Global Asset Allocation Views

Key findings from the Multi-Asset Solutions Strategy Summit

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AUTHOR

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IN BRIEF

- Despite recent market jitters over Omicron, 2021 was a year of strong returns driven by robust economic growth and a powerful rebound in earnings; while the pace of growth may moderate in 2022, we continue to see a positive backdrop for risk assets.
- Currently elevated inflation levels are likely to moderate next year as supply chain issues ease; this may remove pressure on central banks to hike aggressively but even then, we see rates rising gradually over the next year.
- The strong earnings outlook and gradual increase in yields keep us overweight stocks and credit and underweight bonds and cash in our portfolios.
- Within equities we continue to favor the U.S., Europe and Japan but remain cautious on emerging markets as earnings revisions are still negative and we anticipate further modest upside to the dollar in the months ahead.

EXHIBIT 2: NUMBER OF 25 BASIS POINT HIKES PRICED ACROSS MAJOR CENTRAL BANKS

In the U.S. and UK markets have priced an aggressive pace of rate hikes

SUMMARY

Despite, or perhaps because of, the new Omicron variant of COVID-19, stock markets seem determined to close out 2021 near all-time highs. Immediately following U.S. Thanksgiving, Omicron looked to have given markets a bloody nose and scotched hopes of a “Santa Claus rally.” But early data suggest that not only are existing vaccines and boosters effective, but that the strain is both more transmissible and less aggressive than its precursors — prompting some to whisper the hope that this may be the beginning of the end of the pandemic, in turn giving markets a welcome boost.

It is too early to say with certainty how and when the pandemic will finally retreat. Rapid deployment of restrictions in Europe suggests we are not there yet. But at the same time, improving vaccine technology and the new variant’s apparent dip in virulence are reasons for optimism. And with each virus round, the economy is adapting more quickly and bouncing back faster. Even if Omicron presents a speed bump for the economy, it is certainly not a stop sign. We continue to expect above-trend global growth in 2022, with further upside to earnings and a positive outlook for markets.

Robust household balance sheets, strong corporate capex and positive trends in productivity look set to persist into 2022. Although the big fiscal thrust of the last two years is now firmly in the rear-view mirror, we believe that private sector demand will be sufficient to keep the economy growing well above trend. Higher frequency data in China show signs of bottoming, so we see some scope for reacceleration in Asia to add positively to the growth mix. And if we are correct that Omicron is a temporary headwind, then Europe, too, should continue to enjoy economic tailwinds.

The most widely discussed economic trend of 2021 — inflation — likely continues into early 2022, but even now we see signs that it may be peaking. Supply chain issues, which fuelled goods inflation, look set to dissipate in the first half of next year. Meanwhile, in labor markets, we anticipate that the recent step-up in wages will boost participation rates, such that the rise in labor costs is more of a level shift than a persistent trend. Even then, we are optimistic that a better trend in productivity in this cycle than in the last will allow firms to absorb higher wage costs relatively easily, in turn dampening some of the inflationary pressures seen in the second half of 2021.

To be sure, inflation is likely to be higher this cycle, and certainly there is a wider range of risks for inflation — in both directions. As a result, monetary policy is inexorably on a tightening path. However, if inflation pressures have eased by mid-2022 (as we expect they will), the pace of hikes currently priced in may look aggressive.

The environment we anticipate calls for a continued pro-risk stance, and we play this by keeping our overweights (OW) in stocks and credit and our underweights (UWs) in bonds and cash. Our highest conviction view is that equities will perform strongly on improving earnings, but given the recent widening of spreads in credit, we have also upped our conviction in our credit OW. We acknowledge that multiples are elevated in some indices, notably U.S. large cap, but in other regions the dip in P/E ratios by over 20% from 1Q 2021 highs is consistent with historical patterns when moving from early to mid-cycle. In 2022, as in 2021, we expect earnings growth to drive equity returns, and even in more richly valued regions we believe earnings growth will outstrip any drag from multiples. Our preferred regions remain the U.S., Europe and Japan, while we remain more cautious on emerging markets.

Rates are set to rise in 2022, so UWs to duration and cash are warranted. However, we expect the pace and scale of rate increases will be gradual. We do not see rates being forced sharply higher by persistent inflation pressure. Even as central bank demand moderates, we anticipate an insatiable bid for duration, which will increase incrementally as rates rise. As a result, we keep the scale of our duration UW modest. In the short term, the prospect of higher U.S. rates likely keeps USD supported, justifying a modest OW in the currency.

Overall, our positions reflect a pro-risk tilt. Simply put, we believe that the upward pressure on stocks from earnings growth will exceed the upward pressure on bond yields from inflation — and so prefer to express our positive view through an OW to stocks rather than a large bet against bonds.
MACRO OVERVIEW

STILL A MID-CYCLE ECONOMY

The current expansion is developing differently from the previous one in many ways, including the rapidity with which the economy progressed through the early part of the cycle. Indeed, a glance at the prevailing inflation rate, and the Federal Reserve’s (Fed’s) seeming rush to begin tightening monetary policy, might suggest that the economy has already entered late cycle. We think, though, that the bulk of the evidence points to a continuing mid-cycle phase. Recession risk over the next year remains very low, in our view.

Corporate and household balance sheets and cash flows, especially in the U.S., look exceptionally good by medium-term standards. As a consequence, we see little probability that a pullback in spending would be sufficiently large to put the economy in recession, at least absent a major shock. On the corporate side, the jump in leverage that occurred during the pandemic recession has run its course, and indeed firms are now experiencing “passive deleveraging” as the economy continues to rebound. Leverage remains elevated when measured as a share of GDP, but given high margins it looks more moderate as a share of profits. Moreover, the implied corporate interest rate remains below 3%, extremely low compared with history, and the interest burden thus represents a lower share of corporate value-added than at any point since the 1960s (Exhibit 3). In terms of flows, the business financial balance – a measure of corporate saving – is in positive territory. Similarly, free cash flow exceeds spending on capex. Such conditions stand in stark contrast to the typical configuration ahead of recessions, and in general these metrics imply that companies are not currently behaving in a particularly expansionary fashion. Meanwhile, profit margins, which are also historically elevated, edged up in the third quarter.

Household net worth, expressed as a share of income, stands at a record high, and debt looks broadly stable, although mortgage lending has picked up somewhat. After surging in the aftermath of the pandemic shock, the saving rate has normalized. Still, in the 18 months after the pandemic struck, households accumulated a stockpile of “excess savings” that amounts to an estimated USD 2.4 trillion, more than 10% of GDP, much of which is sitting in cash. We see some possibility that consumers dip into these funds in 2022, temporarily pushing the saving rate below its pre-pandemic norm. In any case, as with businesses, household conservativism up to now makes a large decline in spending unlikely. And outside the U.S., household saving rates have stayed higher. On average, in major developed market (DM) economies they are running about 6 points above typical levels from the previous cycle, creating room for declines over the coming year or two.

As we think about the sustainability of this expansion, we are focusing closely on the outlook for productivity growth. After a string of strong readings during the previous year, U.S. productivity stumbled in the third quarter. The simultaneous jump in pay generated significant upward pressure on inflation. Still, we think the medium-term drivers of the productivity acceleration, which were already evident to some degree before the pandemic, remain in place. To be sure, composition shifts in the economy have boosted the reported level of productivity (with, for example, the labor-intensive restaurant sector shrinking in importance), but our calculations suggest that much
of the pickup has been genuine (Exhibit 4). We note that capex has gotten off to a much stronger start in this cycle than in the prior one, bolstering the growth rate of the capital stock, which seemed to suffer much less impairment than usual during the recession. And intellectual property investment, which over time has correlated somewhat with total factor productivity growth, has extended its long-term trend toward greater importance. Should productivity growth sustain a faster pace during this expansion, greater uplift to worker pay could coexist with stable inflation and corporate profit margins.

Our calculations suggest that compositional shifts in the labor force cannot explain all reported increase in U.S. productivity

EXHIBIT 4: U.S. LABOR PRODUCTIVITY AND ESTIMATED COMPOSITION EFFECT


Labor supply is another issue facing the economy in 2022. While the labor market has experienced considerable healing during the past 18 months, the participation rate - the share of the working-age population active in the labor market - stands 1.8 percentage points below its pre-pandemic peak. Here, we think some damage will likely persist. Other things equal, aging would have cut participation by about 0.4-0.5 percentage points (ppt) in the time since the pandemic hit. And in number terms, those over 55 years of age represent the largest bloc of “disappeared workers.” The flow of so-called excess retirees accounts for about one-third of the shortfall in the participation rate relative to its pre-pandemic level, and experience suggests that not all of these individuals will return to the labor market. Still, if even half of them were to come back, along with two-thirds of younger people who have stepped away from work, about 4.5 million jobs could be created by the end of 2022 without pushing the open unemployment rate below 3.5%, the level observed before the recession. Our calculations suggest that such an increase in labor supply should allow for the degree of economic growth that we forecast, unless productivity growth runs at an unexpectedly low rate.

On our business-cycle scorecard for the U.S. (Exhibit 5 - see later), we now score all of the economic factors as mid-cycle, and the same is true for almost all of the market indicators (other than corporate profit margins, which are still rising, as is typical of the early part of the cycle). As mentioned, current inflation readings look like a late-cycle phenomenon, but we expect those to diminish somewhat as 2022 unfolds. Additionally, we see little near-term path from elevated inflation to a recession, as the Fed has not yet begun raising interest rates. Monetary policy tightening might eventually call time on this expansion, though that seems a very unlikely prospect within the next two years at least. Very few postwar expansions have ended because of pressure from higher interest rates, at least directly. But this cycle seems determined to blaze new trails in various respects. We regard most other economies as being a little earlier in their cycles than the U.S., with China as the major exception.
Major economies still have room to grow

EXHIBIT 6: REAL GDP DIFFERENCE FROM PRE-PANDEMIC TREND (%)

Notwithstanding the generalized turn toward less accommodative central bank policy, financial conditions have continued to ease modestly and should remain incrementally supportive of growth for a while yet. Global equities have climbed strongly this year, more than offsetting the upward drift in bond yields, and corporate credit spreads have narrowed. EM bond yields have moved up by more than their DM counterparts amid more stringent monetary policy tightening, but they remain historically low. In another contrast with the previous expansion, bank loan growth is running at moderately positive rates across the developed economies. More importantly, bank lending standards are easing in the U.S. and stable elsewhere, pointing to a very different regulatory dynamic compared with the years following the global financial crisis (GFC). Elevated private sector confidence also underpins our forecasts. While sentiment has generally cooled somewhat relative to its early 2021 peaks, it remains above long-term averages and has ticked higher as the fourth quarter has progressed.

