# Mid-Year Investment Outlook 2022

## Assessing recession risk


### Authors

**Karen Ward**
Chief Market Strategist for EMEA

**Paola Toschi**
Global Market Strategist

**Mike Bell**
Global Market Strategist

**Tilmann Galler**
Global Market Strategist

**Vincent Juvyns**
Global Market Strategist

**Hugh Gimber**
Global Market Strategist

**Ambrose Crofton**
Global Market Strategist

**Max McKechnie**
Global Market Strategist



### In brief

- Our central scenario is that we avoid a severe global downturn thanks in large part to fiscal support, and a more gradual pace of tightening by the central banks in the second half of the year. With major markets having already experienced double-digit declines, significant further downside for risk assets is not our base case.
- In line with this central macro scenario, corporate earnings across developed markets should grow modestly in 2022, albeit by much less than current expectations, and margin resilience will be key to share price performance.
- After a difficult start to the year the risks to government bond prices are now more evenly balanced and bonds can now offer some portfolio diversification in the more extreme negative scenarios.
- Value's outperformance of growth may continue if economic activity proves resilient to higher commodity prices and interest rates.
- Until inflation subsides investors will remain concerned about stagflation. Alternatives such as core infrastructure and real estate, and stocks that offer resilient high dividends, are relatively attractive in this challenging backdrop.


J.P.Morgan
ASSET MANAGEMENT

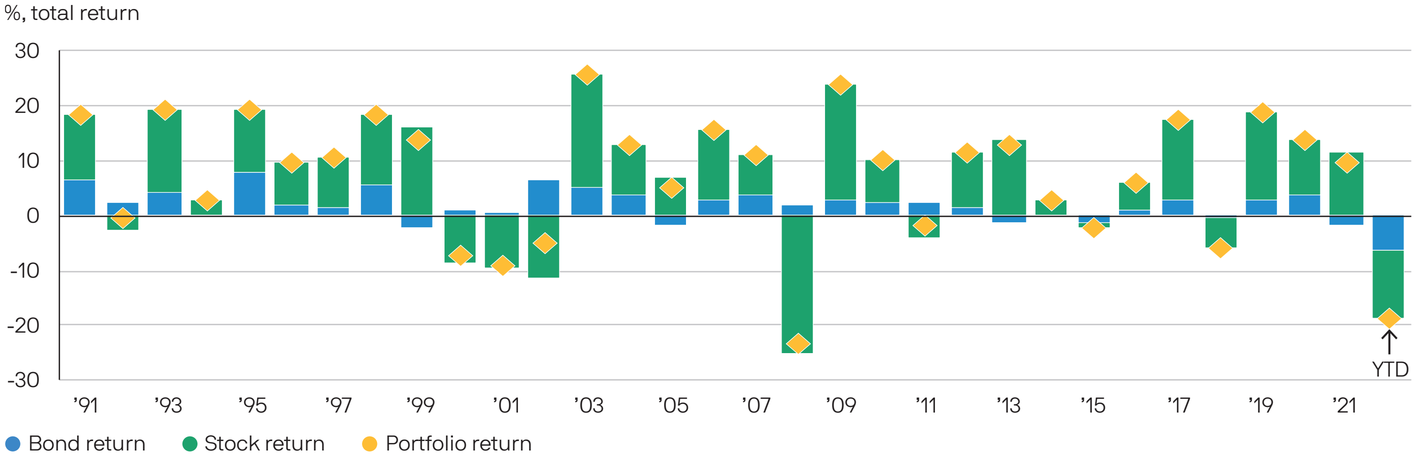
## Not as dire as headlines suggest

The economic outlook has deteriorated markedly since the start of the year. Lingering inflation concerns have been compounded by the spike in commodity prices following the tragic war in Ukraine and the supply chain problems arising from Covid lockdowns in China.

With inflation as the root cause of the problem, investors have found themselves in the worst of all worlds, with the price of bonds and stocks falling (**Exhibit 1**).

**Exhibit 1: 60:40 portfolios on track for their worst year since the financial crisis**

**Annual returns in a 60/40 stock-bond portfolio**




Source: Bloomberg Barclays, MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Stock returns are calculated using MSCI All-Country World Index and bond returns using Bloomberg Barclays Global Aggregate. All returns shown are in USD. Data as of 14 June 2022.

Given the declines already seen this year, the question we seek to answer in this mid-year outlook is not whether the outlook darkened but rather, will it be much worse than the market already expects? Put another way, will there be a recession and if so will it be short and shallow – normally associated with around 10% earnings declines and a 20%-25% price correction – or deep and prolonged, with much larger earnings and price falls?

A further escalation of the Russia-Ukraine war will remain a key tail risk. A negotiated solution to the conflict looks increasingly unlikely. While Europe's ban on importing Russian seaborne oil could force a rethink in Moscow, Putin might retaliate by restricting gas supply to Europe. If that happens it would have grave economic consequences for Europe. Yet even absent further escalation, elevated gas prices suggest European households face more expensive utility bills next winter.

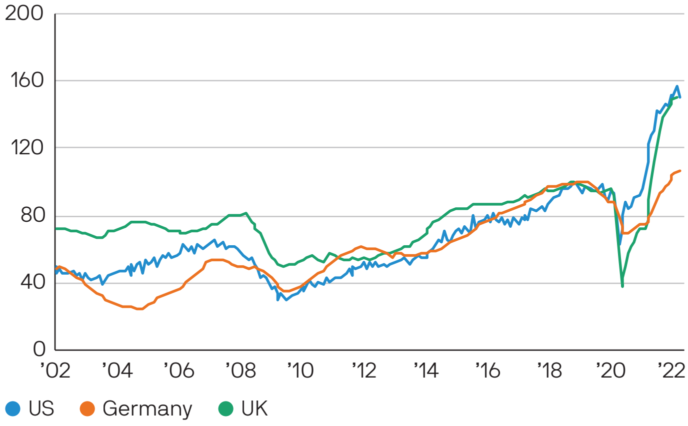
The impact on consumer demand depends on how much finance ministers are willing to support household incomes. This looks challenging for President Biden who faces significant opposition from within his party for further spending. An absence of support could further increase the risk that Biden loses control of both houses at the US midterms in November, which would reduce his ability to enact further legislation in the remainder of his term. The UK has recently announced significant further government support, particularly for the lower end of the income distribution, to help with the squeeze from higher energy bills. Various support measures have also been announced in Europe. The key question is whether the currently announced and any potential further support measures will prove to be enough.

While the "cost of living crisis" and weak consumer confidence have dominated newspaper headlines, the story is not so one-sided. Households accumulated significant savings in the pandemic which have at least provided a buffer in recent months. Perhaps more importantly, the labour market is very strong. There are more job vacancies in the US and the UK (**Exhibit 2**) than unemployed people. Workers are managing to achieve higher pay (**Exhibit 3**), which has reduced the squeeze on household incomes.

