

# The Investment Outlook for 2022

Mid-year outlook: The rocky road to normal



## In brief

- Fiscal drag, a higher dollar and higher interest rates should slow U.S. economic growth and inflation, although widespread pent-up demand still makes a soft landing more likely than near-term recession.
- The U.S. midterm elections are likely to result in divided government, reducing the chances of any further fiscal stimulus.
- While the Federal Reserve is likely to continue to tighten policy throughout 2022 and into 2023, its tone should become less hawkish as both economic momentum and inflation fade.
- Most of the damage to the bond market should be behind us for this cycle, and higher rates and credit spreads are opening up some better fixed income opportunities.
- U.S. equity valuations look more reasonable but are being pressured by higher rates, suggesting a need to focus on those companies best able to sustain margins in a slowing economy.
- The short-term international economic outlook depends on Europe's ability to weather the disruption caused by the war in Ukraine and China's success in suppressing COVID-19 while gradually moving away from lockdowns.
- Attractive valuations, solid earnings performance and prospects for a dollar decline all favor international equities as the impact of COVID-19 and Ukraine hopefully fade in the months ahead.
- Valuations look significantly more attractive than at the start of the year in both global equities and fixed income. However, with long-term prospects still looking mediocre for broad equity and fixed income markets, investors may want to look to some alternatives, ESG strategies and active management to boost portfolio returns.

## The U.S. economic outlook

The first half of 2022 has seen the U.S. economy buffeted by multiple shocks including further pandemic waves, significant fiscal drag and the impacts of both China's "zero-COVID-19" policy and the Russian invasion of Ukraine. In considering how the economic and financial landscape might evolve over the rest of 2022 and beyond, it seems logical to look at these shocks one by one and then consider what they might mean for U.S. economic growth, jobs, inflation, Federal Reserve policy and the dollar.

### Shocks to the economy

The U.S. Omicron wave saw confirmed cases peak at an astounding 800,000+ per day in January, temporarily slowing the economic recovery. Cases then fell to roughly 30,000 per day by mid-March but then rebounded to over 100,000 per day in May. However, the Omicron variant has proven to be less lethal than earlier COVID-19 strains, and vaccines continue to be very effective at preventing serious illness or death. This being the case, after more than two years of the pandemic, most Americans are returning to normal activities, providing a significant boost to aggregate demand in the short run.

Conversely, demand is being reduced by a fast-falling federal deficit. According to the latest Congressional Budget Office estimates, the federal deficit could fall from \$2.8 trillion or 12.4% of GDP in fiscal 2021 to just \$1.0 trillion or 4.2% of GDP in fiscal 2022. This would mark the single largest decline in the budget deficit relative to GDP since 1947 and reflects an end to a host of government benefits, many of which were particularly significant for low- and middle-income consumers. We do not expect any further significant fiscal stimulus from this Congress or the next one and, without this aid, we expect consumer spending, particularly on basic goods and services, to grow more slowly throughout the rest of this year and into 2023.

Inflation has soared over the past year due in part to strong demand and in part to supply chain difficulties due to the disruptive effects of the pandemic. These problems are being extended in 2022 due to the COVID-19 situation in China and Russia's invasion of Ukraine. On the former issue, we expect the Chinese government to maintain a "zero-COVID-19" policy for most of the year. While this may prevent an immediate huge wave of fatalities, it will also result in rolling lockdowns, disrupting both domestic economic activity and exports.

On the latter issue, the brutal Russian invasion of Ukraine has evolved into a protracted conflict in the east of the country. Disruption from the war itself along with sanctions on Russia have resulted in further increases in food and energy prices. However, provided there is no further escalation, global producers and consumers will likely gradually adapt to the situation. High commodity prices will likely play their normal role of promoting more supply and less demand, allowing global commodity prices to generally move sideways or down in the months ahead.

### Lower demand meets constrained supply

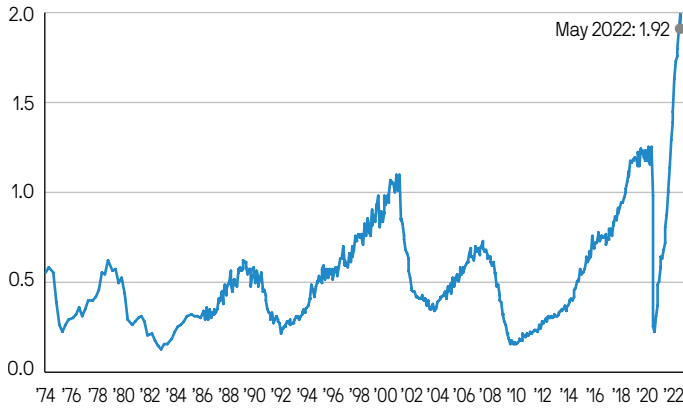
Real GDP fell 1.5% in the first quarter following a 6.9% gain in the fourth quarter of last year. We believe that both the fourth-quarter gain and the first-quarter loss were likely exaggerated, although the Omicron wave added genuine weakness to first-quarter economic activity. Real GDP growth appears to have reaccelerated to a 3%-5% pace in the second quarter. However, we expect growth to drift down in the second half of the year as demand is hit by fiscal drag, a high dollar, higher mortgage rates and lower consumer confidence.

That being said, we do not expect demand to collapse, as there appears to be huge pent-up demand for vehicles, houses and consumer products that have been in short supply over the pandemic. Spending should also be buoyed by pent up demand for travel, leisure and entertainment after the pandemic.

Another source of resilience will be pent-up demand for labor. At the end of April, there were 11.4 million job openings, which amounted to almost twice the number of people counted as unemployed in the May jobs survey conducted two weeks later (see Exhibit 1).

### Exhibit 1: Ratio of job openings to job seekers

JOLTS job openings\* divided by unemployed persons, JOLTS lagged 1 month



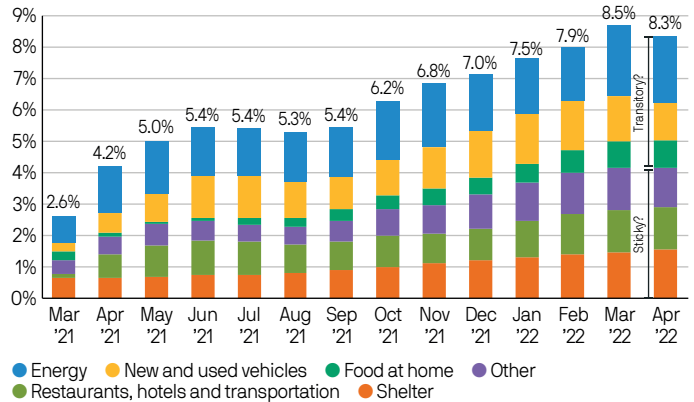
Source: Bureau of Labor Statistics, J.P. Morgan Asset Management.  
\*JOLTS job openings from Feb. 1974 to Nov. 2000 are J.P. Morgan Asset Management estimates. Data are as of June 3, 2022.

