Factor Views

Themes from across the factor investing landscape

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In brief

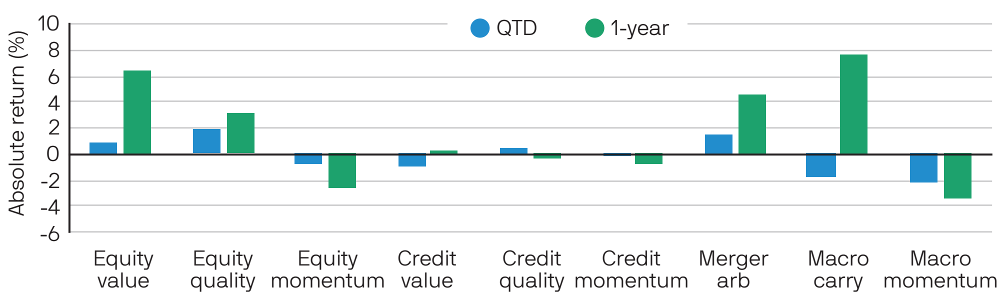
- Factors were little changed to slightly negative in aggregate, in a fourth quarter marked by a shift in economic and market regimes, concluding a year of expectations defied.
- Equity factors rose in aggregate: Value and quality performed well; equity momentum was challenged by an abrupt shift in market leadership from mega caps to small caps.
- Credit factors ended Q4 mixed. Credit quality performed strongly and credit value underperformed.
- The merger arbitrage factor performed well again, boosted by U.S. large and mega cap deals, as regulatory concerns continued to ease. Macro factors were disrupted by the market's regime shift, which challenged currency and momentum factors in particular.
- We maintain our positive outlook for factors overall. Equity factors look well supported: The value factor looks inexpensive globally and the quality factor is attractive in the U.S. Other factors, including merger arbitrage, credit value and macro carry, also appear attractive.

Overview

Global equity and fixed income markets both rallied sharply to close out 2023, fueled by expectations that the Federal Reserve (Fed) could cut interest rates potentially as soon as March 2024. Inflation data showed that the pace of price increases was slowing, and the Fed's mid-December statement was more dovish than anticipated, moving a "higher for longer" policy environment from a fear at the top of investors' mind to a distant concern.

Factors ended Q4 relatively well, as gains in equity factors offset losses in macro momentum

EXHIBIT 1: QUANTITATIVE SOLUTIONS LONG/SHORT FACTOR RETURNS



Source: J.P. Morgan Asset Management; data as of December 31, 2023. Factors presented are long/short. Equity factors are global and represented as 100% long notional exposure and shown on a beta-neutral basis; credit factors are shown on a duration times spread (DTS) neutral basis within U.S. high yield markets; macro factors are an aggregation of 5% volatility subcomponents.

An “everything rally” in Q4 touched nearly all markets except energy commodities. The MSCI ACWI rose by double digits in Q4 and the Bloomberg Global Aggregate Bond Index posted its best quarter in more than 20 years. Investors’ most notable concern by late December was whether asset prices had moved too far too fast.

Given the magnitude of the change in investor sentiment and market conditions, the momentum factor and certain macro factors struggled over Q4. Other equity factors—e.g., value, quality and merger arbitrage—gained. Factors in aggregate were just barely negative for the quarter (**Exhibit 1**), making a 2023 overall a year of modest gains, defying many economists’ and investors’ expectations.

Looking ahead, our base case for 2024 is a soft landing: further moderating inflation and positive economic growth. While that should create a healthy backdrop for traditional stocks and bonds, we also like the considerable potential for relative value opportunities in factor investing. We retain a positive outlook across equity value, equity quality and for macro carry factors more broadly. Factors may be a less crowded and interesting space, particularly for investors looking to add potentially diversifying sources of return.

