 2021, and Europe should follow. China’s economy has normalized and is expected to expand along its trend growth.
• Global inflation has accelerated as expected, but there is little clarity whether a series of one-off factors, such as supply-side bottlenecks, semiconductor shortages and commodity price volatility, could prolong this trend.
• Desynchronized recovery implies diverging paths for global monetary policy. Some smaller central banks have already become more hawkish. China has started to normalize with slower credit growth, and the U.S. is still being patient, despite a pick up in inflation. Meanwhile, the priority of most Asian central banks is to get through the latest wave of infections.

INVESTMENT IMPLICATIONS

• The economic recovery should continue to be positive for risk assets. However, the varying pace of the recovery implies Asian investors should take a more active approach when allocating by region.
• The U.S. and China are still leading in terms of economic performance, even though the strongest period of their rebound has probably passed. Europe is starting to benefit from a higher vaccination rate and the implementation of the European Recovery Fund.
• Asia’s domestic demand is still challenged by further waves of infections, but its export sector is posting strong demand.
• Ongoing inflation worries and future policy normalization could push bond yields higher, which require fixed income investors to be agile. Yet, higher inflation would raise demand for income and could push investors to other income-generating assets such as high-dividend stocks and alternatives, alongside high yield (HY) debt and emerging market (EM) bonds.
The left chart shows the percentage of the global population that has received at least one dose of COVID-19 vaccine. The U.S. and UK have made considerable progress in vaccination coverage in 1H 2021. The eurozone has accelerated vaccinations in the past two months. However, Asia is lagging in vaccinations because of limited supply and public hesitancy toward being vaccinated.

The right chart shows the number of new infections in Europe, the U.S. and Asia. Both the U.S. and Europe are seeing success in pushing down their infection rates, and the effectiveness of the vaccines should be demonstrated in the next two to three months.

Uneven global recovery

The next phase of recovery should be determined by the progress of vaccinations, which in turn will boost consumption and business investment.

- The U.S. and the UK have been the leading major economies in vaccinations. China and Europe have also accelerated the pace of inoculating their populations. However, Asia and other emerging markets are lagging due to vaccine hesitancy and insufficient supply.

- Locations with better progress on vaccinations can re-open their economies on a more consistent basis, attracting consumption and business investments. This is already happening in the U.S., alongside sizeable fiscal stimulus.

- For the laggards, the recovery will likely be delayed until 2022 or beyond. For Asia, the export outlook is still favorable, but domestic demand and travel will stay subdued for much of 2021.
Inflation is driven by a series of one-off events

Global inflation has accelerated as expected. But a few one-off factors in the U.S. are driving prices higher.

- The U.S. labor market distortion could push up wages in the near term. Businesses are struggling to hire despite the unemployment rate still being high. But the situation may ease in 3Q 2021 as supplemental unemployment support ends.

- Nonetheless, supply-side bottlenecks, such as rising shipping costs, could continue to assert pressure on prices. A shortage in semiconductors and fuel could also prolong elevated inflation in the coming months.

- We still expect U.S. inflation to revert to the Fed’s 2% long-term target in 2022. However, investors will remain focused on whether more one-off events would delay the return to normality, and whether the Fed would be pressured to raise rates earlier than expected.

• This chart shows the headline and core Personal Consumption Expenditure (PCE) inflation in the U.S. The PCE inflation is the Federal Reserve’s (Fed) preferred inflation measure and it is aiming for inflation to average 2% in the long run.

• Given that inflation has been below target in recent years (1.6% over the past three years), the Fed’s average inflation targeting implies the central bank should tolerate headline PCE running above 2% for an extended period of time.


The Federal Reserve (Fed) uses the Personal Consumption Expenditure (PCE) deflator to measure inflation. Core PCE is defined as PCE excluding food and energy prices. The PCE deflator employs an evolving chain-weighted basket of consumer expenditures. In August 2020, the Fed unveiled its Average Inflation Targeting policy, which seeks to achieve inflation that averages 2% over time.

Guide to the Markets: Asia. Data reflected most recently available as of 30/06/21.
Central banks are going their separate ways

The varying pace of recovery could prompt global central banks to adopt different strategies in normalizing their monetary policies.

- The Fed is still a kingpin given its influence in global markets. We expect the Fed’s asset purchases to slow in early 2022, and it may even need to advance the first rate hike to 2023, or even 2022, should the inflation momentum persist and the unemployment rate continue to fall.

- The People’s Bank of China has already pared back credit growth in the first several months of 2021, with an emphasis on constraining corporate leverage and the real estate market.

