

Mid-Year Investment Outlook 2023

Too good to be true



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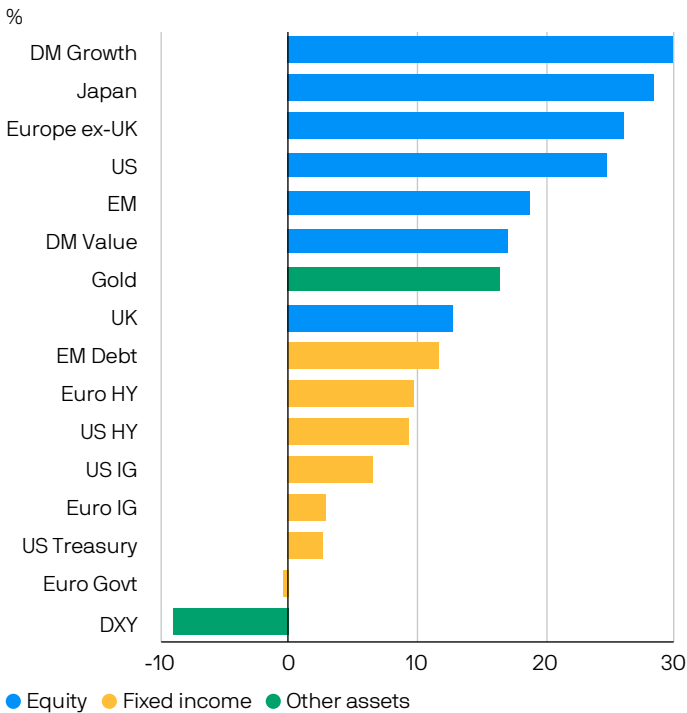
In brief

- 2023 is turning out to be a better year for economies than we had envisaged, but we still believe a recession is more likely than not. Given the rally we've seen in both stocks and bonds since the start of the year, we're therefore more inclined to be well diversified with a focus on quality.
- Our macro "base case" on a 12-month horizon is little changed from the year ahead outlook, although elevated valuations now make it more difficult for us to argue that markets are appropriately priced for the slowdown we still see ahead.
- Against this backdrop, we believe that investors should look to boost the resilience of equity portfolios by focusing on a combination of high-quality names, strong dividend payers and regional diversification.
- We also think that adding exposure to alternative asset classes, such as infrastructure, could provide a more defensive stance to portfolios, while delivering some inflation protection and attractive income.
- Finally, we believe a key theme that active investors should keep a close eye at the moment on is scarcity, with opportunities being created by the supply shortages we are currently seeing across energy, materials, food and labour markets.

Our year ahead outlook was titled ‘2023: A bad year for the economy, a better year for markets’. The prognosis was simple: a recession would be required to get rid of inflation. The only question was how high interest rates would need to get to generate that recession. Central banks had flagged their intentions, meaning most developed world stock markets had already tumbled last year, so we felt that markets were well braced for the economic downturn ahead.

Exhibit 1: Global markets have made strong returns in the last nine months

Returns since 30 September 2022



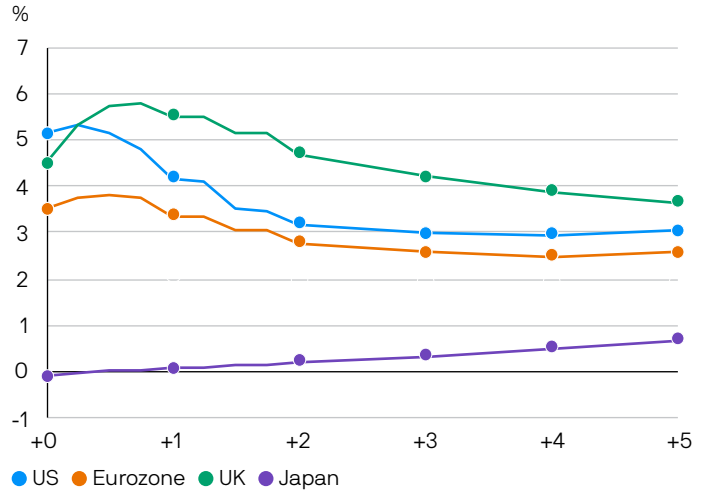
Source: Bloomberg, ICE BofA, J.P. Morgan Economic Research, MSCI, Refinitiv Datastream, S&P Global, J.P. Morgan Asset Management. MSCI indices are used for EM, Europe ex-UK, DM Growth, DM Value, Japan and UK. S&P 500 is used for US. Equity returns are total returns and are shown in local currency, with the exception of EM which is in US dollars. Bloomberg Barclays Aggregates used for US Treasury, Euro Govt, US IG and Euro IG. Euro HY: ICE BofA Euro Developed Markets Non-Financial High Yield Constrained; US HY: ICE BofA US High Yield Constrained; EM Debt: JPM EMBI Global Diversified. Past performance is not a reliable indicator of current and future results. Data as of 15 June 2023.

Fast forward six months and it is indeed proving to be a better year for markets. But it is also turning out to be a better year for economies than we had envisaged. While manufacturing has suffered through the combination of weaker demand for goods and soaring costs, service sector activity remains remarkably robust. A strong labour market, pent-up savings and a desire to make up for the experiences missed during Covid appear to have outweighed the drag from higher costs and interest rates.

Yet the resilience of growth hasn't led to market expectations of an extended period of higher interest rates. Instead, the debate in the bond market has been centred around how quickly rate cuts will be delivered.

Exhibit 2: Markets are pricing in interest rate cuts from several major central banks

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 2023.

It seems markets are increasingly hopeful that Goldilocks is back; that the economy can avoid recession with inflation falling back to target.

Inflation is priced to fade quickly, allowing central banks to shift their attention to supporting growth. Instead of driving a recession, they will be aiming to prevent one, which would be music to both stock and bond investors' ears.

To us, however, this feels a little too good to be true. There are a number of questions that are still outstanding and will need to be answered in the remainder of the year. Running through these issues, we conclude that interest rates won't be slashed pre-emptively and therefore a recession is still more likely than not. If rates are being slashed, it's probably because a recession has occurred which could trouble risk assets.

For that reason, in this mid-year outlook we focus on a) ensuring a portfolio is well diversified against both recession and inflation risk, b) allocating to stocks in a relatively defensive fashion, and c) the secular themes that to us seem increasingly dominant as we shift from a world of abundance to scarcity.

What will the economic toll of recent banking stresses be?

Three large bank failures in the US and the Credit Suisse rescue in Europe were seen by markets as a reflection of growing tensions in the banking sector. But after a short spike in volatility in March, risk aversion in markets retreated as swift liquidity support by central banks and takeovers prevented an escalation. However, we think market perception is probably too complacent in this respect. While we acknowledge that banks are significantly better capitalised and regulated than 15 years ago, first quarter lending surveys in the US and eurozone reminded us how banking troubles can spill into the broader economy.

Bank lending surveys highlight that almost 50% of US commercial banks and nearly 25% of banks in the eurozone had already tightened corporate lending standards in the first quarter. In the past 30 years, this level was usually accompanied with a recession. Higher macro risk, lower risk tolerance, and balance sheet constraints are seen as main contributors to recent tightening of lending conditions. This is unlikely to change in the near term since a bleak outlook for housing and commercial real estate, and a downturn in the credit cycle will likely keep risk tolerance at banks low for the time being.