Factors in focus

Equity factors: A mixed quarter amid a market regime change

The fourth quarter plunge in government bond yields, and shift in sentiment from fear to euphoria, had varied knock-on effects at the factor level, while company fundamentals were little changed. One pattern: A coordinated small cap stock rally in December, particularly for heavily shorted shares. The small cap rally created headwinds for the momentum factor as investors unwound their shorts, seemingly capitulating to the everything rally. Otherwise, as different markets priced in the potential for a new regime, factor performance diverged over the quarter across regions, by market cap and by month.

In the U.S., the value factor performed well on a sector-neutral basis[1] (our favored approach), capping a seven-month run of gains when measured vs. an all-cap universe of stocks and ending 2023 positive (**Exhibit 2**).[2] The U.S. quality factor had a positive Q4 when measured on a beta-neutral basis—i.e., accounting for high quality

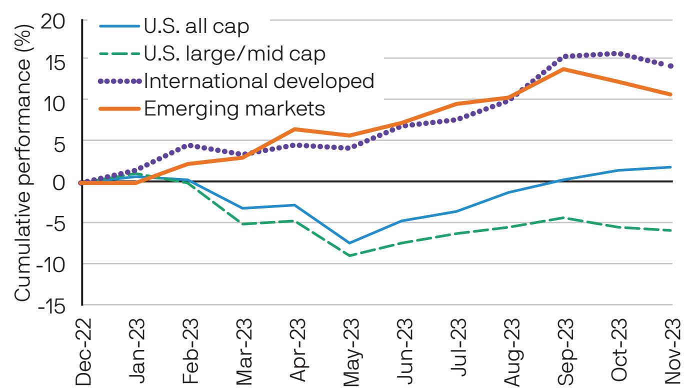
[1] We define and construct equity factors based on an evaluation of stocks relative to their sector peers (e.g., comparing technology companies to other technology companies, and energy companies to other energy companies) and in a manner that seeks to limit any sector biases.

[2] The factor flatlined, however, when only large-to-mid cap names are evaluated, and value finished 2023 negative in the large cap space, as investors favored more expensive growth names—some considered beneficiaries of the recent developments in artificial intelligence.

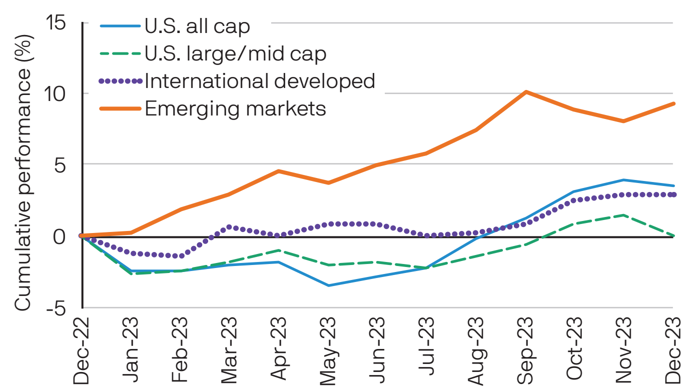
Factor performance diverged across regions and market segments

EXHIBIT 2: CUMULATIVE FACTOR PERFORMANCE BY REGION

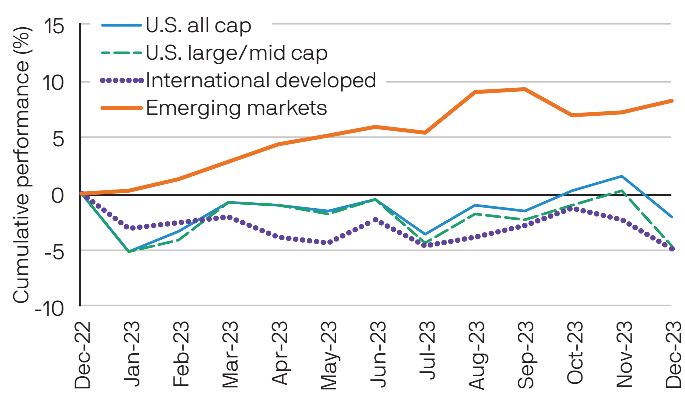
2A: VALUE



2B: QUALITY



2C: MOMENTUM



Source: J.P. Morgan Asset Management; data as of December 31, 2023.

stocks' tendency to exhibit lower betas than low quality stocks—but lagged otherwise, given the extent of December's rally.