Exhibit 2: There are currently more job vacancies than unemployed people in several countries

Job vacancies

Indexed to 100 at pre-pandemic peak




Source: BLS, Deutsche Bundesbank, ONS, Refinitiv Datastream, J.P. Morgan Asset Management. UK vacancy data is a three-month average as published. Data as of 31 May 2022.

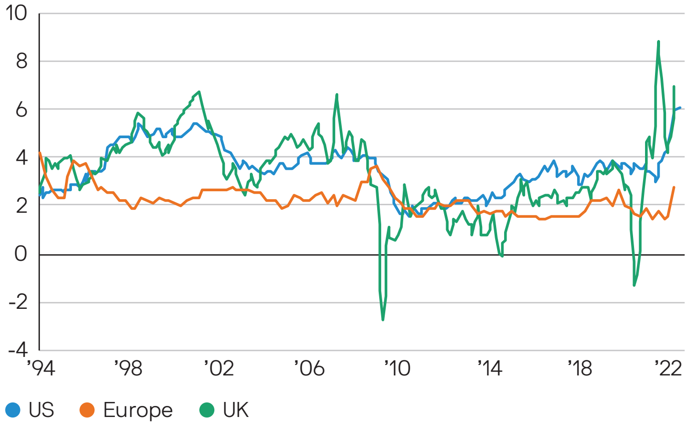
Rapid pay growth is a double-edged sword, however. While it supports household incomes in the face of rising costs, it also signifies an economy that needs to cool to avoid inflation becoming entrenched.

The risk is that the economy slows too much, and rather than just a cooling in activity, we see a more meaningful and long-lasting recession. However, we take some comfort from the fact that we do not see the signs of economic excess in housing construction or business investment that have in the past led to multi-year deep recessions (**Exhibit 4**). In addition, the commercial banks are in a strong position to weather any period of economic weakness having improved their balance sheets markedly since the financial crisis. This makes the prospect of a vicious, credit crunch-induced recession less likely. Gross debt levels are high among corporates, but they are awash with cash and show little sign of having overextended themselves. Consumer debt metrics also look healthy.

Exhibit 3: Wage growth could help consumers manage rising costs

Wage growth

% change year on year

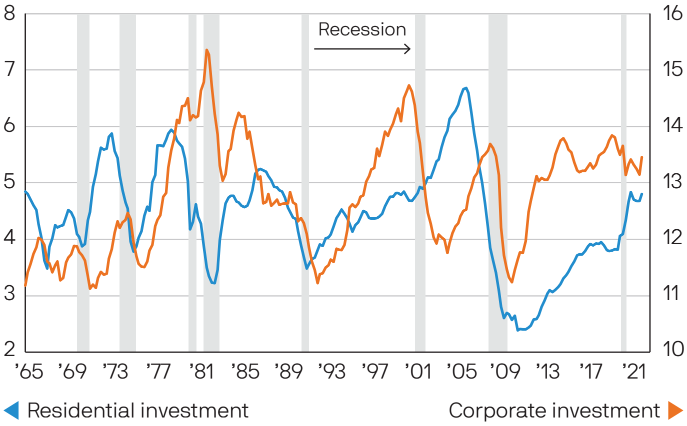



Source: BLS, ECB, Federal Reserve Bank of Atlanta, ONS, Refinitiv Datastream, J.P. Morgan Asset Management. US wage growth is average hourly earnings until 2007 and thereafter it is the Atlanta Fed wage tracker. Eurozone wage growth is based on negotiated wages. UK wage growth is a three-month moving average of average weekly earnings. Data as of 31 May 2022.

Exhibit 4: We haven't seen excesses in construction or investment that have preceded deep and prolonged recessions

US residential & corporate investment

% of nominal GDP




Source: BEA, Refinitiv Datastream, J.P. Morgan Asset Management. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates. Data as of 31 May 2022.

On a less optimistic note, while the West appears to have moved sustainably towards "living with Covid", China is having a more difficult time coping with the more highly transmissible Omicron variant. With a lower level of infection-induced immunity, lower vaccine take-up among the elderly and questions over the efficacy of the domestic vaccines, some form of activity restrictions looks likely for some weeks. Given that China accounts for between a third and a half of all global growth, these restrictions have wider economic consequences. Markets may start to look through the weakness though if it becomes clear that policymakers have a medical solution and stimulus plan to restore activity.

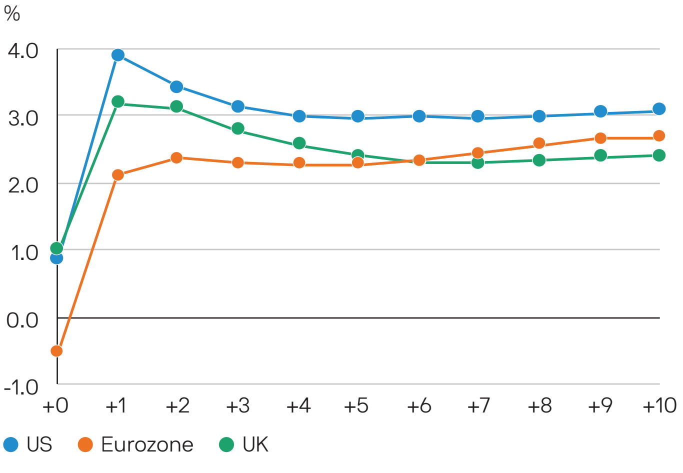
## The central banks are less of a market friend, but still not a foe

The behaviour of the central banks presents another risk to global growth. Investors have become increasingly fearful that central banks have "decided" to engineer a nasty recession to drive out inflation, as we saw in the 1970s.

The Federal Reserve (Fed) has openly discussed this unpalatable possibility, and hawkish rhetoric has encouraged a dramatic repricing of short-term interest rates. **Exhibit 5** shows that the market expects the Fed and Bank of England (BoE) to engineer a slowdown – tightening so quickly this year that within a couple of years they are expected to be cutting rates again.

Exhibit 5: Markets are pricing a sharp rise in interest rates

Market expectations for central bank policy rates




Source: Bloomberg, J.P. Morgan Asset Management. Expectations are calculated using OIS forwards. Data as of 15 June 2022.

However, if the post-pandemic surge in demand fades and higher prices start to deter new spending, inflation and the labour market should cool in the coming months. This could allow for a more gradualist and data-dependent Fed.