Balance sheet constraints caused by unrealised losses and deposit outflows will ease as soon as interest rates fall. A scenario of a fast cooling in core inflation would be the best case in that respect, giving central banks room to lower policy rates which would also translate into looser credit conditions. Unfortunately, we don't expect inflation to disappear quickly enough.

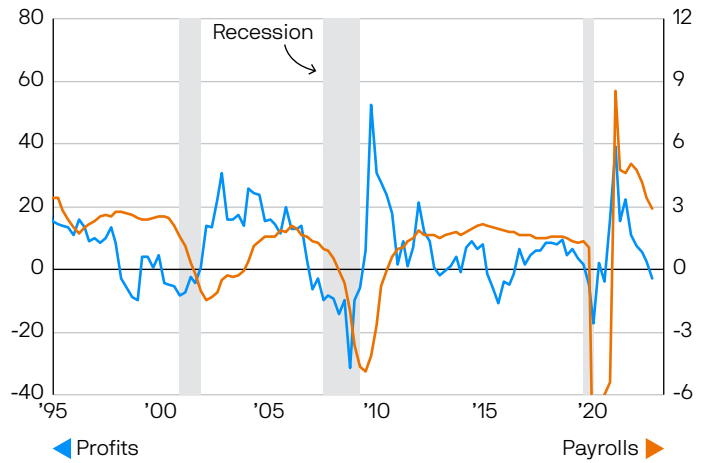
Will businesses cut jobs in the face of slowing earnings?

Another uncertainty is how the labour market behaves. Usually when profits come under pressure, firms quickly cut back on investment, and then staff, in a bid to repair margins. This then marks the start of a vicious cycle as higher unemployment leads to a further downturn in demand, profits and so on.

Exhibit 3: Weakening profits are normally followed by weakening employment

Relationship between US profits and payrolls

% change year on year



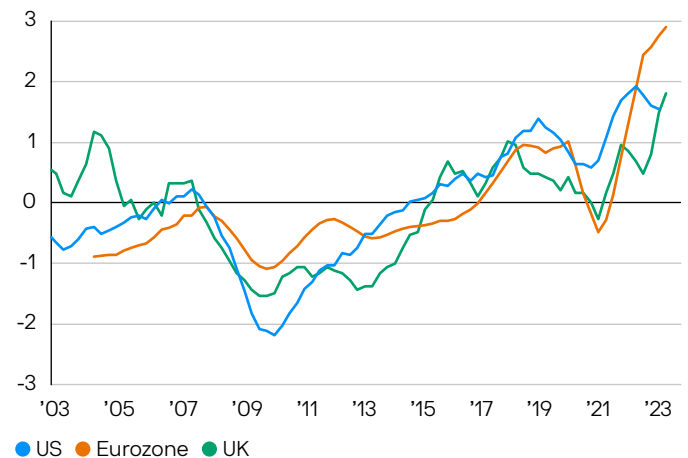
Source: BEA, BLS, Refinitiv Datastream, J.P. Morgan Asset Management. Data as of 15 June 2023.

There are already signs that firms are cutting back on investment plans but employment intentions remain relatively robust. This might reflect the fact that firms have had such a tough job finding staff post pandemic and hence are willing to hoard staff in the hope that the downturn is short lived.

Exhibit 4: The competition for workers has dramatically increased post-pandemic

Proportion of firms struggling to find workers

z-score, four-quarter moving average



Source: CBI, DG ECFIN, National Federation of Independent Business, Refinitiv Datastream, J.P. Morgan Asset Management. Data as of 15 June 2023.

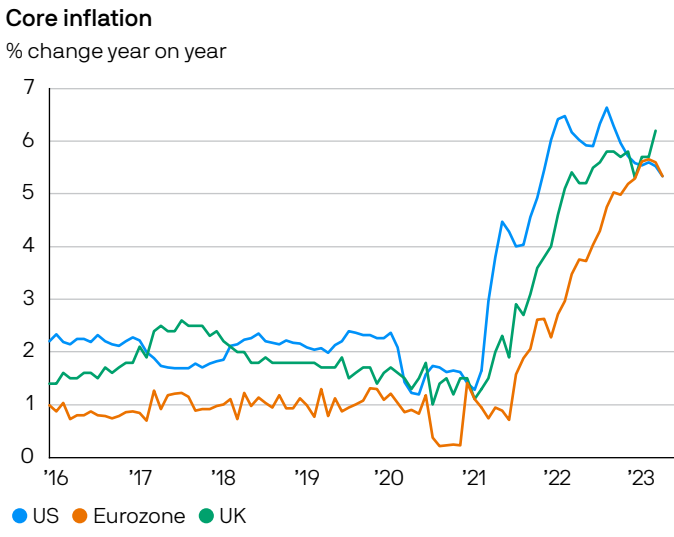
It's also possible that this is a temporary phenomenon and a significant rise in unemployment is around the corner. For now, central banks face a difficult balancing act. They need the labour market to weaken to drive down wage growth and inflation, but being the cause of rising unemployment is never something central bankers relish. Having to deliver that outcome in the run up to a national election, as will be the case in 2024 for the UK and US, makes life even more uncomfortable.

Will inflation cool on both a headline and core basis?

Headline inflation is likely to continue retreating in the coming months and Europe will benefit from favourable base effects as the large gains in energy and food prices seen this time last year start to drop out of the annual calculation.

We are less convinced, however, that core inflation is on a speedy path back to 2%. Demand for services remains buoyant with households still seemingly intent on making up for the lost experiences in Covid times. The tightness of the labour market and ongoing pressure on wages will also keep upward pressure on cost and prices until a recession hits.

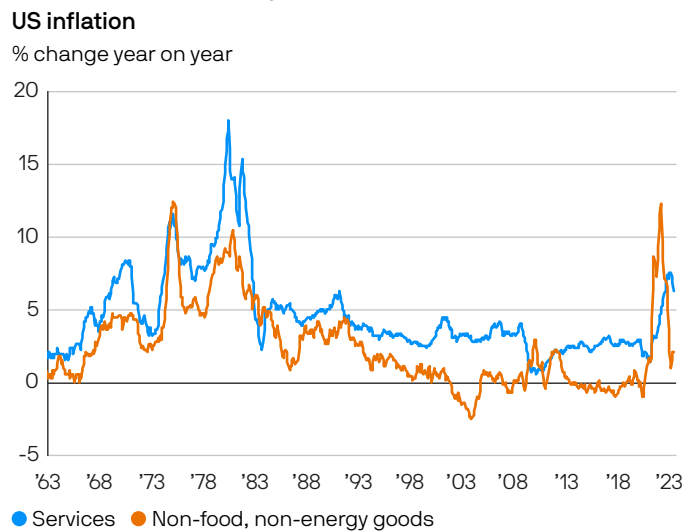
Exhibit 5: Core inflation remains stubbornly high



Source: BLS, Eurostat, ONS, Refinitiv Datastream, J.P. Morgan Asset Management. Core inflation excludes food and energy in the US, and food, energy, alcohol and tobacco in the eurozone and the UK. Eurozone and UK use HICP and CPIH measures respectively to better reflect housing costs. Data as of 15 June 2023.

Stepping back from the short-term drivers, our main concern is that we struggle to see a world in which goods price inflation will be as low and stable as it has been in the past. The US consumer paid the same for the basket of goods that they bought in 2020 as they did 20 years earlier. For the UK consumer it was the same 30 years earlier. With the combination of higher input costs as we transition from fossil fuels and less of a disinflationary drag from globalisation, we struggle to see such a feat being repeated.

