Global Asset Allocation Views

Key findings from the Multi-Asset Solutions Strategy Summit

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AUTHOR

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IN BRIEF

• The economic recovery is gaining pace as macro data improves and business and consumer confidence strengthens. An unprecedented level of monetary and fiscal stimulus will continue to fuel a powerful pickup in growth.

• Nevertheless, we see looming event risks in the fourth quarter. Among them: uncertainty about the U.S. election outcome, the shape of any Brexit deal and rising COVID-19 case counts in Europe. Still, there are also potential upside risks, particularly relating to fiscal policy and a vaccine.

• While our constructive central case leads us to maintain a risk-on tilt in our multi-asset portfolios, we anticipate some volatility over the autumn and look to remain well diversified and nimble. We spread our risk between stocks and credit, while within equities we favor a broad regional diversification. We also move to underweight USD, which has scope to weaken as the global recovery gains momentum. Although we are mildly underweight duration, central bank backstops in credit markets sometimes allow us to use high quality corporate credit as proxy for duration.

Most major asset classes have more than recovered their losses from earlier in the year while 10-year yields remain resolutely anchored

EXHIBIT 2: CROSS-ASSET CLASS TOTAL RETURNS VS. U.S. 10-YEAR TREASURY YIELD, %

SUMMARY

The volatility in global equity markets since Labor Day contrasts markedly with the serene upward march of stock prices that characterized the summer months. The combined effect of improving macro data, a better than expected earnings season and a decline in virus cases in Europe and the U.S. buoyed equity and credit markets for much of the third quarter. But as we approach the fourth quarter, it appears the event risks we face in the coming months are back on investors’ minds, just as virus stats in Europe appear to be worsening.

The balance between improving macro momentum and near-term tail risks underpinned much of the discussion at our mid-September Strategy Summit. In our view, the economic recovery is gaining pace and we expect a robust expansion into 2021, but the tail risks – in both directions – are palpable. Our constructive central case leads us to maintain a risk-on tilt in our multi-asset portfolios. At the same time, the fatter and flatter distribution of tail risks, together with extremely low bond yields, calls for thoughtful portfolio construction.

Our optimism on the underlying economic trajectory may seem at odds with the recent news flow, but away from the hyperbolic headlines macro data continue to improve. New orders data imply further strength in purchasing manager surveys, Asian export data point to a robust goods market, high savings rates suggest reasonable resilience in the household sector, and confidence is improving among businesses and consumers alike.

Further, the level of monetary and fiscal stimulus is unprecedented. We have remarked previously that the alignment of monetary and fiscal stimulus will distinguish this cycle from the last one. While we acknowledge that there is uncertainty about the extensions of fiscal packages in some regions, the combined effect of zero rates and the 13.1% of GDP committed by G20 nations to fiscal stimulus this year continues to fuel a powerful economic recovery.

Nevertheless, we see looming event risks in the fourth quarter. Uncertainty about the U.S. election and the shape of any Brexit deal between the UK and the European Union is acute. While we expect fiscal packages to be extended and monetary policy to remain extremely accommodative, hawkish voices are becoming louder and fears about debt sustainability—muttered only in hushed tones during the height of the coronavirus crisis—are increasingly vocalized. The path of the virus is central to the uncertainty many feel, and the recent uptick in caseloads in Europe is of concern. While we don’t anticipate a repeat of the large-scale lockdown that occurred in the second quarter, some disruption is inevitable.

The apparently growing level of risks in the fourth quarter might suggest it is time to reduce portfolio risk levels. However, while some prudence may be justified, there are tail risks in both directions. Certainly, we should not ignore the upside risks around a vaccine, further monetary accommodation and renewed fiscal support. We also note that corporate earnings are starting to rebound and there are powerful base effects as we enter 2021; moreover, signs of a pickup in capex and a rebuilding of inventories present further upside risks.

At a portfolio level, we maintain an overweight to equities and to credit while sticking to our underweight to bonds. We also downgrade our view on the dollar to underweight, as we see further, but gradual, downside for the greenback ahead. We look to spread our risk between stocks and credit. Within equities we favor a broad regional diversification and are overweight European and emerging market (EM) equities, as well as U.S. equities, with a tilt toward small caps. Our least favored equity region is the UK, although we note that our quant models are flagging the cheap relative valuations of UK stocks.

Our modest underweight to duration is concentrated in negatively yielding regions like core Europe, but the low yields in all markets lead to a negative aggregate duration signal from our quant models. The dilemma for portfolio construction is that low yields also reduce the degree of protection bonds offer. Indeed, a large notional bond exposure would be necessary for duration to function as an effective hedge, which would in turn hit portfolio returns if the low growth expectations priced into yields start to rebound. Central bank backstops in credit markets allow us to use high quality corporate credit as a proxy for duration in some cases; but, above all, diversifying exposure across assets remains a focus.

Our multi-asset portfolios reflect our optimism that the recovery which began in the second quarter will extend over the next 12 months. Nevertheless, we anticipate some volatility over the autumn and expect to remain well diversified and nimble, in equal measure, as we navigate the final months of 2020.
MACRO OVERVIEW

At the September Strategy Summit, our macroeconomic discussion focused on several issues that we believe will shape outcomes during the coming year: the possibility of “second waves” of coronavirus, the short- and long-term outlooks for inflation, the policy implications of the U.S. election, and China’s experience coming out of the virus shock earlier than other economies. We also revisited our base case outlook, which continues to expect slower but still above-trend growth, on average, into 2021, with notable strength in industrial production, occurring against a backdrop of fairly low inflation and steady monetary policy support.

WHAT TO WATCH FOR IN A “SECOND WAVE”

In forming macro views and translating them into tactical portfolios, we want to avoid making bold forecasts about the course of the virus. However, we do need to consider the distribution of possible outcomes - in particular, as a way of understanding the likelihood and magnitude of “left tail” developments. How plausible is a return to the catastrophic atmosphere of February–March 2020? While we cannot rule anything out, back then the initial surge in coronavirus cases led, through a series of strong connections, to extreme financial market turmoil. Today each of the links in that chain looks weaker. Should these connections strengthen, the risk will grow to our base case forecast of continued expansion and well-supported risk assets.

The first of the four links in the chain connects case counts with very bad health outcomes. When cases initially surged in the first quarter of 2020, they almost immediately passed through into high hospitalization and fatality rates. More recent increases in the case count, such as the midsummer jump in cases throughout the southern U.S., have had a diminished negative impact on hospitalization and fatality rates. That may reflect better shielding of the elderly and other vulnerable people, as well as a generally younger skew among the newly infected. We note that some of the European countries now experiencing a strong rise in cases are also observing an uptick in bad outcomes, although this increase looks modest compared with the experience during the first wave.

Amid generally less dire health outcomes, the subsequent link, with societal mobility, also appears to have weakened. The collapse in movement that occurred during the first quarter coincided with outright emergency restrictions imposed by national and local governments across most of the world. Mobility subsequently rebounded when those measures were eased, and it has held steady or continued to improve through subsequent fluctuations in case counts. Governments have avoided re-imposing broad national shutdowns, although these have reappeared in a few local areas, and the emphasis instead has shifted to other mitigating measures, including mask-wearing. As a result, individual confidence in moving around appears to have held up much better in recent weeks than was the case earlier in the year. As an illustration, mobility in four large southern U.S. states fell sharply in the first quarter, when cases there were not particularly high, and then maintained its subsequent improvement even as local cases jumped around midyear.

At the same time, a crucial third link - between mobility and economic activity - has also faded to some extent, likely for two reasons. First, while a large part of the earlier collapse in activity owed to mandated shutdowns, some reflected increased precaution on the part of households and businesses that worried about their future income prospects. That precautionary motive for saving has declined as labor markets have begun healing and as businesses have resumed operations. Second, consumers and firms appear to be developing work-arounds to enable commerce to occur with less movement and interaction than previously, through improved work-from-home practices, greater delivery options, a shift to bigger-ticket purchases and so on. In the U.S., for example, even as mobility drifted sideways through July and August, the subset of consumer spending tracked through credit and debit card usage continued to rise (Exhibit 3).
Economic activity has continued to move higher as mobility has leveled off

EXHIBIT 3: U.S. CARD SPENDING AND MOBILITY, % CHANGE

![Card spending and mobility chart]


The final connection, between economic developments and market turmoil, has also weakened, in large part because of central bank action to support market functioning and provide backstops. During February and March, a panic rush for liquidity strained funding markets and caused many financial assets to trade with unusually high betas to stocks, in turn worsening conditions for the economy and for equities themselves. The array of Federal Reserve (Fed) programs quickly put in place, alongside their international counterparts, helped restore smooth market functioning. More recent equity market wobbles have not been accompanied by financial sector funding stress, evidence of dollar shortages or disproportionate widening of credit spreads. The pernicious feedback loop between the economy and markets is thus happening much less intensely than before. With central banks still quite accommodative and still focused on market-functioning issues, that feedback loop seems unlikely to return to its first-quarter strength.

Of course, these developments do not imply that future reversals are impossible, especially considering that the virus’ path and its health care consequences remain poorly understood. Indeed, the word “lockdown” has recently crept back into the UK conversation as a possible response to an ongoing rise in cases there. In our judgment, though, a chain of events involving widespread international restrictions on mobility that lead to a renewed plunge in economic activity, in turn sparking financial market turmoil, seems less likely to occur than it did in the first quarter of 2020. We will be observing all of these links to determine whether our view remains on track.

THE SHORT AND LONG OF INFLATION

An important connection between the current macro outlook and our asset allocation views hinges on inflation. Indeed, the inflation outlook has been uncharacteristically dynamic, both in terms of the near-term recession impulse, which continues to trace a sharp V-shape, as well as long-term drivers, which are less aligned toward disinflationary outcomes. These features of the outlook frame three key questions: How much signal should we be taking from the rebound in developed market (DM) inflation over the past three months; will the economy eventually reflate, with inflation driving nominal growth higher; and what are the indications that the transition toward higher inflation is actually happening?

In terms of near-term dynamics, what we have observed since the beginning of the pandemic suggests looking through the recent strength in inflation. Viewed more holistically through the lens of the large disinflationary recession shock, the vast majority of recent U.S. consumer price acceleration can be accounted for as payback. Both CPI and PCE inflation undertook massive round trips beginning in March, with a fairly broad pivot in prices, even permeating services categories that don’t typically oscillate very much. A detailed decomposition of industries supports the notion that post-shock normalization is spurring the recent bounce in inflation. There is a clear relationship between categories with the largest price declines through April and those with the largest rises through July (Exhibit 4). Moreover, price declines were most pronounced in industries with the largest changes in real expenditure. Together, these observations paint a picture of inflation that is closely tracking the sharp recession demand shock and the V-shape in growth. Thus, while we expect inflation to remain firm in the coming months as activity continues to rebound, that strength is likely to peter out as activity approaches normal levels.
There is a clear relationship between categories with the largest price declines through April and those with the largest rises through July.

