Global Asset Allocation Views

Key findings from the Multi-Asset Solutions Strategy Summit

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IN BRIEF

- Moderate growth, cooling inflation and less restrictive policy should be generally supportive to asset markets in 2024. We upgrade equities to a modest overweight, maintain a constructive view on duration and continue to find pockets of opportunity across the credit complex.
- While the economy surprised positively in 2023, growth was uneven, and some sectors and regions endured rolling slowdowns. As growth cycles remain out of sync in 2024, there should be tradable differences among sectors and regions, as well as a good outlook for stock selection alpha.
- We see positive U.S. stock performance broadening beyond tech as an improving U.S. inventory cycle boosts cyclical sectors. Japanese stocks remain attractive, given rerating potential driven by corporate governance reforms. Emerging market equities are cheap but so far lack clear catalysts for a rebound.
- The prospect of rate cuts in 2024 supports a duration overweight and a USD underweight. In credit, spreads are tight by historical standards, but carry is attractive and we see opportunities in securitized credit, as well as in shorter-dated crossover credits and high yield.

Exhibit 1: MAS asset class views

Asset class		Opportunity set	UW	N	OW	Change	Conviction
Main asset classes		Equities	○	○	●	▲	Moderate
		Duration	○	○	●		Moderate
		Credit	○	○	●		Moderate
		Cash	●	○	○	▼	High
Preference by asset class	Equities	U.S. large cap	○	○	●		Moderate
		U.S. small cap	○	●	○		
		Europe	●	○	○		Low
		UK	○	○	●		Low
		Japan	○	○	●		Moderate
		China	○	●	○		
		EM ex-China	●	○	○		Moderate
	Fixed income	U.S. Treasuries	○	○	●		Moderate
		G4 ex-U.S. sovereigns	○	●	○	▼	
		EMD hard currency	●	○	○		Low
		EMD local FX	○	●	○		
		Corporate inv. grade	○	●	○	▼	
		Corporate high yield	○	○	●	▲	Low
	FX	USD	●	○	○	▼	Moderate
		EUR	○	○	●	▲	Low
		JPY	○	○	●		Low
		EM FX	○	●	○		

Source: J.P. Morgan Asset Management Multi-Asset Solutions; as of December 2023.

Summary

The year ahead looks set to be characterized by an extension of the business cycle, a further cooling of inflation and the beginning of a rate easing cycle. The strong fiscal thrust and surprisingly robust U.S. consumption patterns of 2023 will likely moderate. At the same time, the industrial cycle and activity in Asia and Europe are set to improve. Together, these factors point to global growth close to trend, continuation of the asynchronous cycle and less restrictive financial conditions – an environment that we believe will be generally supportive of stocks and bonds.

We expect U.S. GDP to grow at 1.8% over the full year of 2024 and for headline inflation to continue moderating to close to the Federal Reserve (Fed) target of 2% by year-end. This environment allows for rate cuts over 2024, as signaled by the Fed in December, which in turn could be positive for both stocks and bonds.

In our view, we do not need heroic growth expectations for risk assets to move higher in 2024. To that end, we upgrade equities to a modest overweight, maintain a constructive view on duration and continue to find pockets of opportunity across the credit complex.

Global stocks rallied over 17% in 2023, but this masks meaningful regional and sectoral dispersion. A 44% rebound in U.S. tech stocks this year – after their 28% slump in 2022 – propelled the S&P 500 to gains of 22%. But just as tech was recovering, parts of the transportation and logistics sectors reported sharp slowdowns in earnings. While the global economy avoided recession in 2023, a number of sectors and regions endured rolling slowdowns.

A backdrop where economic cycles are out of sync increases dispersion of returns; in 2023, the result was a strong year for active alpha. With this environment set to continue in 2024, the outlook for stock selection alpha remains favorable.

Our estimate of around 7% growth in earnings next year, with multiples supported by lower rates, likely sees the S&P 500 test the 5,000 level in 2024. We also expect that positive performance broadens beyond the tech sector as an improving U.S. inventory cycle boosts cyclical sectors.

Japanese stocks remain attractive, given improving nominal growth in Japan and scope for valuation expansion as corporate governance reforms mandated by the Tokyo Stock Exchange support shareholder returns. European growth, meanwhile, remains sluggish going into 2024, but there are signs that leading indicators, like confidence and purchasing manager surveys, are turning. Should this improvement broaden out, it may be supportive of European Union (EU) equities, but for the time being, we prefer to play a European rebound via the currency.

Emerging market (EM) equities are cheap but so far lack clear catalysts for a rebound. To warm up to EM stocks, and particularly to China, we would want to see sustained earnings improvements, a clear turn in the global goods cycle, tangible support for the Chinese property sector and further thawing of geopolitics and trade between Washington and Beijing.

The prospect of a cutting cycle in 2024 supports a duration overweight. Following the Fed's dovish pivot, the trajectory of yields is clearly downward. With U.S. 10-year yields just below 4%, we are toward the lower end of a 50 basis point (bps) to 75bps trading range,

which we expect to hold until the rate cuts actually begin in 2024; from there, we expect yields to track steadily downward.

Our duration overweight is focused on the U.S. – which also hedges against the risk that growth disappoints – but we are more cautious on duration in Europe and Japan. We are skeptical that European rates will be cut ahead of U.S. rates, and as a result German Bunds look more vulnerable to a backup in yields. Meanwhile, we expect the Bank of Japan (BoJ) to raise rates and make further moves to end bond purchases, in turn putting upward pressure on Japanese Government Bond (JGB) yields in early 2024.

Aggregate credit spreads are tight by historical standards, with U.S. high yield (HY) spreads at 335bps and U.S. investment grade (IG) at 100bps. But we see opportunities in securitized credit, as well as in shorter-dated crossover credits and HY, which continue to trade at a discount to par. By contrast, longer-duration IG appears quite rich. Should our base case of moderating growth but no recession play out in 2024, all-in yields in credit could continue to offer attractive carry.

In sum, there is sufficient resilience in the economy to extend the cycle. As central banks move from hiking to cutting in 2024, we expect both stocks and bonds to benefit. Amid receding inflation, stock-bond correlations should eventually fall toward neutral levels – in turn improving the diversification potential in multi-asset portfolios. But for the time being, moderate growth and less restrictive policy are supportive for asset returns in the first half of 2024.

Macro overview

U.S. ECONOMIC OUTLOOK

After a turbulent journey, the U.S. – along with other major developed economies – seems to be closing in on a soft landing. Investors in recent weeks appear to have quickly priced in the notion that high inflation was merely a supply-side problem that needed to work itself out – it was transient, after all – and that as this process enters its final stretch in the coming months, central banks should soon be able to cut rates from restrictive territory back to something more normal. We have some sympathy with this narrative. After all, since September we've pegged the year-ahead odds of entering a U.S. recession at just 20%, just a hair above the long-term historical realized rate. Recent months have delivered substantial progress toward realizing a soft landing, in terms of both gradual economic deceleration and cooling inflation.

From a central bank's perspective, an economy already at full capacity and growing above potential, as the U.S. has been this year, is at risk of overheating. Only months ago, many market participants were concerned about a potential reacceleration of U.S. growth. However, we continue to believe that much of the real GDP strength in 2023 relative to 2022, especially in the blowout third quarter, owed to one-time drivers that have run their course. These include U.S. fiscal expansion, policies encouraging nonresidential structures investment, stabilization in real incomes, a significant rebound in labor force participation and a bottoming in the housing market, as well as a drop in the personal saving rate and an inventory surge centered on Q3 (Exhibit 2).

U.S. Q3 strength has been driven by unusual – and, we expect, a one-time – drop in personal saving

Exhibit 2: U.S. personal saving rate, % disposable personal income

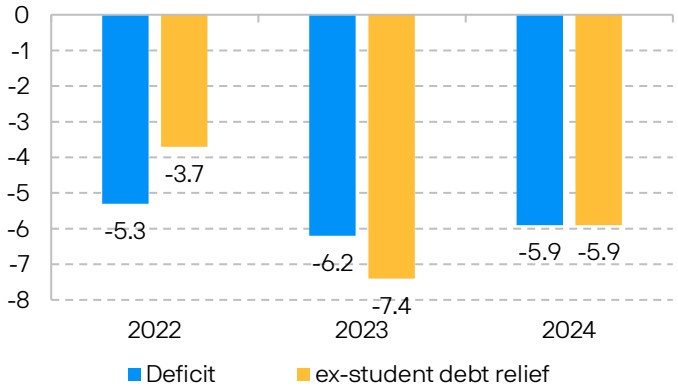
Source: U.S. Bureau of Economic Analysis, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

So far in Q4, growth has evidently decelerated to a meaningful degree. That partly reflects fiscal contraction, including the expiration of the federal student loan moratorium and child care subsidies, and fiscal spending should be a modest drag on growth next year (Exhibit 3). Meanwhile, the pace of job gains has continued its steady decline and is approaching a sustainable "breakeven" pace of perhaps 100,000 per month; that would be consistent with a steady unemployment rate and trend growth.

More broadly, steady economic deceleration is a function of still-tight financial conditions, as evident, for example, in higher yields and diminished commercial bank willingness to make business loans. But with yields down considerably from their mid-October peak and the Fed's latest Senior Loan Officer Opinion Survey showing a pullback in the pace of tightening lending standards, these conditions are not so onerous that they would risk an abrupt slowdown.

The U.S. fiscal deficit is set to narrow somewhat next year

Exhibit 3: Deficit as a % GDP, with CBO forecasts



Source: U.S. Bureau of Economic Analysis, Congressional Budget Office, J.P. Morgan Asset Management Multi-Asset Solutions; data as of November 2023.

Inflation, of course, has been the Fed's primary concern. Recent months have delivered remarkable progress on cooling core inflation measures, as well as wage growth. Looking forward, we see a couple of crosscurrents at play: Helpfully, shelter inflation - which, by our estimates, currently accounts for nearly 80% of excess inflation relative to longer-term trends - should cool, as suggested by leading real-time indices of rents as well as a continued robust supply of multifamily housing. Wage inflation, which has an especially large impact on other core services on which the Fed is focused, should also decelerate. This progress, though, will be offset in part by a gradual fading of the disinflationary tailwind from the normalization of some highly inflated goods prices like automobiles.

Ultimately, inflation and growth developments over the last quarter not only give us greater

conviction in a soft landing but have prompted a dovish shift in our base case for developed market (DM) central bank policy: We are fading the "higher for longer" narrative and now see the Fed making two or three proactive 25bps rate cuts next year, beginning in Q3.