We identify three main downside risks to our current forecasts. First, fiscal policy has already moved past its point of maximum accommodation, and government balances are improving sharply. The negative “fiscal thrust” we project would, under normal circumstances, put significant downward pressure on growth. This time, though, we expect private spending to hold up reasonably well. The fiscal support provided during and after the pandemic shock primarily took the form of emergency income support. With labor markets now functioning well and generating rapid income growth for households, we do not think the withdrawal of the earlier help will do much damage. Indeed, much of the expected tightening has already taken place. The U.S. fiscal deficit, for example, has already narrowed considerably, accompanying the decline in the household saving rate. And “extra” government benefits, on top of those routinely provided before the pandemic, represented less than 2% of U.S. household income in October - and some of those transfers, like the extended child tax credit, will continue in 2022. Still, we will be watching household income and saving dynamics in coming months for signs that fiscal pressure is proving more intense than expected.

Second, the Omicron variant of the coronavirus burst on the scene at the end of November. At the time of writing, we do not know enough about its likely effects to adjust forecasts. Early indications suggest it will likely lead to acceleration in virus case counts, but its implications for more severe outcomes, like hospitalizations, remain unclear. Economies have become more resilient to virus waves over time, and our initial set of forecast downgrades in response to the Delta variant now seem too severe. And we do not expect sweeping restrictions on activity to reappear in the U.S., though European governments have already imposed some limitations in recent weeks as the Delta variant has circulated. Moreover, our forecasts already incorporate some deterioration in virus conditions during the Northern Hemisphere winter. Still, the growth risks associated with Omicron plainly tilt to the downside.

Within emerging markets, low vaccination rates in parts of South Asia and EEMEA suggest these regions are likely to be more vulnerable to a resurgence in COVID-19 cases led by the new variant, which will likely put more strain on their health care systems. However, the economic impact could be higher in South Asia, given governments in the region have shown greater willingness to impose mobility restrictions to contain the spread of the virus. For instance, ASEAN economies were hit particularly hard by the Delta wave in Q3, which led to lockdowns and suspended factory productions.
PATHS FOR CHINESE POLICY AND GROWTH

China represents the third major downside risk to global growth. In our view, the scale of the government’s policy easing in response to slower growth momentum will be the key determinant of China’s 2022 outlook. The experience this year suggests a change in China’s macro policy framework. Chinese policymakers seem to be more tolerant of a near-term growth slowdown for their long-term strategic objectives, such as “common prosperity.” While the strike price for China’s “policy put” appears to be lower than it has been in recent years, a “policy put” remains in place, in our view. To assess where the growth floor is, we will focus on the Chinese government’s annual GDP growth target, which will be formally announced at the National People’s Congress meeting in March 2022. Following an “above 6%” growth target in 2021, the lower bound of the government’s growth target could potentially fall as low as 5% in 2022, a far larger reduction than the typical 50 basis point (bps) adjustment.

Facing increasing downward growth pressure, we expect Beijing to step up monetary and fiscal easing to support growth. However, unlike the easing cycles of 2015-16 or early 2020, the scale of the macro policy easing in 2022 will remain modest, in our view. We expect the People’s Bank of China (PBoC) to further cut the reserve requirement ratio and lean more on low profile monetary policy tools such as relending to provide targeted credit support for small and medium-sized enterprises (SMEs) and green investment. But we think the probability of policy rate cuts is low, given policymakers’ focus on containing financial risks. Following the sharper than expected fiscal tightening this year, we expect a modest easing in 2022, helped mainly by accelerating issuance and deployment of the local government special bonds.

Despite Beijing’s focus on ensuring that growth stays within a reasonable range in 2022, we think policymakers will remain committed to structural reforms. As a result, we do not expect a complete reversal of the regulatory tightening on the property, tech and high emission sectors, although some fine-tuning is likely. Certainly, Chinese policymakers could ramp up easing. But truly aggressive policy easing would likely require a more broad-based growth slowdown, especially weakness in Chinese exports in addition to a worsening property sector and soft consumption.

Apart from the policy reaction function, the magnitude of the property downturn is the other key uncertainty clouding China’s outlook next year. We see signs that the property sector slowdown that started around the middle of 2021 has worsened in recent months, with weakness appearing in lagging indicators such as property investment and home completions. We expect China’s property activities to remain depressed in the next one or two quarters amid tight funding conditions for property developers and tepid sentiment among homebuyers.

However, the myriad easing measures that were rolled out recently suggest a fairly low risk that the property downturn would lead to a systemic crisis. Protecting the interests – and sentiment – of homebuyers is a top priority for policymakers, and local governments have been asked to help ensure the delivery of property projects. Beijing has stressed support for mortgage demand, including demand for second homes, and we expect further mortgage easing in 2022. There is also marginal easing on developers’ financing, with a gradual opening of the onshore corporate bond market and loosening of property development loans. However, these easing measures are more tilted to state-owned enterprises (SOEs) and less leveraged private property developers, suggesting a persistent bifurcation in the market between high quality and low quality developers.

While we expect China’s infrastructure investment to rebound next year with stronger fiscal support, it is unlikely to fully offset the slowdown in property investment. This reflects both deleveraging focus at the local government level and the fact that infrastructure investment has a smaller impact on overall economic activity than does the property sector. Green investment, including investment in green infrastructure and upgrading of production equipment, will likely increase strongly next year, but it’s still relatively small scale, at around 20% of residential property investment.

Elsewhere in emerging Asia, we expect consumption recovery to be a key driver for growth next year, while export momentum moderates. The region as a whole has made significant progress on vaccination: Singapore, South Korea and Malaysia have fully vaccinated 70% of their populations. Higher vaccination rates and more broad-based reopening will likely support a faster rebound in consumption activities in 2022. Meanwhile, the strong export tailwind that emerging Asia enjoyed this year could diminish. EM Asia could give up some of its recent export market
share gains once export capacity in the other economies starts to normalize. A shift in DM demand from goods to services will also likely pose headwinds for regional exports. In particular, strong momentum in electronics exports may be past its peak as economies continue to reopen and demand for “work-from-home” goods moderates.

With an eye on the three key downside risks we have discussed (fiscal policy shift, Omicron and China), we expect global growth to run at roughly a 4.5% (Q/Q, SAAR) clip in the first half of 2022, down slightly from 5.0% in 4Q 2021. We then forecast deceleration to about a 4.25% rate in 3Q 2022, followed by 3.5% in the final quarter of next year. We think the rest of the world will outgrow the U.S., as was already the case in the third quarter, but not to a historically unusual degree. We also think the EM-DM growth gap has bottomed, but it remains only marginally positive and we project it to remain unusually narrow through 2022. That small growth premium underlies much of our caution on EM financial assets at the moment.

After a choppy 2021, we expect global industrial production growth to pick up steam next year. October data already brought signs of reacceleration after supply constraints and virus restrictions slowed output sharply in the prior few months. Purchasing managers’ indices for November echo that optimism, in part because of improvements in supplier delivery times and reductions in work backlogs (factories in many parts of Asia are coming back online). Global shipping costs have also come off their peaks, especially for routes from China to the U.S. and Europe. Data from the hard-hit automobile sector have also turned upward modestly, with output climbing in Germany and the U.S. and Japanese carmakers expressing greater optimism about their medium-term prospects. As mentioned, the Omicron variant may threaten this improvement. Otherwise, however, we think factory output will remain well supported throughout the coming year. True, consumer spending on goods, especially in the U.S., will likely decline as spending rebalances toward services. But industrial output remains below pre-pandemic levels despite the surge in demand for goods; capex growth will partly compensate for softer consumer goods purchases; and inventory restocking from what appear to be historically lean levels should provide a strong ongoing tailwind.

INFLATION STILL RUNNING HOT; GOODS PRICES CRUCIAL FOR 2022 OUTLOOK

After slowing sequentially during the third quarter, inflation has since reaccelerated. Indeed, the month-on-month global inflation rate for October topped any reading from the previous 20 years. In sequential terms (3M/3M, SAAR), global inflation has been running around 5%. Some of that reflects rising energy prices, but core inflation has also been running above central bank targets. These pressures have manifested themselves in fairly generalized fashion, but the spread between DM core inflation rates in year-on-year terms has been unusually wide. Goods prices have told the main inflation story in most places. They have accounted for the bulk of the surge in core inflation this year as services price inflation has remained more moderate. In the U.S., for example, core goods prices jumped 8.5% year-on-year in October, compared with 3.3% for core services.

Two developments in recent months point to an increased likelihood that relatively high inflation persists into 2022. First, underlying measures of inflation, such as medians and trimmed means, suggest that increases have broadened beyond the small number of items, related mostly to supply squeezes and economic reopening, which accounted for the bulk of the initial rise in early 2021. Second, wages have been rising rapidly. In year-on-year terms, most pay measures have been climbing at rates above 4%. To some degree, these pressures likely reflect labor market frictions that should diminish in coming years, and indeed a rise in participation during November did occur alongside a slowing in earnings increases. But corporate surveys suggest that strong wage growth will likely continue. On the other hand, the upward drift in inflation expectations evident in the first half of 2021 has slowed. Survey responses, at least about longer-term views, have been moving sideways, and market-based measures have declined from their peaks.

We continue to see two-sided risks to the outlook over the coming year. In our base case scenario, inflation continues to run hot by the standards of recent decades but gradually moves down toward the Fed’s 2% target. Considerable uncertainty derives from the fact that our top-down and bottom-up approaches to forecasting inflation are sending sharply differing messages at the moment. Top-down methods suggest that inflation will remain high, significantly above 2%, throughout 2022. Bottom-up aggregations of individual components, by
contrast, point to the possibility of a major reversal and an inflation undershoot next year.

Our top-down method conceptualizes inflation as an inertial process, one that is influenced by expectations (which act as a kind of gravitational pull on inflation over time) and the economy’s degree of slack or lack thereof (which puts a thumb on the scale, guiding inflation higher or lower), along with knock-on effects from energy price swings as well as movements in the dollar. These drivers imply a continuation of high inflation as this year’s large shock reverberates for several quarters to come. Having shifted somewhat higher, expectations are not putting as tight a lid on inflation as was the case in the previous expansion, and the economy is headed to overheating territory, likely operating above its potential level in 2022. All else equal, this combination of forces looks consistent with a core CPI inflation rate next year of 3% or a bit more.

But, as discussed, this cycle seems determined to blaze new trails in various ways – so all else may not now be equal. Top-down approaches do not distinguish among shocks, and the one that erupted in 2021 looks highly unusual. The jump in goods prices stands out against a history of fairly steady declines during the globalization era since the early 1990s. And some individual items, most obviously used cars, have experienced much larger price surges than the overall index. If supply constraints continue to ease at the same time that consumer spending moves back toward services, many goods prices are likely to fall in 2022, partly unwinding this year’s shock. To be sure, services prices seem likely to behave more cyclically than during the past few cycles. We expect shelter inflation, for example, to hit 5% by the end of next year, which would be its fastest pace since the early 1990s. Even taking that uplift into account, though, a drop in core goods prices of 5%-6%, reversing only a portion of this year’s increase, could push core inflation below 2% (Exhibit 7).

