J.P.Morgan

2024
YEAR AHEAD OUTLOOK

GLOBAL RESEARCH
December 8, 2023

See page 66 for analyst certification and important disclosures, including non-US analyst disclosures.

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Foreword

Dear Client –

In this report, we present the Global 2024 Year-Ahead Outlook from the J.P. Morgan Research department. We also provide summaries and links to individual year-ahead reports that our department produced for every asset class, sector and region – in total ~100 reports published over the past few weeks.

We started out 2023 with low expectations for global growth and elevated fears of recession, but China's reopening, large fiscal stimulus in the US and Europe, and residual strength of US consumers stabilized growth. Various themes also sparked market optimism (e.g., AI, luxury goods, weight-loss drugs, expectation of Fed rate cuts, cryptocurrency, etc.) resulting in risk markets delivering broadly positive performance.

As we approach 2024, we expect both inflation data and economic demand to soften, as the tailwinds for growth and risk markets are fading. Overall, we are cautious on the performance of risky assets and the broader macro outlook over the next 12 months, due to building monetary headwinds, geopolitical risks and expensive asset valuations.

As you navigate increasingly complex markets, J.P. Morgan Global Research is looking forward to continuing our partnership, providing investment insights and ideas in 2024 and beyond.

On behalf of J.P. Morgan Global Research, we wish you a happy, healthy, and prosperous year ahead.

Sincerely,

Marko Kolanovic
Chief Global Markets Strategist
Global Co-Head of Research

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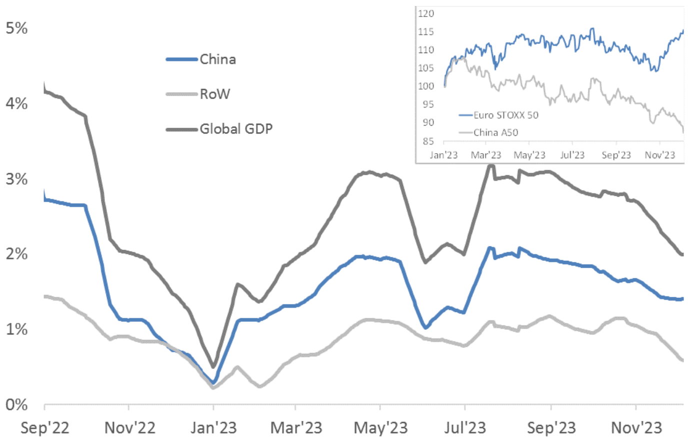
Global Co-Head of Research

Global Markets Outlook

Marko Kolanovic, Chief Global Markets Strategist & Global Co-Head of Research

2023 started with low and declining expectations for global growth and elevated fears of an onset of a recession. However, China's reopening, large fiscal stimulus in the US and Europe, and residual strength of US consumers stabilized growth. Additional market optimism was related to ChatGPT, luxury goods, weight-loss drugs, expectation of Fed rate cuts, bitcoin rally, etc., resulting in broadly positive performance of risk markets. That was despite the largest increase of interest rates in decades, major wars, energy crisis, regional banking crisis, recession in parts of the Eurozone, and emerging signs of credit and consumer deterioration in the US (here, here, here).

Figure A: J.P. Morgan GDP nowcasters: global, China and rest of world (Inset: Europe and China equity performance)

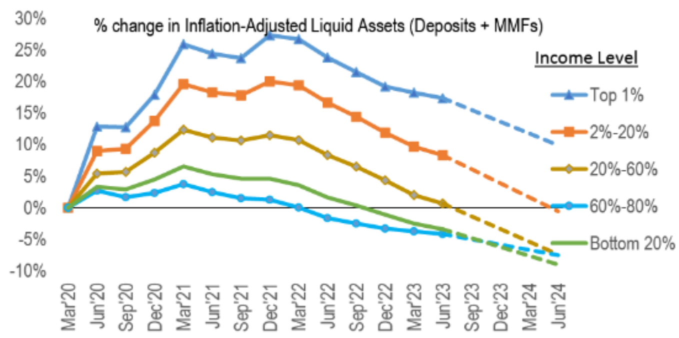


Source : J.P. Morgan.

Investors trade stock and bond markets, not GDP. In the past year there was a fair amount of disconnect between markets and the economy. A significant impulse to the global economy in early 2023 came from China's reopening. This is illustrated in Figure A with JPM GDP nowcasters, which show China contributing ~2/3 of global GDP early in the year and producing the impulse that lifted risk sentiment. This, however, did not prevent China stocks (e.g., A50) to decline nearly 20%; similarly, Germany's effective recession (-0.4% GDP) did not prevent a nearly 20% rally of German and Eurozone stocks, propelling them to all-time highs (Figure A).

Not only did China's reopening ensure positive growth, but it also provided stimulus to global financial markets in a somewhat roundabout way. Investors, likely due to geopolitical considerations, pulled money from Chinese markets and allocated them to various proxy markets such as Japan, India, Europe and US sectors seen to benefit from China (including market-leading stocks such as European luxury goods, or some prominent US AI chip companies).

Figure B: All but the top 1% of consumers will likely be worse off than pre-pandemic by mid-2024

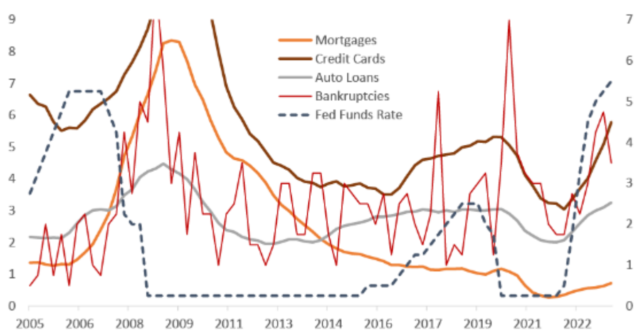


Source : J.P. Morgan Equity Macro Research, Haver Analytics.

US growth held up well through the year and surprised to the upside in the most recent quarter. High fiscal deficits provided support for the economy and risk sentiment, and investors declined to worry about the sustainability of this fiscal path, or events like the US debt downgrade earlier this summer. Contemporaneous positive economic data were enough to lift risk markets, which we see as complacency in the backdrop of declining consumer strength and increased credit stress. Figure B shows excess household liquidity trends, indicating that for 80% of consumers (who account for nearly 2/3 of consumption) excess savings from the COVID era are already gone, and by mid-2024 it is likely that only the top 1% of consumers by income will be better off than before the pandemic. Figure C shows the emerging signs of stress in increased credit card and auto loan delinquencies, and Chapter 11 filings. There are no significant delinquencies in residential mortgages yet, as consumers locked in low interest rates.