Exhibit 6: Goods prices are unlikely to help central banks meet their inflation targets as in the past



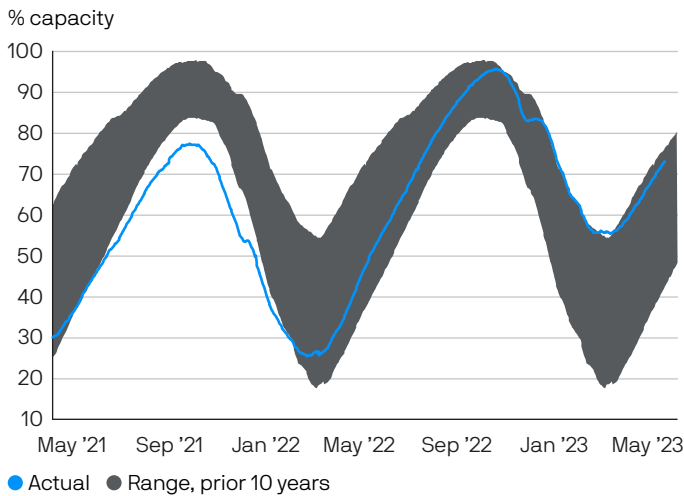
Source: BLS, Refinitiv Datastream, J.P. Morgan Asset Management. Data as of 15 June 2023.

If goods price inflation ends up being higher on average then central banks would have to drive services inflation lower if they are serious about meeting their 2% targets sustainably. It's worth remembering that the last time US service sector inflation dipped below 1% was on the back of a very deep recession. The economic cost of such an endeavour makes this a politically unrealistic outcome in our view. For governments, a little unanticipated inflation also appears an easier way out of a debt problem, having already exhausted the option of austerity. Latest surveys of inflation expectations suggest we are not alone in our suspicions that higher medium-term inflation is on the cards. If central banks cut rates later this year prior to the onset of a recession, it would strengthen our conviction yet further that investors should prepare their portfolios for both higher inflation on average over the medium term and more frequent bouts of inflation volatility.

Will Europe have energy problems next winter?

Europe confounded expectations of an economic meltdown over winter, having lost its biggest supplier of energy last July. In fact, warmer temperatures, curtailed industrial production and some efficient shifts in behaviour meant that storage tanks remained unseasonably full. Plummeting wholesale gas prices are now helping to drive down inflation and revive consumer confidence.

Exhibit 7: EU gas inventories look well placed for next winter
EU natural gas inventories



Source: Bloomberg, Gas Infrastructure Europe, J.P. Morgan Asset Management. Data as of 15 June 2023.

Pessimists might argue this was more luck than judgment which would have to be repeated next winter. But the starting point is so strong the race is already half won; EU storage tanks are at over 70% capacity which compares to just over 50% this time last year. The price of gas on short-term contracts has fallen but even prices further ahead suggest next winter is looking increasingly secure unless temperatures are particularly severe. All the while the race is on to ensure that a domestic renewable solution is in place. We are generally optimistic that energy prices won't surge again.

Will China's recovery be short-lived?

After the end of zero-Covid, China's recovery showed similar patterns to those seen in the US and Europe before. Sentiment in the service industry improved significantly as Chinese consumers caught up with activities they had to forego in the lockdown period. However, investment activity was relatively muted compared to previous recovery cycles as global goods demand weakened and domestic credit growth was less expansionary.

Second quarter business sentiment indicators now point to weaker growth momentum ahead as real estate woes are still taking their toll on private sector confidence and post-pandemic financial buffers are not as extensive as in Europe or the US.

While we acknowledge that Chinese growth in 2023 might fall short of relatively sanguine market expectations at the start of the year, it would be premature to write off the entire year. Moderate government debt levels give policymakers room for additional fiscal stimulus, while very low inflation is allowing the People's Bank of China (PBOC) to cut policy rates to support household and corporate balance sheets.

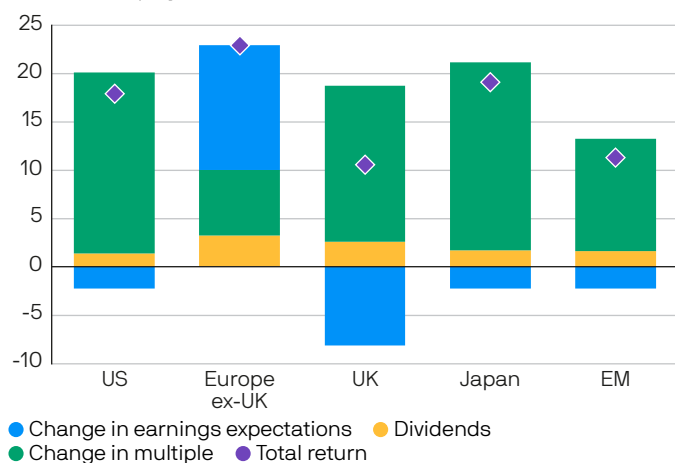
Boosting resilience in equity allocations

Rising hopes of a Goldilocks scenario have been very supportive for stocks this year. The strong rebound since last September’s market trough has been almost entirely driven by multiple expansion, while earnings expectations have flatlined. Europe ex-UK is the one major exception, where the rally has been fuelled by a combination of rising valuations and improved earnings expectations as the risks of an energy supply crunch have faded.

Exhibit 8: Multiple expansion has been the key driver of recent equity returns

Return decomposition since 30 September 2022

Sources of equity market return, %



Source: FTSE, MSCI, S&P Global, Refinitiv Datastream, J.P. Morgan Asset Management. MSCI indexes used for Europe ex-UK, Japan and EM. US is S&P 500 and UK is FTSE All-Share. Returns shown in local currency, with the exception of EM which is in US dollars. Past performance is not a reliable indicator of current and future results. Data as of 31 May 2023.

This might be a matter of market hope over earnings reality. An economic downturn still seems the most likely scenario to rid developed economies of their inflation excesses. But lower inflation, by definition, means lower corporate pricing power.

In order to boost the resilience of equity allocations against this backdrop, we believe that investors should focus on a combination of high-quality exposures, strong dividend payers and regional diversification.

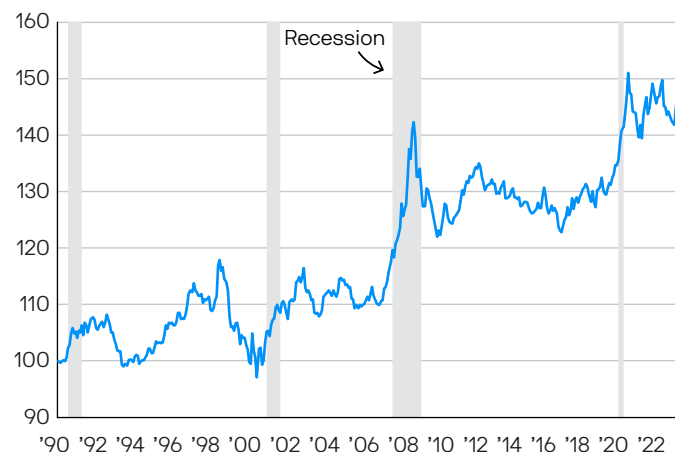
Quality is king

Amid heightened uncertainty, our highest conviction view within equities is that markets will reward companies with stronger quality credentials, such as robust balance sheets and management teams with deep experience through multiple cycles. While these characteristics may always sound attractive for stock pickers, the last bull market saw higher quality stocks trade largely in line with the broad US market for an entire decade. History suggests that a quality focus performs most strongly during periods when the economy weakens.