Goods prices have surged in an unusual fashion

EXHIBIT 7: U.S. CORE PCE GOODS PRICES (2012 = 100, SA)


We take some direction from each of these methods. The inertial nature of inflation suggests that a move of the scale observed this year will likely echo for some time to come. But we also think a swath of goods prices are likely to drop in 2022, bringing overall inflation back down toward the Fed’s target. We expect core CPI inflation to reach roughly 2.4% by the end of next year; that clip implies that the core PCE deflator targeted by the Fed would likely run at about 2%. Inflation in the UK, which is experiencing a similar labor market dynamic but is also dealing with localized supply disruptions associated with Brexit, will likely behave in a similar fashion. By contrast, we think inflation in the euro area will drop below the European Central Bank’s (ECB’s) own 2% target, and Japanese inflation, currently in negative territory, will remain benign.

FED IN PLAY

Monetary policy has shifted direction, and we expect gradual removal of accommodation during the coming year. Until recently, major central banks were focusing on downside risks to growth, related to the virus and its aftereffects. Intense and sustained price pressures, though, have flipped the risk management script. Policymakers have become more concerned with ensuring against excessively high inflation. Almost all central banks are now in the process of scaling back asset purchases, a process likely to be complete by the middle of 2022.

8 Multi-Asset Solutions
Peripheral central banks have begun raising policy interest rates, and those efforts seem very likely to broaden. The Bank of England (BoE) and the Bank of Canada have signaled imminent liftoff for rates, and Fed rhetoric points to rate hikes by the second half of 2022.

We see a few reasons, though, to expect somewhat less withdrawal of stimulus in 2022 than markets are currently pricing. First, we see some possibility that inflation surprises on the low side, if goods prices indeed correct after this year’s jump. Second, although the Fed and some of its counterparts have downplayed the employment side of their mandates as inflation has accelerated, we think they are still focused on facilitating further improvement in employment conditions and will be reluctant to engage in aggressive tightening that might threaten the sustainability of the current expansion. Third, in the case of the Fed, we expect that the Biden administration will appoint dovish individuals to several currently open seats on the Board of Governors. Fourth, while we think a spirited conversation about neutral interest rates will occur in coming years, for now most central banks seem to believe that neutral rates remain very low, leaving little room before aggressive rate hikes begin to bite. Yes, policy interest rates are very likely heading higher in an aggregate sense, but we think that process will occur gradually, not abruptly.

Unemployment has joined all other economic indicators in mid-cycle territory

EXHIBIT 5: THE BUSINESS-CYCLE SCORECARD FOR THE U.S.

<table>
<thead>
<tr>
<th>Economic metrics</th>
<th>Early cycle</th>
<th>Mid cycle</th>
<th>Late cycle</th>
<th>Recession</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall economic output</td>
<td>Below potential, rising</td>
<td>Near potential, rising</td>
<td>Above potential, rising</td>
<td>Contracting</td>
</tr>
<tr>
<td>Consumption</td>
<td>Low, lagging income</td>
<td>Recovering</td>
<td>High, ahead of income</td>
<td>Falling</td>
</tr>
<tr>
<td>Capital investment</td>
<td>Low as % of GDP</td>
<td>Rising, moderate as % of GDP</td>
<td>High as % of GDP</td>
<td>Falling</td>
</tr>
<tr>
<td>Residential investment</td>
<td>Low as % of GDP</td>
<td>Rising, moderate as % of GDP</td>
<td>High as % of GDP</td>
<td>Contracting</td>
</tr>
<tr>
<td>Price inflation</td>
<td>Below central bank target, stable</td>
<td>Below CB target, rising</td>
<td>Above CB target</td>
<td>Falling</td>
</tr>
<tr>
<td>Wage inflation</td>
<td>Low, stable</td>
<td>Moderate, rising</td>
<td>High</td>
<td>Falling</td>
</tr>
<tr>
<td>Private credit formation</td>
<td>Low, starting to rise</td>
<td>Rising in line with output</td>
<td>Rising faster than output</td>
<td>Falling</td>
</tr>
<tr>
<td>Personal savings rate</td>
<td>High relative to income</td>
<td>Starting to decline</td>
<td>Low relative to income</td>
<td>Rising vs. income</td>
</tr>
<tr>
<td>Unemployment</td>
<td>Well above NAIRU</td>
<td>Above NAIRU</td>
<td>Around or below NAIRU</td>
<td>Rising sharply</td>
</tr>
<tr>
<td>Consumer confidence</td>
<td>Low</td>
<td>Moderate</td>
<td>Exuberant</td>
<td>Falling</td>
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EXHIBIT 5: THE BUSINESS-CYCLE SCORECARD FOR THE U.S.

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</tr>
</thead>
<tbody>
<tr>
<td>EPS revision ratios</td>
<td>Downgrade cycle, improving trend</td>
<td>Upgrade cycle, improving trend</td>
<td>Upgrade cycle, falling trend</td>
<td>Downgrade cycle, falling trend</td>
</tr>
<tr>
<td>Corporate margins</td>
<td>Rising</td>
<td>Peaking</td>
<td>Declining</td>
<td>Low</td>
</tr>
<tr>
<td>Credit spreads</td>
<td>Wide, contracting</td>
<td>Tight, stable</td>
<td>Past cyclical trough</td>
<td>Wide, unstable</td>
</tr>
<tr>
<td>Aggressive issuance</td>
<td>Low as share of total</td>
<td>Moderate as share of total</td>
<td>High as share of total</td>
<td>Nonexistent</td>
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<tr>
<td>M&amp;A activity</td>
<td>Low</td>
<td>Moderate</td>
<td>High</td>
<td>Nonexistent</td>
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<tr>
<td>Yield curve</td>
<td>Rates low, curve steep</td>
<td>Rates rising, curve flattening</td>
<td>Rates high, curve flat</td>
<td>Rates falling, curve steepening</td>
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<tr>
<td>Volatility</td>
<td>Vol high, skew falling</td>
<td>Vol low, skew low</td>
<td>Vol starting to rise, skew rising</td>
<td>Vol high, skew high</td>
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</table>

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments as of December 2021.
LEVEL ONE ASSET ALLOCATION

What a difference a day makes. From the start of the fourth quarter up to market close on the day before U.S. Thanksgiving, the VIX averaged around 18; in the two weeks following, the VIX has averaged almost 10 points higher. Over that same post-Thanksgiving period, 10-year U.S. Treasury yields fell almost 30 bps, despite an unexpectedly hawkish speech from Fed Chair Jay Powell, and global equities fell 2.5% despite ongoing earnings upgrades.

A combination of fears - the new Omicron variant, looming rate hikes and the perception that a correction is overdue - seem to have acted in unison to derail the “Santa Claus rally” some were expecting to cap off a remarkable year. Before we return to issues of rate hikes and virus variants, we should qualify what we mean by “remarkable”: Global equities have returned over 15%, small cap stocks over 100%, U.S. high yield bonds close to 5% and broad commodity indices 24%. Meanwhile, this year 10-year U.S. Treasury yields have risen by around 50 bps, a move mainly concentrated in the first quarter of 2021, despite U.S. core CPI rising from 1.6% in January to 4.6% by October (Exhibit 8).

2021 saw yields rise, and equities perform strongly

As well as offering solid returns, the broad-based rally in risk assets in 2021 has stoked fears of market fragility. Excess liquidity can explain much of the apparent dislocation between soaring stocks and depressed bond yields, in our view. But we can understand why some may argue that bonds are delivering an economic warning sign, even though we disagree with that conclusion. Simply put, equity investors appear to have underestimated the power of the earnings recovery, while bond investors underestimated the depth of demand for duration at any price. While both of these forces are moderating at the margin, they remain in play as we move into 2022.

The Omicron variant of COVID-19 has captured a lot of attention in recent weeks, contributing to the jump in market volatility. But while Omicron is playing havoc with plans for the holidays - especially across Europe - implications for growth and earnings are likely to be more muted. The new variant is causing disruption, to be sure, but in no way is the economy - and more importantly, the health care infrastructure - moving from a standing start, as it was in March 2020. Even if vaccines require updating, we would anticipate that demand and growth are merely postponed. Indeed, some argue that Omicron may prove to be a turning point in COVID-19’s journey from pandemic to endemic.

2022 is set to begin as 2021 is ending - with policy slowly starting to normalize (from wildly easy to merely very easy), earnings growing solidly if less spectacularly than in 2021 and the virus-vaccine standoff still driving sentiment day-to-day. However, as the year progresses, we expect that the shift to a new policy regime will be an important determinant in market returns.

Broadly, we favor a continued pro-risk tilt with an overweight to equity and credit and an underweight to cash and bonds. We anticipate that continued above-trend growth will fuel mid-teens EPS growth, and see some upside risks if companies pick up the pace of restocking depleted inventories (Exhibit 9). Rates are set to rise, in our view, but perhaps not as quickly as markets have priced. And should inflation pressures ease, as we expect, then the apparent urgency to hike will likely abate.
The prospect of a strong inventory rebuild is an upside risk to our growth forecasts

EXHIBIT 9: U.S. REAL PRIVATE INVENTORIES

In many regards, our portfolio tilts are little changed from those we’ve held through the second half of 2021. While we have dialed overall risk up and down according to prevailing conditions, we have held our core view of preferring stocks and credit to cash and bonds. Moving into 2022, many of the underlying conditions we observe support a continuation of this view, though we don’t expect the same magnitude of appreciation in equity and credit markets.

We deploy most of our portfolio risk budget with an overweight to stocks. While we are sensitive to concerns about the optically high level of P/E ratios in some indices, we also note that this is an issue mostly for U.S. stocks, and more specifically for a small subset of U.S. stocks. We do acknowledge the headwind that valuations may pose to equity returns in 2022, but we also believe earnings growth will be sufficient to overcome this - even for the most richly valued sectors.

Given that inventory restocking could provide a further boost to the cyclical sectors, we maintain a cyclical tilt via European and Japanese equities. Meanwhile, the capex cycle and high levels of household savings lend broad support to earnings growth. Although U.S. equities trade at more elevated multiples than other regions, we continue to lean toward the U.S., as we believe the U.S. earnings delivery is reliable, and we find increasing opportunities across small caps.

After delivering poor returns in 2021, emerging market equity may be past the worst (Exhibit 10), but persistent negative earnings revisions and the prospect of higher U.S. real rates remain a headwind. Overall, equities continue to be our asset class of choice as we enter 2022, but equally this means our portfolios are most sensitive to continued positive momentum in earnings.