To be sure, the economy hasn't landed quite yet, and we still expect a bumpy ride to get there. The stickiest components of inflation are not yet resolved, and it's precisely the moment of touchdown – when the pace of U.S. growth and job gains ideally falls to a slower sustainable pace – when the risk of crashing is arguably the greatest. Moreover, some distinct risks include a potential U.S. federal government shutdown or further reduction in federal spending starting in late January, as well as residual debt stability concerns in pockets of commercial real estate and among corporate loan borrowers.

WHAT MIGHT FOLLOW A SOFT LANDING?

In a sense, the concept of a "soft landing" is simplistic, in large part because it doesn't answer what comes next. In the wake of a soft landing, we see a narrowing funnel of potential outcomes that leads to an increasingly central scenario of middling growth. In other words, there is less upside as the pace of expansion cools, but also less downside as the risk of recession declines.

We'll first address the diminished upside. If the U.S. economy does manage a soft landing, it won't reaccelerate into full-throttle liftoff. Rather, it will still have a later cycle tone – with the economy running close to full employment we see little room for it to grow above potential for any sustained period, of particular note, the potential contribution from rising labor force participation now seems largely exhausted after having meaningfully contributed to supply-side growth in 2023. In the coming quarters, therefore, we expect a steady expansion of the working-age population (with some help from immigration) and productivity to eke out just under 2.0% real GDP growth.

Second, to consider the diminished downside: If the U.S. avoids a recession in 2024, the downturn doesn't automatically get bumped to the following year. On the contrary, we see a long runway – years, potentially – for a continued expansion. (Cycles don't die of old age, as the saying goes.) Historically, most U.S. postwar recessions have been ultimately caused by some form of visible overheating. These might be market price bubbles, a rapid buildup of private sector leverage, unsustainable patterns in investment and consumption, or excess inflation. In the current cycle, inflation has been the only potential source of overheating, and we don't see it reaccelerating.

On the labor front, a relatively small number of pro-worker actions, including union strikes by the United Auto Workers against the Big Three automakers and by Hollywood actors and writers against producers, have attracted considerable attention in recent months. Broadly speaking, these actions have mostly aimed to protect worker livelihoods in the face of soaring inflation as well as potential future threats like artificial intelligence (AI). Since early 2020, directly before the pandemic recession, U.S. workers' cumulative wage gains have actually slowed significantly in real terms after accounting for inflation, and have even been negative by some measures. In the last cycle, the unemployment rate dipped moderately below the current level without much additional wage pressure. Since then, we see little changed structurally, including in the balance between capital and

labor. Union membership rates, for instance, have in fact declined marginally (to 10.1% in 2022, according to the U.S. Bureau of Labor Statistics).

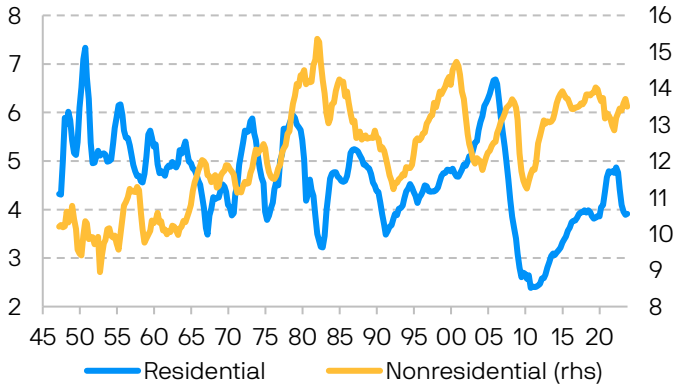
Beyond inflation, which now seems securely on a downward path, there is no other foreseeable ultimate cause for a recession. The private sector has meaningfully delivered in this cycle, thanks in large part to the public-to-private sector fiscal transfers of 2020–21, which built on top of significant deleveraging in the wake of the global financial crisis. Household and business assessments of current conditions and their plans for major purchases and capital expenditures remain relatively subdued.

That lack of exuberance has so far meant a lack of unsustainable patterns of consumption and investment relative to the ends of past cycles. Consider real residential fixed investment. After pulling back nearly 20% from its peak (Exhibit 4), this metric is now below the demographically implied rate of household formation, suggesting plenty of upside. The coming years could thus see a buildup of economic excesses, including residential fixed investment, that have been unusually absent from this cycle.

Even as we see no clear recession catalysts on the horizon, the economy could be more susceptible than usual to unforeseeable shocks. The economy's natural shock absorbers are wearing thin, given the slowing trend of economic growth, as well as low household saving rates that provide less ability to maintain real spending if real incomes are disrupted.

U.S. private fixed investment has room to expand

Exhibit 4: U.S. private fixed investment shares of nominal GDP, %



Source: U.S. Bureau of Economic Analysis, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

We note some developing upside risks to our base case, too. At the top of the list – no surprise – is the potential of AI to boost labor productivity, perhaps by as much as 1.4%–2.7% per year for several years, by our estimates, although the timing of any meaningful impact is quite uncertain. In addition to boosting productivity, AI automation might even help extend the cycle by reducing labor supply constraints. Nearer-term, immigration might also continue to surprise on the upside.

Shifting our focus from the U.S. to the rest of the world, we continue to observe an asynchronous cycle that is likely to persist into 2024. This past year saw stronger than expected growth in the U.S. against a global backdrop characterized by broad-based deterioration. The coming year should effectively see the opposite, with U.S. growth slowing while the rest of the world begins to show signs of modest recovery. That said, for

growth to turn outside of the U.S. we will need additional confirmation that the goods cycle is reaccelerating in Asia and signs that manufacturing activity is beginning to pick up in Europe. Furthermore, any additional stimulus in China to stabilize the property market and support the consumer could act as a broader tailwind for non-U.S. activity next year.

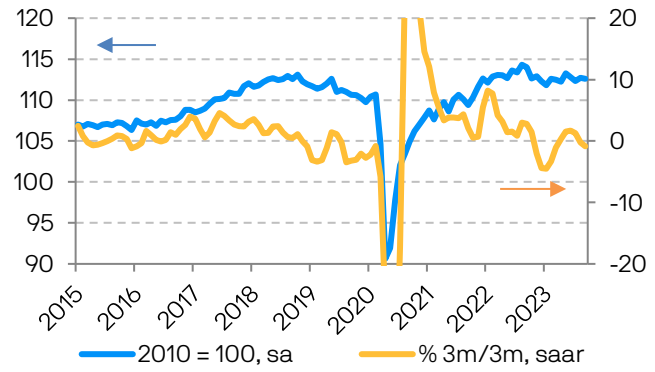
Growth in the euro area underperformed expectations. It is likely that growth for the year as a whole is flat, as the industrial sector experienced a recession (-6.6% year-on-year in October) and inventories were drawn down notably. Having said that, consumer and investment spending has held up reasonably well despite the weak headline GDP data, with retail sales volumes and (real) gross capital formation down just 1.2% and 1.4%, respectively, on the year in October. Looking ahead, we expect a modest recovery led by inventory restocking and a stabilization in the manufacturing sector, and a further moderation in inflation should support consumption as rising real income growth turns positive in 1Q 2024. Added to this, Europe is likely to benefit from a recovery in the global goods cycle over the next year. Thus, while we do not expect a strong V-shaped recovery in euro area growth, we do see the ingredients in place for a modest recovery in manufacturing as headwinds abate. On the policy front, the European Central Bank (ECB) signaled a pause in its hiking cycle and is likely to keep rates restrictive for the coming months. This will act as a limiting factor and keep growth below trend in the first half of 2024.

GLOBAL GOODS CYCLE: MODEST IMPROVEMENT AHEAD

Major economies outside of the U.S. are more exposed to the global goods cycle, which has struggled for over a year. Outside of China, global industrial output stalled again in Q3 after a modest lift in Q2; it remains below its September 2022 level (Exhibit 5). The rebound in the November global manufacturing purchasing managers' index (PMI) eased some concerns that industrial activity was sliding into contraction, but at 49.9 the level does not signal a convincing comeback.

Excluding China, global industrial output stalled again in Q3

Exhibit 5: Global ex-China industrial production



Source: Haver Analytics, J.P. Morgan Asset Management Multi-Asset Solutions; data as of September 2023.

The recent soft momentum in global industry is concentrated in Europe. While European PMI surveys recovered in November, the region remains a source of weakness in the global goods cycle. EM economies have fared better: Recent PMIs in Asia look encouraging, and export data suggest a regional tech recovery. A mini replacement cycle for mobile phones and AI development are likely to be the two main drivers of semiconductor demand recovery in 2024.

With inventory pressure easing across most regions, we believe the near-term outlook for global industry will depend on the path ahead for final goods demand. We expect that demand will moderate as global growth slows to a below-trend pace next year. Industrial

output will likely improve modestly from current levels to meet final goods demand.

JAPAN: PREPARING FOR LIFTOFF

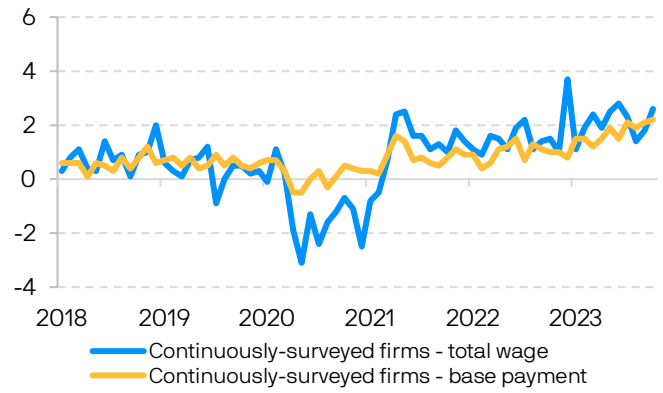
In 2024, the Bank of Japan will likely finally join the global tightening cycle as other major central banks contemplate the end of policy tightening and the introduction of rate cuts. In our base case, we expect the BoJ to exit its negative interest rate policy (NIRP) in January and remove its yield curve control (YCC) in April 2024. Maintaining YCC during Q1 should give the BoJ more room to manage potential market volatilities surrounding the exit from NIRP.

A virtuous cycle between wages and prices holds the key to the BoJ's rate hike plans, and we see increasing evidence that such a cycle may be emerging. Japan's core inflation has stayed above its 2% target for 19 consecutive months. Underlying inflation measures have exceeded the target. We expect Japan's core inflation to remain above 2% throughout 2024, reflecting prolonged goods inflation and broadening services inflation amid rising labor costs.