**EXHIBIT 4: INDUSTRY-LEVEL U.S. INFLATION THROUGH THE PANDEMIC**

<table>
<thead>
<tr>
<th>Change in PCE price index (April - July 2020)</th>
</tr>
</thead>
<tbody>
<tr>
<td>-10%</td>
</tr>
<tr>
<td>-30%</td>
</tr>
</tbody>
</table>


We are more open-minded about upside risks to inflation over the long term, with an eye toward the 10- to 15-year horizon of our Long-Term Capital Market Assumptions (LTCAms). Over that period, the powerful macro forces influencing inflation will grow less aligned, a stark contrast to the past two decades, in which they almost ubiquitously pointed to weaker inflation. Over the next five years, for example, we see risks as being roughly balanced but downside risks remain palpable. Aside from ample cyclical slack, the impulse from rapid technology adoption is likely to continue pushing downward. However, these forces are counterbalanced in the near term – and possibly overwhelmed in the long term – by the transition of long-standing inflation drops toward neutral, the outright reversal of others and the appearance of new upside risks (Exhibit 5). Some of these transitions have already begun to play out. Globalization, which slowed post-global financial crisis (GFC) along several dimensions, has been forced into a moderate retreat by U.S.-China trade tensions and more cloistered migration policies due to COVID-19. Climate transition policies or those that redistribute income are additional upside risks. The point is that the disinflationary impulses of the past will face increasing resistance in the coming years.

Inflation drivers are becoming increasingly mixed over time.

**EXHIBIT 5: LONG-TERM INFLATION INFLUENCES, 10-15 YEARS**

<table>
<thead>
<tr>
<th>Macro Trend</th>
<th>Prior Decade</th>
<th>Early Years (0-5)</th>
<th>Late Years (5-15)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Slack</td>
<td>-</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>Demographics</td>
<td>-</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>Globalization</td>
<td>-</td>
<td>+</td>
<td>0</td>
</tr>
<tr>
<td>Monetary Policy</td>
<td>-</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>Inequality</td>
<td>+</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Climate Change</td>
<td>+</td>
<td>+</td>
<td></td>
</tr>
</tbody>
</table>


Above all, a necessary requirement for future inflation – and a potential catalyst for markets to telescope expectations of future inflation into current pricing – is easy monetary policy. With its recent pledge to accommodate above-target inflation over the cycle, the Fed has embarked on an experiment to create persistently higher inflation in the future, to offset lower policy efficacy that central banks have grappled with over a decade of zero rate policy and to pave the way for other DM central banks to follow suit. Even prior to its September meeting announcement, the Federal Open Market Committee (FOMC) had been laying the groundwork for an increasingly reflationary policy stance, operationalized via more aggressive and less symmetric forward guidance (i.e., in which it is more willing to tolerate above-target inflation than below). The announcement itself enshrined the idea that near-term policy is directly tied to one’s inflation outlook, which, in our view, will remain consistent with zero rates through at least 2023. As such, our tactical forecast horizon continues to be characterized by the combination of limited inflation pressures and a Fed pushing ever harder on the accelerator.

With the Fed having redoubled its efforts at generating reflation, and with that commitment setting the tone for other DM policy...
stances, we have entered a period in which expectations for future inflation toggle between the belief that the Fed’s experiment works and a sense that it doesn’t. In other words, the key unknown is the endgame for central banks, which could range anywhere between reflation on the one hand and a Japan-like outcome of ever easier but ineffective policy on the other. What are some signposts that would signal that inflation is, in fact, on the rise? We are skeptical that simply flooding financial markets with liquidity or overheating the economy will be sufficient to generate sustained inflation. The post-global financial crisis period provided a powerful example that liquidity trap dynamics impair the transmission of policy to the real economy and, even when growth responds, to higher inflation.

In all likelihood, other policy innovations, outside the scope of monetary policy, will also need to play a role. For instance, persistently stimulative fiscal policy may interact with easy financial conditions and the trend of a depreciating dollar to dislodge inflation expectations from their current low levels. Alternatively, the negative productivity shock associated with a pause in globalization trends could raise the trajectory for global goods prices following decades of sluggish growth. Or redistributive policies that raise the minimum wage could repair the linkages between wages and prices that were so important in historical instances of high inflation. As we see it from today’s vantage point, higher inflation seems likely to require several of these forces working in tandem.

THE U.S. ELECTION: WHERE MIGHT IT BE A SWING FACTOR?

Although market participants increasingly focus on the November U.S. election, it has not thus far played a major role in informing our economic views. We do not expect to change our forecasts for the U.S. materially depending on the outcome. True, a Joe Biden administration would likely seek to raise corporate taxes. Our expectation, though, is that this would be less likely to occur in 2021 than in the years following, and would not involve a full reversal of the cut to the statutory rate that was approved in 2017. As such, it would likely reduce corporate after-tax profits by around 5%. Some offset to this would occur in the form of greater fiscal stimulus elsewhere, such as via increased spending on infrastructure (an initiative that also might prosper in a second term for Donald Trump).

We see the election as more of a swing factor for EM economies, specifically through the channel of U.S. trade policy. The impact of the different election outcomes on the U.S.-China relationship is likely to be a focal point and has the most direct impact for emerging markets. Regardless of who wins the election, we are unlikely to see a reversal of the recent hawkish trends in China policy, given the increasingly negative views on China in the U.S. We believe U.S.-China tensions will likely persist, as strategic rivalry between the two countries is a structural trend. But even if both candidates are equally hawkish against China, we expect them to take different policy approaches.

Overall, we expect a Biden presidency to be more favorable for emerging markets than a Trump presidency. Biden is likely to adopt a more multilateral approach in his trade policy, with more predictable policy actions compared with Trump, in turn leading to diminished uncertainty regarding trade. That is likely to be supportive of exports and investment both in China and elsewhere in emerging markets. At the same time, there is likely to be less emphasis on using tariffs as a tool to deal with trade issues, which should also be positive for the more externally oriented EM economies. In particular, a Biden presidency with a split Congress is likely to be the best scenario for emerging markets. Under this outcome, it might take longer for Biden to build a global alliance against China, offering Beijing a longer reprieve from potential trade escalation, with positive spillovers to EM economies.

LEARNING FROM CHINA

As COVID-19’s “first in, first out” economy, China offers an encouraging precedent. China’s economic growth continued to recover in recent months following a sharp rebound in Q2. Industrial activities, which have been leading the recovery since the coronavirus outbreak, in August reached their pre-virus trend growth level. There are also signs that consumption is playing catch-up: Retail sales growth returned to positive territory, helped by improving consumption of discretionary goods and services. At the same time, despite sluggish and slowing global demand during the COVID-19 crisis, China’s exports have held up remarkably well, beating market expectations for six consecutive months since March.
Looking ahead, we expect the ongoing economic recovery in China to continue, driven by further normalization of consumption activities, robust infrastructure investment and solid export performance. China has had no domestic coronavirus cases since mid-August, which has allowed for loosening of capacity limits for domestic flights, cinemas and tourist attractions. Assuming the virus remains largely under control in China, services consumption could rebound further amid easing virus restrictions and improving consumer sentiment.

On the external front, while much of the export strength over the past few months has been concentrated in COVID-19-related products, there are signs that the export recovery broadened into other product categories, such as apparel, in August (Exhibit 6). Demand for medical supplies and tech products for a work-from-home lifestyle will likely remain resilient in the coming months, given the risk of a virus resurgence before the arrival of a vaccine or more effective treatments. Moreover, the ongoing developed world economic recovery should spur a rebound in external demand in general, which should also underpin China’s exports. However, Chinese exports are likely to face increased competition as production starts to normalize in other EM economies, such as Mexico.

**China’s export recovery shows signs of broadening out to non-COVID-related categories**

In our view, the strength of China’s economic recovery so far has likely reduced policymakers’ incentive to roll out additional policy easing. In fact, China’s monetary easing has already turned less aggressive since late May, with no more policy rate or required reserve ratio (RRR) cuts. We believe the People’s Bank of China (PBoC) has shifted from a crisis management mode earlier this year to a current mode that is more data-dependent. However, given risks from a more significant second wave of COVID-19 infections and potential escalation of U.S.-China tensions, we expect monetary policies to remain accommodative. While we do not expect to see further easing in the near term, the PBoC is likely to maintain stable liquidity in the market to facilitate the planned government bond issuance for the rest of this year. On the fiscal side, we expect funding support for infrastructure projects. The marginal tightening of policies on property developers’ financing is likely to constrain property investment growth, but their impact is unlikely to be visible in the near term.

**THE OUTLOOK: ABOVE-TREND GROWTH, MODERATE INFLATION**

As the third quarter draws to a close, it seems certain to have been the strongest period for global growth on record - admittedly, one that follows the weakest quarter in history. For Q2 as a whole, gaudy growth figures were more or less guaranteed by the strong entry point generated by the surge in activity during May and June. But further sequential gains appear to have occurred during July and August, with survey data pointing to continued momentum in September. Still, a transition has occurred, with the explosive initial increases in activity that took place as mobility restrictions were lifted and behavior normalized giving way to a more typical early-cycle pace of growth. We expect a somewhat above-trend pace of expansion to continue, on average, through 2021.

Given the unusual nature of this recession and recovery, we are basing our forecasts in part on judgments about where levels of activity are likely to settle after current gyrations have subsided. For most major jurisdictions, we think that by the fourth quarter of 2021, GDP will have returned more or less to the levels observed in 4Q19. Although in one sense that outcome would constitute a full recovery, it would still leave activity running somewhat below what would have been implied by extending a pre-shock trend line. We see two reasons to expect such a
shortfall. First, in addition to the typical scarring that occurs during a downturn, the virus shock will likely lead to lingering behavioral changes and persistent caution (if less pronounced than today). Second, many economies were likely operating above their potential levels before the virus hit. The U.S. unemployment rate, for example, was running at 50-year lows. It takes time during expansions for overheating to set in, and an immediate return to the pre-crisis trend thus seems unlikely.

With respect to the degree of scarring – or lasting destruction of economic inputs - that is taking place, information so far appears fairly encouraging. Commercial bankruptcies in the U.S., for example, have actually fallen since the shock began, contrary to initial fears, reflecting a combination of forbearance by banks and other creditors and a lack of so-called precipitating events (for example, restaurant landlords may not have foreclosed on their tenants because of a lack of plausible alternative lessees). A similar pattern appears to have occurred in Europe. Meanwhile, new business formation has increased, in contrast with the pattern observed after the 2008-09 recession. In the labor market, a majority of laid-off workers continue to describe their separations as temporary, and while the share of those reporting a permanent job loss has risen lately, it remains below the norm for post-recession periods. The job opening rate is also running at an unusually high level for the early days of an expansion, perhaps corresponding with the jump in new businesses (Exhibit 7). Taking into account these various crosscurrents, we expect the U.S. economy to exceed its post-2009 trajectory fairly significantly, but we still think some shortfall relative to the (somewhat stretched) pre-crisis trend is likely.