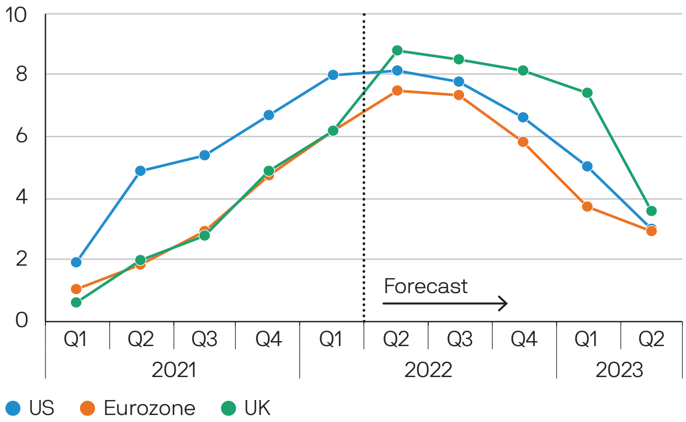
Other developed world central banks are in a slightly different position. There are fewer obvious signs of overheating in the eurozone, allowing the European Central Bank (ECB) to tighten policy more gradually. It seems increasingly likely that Europe can finally get out of negative interest rates. Exactly how far it can get in its hiking cycle is unclear, but it is worth keeping an eye on given the impact Europe's negative interest rates have had on bond yields globally.

The BoE is arguably in the most difficult position. Headline inflation is set to rise further towards 10% and will remain elevated for some time (**Exhibit 6**). If growth is resilient, then the BoE still has some way to go to get to an appropriate monetary policy. It should be noted though that interest rates are already expected to reach about 3.5%, meaning a good deal of tightening is already priced into gilts.

Exhibit 6: Inflation is expected to peak in the second or third quarter of 2022

Median of economists' forecasts for headline CPI

% change year on year, quarterly average




Source: Bloomberg, BLS, Eurostat, ONS, J.P. Morgan Asset Management. CPI is consumer price index. Data as of 9 June 2022.

Signs of cooling economic activity could allow for a more gradualist approach from the central banks. This should limit the downside risk for assets and re-establish the negative correlation between stocks and bonds that had previously proved so helpful to investors trying to construct a balanced portfolio.

## A degree of humility in economic forecasting, a degree of balance in portfolios

Our central scenario is that fiscal support and more gradual central banks help us avoid a severe global downturn. With major markets having already experienced double-digit declines, our central scenario does not point to significant further downside for risk assets.

But this is a time for forecasters to be humble in their convictions. Forecasting economies and markets is never easy. Understanding the post-pandemic economy and unprecedented policy response further complicates the forecasting process. On top of this, our projections depend on the judgments and decisions of a handful of key individuals: Whether the prospect of a long and costly war causes a strategic rethink in Moscow or whether Putin retaliates to the embargo on Russian oil; whether the central banks and politicians do prioritise growth over inflation; and whether President Xi abandons China's zero-Covid policy.

These many variables demand a degree of humility when forecasting the economic outlook. As investors, this translates into a need for balance in portfolios. That's why we think a more neutral allocation to risk assets and government bonds currently makes sense. And the final section of this mid-year outlook – scenarios and risks – requires more attention than usual.

## Earnings outlook: Margins matter most

The sharp year-to-date sell-off in equities has been led by declining valuations rather than a shift in earnings expectations. Multiples on developed market stocks have slipped from close to 20x 12-month forward earnings at the start of the year, to around 15x at the end of May. Over the same period, earnings growth expectations for 2022 have actually been upgraded, from 7% to more than 10%, despite the deterioration in the economic outlook. We look to address the risk that earnings growth disappointment could drive another leg lower in stocks.

History shows that temporary disconnects between economic growth and earnings growth are not uncommon. Earnings growth continued to accelerate as the economy slowed in the recoveries that followed both the dot-com bust and the 2008-2009 global financial crisis, although this trend only persisted for a matter of months.

A closer look at sector-level data helps explain some of the resilience in earnings expectations. Surging energy prices have boosted 2022 earnings growth expectations for the developed market energy sector by more than 60 percentage points; basic materials companies have also benefited significantly from rising commodity prices. Conversely, earnings forecasts for consumer-facing companies have fallen due to growing fears around a squeeze on disposable incomes.

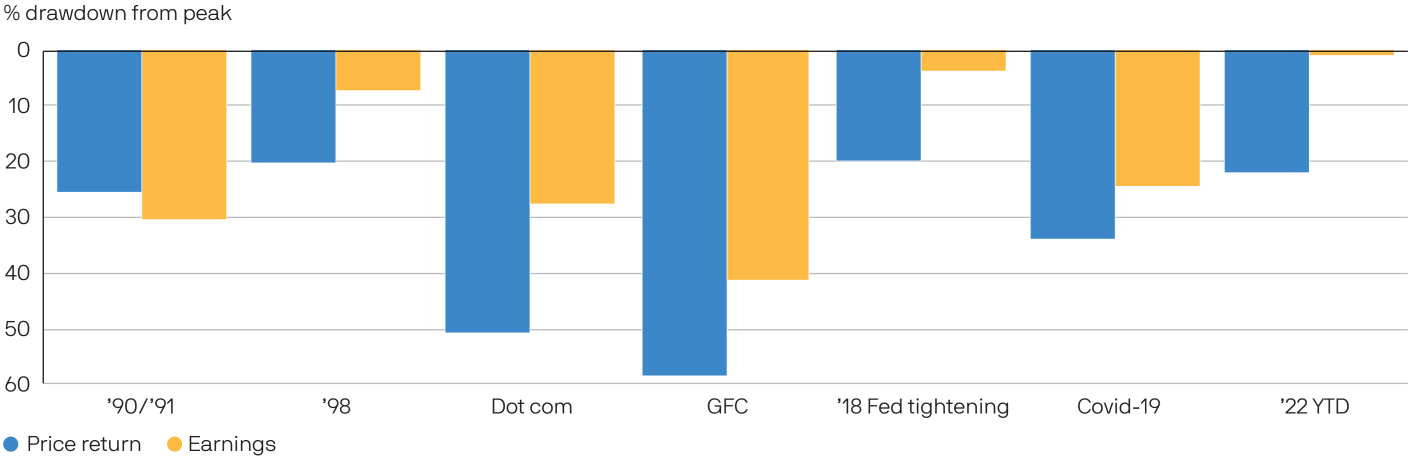
Sector composition has unsurprisingly had a major impact on regional earnings estimates. The commodity-heavy UK market is a prime example where, despite earnings downgrades for every other sector, overall earnings expectations have rocketed, thanks to the significant weighting of energy and materials. While continued support for energy prices appears likely given the protracted nature of the Russia-Ukraine war, we are cognisant that a resolution could trigger a sharp rotation in sector-level earnings expectations.

Some signs indicate that earnings expectations may be approaching a peak. Earnings revision ratios – a measure of the number of analyst upgrades versus downgrades – tend to give a good steer on the direction of earnings ahead. These ratios have been declining since last summer, implying a larger number of downgrades than upgrades. It is perhaps unsurprising that analyst estimates are taking some time to catch up. Forecasters generally like to extrapolate linear growth, yet the past two years have seen a huge "pulling forward" of future demand in some sectors, and a sharp slump in other areas. The rotation away from pandemic trends was clear in Q1 earnings, with several of the "Covid-19 winners" now reporting weakening demand as consumers shift back towards their old ways.