Exhibit 9: Quality stocks have outperformed during previous periods of economic stress

S&P 500 Quality/S&P 500 relative performance

Relative total return index level, rebased to 100 in January 1990



Source: J.P. Morgan Asset Management Quantitative Beta Solutions, S&P Global, J.P. Morgan Asset Management. S&P 500 Quality index is the top quartile of quality stocks in the S&P 500 determined by JPMAM Quantitative Beta Strategies based on measures of profitability, financial risk and earnings quality. Past performance is not a reliable indicator of current and future results. Data as of 31 May 2023.

It is also important to note that an up-in-quality approach does not exclusively equate to growth stocks. Some of the mega-cap growth players will fit a definition of quality thanks to their robust balance sheets, but equally we see high quality opportunities in more value-tilted sectors such as energy and select large-cap financials. The wide gap in valuations between growth and value sectors relative to history is another reason to ensure that portfolios are well balanced across both styles. From a size perspective, a focus on stronger balance sheets generally points to a preference for large caps over smaller counterparts.

Dividends for defence

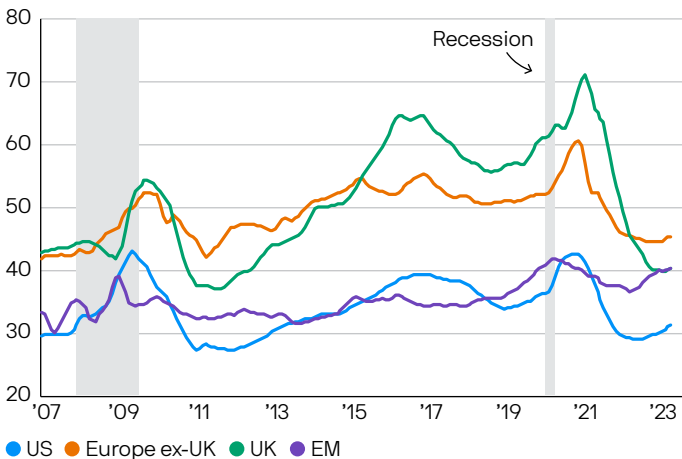
A tilt towards dividend payers may also help to buffer equity portfolios from more volatility ahead. Payout ratios are yet to recover to pre-pandemic levels across most major regions, after many companies were forced to pause dividends during Covid-19. This leaves room for companies to maintain dividends even if earnings do soften.

Strong dividend payers are often found in more defensive sectors such as healthcare and utilities that typically exhibit lower beta to the broad market, unlike some of the more cyclical growth sectors where cashflows are more frequently reinvested into the business instead of being returned to shareholders. Dividend yields in the emerging markets look particularly attractive, standing close to their widest gap to developed markets in over 20 years.

Exhibit 10: Low dividend payout ratios give companies room to manoeuvre

Dividend payout ratios

%, three-month moving average



Source: FTSE, MSCI, Refinitiv Datastream, S&P Global, J.P. Morgan Asset Management. US is S&P 500, UK is FTSE All-Share, MSCI indices used for Europe ex-UK and EM. Dividend payout ratio shows 12-month trailing dividend per share divided by 12-month trailing earnings per share. Past performance is not a reliable indicator of current and future results. Data as of 31 May 2023.

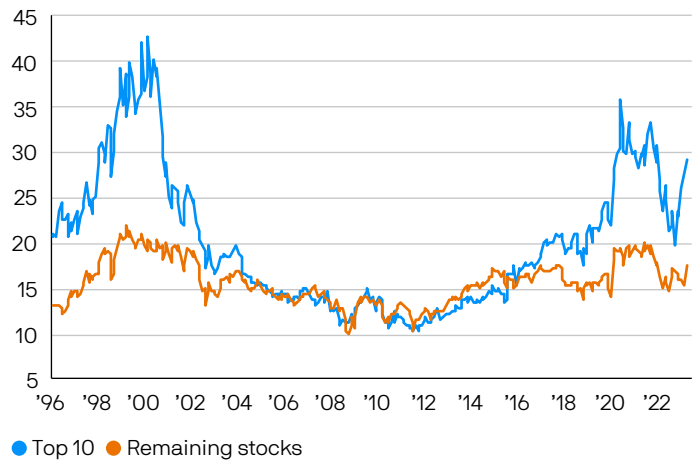
Diversified across regions

Given the uncertainties, we'd caution against positioning portfolios with too much concentration in any one single equity region.

Our primary concern about the US market relates to how concentrated it has become. In the first five months of 2023, the top 10 stocks in the S&P 500 returned just under 40%, while excluding the top 10, the S&P 500 actually declined over the same period. With the exception of the pandemic, the gap between the valuations of the top 10 and the rest is at its widest level since 2000.

Exhibit 11: US valuations are skewed by a handful of stocks
Forward P/E ratio of the top 10 and the remaining stocks in the S&P 500

x, multiple



Source: FactSet, S&P Global, J.P. Morgan Asset Management. The top 10 stocks based on the 10 largest index constituents at the start of each month. Past performance is not a reliable indicator of current and future results. Data as of 15 June 2023.

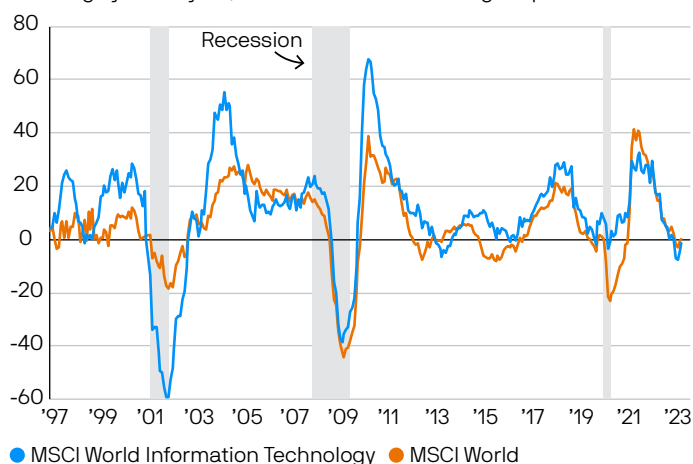
Markets may be betting on either extraordinary profits in tech thanks to recent developments like AI or, the hope that tech will generally prove defensive in the event of economic turbulence that sees interest rates return to very low levels.

We're cautious to place too much weight on the view that the sector's earnings will prove countercyclical in the event of a US recession. A look back in time shows that this is rare. More diverse business models and much stronger balance sheets suggest that it's unreasonable to compare the situation today to the bursting of the dot-com bubble in the early 2000s, when tech earnings fell much more heavily than the broad index. Yet we are also sceptical that tech stocks can repeat their feat of 2020 and see profits tread water at a time where earnings come under pressure across many other sectors, particularly in some of the more economically sensitive parts of the sector such as hardware. Even in the most optimistic scenarios for the evolution of artificial intelligence over the next decade, a shorter-term pullback in spending from both consumers and businesses as the economy weakens appears likely.

Exhibit 12: Investors cannot bank on tech being immune to broader earnings weakness

MSCI World Tech and index earnings

% change year on year, 12-month forward earnings expectations



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 May 2023.