Even if low consumer confidence and slowing economic momentum reduce job openings in the months ahead, an excess demand for labor, in the face of very slow growth in labor supply, could cut the unemployment rate to 3.3% in the fourth quarter of this year and 3.1% in the fourth quarter of 2023 from its current rate of 3.6%.

Very low unemployment should also contribute to continued strong wage gains and this, in turn, should feed through to some stickiness in recently very high inflation. We do expect some transitory forces, such as high energy prices partly due to the Ukraine invasion, a chip shortage boosting auto prices and government aid boosting food spending, to wane in the months ahead. However, the effects of higher wage inflation, higher shelter inflation due to the lagged impact of higher home prices and higher inflation expectations should linger (see Exhibit 2). For this reason, we expect that core consumption deflator inflation, currently at 4.9% year-over-year, will only fade to 4.0% by the fourth quarter of 2022 and 3.2% by the fourth quarter of 2023.

### Exhibit 2: Contributors to headline inflation

Contribution to y/y % change in CPI, non seasonally adjusted



Source: BLS, J.P. Morgan Asset Management. Contributions mirror the BLS methodology on Table 7 of the CPI report. Values may not sum to headline CPI figures due to rounding and underlying calculations. "Shelter" includes owners equivalent rent and rent of primary residence. "Other" primarily reflects household furnishings, apparel and medical care services. *Guide to the Markets – U.S.* Data are as of May 31, 2022.

One crucial assumption in our outlook is that the Federal Reserve will be patient in trying to guide inflation back to its 2.0% target. Clearly, a 4.9% year-over-year increase in the core consumption deflator is higher than it would like and it would prefer inflation to come down quickly. However, it will also likely note the very significant braking power being applied to the economy by falling budget deficits, a higher dollar and higher mortgage rates. Because this could threaten recession and because long-term forces should continue to reduce inflation in the years ahead anyway, we expect Fed rhetoric to turn more dovish in the months ahead. That being said, we still expect the Fed to follow its current rough guidance of 0.5% hikes at both its June and July meetings, and 0.25% hikes at the remaining three meetings of 2022, boosting the federal funds rate to a range of 2.50%-2.75% by the end of this year. In 2023, we expect it to further decelerate its pace of tightening, raising rates by 0.25% only in every second meeting, although continuing its gradual reduction of its balance sheet.

Finally, we believe the combined effects of slowing U.S. economic growth and a more dovish Federal Reserve will put some downward pressure on the U.S. dollar, gradually alleviating some of the pressure on U.S. exports but simultaneously boosting the dollar value of the overseas profits of U.S. corporations and the dollar returns on international financial assets.

## How will the midterm elections impact markets?

The midterm elections are less than six months away, and the prospects for Democrats to hold on to their majorities in Congress is slim. The Democrats have a five-seat majority in the House of Representatives and the Senate is split 50/50. In the upcoming midterms, 35 Senate seats are up for election, 21 currently held by Republicans and 14 held by Democrats. All 435 House seats are up for election, and the reapportionment and redistricting processes following the 2020 Census should favor the Republicans. Not only do the Democrats hold only a razor-thin majority in Congress, but also history is not on their side. The president's party has lost House seats in 17 of 19 midterm elections since World War II and Senate seats in 13 of 19, with an average seat loss of 27 seats in the House and three to four seats in the Senate. Additionally, midterms are often a referendum on the current administration, and the president's approval ratings are low. Therefore, divided government seems to be the most likely outcome.

Ultimately, it's policy not politics that has the most impact on the economy and markets. Despite recent renewed discussions on a stripped-down version of Build Back Better, the odds are against seeing significant spending or tax increases passed before the midterms. After the midterms, divided government is likely to drive political gridlock as there are few areas for bipartisan compromise. Recently improved budget numbers suggest that the debt ceiling won't become an issue before 2024, although a standoff leading to a government shutdown is quite possible in the new Congress. However, investors need not panic over divided government, as it is the most common political configuration. Through divided governments since WWII, the economy has grown at a 2.7% pace on average and market returns were 7.9%.

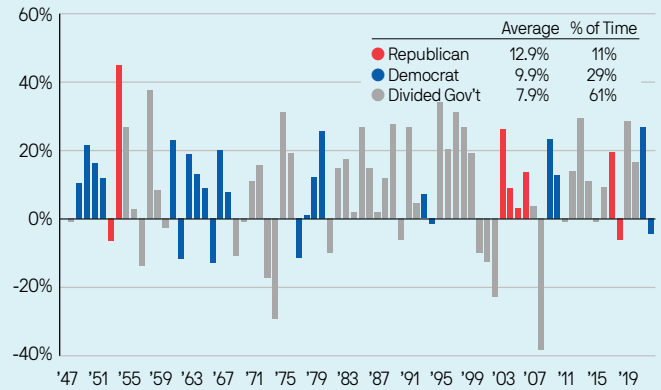
This underscores a critical point for investors: Don't let how you feel about politics overrule how you think about investing. Voters had very strong opinions about the prior two presidents, but average annual stock market returns during the Trump and Obama administrations were nearly identical at 16.0% and 16.3%, respectively, and well above the average over the last 30 years of 10.6%. Investors who allowed their political opinions to get the better of investment logic may have missed out on above-average returns during political administrations they didn't like.

Markets do not like uncertainty, so we typically see higher volatility and lower returns in the lead up to elections. However, election results provide the clarity that allows volatility to settle down and markets to settle up. Since 1942, median equity market returns in the first three quarters of midterm election years were -1%, 2% and 5%, respectively, but fourth-quarter returns jumped to 8%. In summary, history suggests investors shouldn't allow either political preference or political uncertainty to dictate their investment decisions.