The story was different outside the U.S. The value factor paused in Q4 across developed and emerging markets after performing well in those regions earlier in the year. The quality factor, which had also fared well earlier in 2023 outside the U.S., also fell behind on a relative basis outside of the U.S. in Q4, though ended the year positive on a beta-neutral basis.

These differences, by region, and market cap in the U.S., seem to reflect the overbearing influence of mega-caps in 2023 rather than any broader factor narrative—no surprise considering the performance of the Magnificent 7 vs. other stocks during the year.

Given the lack of coordinated factor moves in 2023, we don't read too much into 2023 factor performance as we try to determine what is to come in 2024 and beyond. We lean instead into factor valuations to guide our views and recommended allocations.

From this perspective, we continue to find equity factors attractive, even though they have partially normalized after pandemic-era dislocations. Valuations are, in aggregate, over 1 standard deviation less expensive than their long-term averages. The value factor remains inexpensive across global markets, as does the quality factor, especially among U.S. small cap stocks (**Exhibit 3**).

As we noted last quarter, high quality stocks are also significantly less expensive than they would typically be late in the cycle. Quality stocks tend to outperform during most market regimes, except in the early phase of an earnings growth cycle, which we do not believe is imminent if our soft landing expectations are borne out.

Credit factors: Mixed performance as quality shines at the expense of value

Credit markets ended the year very strongly, supported by lower government bond yields and tighter credit spreads. The U.S. high yield index gained 7.2% over the quarter, with spreads tightening by 73 basis points (bps), to end Q4 at a 12-month low (323bps). Yet credit factors were challenged in aggregate in Q4, as losses in the value and momentum factors offset gains in quality.

The credit value factor gave up 0.92%, suffering its worst quarterly performance in two years, reversing much of the gains of 2023. The move highlighted that value is more than a "risk-on" factor; it also offers diversification potential, relative to credit spreads.

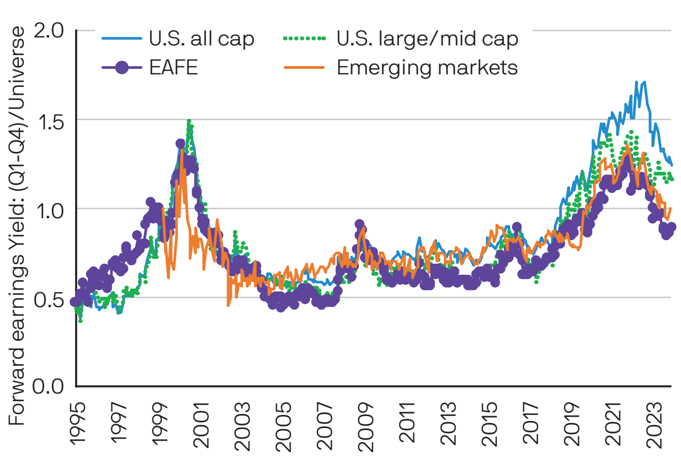
The momentum credit factor was down again, continuing a stretch of underperformance amid a market environment lacking consistent trends (similar to equity markets). The quality factor, though, ended the quarter up 0.56%.