It is important to recognise that stock prices tend to lead earnings, rather than the other way round. **Exhibit 7** compares historical drawdowns in the market and earnings. The decline in developed market stocks year-to-date now looks broadly in line with the size of the drawdowns experienced during previous non-recessionary economic slowdowns, despite the fact that earnings downgrades are yet to feed through.

**Exhibit 7: The stock market has moved ahead of earnings expectations**

**MSCI World earnings and market drawdowns in prior downturns**




Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Chart shows the drawdown in 12-month trailing earnings and price returns in US dollars for MSCI World. Earnings and markets may not bottom on the same date. Data as of 14 June 2022.

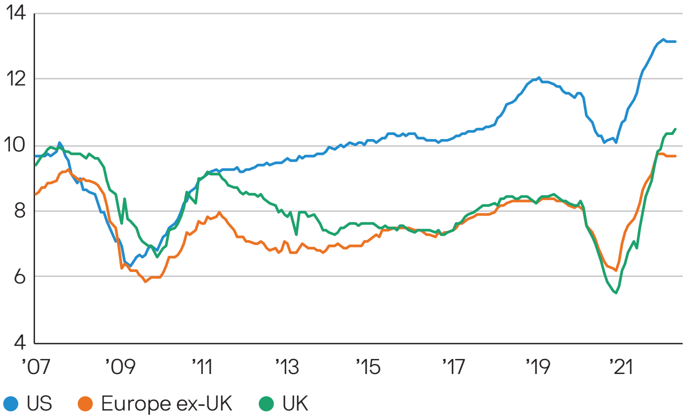
Much larger drawdowns have generally coincided with deeper and more sustained economic downturns. The key question looking ahead, therefore, echoes the theme raised in our opening section. We know that earnings downgrades are likely, but how bad might they be?

The resilience of corporate margins will hold a large part of the answer. **Exhibit 8** shows the elevated starting point for margins in both the US and Europe, as companies passed on higher costs to their customers during the post-Covid surge in input costs. Supply-chain bottlenecks and tight labour markets were already set to put further pressure on corporate costs coming into 2022, but Russia's invasion of Ukraine has added an energy shock to the mix. Pricing power will be a key determinant of relative performance going forward; strong pricing power may come from higher levels of operating leverage (which implies a larger proportion of fixed versus variable costs), strong brand recognition that helps make demand less price sensitive, or potentially a lack of competition within a sector.

Exhibit 8: Corporate margins in the US and Europe have remained strong

Profit margins

%, margins of 12-month trailing earnings relative to sales




Source: FTSE, MSCI, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. US: S&P 500, Europe ex-UK: MSCI Europe ex-UK, UK: FTSE All-Share. Data as of 31 May 2022.

We expect margin resilience to vary both across regions and industries. The risk of earnings disappointment this year looks larger in the eurozone than in the US, in part due to the greater presence of resource and raw material-intensive sectors in eurozone indices. The earnings risk would be particularly acute in the event of energy supply disruption, although further downward pressure on the euro would offset this somewhat. In the UK, large-cap indices are seeing a boost from higher energy prices at a time where more domestically focused stocks are under pressure from a squeeze on disposable incomes. On the consumer front more broadly, companies that are exposed to higher income cohorts may fare better than those that are more sensitive to spending from lower income groups, where higher food and energy prices will absorb a much larger share of total spending.

In sum, while earnings expectations always take some time to reflect the evolution of the economy, the lag is perhaps more understandable this year given the unique circumstances of this recovery. We do expect analyst downgrades ahead, but market moves are already consistent with a modest slowdown in profits. Provided our central macro scenario plays out, corporate earnings across developed markets should keep growing in 2022, albeit by less than current expectations. We will be keeping a close eye on margins for signs that pricing power is being eroded.

## Government bonds: Getting back to benchmark

Government bond yields have moved significantly higher over the last couple of years. So is now the time to consider moving closer to neutral on duration? We believe it probably is.

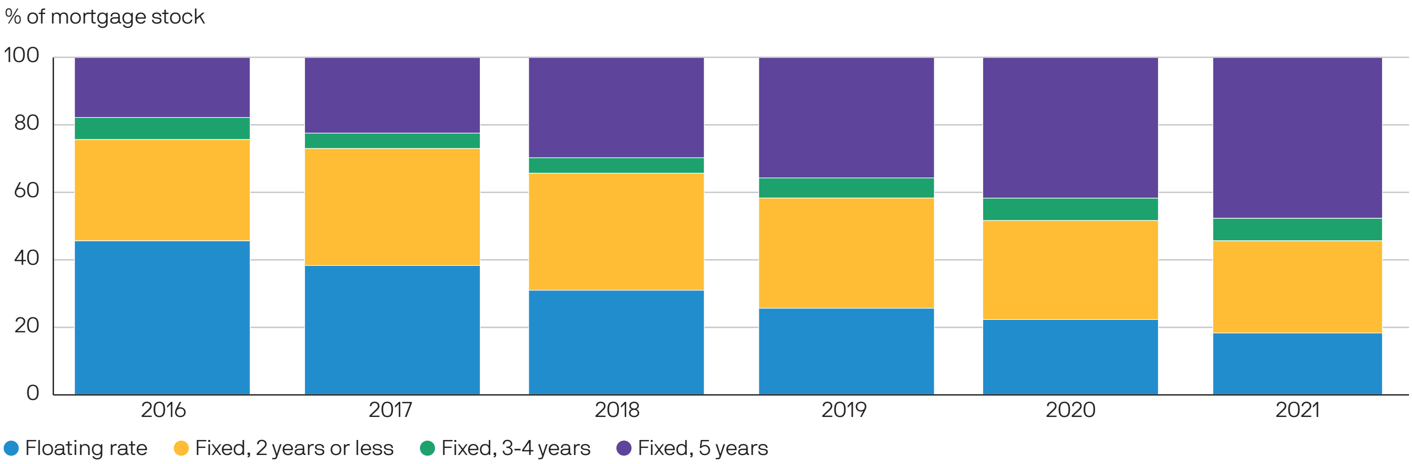
The bond market is already pricing in significant further tightening in monetary policy by major central banks. The Fed and the BoE are expected to lift rates to around 3.5% and 3%, respectively, by year end, while markets are pricing the European Central Bank's policy rate to be approaching 2.5% by the end of next year.

The scope for interest rates to rise beyond these levels rests largely on the ability of households to withstand higher mortgage rates. In the US, 95% of mortgages are now fixed and about 80% are fixed for 30 years, with the other 15% fixed for at least 15 years. So as interest rates rise, the vast majority of homeowners in America won't even notice. This is in contrast to 2007, when about 20% of US mortgages were adjustable rate.