Policy in China has been a drag in 2021, but things look slightly brighter next year

EXHIBIT 10: CHINESE CREDIT IMPULSE AND CHINA MANUFACTURING PMI

The market jitters triggered by the Omicron variant also pushed credit spreads around 50bps wider in U.S. high yield and some 35bps wider in European high yield. This modest widening of spreads leads us to increase our conviction, at the margin, in our overweight to credit. While credit does not have the upside gearing that equities offer, we believe that the carry pickup is attractive and that defaults will remain extremely low in the next year.

Further up the quality spectrum in fixed income, our appetite wanes rapidly, and at the highest quality end - sovereign bonds - we maintain a modest underweight. While our growth outlook might point to a significant risk of higher yields, we continue to expect yields to rise only slowly. Demand for duration remains strong, even with the Fed tapering, and we anticipate that the supply chain issues and energy spikes that caused inflation to
surge this year will subside. As a result, we expect that as yields grind higher they will be met with incremental marginal demand.

Falling inflation and modest yield rises point to a pickup in real yields over 2022 (Exhibit 11). This indeed appears the most likely path, but still we expect real yields to remain negative throughout 2022 and probably well beyond. It is the expectation of persistently negative real yields - even if less extreme than today - that drives our modest duration underweight, not any realistic expectation that rates will reprice sharply higher.

Falling inflation and rising yields point to a pickup in real yields

![EXHIBIT 11: U.S. 10-YEAR REAL YIELD AND MARKET IMPLIED FORECAST, %]

Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2021. *Forecast is derived from futures pricing of UST10 Nominal yield and U.S. CPI.

Cash rates have some scope to rise in 2022 but probably not as far or as fast as money markets are pricing today. The three hikes priced for the Fed and the five for the Bank of England by the end of 2022 are ambitious, given the Fed’s inherent dovish makeup and the UK’s myriad other economic issues, from Brexit to lack of labor supply. In other regions, too, while we are past the low point in policy rates, they are likely to remain depressed and negative in real terms for some years yet. Against this backdrop, we are underweight cash with moderate conviction.

Our multi-asset portfolios remain pro-risk as we enter 2022, with the main risks to our view arising from inflation turning out to be stickier than we expect, from Omicron-triggered disruption running for longer than we expect or from earnings failing to come through as we anticipate. On inflation, our underweight to duration provides a partial offset, and our tilt to cyclical sectors and value may also act as a mitigant. On virus-related shutdowns, early data continue to point to a more transmissible but less virulent variant, and vaccine technology can adapt quickly. Finally, on earnings, we believe that the bottom-up estimates continue to lag the pace of economic activity, so there is some cushion naturally embedded in current earnings forecasts.
LEVEL TWO ASSET ALLOCATION

At this juncture, we shift our perspective. In the preceding pages, we examined our Level One asset choices, the basic portfolio decisions involving broad asset classes (for example, stocks vs. bonds). We now present our Level Two asset decisions. Here, we look within asset classes and determine, for example, what type of credit (investment grade [IG], high yield or emerging market debt) appears most attractive.

RATES

Yield curves have flattened across sovereign debt markets since our September Strategy Summit, a development not without precedent as markets anticipate the onset of Fed tightening. Front-end yields rose sharply in October as market participants priced for a more imminent rate liftoff by both the U.S. and other developed market central banks. Conversely, broader DM long-ends were burdened by a blend of revived growth concerns related to new COVID-19 variants, demand for duration from price-insensitive actors such as liability hedgers, and various concerns in China. Specifically, 2s10s flattened by 25 bps over this period, with U.S. 10-year yields up over 10 bps, but 2-year yields 35 bps higher. Whether these macro developments get better or worse will be key to determining how these market trends progress.

Over the medium term, we expect curve steepening and retracement of yields’ move lower. In turn, we maintain our short U.S. duration bias with modest conviction. This follows largely from our view that global economies remain poised for recovery and growth, as well as our understanding that we are likely in a global reflationary regime. This fundamentals-driven case for higher U.S. rates is long-standing, in our view.

U.S. Treasuries

Today, we emphasize the ongoing withdrawal of global monetary policy stimulus, driven by continued economic recovery, as the chief catalyst for U.S. yields to move gradually higher. Indeed, central banks are still accommodative, even if they have passed the point of maximum accommodation. Yet the trajectory toward less emergency support has accelerated. For example, in its September meeting, the Fed explicitly communicated that the criteria for rate liftoff are more stringent than those for reducing asset purchases. In our view, the Federal Open Market Committee’s recently communicated openness to discussing a faster drawdown of bond purchases in the upcoming December meeting also offers guidance on policy rates, presenting the possibility that U.S. policy rate hikes could arrive earlier than we had initially anticipated. Crucially, though, even if policy tightening occurs as early as 2022, we expect a fundamental backdrop conducive to higher U.S. bond yields.

Admittedly, recent rates price action has made it difficult to have high conviction in our view, and twist flattening in both nominal and real terms has been especially puzzling. The curve is usually much steeper in the middle of an economic cycle, where we believe the U.S. is now. We believe these unusual curve dynamics will eventually correct and real yields will drift higher. A seemingly hawkish path for policy rates should drive real yields higher, implying that real yields have already hit their lows in this economic cycle. Why this has not materialized is not immediately clear, but breakeven pricing is, of course, pertinent (Exhibit 12).

In our base case scenario, as inflation gradually drifts lower, markets likely see some retracement of breakeven inflation pricing through 2022. It is unlikely we see a damaging wage-price spiral. Significant slack remains in the economy, and inflationary pressures so far remain mostly contained to goods prices (rather than services) and to low income wages. Once global supply chain issues are addressed and U.S. labor force participation recovers, these issues should resolve.

In 2021, breakeven pricing has been the principal driver of yields

EXHIBIT 12: U.S. 10-YEAR YIELD DECOMPOSITION

In addition to our expectation for higher U.S. rates, we believe that front-end pricing in nominal yields is too aggressive vs. the long end. Today, futures imply approximately three 25bps hikes by February 2023, a fairly aggressive path, with the risk tilted to less abrupt tightening. We therefore expect some steepening in nominal yields as Fed hikes occur in a less front-loaded manner than currently priced. That said, at the same time, there is a limit on how far two year-maturity bonds can rally. In practice, at the two-year point specifically, markets are pricing a rate liftoff and a subsequent sequence of hikes followed by a pause in hikes. Therefore, even if we see near-term inflation momentum moderate, justifying a later and slower liftoff, it still implies resilient two-year yields as the timing of rate hikes is pushed out, but not removed, leaving the implied terminal rate in two years’ time unchanged. The steepening of the curve will therefore have to be primarily driven by an increase in the yield of longer-duration bonds rather than by a rally in front-end rates. We expect the parallel shift of the yield curve will be best captured around the five-year maturity point, where the upside/downside yield change will be most symmetric. The part of the curve most exposed to a bear steepening appears to be 5s10s, given the current curve shape. We would avoid shorting the long end of the curve in an environment of continued duration demand from pension fund de-risking. Admittedly, we have only modest conviction in this curve view, although we do find affirmation in five-year market positioning, which has moved increasingly short in recent months (Exhibit 13).

Five-year market positioning has moved increasingly short in recent months

EXHIBIT 13: NET LONG SHARE OF NON-COMMERCIAL CONTRACTS, %

<table>
<thead>
<tr>
<th>Year</th>
<th>2y</th>
<th>5y</th>
<th>10y</th>
<th>30y</th>
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<td>2021</td>
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Relative Value

Our relative value (RV) preferences across government bond markets have shifted amid uneven growth and inflation data points, which ought to translate into uneven monetary policy outcomes. Our least preferred regions are the U.S. and Canada. In both countries, post-COVID-19 recovery of output has been especially impressive, particularly in the Canadian domestic labor market. More so than other DM markets, greater policy tightening than what has currently materialized can be justified by the recent strong macro momentum in these countries. On the other hand, Italy is our most favored long leg in cross-market spread trades, owing to its favorable carry and presumed gearing to an ECB that will likely lag other central banks in the withdrawal of monetary stimulus. In one notable change, from underweight and overweight, respectively, we now regard both the UK and Australia more neutrally. The state of central bank policy in these countries is not entirely clear. The Bank of England struggles with the ongoing divergence between UK growth and inflation prospects, whereas the Reserve Bank of Australia’s (RBA’s) dovish bias has waned.

In Europe, although we expect government bond yields to participate in a broader sell-off in DM rates through 2022, price action in the early quarters of the year should be more contained. In the near term, Europe’s position at the epicenter of Omicron concerns and sensitivity to global supply-side bottlenecks temper bearishness. Austria, the Netherlands and Ireland have already reinstated COVID-19-related restrictions, coinciding with a cooling of economic sentiment for November. Moreover, manufacturing supply, particularly in German auto production, continues to lag demand. If these factors do not prove transitory, a flight to quality assets will limit the degree to which core yields, particularly German Bunds, can underperform during the early months of 2022.

That said, over the medium term, our base case assumption is that the euro area leads North America in GDP growth and also sees current inflationary pressures moderate. Successful rollout of vaccinations in Europe reaffirms our sense that any virus-induced lockdowns will likely prove short-lived. In turn, the pronounced recovery in services consumption, business investment and employment that supported real GDP growth in Q3 should persist, albeit at a more moderate pace. Additionally, fiscal exceptionalism should also help sustain the euro area’s
relative growth momentum in 2022. The pandemic emergency purchase program (PEPP) laid the foundation for substantial fiscal actions that should remain supportive for much of 2022 – a stark contrast to the U.S., where fiscal support will be in retreat.

On balance, a constructive growth outlook in which inflation never quite reaches the ECB’s target would seem to lay the foundation for tighter intra-Economic Monetary Union spreads. As discussed, we favor Italy (BTP) among the periphery. Presidential elections in January will provide greater clarity on the longevity of the government of ex-ECB President Mario Draghi, but he does seem likely to remain Italy’s prime minister until 2023. All in all, the political backdrop appears uncharacteristically benign. Although BTP-Bund valuations are expensive by historical standards (reflecting unprecedented policy support in the European Union [EU] recovery fund and ECB asset purchases), we still find BTP attractive. What would present a clear risk to BTP-Bund spreads is a hawkish pivot by the ECB, leading to a material tightening of financial conditions and wider periphery spreads. At the moment, that seems a remote prospect, given ECB President Christine Lagarde’s resolute stance that euro area inflation is transitory.

