Investment Outlook 2023

A bad year for the economy, a better year for markets

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In brief

- Despite remaining above central bank targets, inflation should start to moderate as the economy slows, the labour market weakens, supply chain pressures continue to ease and Europe manages to diversify its energy supply.
- Our core scenario sees developed economies falling into a mild recession in 2023.
- However, both stocks and bonds have pre-empted the macro troubles set to unfold in 2023 and look increasingly attractive, and we are more excited about bonds than we have been in over a decade.
- The broad-based sell-off in equity markets has left some stocks with strong earnings potential trading at very low valuations; we think there are opportunities in climate-related stocks and the emerging markets.
- We have higher conviction in cheaper stocks which have already priced in a lot of bad news and are offering dependable dividends.

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Developed world growth to slow with housing activity bearing the brunt

As we look to 2023 the most important question is actually quite straightforward: will inflation start to behave as economic activity slows? If so, central banks will stop raising rates, and recessions, where they occur, will likely be modest. If inflation does not start to slow, we are looking at an uglier scenario.

Fortunately, we believe there are already convincing signs that inflationary pressures are moderating and will continue to do so in 2023.

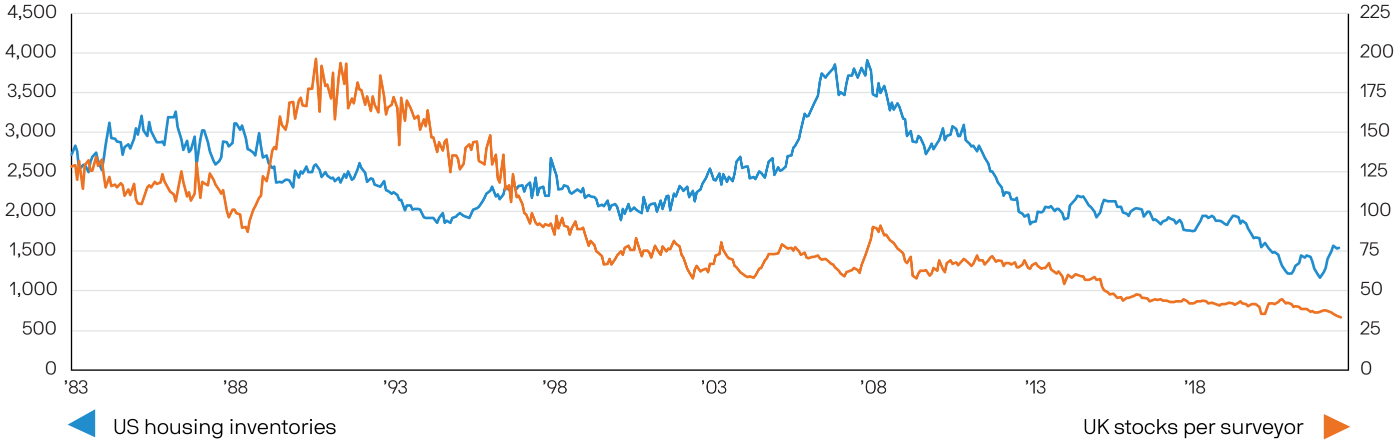
Housing markets are, as usual, the first to react to central banks touching the monetary brake. Materially higher new mortgage rates are crimping new housing demand and we think the ripples of weaker housing activity will permeate through the global economy in 2023. Construction will weaken, spending on furniture and other household durables will fall and falling house prices could weigh on consumer spending for the next few quarters. The decline in activity should have the intended effect of taming inflation.

Thankfully, the risks of a deep, housing-led recession of the type experienced in 2008 are low. First, housing construction was relatively subdued for much of the last decade, which means we are unlikely to see a glut of oversupply driving house prices materially lower (**Exhibit 1**). Second, those that have recently bought at higher prices were still constrained by the banks' more stringent loan-to-value and loan-to-income ratios.

Exhibit 1: Limited stock of housing for sale should prevent large house price declines

Housing inventories

Thousands (LHS); average stocks per surveyor (RHS)



Source: Haver Analytics, National Association of Realtors, Refinitiv Datastream, Royal Institute of Chartered Surveyors, US Census Bureau, J.P. Morgan Asset Management. US housing stocks include new and existing single-family homes for sale. Both series are seasonally adjusted. Data as of 31 October 2022.

Finally, the impact of higher rates on mortgage holders is likely to be less severe. In the US, households did a good job of locking in the low rates experienced a couple of years ago. Only about 5% of US mortgages are on adjustable rates today, compared with over 20% in 2007. In 2020 the 30-year mortgage rate in the US hit just 2.8%, prompting a flurry of refinancing activity. Unless those individuals seek to move, their disposable income won't be impacted by the recent increase in interest rates.

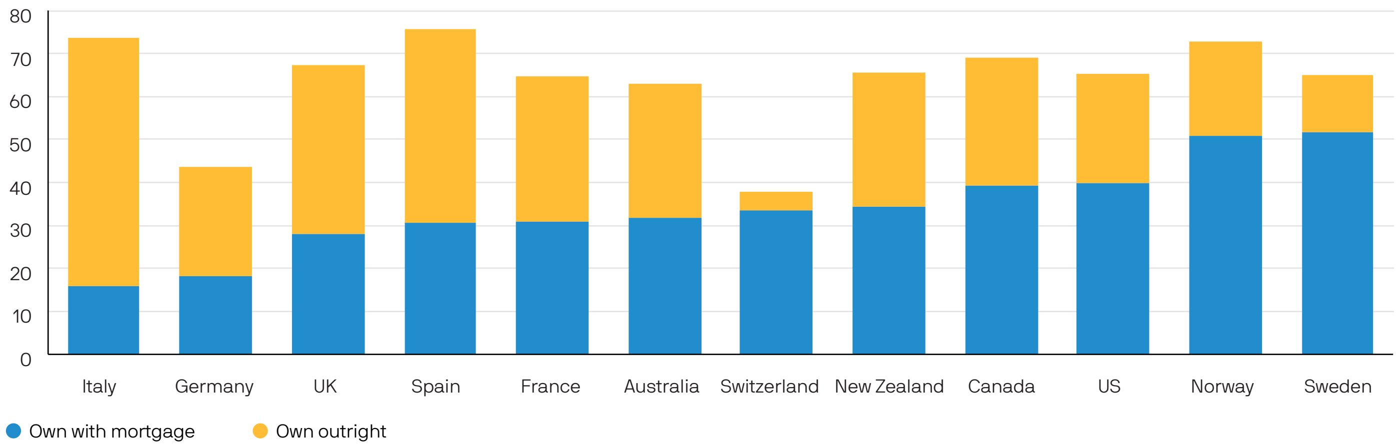
In the UK, some households have similarly done a good job of protecting themselves from the near-term hike in rates. In 2005 – the start of the last significant tightening cycle – 70% of mortgages were variable rate. Today, variable rate mortgages account for only 14%. However, a further 25% of mortgages were fixed for only two years. This makes the UK more vulnerable than the US, albeit with a bit of a delay.