Elevated job openings suggest a healing labor market

A similar pattern will likely emerge outside of the U.S., with some local variation. In China’s case, we look for a basically full return to the pre-crisis trend, and the same will likely be true for Korea and Taiwan, reflecting a combination of reasonably effective local virus control and the fact that these economies are manufacturing-oriented beneficiaries of the current global shift toward goods demand. The same may not hold true for certain other EM economies, where the shock has damaged creditworthiness and where policy support has been less available, and for the UK, which is experiencing a parallel shock in the form of its new, and as yet unspecified, relationship with the European Union. In coming months, a spotlight will shine on differing labor market institutions. In the U.S. and Canada, flexible labor markets initially delivered large-scale unemployment and are now working to reallocate those workers. In Europe and Japan, various formal or informal mechanisms maintained closer relationships between firms and workers, but furlough and short-hour work schemes are now running out. We cannot yet say which setup ultimately will prove more effective, but our initial intuition that rigidity might be an asset against a “temporary standstill” shock may not prove correct.

Most economies today are still a good distance from these forecasted end-of-2021 landing points. And we see significant supports in place for them to continue making progress. Private sector confidence has recovered significantly in the first months of the expansion. Indeed, in the U.S. and Canada our synthetic measures of confidence, based on a variety of surveys, have bounced back to above their long-term averages. In other developed economies, they remain below that mark but nonetheless have improved noticeably. To be sure, measures of U.S. consumer confidence have fluctuated since midyear, but they generally stand at higher levels than is typical for this point in the cycle. Financial conditions, for their part, look quite easy, in part a testament to highly accommodative monetary policies. This tailwind should remain in place for some time, bolstering confidence and allowing for gradually more expansionary private sector behavior in an aggregate sense, as well as providing specific boosts to certain areas, such as the interest-sensitive housing sector. Indeed, the homebuilders survey in the U.S. has reached an all-time high amid a strong increase in single-family starts. And contrary to what often occurs during periods of global stress, these supportive conditions have generally passed
through to emerging economies, where local policy rates and bond yields have fallen to very low levels by historical standards.

The fiscal policy picture looks more complicated. Arguably, in the U.S. the fiscal policy stance has already passed its moment of peak stimulus, with supplemental unemployment insurance benefits having expired at the end of July and Congress having been unable to agree on a fourth package of measures. Elsewhere, as noted, the end or scaling back of furlough programs may dent labor markets, and certain other schemes, such as VAT cuts or restaurant subsidies, are temporary in nature. For the moment, though, economies appear to be absorbing the fiscal tightening that is occurring, thanks to a combination of healing in other income sources - with, for example, labor incomes rising to replace a significant portion of jobless benefits in the U.S. - and ongoing reductions in precautionary saving behavior. We think these trends will likely continue and see households in possession of considerable dry powder, sufficient to allow a solid pace of consumption growth to coexist with a moderate decline in savings rates well into 2021. That said, a complete failure in the U.S. to put in place further fiscal stimulus would pose moderate downside risk to our current projections.

We expect the global industrial cycle - a key area of focus, given its overrepresentation in listed equity markets relative to the economy - to evolve favorably in coming months. Household spending on goods has surged, partly thanks to a shift in consumption patterns away from services, many of which involve physical interaction. Business capital spending also appears to be rebounding earlier than we had projected, probably in part as firms respond to the jump in retail sales, and also benefiting from easy credit conditions (Exhibit 8). Weak profitability typically constrains business spending, and as a result we do not expect a capex boom, but even here the news, at least as regards information about profits from economy-wide national accounts data, has been a little better than expected. And after mandated factory shutdowns sent manufacturing output plummeting earlier in the year, companies appear to be operating with fairly lean inventories. The various vanguard indicators of global industry that we track – including purchasing managers’ indices, Asian export figures, freight traffic data and industrial metals prices - are all pointing to a vigorous upturn in manufacturing production, one that we think should persist for at least another couple of quarters.

Capex indicators are bouncing back earlier than expected

EXHIBIT 8: CAPITAL GOODS ORDERS (2015 = 100, SA)

Source: Haver Analytics, J.P. Morgan Asset Management Multi-Asset Solutions; data as of July 2020.

Against this backdrop - with a strong initial surge in activity that has given way to slower but still solid gains, moderate rather than severe scarring and generally stimulative policies - we see the economy progressing through the cycle fairly rapidly. In our U.S. business cycle scorecard, we have moved four of the 10 economic categories to “mid cycle,” a significantly faster evolution than occurred in the previous expansion (Exhibit 9). Others may arrive there by year-end. We see similar patterns in our euro area and UK scorecards. Is this setting us up for a short expansion?

Not necessarily. In the last cycle, we assessed the economy as being in late cycle for several years without a recession organically emerging from those conditions. And, as discussed, the Fed’s framework change may partially close off one traditional route from vulnerability to downturn – a preemptive monetary policy tightening cycle. We will, however, likely begin monitoring possible recession triggers and assessing their probabilities a little sooner this time around than in the 2010s.
The U.S. economy is advancing rapidly through the early-cycle phase

EXHIBIT 9: 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 central bank target, rising</td>
<td>Above central bank 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 (excl. deep recession)</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>
</tr>
<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>High</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>
</tr>
<tr>
<td>M&amp;A activity</td>
<td>Low</td>
<td>Moderate</td>
<td>High</td>
<td>Nonexistent</td>
</tr>
<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>
</tr>
<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>
</tr>
</tbody>
</table>

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments as of September 2020.
LEVEL ONE ASSET ALLOCATION

Over the third quarter of 2020, global equity markets continued their upward march, with the MSCI ACWI gaining over 5% from the end of June. While the pace was slower than in Q2, when global stocks rallied 19%, it was still an impressive move. Lately, though, it hasn’t been a smooth ride. The S&P 500 rallied 13% over July and August, with an average daily index move of just 64 basis points (bps), and then in September the index gave back two-thirds of its late summer gains with average daily moves closer to 1.5%. Little wonder VIX rose from a low of 21.35 in August to over 30 in mid-September, yet rather odd that U.S. 10-year yields remained resolutely in a narrow 50bps to 75bps range that held throughout the third quarter.

Few would disagree that we are living, and investing, through unusual times. The surprise in looking at 10-year yields isn’t that they are hovering around 65bps after a period of equity market weakness, but rather that they couldn’t sustain a move north of 75bps as stocks went on their summer tear (Exhibit 10). After such a sharp rally in stocks, a period of correction and consolidation is probably overdue, perhaps even welcome. But looked at in the context of other asset market moves, it gives some strong clues about the impact of monetary policy and how price action might evolve in the coming months.

U.S. Treasury yields have traded in a narrow range recently, despite big moves in equity markets.

EXHIBIT 10: U.S. LARGE CAP STOCKS VS TREASURY YIELDS

We came out of our Strategy Summit, held September 15 and 16, with greater confidence in the trajectory of the recovery, yet at the same time expecting an uptick in volatility over the fourth quarter. Our outlook is generally positive but with a fatter, and flatter, distribution of risks around our central case. Crucially, however, we acknowledge that there are risks in both directions. In this environment, we believe it is appropriate to maintain a risk-on bias in our portfolios, but sizing that risk and ensuring proper diversification will be paramount.

Our constructive central case is grounded in our belief that macro momentum continues to improve and will be resilient as the recovery extends into 2021, albeit at lower growth rates than the explosive initial reopening phase in May and June. The U.S. ISM index is now at 56, and the new orders-to-inventory ratio is at post-GFC highs (Exhibit 11); business and consumer confidence have been choppy, but trending in the right direction; export orders in Asia are expanding; and capex and inventory data are improving. All of this increases our conviction in the economic recovery and builds our confidence that we are now in the early phase of a new expansion. But if the destination to which we are heading over the next 12 months is becoming clearer, the route we take toward it remains very uncertain. The fourth quarter in particular is packed with event risks around the U.S. election, Brexit, fiscal policy and trade. And the pandemic itself presents a major tail risk in both directions: Rising case counts in Europe and their rapid evolution elsewhere create downside risks while promising vaccine research offers an upside scenario.

Our central case is that macro momentum can continue into 2021, supported by capex and inventory data.

EXHIBIT 11: ISM MANUFACTURING SURVEY

At a portfolio level, our central case calls for a continued overweight to stocks and to credit. Ongoing central bank buying is compressing rates, but sooner or later yields will need to better reflect the growth recovery; we incorporate this with a mild underweight to duration and a recognition of the limitations that ultra-low yields place on the portfolio-hedging properties of bonds. This gives us a clear risk-on tilt, but given the growing tail risks we face in the fourth quarter, we spread our risk widely across asset classes to ensure thorough diversification.

Our moderate overweight to stocks is a continuation of our positioning from the late spring. The rapid action of central banks and governments prompted us to progressively add risk to our portfolios through the second quarter. While the breakneck pace of the bounce in stock markets is likely behind us, the recovery in earnings and continued macro momentum are supportive. Certainly, valuations are extended, especially in sectors such as technology, but this reflects a massive improvement in financial conditions that followed the central banks’ actions, and the natural lag before this manifests itself in earnings. Still, we can’t escape the conclusion that technology – and thus large cap U.S. equities – are rich on a relative basis. We are beginning to take this into account in our regional equity preferences.

EXHIBIT 12: MSCI EQUITY INDICES


The last cycle was very much the “American Decade,” as U.S. tech stocks rallied 333% in the 2010s and the MSCI U.S. index gained 180%, while MSCI Europe in USD managed a measly 20% rise over the entire 10 years (Exhibit 12). As a result, for much of the past few years we have expressed a strong preference for U.S. equities. With the current recovery very much a global affair, and as technology faces the dual headwinds of high valuation and looming regulation, we believe it is appropriate to spread our risk more widely across global equity markets. To be clear, we are not abandoning our faith in the U.S. stock market but simply recognizing that the huge relative growth advantage of the U.S. vs. the rest of the world that was apparent in the last decade may be narrowing (Exhibit 13).

European stocks struggled to hold onto any gains over the past decade. We think that the relative growth advantage of the U.S. may be narrowing, leading us to spread equity risk across regions.

EXHIBIT 13: RELATIVE U.S. GROWTH PROFILES


Since we are of the view that the economy has entered a new cycle, we feel it is appropriate to take a cyclical tilt to our equity exposure. However, we equally believe that the conditions are not yet in place for a rotation to value. For this to take place fully, we would need to see a clear and sustained path to higher rates — not least as a meaningful switch in leadership to value over growth and quality would require the participation of a financial sector that would be buoyed by steeper curves. Thus, we spread an equity overweight across U.S. – notably small caps - European and emerging market equities, with an offsetting underweight in UK stocks; in short, we diversify our risk with a cyclical tilt.
We also seek to spread our risk across asset classes and so replace some of our equity beta with an exposure to extended credit markets. We have an explicit overweight to U.S. high yield credit in a number of our portfolios and see continued scope to both collect carry and benefit from further spread tightening. In our view, high yield credit is operating as a low beta alternative to equity exposure. To the downside, the Fed’s corporate bond program – which extends to fallen angels – is supportive for credit markets in general. To the upside, the lingering default cycle contains the pace of spread compression. Overall, we feel that a good spread of risk between credit and equity, as well as across the subsectors of each asset class, adds a prudent level of diversification to portfolios.