At the same time, the strong outcome of the fiscal year 2023 (FY23) Shunto spring wage negotiations continues to push the underlying wage trend higher. In October, base wage growth rose by 2.2% year-over-year (y/y) for continually surveyed firms, the highest growth rate since the start of the data series in 2016 (Exhibit 6).

Japan's upward wage momentum remains intact

Exhibit 6: Nominal wages per worker in Japan (% y/y)



Source: Haver Analytics, J.P. Morgan Asset Management Multi-Asset Solutions; data as of October 2023.

The recently published 2023 government survey on wage increases identifies several factors driving the hikes: overall inflation and the need to both attract and retain staff and pay market wages. The survey results suggest that the trend of higher wage growth might be sustainable.

In addition, early news flow around the FY24 Shunto spring wage negotiation points to a greater improvement in base pay compared with the historic 2.1% recorded in FY23.

We expect Japan's growth momentum to reaccelerate in 2024 after a soft patch in 2H 2023 – an environment conducive to monetary policy normalization. Private consumption will likely rebound, supported by stronger wage growth and a one-off tax refund of almost 1% of GDP. Capex intentions remain upbeat, as indicated by the December BoJ Tankan survey. We anticipate that investments in labor-saving technologies (driven by worsening labor shortages), as well as investments in environmental and digital

projects, will likely drive capex demand going forward.

Recent communication by BoJ officials suggests that the central bank is trying to signal to investors that monetary policy normalization is growing closer. On December 6, BoJ Deputy Governor Himino talked extensively about what would happen if the BoJ achieved its 2% price stability goal and boosted the short-term policy rate into positive territory. He also explained how the private sector could benefit from higher rates through rising net interest income. A day later, BoJ Governor Ueda described the mechanics of eventual NIRP removal and rate hikes.

CHINA: BUMPY RECOVERY WITH MODEST POLICY SUPPORT

Much of the outlook for the Chinese economy hinges on the trajectory of policy easing amid an ongoing property downturn and still-weak private sector sentiment.

In recent months, Chinese policymakers have stepped up the pace of policy easing, addressing funding support for infrastructure and property investment and local debt resolution. We believe these measures will help support China's growth momentum in 1H 2024.

Still, recent policy communication signals a modest easing stance in 2024. Both the December Politburo meeting and the Central Economic Work Conference emphasized high quality development and called for an "appropriate pace of easing," implying a low likelihood of aggressive policy support. Moreover, there seems to be more focus on fiscal discipline as policymakers focus on enhancing the sustainability of fiscal policy in the latest policy meetings.

China's fiscal impulse will likely expand modestly next year to support infrastructure investment and offset headwinds from continued contraction in local debt financing. Beijing has shown its willingness to leverage the central government's balance sheet to shore up the economy with the unusual mid-year fiscal deficit expansion to 3.8% from 3.0% of GDP in late October. On the monetary side, we expect the People's Bank of China (PBoC) to implement further reserve requirement ratio (RRR) cuts (25bps) and policy rate cuts (10bps–20bps) in the coming quarters to facilitate increased government bond issuance and other easing measures.

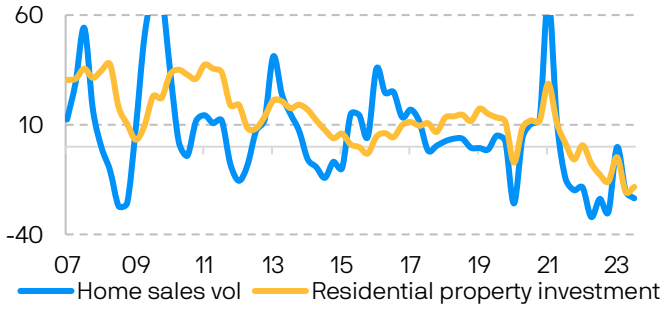
Overall, we expect China's growth momentum to improve modestly in 2024 as previous easing starts to feed through to the economy and the drag from the property downturn moderates. Consumption will likely be a key growth driver, with the help of a release of excess savings and gradual improvement in labor market conditions.

A deeper property downturn remains a key downside risk to our base case outlook for China, given still-subdued sentiment among homebuyers (Exhibit 7). Chinese policymakers are reportedly considering more easing measures to support the property market. Bloomberg reported that China plans to provide at least RMB1trillion (around 0.8% of GDP) of low cost financing to the nation's urban village renovation and affordable housing programs. This would be an important step toward stabilizing the market, as it would support property investment and potentially help reduce inventory in the market.

Easing measures also need to address China's unfinished property projects, including new homes that were pre-sold by developers. As private developers struggle to secure funding, regulators are reportedly drafting a "white list" of 50 developers that could qualify for loan support from banks.

There is lingering weakness in China's property sector

Exhibit 7: China's property sector activity growth (% y/y)



Source: CEIC, J.P. Morgan Asset Management Multi-Asset Solutions; data as of September 2023.

There is room to extend the cycle

Exhibit 8: U.S. business-cycle scorecard

		Early cycle	Mid cycle	Late cycle	Recession
Economic metrics	Output gap (Unemployment)	Below potential (Well above NAIRU)	Near potential (Above NAIRU)	**Above potential (Near or below NAIRU)**	Contracting (Rising sharply)
	Personal saving rate	High	Elevated but declining	**Low and stable**	Rising
	Capital inv. % GDP	Low	**Moderate**	High	Contracting
	Residential inv. % GDP	**Low**	Moderate	High	Contracting
	Private credit formation vs. trend	**Low**	Rising	Above	Contracting
	Price inflation vs. CB target	Below	Near	**Above**	Decelerating
	Wage inflation	Low	Moderate	**High**	Decelerating
	Consumer confidence	Low	**Moderate**	Exuberant	Falling
Asset market metrics	Policy rate setting	Easy	Neutral	**Restrictive**	Cutting sharply
	Yield curve slope (2s10s)	Steep	Flat	**Inverted**	Bull steepening
	EPS revision ratios	Negative, improving	**Positive, improving**	Positive, falling	Negative, falling
	Corporate margins	Low, rising	Peaking	**Stabilizing**	Falling sharply
	Credit spreads	Wide	**Tight**	Above cycle trough	Widening sharply
	Capital issuance	Low	**Moderate**	Aggressive	Non-existent
	M&A activity	**Low**	Moderate	Aggressive	Non-existent
	Equity implied vol	High, falling	**Low**	High, rising	Peak

Source: J.P. Morgan Asset Management Multi-Asset Solutions; data as of November 2023.

Level One asset allocation

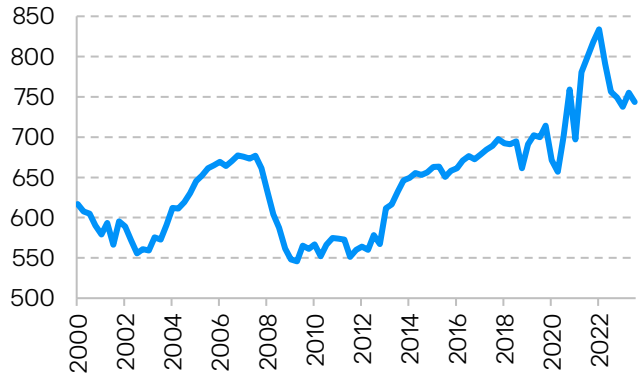
Many investors were wrong-footed in 2023, as global growth proved more resilient than expected and the economy turned out to be less interest rate sensitive than assumed. Observers offered various explanations, but we believe a combination of a stronger than expected consumer together with some fiscal boost drove solid growth this year.

The interest rate resilience is more nuanced: A key reason that the widely forecast recession did not materialize was simply that the imbalances and excesses that form over an economic cycle and are typically exposed by the hiking cycle had not built up this time. That may partly reflect the shorter time from the cycle trough in 2Q 2020 to the first rate hike in February 2022, but it is also a feature of the unique events shaping this cycle.

Consumers still had excess savings from the pandemic as hikes began. What's more (and less remarked upon), aggregate household balance sheets were in relatively good shape (Exhibit 9) after more than a decade of cheap capital. Meanwhile, corporations had resisted the last hurrah of post-pandemic ultra-easy money and instead of levering up chose to term out their liabilities. Scars from the pandemic and prior to that the Sino-American trade war of 2017–18 had also imbued a level of corporate discipline that prevented the usual late-cycle hubris and excess.

Strong consumer net worth helped to offset interest rate hikes

Exhibit 9: Households and nonprofit organizations; net worth as a % of disposable personal income



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of July 2023.

When rate hikes began – a little late but in earnest – in response to soaring inflation, market participants widely assumed that aggregate demand must be severely restrained in order for prices to fall. Had inflation been primarily stoked by soaring demand-side ebullience, such logic would have been correct. But instead, inflation arose primarily due to pandemic-related supply chain problems and, later, Russia's invasion of Ukraine. Cooling inflation, sniffily dismissed as "immaculate disinflation" in some quarters, is more likely to be a function of gradually resolving supply chain dislocations – in turn leading central banks to a policy pivot, creating the potential for a very different monetary backdrop as we enter 2024.

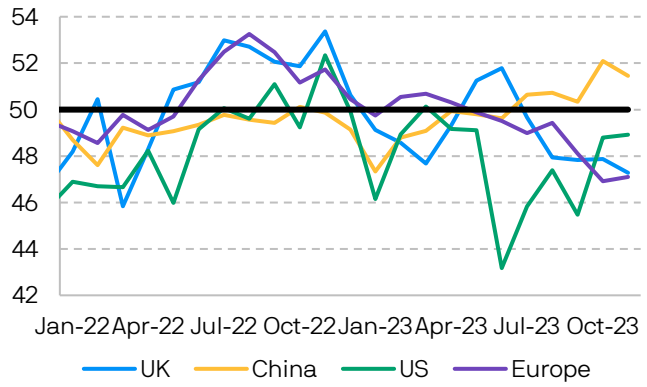
Some observers interpret slowing inflation and moderating growth as a homogenous soft landing for the global economy. However, such a conclusion overlooks the highly asynchronous nature of this cycle. While U.S. growth peaked in 2023 at 5.2% Q3/Q3, Europe

flatlined and China entered deflation. The surge in tech stocks this year drove the S&P 500 to return more than 20%, but masks the challenging conditions faced by sectors such as logistics and transportation.

In aggregate, the trajectory of the economy in 2024 may center on a soft landing, but the reality is likely to be a continuation of cycles that are running at different paces (Exhibit 10). Such an environment is unlikely to support a harmonized surge in activity. But equally, as one cycle rebounds while another crests, the risk of a synchronized slowdown – resulting in a recession – declines.