However, existing home sales have dropped near record lows, and ~$6.5 trillion of commercial real estate debt remains an overhang. One should note that virtually all of the stock market's gains this year came from a small number of tech stocks ('magnificent 7') that rallied around themes of Artificial Intelligence and quality balance sheets, and that disregarded the significant increase in interest rates (the interest rate increase should have reduced multiples of these stocks). The rest of the stock market was largely in a 'holding pattern,' unsure of prospects for the economy. This led to a high concentration of index weight in a handful of the largest stocks, something not seen in over 50 years. Inflation has played a significant role in propping up corporate earnings, which were in many cases delivered by selling fewer units at higher prices or by cost cutting.

Figure C: Delinquencies in consumer loans and Chapter 11 bankruptcy filings are rising



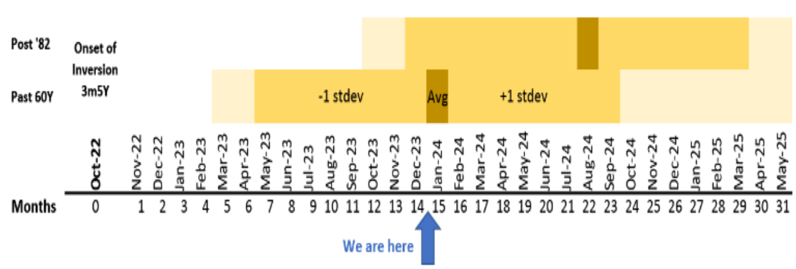
Source : J.P. Morgan, Federal Reserve Bank of NY, Bloomberg Finance L.P.

We expect both inflation data and economic demand to soften in 2024. Should investors and risky assets welcome an inflation decline and bid up bonds and stocks, or will the fall in inflation indicate that the economy is sliding towards a recession? We think that the decline in inflation and economic activity that we forecast for 2024 will at some point make investors worry or perhaps even panic. Our economic forecasts (averaged across different scenarios) would allow the Fed to start easing in 2H24, likely at a 25bp per meeting pace, and a decline in bond yields could be led by the belly and eventually the front end. The US 10-year note yield is expected to drop to 3.75% over the next year if there is a gradual economic slowdown, and more if the economy slides into a recession. Other developed market rates are likely to follow a similar path. Whether it is a risk-off move due to a recession, or the ability of the US economy to navigate the slowdown better than other countries, we look for US dollar strength. Currency carry trades, which attracted significant inflows and performed very well this year, would likely give back some of this performance, or potentially unwind in a sharp risk-off scenario. In commodities, precious metals have structural tailwinds and would benefit from a risk-off sentiment and subsequent easing of monetary policy. There is significant value in energy, but economic weakness may interfere with geopolitical and structural tailwinds.

Overall, we are not positive on the performance of risky assets and the broader macro outlook over the next 12 months. The primary reason is the interest rate shock (over the past 18 months) that will negatively impact economic activity. Geopolitical developments are an additional challenge as they impact commodity prices, inflation, global trade in goods and services and financial flows. At the same time, valuations of risky assets are expensive on average. Currently we have high equity multiples (by various estimates at least 3 turns of P/E expensive), low levels of volatility (investor complacency and excess supply), and tight credit spreads. Bond yields of 5%+ present a high performance hurdle rate for other assets and strategies. For instance, in a very optimistic economic scenario, we can see equities outperforming bonds (or cash) by ~5%, while in a likely environment of declining growth or a recession, they could underperform cash by ~20%. Regardless of whether a recession happens or not, ex-ante, the risk-reward in equities and other risky assets is worse than in cash or bonds. It is hard to see acceleration of the economy or a lasting risk rally without a significant reduction of interest rates and reversal of quantitative tightening. This is a catch-22 situation, in which risk assets can't have a sustainable rally at this level of monetary restriction, and there will likely be no decisive easing unless risky assets correct (or inflation declines due to, for example, weaker demand, thus hurting corporate profits). This would imply that we would need to first see some market declines and volatility during 2024 before easing of monetary conditions and a more sustainable rally.

Finally, we want to point out that it is becoming consensus thinking that a recession will be avoided. We see the arguments such as no landing, goldilocks, election year seasonality, labor market resiliency, up-rating of valuations, Fed put, etc., as various versions of "this time is different." Going back to basics and the relatively small number of recessions we can study – signaling from yield curve inversion indicates that recession risk is highest between 14 and 24 months following the onset of inversion (Figure D). That period will cover most of 2024, and should make it another challenging year for market participants.

Figure D: Timing of the start of recession relative to the onset of yield curve inversion



Source : J.P. Morgan.

J.P. Morgan Global Research Forecasts

Real GDP growth (%oya)	Potential*	2H24	Change
Global	2.3	1.9	-0.4
DM	1.3	0.7	-0.6
US	1.5	0.6	-0.9
Euro area	1.0	0.7	-0.3
UK	0.7	-1.0	-1.7
Japan	0.9	0.7	-0.2
EM	3.7	3.7	0.0
China	4.5	4.3	-0.2
Equities	**Current**	**Dec-24**	**Change (%)**
S&P 500	4,586	4,200	-8%
MSCI Eurozone	269	256	-5%
FTSE 100	7,514	7,700	2%
TOPIX	2,324	2,500	8%
MSCI EM ($)	970	1,070	10%
MSCI China	55	66	20%
Rates	**Current**	**Dec-24**	**Change (%)**
US 10-year yields	4.15	3.75	-0.40
Germany 10-year yields	2.20	2.00	-0.20
UK 10-year yields	3.97	3.45	-0.52
Japan 10-year yields	0.75	1.00	0.25
EM Local (GBI-EM yield)	6.38	5.76	-0.62

Credit (spreads)		Current	Dec-24	Change
US High Grade	JPM JULI	120	125	5
Euro High Grade	iBoxx HG	157	175	18
US High Yield	JPM HY	408	475	67
Euro High Yield	iBoxx HY	422	500	78
EM Sovereigns	JPM EMBIGD	399	475	76
EM Corporates	JPM CEMBI	300	330	30
Currencies		**Current**	**Dec-24**	**Change (%)**
JPM USD Index		130.2	129.7	-0.4%
EUR/USD		1.08	1.13	4.9%
USD/JPY		144	146	1.4%
GBP/USD		1.26	1.26	0.3%
USD/CNY		7.16	7.15	-0.1%
Commodities		**Current**	**Dec-24**	**Change (%)**
Brent ($/bbl, qtr end)		76	85	13%
WTI ($/bbl, qtr end)		71	81	15%
Gold ($/oz, qtr avg)		2,047	2,175	6%
Copper ($/ton, qtr avg)		8,273	8,700	5%
Aluminum ($/ton, qtr avg)		2,103	2,325	11%
Iron ore (US$/dt, qtr avg)		136	110	-19%
Soybeans ($/bu, qtr avg)		13.1	13.5	3%
Wheat ($/bu, qtr avg)		6.4	6.5	1%