Our outlook for credit factors is positive for value, and neutral for quality and momentum. All three are close to fair value, from a long-term perspective; however,

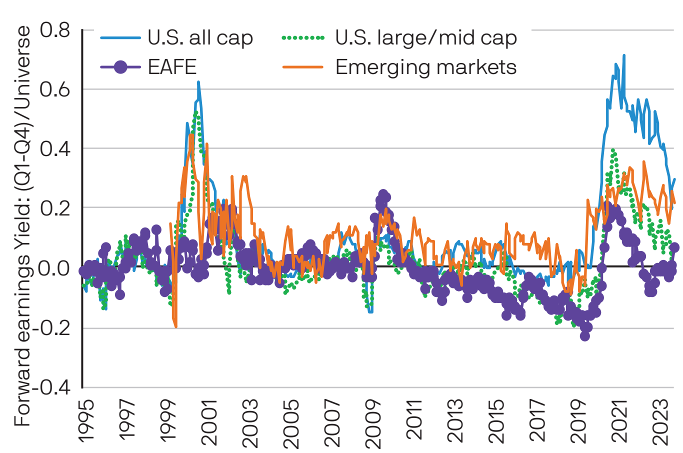
Value and quality generally remain inexpensive across regions

EXHIBIT 3: EQUITY VALUE AND EQUITY QUALITY VALUATION SPREADS

3A: VALUE



3B: QUALITY



Source: J.P. Morgan Asset Management; data as of December 31, 2023.

the credit value factor looks attractive because of dispersion in the valuations of individual credit issuers. These conditions favor relative value approaches. The credit momentum factor is starting to look more attractive as well.

Merger arbitrage: Strong performance supported by regulatory decisions

The merger arbitrage factor had another strong quarter as several large deals closed (e.g., Broadcom's acquisition of VMware and Pfizer Inc.'s of Seagen Inc.), earning the factor the risk premium associated with reasonably wide merger arbitrage spreads. Gains were particularly outsized across U.S. deals and for larger caps. At the larger end of the spectrum, regulatory risk had increased as the Federal Trade Commission took increasingly aggressive actions.

Now that several large deals have closed, it may seem like regulatory concerns have eased. Still, merger arbitrage spreads remain wide enough to compensate for ongoing uncertainty in the macroeconomic and long-term interest rate outlook, which would affect financing conditions. We like the risk-return opportunity.

Merger activity remains low, however, at nearly 1 standard deviation below its long-term average, limiting, to some degree, how much investors can allocate while still remaining diversified across deals (and while minimizing idiosyncratic risk). In addition, the relative proportion of friendly deals, which are more likely to close than hostile deals, has come down. This shift in the mix of friendly vs. hostile deals is one reason spreads remain wide, despite potentially lower regulatory risk. That lingering risk slightly tempers our expectations for the merger arb factor.

Macro factors: A challenging quarter as market regimes shifted abruptly

Both the macro carry and the macro momentum factor were down in Q4, in aggregate, as yields plunged and the U.S. dollar declined.

FX factors fared the worst. The FX carry and the FX momentum factor both struggled as the market regime shifted toward expectations of a soft landing. The FX carry factor gave back in Q4 a portion of gains in an otherwise very strong year. FX carry was dragged down by long U.S. dollar positioning (as the USD went from favored to unfavored) and short Swiss franc positioning (as the currency continued to rally despite its low yield).

A rocky period continued in Q4 for FX momentum. The market's regime shift whipsawed factor positioning (e.g., the sentiment shift moved the U.S. dollar one way while the Swedish krona did the opposite, among other positioning changes).

Cross-asset time-series momentum factors also faced a challenging quarter: Losses were spread across fixed income, commodity and equity market positioning. In fixed income, short government bond positioning hurt investors as yields shifted from generally rising across the globe to falling. In commodity markets, losses due to exposure to soft commodities and industrial metals offset gains elsewhere. Within equity markets, short positioning at the start of Q4 took losses amid the broad global equity market rally.

Despite a challenging fourth quarter, we continue to see potential for strong performance by the carry factor, given generally attractive spread levels. Real yield differentials have shrunk but remain reasonably attractive relative to recent history, as do yield curve spreads. FX carry spreads remain as high as they have been since the 2008 global financial crisis (albeit neutral on a longer-term basis) and commodity carry spreads are around their long-term average. The potential for further regime shifts and market reversals could still challenge the carry factor, which tends to benefit when prices are stable and carry is earned over time.