We have removed our underweight to Gilts even as we continue to see an imminent rate liftoff from the Bank of England. The UK labor market is exceptionally tight, wage growth pressures are building, and households can draw on ample savings cushions to help support the return of UK GDP to its pre-pandemic level. Together these factors will likely drive UK rates higher from current valuations, which seemingly rallied excessively amid recent risk-off moves. However, the UK’s eventual rate hiking cycle, and by extension Gilt underperformance, are unlikely to be long-lasting. To the concern of the BoE, the medium-term pace of UK supply growth is weaker than expected, and higher energy prices and the fading of monetary and fiscal policy support have tempered demand growth. Assuming that the recent pickup in energy prices abates, this backdrop restricts the UK’s “terminal rate” relative to other markets, namely the U.S. and Canada. We believe this outlook roughly reflects market consensus, as evidenced by Gilts leading in DMs’ broader move to flatter yield curves.

Central to our Australian rates view is our perception that RBA policy is currently biased to delay normalization and remain dovish, at least relative to the UK. In turn, we interpret the RBA’s recent and surprise abandonment of yield curve control to signal that economic outcomes are more constructive than originally anticipated. Principally, we note that while Australia has experienced some of the same upward pressure on prices as seen globally, non-oil energy prices have not accelerated to the same degree. Moreover, pre-pandemic wage growth was subdued in Australia. It is thus a material development to now see core inflation within the RBA’s target band of 2%-3%. More broadly, with domestic services activity rebounding and vaccination rates rising very quickly, indications of higher underlying inflation are conducive to the withdrawal of emergency monetary stimulus. It would seem increasingly challenging for the RBA to maintain its dovish bias relative to other DM central banks, which have now begun to increase policy rates. In any case, it is unlikely that policy rates rise in 2022, but we view the balance of risks skewed more hawkish than currently communicated by RBA Governor Philip Lowe. Several risks prevent us from expressing an outright underweight in Australian bonds: Growth in China has slowed, and the prospect of tighter regulation by Beijing raises the prospect of downside growth spillover to Australia. Moreover, by the RBA’s own admission, wage inflation is the critical criterion for rate liftoff, and it has yet to approach levels the central bank would deem satisfactory.

FX

Within our framework for assessing the relative attractiveness of currencies, three criteria broadly explain FX price action throughout 2021. First, growth differentials between emerging markets and developed markets have been narrow relative to history, justifying soft performance in EM FX despite above-trend global growth (Exhibit 14). Second, the policy biases of DM central banks have become more hawkish, drawing clear distinctions between currency “winners” geared to higher beta yield curves, such as USD and GBP, and currency “losers” with structurally lower yield volatility, namely EUR and JPY. Finally, commodity terms of trade have traced higher energy prices generated by global supply chain disruption, driving strong currency appreciation among exporters of energy and nonmetal commodities. Global macro developments don’t always drive currency markets, but recently they have overshadowed country-specific risks (Exhibit 15).
With further narrowing of EM-DM growth differentials, it is unsurprising that EM FX struggled to outperform.

**EXHIBIT 14: YEAR-TO-DATE FX PERFORMANCE ACROSS G10 AND EM**

[Graph showing FX performance]


Amid higher global yields, a hawkish central bank and elevated oil prices, CAD was well-positioned to outperform other G10 FX.

**EXHIBIT 15: YEAR-TO-DATE G10 FX PERFORMANCE VS. USD**

[Graph showing FX performance]


We note, however, that the macro factors dominating our framework have evolved. Given a more modest reopening tailwind to DM GDP, EM-DM growth differentials have likely bottomed. More crucially, even as headline inflation has surged globally, core inflation rates across developed markets are increasingly disparate in year-on-year terms. This contrast in underlying price momentum suggests that DM central banks with similar inflation targets will pursue divergent policy. Overall, monetary policy differentials will likely widen within a more differentiated global growth backdrop. Under these conditions, we favor short-duration proxies, particularly CAD, and in the near-term USD, which offer both robust economic growth and higher core inflation. We look to avoid low yielders and lower quality EM FX that could be vulnerable to DM policy tightening.

**USD**

The near-term case for dollar resilience looks persuasive. However, the longevity of appreciation depends largely on the extent to which current inflationary pressures prove transitory. In our view, should global headline inflation rates decline at a quicker pace, particularly if goods prices fall more rapidly than services prices, the monetary policy differentiation theme would become most constructive for the dollar. Under these conditions, commodity terms of trade would become more contained globally, and price momentum in the U.S. would be even stronger relative to its global counterparts. This would imply a Fed with greater capacity for monetary tightening and thus further room for the dollar to rise. Similarly, if inflation is restrained as new COVID-19 variants continue to burden global supply chains, a more challenged global recovery and worsening risk sentiment would likely boost USD, given the safe haven characteristics of the dollar-denominated assets. At this juncture, both pathways for inflation seem feasible.

However, we can also envision an alternate scenario in which global price pressures prove so persistent that DM central banks other than the Fed, primarily the ECB, begin to question their relatively dovish policy bias. At the same time, though, inflation’s threat to medium-term growth remains benign. Such an environment would be generally constructive for higher yielding currencies, not just the dollar, and also currencies pricing structural dovishness, namely EUR and JPY, likely at the expense of USD. Additionally, several idiosyncratic factors curb our enthusiasm for the dollar over the medium term. In the latter half of 2022, we expect diminished active fiscal support to generate GDP underperformance in the U.S. relative to the euro area and Japan. The prospect of a strong Republican showing in November’s midterm U.S. elections reinforces our assumption of less investor-friendly fiscal policy.

In sum, we anticipate USD resilience for the first half of 2022. But visibility weakens at longer investment horizons due to our expectation of eroding U.S. growth and fiscal exceptionalism.
EUR
After a bullish start to 2021, the euro has cheapened against USD year-to-date. Principally, narrowed yield differentials, balance of payments demand and European growth outperformance have waned as tailwinds to the currency. Whether today’s cheaper valuations are sufficient to warrant EUR appreciation is not immediately clear.

On the one hand, for early 2022, interest rate differentials seem likely to inhibit euro appreciation. The ECB’s December meeting will clarify the euro area’s position amid diverging monetary policy. We do think the absence of wage inflation, coupled with a recent history of inflation undershooting the ECB’s target, underwrites our base case assumption that the ECB will strike a relatively dovish posture. It would not surprise us if ECB President Lagarde announced additional asset purchases and further delayed a policy rate hike. This is in stark contrast to the accelerated tapers and forecasts for liftoff we see in the U.S., the UK and Canada. On the other hand, independent of the inflation curve, we see upside risks to the EUR outlook. For one, global equity allocations are beginning to normalize after a decade of U.S. equity outperformance. In recent months, cross-border equity flows have favored the euro area – an upside risk factor for its currency. Moreover, while the effective fiscal thrust in the U.S. is likely to turn negative over coming quarters, Europe should remain in expansionary fiscal territory. Especially in light of consensus positioning of USD longs, we see a nontrivial possibility that the euro could outperform next year.

The French presidential election injects some additional uncertainty into our outlook. On balance, are neutral on EUR, with the caveat that its balance of risks skews toward appreciation over the medium term.

JPY
Crucially, our more balanced outlook for EUR does not extend to other low yielders, namely the Japanese yen. JPY remains at the bottom of our relative preference ranking due to its negative correlation to higher front-end rates. Of course, cheap valuations and solid (albeit less so) balance of payments fundamentals imply upside to the yen. But history suggests that JPY will be driven principally by yields. Moreover, in an environment of proactive Fed tightening, there is a greater likelihood that unhedged cross-border portfolio outflows, which have recently paused, will resume (Exhibit 16). That would further stimulate yen weakness.

Outbound investment flows have receded as a headwind to JPY

Some near-term factors cloud our outlook. As mentioned, global inflationary pressures have increased the probability of broader risk-off market price action. Should this intensify, we would expect yen short positioning to unwind – possibly relative to the U.S. dollar and almost certainly against high beta commodity currencies. Additionally, as Japan’s COVID-19-related restrictions ease, the economy’s Q4 growth outperformance is also likely to provide some cushion to the yen.

We thus hold JPY underweights with reasonable conviction, particularly vs. currencies issued by more hawkish central banks. That said, the timing of this recommendation has become more challenging. At the margin, we see some near-term supports to JPY challenging our bearishness. Over the medium term, once Fed liftoff is realized and fully priced, it becomes harder to envision the yen continuing its slide to even cheaper valuations.

GBP
In light of their robust growth prospects and underlying inflation rates, the U.S. and Canada could justify earlier rate liftoff relative to other DM markets. The UK, in contrast, seems the prototypical “bad hiker.” UK curve flattening is not surprising, as today’s inflationary pressures are largely supply-side driven. Given the potential for demand-restrictive policy tightening, investors are reasonably concerned about the possibility of stagflation. The BoE has been quite vocal about these risks. But to prevent de-
anchoring of inflation expectations from its target, BoE front-end pricing remains aggressive (and communication from its Monetary Policy Committee is sometimes driving market volatility). Going forward, the UK economy is likely to continue struggling with this awkward position for several reasons, including potential suspension of the Northern Ireland protocol, threat retaliation from the EU and ongoing Brexit labor supply issues. In addition, we expect considerable GDP drag from changes in the UK’s cyclically adjusted fiscal balance from 2Q 2022 onward.

In sum, idiosyncratic political risks and BoE hikes conditioned on inflation compromising growth temper any modest enthusiasm we might have for GBP. Should curves re-steepen and shift our expectations around the UK’s terminal policy rate lift, we could favor the UK’s attractive valuations in either sterling longs or Gilt shorts. Today, we remain neutral on GBP.

EQUITY

Equities have delivered stellar returns in 2021. The global MSCI ACWI index is up by around 15% in USD terms, even after the recent pullback sparked by the emergence of the Omicron COVID-19 variant. This performance is even more impressive considering that it has followed on the heels of a very strong 2020, when global equities rose by 14% amid the shock of a global pandemic. Driving this equity run has been a remarkable earnings performance by global corporations. Global corporate profits have not only recovered quickly from the depths of the COVID-19-induced recession, but they now substantially exceed pre-COVID-19 levels (Exhibit 17). Forward earnings for developed markets are finishing this year 20% above their levels at the beginning of 2020, while emerging market earnings are 15% higher.

Earnings in both DM and EM have recovered so strongly, they already exceed pre-covid levels significantly

**Exhibit 17: 12-Month Forward EPS for DM and EM (Jan 2020 = 100)**

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<thead>
<tr>
<th>Jan-20</th>
<th>Apr-20</th>
<th>Jul-20</th>
<th>Oct-20</th>
<th>Jan-21</th>
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Crucially, earnings growth has consistently exceeded estimates of both bottom-up and top-down analysts, as we have suspected it would. In our view, the extended earnings upgrade cycle (historically very unusual) has allowed equity markets to ride through the many uncertainties around COVID-19, the economic outlook and macro policy. Volatility has also been quite contained, although recently it has been on the rise. Providing further support to equity markets, elevated valuations have not come down as much as might reasonably have been expected. This is particularly true in the U.S., where P/E multiples have fallen by less than 10% from their cycle peak. Low bond yields, both in nominal terms and especially in real terms, likely explain much of the valuation story, although their precise impact is hard to quantify.