Source: J.P. Morgan, current as of Dec 7, 2023.
*Refers to pre-pandemic potential

Summary

Leveraging the expertise of our global research analysts across asset classes and regions, our Year Ahead report summarizes the macro and market outlook for 2024. We highlight key points from the outlook below:

Economics

- ***Global:*** We expect global growth to slow to below-potential due to the continued drag from tight monetary policy and rising yields, and the fading of this year's significant positive shocks. Although headline inflation is expected to drop next year, we look for a shift in inflation psychology to keep global core inflation around 3%, largely because of continued upward pressure on labor costs and service prices. Central bank rhetoric will need to maintain a tightening bias.
- ***US:*** Post-pandemic tailwinds, building monetary headwinds, and dwindling fiscal offsets should all contribute to slow growth to below trend in 2024. We don't see inflation getting all the way back to 2%, and the "final mile" of getting inflation down will require a softer labor market. We expect the Fed doesn't take further strong action against inflation but keeps policy modestly restrictive.
- ***China:*** We expect the economy can maintain its recovery momentum into 1H24, before moderating to trend growth in 2H24. We expect deflation will end in 2024, benefiting from the changing dynamics in global commodity prices, however, low inflation will persist, attributable to biased policy support for production vs. consumption.
- ***EM***: We expect EM growth to moderate slightly to near-trend in 2024. EM easing cycles will broaden in 2024, but rate cuts are likely to remain measured as policymakers balance high domestic real rates against tight global financial conditions. Solid EM macro fundamentals should provide a buffer in the event of a less benign 2024 US scenario.

Equities

- ***US:*** Absent rapid Fed easing, we expect a more challenging macro backdrop for stocks next year. Equities are now richly valued with volatility near historical lows, while geopolitical and political risks remain elevated. We expect another year of flat to low-single-digit earnings growth in developed markets with sharp revisions to unrealistic consensus growth estimates.
- After a period of record pricing power, the recent disinflationary trend should become a major headwind for corporate margins amidst sticky and lagging wage trends. We expect lower sequential revenue growth, no margin expansion, and lower buyback executions.
- ***Rest of World:*** We see signs of a rollover in corporate pricing, a trend that is likely to accelerate as we move through next year and goes against the consensus call that has projections of earnings and margin expansion in 2024.
- In terms of themes, we believe stocks that saw outsized margin expansion will be at risk. We also think companies with imminent refinancing needs and weak balance sheets could trade weaker if interest rates remain elevated.
- ***Market Volatility:*** US Volatility was unusually low this year due to longer than normal lags in the transmission of monetary policy and technical factors. We expect the VIX to generally trade higher in 2024 than in 2023 given high rates, slowing growth, a challenging backdrop for stocks, and elevated geopolitical risks; the extent of the VIX's increase depends on the timing and severity of an eventual recession, which remains a live risk, and the timing of a potential volatility surge that could alleviate the structural short-dated volatility selling flows.

Rates

- ***Treasuries:*** We believe the Fed is done raising rates and expect cuts to start in 3Q24, at a pace of 25bp per meeting, bringing the Fed funds rates to 3.5% by mid-2025. While we expect Treasury yields to decline and curves to steepen into 2024, we think there are unique traits to this cycle that could differentiate early-2024 from other pre-easing periods, for a couple of reasons. First, while the policy rate tightening cycle has come to a conclusion, the balance sheet normalization cycle is ongoing in the background, with no end in sight. Second, the ongoing rebalancing of Treasury demand toward more price sensitive investors should translate into higher term premium over time, which is consistent with steeper curves.
- ***Interest Rate Derivatives:*** The regional banking crisis left behind lingering after-effects that are likely to impact markets. One, inflows into money market funds (and out of bank deposits) continue to be strong, even though they are not at the levels seen during March. We expect this trend to continue into next year. Two, the banking crisis will likely have a lasting impact on the response function of banks, and we look for them to continue to prioritize liquidity build-up and capital conservation.
- ***International:*** Our expectation is that most DM central banks are now done with the tightening cycle and will remain on hold in 1H24. We do not see inflation remaining elevated enough to justify additional hikes, although we acknowledge that risks remain biased towards further tightening in the DM space.

Credit

- ***US High Grade and High Yield:*** Yields at multi-decade highs lead to buying of **HG credit** and also constrain corporate issuance. This is because for the majority of both investors and borrowers, it is yield levels that matter first and spreads are second. The current high yields should lead to ongoing institutional buying, stronger retail buying as stable/declining yields lead to strong total return and a pickup in foreign buying as FX-hedged yields improve. This is why we expect tighter spreads in 2024. We are forecasting moderately wider high-yield bond and leveraged loan spreads in 2024 as growth weakens and the Fed eases in 2H24. For **High Yield** the expected widening yoy is due to our belief that an additional premium will need to be baked into spreads as growth slows, rates remain restrictive, the cycle matures, and recession risks build.
- ***Securitized Products:*** For commercial real estate, we expect lower rate expectations in 2H24 should continue to stave off a significant number of distressed sales and continue to push resolutions out via extensions/modifications. Home prices have continued to creep up this year despite mortgage rates rising to a 7-8% range, and in 2024, we expect prices to be flat due to a frozen market.
- ***International:*** Overall, we like owning euro corporate bonds even though we see credit conditions weakening next year. We look for some spread widening as investors price in a greater recession risk premium. We think that fundamentals and ratings are set to deteriorate over the coming quarters. Recent corporate guidance has generally been poor, with a common refrain being that “end demand is falling.”

FX

- Heading into 2024, the baseline call is for USD to be bumpy but elevated. As Central banks will move to synchronized rate cuts, the USD impact will depend on the cyclical context, but size, sequencing and nature of cuts (“good” vs. “bad”) should generate ample RV opportunities. We believe that sustained USD weakness will require Fed cuts and better growth outside the US – both conditions which are not met yet.

Commodities

- Without strong cross-complex drivers emerging from growth or inflation, investors need to continue to be more sector-specific and tactical within commodities in 2024. We continue to hold a structural bullish view on gold and silver. We remain tactically constructive on energy and believe performance will be driven by a reversal in natural gas losses but also by oil, where solid demand growth should push prices higher off current spot levels, with carry adding further to returns.

Word cloud from our Outlook

Economics

Global

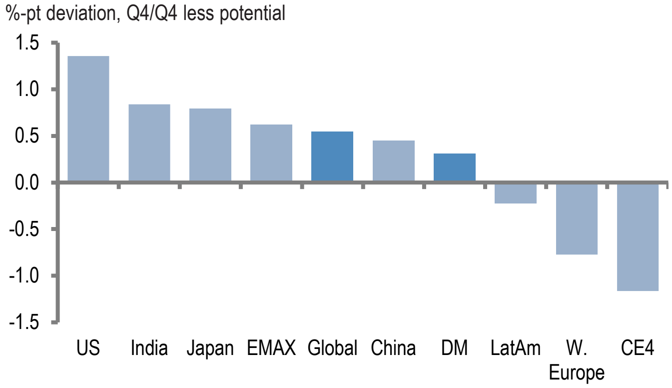
Click here for the full outlook.