It’s also worth remembering that not everyone has a mortgage, while individuals that have cash savings will see their disposable income rise as interest rates increase. This factor is particularly important when thinking about the larger countries in continental Europe, where fewer households have a mortgage, and household savings as a percentage of GDP are higher than in the US and UK (**Exhibit 2**). The European Central Bank (ECB) was often warned that zero interest rates would be counterproductive because of the degree of savings in the region.

Exhibit 2: The main countries of Europe have less housing debt making them less vulnerable to higher ECB rates

Home ownership by mortgage status

% of households



Source: Eurostat, OECD, J.P. Morgan Asset Management. Data as of 31 October 2022.

Europe is weathering the energy crisis well

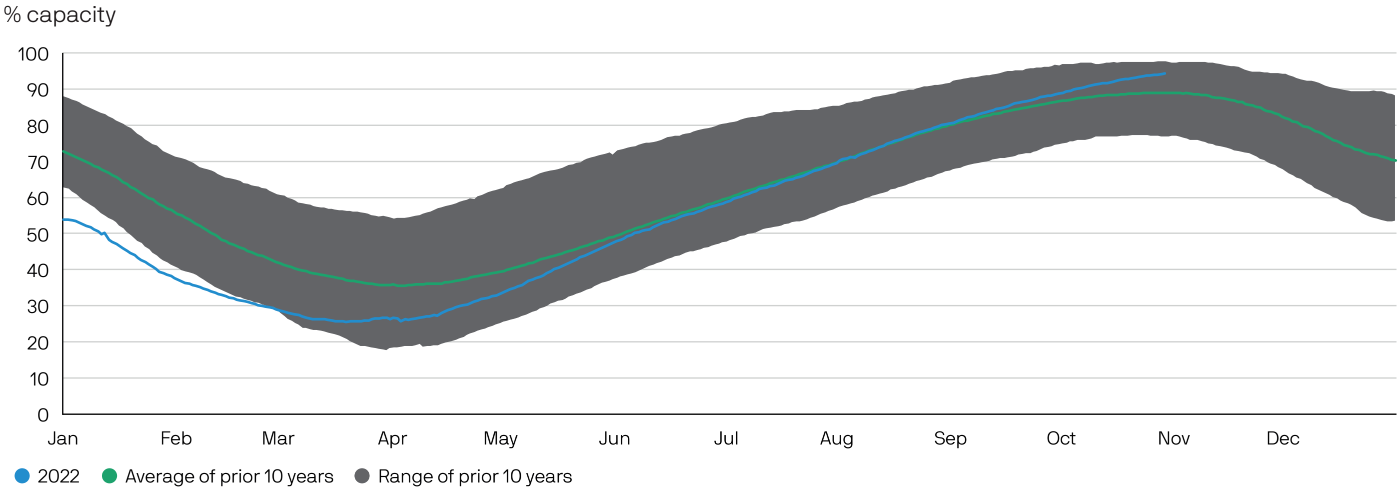
For Europe, the key risk is less about a housing bust and more about energy supply, given that Russia – the former supplier of 40% of Europe’s gas – stopped the bulk of its supplies this summer.

For the coming winter, at least, the risk to gas supplies is in fact diminishing due to a combination of good judgment and good luck. Europe managed to fill its gas tanks over the summer, largely replacing Russian gas with liquefied natural gas from the US.

Since then, Europe has had the good fortune of a very mild autumn and, as a result, enters the three key winter months with storage tanks that are almost full (**Exhibit 3**). Unless temperatures turn and we face bitterly cold weather in the first months of 2023, Europe looks increasingly likely to make it through this winter without having to resort to energy rationing.

Exhibit 3: Europe enters the key winter months with full gas tanks

EU natural gas inventories



Source: Bloomberg, Gas Infrastructure Europe, J.P. Morgan Asset Management. Data as of 31 October 2022.

The gas in storage was, of course, obtained at a very high price. However, governments are to a large extent shielding consumers from the bulk of higher energy prices. We will have to wait to the spring to see whether the cost to the public purse is proving too great for support to continue.

China to open up post Covid, easing global supply chain pressures

The Chinese economy has been faced with an entirely different set of challenges to the developed world with widespread lockdowns still in place to contain the spread of Covid-19. Low levels of vaccination, particularly among the elderly, coupled with a less comprehensive hospital network than in the west, have left the Chinese authorities reluctant to move towards a 'living with Covid' policy.

However, a prolonged period of lockdown also appears untenable and we expect China to experience an acceleration in activity as pent-up demand is released. While the timing of policy changes remains uncertain, the market's performance has highlighted how sensitive investors are to any signs of a shift in approach.

Importantly, normalisation of the Chinese economy could significantly ease the supply chain disruptions that have contributed to rapidly rising goods inflation. Although a rebound in growth in China could also boost demand for global commodities, our assessment is that on balance this is another driver of lower inflation in 2023.

Inflation panic subsides, central banks pause

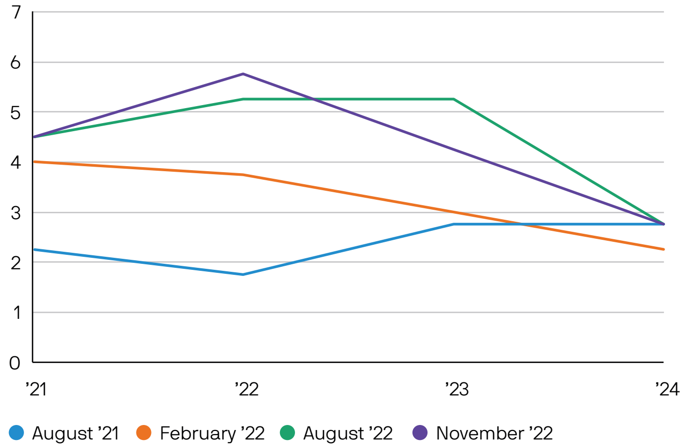
Signs of slowing activity in the west, and a return to full production in China, should ease inflation through the course of 2023, with the shrinking contributions from energy and goods sectors in particular helping price pressures to moderate in the months ahead.

However, to be sure that we're out of the inflationary woods, wage pressures also need to ease. This is where the central banks went wrong in assuming inflation would prove "transitory", as they underestimated the extent to which labour market tightness would result in workers asking for more pay (**Exhibit 4**).