The inventory/goods cycle remains out of sync across regions

Exhibit 10: Inventory PMIs



Source: Haver Analytics, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023

Putting this together, our core economic case envisions growth close to trend in 2024 (a U.S. GDP forecast of 1.8% for FY24), with inflation cooling toward target by 2H 2024. We see rate cuts coming by mid-year, as we do not expect the Fed to wait until inflation is at or below its target before easing policy. We also expect the asynchronous nature of this cycle – across regions and sectors alike – to persist. In aggregate, the economy has some late-cycle characteristics, but this masks a diffuse set of conditions. Some regions and sectors – for instance, parts of the emerging markets and some European cyclical sectors – may be earlier in their cycle, while other regions, including the U.S., are further along.

The receding risk of recession and a more favorable monetary backdrop, as recently signaled by the Fed, provide a supportive backdrop across asset markets. For the time being, the positive correlation between stocks and bonds persists. As a result, the rapidly declining attractiveness of cash is prompting a "financial conditions" trade that is propelling stocks and bonds in tandem. As inflation cools toward trend, we would expect stock-bond correlation to fall to zero and possibly turn negative. But in the early part of 2024, the scope for assets to appreciate together leads us to overweight (OW) stocks, bonds and credit, offset with a high conviction underweight (UW) in cash.

For some months, we have highlighted the potential for positive returns across parts of the equity market despite prevailing concerns about valuations, concentration and the trajectory of earnings. We upgrade our overall outlook on equity to OW, acknowledging that easier financial conditions likely support the valuation of risk assets. The earnings downgrade cycle began to turn in the third quarter of 2023, and we expect that fourth quarter earnings will confirm this trend (Exhibit 11). Seeing a modest recovery in earnings, along with easier policy removing downside pressure on valuations, we anticipate low double-digit returns on global stocks over 2024.

Investors debate the concentration risks surrounding the dramatic outperformance of the "magnificent seven" U.S. technology stocks. In our view, fears that large cap technology and technology-linked stocks will

de-rate ignores these companies' strong free cash flow, which is compounding at a growth rate in the upper teens.

Strong consumer net worth helped to offset interest rate hikes

Exhibit 11: S&P 500 1-year forward EPS

Source: FactSet, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

In the early 2000s, much was made of the risk of the breakup of the tech sector. But we feel that given the strategic importance of technology to the U.S. and developed economies more broadly, the sector is likely to continue to operate as a "tolerated monopoly," with few U.S. lawmakers wanting to undermine Silicon Valley today. Nevertheless, in 2024 we expect broadening market leadership as other sectors – particularly higher quality cyclicals – benefit from a turn in the goods cycle and a less dour economic outlook.

Bond yields fell quickly following the Fed's overt pivot at its December meeting. In our base economic case, we would anticipate four to six cuts of 25bps over the next 18 months. A fed funds rate of 3.75%–4.00% and Personal Consumption Expenditures (PCE) inflation at the Fed's 2% target would imply a real rate of a little below 2%. This would represent a policy setting more restrictive in real terms than at any time since the global financial crisis and would provide the Fed with policy tools – in both directions – to cope with the ebb and flow of the economy.

With U.S. 10-year yields around 4% at the time of writing, the potential for further dips in yield may be muted until rate cuts actually materialize in 2024. Nevertheless, we expect demand for duration will build on any backup toward 4.25% and doubt that yields would increase beyond 4.5% even on robust growth data. Given declining cash rates and moderating growth, clipping a 4% coupon is attractive, but we see an asymmetry of returns to bonds following the Fed's pivot. Should growth disappoint, we believe yields have scope to fall meaningfully, but in the event of positive surprise, we see yield rises as being more constrained.

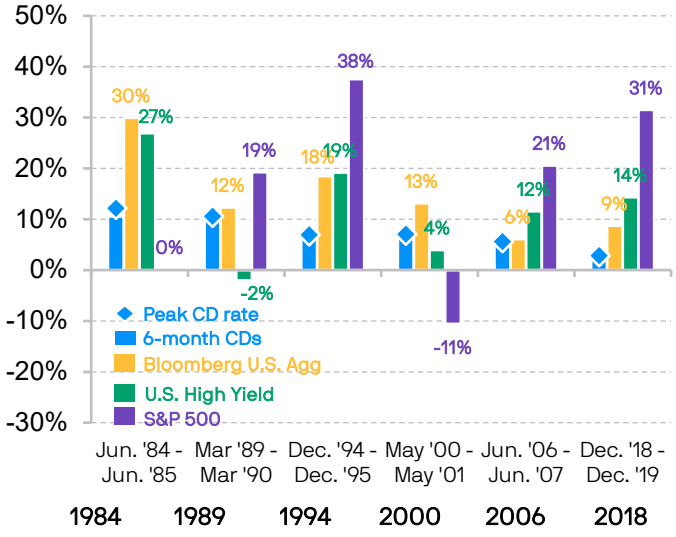
We maintain an OW to credit as declining recession risk provides support for spreads. While in aggregate only modest spread tightening may be possible, all-in yields look attractive. With riskless rates high, a pull to par effect lends further support. Certainly, some pockets of the credit complex are already fully valued – longer-dated (10+ year) investment grade in particular. Still, we find value in parts of securitized credit, as well as in shorter-dated corporate high yield and in financial credits.

After several quarters of promising mid single-digit returns for apparently no risk, cash rates now look distinctly vulnerable. Historically, as central banks cut rates, returns from cash underperform other asset classes (Exhibit 12), and as such we have high conviction in our cash underweight. We do not expect cash rates in EUR to fall faster, or further, than those in USD; meanwhile, cash

rates in JPY are likely to move modestly higher.

Today, there are investment opportunities outside of CDs

Exhibit 12: Peak 6-month certificate of deposit (CD) rate during previous rate-hiking cycles and subsequent 12-month total returns



Source: Bloomberg, J.P. Morgan Asset Management Market Insights, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

In currency terms, this likely translates to a weakening USD. We see modestly more upside for EUR, where some signs suggest the economy could rebound in 2024, than we do for JPY, where reasonable economic momentum is well telegraphed. In any case, a soft landing – asynchronous, as we expect, or otherwise – is consistent with a softer dollar.

In sum, our earlier view – that a recession was not an inevitable outcome to a Fed hiking cycle – is gaining wider support across the market. The modal outcome for investors is now an extension of the cycle. This is a reasonable base case, but with a caveat that economic cycles around the globe remain out of sync, muting recession risks and presenting relative value and alpha opportunities within asset classes. An extension of the cycle against a backdrop of easier policy rates broadly supports asset markets, but anyone expecting a sustained, early cycle-style surge in markets may well be disappointed. Instead, the environment calls for compounding moderate returns and actively leaning into dislocations as discrete industrial cycles ebb and flow.

Our Level One scorecard favors equities, duration and credit over cash

Exhibit 13: Level One Scorecard

	Considerations	Comment	Stock	Bond	Credit	Cash
Macro factors	Economic growth	Base case of soft landing with growth closer to trend, inflation cooling towards target over 2024.	+	0	+	0
	Financial conditions	Cooling inflation allows for rate cuts in 2024, easing financial conditions and supporting assets vs. cash	+	+	+	-
	Monetary policy	Dovish Fed may drive outflows from money market funds, ongoing QT limits downside to yields	+	0	+	-
	Tail risks	Policy rates left too high for too long, corporate caution , sharp additional tightening of credit conditions	-	0	-	+
Market factors	Valuation - absolute	Equities close to long term PE averages (ex. Mag7), bond yields fair, spreads close to bull market average	0	+	0	0
	Valuation - relative	Equity risk premium remains low; bonds a good hedge; corporate credit yield high, but spreads tight	-	0	0	0
	Fundamentals	Upper single digit EPS growth in 2024, limited recession risk caps defaults, rate cuts push yields lower	+	+	+	-
	Positioning	Fast money now OW stocks but real money and retail light, money market funds saw >$1T excess flows	0	0	0	-
	Flows/sentiment	Strong inflows to equities creating some momentum, credit flows supportive.	+	0	+	0
	Overall Score		+	+	+	-

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments as of December 2023.

Level Two asset allocation

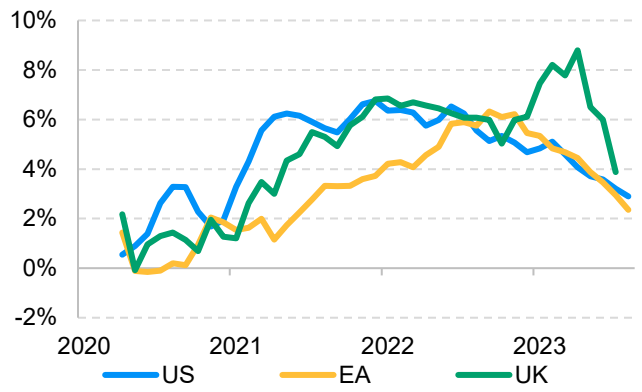
At this juncture, we shift our perspective. In the preceding pages, we examined our Level One asset choices, the basic portfolio decisions involving broad asset classes (e.g., stocks vs. bonds). We now present our Level Two asset decisions. Here, we look within asset classes and determine, for example,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

Rates

We maintain a positive duration stance, underpinned by two key pillars: slowing growth and a gradual downtrend in inflation back to 2%.

Growth vs. inflation pricing in the bond market: The majority of bond market repricing reflects higher growth expectations

Exhibit 14: Core inflation, seasonally adjusted 6-month annualized, y/y%



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

Realized data have confirmed both slowing growth momentum and cooling inflation (**Exhibit 14**), giving us greater conviction in our duration view. Labor growth has moderated from a three-month moving average of 320,000 to 200,000 over this year. Core inflation across developed markets has decelerated sharply and on a three-month annualized basis is now close to central bank targets.

FALLING YIELDS, INVERTED CURVES, MARKET TENSION

In the wake of the data releases, bond yields fell sharply over the quarter as central banks confirmed that policy rates had plateaued; they also broached the prospect of rate cuts over a 12-month horizon. Developed market government bond yields fell 50bps from their peak (using the J.P. Morgan Government Bond Index (GBI)) but at 3.3% remain close to the highest levels since the early 2000s. This has further inverted cash/10-year yield curves. Indeed, on a global basis the curves have not been this inverted since the early 2010s.