Our 2023 global outlook was published a year ago as a tide of 1H23 recession forecasts were rising. The central tenet of the outlook ("Wait for it") pushed against this tide, arguing for resilience amidst sluggish and divergent growth. While recognizing a building drag from synchronized monetary tightening, important sources of lift were anticipated to blunt its impact. More fundamentally, the risk of private sector retrenchment was viewed as modest. Elevated inflation and tight labor markets usually emerge in a maturing expansion where private sector leverage, overextension, and profit margin compression magnify the impact of monetary tightening. But the forced saving and government policy supports engendered by the pandemic lockdowns broke this link. Put simply, 2023 pitted late-cycle inflation dynamics against mid-cycle private sector fundamentals.

This forecast for resilience was not, however, an endorsement of a soft landing. Supply bottlenecks and labor market dislocations were expected to fade and push inflation lower, but damage to mobility and labor supply was expected to linger. Combined with a shift in inflation psychology, constrained supply looked likely to keep inflation above central bank comfort zones. Sustained restrictive monetary policy stances to lower inflation were expected to gradually undermine private sector health. Our baseline "boil the frog" narrative saw this dynamic leading to an early end to the global expansion and placed only a 20% probability on scenarios in which the global economy achieved low inflation and an expansion that extended well beyond 2024.

Figure 1: Real 2023 GDP growth

%-pt deviation, Q4/Q4 less potential



Source: J.P. Morgan Global Economics

The broad contours of this year's forecast have materialized. Global GDP is tracking an above-potential 2.8% Q4/Q4 gain. The US delivered the most substantial outperformance, with Europe a notable source of weakness (Figure 1). Meanwhile, core CPI inflation fell sharply but is tracking a still elevated 4% increase (ex. China and Türkiye) as sharply slowing goods price pressure contrasted with sticky service price inflation (Table 1). But three related developments have tempered our soft-landing skepticism. First, with global nominal GDP growing 1.5%-pt faster than anticipated this year, stronger-than-expected gains in corporate profits, household wealth, and labor income leave the private sector in better health than had been expected.

Table 1: Global CPI

%Q4/Q4

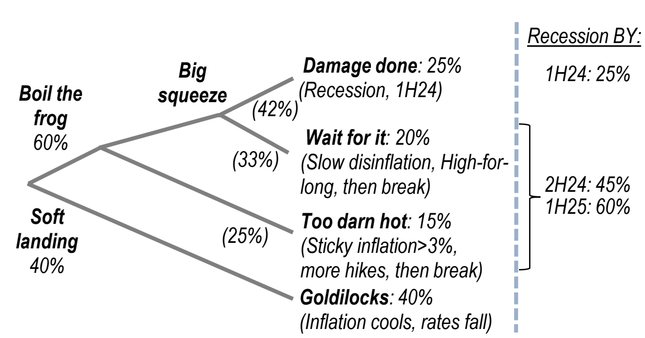
	2017-19	2021	2022	2023	2024
Headline	1.8	5.2	7.9	3.7	2.7
Energy	1.3	24.3	18.9	-4.6	0.5
Food	2.3	4.4	11.2	5.2	3.2
Core	1.8	3.6	5.9	4.1	2.9
Goods	0.7	5.5	5.6	2.2	0.5
Services	2.0	2.7	5.6	4.9	4.3

Source: National sources, J.P. Morgan. Details on request. Excludes China and Türkiye. Core goods and services detail only available for a subset of economies.

Second, last year's tail-risk threats to the expansion did not materialize, and the transmission of monetary policy to broader financial conditions has been more limited than projected. Finally, new disinflationary impulses have emerged on the scene. In the US, both labor supply and productivity gains have been stronger than anticipated, a development that has eased US labor market tightness in the face of above-trend growth. Elsewhere, weak domestic demand has created excess capacity in Germany and China: large manufacturers that could sustain downward pressure on finished goods prices globally.

Figure 2: Global outlook scenarios

Probabilities in parentheses are conditional on "Boil the frog"



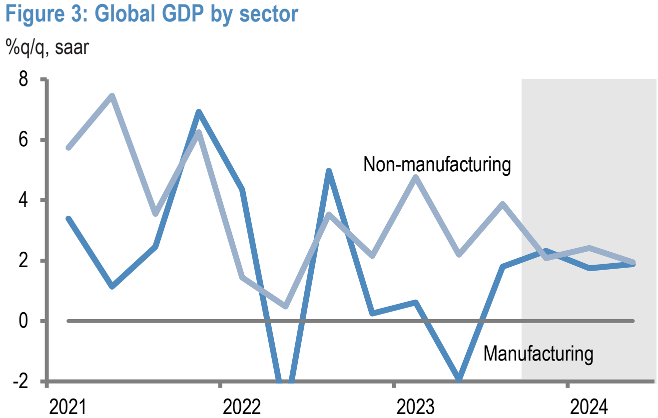
Source: J.P. Morgan Global Economics

It is thus no surprise that a tide of soft-landing optimism is on the rise, boosting asset prices and expectations for early policy ease. Our top-down global views have become more open to a soft-landing scenario (to 40%) but remain biased towards an end to the global expansion by mid-2025 (Figure 2).

The outlook sees only a modest risk that the global economy slides into recession in early 2024, and the latest data pointing to continued resilience and limited financial market stress reinforce this view. Expectations of a gradual "boiling the frog" path to the next recession will likely make it difficult to distinguish between scenarios as we turn into 2024. There are several elements in our 1H24 forecasts that are observationally equivalent on these two paths. Specifically:

- **Global GDP growth slows to a below-potential pace**. After accelerating to a 2.8% gain this year, we expect global growth to slow to a below-potential 2%ar in 1H24. Along with a continued drag from tight monetary policy and rising yields, the fading of this year's significant positive shocks should weigh on overall growth.
- **Service sector cools, manufacturing remains soft**. Growth rotated sharply towards the service sector over the past year, but normalization of the COVID-depressed parts of services is now over (Figure 3). In addition to contributing to slower GDP growth, a moderating service sector should be a catalyst for slowing global employment growth. At the same time, global industry is unlikely to see much lift in the coming months, as final goods demand growth looks to have struggled in the latest data.
- **DM underperforms EM**. While the DM is set to slow to a below-potential pace of growth in 1H24, the EM is set to outperform in response to policy easing and fading food inflation. Fiscal supports in China also are providing support for growth. The result will be a sluggish global economy no longer fueled by US exceptionalism.