One of the biggest shifts to our allocation views this quarter is the acknowledgment that we believe the U.S. dollar has entered a longer-term downward trend. Previously, we had argued that downside risks were starting to build for the greenback, but having observed key technical levels breached and important shifts to the fundamental underpinnings of the currency, we see a further, if gradual, downside. Of course, the same tail risks for our macro outlook imply that dollar depreciation will not be a one way street over the coming year.

Our LTCMA projections have highlighted the high valuation of the dollar for some time. But we now anticipate a period where the growth differential between the U.S. and the rest of the world is narrowing, in part following widespread fiscal stimulus that is likely to weigh on the dollar. Given Fed commitments to low rates for an extended period, the U.S. no longer enjoys such a sharp yield advantage over other regions. As a result, we see downside risk to the dollar and note that these currency cycles can take some time to play out (Exhibit 14). For dollar-based investors nervous about geographical diversification – especially after a prolonged period of U.S. asset outperformance - a declining dollar removes one of the headwinds to international returns and is specifically supportive for emerging markets.

Perhaps the biggest conundrum for multi-asset investors is what to do with government bonds. While ultra-easy monetary policy and forward guidance means rates are unlikely to rise quickly, the risks over the intermediate term are skewed to modestly higher yields. Indeed, in recent periods of stock market weakness, the level of portfolio hedging that bonds provide proved rather limited: Between September 2 and 21, as the S&P 500 declined 8.4%, the U.S. 10-year yield was essentially unchanged at 66bps. Simply put, with prevailing yields so low, the notional size of bond exposure required to provide a meaningful portfolio hedge is incompatible with the skew of risks that point – eventually – toward higher yields.

We expect the U.S. dollar to depreciate over coming years, noting the growth environment and the Fed’s eroded yield advantage.

EXHIBIT 14: TRADE WEIGHTED USD


Our quant models are strongly negative on duration, given the low level of yields, but as we balance this against our qualitative perspective which incorporates our forward-looking expectation of zero rates for an extended period, we alight on a mild underweight on duration. This is expressed mainly in the profoundly negative yielding regions such as German Bunds; in the U.S., where our opportunity set allows we continue to lean toward TIPS to manage any upside risks to inflation. Nevertheless, we are mindful that running a moderately pro-risk portfolio through our equity and credit positions when duration is providing an insufficient offset may be undesirable. To address this, we are increasingly viewing high quality investment grade (IG) corporate bonds as a duration proxy.

The Fed’s corporate bond-buying program offers an effective backstop to IG credit that we believe is sufficient to allow IG to assume a safe haven status that is often reserved for sovereign bonds alone. While we are mindful of the optically extended leverage for some IG corporates, it is concentrated mainly in the BBB sector and is mitigated to a large extent by appealing...
interest cover ratios. We also note that large corporate issuance over the summer months has termed out leverage and removed many near-term concerns about rolling over liabilities. Given the Fed’s backstop and the carry pickup in IG, we have partially switched from government bonds to high quality credit in a number of portfolios.

In conclusion, we believe that our moderate risk-on tilt is justified by the trajectory of macro data and our expectation that support from policymakers through both fiscal and monetary stimulus will remain in place. Clearly, with rates so low, the portfolio-hedging role of duration is compromised, but we believe that with wide diversification and thoughtful deployment of duration proxies and other safe haven assets we can achieve an acceptable level of portfolio risk. Nevertheless, at a time when tail risks are evolving rapidly, we expect to remain nimble and active in managing our portfolios, and frequently remind ourselves that tail risks can and do operate in both directions.

Our Level One scorecard favors equities and credit

### EXHIBIT 15: LEVEL ONE SCORECARD

<table>
<thead>
<tr>
<th>Considerations</th>
<th>Comment</th>
<th>Stock</th>
<th>Bond</th>
<th>Credit</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic growth</td>
<td>The recession was short and sharp; we are now in recovery phase and in a new business cycle.</td>
<td>+</td>
<td>-</td>
<td>+</td>
<td>0</td>
</tr>
<tr>
<td>Financial conditions</td>
<td>Financial conditions have eased somewhat as equities have rallied, but vol and spreads remain elevated.</td>
<td>+</td>
<td>-</td>
<td>+</td>
<td>0</td>
</tr>
<tr>
<td>Monetary policy</td>
<td>Developed market central banks are in stimulus mode, with many policy rates hitting their lower bounds.</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Tail risks</td>
<td>Downside: virus spread, trade risks; upside: virus containment, stimulus measures effective.</td>
<td>-</td>
<td>+</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>Valuation – absolute</td>
<td>Global equities now expensive, esp. in the U.S.; real yields rich; backup in spreads build in some value.</td>
<td>-</td>
<td>-</td>
<td>+</td>
<td>0</td>
</tr>
<tr>
<td>Valuation – relative</td>
<td>Equity risk premium reaching historical highs; duration expensive relative to other assets.</td>
<td>+</td>
<td>-</td>
<td>+</td>
<td>0</td>
</tr>
<tr>
<td>Fundamentals</td>
<td>ERRs turning sharply positive; stimulus balancing growth recovery for bonds; leverage extended in credit</td>
<td>+</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Positioning</td>
<td>Equity positioning is still light; UST still well held despite volatility; cash preferred.</td>
<td>+</td>
<td>-</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Flows/sentiment</td>
<td>Equity rally still unloved, seeing flows into HY, starting to see first outflows from money markets.</td>
<td>0</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Overall Score</th>
<th>Stock</th>
<th>Bond</th>
<th>Credit</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>+</td>
<td>-</td>
<td>+</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments as of September 2020.
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, high yield or emerging market debt) appears most attractive.

RATES

Government bonds: Still modestly underweight

Since our Strategy Summit in June, major developed market government bond yields have changed very little, but the global economic backdrop has changed a great deal. The continued rebound in activity has improved the balance of risks and made us increasingly confident in a V-shaped recovery. At this juncture, the usual early-cycle playbook would lead us to underweight bonds. While we are indeed sticking with our bond underweight, the atypical nature of this cycle narrows the range of yield outcomes in either direction.

Our base case scenario anticipates a steady grind higher in bond yields as the economy further recovers, as a COVID-19 vaccine becomes closer to a tangible reality and as fiscal spending and accompanying debt issuance likely pick up following the U.S. election. A year from now, we think, the yield on the 10-year U.S. Treasury (UST) could be close to 1.00%, but it is difficult to see yields rising much beyond that level. In the U.S., the Fed signaled at its latest meeting that it expects to keep its policy rate at the zero lower bound through at least the end of 2023. And at least for the foreseeable future, it expects to continue to purchase roughly $120 billion per month of Treasury and agency mortgage-backed securities. Given the Fed’s newly codified average inflation targeting (AIT) framework and its desire to run the economy hot, these stances seem unlikely to shift in a hawkish direction over the next year, even in the most positive imaginable economic environment.

At the same time, central bank policy stances are not likely to shift meaningfully more dovish in an adverse economic scenario. Major developed market central banks are already doing about as much as they can to support their economies. The Fed, which has the most policy space left among them, has shied away from implementing negative rates, worry that the costs of such a policy may outweigh its benefits. Moreover, given current valuations so close to the effective lower bound, it is nearly impossible for yields to fall significantly lower. Outside of a very negative shock, the U.S. 10-year Treasury yield would likely not fall below 0.50%, in our view, and even in another significant economic downturn it is hard to see the yield remaining below 0.40% for a sustained period.

The course of easy monetary policy globally is thus more or less set, with only modest sensitivity to different economic outcomes. Indeed, fundamentals have lost their once-strong link to bond yields, as seen in the breakdown of Treasury yields’ relationship with our U.S. Current Conditions Index from mid-2011 to March 2020 (Exhibit 16). That suggests less scope for yields to move in either direction, but, again, yields at the zero lower bound mean especially limited scope for yields to fall, with risks skewed well to the upside (Exhibit 17). Although we have modest conviction in this view, the low volatility of bond yields suggests a greater-than-usual-sized bond allocation in portfolios.

For years, bond yields had closely tracked fundamentals, represented here by our U.S. Current Conditions Index, but aggressive central bank policy means those yields have barely begun to recover.

EXHIBIT 16: U.S. 10-YEAR TREASURY YIELD VS. MAS U.S CCI TREND

Since yields are already so low, even an unlikely “L shaped” economic downside scenario presents limited bond yield downside.

**EXHIBIT 17: U.S TREASURY SCENARIOS**

<table>
<thead>
<tr>
<th>Scenarios: where we end up in one year</th>
<th>U.S. yields in 12m (%/bps)</th>
</tr>
</thead>
<tbody>
<tr>
<td>#</td>
<td>U.S. economic recovery</td>
</tr>
<tr>
<td>---</td>
<td>------------------------</td>
</tr>
<tr>
<td>1</td>
<td>“L-shaped”</td>
</tr>
<tr>
<td>2</td>
<td>“V-shaped”</td>
</tr>
<tr>
<td>3</td>
<td>Tightening QE support</td>
</tr>
<tr>
<td>4</td>
<td>“Sharp-V”</td>
</tr>
</tbody>
</table>


We expect some yield curve steepening from here, particularly U.S. 5s30s, a natural consequence of our expectation that longer-end yields should rise modestly, while the front end remains pinned by forward guidance. Historically, early-cycle periods would tend to coincide with dramatic steepening of yield curves. Our historically calibrated quantitative model reads the flatness of today’s Treasury yield curve as a strong signal that longer-dated yields should rise in the future, suggesting a more aggressive underweight to duration. But this cycle is different, as central banks directly weigh on yields through quantitative easing (QE) and yield curve control. Our quantitative signals make no special adjustment for central bank distortions, but we do in our overriding subjective assessment, which points to a more modest steepening of curves and rise in yields.

**Market pricing of inflation should keep pushing higher**

Although we see the upside to nominal yields and curve steepening as somewhat contained by central bank policy, we do see greater scope for market pricing of inflation to keep rising. U.S. TIPS 10-year breakeven inflation (BEI) has recovered from well below 1% in Q1 to above 1.55% today, only modestly below pre-pandemic levels of around 1.80%. The earlier sharp fall and subsequent rebound in BEIs seem to have been driven largely by the disappearance and gradual return of liquidity, which has played out. Thus, if we are to see higher breakevens from here, we would need to see an uptick in actual inflation expectations – and these remain resolutely below the levels they stood at for most of the last cycle. According to some model estimates (Exhibit 18), breakevens have not yet begun recovering from their drop at the start of the recession but should do so gradually, as they reflect the same fundamentals putting upward pressure on nominal yields, as well as the foreseeable inflationary consequences of central banks effectively supporting government deficit spending. Heightened uncertainty about the path of inflation might also push the inflation risk premium and thus breakevens higher.