### Exhibit 3: Divided government does not hurt the economy or markets.

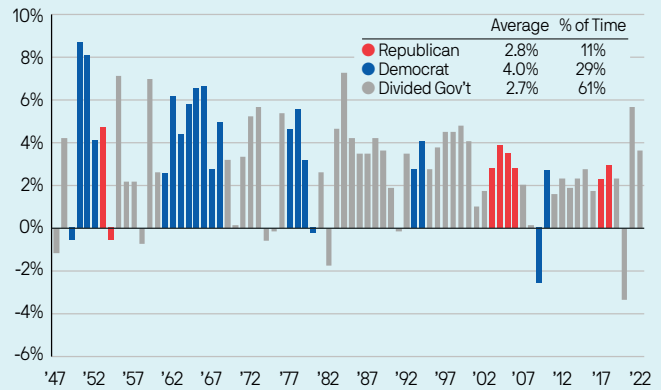
#### S&P 500 Price Index

##### Calendar year returns



#### Real GDP

##### Year-over-year % change, annual



Source: FactSet, Office of the President, J.P. Morgan Asset Management; (Top) Standard & Poor's; (Bottom) Bureau of Economic Analysis. Top chart shows S&P 500 price returns. Returns for 2022 are year-to-date as of March 31, 2022. *Guide to the Markets - U.S.* Data are as of May 31, 2022.

## International economy: Can China normalize, and can Europe avoid a recession?

As the year began, the global economy had solid momentum, with even brighter prospects due to expectations of both a surge in services activity as pandemic restrictions were lifted and a rebuilding of inventories as supply chain stresses slowly improved. An easing of supply chain issues, combined with an easier base of comparison for energy prices, was expected to reduce elevated global inflation levels after the first quarter.

A few things have worked out as expected: global services momentum did pick up meaningfully outside of China as mobility improved, lifting the Markit global services PMI to 54.0 in February. Since then, however, two ominous waves have darkened the horizon, prompting downgrades to economic growth and upgrades to inflation expectations: 1) surging lockdowns in China in response to rising COVID-19 cases, prompting concerns about an economic contraction in China and stress on supply chains, and 2) surging commodity prices largely due to the war in Ukraine, prompting concerns about economic growth and inflation dynamics in Europe. The outlook for the global economy crucially depends on whether China can normalize and Europe can avoid a recession.

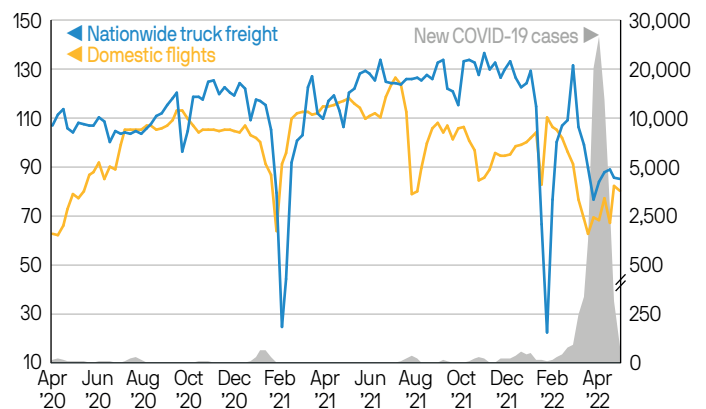
For China, the question is not whether activity is currently contracting (the April Caixin/Markit Composite PMI of 37.2 and high frequency indicators suggest that it is, Exhibit 4), but whether April marked a bottom. The following conditions are needed in order for confidence to build that the nascent improvement in activity in May is sustainable:

1. Implementation of a pandemic strategy that permits a sustainable peak in lockdowns. Shanghai's reopening experience in the weeks ahead will serve as a nationwide test for how China can slowly back away from its "zero-COVID-19" approach. The roadmap involves: 1) ramping up vaccinations, especially of the more vulnerable, 2) setting up large-scale testing and surveillance, 3) implementing "closed loop" work systems in factories and transportation hubs and 4) focusing on community transmission as the metric to ease individual mobility restrictions – very slowly. Should it be successful, China's activity may slowly improve in May and June and normalize in the second half of the year.

2. Laying the groundwork with large-scale policy stimulus. Concerns around leverage and capital outflows constrained policymakers' willingness to ease policy at first. However, April's pop in the unemployment rate to 6.1% (a near-record high) shifted policymakers' actions, including toward real estate lending and broad fiscal spending. Weak credit demand by businesses and households has dampened the full effects of policy easing, so reopening activity sustainably is key.
3. Confirmation the regulatory cycle has moved from introduction to "status quo." China's economy had already decelerated before the rise in COVID-19 cases in March, due to the uncertainty generated by the introduction of new regulations. More predictability around the rules of the road would give companies confidence to invest and hire once again. Regulators' words have shifted to emphasizing "normalized supervision" – but the passage of time with no new announcements is needed.

**Exhibit 4: China's pandemic strategy will determine how sustainable May's improvement in activity is**

Index 2019 = 100, 7-day moving average



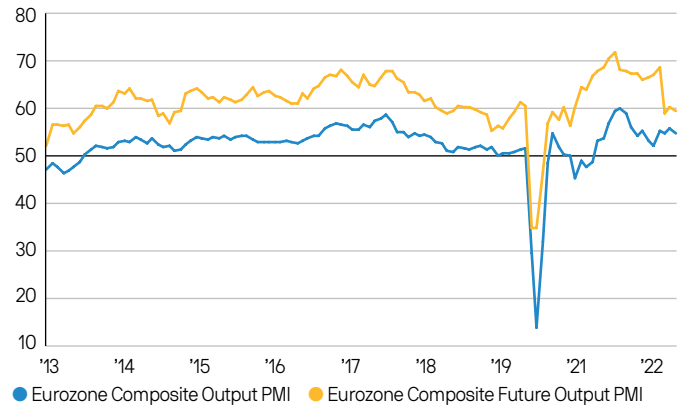
Source: OAG Schedules Analyzer, Our World in Data, Oxford University, Wind, J.P. Morgan Asset Management. Data are as of May 31, 2022.

For Europe, the question is not whether the region is currently eking out positive growth (the May Eurozone Markit Composite PMI of 54.9 is consistent with 2% GDP growth), but whether consumer and business confidence may deteriorate enough to land the region in a recession. Confidence indicators have stumbled since Russia's invasion of Ukraine triggered a surge in energy costs and kinks in supply chains. The Composite PMI future output index saw a steep fall of 9.3 points from

February to May (Exhibit 5), with particular weakness in manufacturing. Thus far, current activity has been supported by solid corporate and household balance sheets, a record low unemployment rate and fiscal transfers from national governments. Should the worst of the energy price pressures soon pass, the region may be able to weather this latest challenge. This depends on whether the European Union is able to transition away from Russian fossil fuels over time (as currently seems to be the case) – or whether it ends up doing so suddenly as a result of sanctions and/or counter sanctions. Should energy prices continue to stabilize, price pressures may be able to peak mid-year, permitting confidence to find a bottom and activity to stay resilient.