Figure 3: Global GDP by sector



Source: National sources, J.P. Morgan. Details on request.

A global economy heading down the road to recession should be distinguished from one gliding toward a soft landing based on the following developments:

- **Core inflation should remain sticky at 3%**. The central condition for a recession dynamic to take shape is inflation that fails to give sufficient comfort to central banks to relax their restrictive stances. Although headline inflation is expected to drop next year, we look for tight labor markets and a shift in inflation psychology to keep core inflation at around 3%, largely because of continued upward pressure on labor costs and service prices.
- **Central banks likely to stay high-for-long**. In the face of sticky inflation, current market expectations for an early start to DM easing cycles are likely to be disappointed. Rather than cuts, our global baseline assumes central bank rhetoric will need to maintain their tightening bias, a development that will put upward pressure on short-term interest rates and lead to an additional tightening of financial conditions.
- **Supply softens with demand**. In our "boil the frog" scenario, the recent pickups in productivity growth (in the US) and labor supply growth (more broadly) are expected to fade. If realized, supply-demand imbalances will likely percolate back to the surface, diminishing disinflationary pressures and lifting inflation expectations.
- **Business shows limited appetite to cushion**. In an environment of expected profit margin compression and tight financial conditions, we expect business attitudes to gradually turn cautious, leading to a stall in capex and hiring. Once this begins, a negative feedback loop between business caution and moderating household income growth will significantly raise recession vulnerability.

There is an alternative branch of our "boiling the frog" narrative in which this year's upside surprises to global growth and inflation are extended. To the extent that demand growth proves stronger and business has more pricing power than anticipated, global core inflation will likely remain well above a 3% pace. Such an outturn would be unacceptable to central banks and prompt another round of rate hikes. This could potentially see the Fed, and others, hiking another 50-100bp. In that event, the financial market shock would likely spark a deeper and more synchronized global recession.

In considering alternative scenarios, it is important to recognize that recessions represent a significant break in economic performance that reverberates broadly and over time. As such, even a mild recession should not be viewed as a mild event and would likely differ substantially from a soft-landing path in which growth was persistently sluggish. For the US, mild recessions have normally produced a rise in the unemployment rate of 2%-pts or more and have had a lasting negative influence on credit markets. Recessions are also reliably disinflationary. For these reasons, central banks are likely to move immediately and aggressively if they recognize a recession has taken hold, even in an environment of still-elevated inflation.

US

Click here for the full outlook.

For many, life after the pandemic returned to normal long ago. The US economy, however, has been living in the shadows of that event for the past three years. While the pandemic was measured in months, the disruptions were deep enough that unwinding the economic symptoms has been a matter of years. But unlike "long COVID," not all the symptoms are pernicious. Firms and households that locked in borrowing rates in '20 and '21 have had the equivalent of acquired immunity to Fed rate hikes. And the fiscal medicine from that era had surprisingly long-lasting effects stretching well into '23.

These symptoms were strong enough to overpower some of the most important laws of economics. The "IS curve" linking higher interest rates to slower growth has been notoriously absent, or maybe just slow to appear. And in an apparent rebuke of the Phillips curve, which links inflation to labor markets, the current inflationary episode took off when labor markets were still loose, and the disinflation of the last year has occurred alongside a tight labor market.

Turning into '24 the economy is becoming further removed from the pandemic and continues to step out of the shadows of that event. As that occurs, some of the laws of economics that were suspended should reassert themselves. We expect higher interest rates will begin to slow growth, particularly as this year's fiscal tailwinds fade. And while the unwinding of the supply chain shocks could deliver some further immaculate disinflation, we think the "final mile" of getting inflation down will require a softer labor market.

Although the economy has apparently managed to escape recession this year, we believe the risk of a downturn in '24 remains elevated. Fading post-pandemic tailwinds, building monetary headwinds, and dwindling fiscal offsets should all contribute to holding growth below trend, and we project real GDP to expand 0.7% in the coming year (4Q/4Q). We look for this to weaken the labor market and anticipate the unemployment rate, which is already 0.5%-point above its cycle low, will drift another 0.5%-point higher toward a peak of 4.4% next year (Table 2).

Table 2: US economic forecasts

	Forecasts								
	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	2023 %q4/q4	2024 %q4/q4	2025 %q4/q4
Real GDP (%q/q, saar)	4.9	2.0	1.3	0.5	0.5	0.8	2.8	0.7	1.9
Real consumer spending (%q/q, saar)	4.0	2.3	1.3	0.3	0.3	1.1	2.7	0.6	1.5
Core PCE prices (%q/q, saar)	2.4	2.6	2.5	2.4	2.4	2.3	3.4	2.4	2.2
Unemployment rate (%, qtr avg)	3.7	3.8	3.9	4.1	4.3	4.4			
Fed funds target (%, eop, top of range)	5.50	5.50	5.50	5.50	5.00	4.50			

Source: J.P. Morgan Forecasts

While we expect demand to falter due to the lagged effects of higher interest rates, the supply side of the economy has been picking up momentum in '23. Even if only a fraction of that improvement carries through to next year, we could see some further relief on inflation pressures. But absent a recession next year—to reiterate, a very real possibility—we don't see inflation getting all the way back down to 2%. Thus, while the Fed may have enough breathing room on inflation to ease up on the economy, we don't see it returning the funds rate all the way down to its estimate of neutral. With inflation below 3% but above 2%, we see the Fed returning to the mid-1990s strategy of "opportunistic disinflation": an approach in which the Fed doesn't take further strong action against inflation but keeps policy modestly restrictive and waits for external events like favorable supply-side shocks or an unforeseen recession to finish the job.

Is this thing on?

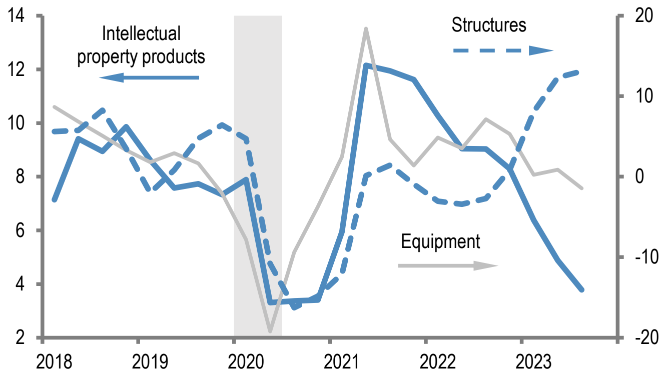
The strength of economic growth this year despite the 525 basis points of Fed rate hikes has led some to believe that the economy is less interest sensitive than in the past. In this section and the next we examine that idea and conclude that monetary policy is largely working as expected, albeit so far countered by easy fiscal policy.