Today, we observe a tension in markets – recession risk is low, but at the same time, growth is slowing – which we think will restrain any investor exuberance. This tension informs our expectations for yield trading ranges. Until Fed cuts actually materialize in the months ahead, we anticipate a trading range of 3.8% to 4.6% for 10-year U.S. Treasury yields. As rates cuts are delivered, the trading range likely resets lower with each cut, but absenting a recession we do not anticipate a further sharp downward repricing of yields

Given current market momentum and our expectation that inflation will continue to moderate, we are biased to add to duration at the top of the yield range.

Recently, markets quickly shifted to pricing in significant policy rate cuts. Market pricing now assumes that the Fed and ECB both cut

rates by over 150bps over the next 12 months. A first cut is fully priced by Q2 in both markets. We agree that rate cuts are coming – it's a question of when, not if. However, the speed of the recent yield fall and the market's aggressive pricing for cuts give us pause (**Exhibit 15**). We think inflation will retreat more gradually than markets expect. Rate cuts will likely arrive toward the end, not the start, of 2024. Thus, we are cautious about taking big positions at the long end of the curve and selective about when to add to duration.

As we consider the outlook for rates over the next year, we make a distinction about what will drive rate cuts. In theory, at least, if central banks cut rates to recalibrate for lower inflation, the cuts should be more modest in size and therefore a potential positive for risk sentiment, and lead to a modest fall in yields. However, if central banks cut rates due to weakening growth and concerns about inflation undershooting targets, cuts could be more substantial. In that case, long-duration bonds could rally significantly.

We think the first scenario is the more likely: Growth remains respectable, but cooling inflation prompts central banks to cut rates modestly to recalibrate real policy rates. In this scenario, we see room for between four and six rate cuts (100bps–150bps) but perhaps no more, keeping yields in the long end of the curve range-bound.

A world in which central banks are easing policy without the risk of recession hanging over markets should support both bonds and stocks. Put differently, we see a window in which investors focus on easing financial conditions as the prospect of Fed cuts supports all risk premia, bonds and equity alike.

EUROPE

In Europe, weak data momentum and a sizable drop in inflation led to a strong Q4 rally in German Bunds. Yields fell over 80bps in the last two months, making German Bunds relatively less attractive compared with other markets.

The ECB strongly suggests that it will end the hiking cycle at 4%. But it is too soon to say that the central bank is ready to cut rates either as early or as aggressively as markets are pricing. As a result, we have turned tactically neutral on euro area bonds.

On the economic growth front, we find signs that manufacturing is bottoming out amid a rundown in inventories. A modest improvement in inventory restocking and a stabilization in global goods demand may well support growth in the euro area.
In sum, European bond yields look vulnerable to a sell-off in the near term. We move from overweight to neutral on G4 ex-U.S. government bonds.

UK

A few months ago, we turned neutral on Gilts amid growing signs of persistent or even accelerating inflation. Today, the UK appears to be the economy with the worst growth and inflation trade-off: Growth has slowed materially, but inflation is simply too high.

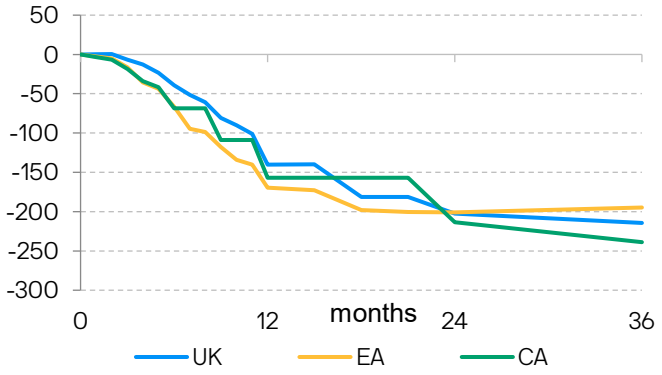
Gilts have rallied in recent months as they have participated in a disinflation-driven global bond market. But looking ahead, we think the disinflation process will be slower in the UK than in the euro area or the U.S. That's largely due to structural factors like labor supply and participation but also to cyclical

factors where starting inflation is much higher in the UK on a relative basis.

On fiscal policy, the UK will see a large fiscal impulse relative to other regions – likely in the form of tax cuts ahead of general elections in 2024. This will be problematic in an economy with limited cyclical space and current wage growth and inflation significantly above 5%. Hence, we are neutral on Gilts and prefer other bond markets on a relative basis.

Markets are pricing in aggressive rate cuts relative to our expectations

Exhibit 15: Market-implied interest rate cuts, bps



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

JAPAN

Japanese Government Bonds have been a long-held underweight within our bond relative value framework. That view reflected very low JGB yields and expectations that the BoJ would gradually move away from its unconventional negative interest rate policy and yield curve control. After 14 months of inflation above 2%, the BoJ is now widely expected to remove negative rates. We think that will happen at the January meeting, as the central bank has signaled is possible.

To smooth market volatility around the announcement of NIRP removal, the BoJ will likely continue YCC, which we think will prevent a sharp rise in yields. If Japanese bond yields did move higher, it could pressure other global markets. But we think the prospect of Fed cuts on the horizon would then act as a strong countervailing force preventing a sharp sell-off. We maintain an underweight stance in Japanese Government Bonds, with the view that two- to five-year sector bond yields can rise.

FX

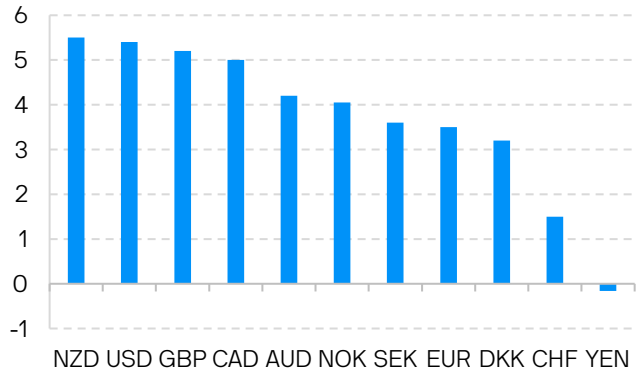
Over the last three months, DXY fell a modest 2% as the prospect of Fed rate cuts came into view. In light of the significant downdraft in interest rates over the same period, the depreciation seemed meager. The explanation for the relatively small USD decline, in our view: Interest rates fell across major developed markets in a synchronized fashion, and markets price for rate cuts across all markets, not just in the U.S (**Exhibit 16**).

Our move to underweight the U.S. dollar is predicated on both rate and growth differentials. On the rate front, over a 12-month horizon we expect that Fed rate cuts should dominate rate cuts elsewhere. As the Fed's mid-December meeting made clear, the Fed seems once again in the vanguard of policy change. It led the central bank hiking cycle, and it looks poised to repeat the role in the coming easing cycle. Rate differentials would still be supportive of the USD up to Fed cuts of about 100bps. Simply put, we would require sizable rate cuts to get the USD to weaken materially.

In terms of the growth outlook, we expect a soft landing in the U.S. as growth gradually moderates. In the euro area, we think growth will stabilize, and we also see scope for a modest pickup. To be sure, we do not expect the kind of stellar global growth that would be needed to push the U.S. dollar significantly lower. Instead, our view of trend-like U.S. growth and slightly below-trend global growth should be consistent with modest depreciation in the USD. We can see EURUSD rallying to 1.13-1.15 on a 6- to 12-month horizon; more significant upside would require more meaningful improvement in growth outside the U.S.

Central bank interest rate hikes have created carry opportunities

Exhibit 16: Carry across different currencies, %



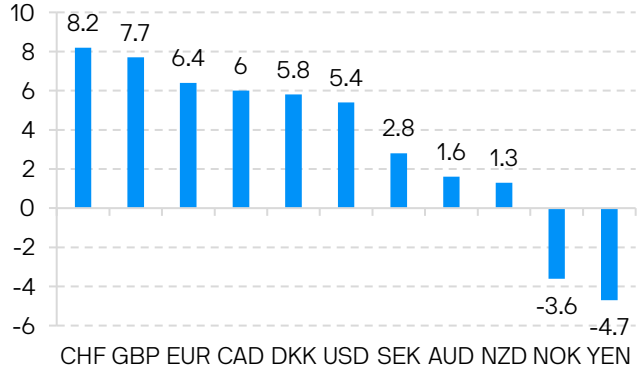
Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

We maintain a positive view on the yen relative to the USD. That mainly reflects our expectations for BoJ policy change in the coming months. As we discussed in the Macro and Rates sections, we anticipate that the BoJ will raise the policy rate back to 0% (from -10bps) in January. Expectations that the BoJ will continue to raise rates over the next 12 months should support the Japanese currency.

There is also a case to be made that the yen will appreciate passively as the U.S. dollar weakens. According to a simple rate differential model, USDJPY can potentially rally to 137 (i.e., 3%–5%) in our base case scenario: The BoJ raises rates and the Fed keeps rates on hold. Having said that, though, we expect that Fed policy – more than BoJ action – will largely determine the destination of the yen (**Exhibit 17**).

Inflation and central bank policy led to a divergence in FX returns

Exhibit 17: 12-month total return, %



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

Turning to Sterling, we see fundamental reasons why the currency should weaken, on a TWI basis, as growth underperforms the rest of G10 and inflation persists. This year's strong performance was a function of a cheap starting point and activity data outperforming very pessimistic consensus expectations; these factors are unlikely to support GBP next year. Looking ahead, we see Sterling appreciating vs. the U.S. dollar, mostly as a function of the modest weakness of the USD.

Against the euro, the outlook for sterling is less clear. Over the next six to nine months, we see both the ECB and the Bank of England

(BoE) remaining on hold, waiting for domestic wage pressures to subside. This keeps both currencies supported by rate differentials. On the growth front, the UK economy is likely to find support from fiscal spending ahead of the 2024 general elections while the euro area enjoys fiscal support and the prospect of a recovery in the goods cycle. Thus, there is very little differentiation to be made between these two currencies.

Equity

We take a modest overweight to equities in 2024.

The MSCI AC World Index (ACWI) fell 11% between the start of August and the end of October, reflecting an increasingly pessimistic outlook for global equities (**Exhibit 18**). That pessimism mainly reflected a sharp rise in interest rates, as opposed to a significant deterioration in company fundamentals. Since then, equities have completely – and remarkably swiftly – reversed these losses, which were initially catalyzed by softer than expected U.S. inflation data and dovish Fed commentary in early November. Global equities' 11% return since October 27 has been exceeded in only 2% of six-week periods since 1990.