Lingering commodity and supply chain issues, combined with strong services spending, implies peak global inflation may not occur until the third quarter. While global central banks have already hiked rates 81 times this year, more tightening is expected in some emerging markets and normalization is expected in EM Asia and Europe (excluding China and Japan). Given the quick repricing of the Fed’s rate hike path at the beginning of the year, the U.S. dollar surged over 5% from February to April. However, global yields have also moved higher, with the share of negative yielding debt falling from 12% of global bonds in March to 4.5% in May. The U.S. dollar’s more recent leg of 2% appreciation seems to be more driven by global growth fears in the U.S., China and Europe. For the U.S. dollar to sustainably peak (and eventually embark on its expected structural downtrend), investors will need to regain confidence that the U.S. can see a soft landing, China can normalize and Europe can indeed avoid a recession.

**Exhibit 5: Eurozone’s current activity remains resilient, but sentiment has taken a tumble**



Source: Markit, J.P. Morgan Asset Management. Data are as of May 31, 2022.

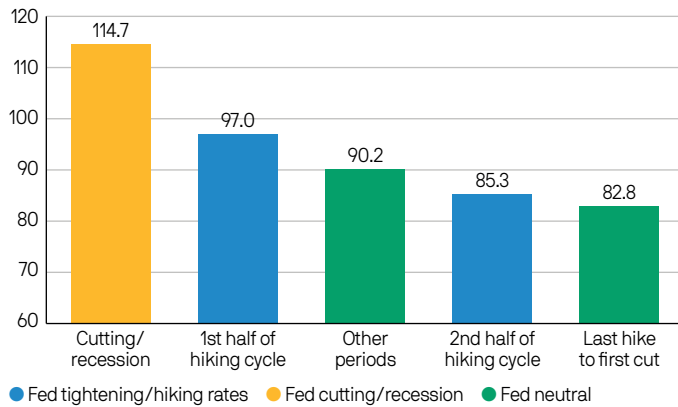
**Fixed income: How are yields and interest rates impacting core fixed income?**

The hawkish pivot from the Fed has sent shock waves through the bond market, and interest rate volatility has spiked higher as a result. Investors are increasingly concerned about the trajectory of monetary policy, and crucially, if the Fed will be patient in raising rates rather than overly aggressive in its efforts to quell inflation at the risk of slowing growth. Still, while policy uncertainty remains elevated, particularly for 2023, the Fed has solidified its hiking path this year, suggesting it will lift the target range for the federal funds rate to 2.50%-2.75% by year’s end.

From a performance standpoint, the first half of this year will be one of the worst on record for core fixed income. That said, most of the pain is likely behind us, assuming that the full repricing of this year’s rate hikes are fully baked into bond yields. Importantly, given the Fed’s transparency, its likely rate volatility will fall in the second half of this year and into next. As we show in Exhibit 6, since 1983, interest rate volatility as measured by the MOVE index has been highest (outside of recessionary periods) in the first half of a rate hiking cycle and comes down meaningfully in the second half. This makes intuitive sense; a decision to remove accommodative policy tends to be jarring for investors, but as a steeper trajectory for rates is priced in, rate volatility settles down.

**Exhibit 6: Outside recession, rate volatility tends to be highest when the Fed first starts hiking**

Average level of the MOVE index in different policy cycles, 1983-present\*

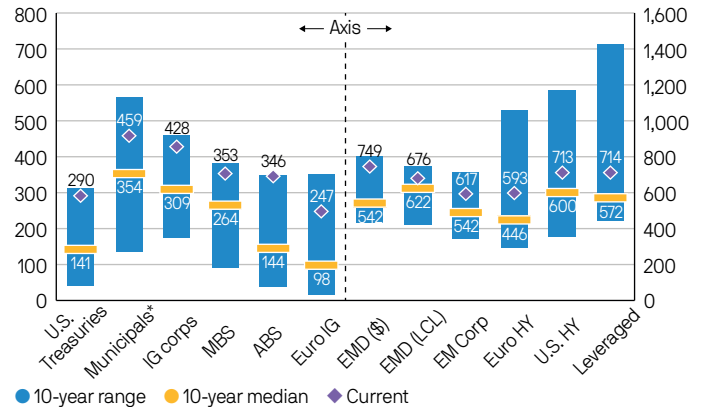


Source: Federal Reserve, Haver Analytics, J.P. Morgan Asset Management. Cutting/recession periods are calculated from the first rate cut to the last rate cut or recession end, whichever occurred last. \*From Jan. 1983 - Apr. 1988 (inception of MOVE index), a regression model is used based on a 30-day standard deviation in daily changes in the U.S. 2-, 5-, 10- and 30-yr. Treasury yield; the r-squared = 70%. Data are as of May 31, 2022.

As interest rate volatility settles down, bond yields should be more well-behaved, and investors should look to take advantage of the dramatic repricing year-to-date. The move higher in rates and credit spreads has led to some of the most attractive yields/valuations seen in recent years. Exhibit 7 shows current yields for major fixed income asset classes relative to the past 10 years. It is evident that core bonds are at their highest yields relative to recent history, and given the very tight relationship between current yields and subsequent performance, bond investors can expect decent returns from these assets over the next few years.

**Exhibit 7: Yield-to-worst across fixed income sectors**

Basis points, past 10 years



Source: Bloomberg, FactSet, J.P. Morgan Credit Research, S&P, J.P. Morgan Asset Management. Indices used are Bloomberg and S&P except for emerging market debt and leveraged loans: EMD (\$): J.P. Morgan EMIGLOBAL Diversified Index; EMD (LCL): J.P. Morgan GBI-EM Global Diversified Index; EM Corp.: J.P. Morgan CEMBI Broad Diversified; Leveraged loans: JPM Leveraged Loan Index; Euro IG: Bloomberg Euro Aggregate Corporate Index; Euro HY: Bloomberg Pan-European High Yield Index; U.S. Treasuries: Bloomberg U.S. Aggregate Treasury Bond Index. All sectors shown are yield-to-worst except for Municipals, which is based on the tax-equivalent yield-to-worst, and Leveraged loans, which is based on Yield to 3Y takeout. *Guide to the Markets – U.S.* Data are as of May 31, 2022.