The difference between yields on nominal and inflation-protected U.S. Treasury securities of comparable maturities, known as “breakeven inflation,” is often used to proxy market participants’ inflation expectations. But this spread also includes risk premia for assuming inflation uncertainty or relative illiquidity. Models like D’Amico, Kim and Wei (DKW), shown here, attempt to disaggregate inflation pricing into these components. These models generally suggest the greatest driver of year-to-date swings in inflation pricing was fading liquidity and its subsequent recovery; actual inflation expectations also declined but have not yet recovered.

**Models suggest that fading liquidity, and its subsequent recovery, was the biggest driver of inflation pricing**

**EXHIBIT 18: TIPS BREAKEVENS BREAKDOWN**

Estimated composition of year-to-date changes in 10-year U.S. inflation pricing, %

Bonds a less effective risk asset hedge

Along with a negative view on global bonds, we hold generally positive views on risk assets. In the last couple of cycles, these views might have been more at odds. Negative correlations between stocks and bonds meant that if one were overweight stocks, one would have more reason to be overweight bonds. With bond yields so close to the effective lower bound, however, their ability to decline further and provide ballast against a risk-off episode is greatly diminished (Exhibit 19). From a portfolio perspective, this is growing reason to limit bond allocations.

Historical evidence suggests a sweet spot of negative stock-bond correlations when yields are between about two and five percent; with yields effectively pinned at low levels and unresponsive to growth shocks, bonds provide very little portfolio diversification.

EXHIBIT 19: 2-YEAR STOCK-BOND BETA OF MAJOR MARKETS, 10-YEAR GOVERNMENT BOND VS. S&P 500 PRICE MOVES SINCE 1990

Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of September 2020

Bond relative value: Favor Australia, Canada and Italy; underweight Germany

Our overweight to Italian BTPs goes hand in hand with our underweight to German Bunds. Italian spreads remain supported by both fiscal and monetary policy. We also see scope for euro area bond yields to rise faster than in the U.S., given historically low relative valuations as well as the particular flatness of German curves, which make Bunds less attractive to international investors. A risk to that view is the European Central Bank’s (ECB’s) struggle to push up inflation expectations, especially given the new headwind of an appreciating euro. Markets appear to be losing faith in the ECB’s credibility in achieving its inflation target, which raises the odds that the central bank will try to anchor Bund yields, but it also adds confidence to our positive view on BTPs, as the ECB should extend QE.

On Canadian bonds, we are modestly positive relative to U.S. Treasuries, though our conviction has waned a little. History and fundamentals suggest lower relative yields in Canada, although the current yield differential has persisted for months and there is now no obvious potential catalyst for the differential to widen meaningfully in favor of Canadian bonds. We had thought the Bank of Canada more likely than the Fed to implement yield curve control, but both central banks have shied away from the policy. As bond yields eventually do rise meaningfully, however, we would still expect them to rise faster in the U.S. than in Canada; and maintaining this relative value position costs virtually zero carry.

We remain modestly positive on Australian government bonds, due largely to a small relative yield advantage and positive carry, though there are risks in both directions. On the positive side, and potentially further supporting our view, are economic fundamentals: low inflation, high household indebtedness and U.S.-China trade risks. On the negative side: Australia’s relative success (to date) with COVID-19 and its lack of exposure to winter flu season in coming months, along with a less accommodative Reserve Bank of Australia (RBA) including no further QE and yield curve control only on the short end.

Regarding UK Gilts, we shifted from overweight to neutral following a rally to rich valuations amid growth headwinds - a pickup in idiosyncratic Brexit risk and relative mismanagement of COVID-19 cases - that should lead to lackluster recovery in the UK economy in the coming months.

FX

Several political and macroeconomic developments have unfolded since our Strategy Summit in June: stronger than expected economic growth and a Fed announcement to make a formal shift to average inflation targeting, heightened U.S.-China geopolitical tension and increased uncertainty about the outcome of the U.S. election. And yet the performance of G10 FX has been remarkably consistent with historical averages of beta to global risk (Exhibit 20). This suggests that investor faith in global...
growth resurgence has dominated FX price action and the associated weakness in USD. As markets transition from a phase of explosive growth to a more normal pace of early-cycle expansion, this overwhelming tailwind from positive risk sentiment will likely wane. While the next phase in FX will remain pro-cyclical, we expect greater regional differentiation based on several idiosyncratic factors.

Relative performance across G10 FX has been largely consistent with historical averages of beta to global risk

EXHIBIT 20: REALIZED AND BETA-IMPLIED G10 FX PERFORMANCE OVER Q3, AVERAGE 3-MONTH BETA OVER THE LAST 10 YEARS


This quarter, we downgrade USD to an underweight to reflect our expectation that the U.S. economic exceptionalism of the past decade is coming to an end. Over the medium term, we think USD will struggle to sustain its still structurally rich valuations as its real yield advantage is eroded and moves increasingly negative. This dynamic will be reinforced by a renewed synchronization in the global economic expansion that favors more cyclically geared currencies and discounts the dollar’s safe haven premium.

While we expect the U.S. dollar to trend lower over time for the reasons discussed above, we do not believe the recent change to the Fed’s policy framework is a decisive contributor to that move. Although the framework represents a significant conceptual leap for the Fed, its adoption of an average inflation targeting approach has been in the works for a while and seems unlikely to affect near-term monetary policy decisions. Forward guidance and economic slack have already anchored the path of short-term rates for the foreseeable future. Moreover, although U.S. inflation expectations have risen, nominal exchange rate fluctuations depend more on cross-country differentials than absolute levels. With global central banks almost universally dovish, the Fed’s desire to aim for a moderate inflation overshoot likely will do little to widen those gaps, at least in the short term.

The November presidential elections present a near-term source of volatility for the dollar. Over the longer run, the trajectory of the dollar will be determined principally by the relative growth differential between the U.S. and other regions. Nevertheless, the two presidential candidates do differ in their trade, tax and fiscal priorities. Thus, at the margin, the election outcome could influence the shape of the future trend in the dollar, but whoever wins the presidency we believe the trend will remain toward a softer dollar over the long-term.

We turn positive on the euro in a mirror image of our USD view. Over the last quarter, EURUSD appreciation has been noteworthy in its magnitude and in the resilience it has displayed in risk-off periods. Multiple tailwinds have played their part: a decline in COVID-19 infections and local restrictions over the summer leading to relatively strong macro outcomes; EU leaders agreeing on a EUR 750 billion recovery effort backed by joint issuance and strong balance of payments fundamentals – a source of EUR demand. The euro’s outperformance has exceeded a traditionally modest gearing to global risk, and according to interest rate models it has pushed EURUSD to be modestly overvalued.

However, our medium-term outlook on the euro remains EUR-positive. Favorable (though now worsening) COVID-19 outcomes, and by extension recent price action, bear little relevance to Europe’s ability to grow at a pace more comparable to the U.S. over this next cycle. We foresee a prolonged period of narrower growth and inflation differentials keeping the dollar on a weakening trend. In addition, while valuation and macro performance in Europe are certainly moderating, net equity and FDI inflows also imply EUR resilience over the short term.

Like other low yielding reserve currencies, the yen has benefited from erosion of the exceptionalism priced into DXY and the fall in yield differentials. However, in contrast to the environment surrounding the euro, local JPY dynamics are not strongly supportive. Investment outflows in Japan remain an idiosyncratic hurdle for JPY appreciation, although recent purchases of overseas debt have increasingly been financed via rotation out of global equity allocations (Exhibit 21), thus mitigating JPY depreciation. We expect JPY to struggle on a trade-weighted
GLOBAL ASSET ALLOCATION VIEWS

basis due to its safe haven characteristics. We note our outlook is little changed in the wake of the resignation of Japanese Prime Minister Shinzō Abe. Neither monetary nor fiscal policy looks set to shift dramatically under new leadership, and we thus expect JPY to continue to reflect a weaker USD outlook balanced by continued outflows from yen assets by domestic investors.

JPY portfolio outflows remain an idiosyncratic headwind for sustained appreciation

EXHIBIT 21: JAPANESE PURCHASES OF FOREIGN ASSETS (BILLIONS OF JPY)

Billions of Yen, Positive is a buying of foreign assets by Japanese investor

<table>
<thead>
<tr>
<th>Year</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan Weekly Securities Investment Abroad, Net</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-Term Securities (4WMA)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stocks (4WMA)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medium &amp; Long-Term Bonds (4WMA)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Turning to our outlook for GBP, we've previously highlighted the market’s focus on the resolution of COVID-19 lockdown measures, with Brexit seemingly relegated to an afterthought. As both mortality and new infection curves flattened over Q3, many expected that Brexit-induced volatility would re-emerge. Sterling volatility has indeed picked up even as a future Brexit deal hangs in the balance and the clock is ticking. But higher volatility also reflects other factors: the risk of negative rates, a resurgence of COVID-19 cases and the UK’s fundamental vulnerabilities – namely, its significant external financing requirement and impending 2021 fiscal drag. All told, GBP’s participation in the current pro-cyclical rally has been rather choppy.

Amid this complicated cyclical backdrop, there is now scope for a more disorderly conclusion to Brexit negotiations. The Brexit balance of risks is certainly two-sided – in fact, it’s hard to envision how a “no-deal” outcome would be desirable to either party. Yet we view the distribution of GBP outcomes as skewed negative and thus remain skeptical of sterling’s ability to appreciate strongly despite improving risk sentiment. The UK’s heavy reliance on capital inflows means not only that sterling would be burdened by the economic consequences of a narrow trading agreement, but it is also likely that the Bank of England would entertain a negative interest rate policy. The resulting flight of foreign capital amid an already weak capital account does not bode well for sterling over the coming year.

EQUITY

The global equity market rally that began in late March continued for much of the second quarter before retreating at the start of September. After rallying 13% from the start of Q3 to a new all-time high on September 2, global equities (MSCI ACWI) have now declined by around 8% at the time of writing – the second such correction since the start of the recovery. This leaves the global index just 4% below its previous high in February of this year, testament to the ferociousness of the post-COVID-19 recovery in markets. From the lows of March, global equities are up by 43%.

The shape and timing of the equity market recovery have not been that remarkable in an historical context. In line with historical patterns, the market’s low in March preceded the low in economic activity by around three months. On the other hand, the size and speed of this equity rebound are nearly unprecedented. In hindsight this makes sense at a macro level given the shape of the economic recession (very deep, but also very short) as well as the huge amounts of both monetary and fiscal stimulus that have been applied by policymakers (explaining the so-far V-shaped economic recovery).