As we go through year-end and into early next year, equities could continue to grind modestly higher, given favorable seasonality and accelerating buyback activity. However, we think that large cap U.S. equities – which account for the majority of the MSCI ACWI – now appear to be broadly pricing in our baseline view of a soft landing. As a result, we expect that valuations are unlikely to rerate higher from current levels. Earnings growth will likely be the driver of returns in 2024.

Global equities have recouped the losses incurred in Q3

Exhibit 18: MSCI ACWI price performance

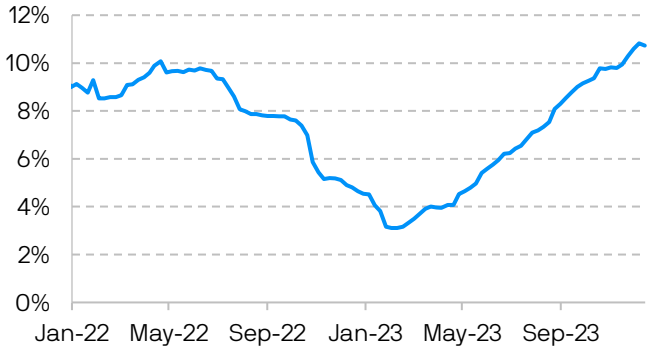
Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of October 2023.

Our estimates for U.S. and global GDP growth, inflation and interest rates imply roughly mid single-digit growth for S&P 500 EPS in 2024, in line with the top-down consensus. In addition, if the bottom-up consensus estimate follows its typical pattern of modest negative revisions over the course of the year, it also suggests mid single-digit profit growth by the end of 2024 (**Exhibit 19**).

At the aggregate level, S&P 500 multiples look expensive relative to history. However, mega cap tech stocks are almost solely responsible for these lofty valuations. On an equal-weighted basis, the S&P 500 forward P/E multiple of 15x is in line with its long-term average. Although valuations for mega cap tech stocks are elevated, they are far from bubble territory. Notably, too, mega cap tech companies have continued to beat already-high consensus earnings expectations, offer high quality, cash-rich balance sheets, and remain optimistic about the significant potential for AI.

The U.S. bottom-up EPS growth estimate is slightly optimistic

Exhibit 19: U.S. large cap 12-month forward EPS growth



Source: FactSet, Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

Taking these various factors into account, we estimate high single-digit to low-double-digit returns (including dividends) for both the S&P 500 and the MSCI ACWI. The growth expectations that underlie our forecast are by no means heroic but do imply solid returns. Thus, we have a modest overweight to equities.

Risks to our forecast appear relatively balanced. Renewed recession concerns stemming from slowing growth or sticky inflation could present the biggest headwind to equities next year. A rapid repricing in Fed cut expectations and rising policy uncertainty – likely tied primarily to U.S. elections in November – could also weigh on equity valuations.

Positioning has moved from being extremely light to slightly stretched. But history suggests that stretched positioning pressures forward returns only in the very near term, all else equal, and typically when the macro environment is also unfavorable for risk assets (not our base case for 2024).

AI is a key upside risk to our forecast. Growing enthusiasm about the potential for AI could drive valuations higher and also support margin expansion for AI beneficiaries, as it did this year. Other upside risks to margins include an improving inventory cycle or a manufacturing recovery, particularly within the cyclical pockets of the market. Finally, an earlier-than-priced Fed cutting cycle, due solely to a decline in inflation and not because of any deterioration in growth, would also act as a tailwind to broad equity valuations.

RELATIVE VALUE EQUITY

Throughout 2023, we have argued for a lower probability of a recession than consensus, and we now have greater conviction in the possibility of cycle extension in the U.S. However, asynchronous industrial and regional cycles continue to inform our preference to maintain a balance of cyclical and defensive tilts in our portfolios.

U.S. small caps have rallied by more than 20% since the end of October, but we think that further upside is limited, as we expect economic growth to slow to near-trend levels. However, we still see potential upside in some U.S. cyclicals, such as the Industrials sector, which could benefit from an improving U.S. inventory cycle. In Europe, on the other hand, we prefer defensives, such as health care, as activity indicators still suggest very low levels of growth.

We maintain our up-in-quality bias but selectively look for opportunities to lean into value, particularly outside the U.S. While pockets of high quality, growth stocks in the U.S. screen as expensive on some valuation

metrics (such as forward P/E), they appear reasonably priced on other metrics that adjust for growth expectations (such as the price/earnings-to-growth [PEG] ratio), and include AI beneficiaries. In Japan, we like financials, given that the BoJ's exit from its negative interest rate policy will help improve banks' net interest margins. In the U.K., we prefer financials and energy stocks, which appear cheap compared with their American peers and offer higher free cash flow yields

In terms of our regional equity exposures, we maintain our preference for U.S. large caps, which we expect will deliver better earnings growth than their non-U.S. peers. U.S. large caps' growth, quality and tech exposures should also be tailwinds in an environment of slowing economic growth.

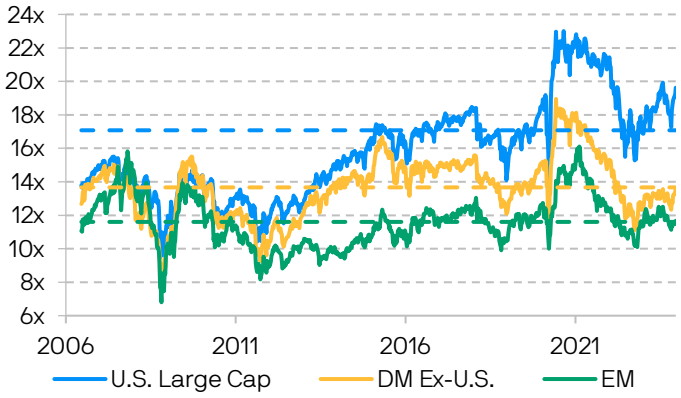
Additionally, we continue to maintain our overweight stance on Japanese equities, driven by above-trend economic growth in Japan, limited headwinds from the yen and light positioning. The Tokyo Stock Exchange's reforms to improve corporate capital structure and boost shareholder returns should also continue to support valuation expansion. Further yen appreciation is a key downside risk, but we think that the currency is already near fair value.

We are slightly overweight UK equities. They remain underowned, have attractive valuations and provide exposure to commodity businesses with higher free cash flows. We acknowledge that in a risk-on equity rally the UK market would lag its peers owing to its low beta and lack of tech exposure. But at the same time, UK stocks would mitigate downside exposure if the lagged effects of monetary policy tightening lead to increased concerns about global growth.

In European equities, we maintain our underweight. While macro data seem to be bottoming out, we see limited scope for a V-shaped recovery in the near term. European equity margins remain above the pre-pandemic trend levels, which keeps us cautious on prospects for earnings growth. Valuations are also less compelling, with 12-month forward price-to-book (P/B) remaining in expensive territory and sector-neutral 12-month forward P/E multiples in line with their long-term average (**Exhibit 20**).

Valuations are more or less in line with historical averages outside the U.S.

Exhibit 20: 12-month forward P/E ratio



Source: FactSet, Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

We continue to take a cautious view of emerging market equities: We are underweight EM ex-China and neutral on Chinese equities. Chinese stocks have underperformed the broader EM index so far this year as expectations of a reopening-led recovery faded amid higher unemployment, weak consumer sentiment and continued softness in the property sector. The Chinese government has provided targeted fiscal support to vulnerable economic sectors, and we expect the cumulative impact of the

announced measures to be realized in months to come.

China equities trade at cheaper valuations than they have in recent years and have faced a higher risk premium. But improvements in macro data news flow, along with some resolution in U.S.-China trade relations, could help alleviate investor concerns.

For the rest of the EM complex, a pickup in growth will be key for outperformance. Current mid- to late-cycle dynamics in the global economy provide less runway for EM equity returns, as investors prefer to bid for quality assets. While earnings expectations have improved for emerging market corporates, we look for a sustained trend in positive EPS revisions.

Industrial activity has shown signs of stabilization in export-heavy Asian EM economies such as Korea and Taiwan. Further improvements in the global goods trade, specifically tech/semiconductor demand, could lend support to earnings recovery in these regions. For now, we have not seen a pickup in investor inflows into the region, as higher rates in developed economies act as a headwind. However, in the medium term, a weaker USD could support EM equities, which now trade at relatively attractive valuations – including 12-month forward P/Es slightly below the historical averages.

Credit

The past few months have seen several shifts in the credit landscape as spreads widened meaningfully in October on the back of investor concerns about sticky inflation and a more hawkish Fed. In November, the trend reversed as a cooler inflation print increased expectations for easier Fed policy and a soft landing – a forecast that gained additional support following the December Fed meeting. As we look ahead, an extension of the current business cycle supports an overweight to credit, which we recognize is more about carry than the potential for capital appreciation.

Progress on inflation and the rising likelihood of easier monetary policy have brought spreads across the credit complex back to where they were before the October sell-off, if not lower. Our macro view centers on the idea that inflation can continue to decelerate without a sharp slowdown in growth, leaving us inclined to continue leaning into risk. While we do not see room for meaningful spread tightening from here, high yield may be a useful way to add risk to a portfolio, particularly for investors with an income focus.

We would look to add to these positions were spreads to widen. However, if this coincided with a rapid and significant deterioration in the economic backdrop, we would undoubtedly become more cautious. Barring that outcome, we feel that investors are being compensated for the default risk they are taking on with spreads at their current levels.

HY AND BANK LOANS

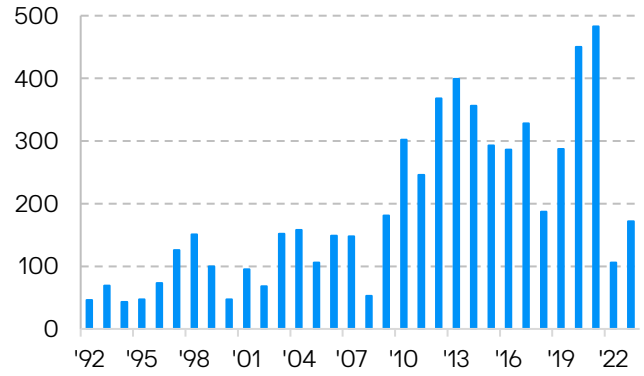
With the upside to equities now looking more constrained, we see opportunity in credit and specifically high yield. Spreads widened across the board in October, with high yield moving from 370bps to 440bps and dollar-denominated emerging market debt (EMD) rising nearly 60bps to 460bps. Investment grade, on the other hand, widened a mere 15bps.