Even though yields have moved a lot already, we are still biased to higher yields in the back half of this year. We anticipate the nominal U.S. 10-year Treasury yield will end the year between 3.00%-3.25%, suggesting a modest move higher in long rates for a few reasons:

1. The Fed’s balance sheet reduction (quantitative tightening) and possible consideration of outright mortgage-backed security sales sometime next year should put upward pressure on long-term interest rates,
2. While realized inflation should come down for the remainder of the year and next, it may not come down fast enough to satisfy policymakers, increasing the risk of further aggressive policy rate hikes in 2023, and
3. As the Fed lifts short-term rates more aggressively than other developed market central banks, the appetite for long-dated U.S. Treasury debt from foreign investors should weaken given the rise in hedging costs.

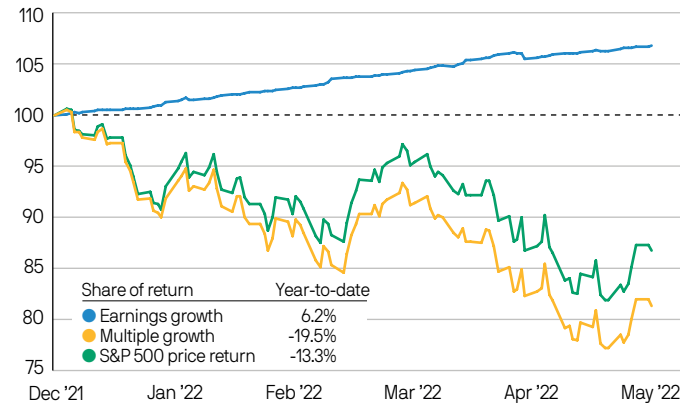
Investors who are outright short duration and have embraced lower-quality credit in portfolios should consider edging back to a more neutral position and increase the quality of bonds they own. Moreover, an active approach to fixed income is critical at this juncture; rates will not move in a straight line and active managers have a broader ocean of bonds in which to fish.

### U.S. equities: The importance of profit growth in a rising rate environment

Markets have been under pressure to start the year as elevated inflation, a more hawkish Federal Reserve, slower growth and geopolitical tensions have all weighed on both valuations and investor sentiment. In fact, the S&P 500's forward P/E ratio has declined 19.1% from a peak of 21.4x in early 2022, and now sits below its 25-year average.

#### Exhibit 8: Equity volatility has been driven by a re-rating in valuations

S&P 500 price return decomposition



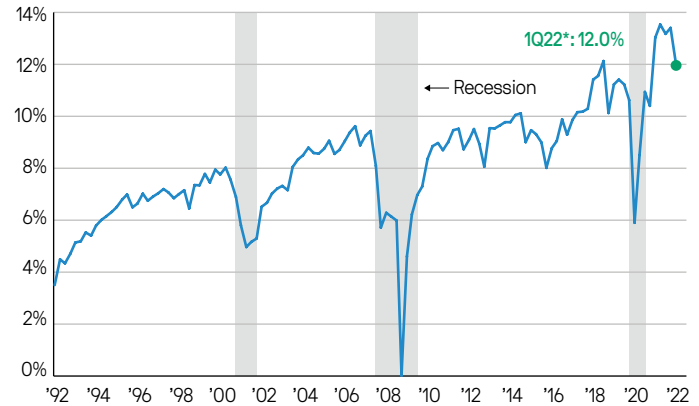
Sources: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Data are as of May 31, 2022.

With the Federal Reserve set to continue normalizing monetary policy over the coming months, equity market volatility will likely persist and valuations will likely remain under pressure, leaving corporate profits as the primary driver of returns. Although 1Q22 earnings were better than expected and consensus earnings estimates have steadily risen so far this year, the outlook for profits rests on the ability of companies to defend margins.

There are three levers that companies can pull to offset margin pressure – reduce costs, pass costs along in the form of higher prices or focus on automation and efficiency. In the current environment, businesses seem inclined to embrace all three; we have heard about hiring freezes and layoffs in sectors like technology, whereas costs are likely to be passed on in the industrial, energy, material and consumer staples sectors. Across the board we expect a greater focus on productivity, which could potentially be supported by some of the investment spending we have observed so far this year. Margins will decline from their 2021 highs, but should stabilize in the mid-12% range barring a more significant downturn in the economy.

#### Exhibit 9: Margins will decline from all-time highs, but seem unlikely to collapse

S&P 500 operating profit margin



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. Past performance is not indicative of future returns. \*1Q22 operating margin is an estimate from Standard & Poor's based on 97.1% of the S&P 500's market cap having reported results. Data are as of May 31, 2022.

From a size and style perspective, we have a preference for large caps but believe there are opportunities across both value and growth. On the value side, greater operating leverage should support earnings and cheaper valuations should be less sensitive to any further rate increases. At the same time, the sell-off so far this year has left valuations in the more profitable parts of the growth complex looking attractive, and we anticipate that investors will rotate back into these names as interest rate volatility subsides and economic growth begins to slow. At the end of the day, we are inclined to focus on those sectors and industries that are able to continue growing profits in



the macroeconomic growth environment we project, while simultaneously being mindful of valuations given elevated inflation and hawkish central banks.

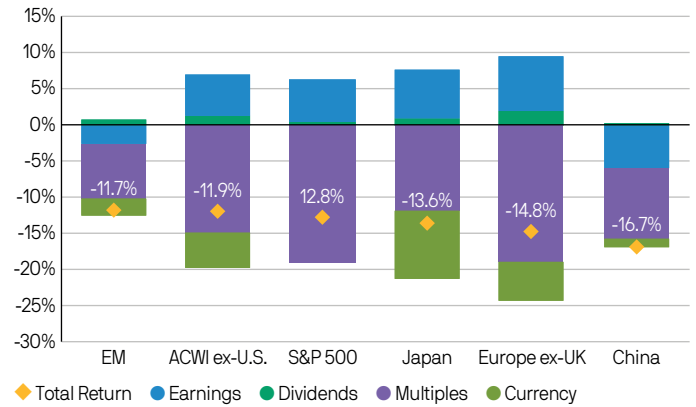
### International equities: Will investors regain confidence in the international earnings outlook?

2022 was expected to be a strong year for international equities, driven by solid (albeit more modest) earnings growth and reasonable valuations that left room for multiple expansion. A depreciation of the U.S. dollar, driven by cheaper currencies elsewhere and building risk appetite, was expected to be the cherry on top for U.S. dollar-based investors. A third of the outlook has played out as expected: international earnings growth thus far has been solid, with more companies than usual beating both top and bottom line expectations. During the first quarter, year-over-year earnings per share grew 35% in Europe (9% excluding energy and materials), 11% in Japan and 17% in emerging markets. For the full year, consensus analyst estimates point to 9% international earnings growth, an upgrade of 4% versus estimates at the start of the year. The exception is in emerging markets, where earnings estimates have moved lower by 3% due to lower expectations in China and Russia.