- Asia’s central banks are lagging the rate-hike cycle given the new waves of infections in a number of Asian economies, despite the recent pick up in inflation. This could also limit the strength of Asian currencies in 2H 2021.

- This chart shows the number of interest rate hikes or cuts by developed market (DM) and EM central banks since 2008. It shows central banks cut rates aggressively in 2020 due to the pandemic—the largest number of cuts since the global financial crisis.

- Central banks are likely to make very few changes in 2021 despite the latest spike in inflation. We believe there could be more tightening in 2022 and 2023.
Staying on course with the recovery playbook

OVERVIEW
- The ongoing recovery and rising yields still favor risk assets such as equities, corporate HY debt and EM fixed income.
- Recovery has peaked for the U.S. and China, and there is more in store for Europe, as well as Asia and other EM economies, as vaccination rates increase and infections recede. This implies relatively modest returns for equities at the index level, but ample opportunities among sectors.
- Higher U.S. Treasury (UST) yields still pose a challenge for fixed income. HY corporate bonds and EM debt remain viable sources of income generation.

INVESTMENT IMPLICATIONS
- Asian investors should continue to diversify their equity portfolios globally. Europe has enjoyed strong performance in 1H 2021, and we expect the ongoing cyclical sector rebound to provide more impetus.
- Asian equities have lagged this year due to policy normalization in China and new waves of infections in some of the region’s economies. Exports should still be well supported, while patience is needed for domestic demand to recover as current infections are being brought under control.
- In terms of sectors, cycicals should ride the economic tailwinds and the strength of the earnings outlook. Still, be mindful of rising raw material and wage costs. Higher inflation costs could add pressure to the profitability of downstream manufacturing industries in the near term.
- UST yields could consolidate in the near term but may push higher over the medium- to long-term trend. Investors should think short duration on fixed income while opting for higher-yielding debt.
Recovery is still positive for risk assets but expect more moderate returns

The different recovery stages call for a more diversified approach on global equities.

- China and the U.S. are likely to have gone through the strongest period of their recoveries, but their growth paths have solidified. This implies rotation within the indices would be critical in return generation rather than at the benchmark level.

- Europe is in a sweet spot as the region is emerging from the latest wave of infections at a time when vaccination rates are accelerating. The European Recovery Fund should also provide some fresh growth momentum.

- Asia and emerging markets may require more patience and differentiation. The export sector is still in solid shape, but domestic demand will take longer to revert back to the long-term trend as vaccination rates remain a critical ingredient.

This chart illustrates the historical return profile of different assets at various phases of the economic cycle, using the global manufacturing purchasing managers’ index (PMI) to define such a cycle.

While the global manufacturing PMI may be nearing a peak, we are still some distance away from late cycle cooling since many economies are still in the recovery phase. This suggests risk assets, such as equities and corporate bonds, should still generate returns, albeit at a slower pace.
United States: Interest rates and equity performance

Correlations of S&P 500 relative sector performance to U.S. 10-year Treasury yield

Returns are based on price index only and do not include dividends. Past performance is not a reliable indicator of current and future results.

- This chart illustrates the relative performance of individual sectors against the S&P 500 and its relationship with UST yields. In a rising yield environment, cyclical sectors, such as financials, industrials and materials, outperformed the index. Meanwhile, utilities, real estate and consumer staples underperformed.
- Since we expect UST yields to rise in the medium term on the back of the economic recovery, the rebound in cyclical sectors is expected to continue.

Cyclical rotation to continue

With rising yields and the ongoing economic recovery, tactical investors will favor cyclical sectors.

- Rising government bond yields have supported cyclical, including financials, materials and industrials, while technology (tech) has come under pressure. We expect this to continue in 2H 2021.
- Strategic investors may look to build their tech portfolios during this period of underperformance, given the sector’s long-term track record. In the U.S. and China, tech leaders are under regulatory scrutiny, but this presents opportunities for the sector’s smaller players.
- Rising labor and raw material costs are a concern for manufacturers. Downstream players in the supply chain are currently in a more vulnerable position. Materials and energy could be useful as a hedge against inflation and higher prices.
Preparing for higher yields

UST yields are still expected to rise over the long term as recovery solidifies, alongside the possibility of inflation staying higher for longer.

- UST yields are expected to rise in the medium term on the back of higher real yields. Sustained inflation could add to this scenario. Short duration is one way to protect investors from such a scenario. Gold’s role is more ambiguous as the commodity excels when inflation depresses real yields, but struggles when inflation expectation recedes.