Looking ahead to next year, we continue to have a favorable view on the direction of equities as an asset class, even if returns should be more modest. After global EPS growth of over 50% in 2021, consensus forecasts currently expect growth in 2022 to slow to the high single digits as base effects fade. Once again, we expect results to exceed expectations in an environment where economic growth should stay well above trend across developed economies and global EPS growth is more likely to end up in the low double digits. However, while this performance would still be very robust in a historical context, it should provide a much more modest cushion against further declines in our valuations. We think it is prudent to expect valuations to grind lower from still-
elevated levels in 2022, as monetary policy should slowly become less supportive and investors will at some point have to begin to look forward to further growth normalization in 2023. Valuations shouldn’t collapse, in our view, given that equity valuations will continue to look attractive relative to bonds as bond yields move only modestly higher from here. Putting it all together, mid-to-high single-digit global equity returns seem a reasonable assumption and support our continued overweight stance on equities.

We note a few other reasons for staying positive on equities. The first reflects our view of the economic cycle. The economy is still only in mid-cycle, with low near-term recession risk. In this part of the cycle, equities historically do well, apart from a usually temporary hiccup around the turn in the monetary policy cycle, which typically occurs mid-cycle. We expect any policy tightening, when it happens, to be very gradual. The second cause for optimism is the likelihood that flows into the equity asset class should stay robust for at least a while longer, given the accumulated household savings across many countries. At least some of that money should find its way into risk assets.

Clearly, a more modest return for equities does leave the market potentially more at risk for pullbacks and corrections. But as long as we don’t see a material rise in the likelihood of imminent recession, these market retreats should prove temporary.

**Earnings**

Why has earnings growth not just been strong globally but also consistently underestimated by market participants? For one, it’s not a coincidence that analysts have also consistently underestimated the strength of the economic rebound. For another, the nature of this cycle likely has presented analysts with a set of circumstances they are not well equipped to deal with, combining a high degree of uncertainty with the often nonlinear impact of large changes in top line growth. Thus, exceptionally strong top line growth has gone hand in hand with record margins, as operational gearing has outweighed any underlying margin pressures from rising costs caused by supply chain disruptions or labor shortages. The result has been a string of record-breaking positive earnings surprises during recent reporting seasons and large upward earnings revisions throughout the year. That’s a fairly unusual set of circumstances. Historically, in the vast majority of cases, earnings estimates are revised lower throughout the year. Just over the last two quarters, 2021 earnings growth expectations have risen by 6.7% for ACWI, 8% for the U.S. and 19.5% for Europe, although only 1.5% for emerging markets. Global (MSCI ACWI) earnings are now expected to grow ~52% in 2021, up from an expectation of roughly 46% growth at the start of Q3, and consensus expects this pace to moderate to 7% in 2022 as base effects fade.

Interestingly, there is little variation in expected 2022 growth across developed markets, at 8% each in the U.S., Europe and Japan. This does not seem overly ambitious in light of the robust nominal GDP growth environment we see for next year, and, as mentioned, we see room for earnings upside surprise and EPS upgrades. EPS growth in the low teens seems achievable across developed equity markets. The picture is murkier for EM equities. Current EPS growth expectations in emerging markets are not very different from developed markets, but recently a downgrade trend has set in. Clearly, there are risks to our positive view on earnings, particularly on the issues of margin pressures and the impact from new COVID-19 variants. On the margin front, we suspect operational gearing and cost control will yet again win out over input cost pressures. And as we think about the virus, we expect the global economy and businesses will yet again prove adaptable.

**Valuations**

As we’ve discussed, equity valuations have held up better in 2021 than many had expected (including ourselves), with the 12-month forward P/E for the global ACWI index down by just under 10% from its September 2020 high. At 17.6x, it remains well above historical averages. Valuations will likely decline somewhat in 2022 as monetary policy becomes less supportive and growth further normalizes. But valuations won’t collapse, in our view, as bond yields will rise only modestly from here.

We do see greater divergence between the U.S. equity market and the rest of the world. In the U.S., the forward P/E of 20.5x is at the 85th percentile of its recent 10-year history and 23% above its 10-year average. Since the peak in P/E ratios across regions around a year ago, U.S. valuations have also held up much better than for other markets (Exhibit 18), having fallen by only 8% in 2021, compared with 16%–24% across other major equity regions. Given the dominant weighting of the U.S. market in global equity indices, it is actually the U.S. component’s
persistently high valuation (also visible in other equity-only metrics, such as price-to-book ratios and dividend yields) that is driving the global picture of high equity valuations. Valuations in most other regions now look fairly unremarkable, at least relative to the last few decades.

P/E ratios have declined across regions from their late 2020 peaks, but the fall has been more moderate in the U.S.

**EXHIBIT 18: 12-MONTH FORWARD P/E RATIO ACROSS MAJOR EQUITY MARKETS, AND THEIR FALL FROM PEAK**

Even in the U.S., valuation metrics that compare equities to the prevailing low level of bond yields or interest rates tell a more supportive story, as demonstrated by our preferred metric of equity risk premium (ERP), shown in **Exhibit 19**. The U.S. ERP has been range-bound for the past few quarters, following a sharp decline over the course of the year from March 2020 to March 2021, when both equity prices and bond yields recovered sharply. Bond yields are now lower than they were in March 2021, and the U.S. ERP has repeatedly failed to break decisively below the 6% mark even as equity prices have continued to grind higher. Thus, the ERP remains only marginally below its post-GFC average, suggesting that even U.S. equities can rise further before their valuations look less attractive relative to bonds. Conversely, equities should be able to digest the expected modest rise in bond yields through a compressing ERP.

**Relative Value**

**Styles**

The onset of the Omicron variant, a hawkish shift by global central banks and stubbornly low real rates acted as the key drivers of equity styles over the start of Q4. In the U.S., cyclical outperformed defensives, but value performed similarly to growth. Looking forward to next year, performance in terms of style will likely be more balanced than in 2021.

The relationship between U.S. cycicals and defensives continues to closely track U.S. breakeven rates (**Exhibit 20**). With inflation prints stickier than expected, companies set to benefit from higher prices, like those in the energy sector and some consumer companies, have outperformed. Cyclical materials stocks have struggled, but weak performance from the utilities and healthcare sectors has dragged on the performance of the defensive component of the stock market over the past three months. Earnings revisions for cycicals have held up relatively well compared with defensive sectors, and this should support outperformance going into 2022. We think economic growth will remain above trend, with rates grinding higher: All these factors support an overweight to cycicals vs. defensives. That said, with breakeven rates already elevated, most of the strong performance of cycicals vs. defensives is likely behind us.
Breakeven rates continue to track cyclicals vs. defensives closely

EXHIBIT 20: U.S. CYCLICALS VS. DEFENSIVES AND BREAKEVEN YIELDS


The relationship between U.S. value stocks and growth stocks continues to closely track U.S. real rates. For value to outperform growth sustainably, financials need to outperform mega cap technology stocks. We can envisage a scenario in which higher real rates, and perhaps concerns about regulation of the technology sector, bring down the valuation of mega cap technology names relative to financials. However, with the economy in mid-cycle, the quality offered by U.S. mega cap stocks is likely to remain attractive to equity investors. In sum, we stick with a more balanced approach to the value vs. growth relationship in our portfolios.

U.S.

U.S. large cap stocks have had an exceptional year, owing to the market’s sustained earnings growth and limited valuation retracement. U.S. large caps remain attractive to us, boasting the highest return on equity (RoE) across major regions. Going into the new year, earnings growth estimates are largely in line with other regions. But rising rates may present a challenge to the U.S. market, given its higher concentration of tech/growth stocks. We do see scope for large cap valuations to normalize but think that this can be balanced by the strength and quality of the earnings picture. We remain overweight U.S. stocks and expect that small cap stocks, which are geared to the U.S. domestic economy, should perform well.

Europe

We maintain a positive stance on the European market. Continued strength in earnings revisions, along with attractive valuations when compared with the U.S., make the market attractive. There has been some volatility in the region in response to the new virus variant, but ultimately we expect the EPS recovery to continue. Relative to the U.S. and other developed markets, ECB monetary policy looks set to remain easy, and the fiscal picture is positive as well. The European tech sector has led the index gains for the EURO STOXX 50 this year, and the growing importance of the semiconductor and luxury components raises the quality of the European market. We also think that smart stock selection can uncover some attractive European deep value and high dividend plays.

Japan

Japanese stocks experienced periods of both sharp outperformance and underperformance this year. Whipsawing political developments, unexpected waves of COVID-19 and firm policy responses have been the key drivers of Japanese stocks. More traditional measures, such as global goods trade and USD/JPY, have been less useful indicators.

We still see room for Japanese stocks to outperform. There is a longer earnings recovery runway, political issues look set to fade, and the economy is getting stronger. Japan is likely to manage the Omicron variant better than other major developed economies, with its population more recently vaccinated. Should supply chain issues in the auto sector fade, Japanese auto companies should benefit. Interestingly, Japan’s dividend yield is higher than the global average, and the market has a low correlation to other major indices – all of which provides diversification opportunity for equity investors (Exhibit 21).
Japanese stocks are less correlated to other key indices

**EXHIBIT 21: CROSS EQUITY MARKET CORRELATIONS**

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**Emerging markets**

It is too early to make a big shift back into emerging market stocks, in our view. Regulatory tightening in China and issues in the country’s troubled property sector have recently weighed on the wider emerging market complex, and we see few signs of relief on either front. One might argue that there is some upside asymmetry to emerging market stocks – a number of key Chinese internet names are trading at increasingly attractive valuations, and Chinese policymakers may feel the need to stimulate a sluggish economy. However, we think that may be more of a 2Q 2022 story. Broadly, earnings revisions for EM equity indices look paltry, and the semiconductor cycle is unlikely to provide a positive boost to other big EM index components, such as Korea and Taiwan (Exhibit 22).

**Earnings revisions for emerging markets have largely collapsed**

**EXHIBIT 22: EMERGING MARKETS EARNINGS REVISION RATIOS**

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</tbody>
</table>


**UK**

We remain neutral on UK equities. The relative performance of UK stocks largely reflects a lack of technology exposure, from which both European and U.S. markets have benefited this year. The UK market has been trading with value, but it also has a healthy amount of defensives in the index, which have been a laggard amid strong economic reopening. Recently, the UK has done well in down market periods, but we think global equities should generally outperform. In that scenario, it will be difficult for investors to get too excited about UK stocks.