While earnings have delivered, the two other pieces of the international equity outlook have not: multiples have contracted instead of expanding and the U.S. dollar has strengthened instead of depreciating. These two components have subtracted nearly 20 percentage points from returns (Exhibit 10), more than offsetting the positive contribution from earnings and dividends to sum up to a negative return thus far of -12% (an outperformance versus the U.S. of 110 basis points). Initially, multiple contraction was led by higher global bond yields pressuring longer duration parts of the international equity market, like technology and North Asia. Since April, however, global economic growth fears have intensified due to lockdowns in China and the energy price shock in Europe, leading investors to doubt analysts' earnings forecasts and to price in greater uncertainty via lower multiples.

### Exhibit 10: International earnings have been resilient, but more uncertainty has led to multiple contraction and currency weakness

Year-to-date total returns, U.S. dollars



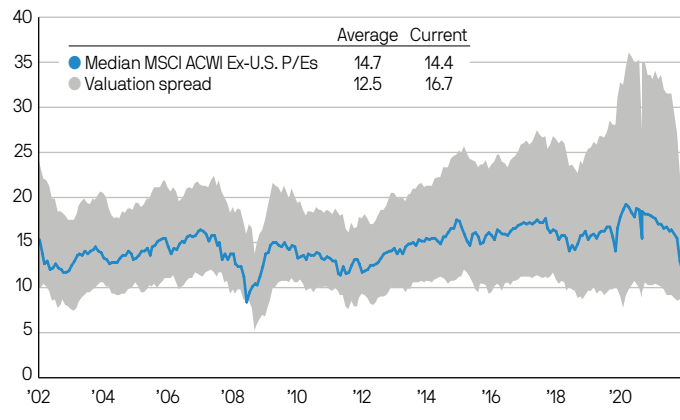
Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. All return values are MSCI Gross Index (official) data. Multiple expansion is based on the forward P/E ratio, and EPS growth outlook is based on NTMA earnings estimates. Chart is for illustrative purposes only. Past performance is not indicative of future results. Data are as of May 31, 2022.

As a result, the valuation discounts of international equities versus their own averages and versus U.S. markets are now even larger than at the start of the year, at -6% and -28%, respectively. Looking forward, this better starting point sets investors up for even stronger international equity returns from here. While risks around the growth outlook are higher, they are also much better reflected in valuations. With that said, a catalyst is needed for investors to feel confident in the “E” of the P/E. Sustainable normalization in activity in China and convincing signs that Europe can avoid a recession will be key catalysts for multiples to find a bottom and eventually expand, especially within cyclical sectors and regions like financials, industrials and Europe.

A more uncertain earnings outlook does highlight the need to focus on quality over quantity when investing overseas in order to avoid tourist traps. With that said, many of the desirable destinations are unchanged – and unlike flights at the moment, are on discount. These include themes like technological innovation, the growth of the emerging market middle class and the global push for decarbonization. These are themes that can be found across regions, such as hard technology companies listed in China, Korea and Taiwan; luxury goods companies listed in Europe that derive the majority of their revenue from emerging consumers; and renewable energy and electric vehicle

companies in Europe and China. While the need to invest internationally is unchanged, the way to do so has become even more important than is normally the case. While some excesses within global equity markets have been corrected since the start of the year, significant valuation dispersion exists beneath the surface (Exhibit 11). While normally a valuation dispersion of 12.5x exists between the 20th and 80th percentile of international stocks, this gap is still unusually wide at 16.7x. This suggests that alpha can provide even more of a supplement to international beta than usual.

**Exhibit 11: Valuation dispersion between the 20th and 80th percentile of MSCI ACWI Ex-U.S. stocks**



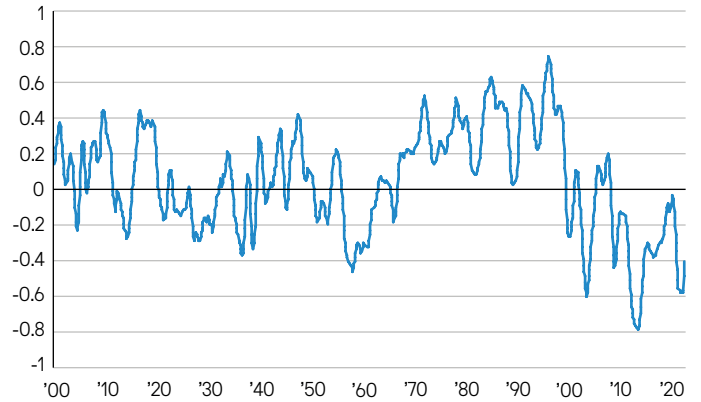
Source: FactSet, J.P. Morgan Asset Management. Average is from May 2002 to May 2022. Data are as of May 31, 2022.

**Alternatives: How are alternatives continuing their transition to an essential portfolio allocation?**

The first quarter of the year saw stocks and bonds sell off in lock-step, as fears of inflation and a hawkish pivot by the Fed sent yields higher and equity valuations lower. Taking a step back, however, interest rates have risen but remain low by historical standards, and the re-rating of equity valuations has only marginally improved the prospect for future equity returns. The reality is that neither the level of rates nor the outlook for equity returns will be sufficient in meeting investors’ needs for income and return. As such, alternatives will continue their transition from an optional portfolio allocation to an essential one.

**Exhibit 12: Stock-bond correlations are unstable over time**

S&P composite, 10-year UST yield, 12-month rolling correlations, 1900 - present



Source: Robert Shiller, Yale University, J.P. Morgan Asset Management. Data are as of May 31, 2022.