Exhibit 4: The central bank inflation errors are rooted in the labour markets

Bank of England average weekly earnings forecasts

% change year on year



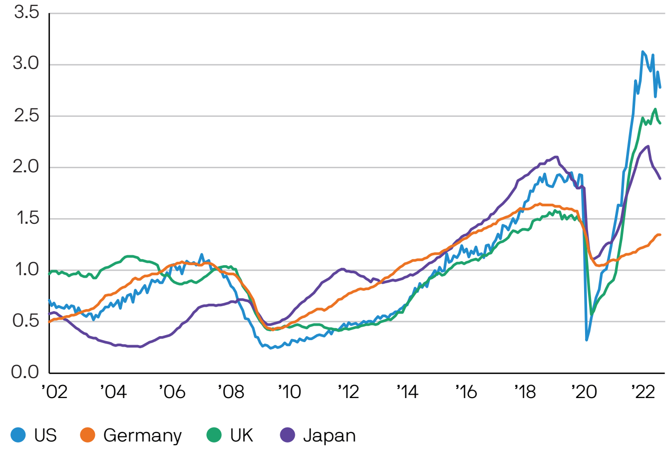
Source: Bank of England, J.P. Morgan Asset Management. Forecasts are based on four-quarter growth in whole-economy total pay in Q4. Data as of 18 November 2022.

Job vacancies – which in all major regions still exceed the number of unemployed – will be a key indicator to watch in the next couple of months (**Exhibit 5**). Job hiring and quits are already rolling over and, given higher pay is one of the most common reasons for people moving jobs, we see this as a sign that wage growth should ease.

Exhibit 5: The labour market is still too hot

Job vacancies versus unemployment

x, vacancies as a multiple of unemployed, relative to average



Source: Bloomberg, BLS, Eurostat, MIAC, Ministry of Health Labour and Welfare, ONS, J.P. Morgan Asset Management. UK vacancy data is a three-month average as published. Data as of 31 October 2022.

Assuming headline inflation and wage inflation are easing, we see US interest rates rising to around 4.5%-5.0% in the first quarter of 2023 and stopping there. The ECB is similarly expected to pause at 2.5%-3.0% in the first quarter. The Bank of England may take slightly longer to reach a peak, given that inflation is likely to prove stickier in the UK. We see a peak UK interest rate of 4.0%-4.5% in the second quarter.

Central banks also have ambitions to reduce the size of their balance sheets by engaging in quantitative tightening, but we do not expect a particularly concerted effort, nor any significant disruption. Quantitative easing was designed to give central banks extra control and leverage over long-term interest rates, helping the market to absorb large scale government issuance. We expect quantitative tightening to operate under the same principle and, given bond supply is still expected to be meaningful in size in 2023 – and borrowing costs have already risen meaningfully – we expect central banks to be modest in their ambitions to reduce their balance sheets.

Recessions to be modest

Ultimately, our key judgment is that signs will emerge in the coming months that inflation is responding to weakening activity. Inflation may not be heading back quickly to 2%, but we suspect that the central banks will be happy to pause, so long as inflation is headed in the right direction.

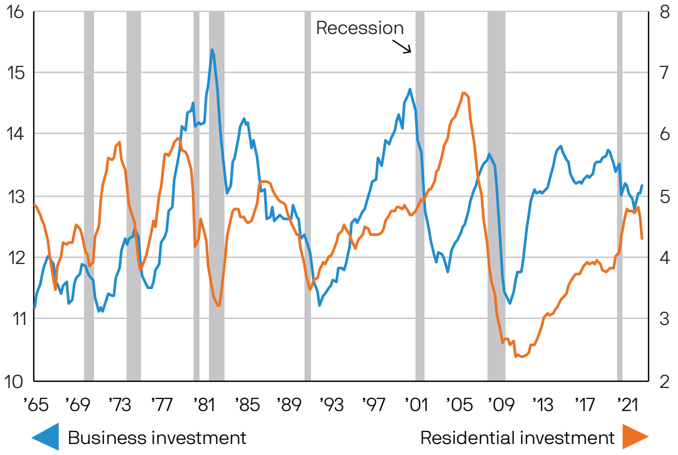
Against this view, there are two types of bearish forecasters. Some still believe we have returned to a 1970s inflation problem, which will require a much deeper recession and much larger rise in unemployment than we expect to drive inflation away.

Others argue that moderate recessions are difficult to engineer because slowdowns take on a life of their own, with a tendency to spiral. This situation has been true in the past, when deep recessions were busts that followed a boom. Following excessive growth in one area of the economy – most commonly business investment or housing – it has often taken a long time for the economy to adjust and find alternative sources of growth. However, this time round, investment and housing growth has been more modest (**Exhibit 6**).

Exhibit 6: There wasn't enough of a boom for us to worry about a bust

US residential and business investment

% of nominal GDP



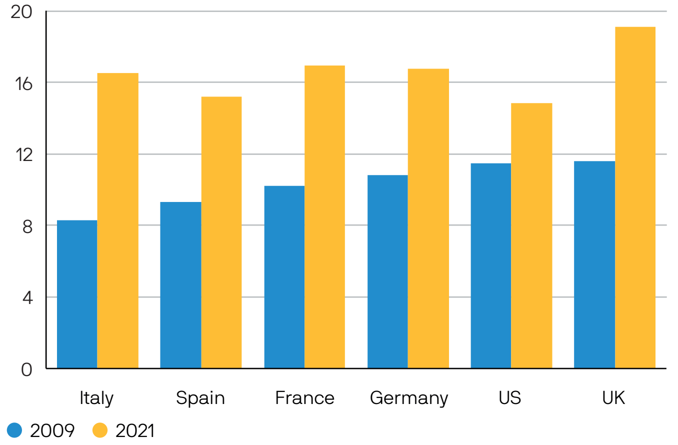
Source: BEA, Refinitiv Datastream, J.P. Morgan Asset Management. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates. Data as of 31 October 2022.

In addition, bouts of excess enthusiasm have usually been fuelled by excessive bank lending, which has historically led to a period of weak credit growth, further compounding the downturn. This time round, however, more than a decade of regulation since the global financial crisis means that the commercial banks come into the current slowdown extremely well capitalised, and they have been thoroughly stress-tested to ensure they can absorb losses without triggering a credit crunch (**Exhibit 7**).

Exhibit 7: The health of the financial sector should prevent a credit crunch

Core tier 1 capital ratios

%, regulatory tier 1 capital to risk-weighted assets



Source: IMF, Refinitiv Datastream, J.P. Morgan Asset Management. Core tier 1 ratios are a measure of banks' financial strength, comparing core tier 1 capital (equity capital and disclosed reserves) against total risk-weighted assets. Data as of 31 October 2022.