In the UK, there has also been a shift towards fixed-rate mortgages (**Exhibit 9**). In 2007, 50% of UK mortgages were trackers, whereas today that's down to about 20%. However, the period for which UK households are fixed is much shorter than in the US. About half of all UK mortgages are either on a tracker or 2-year fixed rate. Therefore, within a couple of years, any increases in interest rates from the BoE will have fed through to about half of all UK mortgage holders. So for those who don't plan on moving home, UK households are more exposed to rising rates than those in the US.

Exhibit 9: Mortgages in the UK are shifting from floating rate to fixed rate

UK mortgages




Source: Bank of England, J.P. Morgan Asset Management. Data as of 31 March 2022.

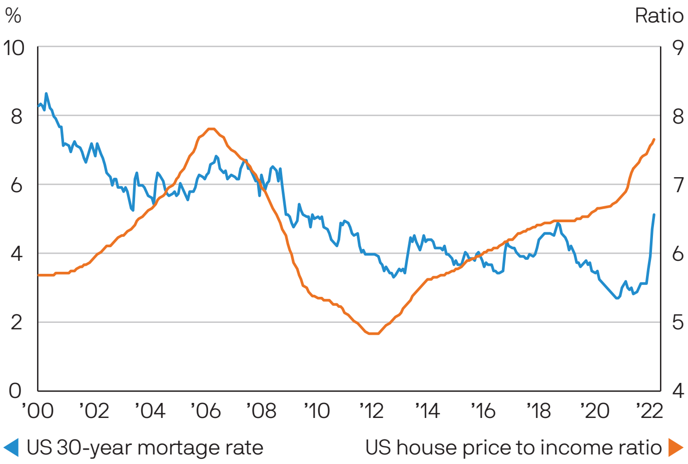
The other factor to consider though is the affordability of housing for people who do want to move home or buy their first home. Since the pandemic, house prices have risen significantly, up by about 40% in the US and 25% in the UK. That has been driven by demand for more space because of the shift to hybrid/home working, a lack of available housing supply and lower interest rates during the pandemic. Now that interest rates are rising again, housing is becoming less affordable (**Exhibit 10**).

The 30-year mortgage rate in the US has risen from below 3% to close to 6% in the last couple of years. Combined with the large increase in house prices, that means that the share of average income required to buy the average house today has already risen materially. In the UK the cost of a 2-year fixed-rate mortgage has increased from 1.2% in September to over 2.5% for a buyer with a 75% loan-to-value ratio.

It is therefore reasonable to believe that interest rates may not be able to rise much further than is already being priced in to US and UK government bonds before the housing market would come under pressure.

Exhibit 10: Housing is becoming less affordable

US mortgage rates and house prices




Source: BLS, Federal Reserve, National Association of Realtors, Refinitiv Datastream, J.P. Morgan Asset Management. House price to income ratio is calculated using average annual house prices and annualised average weekly wages. Data as of 31 May 2022.

However, there are some counter arguments to the idea that government bond yields won't rise much further from here. First is that we have entered a much more uncertain economic period, where the range of realistic potential outcomes for both growth and inflation is wider than in most of the last decade. For example, if wage growth stays strong then households may be able to afford higher mortgage costs. Bond investors may demand a higher yield to compensate them for the potential that we have shifted into a new inflation regime, where inflation and interest rates could potentially be sustained at higher levels than over the last decade.

Second, without quantitative easing and with the commencement of its gradual reversal, demand for government bonds could be substantially lower, putting further upward pressure on yields.

Third, even if one thinks bond yields won't rise much further, absent a recession, the real return on bonds could still be negative unless inflation falls back to target quickly.

Weighing up these arguments, we believe that government bonds are less unattractive than they were when yields were much lower. While investors could still lose money in government bonds, particularly in real terms, the potential upside is now probably more evenly balanced with the potential further downside from here. Additionally, they offer some portfolio diversification in the more extreme negative scenarios, so long as weaker activity coincides with diminishing inflationary pressure. With that in mind, while stopping short of recommending an overweight position to government bonds and duration, we believe it now makes sense for investors to consider moving their government bond and duration exposure closer to their benchmark.

## Chinese stocks: Long-term gain after the recent pain

Investors' confidence in Chinese equities has been severely tested over the last year. Growth in China has deteriorated due to the government's zero-Covid policy, increased regulation, weakness in the real estate sector and fiscal consolidation. The official GDP growth target of 5.5% for 2022 now seems hard to achieve. Chinese stocks have fallen sharply and valuations are now low, by historical standards.

Are investors' concerns justified, or does the current situation offer an attractive investment opportunity for longer-term investors? We believe some of the risks are beginning to diminish and that the stock market is attractively valued.

Covid remains a risk for the time being. The highly contagious Omicron variant recently caused the highest level of infections in China since the outbreak of the pandemic. The authorities implemented restrictive lockdown policies, with serious consequences for economic growth. At the beginning of April, 400 million Chinese were affected by lockdowns. The implementation of these measures has led to a significant slowdown in growth. Retail sales, for example, are down 11% year-on-year (y/y) and road freight traffic nationwide has contracted significantly since the beginning of the Omicron wave (**Exhibit 11**). Supply bottlenecks have also returned with full force and are likely to have global repercussions.

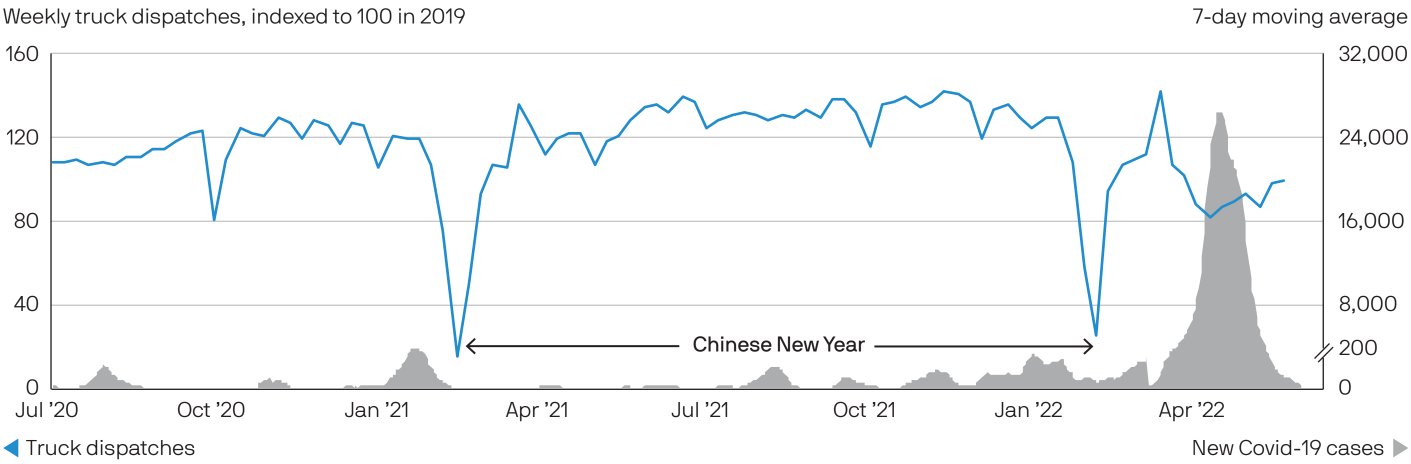
We expect some improvement in the situation by October or November, given President Xi's desire to be selected for a third term as the head of the Communist Party. Wide-scale lockdowns are not sustainable, although removing them quickly might risk overwhelming the health system. The latest data suggests that China still has a relatively low proportion of the elderly who have received booster vaccinations.