From an equity market perspective, this top-down narrative has its limitations. Consider that share prices in many economically sensitive sectors remain well below their pre-pandemic levels (most conspicuously so in financials and travel related stocks), while the perceived relative winners from the pandemic have surged ahead to new record highs – led by a small group of high profile U.S. mega cap stocks. This has led to worries about deteriorating market breadth and increasing market cap concentration in equity markets. And, perhaps predictably, it was precisely this area of the market that led the accelerating rally into early September, which then also sparked the currently-ongoing correction. As often happens, though, the selloff then
broadened as investors’ latent worries came to the fore – first and foremost regarding the lack of further U.S. fiscal stimulus and uncertainty about the U.S. election outcome, but also including the increased coronavirus infection count in Europe.

Still, given our confidence in a continued economic recovery, we read the current market action as more likely to be a fairly run-of-the-mill correction than the start of a deeper drawdown that would cause us to change our generally positive outlook for risk assets. The risks around politics and the pandemic are real. But as we see it, outside a very short-term horizon the key consideration is clear: We’re in the early days of a new economic cycle and this should be a positive environment for risk assets. We remain overweight equities as an asset class, and favor broadly spread exposure, avoiding too much regional and/or factor bias.

One of our favorite short-term metrics of market pricing relative to economic fundamentals plots equity S&P 500 returns against the ISM manufacturing index (Exhibit 22). Following the recent correction, market and economic momentum appear to be pretty closely in sync once again.

There has been a good degree of synchronicity between the S&P 500 and U.S. economic momentum recently


So far in this equity market rally, expanding valuations have done all the heavy lifting, especially when focusing on earnings-based metrics. For example from the low on March 23, the global 12-month forward P/E has risen by 54%, allowing the index to rise by some 40%. Of course, this highlights the problem with using P/E-type valuations around an economic downturn: for a time, the falling earnings basis makes valuations look more elevated than longer-term fundamentals would suggest. This is true of course only as long as earnings do eventually recover – and we think they will rebound quite emphatically – and indeed the 12-month forward earnings used in the above examples have been rising for several months now as next year’s recovery comes to dominate numbers (Exhibit 23).

Still, with the global MSCI ACWI 12-month forward P/E at a very elevated 19.5x, compared with a long-run average of just under 16x, and the highest level since its peak of around 25x in the dot-com bubble, it seems clear that the valuation market driver now has diminished force. To be sure, this is largely a phenomenon of the U.S. equity market, where the same metric now stands at 22x (vs. a long-run average of around 15x). Overvaluation in the rest of the world is not nearly as stark, with a current forward P/E of 17x vs. a long-run average of 16x.

Valuations have expanded significantly through this downturn, especially in the U.S.

![Exhibit 23: 12-Month Forward P/E Multiples for Major Equity Markets](source: Refinitiv Datastream, J.P. Morgan Asset Management Multi-Asset Solutions; data as of September 2020.)

From a cross-asset perspective, equities continue to look attractive compared with bonds, or more generally on any valuation metric that takes into account the low level of interest rates. We calculate that the implied equity risk premium of U.S. equities over U.S. Treasuries today stands at 6.9% (Exhibit 24) -
still well above its long-run average of 4.7%, although admittedly down quite a bit from the record high of nearly 8% that it reached at the equity market low in March. Equities look set to remain attractive on this type of comparison for some time given the limited upside for bond yields: we expect U.S. 10-year Treasury yields will struggle to exceed 1.0% over the coming year.

Equities still look attractive from a cross-asset perspective, most notably against government bonds

EXHIBIT 24: U.S. EQUITY RISK PREMIUM


Nevertheless, from this juncture it seems likely that earnings growth needs to take over from valuations as the main force spurring further equity markets gains.

It is welcome news, then, that the data suggests Q2 was the low point for earnings this cycle, and that profits should already be improving strongly in Q3 alongside the economy. The clearest piece of evidence for this view was the rather spectacular Q2 earnings season, and analysts’ reaction to it. In this most recent reporting season results beat expectations by unprecedented amounts across all major regions (Exhibit 25). On the one hand this tells us that analysts had simply become too negative about what was going in the economy and in businesses (admittedly they had very little guidance or precedent to draw upon). But it is also evidence that companies have responded to the new environment much more effectively than we might have thought possible. Corporate revenues were not all that much above expectations – but corporate cost and margin management proved formidable and they are likely to provide further support from here.

The most recent earnings season saw results beat expectations by a historic margin

EXHIBIT 25: AGGREGATE EPS SURPRISE FACTORS

Looking forward, it’s even more encouraging that analysts reacted to the huge upside surprise by further raising their earnings forecasts for the coming year: 12-month forward earnings revisions ratios, which bottomed in April, began another leg higher following the reporting season in July. Many had feared the opposite would occur. Since then, earnings revisions have been rising strongly across all regions we monitor, just as correlated on the rebound as they had been in the collapse earlier in the year (Exhibit 26). This underscores the global nature of this earnings cycle - the size of the earnings drop and rebound varies by country due to sector make up and gearing, but the shape of the cycle has been fairly uniform.

The latest results season brought with it a historic set of earnings surprises

EXHIBIT 26: EARNINGS REVISIONS RATIO, 4-WEEK MEASURE

Current consensus growth forecasts for 2021 project a 30% rebound in earnings at a global level (ACWI), following this year’s 20% drop – a fairly realistic scenario in our view given the economic recovery we anticipate. But if this scale of earnings growth does materialize over the next year it should do wonders for both earnings-based valuations and sentiment towards equity markets. Admittedly, this rebound is to a large degree base effect-driven, and as Exhibit 27 shows, there is a very strong correlation between the size of a given country’s 2020’s EPS drop and the size of its 2021 rebound. Nevertheless, at the global level current consensus forecasts imply FY 2021 earnings above the 2019 pre-pandemic base level. This is true for the all-important U.S. market, where the current estimate for 2021 S&P 500 EPS of $163 is some 2% above the 2019 number. But it is even more striking in the MSCI EM index, which was spared the worst of the 2020 EPS drawdown: here 2021 EPS should come in some 20% above the 2019 level. Major market laggards from this perspective are the UK and EMU, but even here there is a good chance that 2021 estimates will eventually rise above 2019 levels once the recovery is further along.

Next year’s earnings forecasts look high but achievable given our macro outlook

EXHIBIT 27: GLOBAL EPS GROWTH EXPECTATIONS, 2021 VS. 2020

Breakeven rates have provided a guide for the cyclical vs. defensives rotation

EXHIBIT 28: CYCLICALS VS. DEFENSIVES, WITH BREAKEVEN RATES

Before we turn to regional equity preferences, it is worth highlighting the issue of narrowing breadth in equity markets. As discussed earlier (and is widely understood among market participants) the narrow leadership by large tech stocks has led to record levels of market cap concentration in the mega-cap tech stocks, particularly in the U.S., where it has exceeded even the dot-com bubble. This is not to say that other parts of the market have failed to participate in the recovery. After all, U.S. small caps are up by 48% from the March low, and the equal weighted S&P 500 index by 45% - but these gains clearly lag well behind the tech stock surge.

Going forward our regional equity preferences will need to address one important question: Will U.S. large cap equities’ heavy overweight toward tech and “pandemic winners” turn from a positive into a negative if and when a rotation takes place toward a broader group of economic recovery plays? A market rotation has been a key focus for equity investors for some time. Over the past few months, there has been a marked rotation in cyclical vs. defensive stocks, and in a way that has neatly lined up with U.S. 10-year breakeven rates over the year (Exhibit 28). These stocks have benefitted from the end of the global recession, and a reduction in perceived left-tail risks related to the global economy. Despite some false starts, there has been no such rotation in the ‘value’ factor, especially relative to growth. In fact, the divergence between the cyclical and value factors appears to be the greatest it has been for at least a decade (Exhibit 29).

Breakeven rates have provided a guide for the cyclical vs. defensives rotation

EXHIBIT 28: CYCLICALS VS. DEFENSIVES, WITH BREAKEVEN RATES


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Breakeven rates have provided a guide for the cyclical vs. defensives rotation

EXHIBIT 28: CYCLICALS VS. DEFENSIVES, WITH BREAKEVEN RATES

The divergence between the cyclical and value factors looks extreme

EXHIBIT 29: CYCLICALS VS. DEFENSIVES, VALUE VS. GROWTH

![Cyclical vs Defensives, Value vs Growth]


The major contributor to this divergence is the value factor’s exposures to financials and energy, two particularly embattled sectors this year. Pre-pandemic, the high valuations of growth stocks relative to value stocks were already garnering attention, and this dynamic has extended further as the year has progressed. In fact, recent market action suggests that it might be easier to envisage a value vs. growth rotation beginning with a valuation reset lower for the mega-cap tech stocks rather than a reset higher in the most beaten-up sectors.

We have lower conviction in our overweight to U.S. large cap stocks this quarter, noting the market’s high valuations and the gridlock in the U.S. Congress. Depending on the outcome of the November election, there may be scope for a less corporate-friendly tax and regulation environment, especially for major technology firms. Still, in an environment of very low government bond yields, muted inflation, and significant risks to the growth recovery, the earnings growth offered by the U.S. large cap market remains attractive. While the valuations of many U.S. tech stocks can be startling at first glance, it’s notable that the earnings performance of this sector has significantly outperformed over a number of time periods, and especially so over the recent crisis (Exhibit 30).

Tech performance has reflected both valuation expansion and earnings leadership

EXHIBIT 30: BREAKDOWN OF U.S. TECH PERFORMANCE VS. THE MARKET

![Tech performance breakdown]


U.S. small cap stocks have been in the middle of our qualitative preferences, but our sentiment towards them is improving, and our quant models favor the market. As a result, we are overweight small caps in our portfolios. U.S. small cap is high beta, and looks to be a good stock market to capture the continued cyclical recovery (Exhibit 31). Recently U.S. small caps have struggled to keep up with large caps, in part because the small cap market doesn’t have many of the long-term “new economy” winners. However, the exposure of U.S. small caps to financials and the manufacturing part of the U.S. economy should be attractive in our base case macro environment. Given our somewhat diminished conviction in U.S. large caps, small caps seem an attractive way to diversify some U.S. equity risk.

U.S. small cap stocks are the highest beta stock market in our opportunity set

EXHIBIT 31: EQUITY MARKET BETAS

![Equity market betas]

European stock markets have failed to deliver better performance than their peers, despite a number of positive catalysts. Over the past three months, European companies in the auto, materials and chemicals sectors have done well; these are sectors geared to the global economic recovery. At the same time, the market has drawn support from positive news flow on the European Recovery Fund and monetary stimulus from the European Central Bank. However, two major factors have held back the performance of European stocks. First, a second wave of coronavirus cases is broadening out from initial hotspots in tourist areas, and appears to be accelerating in key economic centers, raising the prospect of renewed lockdowns. Second, a rally in EUR, which benefitted from general USD weakness and a period of relative political calm, presented a headwind for European exporters albeit more in sentiment than practical terms (Exhibit 32). With the EUR a long way below our estimates of fair value, we are not too worried about competitiveness. In general, we think of the European stock market as having very little growth exposure, and a larger amount of cyclical and value exposures than other markets. It is notable, though, that this dynamic is changing, with some financial companies exiting the headline indices and more growth focused companies joining the roster. Additionally, we remain positive on the Recovery Fund theme, and the continued cyclical rotation in European equity markets. As a result, despite recent lackluster performance, we remain overweight European equity.