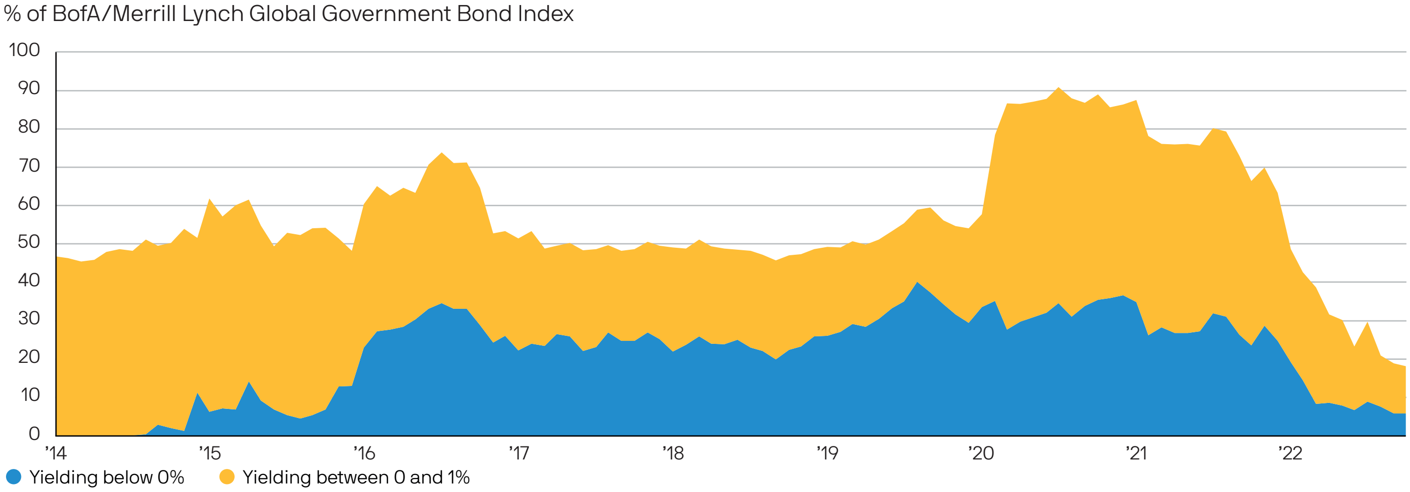
In short, busts follow booms. But booms were notably absent in the last decade where activity across sectors was, if anything, too sluggish. Although economic activity does need to weaken to be sure inflation moderates, we do not expect a lengthy, or deep, period of contraction. Given the decline already seen in the price of both stocks and bonds, we believe that while 2023 will be a difficult year for economies, the worst of the market volatility is behind us and both stocks and bonds look increasingly attractive.

The fixed income reset

Allocating to fixed income has been a never-ending source of headaches for multi-asset investors in recent times. After a long bull market, yields had reached the point where government bonds could no longer offer either of the key characteristics that they are typically expected to deliver: 1) income, and 2) diversification against risky assets. At one point, a staggering 90% of the global government bond universe was offering a yield of less than 1%, forcing investors to take on ever greater risk in extended credit sectors that had much higher correlations to equities. Low starting yields had also diminished the ability of government bonds to deliver positive returns that could offset losses during equity bear markets (**Exhibit 8**).

Exhibit 8: The proportion of government bonds that offered no income has finally receded

Global government bond yields



Source: Bloomberg, BofA/Merrill Lynch, J.P. Morgan Asset Management. Index shown is the BofA/ML Global Government Bond index. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

This year's record-breaking drawdown has added to fixed income investors' woes. Surging inflation, central banks desperately trying to play catch-up and governments that had seemingly lost their fear of debt, have all combined to trigger a brutal repricing. Markets have had to totally rethink the outlook for monetary policy rates and the risk premium that should exist in a world in which central banks cannot backstop the market. The drawdown in the Bloomberg Barclays Global Bond Aggregate in the first 10 months of 2022 was around -20%, four times as bad as the previous worst year since records began in 1992.

Crucially, while the correction in global bond markets has been incredibly painful, we believe that it is nearing completion. Further hikes from the central banks are likely in 2023 as policymakers continue to battle inflation. Yet with the market now pricing a terminal rate close to 5% in the US, around 4.5% in the UK and near 3% in the eurozone, the scope for further upside surprises is significantly diminished provided that inflation starts to cool. This is a key difference versus the start of 2022: this year's problem has not only been that the central banks have been hiking rates aggressively, but that they have been hiking by far more than the market expected.

Looking forward, it is clear that the income on offer from bonds is now far more enticing. The global government bond benchmark has seen yields rise by roughly 200 basis points (bps) since the start of the year, while high yield (HY) bonds are again worthy of such a title with yields approaching double digits. Valuations in inflation-adjusted terms also look more attractive – while the roughly 1% real yield on global government bonds may not sound particularly exciting, it is back to the highest level since the financial crisis and around long-term averages.

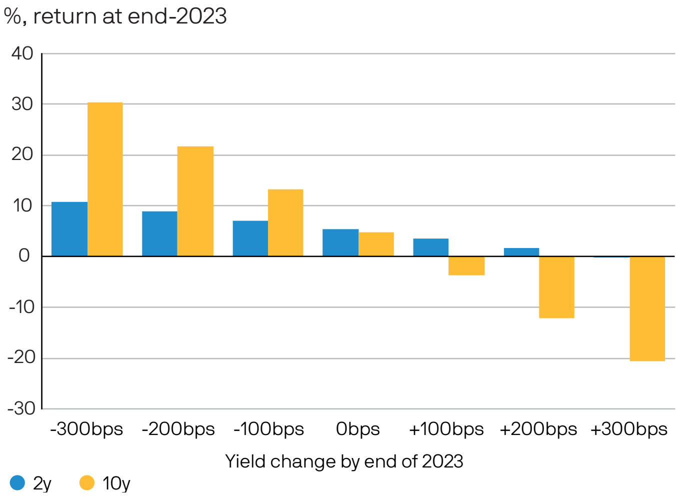
What about the correlation between stocks and bonds? What has been so punishing for investors this year has been the fact that bond prices have fallen alongside stock prices. This could continue if stagflation remains a key theme through 2023. While our base case sees stocks and bonds staying positively correlated in 2023, we think this time both asset classes' prices will rise together. If inflation dissipates quickly, we could see central banks pause their tightening earlier than forecast or even ease policy, supporting both stock and bond prices.

The potential for bonds to meaningfully support a portfolio in the most extreme negative scenarios – such as a much deeper recession than we envisage, or in the event of geopolitical tensions – is perhaps most important for multi-asset investors. For example, if 10-year US Treasury bond yields fell from 4% to 2% between November 2022 and the end of 2023, that would represent a return of c.20% which should meaningfully cushion any downside in stocks (**Exhibit 9**). Such diversification properties simply weren't available for much of the past decade when yields were so low.

Given this uncertainty about inflation and growth, and the chunky yields available in short-dated government bonds, investors might want to spread their allocation along the fixed income curve, taking more duration than we would have advised for much of the year.

Exhibit 9: The reset in yields has boosted the diversification potential of bonds

Total return scenarios by change in US Treasury yields



Source: Refinitiv Datastream, J.P. Morgan Asset Management. Chart indicates the calculated total return achieved by purchasing US 2-year and 10-year Treasuries at the current yield and selling at the end of 2023 for various year-end yields. For illustrative purposes only. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

Within credit markets, we believe that an "up-in-quality" approach is warranted. The yields now available on lower quality credit are certainly eye-catching, yet a large part of the repricing year to date has been driven by the increase in government bond yields. Take US HY credit as an example, where yields increased by around 500bps in the first 10 months of 2022, but wider spreads only accounted for around 40% of that move. HY credit spreads still sit at or below long-term averages both in the US and Europe. It is possible that spreads widen moderately further as the economic backdrop weakens over the course of 2023.