The effects of monetary policy operate through several channels. Perhaps the channel with the most prestigious intellectual lineage is the cost of capital channel. For long-lived investments such as business capital spending or housing, the interest rate will be an important determinant. Through 3Q, real residential investment and business investment in equipment is are contracting on a year-ago basis. Even investment growth in intellectual property products—which intuitively and empirically is less interest sensitive than physical capital—has slowed considerably.

However, the category of business investment spending—structures—that in principle should be the most interest sensitive has shown strong *growth* this year (Figure 4). Much of this has been driven by incentives in the CHIPS and IRA legislation. This is a prime example of fiscal policy working at cross purposes with monetary policy.

Figure 4: Real business investment spending

%ch, oya, both scales



Source: BEA, J.P.Morgan

Another monetary transmission channel affecting the consumer is the consumption wealth effect. Arguably this channel has not worked as expected, as the aggregate wealth-to-income ratio has declined after peaking in 1Q22, yet the saving rate has remained near the cycle low. To be sure, the wealth effect has been hard to detect since 2007 so it's hard to know if this channel is dormant or just plain dead.

The international channel of monetary policy runs through foreign exchange, and we don't see a good reason why this channel should be weaker. If anything, the reduction in petroleum imports—which were relatively price inelastic—should increase the sensitivity of trade flows to monetary policy. And yet, over the first three quarters of '23 foreign trade made a positive contribution to US GDP growth. Rerouting global purchases can take time, and here we expect the lagged effects of a stronger dollar will weigh on net exports next year.

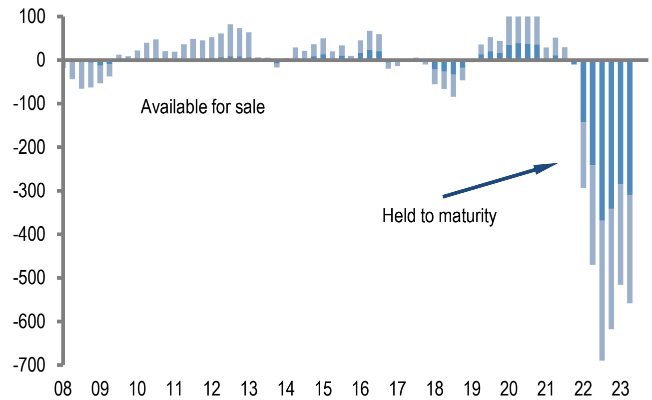
The Conservation Law of Interest Rate Risk

Another argument for the reduced interest sensitivity of the economy is that borrowers—both businesses and households—termed out their debt exposure during the pandemic. While this is certainly true, we think it is incomplete in two respects. First, it looks at only one side of a transaction. Second, it is more an argument about lags than about interest sensitivity.

It is well known that relative to their developed market counterparts, US consumers are very well-insulated from the effects of higher interest rates. Yet this is rarely connected to the fact that the US is the only economy to have experienced a true banking crisis in this cycle. Of course, these two facts are related and bound together by an immutable truth: a choice of financing tenor neither creates nor destroys interest rate risk, but merely distributes it among agents in the economy. If consumers and businesses have been protected from rising interest rates, their creditors have been exposed to those increases. This exposure was a leading cause of last March's banking crisis, and it's too soon to say we are out of the woods with respect to further stress here (Figure 5).

Figure 5: Unrealized securities gains, FDIC-insured banks

$bn



Source: FDIC, J.P.Morgan

The second caveat is that the argument is really about the lags with which interest rates affect the economy. An important channel through which monetary policy impacts business performance is interest expense. So far coverage ratios in most sectors have gone from stellar to merely normal (Figure 6), but the longer that rates remain high, the more painful will be the interest expense pinch on margins.

Figure 6: Coverage ratio-manufacturing

Net operating income/interest expense

Source: Census Bureau, J.P.Morgan

All told, we don't see significant "clogs" in the various monetary transmission channels, though some may take longer to realize their full effect.

Euro Area

Click [here] for the full outlook.

2023 was a mixed bag for the Euro area economy. An energy recession was avoided, and growth appeared to be rebounding in the spring. Corporates in particular remained expansionary, helped by sharp declines in energy prices and the fading risk of gas shortages. But, consumers remained cautious despite a pickup in real incomes growth and German industry disappointed. As a result, the rebound in the PMI through April was short-lived and, by August, the survey was back to signaling stagnation. It has been stuck there since.

The immediate question is whether the region is falling into recession. Traditional growth drivers do point to contraction. The lagged effect of the monetary tightening is still building, fiscal policy is consolidating, credit growth is weak, sentiment remains low, the external backdrop is mixed and energy prices remain higher than normal. These headwinds are large for an economy with a growth potential of only around 1%.

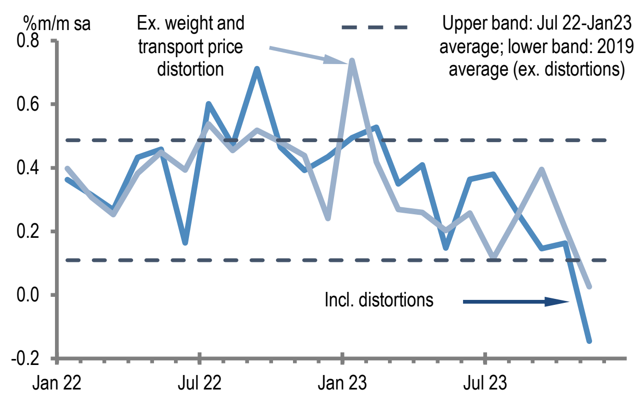
But, the unwinding of past shocks is generating non-traditional positives. First, a strong rebound in household real incomes is set to continue as inflation looks set to remain below the growth of wages for a while. While the saving rate has increased in 1H23, the further income gains are large and make some consumption growth likely. Second, sharp increases in unit profits have left corporates with strong income positions, which may explain why stagnant GDP has failed to deter them from hiring strongly and increasing their capex. Third, order backlogs continue to look very high in manufacturing, which indicates some pent-up demand.

Our baseline assumes that these positives offset much of the traditional headwind. The result is an improvement in growth from where it has been recently but only to a subpar pace and hence falling short of official institutions' forecasts (e.g., ECB, European Commission) that have a return to modestly above-trend growth momentum next year.

The positive side-effect of a subpar recovery is that it helps with the disinflation journey. We think of this as having three phases. First, transitory factors, relating to the pandemic and the energy shock, fade. The momentum in core prices has already halved to a 3% pace. Second, corporate pricing behavior needs to moderate after the large increase in unit profits of the past 1-2 years. In our view, this is more likely in an environment of sluggish growth and lower inflation, which makes opportunistic margin expansions harder. Third, wage growth needs to moderate. While we do not expect a meaningful increase in unemployment, given the recruitment difficulties firms have experienced in recent quarters, the sharp fall in inflation already seen and some margin pressures on corporates make an eventual slowing in wage growth likely as well.