Investors looking to diversify US holdings may wish to allocate more to Europe than they have in the last decade. Cheaper multiples and stronger dividend yields in the UK and Europe ex-UK should fare relatively better versus the US in the scenario that equity valuations come under pressure. Europe's departure from its low rate, low inflation rut also bodes well for the region's prospects over the medium term, as we highlight in our [recent piece](#).

Our base case of a slowdown in the global economy would typically bode badly for emerging market stocks relative to developed market counterparts, yet there are reasons why this relationship may not hold this time round. The first is valuations: emerging market stocks already trade at close to a 30% discount to developed markets on a 12-month forward earnings basis, and many currencies screen as cheap relative to the US dollar. The second is monetary policy: with several emerging market central banks having frontloaded their hiking cycles in 2021, cooling inflation this year is now opening up the potential for rate cuts that would support economic growth.

China's post-Covid recovery was expected to provide support for the broad emerging market region, although after a very strong first quarter, economic data has more recently underwhelmed investor expectations. Pockets of the services sector are rebounding strongly but the manufacturing sector remains weak, emphasising the need for an active investment approach to tap into pockets of stronger earnings growth. Potential catalysts for an improvement in broad market sentiment include Chinese policymakers providing greater economic support, a rebound in private sector confidence and investment, and/or dissipating geopolitical tensions.

Japanese stocks have enjoyed a strong run relative to other regions this year. While green shoots in the economy are emerging with inflation and wage growth picking up, our optimism is tempered by the prospect of either yield curve control adjustments or a global recession leading to a stronger yen that would weigh on Japanese companies' foreign earnings.

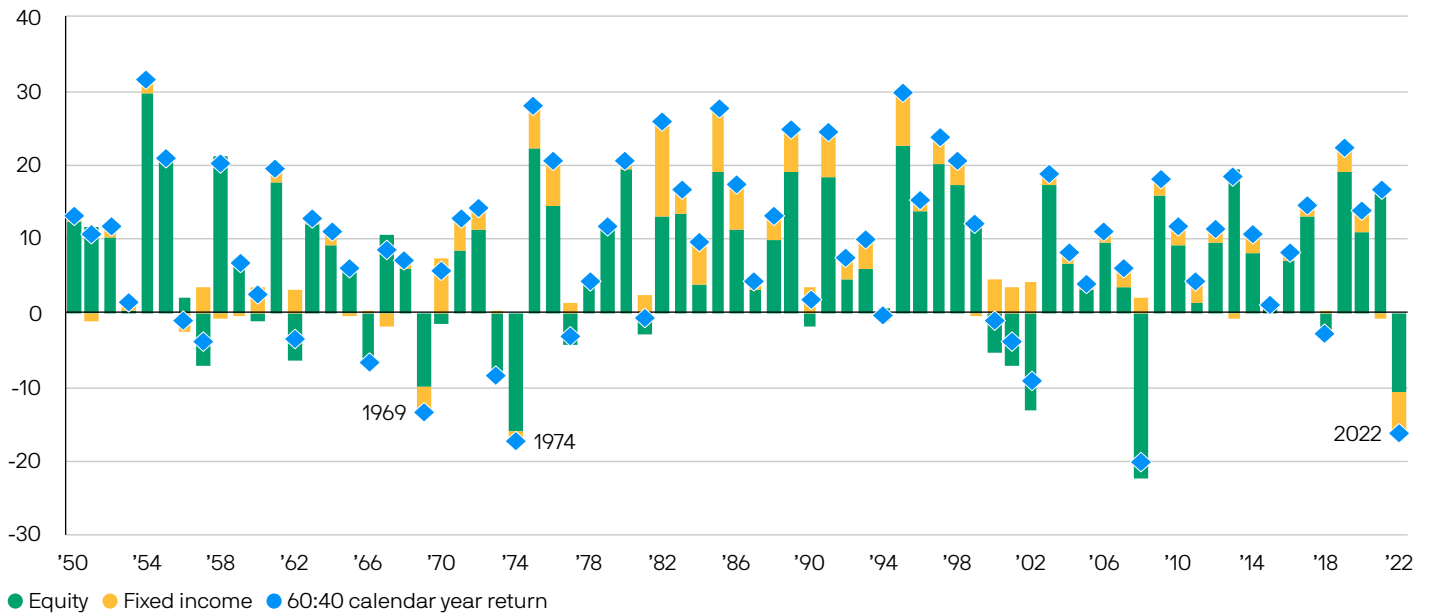
Thinking more broadly about portfolio diversification

2022 was a challenging year for investors as stocks and bonds fell together, posting one of the worst returns on record for a traditional 60/40 portfolio. There have only been three occasions in the last 50 years when US stocks and bonds both lost money. Those were: 1969, when US inflation breached 6%; 1974, when inflation reached 12% on the back of the oil crisis; and 2022, when inflation suddenly reached 40-year highs.

Exhibit 13: When inflation spikes, neither bonds nor stocks are your friend

Annual returns in a 60:40 US stock-bond portfolio

%, total return



Source: Ibbotson, Robert Shiller, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 31 May 2023.

As we look forward, there are a number of plausible economic scenarios. One is that a recession arrives with enough force to quickly eradicate inflation concerns. This scenario might send tremors through risk markets, but we are now in a position where bonds can diversify deep recession risk in a way that they struggled to do in a low yield world. The rise in bond yields is one of the reasons we became so much more positive on fixed income last year.

However, there is another potential scenario whereby inflation remains problematic; one in which recession is avoided in the near term and inflation pressures don't sustainably subside. In this scenario, the cuts in interest rates that are already priced in by bond markets may not materialise and rates could rise further. As a result, bonds – and quite possibly also stocks – could struggle.

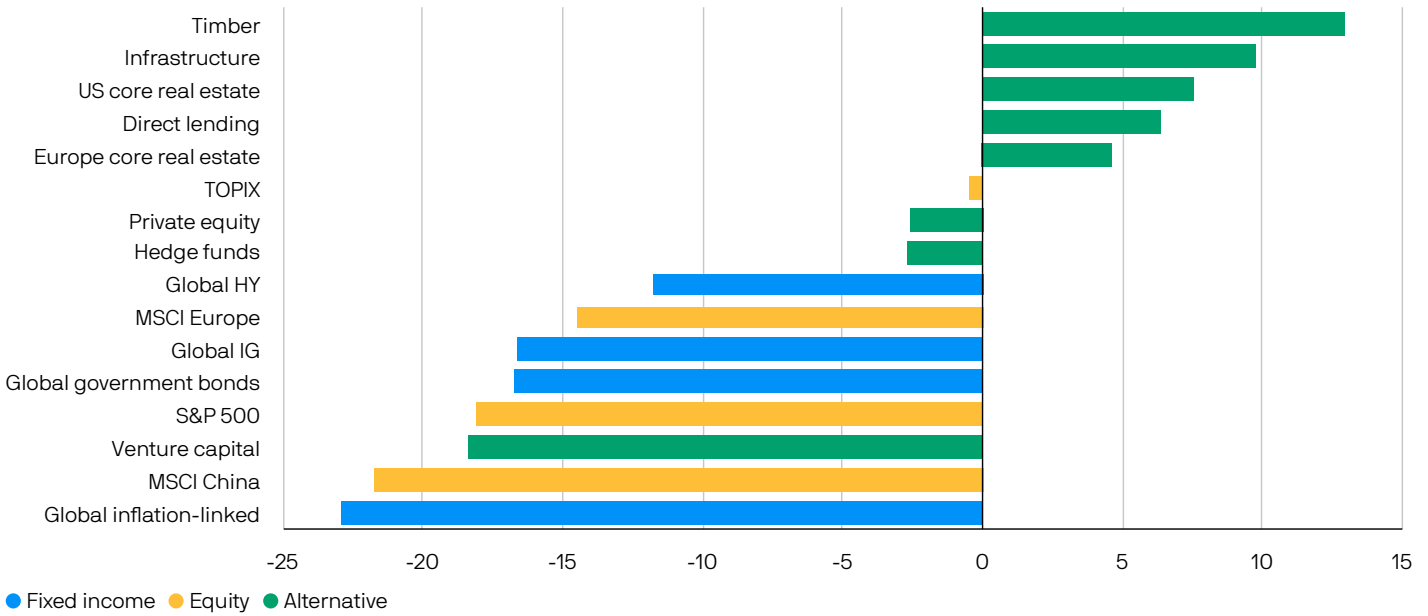
We also see a reasonably high likelihood of above-target inflation remaining a challenge over the medium term. This is due to a scarcity of various things, not least workers, which have previously been abundant. The bottom line is investors need to think more broadly about portfolio diversification, accounting for solutions that work in disinflationary recessionary scenarios (government bonds) but also diversification that could work in more inflationary scenarios, where stocks and bonds could fall together as they did in 2022.