The reset in fixed income this year has been brutal, but it was necessary. After the pain of 2022, the ability for investors to build diversified portfolios is now the strongest in over a decade. Fixed income deserves its place in the multi-asset toolkit once again.

The bull case for equities

Our 2023 base case of positive returns for developed market equities rests on a key view: a moderate recession has already largely been priced into many stocks.

By the end of September 2022, the S&P 500 had declined 25% from its peak. Historically, following this level of decline, the stock market has tended to be higher a year later. There have been two exceptions since 1950: the 2008 financial crisis and the bursting of the dot-com bubble in 2000.

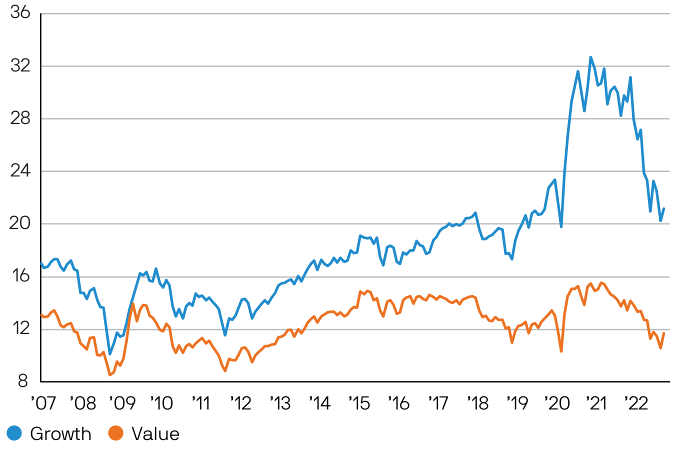
We don't see macroeconomic parallels with 2008, but what about valuation similarities with 2000? One risk to our bullish base case scenario for stocks would be if valuations still need to fall considerably further from here.

S&P 500 valuations started 2022 not far off those seen during the dot-com bubble. However, high valuations could largely be attributed to growth stocks (**Exhibit 10**). Despite underperforming in 2022, these stocks are still not particularly cheap by historical standards.

Exhibit 10: Growth stocks still aren't cheap by historic standards

MSCI World Growth and Value forward price-to-earnings ratio

x, multiple



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

Value stocks, however, are now quite reasonably priced compared with history. We have stronger conviction that value stocks will be higher by the end of 2023 than we do for those growth stocks that still look expensive. However, a peak in government bond yields could provide some support to growth stock valuations in 2023.

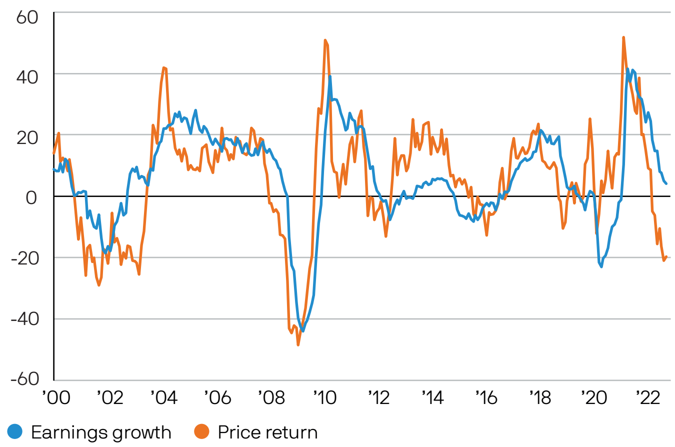
Another risk to equities is that consensus 12-month forward earnings expectations currently look too high, having only declined by about 5% from their recent peak. A recession is likely to lead to further reductions in earnings expectations. We believe that in a moderate recession, 12-month forward earnings estimates are likely to decline somewhere around 10% to 20% from the peak, as they did in the 1990s or early 2000s.

While some might argue that when these earnings downgrades materialise, they will lead the stock market lower, we believe that the market has already priced in some further downgrades to consensus forecasts (**Exhibit 11**). For example, at the beginning of 2022, US bank stocks were reasonably valued at 12x earnings and consensus 12-month forward earnings forecasts rose about 10% over the course of the year – yet bank stocks fell about 35% from peak to trough. This supports our view that the market is already factoring in worse news than consensus earnings forecasts suggest.

Exhibit 11: Markets often move ahead of earnings forecasts

MSCI World earnings growth and price return

% change year on year



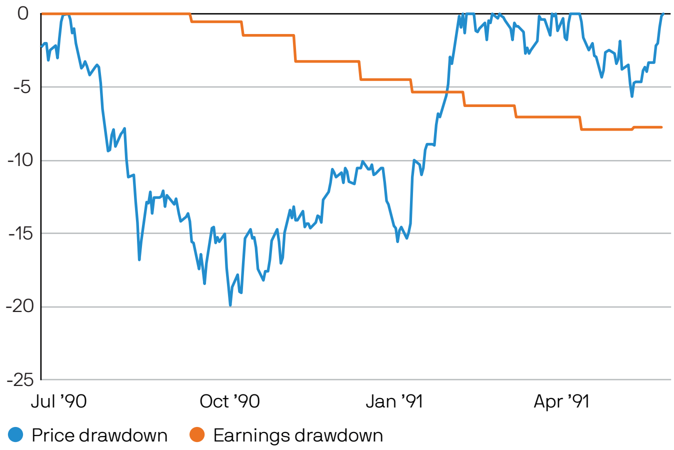
Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Earnings are 12-month forward earnings expectations. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

We also note that the interaction between consensus earnings forecasts and markets has been inconsistent over time. In the early 2000s and in the 2008 financial crisis, reductions in earnings forecasts led to further stock market declines; but in the early 1990s, stocks rallied as 12-month forward earnings expectations declined (**Exhibit 12**).

Exhibit 12: In the early 1990s, stocks rallied on declining earnings expectations

Performance of the S&P 500 vs. drawdown in 12-month forward earnings

%, drawdown from local peak



Source: IBES, Refinitiv Datastream, S&P Global, J.P. Morgan Asset Management. Earnings are 12-month forward earnings expectations. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

While falling earnings forecasts could lead stocks lower, if the magnitude of the decline in earnings is moderate – as we expect – then it would likely only lead to limited further downside for reasonably valued stocks, relative to the declines already seen in 2022.

We acknowledge that it would be unusual for the stock market to have bottomed already—that does not tend to occur before the unemployment rate has started to rise and the Federal Reserve (Fed) has started to cut interest rates. However, the market has already declined much more than usual before jobs have started to be lost. Given this is probably the best predicted recession in the last 50 years, we believe there is a chance that equity markets could have priced it in sooner than they normally do.

Overall, while we are not calling the bottom for equity markets, we do think that the risk vs. reward for equities in 2023 has improved, given the declines in 2022. With quite a lot of bad news already factored in, we think that the potential for further downside is more limited than at the start of 2022. Importantly, the probability that stocks will be higher by the end of next year has increased sufficiently to make it our base case.