A possible route to "living with Covid" centres on increasing the proportion of the population covered by three doses of the domestic vaccine. Individuals could be encouraged by a combination of increased threat of infection and government mobility restrictions on unvaccinated members of the population (similar to Europe's strategy). This could then support the process of re-opening while the authorities manage the speed according to pressure on the health system. While this process is still likely to be slow, a long period of lockdowns is untenable, in our view.

The tide may also be turning in the property market. Fiscal restraint and tighter regulation in the financial sector led to a slump in real estate market activity and a crisis for some property developers. Real estate investment fell 10.1% y/y in April.

**Exhibit 11: Lockdowns due to China's zero-Covid policy are impacting the economy**

**Road freight activity and new Covid-19 cases**

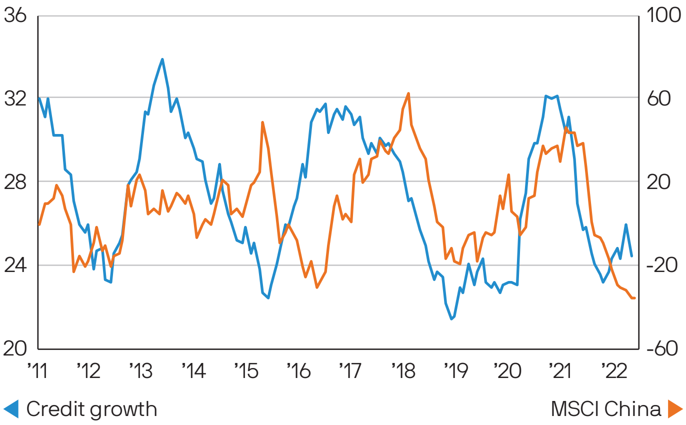



Source: G7, WIND, J.P. Morgan Asset Management. Data as of 31 May 2022.

At the regional level, policymakers have begun to ease restrictions on home purchases and lower down-payment requirements. But much more important is the prospect of a more expansive fiscal policy and a supportive central bank that can ease monetary conditions further due to the relatively moderate level of inflation. The supply of credit for the economy is already beginning to recover. **Exhibit 12** shows how the momentum in credit growth has been a reliable indicator of stock market performance in China over the past 10 years. The stabilisation in credit growth suggests that the headwind for equities may be receding.

**Exhibit 12: Chinese equity performance tends to be correlated with momentum in credit growth**

China credit growth and equity performance




Source: Bloomberg, MSCI, People's Bank of China, Refinitiv Datastream, J.P. Morgan Asset Management. Credit growth is the 12-month change in the credit stock to the real economy as a percentage of nominal GDP. Data as of 31 May 2022.

Regulation has been another ongoing headwind for the stock market. Information technology, media and online companies were particularly caught in the regulatory tightening. However, recently some positive signs have emerged. In March, China's State Council Committee encouraged regulators to establish more transparent and predictable policies and in April, the Chinese Communist Party Politburo became more supportive of policies to stabilise growth, with support for infrastructure investment, the property market and internet platforms. As a result, we are more confident that regulation will become less of a headwind.

Offshore-listed companies were particularly hard hit by regulation. On top of domestic regulation, the ongoing disagreement between the US and China over audit firm access to US-listed Chinese ADRs has heightened fears of forced de-listings by 2024. The Chinese Securities Regulation Committee has since announced that it is working on a draft proposal to give US regulators full access to auditing reports of most US-listed Chinese companies. If reached, an agreement would significantly reduce the de-listing risk associated with Chinese ADRs.

Investors have undoubtedly experienced some short-term pain in Chinese stocks, but we think there is an opportunity for long-term gains. After the very weak performance over the last year, the valuation of Chinese equities is significantly below the long-term average. Investors have an opportunity to benefit from long-term earnings growth prospects in China at valuations that already factor in a lot of bad news.

## Still value in value

Value has outperformed growth significantly this year. The MSCI World Index is down by over 20% but within that, the MSCI World Growth Index shrank by 30% while the MSCI World Value Index declined by just 13%.

While the decline in growth stocks has been broad based, value's performance has been much more uneven. The main driver of its outperformance has been the jump in energy stocks, while some defensive sectors like utilities and consumer staples, which tend to benefit from resilient demand, also aided relative returns. By contrast, the cyclical value sectors like financials and industrials suffered more than the value average as investors worried about the risks of a recession.

Will value's outperformance continue? Looking at both the key upside and downside scenarios that we face, we think the likely answer is yes. Within our downside scenario, a further escalation of the conflict in Ukraine could put further upward pressure on commodity prices and, in turn, energy stocks (although investors do need to be watchful of governments tempted by windfall taxes). In a more positive scenario, whereby global cost pressures ease and the economy proves resilient, the more cyclical areas of value have potential to catch up, particularly financials, where the combination of higher interest rates and solid loan performance could cause a re-rating of the sector.

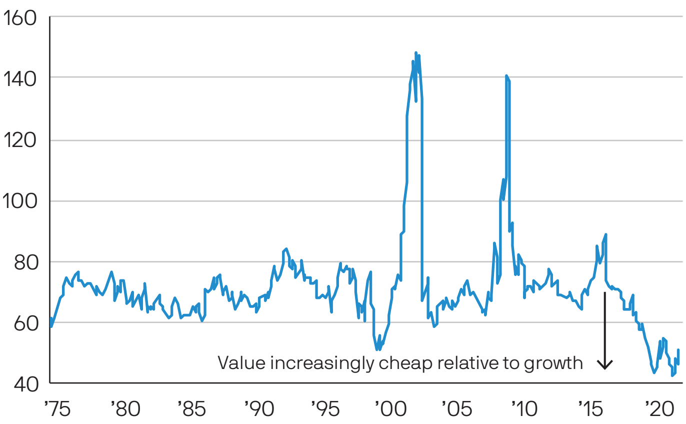
It should also be noted that despite recent moves, the valuation gap between the two styles remains considerable. **Exhibit 13** shows that at the height of the pandemic in 2020, the trailing price-to-earnings (P/E) ratio of the MSCI World Value Index was just 42% of the equivalent for growth stocks. Today the P/E ratio is still only half that of growth stocks, which is the same ratio seen in 1999 on the eve of the tech bubble bursting and well below the 70% average of the entire period.