This three stage disinflation process implies that the GDP deflator slows ahead of unit labor costs and that the evidence of a slowing in wage growth will take some time to emerge. In particular, the forecast assumes that workers accept that their real wages recover the pre-pandemic level only by end-2025, which implies upside risks in the near-term if there is a bigger push for catch-up. Such risks are greater if growth steadies itself, as we expect, and suggests that the ECB may wait until it sees some evidence of slower wage growth. We have penciled in a first cut for 3Q24, followed by steady moves down to a neutral rate of 2%, which we see the ECB reaching by 3Q25. Risks are skewed to an earlier start, partly due to downside risks on growth and partly because of some hints in the latest inflation data of another step down in core price momentum (Figure 7).

Figure 7: Euro area HICP core prices



Source: J.P. Morgan.

Table 3: Euro area forecasts

%oya, except where stated, annuals are %oya except year-end for deposit rate

	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	2023	2024	2025
GDP (%q/q ar)	-0.2	0.0	0.5	0.8	0.8	0.8	0.5	0.4	1.0
Germany	-0.5	-0.3	0.3	0.5	0.5	0.8	-0.1	0.2	0.8
France	-0.5	0.0	0.5	0.8	0.8	0.8	0.8	0.5	1.0
Italy	0.2	0.3	0.5	0.5	0.8	0.8	0.7	0.3	0.8
Spain	1.3	1.5	1.3	1.3	1.0	1.0	2.4	1.3	1.2
U-rate (%)	6.5	6.5	6.6	6.7	6.7	6.7	6.5	6.7	6.6
Inflation									
Headline	5.0	3.0	2.6	2.5	2.1	2.1	5.5	2.3	1.9
Core	5.1	4.0	3.3	2.9	2.5	2.5	5.0	2.8	2.1
ECB depo. Rate	4.00	4.00	4.00	4.00	3.75	3.25	4.00	3.25	2.00

Source: Eurostat, ECB, J.P.Morgan

China

Click here for the full outlook.

2023 was a year full of surprises for China. Reopening happened earlier and faster than expected, yet the recovery path has been bumpy and uneven. Activity rebounded strongly in 1Q (10.4%q/q saar) after the rapid ending of COVID-related drags, but then slumped in 2Q (-0.8% q/q saar). Housing market witnessed the worst downturn in China's history. Meanwhile, beneficiary sectors in China's structural transformation, e.g., new energy and NEV (New Energy Vehicles) sectors, made remarkable progress, and China is on track to become the largest auto exporting country.

Encouragingly, economic activity has been bottoming since August, with solid 3Q rebound (6.9% q/q saar) upon consumption recovery and improving exports. Economic policy has also turned growth friendly, e.g., 1 trillion yuan additional fiscal deficit (0.8% of GDP) approved by the NPC in October, PBOC's rate cut and RRR cut, housing stabilization measures, and a trillion-yuan package to address liquidity stresses for local government hidden debt.

As we turn towards 2024, the impact of latest policy easing measures will be reflected in the coming quarters. Hence we expect the economy can maintain its recovery momentum into 1H24 (5.1%q/q saar), before moderating to trend growth in 2H24 (4.3%q/q saar). We also expect the government will keep the annual growth target unchanged in 2024 at around 5%. This is challenging, but achievable as reflected in our growth forecast of 4.9% (vs. 5.2% growth forecast in 2023).

To achieve this goal, macro policy will be accommodative. On the fiscal front, the 1 trillion additional fiscal deficit approved in October sent a signal that policymakers may be ready to utilize the relatively healthy balance sheet of the central government to mitigate fiscal difficulty of local governments. Budgetary fiscal deficit in 2024 will likely break the 3% implicit ceiling (3.8% of GDP in JPM forecast), and augmented fiscal deficit will be higher than 2023 by 0.1% of GDP (vs. a fiscal contraction of 0.9% of GDP in 2023).

On monetary policy, we expect the PBOC will maintain an easing policy stance going ahead. Our forecasts include a 10bp policy rate cut in 3Q24 (when the pressure from tightening global financing conditions may ease off), and three RRR cuts (25bp each) in next 12 months. In addition, the PBOC will expand structural monetary policy, a quasi-fiscal operation, to support public housing / urban village and LGFV debt restructuring.

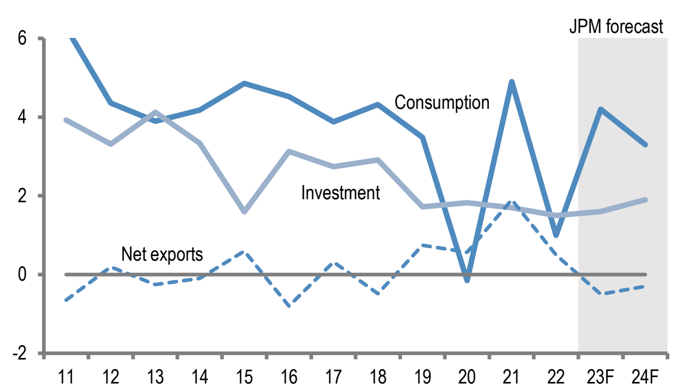
In terms of growth drivers, we expect a normalization of structural breakdown as in pre-pandemic years. In particular, we expect consumption will contribute about two-thirds (3.3%pts) to 2024 GDP growth, investment will contribute about one-third (1.9%pts), while net export contribution is minor (-0.3%pt). This is in contrast with the current year, when consumption contribution to GDP growth is disproportionately high at 80% (4.2%pts). As reopening dividend fades, consumption growth (in real terms) will slow down from 8% this year to 6% in 2024. Meanwhile, housing drag on the macroeconomy tends to be smaller, if the PBOC will roll out a 1-trillion yuan program to support public housing and urban village as media reported.

Deflation pressure is a unique phenomenon in China after reopening. We expect the deflation will end in 2024, benefiting from the changing dynamics in global commodity prices and domestic pork prices. Nominal GDP growth will improve to 6.7% in 2024 (vs. 2023 forecast of 4.4%). Meanwhile, low inflation will continue to stay, which is attributable to biased policy support for production vs. consumption.

It will take more than growth-friendly policies to address various challenges faced by the Chinese economy. Restoring confidence among non-SOE sectors will require transparent, stable and predictable policy environment, and actions matter more than policy talks. Fixing policy distortion is also important here, e.g., shifting policy focus from investment to consumption to address the deflation pressure, and equal treatment for innovations and industry upgrade in manufacturing and service sectors to tackle with structural unemployment problem. Another pressing issue is local government hidden debt problem. LGFV debt has exceeded 60 trillion yuan in 2023, but nearly 80% of LGFV could have debt repayment problem (cash / short term debt ratio <1). Debt swap and debt restructuring can mitigate liquidity stress in the near term, but do not provide a fundamental resolution.