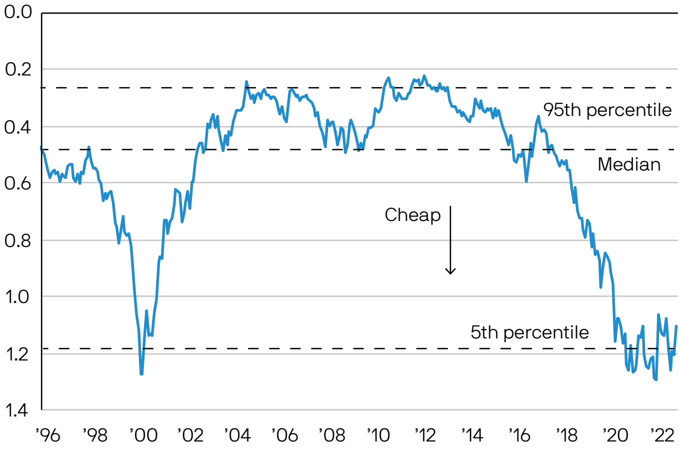
Defend with dividends

Our base case sees a moderate recession in most major developed economies in 2023. We believe that equity markets have already priced in a lot of the bad news in 2022, but stocks which provide an attractive income appear more reasonably valued than those with little or no income (**Exhibit 13**). Investors who are more cautious than us about the outlook may want to focus on this cheaper segment of the market to hopefully limit further downside.

Exhibit 13: Low income stocks still look quite expensive

Relative valuation of global higher dividend yield stocks

x, valuation spread based on earnings yield



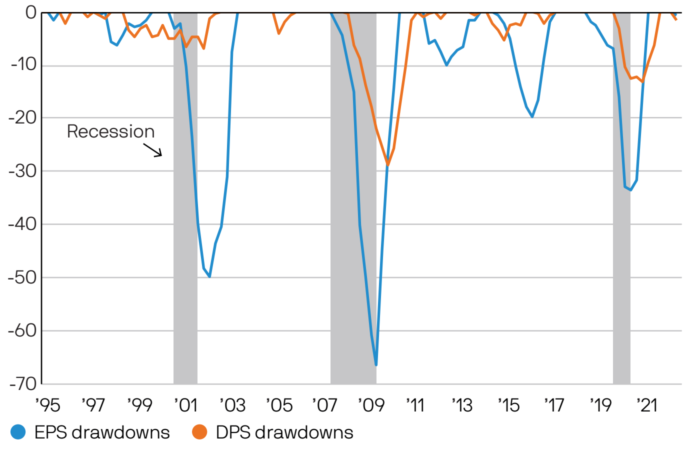
Source: J.P. Morgan Asset Management. Index shown is a subset of the S&P Global BMI Index, which includes both developed and emerging market stocks with a minimum market cap of c. USD 1 billion. Valuation spreads are calculated by subtracting the median valuation of stocks in the lowest ranked quintile for dividend yield from the median valuation of stocks in the highest ranked quintile of dividend yield, and then dividing this by the median valuation of the market. 1st percentile is cheap, 100th is expensive. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

Of course, the income stream from dependable dividend payers can also help buffer returns. Strong, dividend paying companies often go to great lengths to maintain dividends, even when earnings are under pressure. With payout ratios relatively modest at present, maintaining current dividends looks more feasible than in some prior recessions (**Exhibit 14**).

Exhibit 14: Dividends tend to fall by less than earnings

MSCI World earnings and dividends drawdowns

% drawdown from rolling 2-year high, EPS and DPS



Source: Bloomberg, J.P. Morgan Asset Management. EPS is earnings per share and DPS is dividends per share. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

Another factor worth considering is that the universe of companies currently paying healthy dividends is fairly diverse, spanning a wide range of sectors. Some of the usual suspects like utilities remain in the pool but we believe sectors such as financials, healthcare, industrials and even some parts of tech contain a number of dependable dividend payers that can also grow their dividends over time. As a result, should the macro backdrop not improve, and stagflationary pressures persist into 2023, we would expect income paying stocks to prove relatively resilient.

In conclusion, even though we expect a challenging macroeconomic environment in 2023 and downward corporate earnings revisions, we think income stocks could have a good year with dividends proving more resilient than earnings. For investors that are tentatively looking to increase their equity exposure, an income tilt could prove relatively resilient in the worst-case scenario, while also providing the potential for outperformance in our more optimistic scenario for markets given attractive valuations.

Catalysts for a recovery in emerging market assets

Emerging market equities had another very challenging year and disappointed investors' expectations for this promising high growth asset class. By the end of October, the MSCI Emerging Markets Index had lost 29% in 2022, underperforming developed market equities by 10%.

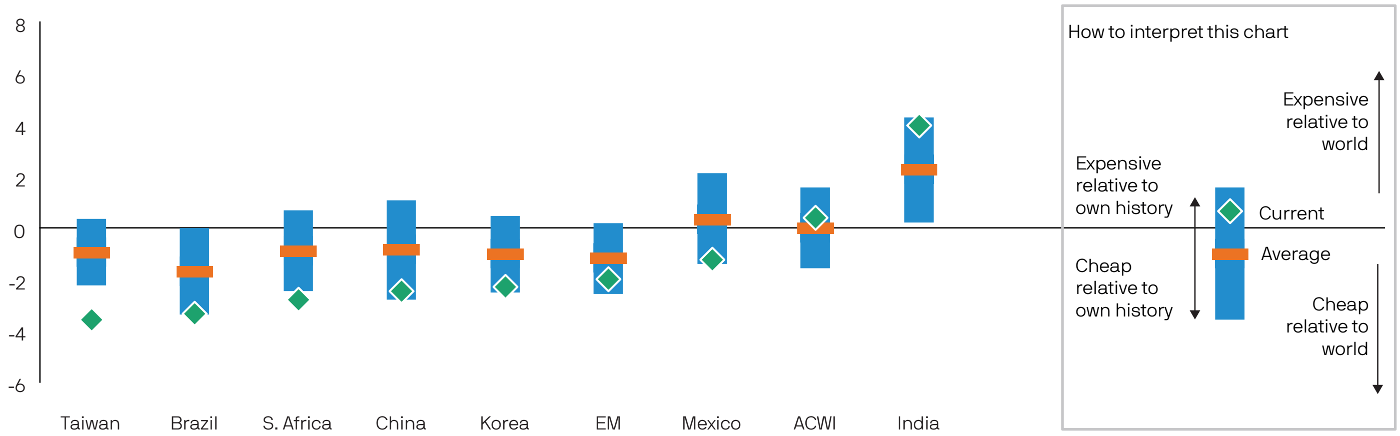
Emerging markets were hit by multiple headwinds, including a sharply slowing global economy, escalating political risks, China's zero-Covid policy and the fastest Federal Reserve (Fed) tightening cycle in more than three decades.