The appeal of dividends may also tempt investors towards value stocks. The average dividend yield of the value index is more than 3%. Although government bond yields have risen, the coupons are fixed and therefore do not offer the inflation protection that corporate dividends potentially could.

**Exhibit 13: Value stocks appear historically cheap vs. growth stocks**

MSCI World Value and Growth valuation gap

Value P/E as a % of Growth P/E, based on trailing P/E



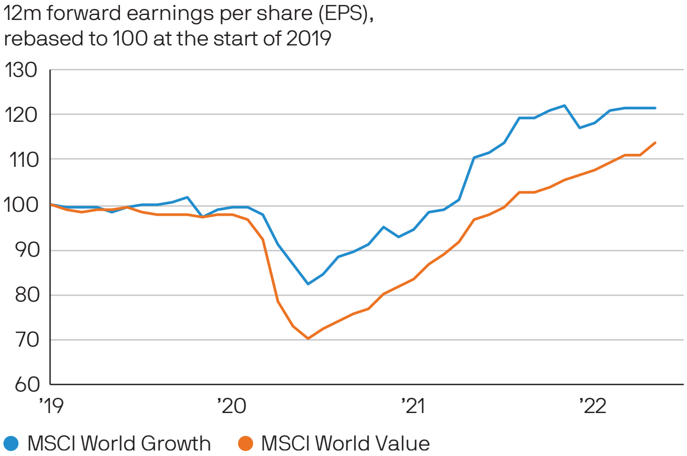

Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Data as of 31 May 2022.

The relative performance also depends on the prospects for growth stocks, which face two ongoing uncertainties. Firstly, the earnings prospects of companies in this category are particularly hard to forecast right now. The pandemic coincided with a rapid adoption of technology which led to a large upgrade in earnings expectations (**Exhibit 14**). But some stocks – such as streaming services – are struggling to meet these lofty expectations. Secondly, it remains a risk that interest rates rise further if economic activity and/ or inflation rise further which has the potential to weigh on longer-duration growth stocks. However, such a broad sell-off is also providing selective opportunities to obtain good growth companies at better prices. The challenge for investors will be to find compelling innovative companies without overpaying.

Fundamentally, we believe the combination of the pandemic and war in Ukraine has shifted us into a new growth, inflation and interest rate regime. The low growth, low inflation and low interest rates of the last decade, which provided the foundations for growth stocks' phenomenal outperformance now looks to be behind us. In our central scenario, whereby economic growth demonstrates a degree of resilience, value's outperformance could have further to run.

**Exhibit 14: Earnings growth estimates for growth stocks rose significantly during the pandemic**

MSCI World Value and Growth 12-month forward EPS




Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Data as of 31 May 2022.

## Where to hide if stagflation takes hold

The war in Ukraine, China's zero-Covid policy and tighter global monetary policy have raised concerns about a prolonged period of stagflation. This term refers to an economy plagued by low or negative growth, rising unemployment yet stubbornly high inflation, a combination of which we haven't experienced since the 1970s.

Stagflation is the worst-case scenario for investors since central banks have to tighten into slowing growth, causing both stocks and bonds to fall in price. Fears of stagflation have caused the traditional 60:40 portfolio to trade over 18% lower year-to-date, having made on average a positive return of 7% per annum between 2008 and 2021.

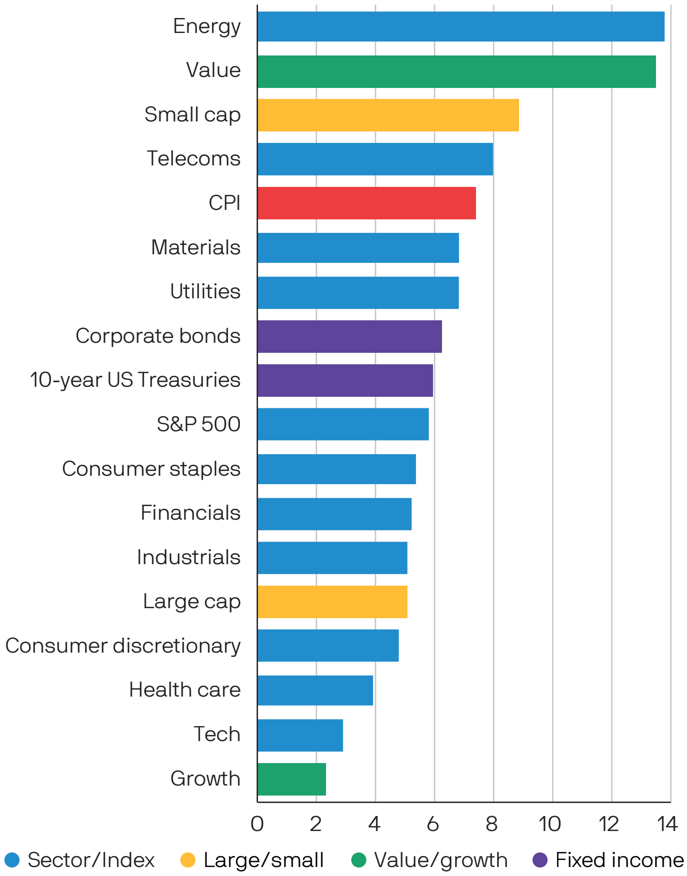
While at first glance there seems to be no place to hide for investors in a stagflationary environment, the analysis of the market developments during the 1970s (**Exhibit 15**) and the three bear markets that occurred during this period allow us to make a few observations which provide some guidance on how to navigate this environment.

Energy, materials, telecoms and utilities should be more resilient. Exhibit 15 shows the nominal, annualised returns over the 1970s. Sectors that proved most resilient were energy and materials, which benefited from high commodity prices, while defensive sectors such as telecoms and utilities were also well supported. Value stocks and small caps also consistently outperformed their growth and large cap counterparts, even though small caps suffered relatively more during the bear markets.