Alternative diversifiers

Unlike stocks and bonds, many alternative asset classes – including timber, infrastructure and real estate – managed to generate positive returns last year.

Exhibit 14: Many alternative assets produced positive returns last year
Selected public and private market returns in 2022

%, total return in USD



Source: Bloomberg, Burgiss, Cliffwater, Factset, HRFI, MSCI, NCREIF, Refinitiv Datastream, S&P Global, J.P. Morgan Asset Management. Returns shown are for 2022. Indices used are as follows: Global government bonds: Bloomberg Global Aggregate – Government; Global inflation-linked: Bloomberg Global Inflation-Linked; Global IG: Bloomberg Barclays Global Aggregate – Corporate; Global HY: ICE BofA Global High Yield Index; Hedge funds: HRFI Fund Weighted Composite; US core real estate: NCREIF Property Index – Open End Diversified Core Equity component; Europe core real estate: MSCI Global Property Fund Index – Continental Europe; Direct lending: Cliffwater Direct Lending Index; Global infrastructure: MSCI Global Quarterly Infrastructure Asset Index (equal-weighted blend); Timber: NCREIF Timberland Total Return Index. Private equity and venture capital are time-weighted returns from Burgiss. All returns are in USD. Past performance is not a reliable indicator of current and future results. Data as of 15 June 2023.

These asset classes are generally decent inflation hedges as they can often pass through higher inflation via higher rents or usage costs. To be clear, parts of real estate could come under further pressure in a higher rate environment, particularly those parts facing structural challenges. But alternative assets, such as infrastructure, could continue to prove relatively defensive while also providing some inflation protection and an attractive income. Hedge funds have also historically done a decent job of limiting drawdowns relative to equity markets in periods where equities (and bonds) struggle.

With the potential for more inflation volatility over the coming years, one may not be able to rely on a consistent negative correlation between stocks and bonds to limit portfolio downside and improve risk-adjusted returns. So, while our base case sees government bonds providing some portfolio diversification if stocks were to fall in the near term, investors might want to look beyond traditional asset classes to further diversify their portfolios.

Secular investment themes: From abundance to scarcity

In periods of market uncertainty, it can be easy to lose sight of the bigger picture. But these periods can also create opportunities to position for longer-term themes. In our view, a number of secular trends are centred around the theme of scarcity.

The changing supply side

Scarcity has not been an issue for much of the past two decades. With China joining the World Trade Organisation and bringing 1.2 billion people into the global labour market, increasingly integrated global supply chains, and the discovery of significant additional oil and gas in North America, the last few decades could be characterised as a period of abundance. If anything, the problem has been ensuring demand kept up with rapidly expanding supply.

But the supply side of the global economy is changing. Worries about climate change have raised concerns about the exploitation of natural resources for some time, while the pandemic has led to what we perceive to be lasting changes to supply chains and labour markets. And Russia's invasion of Ukraine has created a shortage of numerous commodities, at least for western buyers.

One might expect this to act as a considerable restraint on global growth. However, history has multiple examples of humankind's ability to overcome problems with innovation. Innovation and change require capital investment, which creates exciting opportunities for long-term, active investors across a variety of sectors.

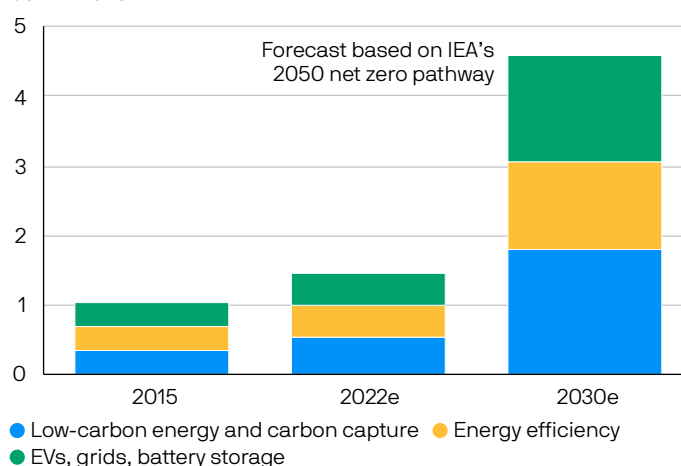
Clean energy scarcity

Low-carbon energy is perhaps the most obvious example. Forecasts for renewable energy investment shortages are eye catching – for example, spending on electricity generation from renewables will need to more than triple by 2030 for the world to meet energy demand in a way that is consistent with net zero targets.

Exhibit 15: The energy transition requires a huge increase in investment spending

Global investment in clean energy and energy efficiency

USD trillions



Source: IEA, J.P. Morgan Asset Management. Data is from the IEA's "World Energy Investment 2022" report. 2030e is based on the IEA's net zero by 2050 scenario. Data as of 15 June 2023.

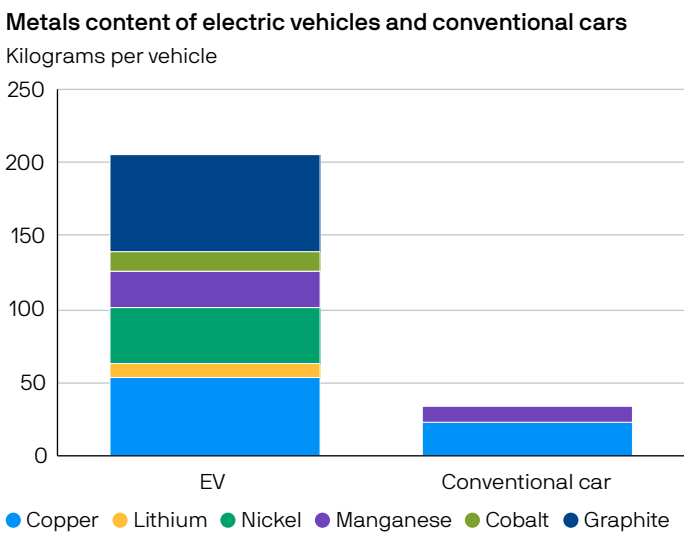
After many years of scarce low carbon energy being a problem, policymakers are finally taking action. Public investment in the transition is ramping up – see the European Union's (EU's) Recovery Fund, with its focus, among other objectives, on catalysing a transition in Europe's energy supply. Incentives for private clean energy investment are also multiplying, thanks to the US's Inflation Reduction Act and EU's Green Deal Industrial Plan.