Since the COVID-19 crisis, EUR has been negatively correlated with the outperformance of European stocks

Emerging market equities, which we’ve long appreciated for their balanced factor exposures, were the best performing in our opportunity set over the past three months. The MSCI EM index is exposed to secular growth new economy names, like Tencent and Alibaba, while also including more cyclical stocks, most notably the large EM Asian manufacturers. MSCI EM is thus well-positioned to capitalize on both the economic recovery, which is clear in the EM Asian goods economy, and the emergence of new ways of working and living following the COVID-19 shock. An environment of USD weakness has supported EM sentiment, but it’s interesting that the strength of the negative correlation between the two assets has waned somewhat. COVID-19 continues to be well contained in Asia, and the case count in Latin America is also starting to look better. We continue to like emerging market equities and remain overweight.

Japan’s relative performance has improved over the past month, appearing relatively insulated from the broader selloff in stocks. The market appears to expect a high degree of policy continuity after the resignation of Prime Minister Shinzo Abe, and we expect Japanese equities to continue to reflect international trends and local cyclical developments rather than de-rating on an “end of Abenomics” theme. Japan’s COVID-19 profile has been a support as well, with hopes for an economic recovery supported by recent reductions of restrictions on large events and restaurant regulations. As the profile of European stock markets shifts, Japan looks like a cleaner play on global cyclicality. Of course, the growth profile of Japan’s economy matters too, with 60% of revenues coming from the domestic market. We are neutral on Japanese equities.

The UK market has been the weakest performer in our opportunity set over the past three months, for several reasons. First, the index has very little exposure to technology stocks, at just a 1% weighting. This makes the UK less exposed to the new economy and work-from-home peers that have been winners this year. Second, the index has significant exposures to energy, via two major oil companies, and to financials. Both of these sectors have struggled, the former due to low oil prices, and the latter due to muted economic activity and flat government bond curves. Third, Brexit continues to keep investors away from the market, with various fund manager surveys suggesting that the UK is a key underweight. Given the scale of the underperformance, the UK now looks very cheap. It is difficult to
CREDIT

We have held a fairly constructive view on credit throughout much of the recovery. As economic activity has returned, and with monetary stimulus explicitly supporting the debt markets, credit assets have delivered solid returns since our Strategy Summit in June. Extended credit markets, U.S. high yield (HY) and emerging market debt (EMD) have led performance over the past three months, taking the mantle from the safer investment grade market, which saw its spreads contract markedly at the start of the asset market rebound. With less volatility, the riskier markets have outperformed their traditional beta to the S&P 500.

Each of the credit markets has experienced a remarkable amount of issuance in the recovery. At times, new supply flooding the market has caused temporary pauses in performance, but we interpret them as signs that the credit market is healthy and functioning properly. Companies have been able to bridge their financing needs through the virus-induced interruptions in economic activity. We’re encouraged, too, that firms are largely citing refinancing and building cash positions as their “use of proceeds” for issuing new bonds, as opposed to the riskier categories, “general corporate practices,” “LBO,” or “M&A” (Exhibit 33). In other words, we see firms as prudently using the Fed-supportive accommodative conditions to build up cash positions and term out debt in an effort to lock in today’s low rates and delay refinancing needs for the foreseeable future.

Issuance has generally been used in a credit-friendly fashion

EXHIBIT 33: U.S. HY CORPORATE ISSUANCE BY USE OF PROCEED


We remain positive on HY credit even as defaults continue to accumulate in the space. Depending on the source, trailing 12-month default rates already range from roughly 6%-8%. We’re encouraged that - independent of the source - the pace of defaults has slowed considerably in recent months alongside a deceleration in the pace of net downgrades from the rating agencies. Under our base case scenario of economic recovery, the worst of this default cycle is likely already behind us. As ever, there are risks to this outlook, notably renewed widespread lockdown measures and/or a delay in the release of a vaccine.

At around 500bps, HY spreads still have the cushion to absorb further defaults. Moreover, refinancing math has turned favorable for much of the HY index. Outside of CCC rated firms, the going yield in the HY market is below the current coupon, implying that even risky firms can refinance their debt with lower interest rates (Exhibit 34). From a portfolio construction perspective, we view HY as a viable risk option that will likely produce a better Sharpe ratio relative to equities and be mostly immune to the fluctuations in tech performance that have recently afflicted the S&P 500.

US HY corporates, outside of CCC-rated firms, have favorable refinancing conditions

EXHIBIT 34: U.S. HY CORPORATE COUPON LESS YIELD TO WORST


We maintain a positive view on IG credit, although we note – as we did coming out of the June Strategy Summit - that the best of the market’s returns are behind us at this point in the recovery.
Spreads have continued to contract to around 130bps. Leverage will almost certainly continue to rise over the next quarters, given companies a strong incentive to refinance and take out additional debt to raise cash levels amid the ongoing uncertainty surrounding the virus.

Nevertheless, the pace of net downgrades coming from rating agencies has slowed significantly, a positive development; agencies have only been targeting virus-sensitive businesses and are seemingly allowing firms the latitude to build up their debt levels over the near term. We also note that, despite the relative tightness of spreads, the U.S. IG market continues to offer euro and yen investors a nice pick up in yield thanks, in part, to the low costs of hedging dollar risk amid the Fed’s accommodative monetary policy stance. Lastly, we note an important portfolio construction consideration: The ongoing Fed credit facilities should provide a backstop for IG credit should downside risks materialize over the near term. For this reason, we believe IG credit can serve as an alternative to sovereign duration in some multi-asset portfolios.

We are a little more circumspect on the outlook for hard currency emerging market debt, leaving us neutral overall on the asset class. We note that EMD has been the strongest credit performer in recent months, benefiting from the restructuring of Argentine and Ecuadorian debt, a solid external backdrop and a pickup in EM activity. EM economies have been able to begin their recoveries even as virus infection rates have been rising in some countries. The pickup in the global industrial cycle has certainly benefited the manufacturing-sensitive region. Global financial conditions, including the dollar, have remained accommodative and allowed EM central banks to maintain easy monetary policy, though they have had to reduce the pace of easing amid some signs of reflation. Moreover, the prior EM currency depreciations have started to reduce current account deficits and, at the margin, improved external financing needs. All told this has led to a notable deceleration in the pace of rating downgrades. Given that the high yielders within the EMD index retain a little bit of a valuation cushion relative to U.S. HY companies, we can see EMD continuing to perform over the very near-term. The medium term is another matter, though, given questions about the fiscal sustainability of the riskiest part of the EMD market. As in the developed world, many EM countries have had to borrow to finance large 2020 fiscal deficits amid the pandemic. It’s unclear how willing or able these countries will be to resume their pre-virus deleveraging plans. Moreover, many of the index’s high-yielding countries have relied on two important benefits: G20 debt service suspensions that extend only through the end of the 2020, and an increased availability of funds from the International Monetary Fund (IMF).

These measures will likely be reviewed at the upcoming winter IMF meetings, and it remains possible that the multilateral organizations will call for some austerity and/or reduce the amount of accommodation they have been providing to the most troubled EM countries. This leaves the prospect of further defaults accruing in 2021. Given these prospects, along with some technical market concerns – positioning looks fairly overweight on some metrics, while supply will likely continue ahead of the U.S. presidential election - we are inclined to take most of our credit risk in U.S. markets.

REAL ESTATE

U.S. REITs have continued to struggle since the market peaked in February. REITs had a sharper drawdown than the S&P 500, and they have trailed behind the index for much of the economic recovery. The asset class has underperformed relative to other defensive sectors, such as utilities, and even compared with other “epicenter” stocks that have been directly impacted by the virus – REITs are down more than 10% vs. U.S. airline stocks since the start of the virus. Several subsectors of the REIT asset class are directly affected by the economic fallout from the pandemic. Retail and hotel REITs are both down over 40% since the start of the downdraft, while apartments, office and health care (senior housing) have fallen between 25%–35%. Industrial and specialized REITS (e.g., data centers) are the outperformers, down modest single digits since February.

A quick look at fundamentals explains the poor performance. Net operating income fell 7.5% in the second quarter, the largest decline on record; retail income was down 20%. The drop in income is leading to some weak cash flow expectations. Adjusted funds from operations (AFFO) are now expected to be down 7% in 2020; analysts have kept lowering AFFO expectations for REITs even as the broader S&P 500 earnings expectations have troughed and started to improve (Exhibit 35).

Hotel REIT AFFO expectations have been particularly hard hit, plummeting to zero, with some firms expecting negative cash
flow over the entirety of 2020. On a positive note, rents have shown some resilience in recent months and are not actively cratering amid continued vaccine/virus uncertainty and the recent end of supplemental unemployment insurance.

Nevertheless, REITs still don’t have the same gearing toward a reopening of the economy as the broader S&P 500. While 2021 AFFO growth expectations are positive, at 6.8% that pales in comparison to the 26% earnings growth expected from the S&P. The issue is that office space, hotels, retail and urban residential property aren’t expected to snap back with a vaccine; each of those assets is expected to need some time to normalize cash flows even in a post-vaccine world.

REITs’ cash flow expectations have continued to moderate even as S&P 500 earnings estimates have started to recover


REIT valuations are the relative bright spot for the asset class. Price-to-AFFO multiples have not widened to the same degree that S&P 500 P/E multiples have when looking at the 2021 estimates (Exhibit 36). Cap rates have not really budged, which leaves them looking attractive relative to yields now available in the fixed income markets, particularly among Treasuries. Price-to-net asset values look more neutral (unlike the previous valuation metrics cited, they incorporate cash flow expectations over several years), but net asset valuation metrics are themselves more uncertain, given the existential questions surrounding the future of the office and retail sectors.

EXHIBIT 36: U.S. REITS’ PRICE-TO-2021 AFFO VS. S&P 500 PRICE-TO-2021 EPS

REITs’ valuation multiples now look cheap vs. S&P

Valuations do offer some buffer, yet large portions of the REIT space still face considerable uncertainty in both the near and medium terms. We maintain a neutral stance on REITs. While the asset class should benefit from an economic recovery and/or vaccine, we are wary of building a large position, especially as analysts continue to revise their expectations lower. We believe the broader equity indices, particularly those exposed to the cyclical goods recovery, offer a cleaner play on the economic recovery.