- HY corporate debt has the advantage of both relatively shorter duration and higher yields, which counter the negative impact on returns from rising UST yields. Ongoing economic rebound should also keep default rates low.

EM fixed income had a challenging first half, partly due to the rebound in the U.S. dollar (USD). Greater USD stability in 2H 2021 against EM currencies should help EM debt improve its return. However, individual market challenges imply active selection is a must.

- This chart illustrates the yield-to-maturity (YTM) of different types of fixed income, which includes government bonds, investment-grade (IG) and HY corporate debt, and Asia and EM bonds. Their durations, or sensitivity to a rise in yields, are also listed. Higher yields would imply lower bond prices.

- A rising yield environment would require investors to stay short duration to reduce downside risks to bond prices. They should also opt for higher YTM as a buffer to duration risks.
Asia is lagging but not for long

OVERVIEW

- Hopes of a quick recovery in Asia are being dashed by a resurgence of COVID-19 cases and the slow vaccination rollout across the region. Recent spikes in infections remind us that even locations that have done well in controlling the pandemic previously are not immune in the absence of higher vaccination rates.
- The U.S. and Europe may be ahead in vaccination rates, but we expect their recovery to benefit Asia as global demand rises.
- The recovery has been uneven and this could likely continue. China should lead the way, but other Asian economies will follow as they benefit from pent-up consumer demand and the fading impact of the pandemic.

INVESTMENT IMPLICATIONS

- We remain positive on Asian equities. Diverging intra-region performance could likely continue. China and other locations involved in electronic supply chains, or with an electronic product bias, should gain from increasing global demand. Although the share of U.S. and European demand for Asia's goods is not as high as it once was, it remains an important driver.
- Earnings are expected to improve. Profit margins are rising despite worries over inflation and higher input costs.
- Asian equity valuations are not extremely attractive from a historical perspective, but relative to the U.S. and other major regions, they are undemanding.
Asia is lagging behind but this won’t last forever

Asia has been lagging DM performance as resurgent COVID-19 cases dragged down the economic outlook and investor sentiment for several Asian markets.

- Asian equities have been falling behind economies such as the U.S. and UK because of the region’s relatively slow vaccination rollout. Equity performance compared to other DM economies has suffered, but this situation should improve as vaccination rates increase with supply over the course of the year. We expect the growth differential to developed markets to narrow and Asian equity performance to close the gap.

- A possible peak in credit and activity in China, alongside regulatory uncertainty, has weighed on the Chinese markets. But we still believe China will lead the recovery in Asia. The overall global recovery and pent-up demand is a positive for Asian exports and trade in general.

- Asian equities tend to underperform as developed markets when the gross domestic product (GDP) growth differential is small. We observe that this differential has been trending down since the pandemic started, showing APAC ex-Japan economic growth outperformance versus developed markets has been shrinking. Asian markets have lagged their DM peers, but growth in the U.S. may peak later this year after the initial impact of fiscal stimulus fades.

- Asian earnings are still highly correlated with global trade. The re-opening of the global economy is good news for pent-up demand and export activity. This should lead to better earnings results.
How worried are we about inflation?

Rising inflation, especially in the U.S., has led to worries that the end of supportive policy is near.

- Despite some higher-than-expected inflation numbers from the U.S. recently, we believe this inflation is transitory and normal for a recovering and growing economy. We would only become concerned if inflation remains elevated, along with strong labor market and wage growth numbers, over several consecutive months.

- In Asia, inflation is a minor concern, with most of the pick up coming from base effects and higher commodity prices.

- Rising input prices are likely to put cost pressure on businesses. However, this currently does not appear to be the case. Profit margins in Asia are rising, which is normal in the early part of an economic recovery and should lead to higher earnings and performance.

- We attempt to gain some insight into the pass-through of movements from input costs to output prices. The input-output price line is calculated using the Purchasing Managers’ Index survey sub-components to show recent changes in costs and output prices.

- This chart shows that profit margins still expand when input prices are expected to rise faster than output prices. This is because not all businesses are sensitive to input cost increases and some companies, especially those with large fixed costs, can still expand their profit margins when business improves.
APAC ex-Japan equities: Performance drivers

Other factors to keep in mind

Other drivers of Asian equities still look favorable, but there are some risks.

- Valuations are currently not cheap at this level on a P/B basis, but they are still relatively undemanding when compared to the U.S. and European markets. Current levels are above long-term averages but not extremely so.
- EM and Asian equities tend to be inversely correlated with the USD. A stronger USD would suggest poorer relative performance. Our outlook is for the USD to weaken on the projected increase in U.S. spending, but there is a risk of USD strength if we see an unexpected early start to the Fed’s tapering and a shift in interest rate differentials.