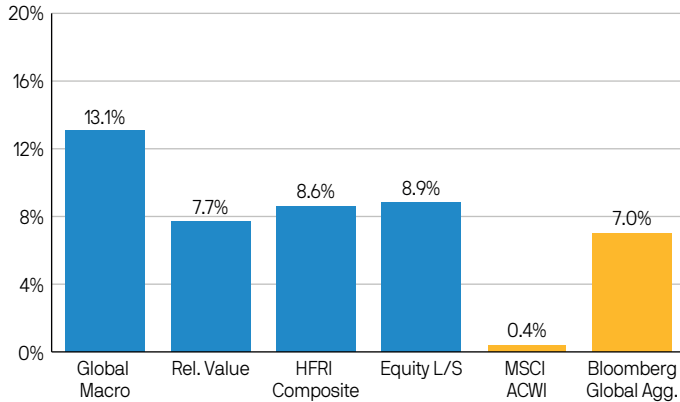
Core real assets are in focus, as real estate, infrastructure, timberland and transportation assets have all historically provided investors with both inflation protection and income. While there are lingering concerns about some parts of the real estate market – particularly the office sector – activity has been resilient. Importantly, when it comes to the real estate market more broadly, tenants are not shying away from higher rents. For clients who cannot or are unwilling to hold illiquid assets in their portfolios, we have seen significant growth in the semiliquid opportunity set and believe that this improving access will continue, thereby democratizing alternatives as an asset class.

Private equity activity has cooled against an uncertain macro backdrop, with general partners focusing less on traditional buyouts and more on add-ons, platform creation and growth equity. Furthermore, we have seen an increasing focus on the middle market, as well as on the old economy sectors that stand to perform well in an environment characterized by a tight labor market and elevated inflation. In private credit, direct lending and mezzanine debt strategies remain attractive. At the same time, we are increasingly seeing investors discuss committing to distressed or special situation funds, as there is an expectation that a backdrop of slower growth and higher interest rates may lead to an expansion of this opportunity set.

Finally, hedge fund performance should continue to improve, especially macro funds and those strategies that are agnostic to the direction of markets. Macro strategies in particular have proven to be a port in the storm given they tend to traffic less in traditional stocks and bonds, while relative value credit and equity long/short strategies have been able to take advantage of lower correlations and elevated return dispersion. In general, our work has shown that environments of greater macroeconomic volatility tend to translate into elevated capital market volatility; in these types of environments, hedge funds tend to outperform traditional long-only equity and fixed income strategies.

**Exhibit 13: Hedge funds tend to outperform in environments of elevated rate volatility**

Hedge fund performance by MOVE quartile



Sources: Bloomberg, FactSet, HFRI, Merrill Lynch, MSCI, J.P. Morgan Asset Management. Data are as of May 31, 2022.

At the end of the day, however, we still believe that alternatives require an outcome-oriented approach. Furthermore, we recognize the ability for manager selection to make or break an allocation to alternatives. As a result, we believe that having a framework for allocating to these assets and strategies is imperative, as traditional portfolio construction methods may not be an optimal approach when constructing portfolios of alternative assets.

**ESG: How do geopolitics highlight the need for more sustainable innovation?**

The crux of sustainable investing is assessing how durable companies are in the long run by identifying risks that traditional company analysis may not capture. The war in Ukraine is first and foremost an immense human tragedy, but it also exposes how seemingly unrelated geopolitical risks and climate challenges intersect, and how companies can innovate to reduce the economic impacts to the consumer. Three key areas of innovation that could address these challenges are renewable energy, agriculture and electrified transport.

Europe’s reliance on fossil fuels from Russia has hindered its ability to swiftly impose energy sanctions. The EU has now reached an agreement to ban Russian oil imports, but it imports 23% of its oil and 38% of its natural gas from Russia, making this a real challenge to achieve. It will require an accelerated transition to renewable energy, but also investment in means to store and transport renewable energy and electrify the grid. These technologies exist, but it will take time and resources to scale up.

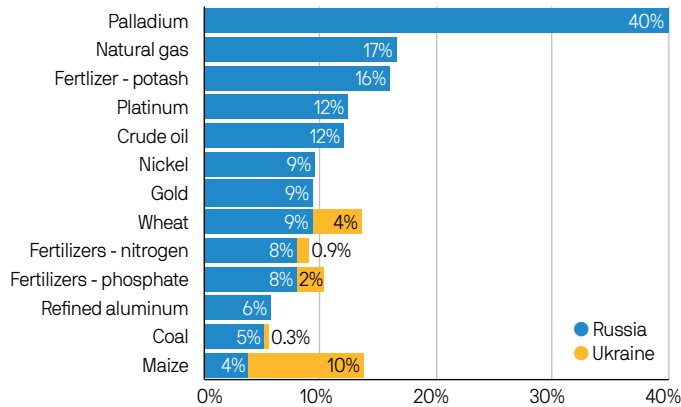
Additionally, Russia and Ukraine together account for a significant portion of the world’s corn, sunflower oil, wheat and fertilizer production. The war has caused significant disruption to global food supply and the UN’s food price index has posted successive record highs. Climate change compounds these disruptions as it contributes to depressed crop yields and extreme weather that can damage food production. However, companies are developing solutions for more efficient agricultural techniques and technologies, better waste and water management, sustainable fertilizers and improved supply chain practices that should strengthen the global food system over time.

Finally, the war has also caused energy prices to soar. WTI oil is up nearly 60% YTD and gas prices in the U.S. have topped \$4 a gallon for the first time since 2008. This has many consumers reconsidering the merits of electric vehicles (EVs). The shift to EVs is still in its infancy, but automakers are expanding their line-ups to include EV options. IHS Markit estimates there will be 130 models available by 2026 from 43 brands globally. Investors should also consider opportunities in the broader EV ecosystem, including batteries, EV chargers and electrification of the energy grid.

The war unfolding in Ukraine is a political crisis, yet it also highlights economic vulnerabilities to many industries and underscores the need to adapt in the face of both geopolitical and climate risks.

**Exhibit 14: Contribution to global production of commodities**

% of global production, latest



Source: Eurostat, FactSet, HSBC, J.P. Morgan Asset Management. *Guide to the Markets - U.S.* Data are as of May 31, 2022.

**Cyclical location and asset allocation: How should investors position through a challenged recovery?**

As investors consider the rest of this year, it is clear that the backdrop for investing has changed from the beginning of 2022. Moreover, much is still uncertain, and investors face a wall of worries.

Cyclical positioning remains the foremost concern, and it should be noted how unusual this cycle has been. However, halfway through the year, the concerns have changed: no longer are investors worried about the length of the runway; instead, they are worried that the runway has disappeared. Still, investors would do well to step back from near-term concerns and focus on the bigger picture.

The impact of the pandemic on the economy continues to fade as the U.S. government shifts policy away from COVID-19 eradication and toward “cohabitation”; a high probability of divided government in the U.S. following mid-year elections suggests that future fiscal stimulus will be limited; and, due to upward wage pressure and ongoing supply chain constraints, higher inflation will likely linger. This economic landscape is impacting corporations, which face weaker demand alongside higher costs and a normalizing Fed. Meanwhile, the re-acceleration in global economic momentum, which once looked promising, is now rolling over very bumpy terrain.