**CREDIT**

Our views of credit are similar to where they were following our last two quarterly Strategy Summits.

For developed market corporate debt, we continue to view spreads on high yield bonds and leveraged loans as opportunities for healthy carry with limited volatility and downside risk. By contrast, EM corporate and sovereign hard currency debt, while boasting more attractive valuations than similarly rated DM corporates, continues to face stronger headwinds, largely stemming from the pandemic. Next year, though, we will be looking for a turning point in which EM asset performance rebounds against its DM counterparts.

**Developed market corporate debt**

At our June Strategy Summit, we noted the economy’s transition to mid-cycle. In our view, it marked the completion of the rapid spread compression of the early-cycle recovery, with spreads normalized to relatively tight levels and any further compression expected to be a slow grind. For the last couple of months especially, setting aside the impact of the COVID-19 Omicron variant, DM credit index spreads had been bumping against a floor even as equity prices kept rising. Over the next year, we expect this trend to continue. Credit returns will likely come mostly from carry. We see more limited scope for capital appreciation as average spreads for a given credit rating grind tighter and as issuers’ ratings continue to improve.

The known downside risks we flagged last quarter – China’s cooling property sector, ongoing supply chain shortages and central bank tightening – are all still in play. But the risk of a serious economic downturn, problematic price pressures or rapid rate hikes remain quite limited, in our view. Were any of these
risks to materialize, the consequences would most likely be graver for credit than for equities, relative to their respective return potential and volatility. For instance, for the month of November, when news of the Omicron variant drove a sell-off in risk assets, U.S. high yield spread returns, on a normalized basis, were 58% more negative than S&P 500 total returns. That return pattern looked like a scaled-down mirror of March 2020, when risk-adjusted credit spread returns also significantly lagged equity total returns. (On the Omicron news, U.S. high yield spreads widened only about 50bps, or 6% of the nearly 800bps of widening that occurred when the pandemic began.) Since the end of November, as Omicron has faded as a concern, spreads have once again narrowed. We see little scope for this new variant to significantly alter our baseline economic view of above-trend global growth.

Looking ahead to 2022, we are also mindful that corporate fundamentals are likely to deteriorate gradually, with increased emphasis on equity-friendly practices. That would be expected as the economy progresses further through mid-cycle. Over the last two years, corporate behavior has been fairly conservative and bondholder-friendly. But lately, issuance quality has deteriorated somewhat, especially in the leveraged loan space, including multi-year high volumes for M&A and leveraged buyouts and a pickup in B rated or lower issuance. We will be watching new issuance for any deterioration in average ratings, use of proceeds and covenants. Another potential mid-cycle scenario, once growth rates moderate, is that risk sentiment pulls back more generally, affecting credit spreads as well as other risk assets, including equities. These risks could eventually emerge, but in the year ahead they do not appear likely to significantly threaten spreads.

Finally, DM corporate debt technicals should also be supportive. Even as the quality of issuance gradually declines, volumes ought to settle down from the breakneck pace of 2020–21. Demand for spreads should remain strong so long as inflation remains contained and yields rise at a gradual pace, as we expect they will, spurring a continued search for yield.

While we continue to find attractive opportunities in DM high yield bonds and leveraged loans, we find limited value in DM corporate investment grade debt.

U.S. high yield

By most any measure, U.S. high yield fundamentals look exceptional. The year 2021 is set to mark a record low in default rates (Exhibit 23), and we expect only a modest pickup in 2022. Several factors explain the market’s healthy outlook. Average index quality increased following the defaults and fallen angels of 2020. The remaining issuers took the opportunity to build excess liquidity and term out maturities. As a result, index leverage ratios have more than fully recovered, thanks largely to an exceptional earnings rebound. For example, net debt-to-EBITDA is at the lowest since 2005. The distressed share of the high yield universe (securities trading below USD 0.70) accounts for a mere 1% of the total, in part because higher energy prices have helped an often problematic energy sector. Finally, U.S. capital markets remain wide open for new funding (Exhibit 24), as suggested by results of the Fed’s latest Senior Loan Officer Opinion Survey.

U.S. high yield’s 12-month trailing default rate at its lowest in 40-year history

EXHIBIT 23: U.S. HIGH YIELD DEFAULTS

![Default and Par-weighted default rate, trailing 12m]

GLOBAL ASSET ALLOCATION VIEWS

U.S. debt capital markets remain wide open, conditions easing

EXHIBIT 24: NET SHARE OF BANKS TIGHTENING LENDING STANDARDS TO NONFINANCIAL CORPORATES, %


Meanwhile, the pace of rating upgrades should continue to be elevated for a little while longer, particularly for rising stars, which have so far lagged in this cycle. Year to date, the roughly $550 billion in U.S. high yield upgrades has been mostly in down-in-quality names, with only about USD 35 billion of rising stars. Now, with an elevated share of BBs on “positive outlook” by the rating agencies, the “crossover” trade presents selective opportunities to capture modest additional spread tightening on issues where pricing is not already very close to BBB levels or severely call constrained.

Security selection will be increasingly key in avoiding issues with declining quality and selecting future rating upgrades.

U.S. leveraged loans

U.S. leveraged loans offer perhaps the best opportunity for carry. Spreads appear relatively wide to like-rated bonds, and performance should continue being less susceptible to rate volatility. Fundamentals also look compelling, notwithstanding somewhat less attractive trends in issuance quality.

Technicals should also be relatively more supportive. Demand from investors seeking refuge from duration exposure is already driving a shift in favor of floating rate securities, via strong retail loan fund inflows and strong collateralized loan obligation (CLO) demand. Should yields rise as we expect, accelerating investor demand could push prices modestly higher (granted, prices already trading close to par limit the scope for capital appreciation) while rising benchmark rates will push up loan rates for those with low or no floors.

European high yield

We put European high yield issuers on roughly equal footing with their U.S. peers. European high yield bonds look fundamentally similar to, if not even healthier than, their U.S. counterparts, given issuance in Europe has actually been more restrained and skewed more to much-in-demand ESG names and less to equity-friendly activity. Still, likely owing mostly to anticipation of diminished ECB support, index relative performance has lagged since September. This underperformance has left European valuations relatively attractive again, after accounting for index composition (higher average credit quality, different sector mix, shorter duration). However, a lagging economic rebound in Europe and the fading of the ECB’s significant support in credit markets since 2016 could somewhat limit the scope of spreads to re-tighten.

Corporate investment grade

In contrast to high yield and leveraged loans, DM corporate investment grade offers limited value, in our view. Spreads offer little pickup vs. government bonds. And spreads are arguably even narrower than prior tights after adjusting for compositional changes including lately declining average credit ratings. Our outlook for rating migration remains circumspect; management has limited incentive to pursue or maintain higher ratings, given the weighted-average cost of capital (WACC) for BBB rated and AA or A rated companies is quite similar. And as yields do rise, flexible buyers may be increasingly looking to reduce exposure to higher duration IG, in which case spreads could widen.

Emerging markets sovereign debt

We continue to avoid emerging market sovereign debt (EMD). Valuations are attractive, but fundamentals face serious headwinds. EMD spreads screen cheap compared with like-rated DM corporate bonds, and this valuation gap has only widened with lagging performance over the last quarter. Following news of the Omicron variant, DM corporate spreads have about fully recovered from the shock, but EMD sovereign spreads have recovered only partially. And in marked contrast to DM corporates, EMD sovereign spreads remain wider than they were at the start of the year.
But this valuation gap reflects generally weaker fundamentals, although we note there is more than the usual degree of variation among the EM economies, which complicates broad generalization. For EM sovereign issuers, growth remains broadly disappointing, even following significant vaccination progress and strong commodity performance. Net rating migration has stabilized but has yet to turn positive. Given significant economic scarring and debt accumulated during the pandemic (Exhibit 25), the upgrade cycle should be modest. In 2022, fading DM monetary policy accommodation and potentially prolonged virus-induced travel restrictions may intensify somewhat the headwinds facing EMD. The asset class will likely become an attractive opportunity at some point in the intermediate-term future. While we are not expecting a significant EM rebound, the fading of some headwinds – if, say, supply chain issues resolve, inflation peaks, travel restrictions ease and/or the Chinese property sector stabilizes – could act as a catalyst to narrow EMD’s valuation gap vs. DM corporates.

EM public finances have suffered long-term damage from pandemic recession

EXHIBIT 25: FISCAL BALANCES WITH IMF PROJECTIONS (% OF GDP)

![Graph showing fiscal balances with IMF projections as a percentage of GDP](image)


COMMODITIES

Following the outbreak of the Omicron variant, oil prices plummeted from over USD 80/bbl to below USD 70/bbl. Then, in concert with other risk assets, oil prices recouped some of their losses, and the Brent measure is trading now around the USD 75/bbl level. Market participants are monitoring mobility measures, flight statistics and broader measures of oil demand to estimate how much the new variant, and the policy response to it, might reduce oil demand.

Early signs look encouraging: There has been little change in the high frequency data, and most governments have refrained from enacting the tougher measures (e.g., “stay-at-home” orders) that accompanied the pandemic’s first wave. Oil demand managed to weather the Delta variant wave better than expected, and sentiment appears hopeful. But these are early days for the Omicron variant, and the policy response in places like China and India will be key. If Omicron breaks out in China, it may prove so transmissible that it effectively defeats Beijing’s zero-COVID-19 policy. A more significant virus wave in China may bring unpredictable impacts on energy markets.

For now, though, crack spreads for gasoline and gasoil remain at healthy levels, reflecting the moderating pace of economic activity and easing of energy supply issues rather than anything marked on the virus front. With natural gas prices pulling back from their elevated levels in Q3, it is unclear how much gas-to-oil switching will be required over the winter. The International Energy Agency (IEA) still has an extra 500,000 barrels per day (bpd) penciled in its latest estimates. All in all, the oil demand environment looks moderately healthy going into 2022.

Supply is also increasing. OPEC+ has so far shown little concern with the Omicron variant. At its latest meeting, OPEC+ reaffirmed its plans to increase production by 400,000bpd for January. Most market participants had expected the group to pause production increases in order to judge the impact of the new variant. While the OPEC+ decision was a surprise, a number of member states have limited capacity to bring barrels to market, so it’s unlikely that the full 400,000bpd will be added. Members have also kept their meeting “in session” pending further developments on the virus front, opening the door to swift action from OPEC+ should the pandemic cause a more significant drop in oil demand.