The outlook for macro momentum is mixed. At this point, markets are well positioned should equity and fixed income continue to rally and the U.S. dollar continue to ease. But the trend is not strongly significant and momentum factors would be susceptible to more market reversals.

Concluding remarks

We continue to see generally attractive prospects for a wide range of factors: equity value, equity quality in the U.S. market and credit value. We also maintain our positive outlook on merger arbitrage and macro carry. While our outlook for traditional asset classes has improved, supported by a likely soft landing, we see a place for factors.

Factors are attractive for investors looking for diversification, to capture opportunities removed from the market consensus, and for those who may harbor concerns that asset classes moved too far too fast in the fourth quarter of 2023.

Factor opportunity set

The table below summarizes our outlook for each of the factors accessed across J.P. Morgan Asset Management. It does not constitute a recommendation, but rather indicates our estimate of the attractiveness of factors in the current market environment.

Our framework for evaluating factor outlooks is centered on the concepts of dispersion, valuation and the opportunity for diversification. For equity factors, we measure dispersion and valuation spreads between top-quartile and bottom-quartile stocks on a market, region and sector-neutral basis. For event-driven factors, we measure implied carry and the level of corporate activity as indicative of the ability to minimize idiosyncratic stock risk. For credit factors, we measure dispersion and valuation spreads between top-quartile and bottom-quartile issuers. For macro factors, we measure the dispersion or spread between top-ranked and bottom-ranked markets, as well as the number of significantly trending markets.

FACTOR VIEWS VS. LAST QUARTER:

▲ Upgrade ▼ Downgrade — No change

Low | Below average | Average | Above average | High

OPPORTUNITY

				Rationale
Equity	Valuation		—	Attractive on valuation, neutral on dispersion
	Quality		—	Attractive on valuation (driven by US markets), neutral on dispersion
	Momentum		—	Neutral on valuation, neutral on dispersion
	Size		—	Neutral on valuations
Credit	Value		—	Neutral on valuation, attractive on dispersion
	Quality		—	Neutral on valuation, neutral on dispersion
	Momentum		—	Neutral on valuation, neutral on dispersion
Event-driven	Merger arb		—	Attractive on deal premia, neutral on % of friendly deals (decrease from last quarter), negative on activity level
Macro	Carry		—	Neutral on FX spreads, positive on fixed income spread, neutral on commodity spread (decrease from last quarter)
	Momentum		—	Negative on FX price dispersion (downgrade from last quarter), positive on commodity price dispersion, neutral on significant price trends

Source: J.P. Morgan Asset Management; data as of December 31, 2023. For illustrative purposes only.

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Glossary

- **Credit value:** Long/short U.S. high yield corporate bonds based on default-adjusted spread and spread to long-term sustainable debt ratio; sector and market neutral
- **Credit quality:** Long/short U.S. high yield corporate bonds based on profitability, coverage ratios and market leverage; sector and market neutral
- **Credit momentum:** Long/short U.S. high yield corporate bonds based on equity and bond price changes; sector and market neutral
- **Equity momentum:** Long/short global developed stocks based on price change and earnings revisions; sector and region neutral
- **Equity value:** Long/short global developed stocks based on book-to-price, earnings yield, dividend yield, cash flow yield; sector and region neutral
- **Equity quality:** Long/short global developed stocks based on financial risk, profitability and earnings quality; sector and region neutral
- **Equity size:** Long/short global developed stocks based on market capitalization; sector and region neutral
- **Merger arb:** Long target company and short acquirer (when offer involves stock component) in announced merger deals across global developed markets
- **Event-driven (other):** Conglomerate discount arbitrage, share repurchases, equity index arbitrage, post-reorganization equities and shareholder activism
- **Macro carry:** FX G10 carry, FX emerging market carry, fixed income term premium, fixed income real yield, commodity carry
- **Macro momentum:** FX cross-sectional momentum, commodity cross-sectional momentum and time-series momentum across equity, fixed income and commodity markets

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