In other words, investing has become more complicated in a short period of time.

The natural next question, then, is: How should investors be positioned?

Despite the changes in the backdrop, there is still room to run for cyclicality and quality in portfolios.

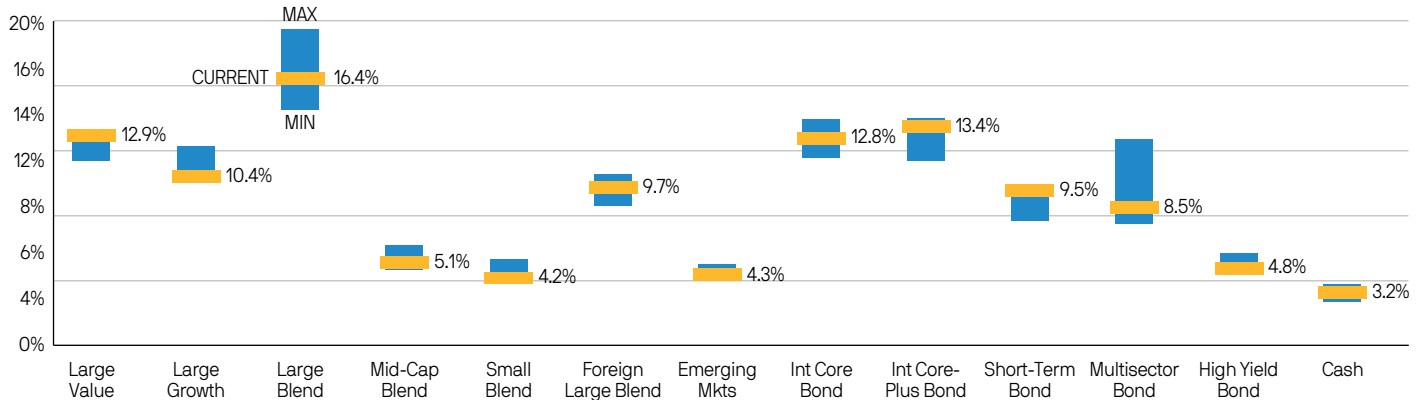
Ongoing U.S. monetary policy tightening has pushed yields sharply higher, resulting in one of the worst years for bond investors in recent memory. However, given the possibility of a Fed “balk” in the face of deteriorating economic data, investors may consider taking a more neutral stance on duration while taking advantage of widening spreads by increasing allocation to lower-quality debt instruments.

From an equity perspective, investors should look primarily toward profitability. This favors an allocation both to quality and to some value sectors. Outside the U.S., cyclically oriented markets like Europe and Japan could benefit from the global recovery, but the war in Ukraine and China’s slowdown have temporarily complicated this outlook. Longer-term opportunities are also worth considering, particularly as valuations have become more attractive, including the emerging Asian world and U.S. technology.

This changing backdrop may also push investors to further diversify portfolios. Correlations have worked in the wrong way so far this year, suggesting the need to consider a heartier allocation to alternatives, which are typically uncorrelated to public markets. Meanwhile, geopolitical tension helps explain the heightened interest in ESG investing, which can mitigate some – though not all – of the risks in markets.

**Exhibit 15: Investor allocations**

Trailing 12-month allocation, April 2022



Source: J.P. Morgan Asset Management. Data are as of May 31, 2022.

Looking at portfolio positioning, this outlook has only partially been implemented. Fixed income allocations to low duration, core bonds and foreign debt are relatively elevated; however, appetite for extended credit is depressed. In equities, allocation to value has moved higher while allocation to growth has fallen, resulting in portfolios that appear to be more value-oriented than in recent history. However, continued interest in passive investing has pushed dollars into funds that may be “value” in name only, with more “growth” than “core” in the broad Russell 1000 Index and more “core” than “value” in the Russell 1000 Value index. Meanwhile, interest in non-U.S. stocks has waned. Put another way, today’s opportunities have not yet been fully embraced.

All told, the investing landscape is challenged. Given the nature of the global recovery and the shifting pockets of opportunity, the best way to approach asset allocation is to broadly diversify and work with active managers.

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# Index Definitions

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not include fees or expenses.

The **Composite PMI future output index** is a gauge of economic growth and can provide valuable insights into GDP, service sector growth and industrial production trends well ahead of official data.

The **Bloomberg Euro Aggregate Corporate Index** is a benchmark that measures the corporate component of the Euro Aggregate Index. It includes investment grade, euro-denominated, fixed-rate securities.

The **Bloomberg Pan-European High Yield Index** measures the market of non-investment grade, fixed-rate corporate bonds denominated in the following currencies: euro, pounds sterling, Danish krone, Norwegian krone, Swedish krona, and Swiss franc. Inclusion is based on the currency of issue, and not the domicile of the issuer. The index excludes emerging market debt.

The **Bloomberg U.S. Aggregate Treasury Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar denominated, fixed-rate taxable bond market. This includes Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities and collateralized mortgage-backed securities.

The **ICE BofA MOVE Index** tracks fixed income market volatility.

The **J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI Broad Diversified)** is an expansion of the J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI). The CEMBI is a market capitalization weighted index consisting of U.S. dollar denominated emerging market corporate bonds.

The **J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified)** tracks total returns for U.S. dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds. The index limits the exposure of some of the larger countries.

The **J.P. Morgan GBI EM Global Diversified** tracks the performance of local currency debt issued by emerging market governments, whose debt is accessible by most of the international investor base.

The **J.P. Morgan Leveraged Loan Index** is designed to mirror the investable universe of U.S. leveraged loans.

The **MSCI ACWI (All Country World Index)** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

The **MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The **MSCI Europe Index** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe.

The **MSCI Pacific Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the Pacific region.

The **MSCI World with USA Gross Index** measures the performance of the large and mid-cap segments across 23 Developed Markets (DM) countries. With 1,540 constituents, the index covers approximately 85% of the global investable equity opportunity set.

The **Russell 1000 Index**<sup>®</sup> measures the performance of the 1,000 largest companies in the Russell 3000.

The **Russell 1000 Value Index**<sup>®</sup> measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The **S&P 500 Index** is widely regarded as the best single gauge of the U.S. equities market. The index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. The **S&P 500 Index** focuses on the large-cap segment of the market; however, since it includes a significant portion of the total value of the market, it also represents the market.

The **U.S. Treasury Index** is a component of the U.S. Government index.

## J.P. Morgan Asset Management

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