COMMODITIES

Compared with the previous quarter, recent months have been markedly more “normal” for the oil market. In Q2, the oil market looked grossly oversupplied, as OPEC’s modest actions failed to counterbalance an extreme fall in demand associated with COVID-19. This dynamic, combined with technical idiosyncrasies, led to a short period of negative oil prices in the WTI market. In Q3, changes in the oil price were far less dramatic, with prices trading in a narrow range close to the $40/bbl mark.

The demand side of the oil market is recovering at varying paces, depending on region and economic sector, although recent data suggest that the recovery is stalling. In its latest report, the IEA reduced its 2020 forecast by 140 kb/d, the first downgrade in several months, reflecting limited mobility as the number of COVID-19 cases remains high, and ongoing struggles in the aviation sector. Similarly, the recovery in gasoline cracks has run out of steam recently, reducing the incentive for refiners to purchase crude (Exhibit 37).
The recovery in gasoline cracks stalled in the third quarter, suggesting that the “easy” part of the recovery was over.

EXHIBIT 37: GASOLINE CRACKS

![Gasoline Crack Spread, USD/bbl (Rotterdam)](chart)


In the face of sluggish demand, OPEC has been restraining supply. While production levels remain above quotas, compliance has been high, routinely between 90%-100%. Recently, OPEC plus exports have started to rebound, which might suggest that the vigor of the supply cuts is waning. But Saudi Energy Minister Prince Abulaziz bin Salman has been speaking forcefully to the press, condemning members that have missed their production targets and continuing to defend the oil recovery.

Among U.S. producers, the rig count remains at depressed levels, though the moves lower appear to have ended. Given the steady price environment, with a lot of shale “in the money,” the count should start to move marginally higher in coming months. However, the rebound in shale activity should be more muted than in recent years. Capex guidance has been moderate as companies focus on returning cash to shareholders rather than drilling. That is especially true for Exxon and Chevron, which are set to become the biggest players in the shale patches.

Over the medium term, a global economic recovery, accompanied by a more constrained shale sector and OPEC compliance, should bring higher prices. Wall Street estimates suggest mildly higher prices, with forecasts ranging from $50-$65/bbl for the middle of 2021. Among the downside risks to those forecasts: changes in OPEC’s supply management strategy, better than expected shale production and, more broadly, shifts in the macro outlook.

In recent years, copper prices have traded very closely with risk sentiment, especially sentiment about Chinese growth and emerging market assets. It’s notable, then, that copper prices have continued to appreciate even while emerging market stocks have taken a bit of a breather. The copper market is supported from the supply side, with inventories at key exchanges falling notably and key mines in South America failing to grow output. On the demand side, onshore Chinese demand remains strong following sequential rounds of copper-friendly stimulus and a Chinese property market remaining at elevated levels. This has led to a significant backwardation in front month copper contracts, the steepest since March 2019 (Exhibit 38). Concerns about a second round of COVID-19 cases would be negative for copper prices, especially as speculative positioning has moved more positive.

Copper prices have increased even as equity markets have moved sideways, suggesting idiosyncratic strength in the base metals complex.

EXHIBIT 38: COPPER CURVE

![Copper Curve, Spot-3M Spread, USD/mt](chart)


Like copper prices, iron ore prices have been supported by strong industrial demand from China. The construction season peaks in September–October in the region, so Chinese steel mills have been increasing production ahead of this period. This has supported iron ore demand, especially demand for high grade ores. However, there are already signs that this driver of iron ore demand is on the wane; the latest China steel PMI signaled that steel demand has been declining (Exhibit 39). Additionally, Chinese authorities have suggested that they see the iron ore price as too high; the Dalian Commodity Exchange, in an attempt
to curb speculation, has increased transaction fees on its iron ore contract.

Steel demand has been a significant positive driver of the iron ore price over recent months, but there are signs that this demand driver has peaked.

For some time, commodity analysts have expected iron ore prices to fall into a sub-$100/mt range on the back of increasing Brazilian exports. Over the past year or so, these exports have been very slow to recover, and shipment and mining restrictions stemming from COVID-19 have been a further restraint. That said, increased Brazilian volumes should emerge at some point, relieving the tightness in the iron ore market.

EXHIBIT 39: CHINA STEEL PMI

PORTFOLIO IMPLICATIONS

Our base case view is that the economy will continue to recover, but equally we expect to face challenges and uncertainty ahead – which may be particularly acute in the fourth quarter. History would suggest that when the economy is in an early-cycle phase and data are accelerating from their lows, risk assets perform well. Arguably, the playbook suggests owning cyclical, deep value and beaten-up stocks, as well as the most speculative part of credit; further, it might also point to bonds beginning to sell off and yield curves steepening.

However, this was no ordinary recession, and the pace of the rebound once policymakers unleashed massive stimulus implies that neither the pace nor the complexion of the recovery fit historical patterns especially well. This factor comes through in some of our quant signals, and the sheer speed of the rebound demands that we scrutinize the output from our models with particular care. In this recovery, we have seen the rally in beaten-up stocks and speculative credit, but leadership quickly passed to the sectoral winners of the last cycle, in particular Technology. Cyclical exposure has generally performed well, but value sectors have not really taken off. We believe that massive monetary stimulus, including the commitment to holding rates near zero for an extended period, explains why value hasn’t performed and yield curves remain quite flat.

Simply put, the early-cycle playbook appears to hold for those assets that are most geared to the economic rebound – and especially those linked more to the goods side of the economy, which suffered rather less and have rebounded more persistently than services. Thus, equities, particularly cyclical sectors, credit and a number of commodities are doing well. Meanwhile, those assets where the imprint of monetary policy is greatest are not following the classic early-cycle playbook. Bonds are not selling off sharply, curves have not steepened, and neither value styles nor financial stocks are performing (Exhibit 40).

This pattern of asset performance may well continue through the fourth quarter. The recovery is expected to manifest itself further in data, but the near-term uncertainty and concerns surrounding tail risks likely mean the growth rebound will not be fully priced into assets. At a minimum, that would require more definitive evidence than upside risks to growth or economic normalization are materializing. Instead, the imprint of extremely easy policy will keep curves flat, in turn influencing the sectoral and style mix of the equity market recovery. Eventually, however, we do expect that the pattern of returns will shift from one that reflects easing financial conditions to one that reflects increasing confidence in growth. This will likely bring with it steeper curves and a rotation in equity market leadership, as well as volatility as investors digest the shift in market drivers. But in our view, this is unlikely to be a factor until we are some way into 2021.

The result is a world where stocks are supported at an index level and credit continues to perform but bond yields remain range-bound. This will make itself felt in correlation patterns across markets and, by extension, in how we construct an optimized portfolio. Correlations across equity markets and credit may well remain somewhat elevated as easy policy supports risk assets generally; this in turn will make diversification a particular focus. At the same time, correlations within equity indices have scope to drift lower as the prevailing economic conditions offer different degrees of support to different sectors and the impact of social
restrictions affects services and goods firms differently. Meanwhile, bonds look set to remain in a narrow range, suggesting that the negative correlation of stocks and bonds may move nearer to zero correlation (Exhibit 41) – presenting a challenge for portfolio construction.

Recent weakening of negative stock-bond correlation has presented a challenge for constructing diversified portfolios

EXHIBIT 41: ROLLING 12-WEEK DAILY CORRELATION, S&P 500 VS. U.S. 10-YEAR FUTURE


For the moment, the setup we’ve described – with easier financial conditions driving market returns – supports a diversified allocation to risk assets. But unlike similar episodes in the last business cycle, we can’t rely on bonds to act as much as a hedge. When we see growth begin to be priced more fully into markets and curves eventually steepen, it may be more appropriate to express a risk-on view through a negative bond allocation. Indeed, this is something our quant models are already picking up. For now, though, we believe that central banks are operating explicitly to contain bond yields, and so we judge that for the rest of 2020 and into early 2021 the risk-reward for being significantly short duration is not compelling.

With negative stock-bond correlation effectively sidelined, what are the balancing items against our pro-risk tilts? Diversification across our risk assets provides some stability in lieu of government bonds, as does the use of duration proxies – such as IG credit – which have less of a carry penalty. But we also need to increasingly consider upside and downside characteristics of the assets in our portfolio.

For instance, under normal circumstances high yield trades with a beta of around 0.3-0.4 to U.S. equities. But during March, as the market sold off, the beta was much higher – as a result, the diversification from high yield ebbed away just when it was needed (Exhibit 42). Now, however, the Fed is offering a backstop to the credit market that we believe translates to high yield credit having a greater likelihood of retaining a modest beta to equities during bouts of market weakness. Indeed, in September that has largely proven to be the case. As a result, we are comfortable using high yield to diversify our equity overweights.

On a cross-asset basis, correlation across returns has abated from extreme levels

EXHIBIT 42: CROSS-ASSET CORRELATION


A final consideration that we think is important in the current environment is the way we use currency within portfolios. In our view, the trend of the U.S. dollar has now shifted, and history suggests that the dollar tends to move in lengthy cycles. The 2010s were characterized by a dollar bull market, but in the latter two years of the decade currency movements, in major crosses at least, were relatively muted. As the regime shifts and the dollar begins a gradual weakening trend, we expect currency movement to become more pronounced. A decline in the dollar not only improves the outlook for international diversification for a U.S. dollar-based investor but also lends support to dollar-sensitive assets and sectors such as emerging markets.

On balance, our portfolios reflect a risk-on tilt, but in their construction we are mindful of the challenges that low yields and near-zero stock-bond correlation present. We address this issue in part through diversification both across and within asset classes; above all, we believe a thorough assessment of how upside and downside characteristics might evolve for various asset classes is essential.
Multi-Asset Solutions Key Insights & “Big Ideas”

In previous editions of our Global Asset Allocation Views, we included a map and table of key global themes. Those themes helped us discuss the economic and market outlook, and shape the asset allocation that Solutions reflected across portfolios. While some of those themes are still in play, we now choose to share the Key Insights and “Big Ideas” discussed in depth at the Strategy Summit. These reflect the collective core views of the portfolio managers and research teams within Multi-Asset Solutions and are 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.

- Expansion gathering pace, but tail risks are elevated in 4Q.
- Fiscal and monetary stimulus persists well into the new cycle.
- Quantitative easing is capping yields, but they will rise as growth picks up.
- The dollar is entering an extended but gradual downtrend.
- Credit default risks more than offset by central bank support.
- We prefer to diversify portfolio risk across equity and credit.
- Equity earnings improving; we favor a broad regional exposure.
- Cyclical sectors lead, but value rotation unlikely until rates rise.

Active allocation views

In normal times, these asset class views apply to a 12 - to 18-month horizon; however, given current volatility and uncertainty, they reflect a horizon of several months but are subject to revision as new information becomes available. We will update this tick chart at minimum monthly during this period of volatility. The dots represent our directional view; up/down arrows indicate a positive (▲) or negative (▼) change in view since the last revision. 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>
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<tr>
<th>Asset class</th>
<th>Opportunity set</th>
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Source: J.P. Morgan Asset Management Multi-Asset Solutions; assessments are made using data and information up to September 2020. 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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