An ongoing scarcity of low-carbon energy and these more recent government carrots (and sticks) create earnings opportunities for firms who can help countries and companies clean up their energy footprints. Obvious examples include businesses in the renewable energy, efficiency, electrification and carbon capture spaces. If a recession does materialise and "growth-ier" clean energy firms are caught up in a broad-based stock market decline, investors could be provided with an opportunity to position for these secular themes. Beyond energy generation, low-carbon power will need to permeate the economy more widely, and thus the sustainable transport and construction sectors also look set to benefit.

Materials scarcity

Solving for energy scarcity, however, creates another scarcity problem: materials scarcity. Demand for certain metals, such as lithium, copper and silicon, will soar as the energy mix is transformed. For example, solar energy generation is more than four times more materials-intensive than gas-fired plants. The need for utility scale electricity storage to deal with the intermittency of wind and solar generation will also contribute to increased metal demand, as will a shift to electric vehicles (EVs), which are six times more minerals-intensive than traditional combustion engines.

Exhibit 16: Electric vehicles use significantly more metals than conventional cars



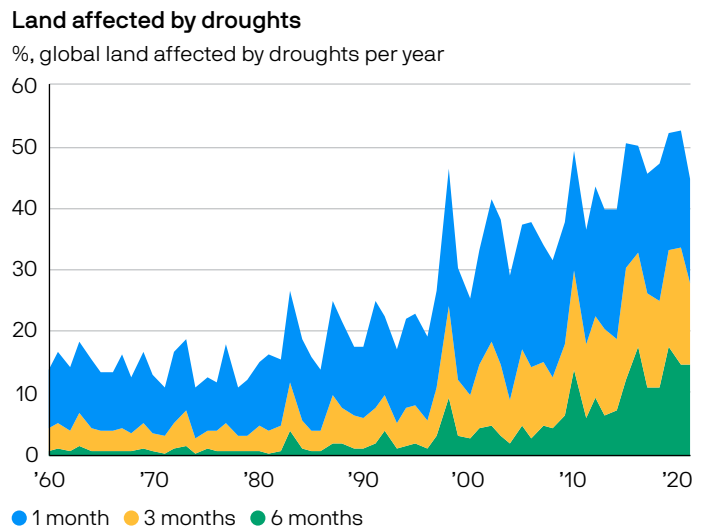
Source: IEA, J.P. Morgan Asset Management. Data is from the IEA's "The Role of Critical Minerals in Clean Energy Transitions" report. Data as of 15 June 2023.

While emerging market regions will be some of those most challenged by climate change, they are also likely to be secular beneficiaries from this huge rise in materials demand given they are often where these critical inputs are primarily mined and processed. However, mineral-rich regions won't be the only winners – as the sources of these critical minerals and their processing facilities tend to be concentrated in a few countries, supply chain concerns will force developed markets to look for solutions closer to home. Companies focusing on the domestic processing and recycling of rarer metals will therefore also likely profit. In the nearer term, recession risks could lead to volatility in resources markets, creating opportunities for those looking to identify attractive entry points for these longer-term themes.

Food and water scarcity

Over the next decades, climate change and population growth will generate scarcities in other natural resources too, primarily food and water. Along with higher average temperatures, water-related extreme events, such as floods and droughts, have already risen in frequency and are expected to do so further, hurting agricultural yields. The amount of global land affected by droughts has already doubled since 2000.

Exhibit 17: The annual impact of droughts on global land usage is rising fast



Source: Global Standardised Precipitation-Evapotranspiration Index Database, 2021. Beguería, S et al., The Lancet Countdown on Health and Climate Change: 2022 Report, J.P. Morgan Asset Management. Data as of 15 June 2023.

Meat consumption – which has more than doubled per person since 1990 – will have to fall to allow the food production necessary to feed a global population expected to reach 10 billion by the end of the century, as well as to limit greenhouse gas emissions and deforestation. At the same time, as sea levels rise more river deltas – usually particularly fertile as well as highly populated regions – will become salinated, reducing both the amount of water available for drinking and agricultural yields. Food inflation and its volatility are likely to increase as a result.

To deal with these issues, a major shift is needed towards more sustainable food and water systems that reduce carbon intensity, limit land exploitation, and protect forests that act as natural carbon sinks. Firms in sustainable agriculture, water management, reforestation and green infrastructure will benefit as water availability becomes more limited and food yields from traditional agriculture fall, transforming challenges into huge opportunities for investors.

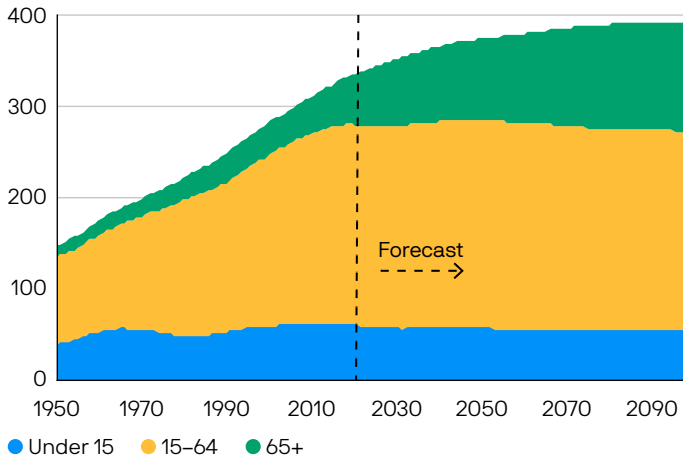
Labour scarcity

Finally, despite global population growth we see labour scarcity as another secular theme. In most major economies, the ratio of over 65s to the working age population will rise unrelentingly over the coming decades, leaving fewer workers to support more dependents.