OPEC+ may have been influenced in its decision by foreign powers such as the U.S. that have been keen for the group to bring barrels to market more quickly. The U.S., along with other consumer countries, was also able to coordinate a Strategic Petroleum Reserve release of around 70 million barrels, further increasing winter supplies. The decision was likely driven by surging retail gasoline prices. Other components of the U.S.
supply picture have moved more moderately. For example, the rig count continues its slow grind higher. But the overarching theme of curtailed U.S. supply as energy companies focus on shareholder returns, rather than maximal production, remains in place.

As we assess positioning, we note a sharp retrenchment in Brent managed money positioning (Exhibit 26). Given more moderate positioning, oil prices significantly lower than last quarter and a flatter forward curve, it’s fair to assume that a lot of bad news about the energy complex is already priced in. That said, it’s difficult to get excited about an asset vulnerable to increased supplies from OPEC+ and the effects of new COVID-19 variants.

We note a sharp retrenchment in Brent managed money positioning

EXHIBIT 26: BREN (ICE) MANAGED MONEY POSITIONING


Iron ore prices continued to move lower through October and November. Continuing curbs on steel production, decarbonization goals and uncertainty about the property sector have all contributed to weakness in industrial metals. Additionally, policymakers seem to be more tolerant of slower economic growth, lowering the strike price for the “China policy put.” Iron ore price levels are still elevated vs. iron ore’s longer-term history. What’s more, the China Steel PMI has not shown any signs of relief, with the new orders component still languishing in the 20s. On supply, consensus sees the iron ore market remaining in surplus in 2022 and 2023, based on supply increases from Brazil and Australia. Taken together, demand and supply drivers for iron ore are still pointing toward weakness. However, with iron ore prices already down around 60% from the recent highs, iron ore grade differentials might offer the clearer trade (Exhibit 27). We think differentials should narrow as high grade ore prices, which Chinese steelmakers have favored due to high coal prices, moderate.

Iron ore grade differentials remain elevated amid a less favourable fundamental backdrop

EXHIBIT 27: IRON ORE GRADE DIFFERENTIALS, 65% VS. 58%


Mild weakness in copper markets over October and November reflects similar forces at work, but in general the metal has been able to hold up a bit better than iron ore. This is partly because inventories appear to be very tight (Exhibit 28). Several analysts have flagged that copper supplies are getting caught up in supply chain and logistics issues, and that the move lower in copper inventory data suggests moving from “visible” stocks (in warehouses) to “invisible” stocks (at ports). Even so, copper balances have seemed reasonable, supported by seasonal factors. Despite the focus on the longer-term demand drivers for copper, China’s policy setting should be the most important determinant of copper prices over 2022, and any rebound in chip and container ship availability should help demand somewhat. The 50bps reserve requirement ratio (RRR) cut announced at Beijing’s December Politburo meeting sends a more pro-growth signal, but we are expecting only targeted and marginal policy support from China in the coming months.
Through 2021 tight inventories have supported copper prices

EXHIBIT 28: SHFE COPPER INVENTORIES

PORTFOLIO IMPLICATIONS

As we move into 2022, our overall portfolio tilts have not significantly changed from those that we held over the second half of 2021. We expect above-trend global growth – although regional leadership continues to pass from one place to another quite frequently. The economy is largely in mid-cycle, and while we are seeing acutely elevated inflation just now, we expect supply chain issues to ease and believe that prevailing inflation levels will drop by mid-2022.

Asset markets have had a very strong year in 2021. Taking into account the surge from the March 2020 lows, global equities have almost doubled in a little over 18 months. While we remain optimistic on the outlook for stocks and, to a lesser extent, credit, we acknowledge that the cycle’s strongest returns are behind us. Still, we anticipate up to 15% earnings growth in 2022 and, even accounting for prevailing valuations, this should present a favorable backdrop.

As we consider the portfolio implications of our economic views and the underlying fabric of the financial markets, we focus on four principal issues: policy timing, the role of duration, correlations and the outlook for volatility (Exhibit 29). All of these help us determine not just the level of risk to deploy, but also how to fine-tune it and – critically – how to build in resilience for an uncertain future.

Implied volatility has risen in FX this year, remained fairly stable in rates and fallen in equities

Over the next few months, the mid-phase of this economic expansion will take shape fully. Ultra-easy monetary policy and the boost of meaningful fiscal expansion are now in the past. While we expect monetary policy to remain easy by any reasonable comparison, it will be incrementally tighter than today. Equally, we now rely on the unleashing of private sector spending and on the rebuilding of inventories to fuel demand, as fiscal policy takes a back seat.

Money markets have moved quickly to price in this hawkish shift in tone to the front end of the curve, while bond yields further along the curve remain low. Despite the tapering of bond purchases by central banks, we see a great deal of demand for duration, much of it not especially price sensitive. This demand is likely to increase at the margin with any move up in rates. As a result, the back end of the curve likely remains constrained.

At the front end, the degree of hiking currently priced in may well be a little excessive. In the last cycle, market pricing of rates consistently overshot the actual pace of hikes throughout the mid-cycle. Of course, in the last cycle, the possibility of overshooting inflation was not a consideration, as it is today. Nevertheless, as we expect inflation to moderate through next year, the pressure on central banks to hike quickly will abate, and we expect the timing of hikes to be pushed out.

In such an environment, curves could steepen modestly, in turn giving some boost at the margin to sectors with a value signature, such as financials. A modest re-steepening of the curve would also address some of the concerns that the recent flattening trend is not merely a manifestation of mechanical supply/demand factors – as is our view – but is in fact a portent of troubled economic times ahead.

Under normal circumstances, a steeper curve might imply value in taking significant duration shorts. But while our quant models do signal a negative view on duration, and qualitatively we do expect rates to move higher, the risk-reward ratio for expressing a pro-growth view with an underweight to duration is likely to be limited.

Steeper curves, if driven by some moderation in the pricing of rate hikes, would be a positive signal for equity markets. Relatively easy policy and a continuing backdrop of negative real rates would be supportive to stocks, especially if the risk of a prolonged surge in inflation was beginning to subside.
Bonds, meanwhile, continue to find enthusiastic buyers even as central banks step back. From liability hedgers to reserve managers, we expect ongoing demand for duration in 2022 to limit the pace at which rates can increase. As a result, bonds may continue to provide something of a portfolio hedge, and on balance this compels us to limit the degree to which we wish to underweight duration in our portfolios.

The assumption of a negative stock-bond correlation is ultimately what allows bonds to function as a portfolio hedge, even if they do not offer any realistic hope of a positive real return. Over recent weeks, we once again saw the value of bonds as a hedge on days when stocks decline. However, a portfolio hedge that was once assumed to pay for itself with a modest but positive real return must now be paid for – at least in real terms.

More widely in the portfolio, we continue to broadly prefer developed market over emerging market equities. However, at this time, we see only limited scope for large regional RV positions. If we were expecting valuation differentials, rather than earnings delivery, to be the main driver of performance across markets, then there could be a case for non-U.S. over U.S. equities. However, we believe that the earnings delivery in the U.S. continues to be extremely strong, and as such we maintain a broad preference for U.S., Europe and - to a lesser extent - Japan in our portfolios.

Taking less RV risk at the margin compels us to look more closely at cross-asset correlations (Exhibit 30), which we note are below long-run averages. This implies scope for diversification within our risk asset allocation, as well as against duration, which albeit an underweight tactically remains a part of our strategic benchmarks in most cases. With the move wider in high yield credit spreads, we have the opportunity to further diversify our risk asset allocations - an important portfolio construction consideration as we move through 2022.

Finally, we do not think the recent Omicron-driven spike in volatility signals a move to a higher volatility regime. While we will likely see further isolated spikes in volatility - indeed, they are a natural feature of markets - we believe that the baseline in volatility will continue to decline. Typically, in an expansion and an equity bull market, we would anticipate that key metrics such as the VIX would ultimately trade down to the low double digits, perhaps even into single digits for a time. Over 2021, the baseline remained some way north of this level, and as the recovery continues we would expect further downside on volatility in aggregate.

In portfolio terms, this implies perhaps some challenges fully deploying \textit{ex ante} risk budgets. But as we have seen in recent weeks, if we are willing to be somewhat opportunistic as the news around the virus and vaccines ebbs and flows, there are ample opportunities to build returns. Looking through short-term bouts of volatility has proven to be an effective strategy in 2021, and given our constructive economic outlook, we expect the same to be true in 2022.
Multi-Asset Solutions Key Insights & “Big Ideas”

The Key Insights and “Big Ideas” are discussed in depth at our Strategy Summit and collectively reflect the core views of the portfolio managers and research teams within Multi-Asset Solutions. They represent the common perspectives we come back to and regularly retest in all our asset allocation discussions. We use these “Big Ideas” as a way of sense-checking our portfolio tilts and ensuring they are reflected in all of our portfolios.

- Global growth above trend, with the economy broadly in mid-cycle
- High prevailing inflation should ease by mid-2022, but risks remain in both directions
- Policy set to normalize, but perhaps more slowly than currently priced in
- Bond yields move up slowly, but demand picks up incrementally as rates rise
- Dollar supported near-term by rates, but long-run trend likely to be lower
- Further EPS upside supports stocks, while multiples may slip further
- OW equities balanced across developed regions; EM equities may be past the worst
- Prefer a blend of quality, value and cyclical sectors in equities
- Key risks: stickier inflation, prolonged lockdowns, weaker EPS growth

Active allocation views

These asset class views apply to a 12- to 18-month horizon. Up/down arrows indicate a positive (▲) or negative (▼) change in view since the prior quarterly Strategy Summit. These views should not be construed as a recommended portfolio. This summary of our individual asset class views indicates strength of conviction and relative preferences across a broad-based range of assets but is independent of portfolio construction considerations.

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Opportunity set</th>
<th>UW</th>
<th>N</th>
<th>OW</th>
<th>Change</th>
<th>Conviction</th>
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<tr>
<td><strong>MAIN ASSET CLASSES</strong></td>
<td><strong>Equities</strong></td>
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</tbody>
</table>
| **EQUITIES** | U.S. | | | | | High
| | Europe | | | | | Moderate
| | UK | | | | | Moderate
| | Japan | | | | | Moderate
| | Emerging markets | | | | | Moderate
| **FIXED INCOME** | U.S. Treasuries | | | | | Low
| | G4 ex-U.S. sovereigns | | | | | Moderate
| | EMD hard currency | | | | | Moderate
| | EMD local FX | | | | | Moderate
| | Corporate investment grade | | | | | Moderate
| | Corporate high yield | | | | | Moderate
| **CURRENCY** | USD | | | | | ▲
| | EUR | | | | | ▼
| | JPY | | | | | Moderate
| | EM FX | | | | | Moderate

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments are made using data and information up to December 2021. For illustrative purposes only. Diversification does not guarantee investment returns and does not eliminate the risk of loss. Diversification among investment options and asset classes may help to reduce overall volatility.
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PORTFOLIO INSIGHTS

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