- APAC ex-Japan equities have better subsequent returns when price-to-book (P/B) valuations are low. Current valuations are not cheap but are still not at a level that has historically seen a consistent negative return.
- APAC ex-Japan equities have generally outperformed developed markets when the USD is weakening. The USD has just started to weaken, and our longer-term outlook is for this weakening to continue with the U.S. government now running very large fiscal deficits.
Income beyond fixed income

OVERVIEW
• The struggle to find income is not new, but is currently complicated by expectations of rising government bond yields and heightened inflation, creating risks for holders of core government bonds or longer duration assets.
• The strengthening economic recovery has bolstered the earnings outlook. This should lead to a recovery in dividends as companies return capital through higher dividend payouts.
• For those looking for potentially more stable income streams, with a lower correlation to equities, alternatives, such as real estate and infrastructure, present predictable inflation-linked income options.

INVESTMENT IMPLICATIONS
• Some segments of the bond market can still be tapped to provide income in portfolios, such as HY bonds and EM debt. However, investors will increasingly have to look beyond the bond market for income.
• The strength in earnings growth means companies can reward shareholders with higher dividends as well as reinvest for growth. Higher-yielding equity markets are trading at elevated valuations, and this is an option that should be considered.
• For investors who can allocate to illiquid assets, the stable cash flows from real assets, such as infrastructure, transport and real estate, may be a viable source of reliable income and bond-like portfolio diversification.
Fixed income to low income

Years of financial repression by central banks as well as longer-term secular forces have created a downdraft of income in the traditionally held parts of the fixed income market.

- There are still sources of income within the fixed income market, such as U.S. HY bonds or EM debt, or the relatively newer China government bonds. But investors must be more selective in their allocations given market and idiosyncratic risks to these assets.
- Meanwhile, the risk/reward of holding higher-quality fixed income assets, such as core government bonds and IG debt, has become less appealing as higher duration assets are susceptible to capital losses as interest rates rise.

- The opening of China’s financial markets has led to greater investor interest in its relatively higher-yielding government bonds.
- Not only do Chinese bonds have a higher yield than many developed markets, but also they do not exhibit the same risks as other EM government bonds, with a much lower correlation to the flagship Bloomberg Barclays Global Aggregate Index.
The Asian equity market can be fruitful grounds for income seekers, with more companies offering up a greater than 3% yield than many other parts of the world.

Moreover, as earnings growth is expected to rise, dividend growth is expected to increase as well. Investors should not only focus on the absolute level of dividend yield but also the prospects for it to grow over time.

The popularity of growth stocks, traditionally lower dividend payers, has reduced the dividend component of total shareholder return.

- In the U.S., for example, 22% of the 10.2% average total return since 2002 came from dividends. In the last five years, this number has fallen to 14% given the explosion in U.S. growth stocks. However, the change has not been as swift in Asian markets as dividends have still accounted for 24% of total returns in the last five years (28% since 2002).

- This trend may be starting to turn as elevated valuations in growth sectors greatly diminish return prospects and investors rotate toward value and higher dividend payers.

- In the depths of the COVID-19 pandemic, dividend forecasts collapsed alongside earnings expectations. Regulatory changes also prevented some companies from paying or increasing dividends during the period. However, a V-shaped recovery in many economies has led to a sharp increase in dividend forecasts, which are noticeably stronger in Asian markets.
Alternative income

Looking beyond bonds for income means considering non-traditional assets. Alternative assets present their own challenges but offer similar characteristics for income and portfolio diversification.

- In recent years, investors have been increasing their allocations to alternatives as such assets offer the prospect of increased returns, steady income and, in some cases, bond-like diversification.

- Real assets, such as infrastructure, real estate and transport, are assets that have steady cash flows that can translate to higher income. The contractual nature of these cash flows, often with high-quality counterparties, leads to more predictable income streams and lower return volatility.

- These assets may also be an inflation hedge as the cash flows are indexed to rising inflation rather than having to absorb it.

- This page shows the yield that can be earned across different asset classes. U.S. Treasuries offer one of the least attractive options as higher income can be found in higher-dividend equities and extended segments of the fixed income market.

- Extending into some riskier bond assets or added equity income can increase overall portfolio correlation to equities. Alternatives, such as transport, infrastructure and real estate, can offer both higher yield and increased diversification.
Quarterly Perspectives

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