Exhibit 18: Populations are ageing in many of the world's major economies

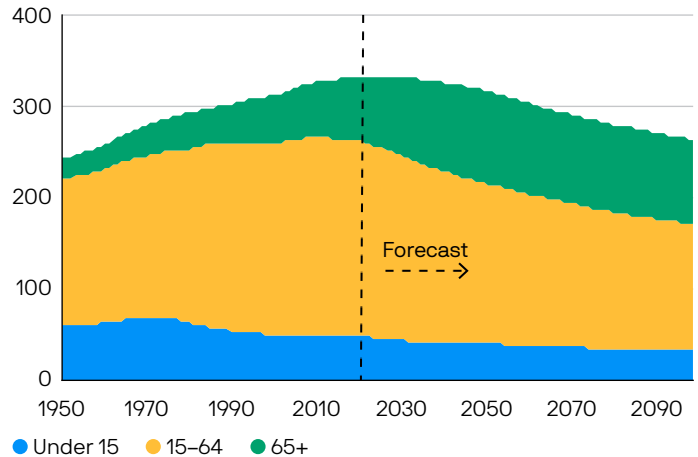
Population split by age: US

Millions of people



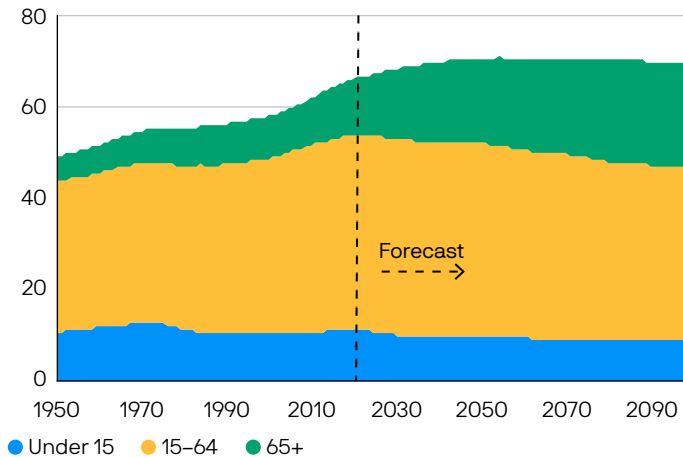
Population split by age: Eurozone

Millions of people



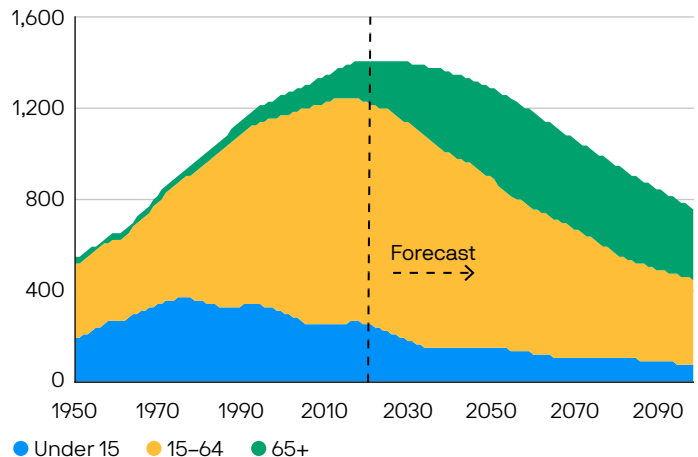
Population split by age: UK

Millions of people



Population split by age: China

Millions of people



Source: (All charts) United Nations, J.P. Morgan Asset Management. Forecast is United Nations. Data as of 15 June 2023.

It is sometimes argued that the solution to labour scarcity will be found in increased migration from higher fertility parts of the world, such as Africa. There are economic merits to this argument, but in our view they ignore the political realities that have become evident in recent years.

Numerous investment themes arise. Physical capital will be required to compensate for labour scarcities. For that reason, we don't fear automation and artificial intelligence (AI) – we see these developments as necessary to fill impending labour shortages

(though acknowledge they could exacerbate inequality). Then there is the issue of how to provide the goods and services for older populations to live well.

Given the gravity of this topic, this overview is just an initial outline of our thoughts and more will follow. The new era of scarcity – across clean energy, materials, food and water, and labour – will pose challenges. But it will also create secular economic shifts and consequent opportunities, which longer-term active investors should not ignore.

Central scenarios and risks

Our macro “base case” on a 12-month horizon is little changed from the year ahead outlook, although elevated valuations now make it more difficult for us to argue that markets are appropriately priced for the slowdown we still see ahead. The path of inflation is the key difference between our two downside scenarios. In one, falling inflation prompts rate cuts and enables bonds to act as diversifiers, while in the other, sticky inflation is likely to see the price of stocks and bonds falling together.

Central: Moderating inflation, mild recessions

Macro: Fading business and consumer spending tips developed economies into mild recessions. Labour market hoarding keeps unemployment rates relatively low, but cooling wage growth helps to gradually ease core inflation pressures, allowing the central banks to pause. China’s post-Covid recovery continues in the services sector but weak business investment continues to drag on growth. The Fed pauses its hiking cycle with rates below 5.5%, while for the Bank of England (BoE) and the European Central Bank (ECB), hiking cycles pause with rates at around 5% and 4% respectively. Rate cuts don’t start until 2024, and are modest when they do arrive.

Fixed income: Government bond yields range bound. Investment-grade (IG) credit spreads remain well behaved, high yield (HY) credit spreads widen as default rates rise gradually towards long-term averages.

Equities: Challenging environment for stocks with elevated volatility and muted total returns. Higher quality stocks outperform and DM ex-US leads US given higher dividend yields and cheaper valuations.

Currencies: USD modestly weakens on a trade-weighted basis. JPY strengthens as yield curve control is removed, while EUR is supported by a degree of convergence on growth and interest rates.

Alternatives: Real assets provide income and some inflation protection. Hedge funds benefit from higher equity market volatility.

Downside: i) Simultaneous decline in growth and inflation prompts central bank support

Macro: Developed market growth slows sharply, pushing economies into deeper recessions. Weakening labour markets, lower commodity prices and rapidly falling inflation force central banks to aggressively cut rates. China’s post-Covid recovery stumbles, prompting more monetary stimulus. The Fed begins a substantial rate cutting cycle in the autumn. The ECB and the BoE continue to hike this summer but then are forced to U-turn abruptly, and also begin cutting later in 2023.

Fixed income: Government bond yields fall, with yield curves re-steepening. IG spreads widen modestly and HY spreads widen sharply, but falling government bond yields help to dampen total returns.

Equities: Negative total returns for stocks, but without testing lows seen last October. Earnings are hit hard, higher quality stocks outperform and Growth outperforms Value. US leads DM ex-US given Growth tilt, while emerging markets underperform developed market counterparts.

Currencies: USD and JPY strengthen against cyclical currencies due to safe-haven flows.

Alternatives: Commodities struggle, real estate challenged, hedge funds benefit from higher vol (but bonds are the most effective diversifier).

Downside: ii) Sticky inflation prevents central banks from riding to the rescue

Macro: A combination of consumer resilience and extremely tight labour markets keep core inflation sticky. China's recovery gathers steam, putting upward pressure on commodity prices. The Fed and the BoE both hike rates towards 6%, and the ECB hikes past 4.5%. Higher rates force more things to break in the economy, but central banks maintain "higher for longer" rates given stubborn price pressures.

Fixed income: Bonds fail as diversifiers, with front-end government bond yields rising to reflect both a higher terminal rate and the pricing out of rate cuts. IG spreads widen given growth slowdown and HY spreads widen sharply in anticipation of default rates rising above long-term averages.

Equities: Short-term earnings resilience is offset by valuations falling leading to negative total returns, as markets anticipate central banks having to deliver a deeper downturn. Quality outperforms. US underperforms DM ex-US given larger hit to valuations.

Currencies: USD strengthens against cyclical currencies as risk-off leads to safe haven flows.

Alternatives: Real assets outperform given inflation protection and hedge funds benefit from higher volatility. Private equity and private credit come under pressure.

Upside: Goldilocks environment of resilient growth and cooling inflation

Macro: Growth remains resilient while inflation cools, as a boost to labour supply eases wage growth despite no increase in unemployment and base effects drag the rest of the inflation basket lower. China's recovery gathers pace as business investment accelerates, but without creating major upside to commodity prices. Central banks deliver on current market pricing for rate cutting cycles, as lower inflation allows rates to return to neutral levels.

Fixed income: Government bond yields fall modestly. Credit outperforms rates and HY outperforms IG as spreads tighten across all credit sectors. Great environment for EMD.

Equities: Best outcome for stocks. Earnings expectations rise as markets look through to 2024 re-acceleration, and valuations continue to rebound. Higher quality stocks underperform, and cyclicals outperform defensives.

Currencies: USD weakens on a trade-weighted basis.

Alternatives: Real assets provide income and capital appreciation given lower rates. Hedge fund performance is sluggish amid low volatility.

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