**Exhibit 15: Energy, materials, telecoms and utilities sectors could be more resilient in a stagflationary environment**

1970s asset returns

%, annualised nominal total returns

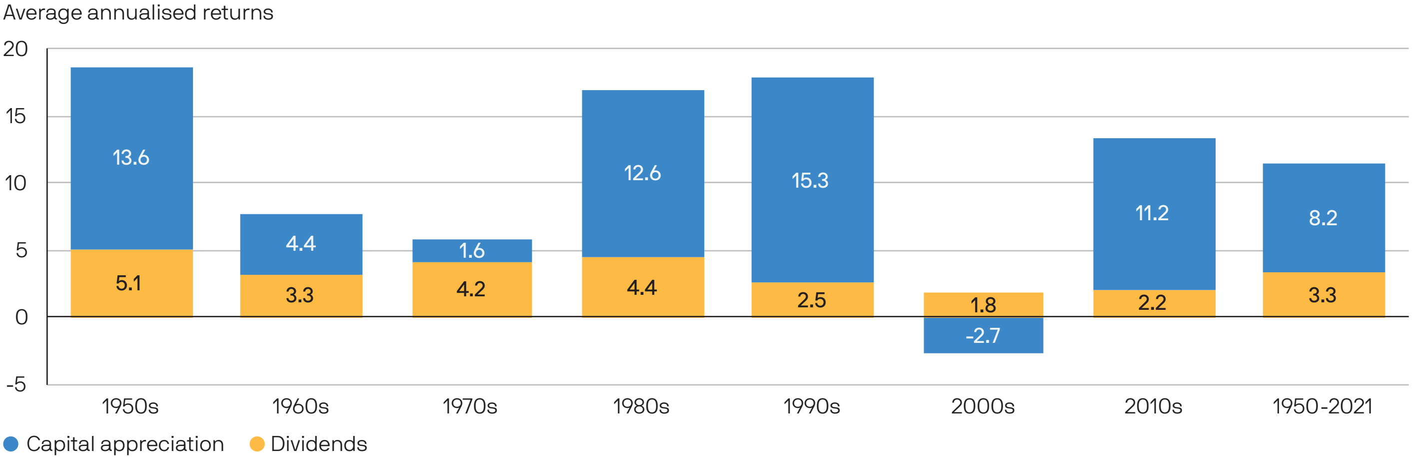



Source: BLS, French, Haver Analytics, Refinitiv Datastream, Shiller, Standard & Poor's, Ibbotson, J.P. Morgan Asset Management. Returns shown are from the beginning of 1970 to the end of 1979. Data as of 31 May 2022.

Assets that provide sustainable income are also attractive in a stagflationary environment. When the beta of markets is less supportive and capital gains cannot be relied upon, dividends and coupons become more important. For example, dividends accounted for two thirds of the S&P 500's total return in the 1970s, while historically they have, on average, only accounted for one third of its total return (**Exhibit 16**). High coupons were a significant factor of the performance of both the corporate and government segments of the fixed income space flattering fixed income's nominal returns in the 70s.

Exhibit 16: Dividends accounted for a large portion of the S&P 500's return in the 1970s

S&P 500 total return: Dividends vs. capital appreciation




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

Alternative assets, for those that can access them, provide some of the most attractive offerings. Real estate and infrastructure have low correlations to equities and bonds and generate income streams that tend to rise with inflation.

It's also worth noting that although the 1970s were certainly challenging for investors, it was not a lost decade for financial markets and it generally paid to stay invested. Indeed, even though the S&P 500 experienced drawdowns of up to 46%, it still posted an annualised total return of 5.8% over the period as a whole.

Investors should also be mindful that short-term challenges often tend to sow the seeds of long-term opportunity. The oil shocks in the 1970s forced many countries to substantially reduce their oil intensity not only by reducing their oil consumption but also by investing in new sources of energy, such as renewables or nuclear. Industries, such as the car industry, changed dramatically during this period with Japanese car manufacturers gaining substantial market share thanks to more fuel-efficient models. Like in the 1970s, the current energy crisis will turbocharge the energy transition and investors will need to identify the relative winners of this trend. Valuations for climate technology companies have fallen significantly in the recent broad growth sell-off but if earnings prove resilient as the transition is accelerated then these companies might now offer a compelling medium-term opportunity.

## Central scenarios and risks

Our core scenario looks for global growth to moderate and inflation to cool, albeit to still above-target levels over the next 6-12 months. Yet, as we laid out in the opening section, it's more important than ever to consider the risks to our central view given elevated levels of uncertainty. Below we describe a range of scenarios for the economy and markets that we view as plausible over the coming year.

### Central scenario: Cooling growth, cooling but above target inflation

Growth slows significantly in developed markets, but any downturn is short and shallow. Fiscal stimulus helps to offset real wage pressures in Europe. Policy support helps to stabilise China's economy as Covid restrictions gradually ease. Inflation persists above central bank targets, but with economic activity cooling and headline inflation rates trending down from high levels. Interest rates rise more gradually than current market expectations, easing market fears of a central bank-induced recession.

Equity markets stabilise despite earnings downgrades. Growth stock valuations face further headwinds. Long-term bond yields edge gradually higher, with credit outperforming core government bonds.

### Downside scenario: Stagflation

Slowing demand fails to bring inflation down as energy supply scarcity drives prices higher. Wage costs eat into corporate margins as spiralling prices cause workers to persistently demand higher pay. Despite slowing growth, central banks are forced to tighten aggressively, given fears of inflation expectations de-anchoring, causing a deep recession.

Worst case scenario for equity markets. Bond yields move higher with curves flattening as central banks are forced to hike more than current market expectations. Government bonds outperform equities, but all major asset classes deliver negative returns. Value outperforms growth given substantial pressure on equity multiples and elevated commodity prices.

### Downside scenario: Global recession

Developed market economies slow sharply as price pressures overwhelm the consumer. Covid concerns and lockdowns are extended in China. Negative demand shocks eventually lead to falling energy prices, helping to bring inflation back down but at the expense of a significant hit to growth. Unemployment rises as business confidence slumps and cooling wage growth eases inflationary pressures further. Central banks pause tightening plans given slowing inflation and in order to prioritise the growth outlook.

Equity markets decline, but the central bank pivot provides some offset. Government bonds outperform both credit and equity as sovereign yields decline. Growth stock underperformance slows given lower bond yields.

### Upside scenario: Goldilocks

A faster than expected reopening in China leads to easing supply chain bottlenecks. Despite the associated boost to demand, commodity prices remain anchored, potentially on the back of a de-escalation of the war in Ukraine. As a result, inflation falls back more quickly than currently anticipated. A degree of resilience in labour markets supports real wage growth as broad inflationary pressures ease. Central banks move ahead gradually with tightening plans without materially slowing growth.

Best case scenario for equity markets, with strong earnings growth being delivered. Value outperforms, but with rotation from energy to financials. Equities outperform credit, and credit outperforms government bonds as spreads narrow.

## Authors


**Karen Ward**
Chief Market Strategist for EMEA

**Paola Toschi**
Global Market Strategist

**Mike Bell**
Global Market Strategist

**Tilmann Galler**
Global Market Strategist

**Vincent Juvyns**
Global Market Strategist

**Hugh Gimber**
Global Market Strategist

**Ambrose Crofton**
Global Market Strategist

**Max McKechnie**
Global Market Strategist




**LV–JPM53690| 05/22 | 09hu221006094554**

J.P. Morgan
ASSET MANAGEMENT