Spreads have since retraced this move. Investment grade spreads are tight, and these rich valuations leave us neutral on IG, particularly given our willingness to embrace risk. That said, high yield fundamentals remain supportive, and the market's quality has increased steadily in recent years. We think those key factors should keep default rates relatively low in 2024.

At the same time, limited issuance in 2022 and 2023 should allow supply-demand dynamics to remain supportive next year (**Exhibit 21**). This technical backdrop may partially explain the sharp spread tightening that has occurred over the past few weeks.

High yield bond issuance has been subdued as rates have risen

Exhibit 21: New high yield issuance, USDbn



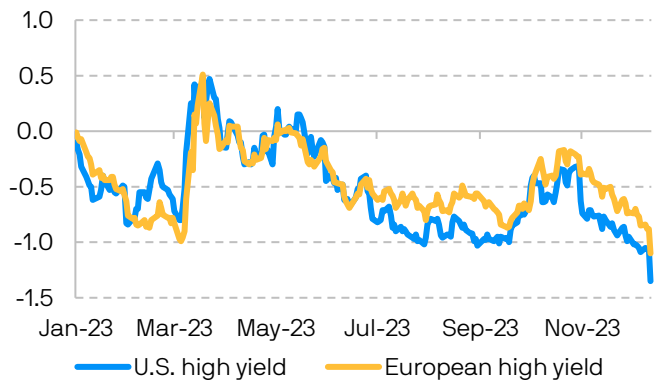
Source: J.P. Morgan Credit Research, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

The number of bonds maturing will pick up over the next few years, but the 2024 maturity wall seems manageable and skews toward higher quality credits. That reinforces our expectation that a spike in defaults is unlikely. Companies could hold off on refinancing debts as long as they can – or until interest rates decline to more attractive levels – but the capital markets do seem to be open for higher quality borrowers. Still, the cost of debt has clearly risen relative to what was available during the early stages of the pandemic.

Although credit spreads in the U.S. and Europe tightened in November (**Exhibit 22**), valuations in Europe currently look more attractive across both high yield and investment grade sectors. That said, the fundamentals in Europe are weaker than in the U.S., and the macro narrative would need to improve for us to become more constructive on European IG and HY. Specifically, any uptick in manufacturing activity that coincides with easier ECB policy would lead us to reevaluate the opportunity in this space.

U.S. and European high yield spreads are notably tighter since the Fed's pivot

Exhibit 22: Change in EUR and U.S. HY spreads, percentage points



Source: FactSet, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

While high yield bonds look interesting in the current environment, the fact that leveraged loans have performed so well this year leads us to fade our positioning in this segment of the asset class. Leveraged loans' floating rates allowed them to outperform in a rising

rate environment, but with lower rates on the horizon, we are inclined to focus on bonds for the duration that they provide.

Further, bank loans and private credit (another floating rate instrument) have become the preferred financing vehicles for private equity, and market participants may underestimate the risk in these asset classes. The leveraged loan default rate sits just below that of high yield, but given the reliance of private equity investors on the asset class as a funding source, it is not clear that this trend will persist over the next 12 months. Interest coverage ratios have deteriorated more significantly for loans than for high yield, while overall leverage ratios (debt/EBITDA) have remained broadly unchanged for loans while high yield ratios have declined.

Finally, on private credit, we recognize that middle market direct lending will likely continue to grow as a structural allocation for institutional investors, but we believe some caution is warranted at the current juncture. The growth in both the number of assets and the number of managers means that there are surely some bad apples in the bunch. We are particularly cautious on loans that were made in 2020 and 2021 and are soon coming due. Manager selection will thus be critical, and we would encourage investors to look at strategies focused on distressed debt and special situations as a way of hedging against the risk of a increase in private credit defaults.

EMD

While we are not wildly enthusiastic about the opportunity in emerging market debt, we are more constructive on how the asset class might perform in 2024. EM central banks moved well ahead of their developed market counterparts in the fight against inflation, tightening policy meaningfully in 2021. With signs that the Fed and other DM central banks may ease policy next year, we see scope for EM central banks to ease as well, supporting growth in their local economies and allowing for a modest tightening in credit spreads.

From a valuation perspective, hard currency EM IG debt spreads at 400bps are back to the lows seen earlier this year, but EMD HY spreads at 725bps remain above the 2021 lows. Further, local currency yields at 6.4% remain north of the lows seen earlier this year, as well as the 5% level that prevailed before inflation took off in 2021.

Assuming the U.S. economy achieves a soft landing, we see limited downside risks to growth in emerging markets, but we do not assume there will be a significant reacceleration in economic activity. As a result, hard currency paper looks interesting for its carry, while there could be modest price appreciation in local currency bonds. At the same time, if the U.S. dollar weakens in 2024 due to narrower growth and inflation differentials, we see room for FX to help enhance the overall rate of return. Overall, this leaves us with a preference for local currency paper, as both price appreciation due to lower yields and currency appreciation relative to the USD seem to be in the cards.

Commodities

OIL: SUPPLY-SIDE CONCERNS DROVE VOLATILITY

Oil markets experienced heightened volatility over the past three months, ending the quarter significantly lower. West Texas Intermediate (WTI) crude declined 17.7% over the quarter, while Brent crude fell near 16.2%.

Supply-side factors explain the initial bout of volatility, which began with a sharp increase in prices in September, when WTI climbed to a 10-month high of USD 93 per barrel. That move largely reflected a dramatic drop in U.S. crude oil inventories, which fell to their lowest level since 1985. Simultaneously, oil reserves in the Strategic Petroleum Reserve also fell, to their lowest point in over four decades.

The sharp oil price rise quickly reversed. This time, demand-side drivers explain the market move. High crude prices pushed up gasoline prices, leading to demand destruction as consumers cut back on expensive fuel. By the end of the first week of October, oil prices had given back all their September gains.

For the remainder of the quarter, oil prices bounced around but generally trended lower as U.S. crude oil inventories slowly began to rebuild and the Israel-Hamas conflict was seen to have a minimal impact on oil supply.

WTI and Brent oil currently trade around the USD 70–USD 80 range, which is above their five-year average of USD 65 per barrel. Thus, in our view, oil prices already discount any supply-side fragilities (including OPEC+'s constrained supply), as well as a decent oil demand backdrop. In the short term, then, absent a significant supply-side shock or a significant pickup in oil demand (unlikely in a subtrend, late-cycle environment), we expect oil prices to stay range-bound around USD 70–USD 80 per barrel.

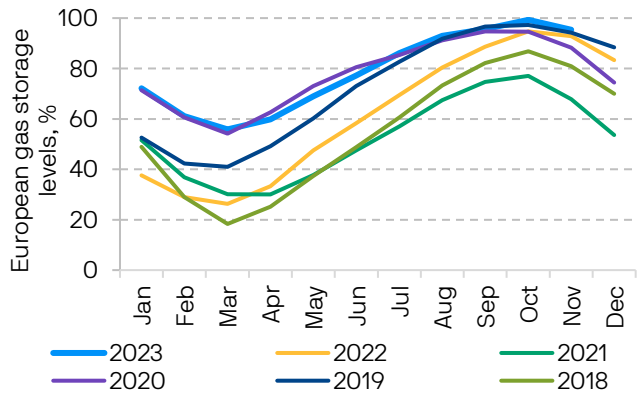
EUROPEAN NATURAL GAS: COMFORTABLE STORAGE LEVELS

Currently trading at EUR 39/megawatt-hour (MWh), European natural gas prices are flat over the quarter. Like oil, gas prices in Europe have been volatile, soaring nearly 45% in a week in October to a high of EUR 55/MWh, coinciding with the sharp reversion in oil prices.

Concerns about supply drove much of the spike. Numerous gas supply issues had come to the fore all at once – including Australian liquefied natural gas (LNG) strikes, the Israel-Hamas conflict and suspected interference with a major Baltic gas pipeline. When the concerns proved overstated, gas prices began to trend lower and normalize during the remainder of the quarter (**Exhibit 23**).

European gas storage sits at very comfortable levels

Exhibit 23: European gas storage levels, %



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of November 2023.

Going forward, we expect European natural gas prices to remain volatile and higher than their five-year average of EUR 15–EUR 20/MWh. That expectation reflects the

structural market fragilities that emerged after Russia's invasion of Ukraine. We also note that higher than average European gas storage levels should help normalize any sudden spike in gas prices, absent a major gas supply shock.

METALS: POTENTIAL FOR MORE SHORT-TERM UPSIDE FOR COPPER

In the metals space, iron ore's performance has been closely tied with China's anticipated demand for the metal. This quarter, iron ore prices have surged nearly 12%. Fiscal stimulus in China, aimed at stabilizing the ailing property sector (among other targets), resulted in an improved demand outlook for steel. We expect more piecemeal policy measures to be rolled out soon. But as iron ore prices already trade above their historical averages, we think markets have priced in most of the upside from additional Chinese fiscal stimulus, at least in the short term.

Copper prices, much like iron ore, have been trading in line with the metal's anticipated demand in China. After experiencing some volatility through the quarter, copper prices are currently trading roughly where they were at the start of October. Unlike iron ore, however, copper prices are trading below their historical averages. As a result, we think copper prices have more upside if another piecemeal stimulus package is introduced soon.

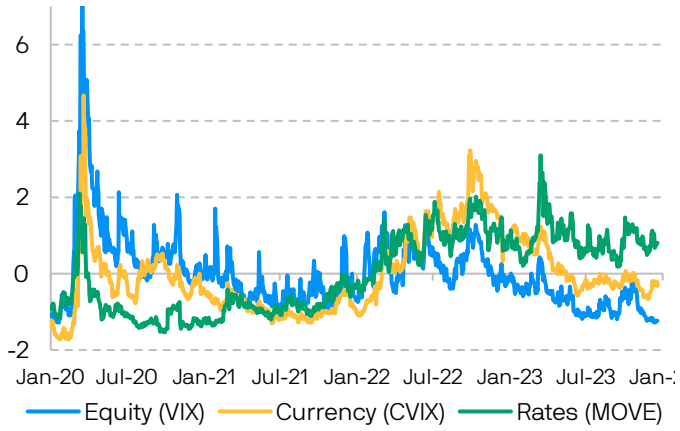
Portfolio implications

The dovish pivot from the Fed at its December meeting appeared to fire the starting gun on a more constructive stance for investors. However, we believe that the shift in focus from overt caution to a more risk-on tilt began with the failure of U.S. 10-year rates to make much progress north of 5% late in the third quarter. This is not a simple risk-off/risk-on shift, but instead there are a number of subtleties for investors to consider.