Due to the sharp drop in share prices, equity valuations have fallen across the board. As a result, emerging market equities now look increasingly attractive from a valuation perspective. Our proprietary valuation composite for emerging markets, which includes price-to-earnings, price-to-book and price-to-cash flow ratios, as well as dividend yield, is currently significantly below its long-term average and is also cheap relative to global equities (**Exhibit 15**).

Exhibit 15: Emerging market valuations are increasingly attractive

Emerging market valuations

Standard deviations from global average



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Each valuation index shows an equally weighted composite of four metrics: price to forward earnings (P/E), price to forward book value (P/B), price to forward cash flow (P/CF) and price to forward dividends. Results are then normalised using means and average variability since 2004. The blue bars represent one standard deviation either side of the average relative valuation to the All-Country World index since 2004. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

What are the potential catalysts to watch that could help to close this valuation discount in 2023?

1. The Fed pausing

The Fed, and the other large central banks in Europe, are determined to slow growth to ease inflationary pressures. Rising interest rates, increasing energy and input costs, and changing consumer patterns (from goods to services) are already slowing down demand for goods and hampering global manufacturing. North-east Asian markets, with their high export dependency, have been hit hard in the past couple of quarters as manufacturing purchasing managers' indices have fallen and earnings expectations have been revised down. In Taiwan and Korea, the highly significant semiconductor industry was at the centre of the storm as a combination of weakening demand, higher capacity and US restrictions on Chinese exports added to the overall economic headwinds.

Given our base case macro outlook of a modest recession in the US and Europe, and retreating inflation in 2023, we expect the Fed to stop increasing rates early in 2023. In such a scenario, cyclical stocks, such as those in the technology sector, and cyclical markets, such as Korea and Taiwan (which have also derated), would find a much more favourable environment, since equity markets are usually forward-looking and look ahead to price in an economic recovery.

2. The end of the zero-Covid policy in China

Beijing has stuck to a restrictive lockdown policy through much of 2022, with serious consequences for economic growth. Consumption growth remains subdued, weighing particularly on the services sector. Meanwhile the struggling property sector has limited room to improve as home buyer sentiment remains depressed by uncertainty over future incomes.

However, policymakers introduced an easing of Covid control measures in November which re-ignited confidence that China is moving incrementally towards an ending of its zero-Covid policy. While an announcement of a complete end to Covid measures does not look imminent, even a roadmap for gradual easing could provide the catalyst for a strong recovery in Chinese demand, which would be beneficial for not only for China but also for all its major trading partners in the region.

3. Abating political risk

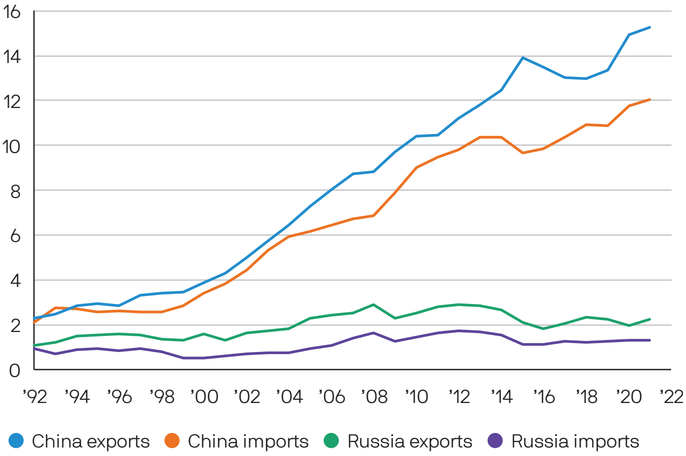
Emerging markets were also hit hard by an escalation of political risk in 2022. Russian equities (3.6% of the MSCI Emerging Markets Index at the beginning of 2022) became un-investable following the Russia-Ukraine war and the subsequent international sanctions imposed on Russia. In addition, a tightening of regulations in China and growing Sino-American tensions contributed to the decline in Chinese equities.

While political outcomes are hard to predict, investors need to acknowledge that abating political risks are a possible outcome in 2023. The Chinese economy is highly dependent on global demand, and global consumers are highly dependent on Chinese production (**Exhibit 16**). As a result, there are significant economic incentives for both sides to remain on good terms.

Exhibit 16: China needs the rest of the world, and vice versa

China and Russia's share of world trade

Exports and imports as a % of world total, goods only



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

For attractively valued emerging markets to shine in 2023, at least one of these three featured catalysts need to occur. We strongly believe that central banks will be less restrictive in 2023, but certain political outcomes, such as the end of China's zero-Covid policy, or a cessation of hostilities in Ukraine, remain very uncertain.

Therefore, while the significant valuation contraction in the past year has made emerging markets an attractive choice for cyclical exposure in portfolios, investors should continue to acknowledge that some risks are likely to linger.

Sticking with sustainability

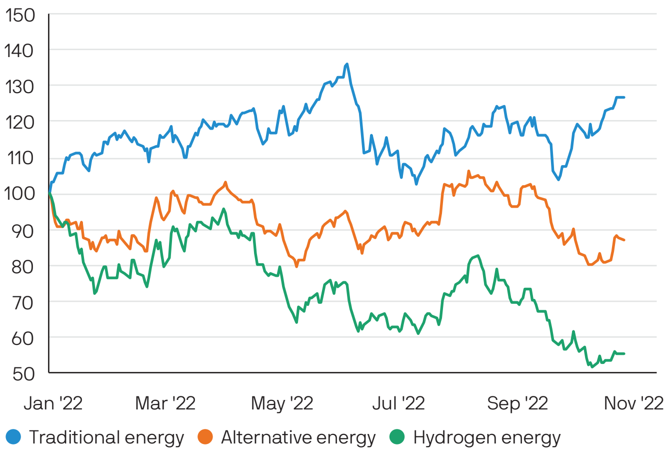
2022 has been a very challenging year for all investors, but there have arguably been additional headwinds for those with a sustainable tilt. The strong performance of oil and gas companies has led many sustainably tilted strategies – particularly those that apply blanket exclusion policies – to underperform benchmarks, while the growth tilt of renewable technology stocks has also been problematic in a year where surging bond yields prompted a broad-based growth sell off.

A closer look under the surface of the equity market helps to track how sentiment has ebbed and flowed. Fossil fuel companies have been the major beneficiary of high commodity prices, outperforming global stocks by more than 50% in the first 10 months of 2022. Sustainably focused strategies that tilt away from the traditional energy sector are therefore likely laggards. Performance across the broader renewable energy sector has been more nuanced, with a sharp sell-off at the start of the year as bond yields rose followed by a turnaround that began with the Russia-Ukraine war. Strategies linked to hydrogen stocks have suffered much more, with several of the most popular funds down more than 40% from January to October 2022 given their acute sensitivity to rising bond yields (**Exhibit 17**).

Exhibit 17: Performance has varied widely across the energy spectrum this year

Energy sector performance in 2022

Index level, rebased to 100 in January 2022



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Alternative energy is the MSCI Global Alternative Energy index, traditional energy is the MSCI ACWI Energy index and hydrogen is a custom-built, equally weighted index of five hydrogen focused ETFs. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

Despite these near-term difficulties, we see many reasons why it would be a mistake for investors to shy away from reflecting sustainability considerations in portfolios.