Correlation between stocks and bonds remains positive, but as inflation cools we expect it to decline; allocators will need to take this into account in 2024. Volatility across assets continues to be dislocated, with equity volatility subdued and rate volatility elevated. We would expect these factors to converge, but whether equity volatility rises or rate volatility falls to close the gap between them will have very different investment implications (Exhibit 24). Finally, the cycle itself is far from harmonized across sectors and regions, implying that relative value positions with asset classes and active alpha will continue to be important return sources in 2024.

There is divergence in volatility across assets

Exhibit 24: Normalized key volatility measures from 2020 to present



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

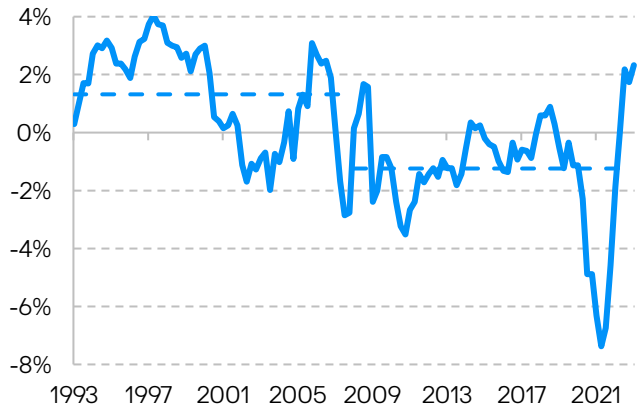
The prospect of a rate-cutting cycle in 2024 will take the shine off cash as an asset class, in our view. Over the course of the hiking cycle, money market fund assets under

management have grown by over USD 1 trillion, to USD 5.9 trillion. But with the Fed on course to start cutting in 2024, we anticipate that much of this excess cash will be redeployed into the asset markets. The market moved very quickly to price in an apparently aggressive series of cuts.

While market price action was swift, we would not argue that it was unjustified. Since the Fed anticipates inflation returning close to target in 2024, the dovish pivot might be interpreted as tacitly placing a roughly 2% limit on where the real fed funds rate should sit. Under this interpretation, policy rates may well decline quite quickly, but policy would not be easy: The level of real rates would still remain higher than at any time since the global financial crisis (Exhibit 25).

Fed policy setting remains restrictive in real rate terms

Exhibit 25: Real Fed Funds (deflated by CPI, with pre- and post- GFC averages)



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

Nevertheless, with growth proving resilient, even allowing for this policy setting and investors starting to move away from cash as rates fall, we expect continued support for asset markets. In this environment, flows and positioning will be important factors to monitor. We doubt that the run rate of economic growth will translate to anything more than upper single-digit earnings growth, and with limited scope for multiple expansion from current levels, return potential looks solid but not spectacular.

Under these circumstances, instances of crowding or exuberance should be heeded as warning signs. Equally, with capital still on the sidelines and the economy reasonably resilient, periods of consolidation will likely prove to be entry points. In any case, maintaining a nimble approach with a willingness to dial risk up and down quickly will remain important for allocators in 2024.

Surging inflation in 2022 drove stock-bond correlation well into positive territory as yields spiked and multiples fell – contributing to a correlated decline in asset prices and returns of -19% for a USD-denominated 60/40 balanced portfolio. Correlation remained broadly positive in 2023, but certainly in 4Q 2023 the positive correlation was much more welcome to investors as stocks and bonds both rallied hard. Indeed, fourth quarter returns for a USD 60/40 portfolio were the best quarterly returns since Q2 2020 which returned 9.6%, before that was Q3 2010 returning 9.4%.

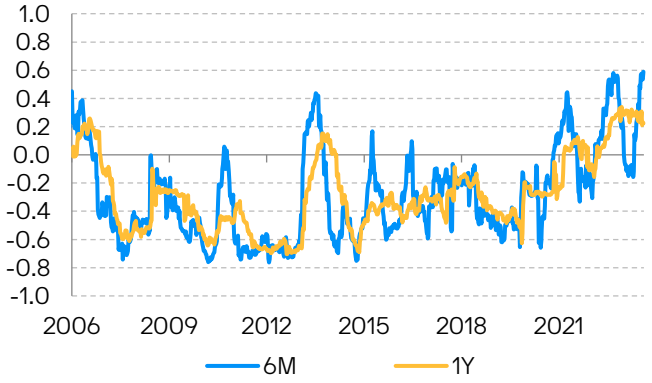
At present, stock-bond correlation is sticky in positive territory (Exhibit 26), but with rates declining this is fueling a "financial conditions" trade where cash is chasing both riskless and risky assets higher. In our view, this situation will probably moderate in the coming months as inflation continues to decline and the market refocuses on the trajectory of growth. We are in the more constructive camp on growth but

acknowledge that risks have not disappeared.

As investors focus more on the outlook for growth than on inflation, we expect the stock-bond correlation to decline. While bonds are certainly attractive today from an income perspective, we believe it is their ability to make portfolios more resilient in the face of negative growth shocks that will drive capital into the bond market – likely limiting any backup in yields.

Stock-bond correlation remains positive as financial conditions unwind

Exhibit 26: Rolling 6-month and 12-month stock-bond correlation



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of December 2023.

With topside risk to yields potentially more contained in 2024 than in 2023, we see scope for rate volatility to moderate. Uncertainty over inflation, policy setting and growth led to a febrile environment in 2023 where rate volatility remained elevated even as equity volatility fell. Patterns of volatility across assets will likely recouple in 2024, mostly driven by a moderation in rate volatility rather than a jump in equity volatility. In a portfolio context, a downtrend in rate volatility can also serve to support demand for bonds even as yields fall.

A feature of 2023 that we expect to persist in 2024 is the asynchronous nature of the business cycle. We do not see cycles across regions or across sectors recoupling in the near term – not least as the global economy has thus far avoided a recession that might serve to reset and resynchronize the global cycle. As cycles moved idiosyncratically over the past year, correlations between sectors and securities fell even as correlations at the broad stock-bond asset level rose. Greater dispersion of returns at the sector and individual security levels made 2023 a good year for active alpha – a condition that we expect to hold as we move into 2024.

In sum, the Fed's pivot marks a turning point in some elements of portfolio design – most notably, the role of cash – but probably doesn't affect the richer alpha environment that we've seen in the last year or two. Investors will need to evaluate the job that bonds do within portfolios, particularly as stock-bond correlation declines and bonds regain their potential as a portfolio diversifier. Finally, volatility patterns also bear scrutiny – our base case of bond vol catching down to equity vol may increase nominal position sizing over the course of the year. But equally, as the cutting cycle leads investors to become more risk tolerant at the margin, we believe that it will be important to pay close attention to any signs of stretched sentiment or positioning – in both directions.

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.

- Growth moderates close to trend as U.S. cools and EU, Asia improve
- Slowing inflation points to rate cuts in 2024, total of 4–6 cuts by end of 2025
- Supports a duration OW with yields set to fall steadily as rate cuts begin
- Prefer U.S. Treasuries to other G4 as ECB follows Fed and BoJ set to hike
- Carry attractive in credit; may see spreads tighter as recession risk fades
- Equities outlook improving as earnings downgrade cycle bottoms
- Prefer U.S. equity, given cash generation, and Japan, given rerating potential
- USD set to weaken in soft landing and as growth broadens out globally
- Key risks: Central banks leave rates elevated too long, corporate caution extends, sharp additional tightening of credit conditions

Multi-Asset Solutions: Active Allocation Views

These asset class views apply to a six- to 12-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.

● Underweight ● Neutral ● Overweight

Asset class		Opportunity set	UW	N	OW	Change	Conviction	
Main asset classes		Equities	○	○	●	▲	Moderate	Earnings downgrade cycle has turned, and multiples supported by easier monetary conditions
		Duration	○	○	●		Moderate	Peak in yields behind us as we move to cutting cycle; yields may decline slowly, but >4% coupon is attractive
		Credit	○	○	●		Moderate	Carry attractive in base case of no recession; some spread tightening potential in high yield
		Cash	●	○	○	▼	High	Cash returns set to fall as cutting cycle begins; long-term USD rates likely nearer 2.5% than 5.5%
Preference by asset class	Equities	U.S. large cap	○	○	●		Moderate	7% EPS growth and valuations supported by falling rates; can see S&P test 5,000 by year-end 2024
		U.S. small cap	○	●	○			Outlook improving as recession risk fades, but favor profitable firms with low leverage, given elevated financing rates
		Europe	●	○	○		Low	Macro data stabilizing in Europe, but sector-neutral P/E (14x) at long-term average and margins above pre-COVID levels
		United Kingdom	○	○	●		Low	Cheap, defensive market; supported by valuations and flows in quantitative model and positive gearing to commodities
		Japan	○	○	●		Moderate	Room to run further, given solid domestic growth, corporate governance reform driving up ROE and light positioning
		China	○	●	○			Domestic growth and property sector remain weak, with limited signs of policy support or a convincing turn in earnings
		EM ex-China	●	○	○		Moderate	Improving at the margin, with earnings outlook showing signs of bottoming, but flows remain a headwind
	Fixed income	U.S. Treasuries	○	○	●		Moderate	Yields in low 4s attractive ahead of Fed cuts; potential returns of 10%–20% should growth disappoint
		G4 ex-U.S. sovereigns	○	●	○	▼		Bunds <2.2% too rich if EU growth improves and ECB cuts more slowly; BoJ tightening may see JGB yields retest 100bps
		EMD hard currency	●	○	○		Low	Spreads of 400bps close to year lows; prefer carry in developed market IG, but EMD HY can tighten if growth improves
		EMD local FX	○	●	○			Yields >6% are still elevated vs. 2021 lows; room for FX appreciation based on narrowing rate and growth differentials
		Corporate investment grade	○	●	○	▼		Spreads are tight and show limited room for further decline; marginal benefit relative to all-in sovereign yields
		Corporate high yield	○	○	●	▲	Low	Modest scope for spread tightening and fundamentals supportive; limited rise in defaults means carry looks attractive
	Currency	USD	●	○	○	▼	Moderate	Soft landing and growth recovery in regions outside U.S. would imply a softer USD; Fed cuts further reduce support
		EUR	○	○	●	▲	Low	ECB unlikely to cut as fast as priced; coupled with 2024 growth, recovery in the eurozone should lend support to EUR
		JPY	○	○	●		Low	Modest strengthening of JPY plausible as macro improves and BoJ moves on from negative rates early in 2024
		EM FX	○	●	○			Mixed picture: Better global growth a support, but easier Fed policy and better Chinese growth needed for appreciation

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments are made using data and information up to December 2023. 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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