In Europe, the energy crisis has forced governments to prioritise energy security in the short term, with coal demand set to reach new record highs in 2022, and oil and gas companies delivering strong profits growth as prices surged. Yet these events must not obscure the bigger picture. To reduce dependency on Russian fuel while also meeting climate objectives, Europe needs to reshape how it sources and uses energy, and fast.

An accelerated rollout of lower priced renewable projects is the only medium-term solution, with associated earnings tailwinds for energy companies that can scale up their renewable capacity. Clean energy investment is accelerating in response, with the International Energy Agency expecting at least USD 1.4 trillion in new investment in 2022 and the sector now accounting for almost three quarters of the growth in overall energy investment. The European Union's (EU's) REPowerEU plan allocates nearly EUR 300 billion in investment by 2030 to help reduce the bloc's dependence on Russian fossil fuels. The US is also joining the party, with the Inflation Reduction Act including tax credits and other financial incentives aimed at making clean energy more accessible.

Fears around windfall taxes – not just for energy companies but also for electricity providers – may be one reason why this earnings optimism has not been fully reflected in prices so far. Clearly it is not socially acceptable to allow utility companies to reap large windfall profits from surging electricity prices in the midst of a cost-of-living crisis. Yet given the need for governments to encourage investment as part of the energy transition, we would expect any impact of windfall taxes on renewable providers to be far less than for traditional energy companies. If the marginal cost of electricity is eventually de-linked from the natural gas price – as the EU and UK are examining – then renewables providers would probably fall out of scope of such taxes too.

Changes in the broader macro environment could also be more conducive for sustainable equity strategies in 2023. After a historic sell-off in the bond market, our base case sees moderating inflation leading to more stable bond yields next year. This should help to reduce the pressure on companies pushing for technological breakthroughs who have a much greater proportion of their earnings assumed to be further in the future (and are therefore much more sensitive to changes in discount rates).

Sustainably minded investors should not only look to equity markets next year – we also expect green bond markets to see significant development. With governments and corporates across Europe looking to raise capital to tackle environmental challenges, there is no shortage of projects that could be financed via greater green bond issuance. Issuers in these markets benefit not only from strong demand that can help to drive down yields (**Exhibit 18**) relative to traditional bond counterparts, but also an investor base that is tilted towards more stable lenders of capital than conventional syndications.

While the prospect of greater issuance is rarely something to cheer for bond investors, this activity should go a long way to addressing one of the green bond market's key deficiencies: the lack of a "green yield curve" that makes manoeuvring portfolios in this universe more challenging. As the green bond market matures, an expanded opportunity set that offers greater flexibility will be a major requirement. The key for investors will be to scrutinise covenants for measurable and specific targets, and ensure that proceeds make a material difference to the ability of the issuer to deliver their green, social or sustainable project.

In sum, many investors will end 2022 feeling battered and bruised and, unlike in recent years, a sustainable tilt is unlikely to have helped to boost portfolio resilience. Yet we believe it would be short-sighted to shun the sustainable agenda as a result. Policy tailwinds look set to combine with improved valuations and a more conducive macro backdrop, creating investment opportunities that are too exciting to ignore.

Exhibit 18: The green premium between green and traditional bonds continues to widen

Spread between green and traditional corporate bonds

Basis points

Source: Barclays Research, J.P. Morgan Asset Management. Data shown is for a Barclays Research custom universe of green and non-green investment-grade credits, matched by issuer, currency, seniority and maturity. The universe consists of 164 pairs, 99 EUR denominated, 61 USD denominated, and 4 GBP denominated and 88 financials and 76 non-financials. Spread difference is measured using the option-adjusted spread. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2022.

Central projections and risks

Our core scenario sees developed markets falling into a mild recession in 2023 on the back of tighter financial conditions, less supportive fiscal policy in the US, geopolitical uncertainties and the loss of purchasing power for households. Despite remaining above central banks' targets, inflation should start to moderate as the economy slows, the labour market weakens, supply chain pressures continue to ease and Europe manages to diversify its energy supply. However, we remain in an unusual environment, and it's as important as ever to keep an eye on the risks to our central view, as they are skewed to the downside.

	Downside	Central	Upside
Macro	**Persistent inflation, deep recession** Inflationary pressures increase as geopolitical tensions spike. The hit to both business confidence and profitability leads to layoffs, driving unemployment materially higher. Social unrest – given ongoing cost of living pressures –keeps wage growth high, but declining real incomes still hit consumption.	**Moderating inflation, mild recession** Developed markets fall into a mild recession and inflation moderates as the labour market weakens modestly and supply chain pressures continue to ease. A deep recession is avoided. The housing market cools although this is unlikely to look like 2008. Geopolitical tensions remain elevated but do not escalate and economic sanctions are kept in place.	**Inflation fades, growth recovers** Inflation cools quickly as geopolitical tensions ease. Energy and food prices retreat as the Russia-Ukraine situation improves. Capital spending (capex) rebounds with confidence restored, helping economic growth to recover. Unemployment rates remain low.
Policy	**Monetary:** Central banks are forced to tighten policy more than in our central scenario to anchor inflation expectations, even as growth deteriorates. **Fiscal:** Higher borrowing costs constrain any ability to ease fiscal policy.	**Monetary:** The Federal Reserve increases rates to around 5% and stops there. The European Central Bank stops hiking at around 3%. For the Bank of England, we see a peak UK interest rate of around 4.5%. **Fiscal:** Divided Congress limits fiscal stimulus in the US. Continued disbursement of the recovery fund and energy support packages cushion activity in Europe.	**Monetary:** Central banks stop hiking rates sooner and at lower levels than in the central scenario. **Fiscal:** Stabilising debt service costs ease concerns around fiscal headroom.
Markets	**Fixed income:** Stagflationary pressures limit government bonds' ability to diversify equity losses. Credit spreads widen, with riskier sectors hit hardest. **Equities:** Worst scenario for equity markets with earnings hit hard. Quality and defensives outperform. **Currencies:** Safe-haven flows boost the US dollar. **Alternatives:** Real assets provide some inflation protection. Hedge funds benefit from higher volatility.	**Fixed income: Government bonds deliver positive returns. Investment grade credit outperforms government bonds.** **Equities: Positive returns from stocks. Value outperforms but to a lesser extent than in 2022.** **Currencies: The US dollar remains well supported.** **Alternatives: Real assets provide income and some inflation protection. Hedge funds also provide diversification.**	**Fixed income:** Government bonds deliver positive returns, but riskier fixed income sectors strongly outperform. **Equities:** Strong returns across equity markets, with cyclical regions and sectors outperforming. **Currencies:** The US dollar weakens as growth broadens by geography. **Alternatives:** Particularly strong environment for private equity and private credit.

Source: J.P. Morgan Asset Management, as of November 2022. Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

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