Figure 8: China: Contribution to headline GDP growth

%-pt contribution to headline %oya growth



Source: NBS, J.P. Morgan.

Equities

Global and US Overview

Click here for the full outlook.

Since the start of the rate hike cycle in 2022, regional business cycles have weakened, earnings growth has stagnated (S&P 500 2021-2024E EPS: $208-$225, ~2.5% CAGR), and the market has moved sideways averaging near our price target of 4,200 (2022 avg: ~4,100; 2023 avg: ~4,250). Equity concentration reached levels not seen since 1970s with a very narrow leadership, which is typical ahead of a slowdown. Most active investors and diversified portfolios underperformed in this environment with S&P 500 performance led by a small number of mega-cap stocks (Magnificent 7 +101% vs. S&P 500 equal weight +3.5%, Russell 2000 +2.3%, Defensive sectors -11%, 46% of S&P 1500 stocks down YTD). Many argue the next leg up for global equities will be supported by laggards. However, we see this as a tall order given that underperformers are more economically sensitive with lower and vulnerable margins. After a period of record pricing power, the recent disinflationary trend should become a major headwind for corporate margins amidst sticky and lagging wage trends. In fact, pricing power could outright turn negative / deflationary in some industries. Absent rapid Fed easing, **we expect a more challenging macro backdrop for stocks next year with softening consumer trends at a time when investor positioning and sentiment have mostly reversed. Equities are now richly valued with volatility near the historical low, while geopolitical and political risks remain elevated. We expect lackluster global earnings growth with downside for equities from current levels. For S&P 500, we estimate earnings growth of 2-3% next year with EPS of $225 and Price Target of 4,200 with a downside bias. At the style and sector levels, we recommend investors overweight Bond Proxies and Quality at a Reasonable Price with Utilities sector at a sweet spot of this mix.** While it is difficult to pin down the start date and depth of a recession ahead of time, we think it is a live risk for next year even though investors are not pricing in this uncertainty consistently across geographies, styles, and sectors yet.

- **Decelerating Global Growth and Shrinking Liquidity.** Our Quant Macro Indicators (QMIs) imply further deceleration in global business cycle. JPM Economists expect US growth to slow to 0.7% YoY by 4Q24 from 2.8% 4Q23 and global growth to moderate to 2.0% YoY by 4Q24 from 2.7% 4Q23. At the same time, liquidity continues to contract as G5 Central Banks shrink balance sheets at an unprecedented pace of ~$5.2T over the last six quarters and borrow rates remain restrictive across consumer and corporate segments, see Higher for Longer. Yield curves of major liquid developed bond markets (Germany, France, UK, Australia, Canada, US) have inverted in unison for the first time since the GFC. Japan is the sole exception as BoJ is cautious about raising the short-term policy rate too quickly even as JGB yield comes under pressure in spite of YCC.
- Excess US household liquidity (cash-equivalent assets) has fallen from a peak of $3.4T to $1.0T and should largely be exhausted by 2Q24 based on our estimates. Importantly, nearly all the inflation-adjusted **excess cash sits with the relatively affluent (top 20%) while the middle class (top 20%-60%) real liquidity is back to pre-Covid level and the bottom 40% are worse off.**
- **Geopolitical and political risks remain high,** with an ongoing shift to a multipolar world order, two major wars, and 40 countries holding national elections (including the US) that could add policy volatility, see Geopolitical tectonic shifts. As such, we expect equity volatility to generally trade higher in 2024 than in 2023, and the extent of the increase depends on the timing and severity of an eventual recession.
- **Consensus estimates and equity valuation imply growth acceleration consistent with an intra-cycle / early-cycle recovery**. The market is assuming a near perfect landing with inflation cooling without a significant impact to demand and pricing power — not likely in our view. Consensus forward EPS growth of 11% for US and 9% for AC MSCI ex-US is in harmony with this Goldilocks outlook, which does not consider Higher for Longer or a recession outcome depending on course of policy actions and geopolitical developments. In contrast to this robust outlook, we expect lower sequential revenue growth, no margin expansion, and lower buyback executions.
- **Current valuation is rich, especially in light of the aging business cycle, restrictive monetary policy, and geopolitical risks.** S&P 500 multiple relative to real rates is overvalued by ~3x (or ~4x if post-Covid stimulus and TMT bubble episodes are excluded), Equity Risk Premia (ERP) is at 96%ile since 2010, i.e., very low reward for the risk. Traditional valuation metrics are similarly in the richest deciles with EV/EBITDA of 14x (90%ile), EV/Sales of 2.7x (88%ile), and P/B of 4.3x (89%ile). At this valuation and VIX near historical low, the market is far from appreciating the known risks (e.g., CRE, rising bankruptcies, credit delinquencies) and unknown unknowns (i.e., unwinding of carry trades implemented during ~15 years of ZIRP).
- **There are increasing signs of caution emerging.** Credit card delinquencies continue to rise. Office CRE trends continue to weaken with a wall of maturities looming in

'24. Syndicated leveraged loan defaults are well above '19 levels and rising. All of this adds up and suggests a credit cycle that is running a little long in the tooth. Also, venture-backed companies are facing sharp tightening with 3Q23 LTM investments activity down -33% y/y and -53% from the peak.

Table 4: 2024 Regional Sector Views

Sector Views	US	Europe	Japan	EM	China	Asia ex-JP	CEEMEA	LatAm
EN	OW	OW	N	OW	OW	N	N	N
MT	N	N	UW	UW	UW	UW	UW	OW
ID	UW	UW	N	N	OW	N	N	UW
CD	UW	UW	OW	OW	OW	OW	N	OW
CS	OW	OW	OW	OW	N	OW	OW	N
HC	OW	OW	N	UW	N	N	OW	N
FN	N	UW	OW	N	UW	OW	OW	OW
IT	N	N	UW	N	N	UW	OW	UW
TS	N	OW	N	N	N	N	N	N
UT	OW	OW	N	N	N	N	N	UW
RE	UW	OW	N	N	N	N	OW	OW

Source: J.P. Morgan Global Equity Macro Research

Cross-Regional Equity Strategy. US continues to command a quality premium over other markets given its sector composition and cash rich mega-cap stocks. If the economic growth momentum of this year continues into 2024, it is likely that the US will underperform given the wide valuations gap of the US vs other regions, and its rich investor positioning. However, if the expected Goldilocks environment does not materialize, a risk we believe is under-appreciated, the US will likely outperform in an otherwise disappointing global equity performance in 2024.

- Outside the US and within **international developed markets**, we are relatively more optimistic on **UK** equities given significant valuation support and favorable sector compositions. Despite cheap valuation, we expect European equities to have a v-shaped path (weak 1H and then some recovery on Fed rate cuts), ending the year relatively flat (this assumes no recession in 2024). On the other hand, **Japan** remains attractive with a potential pick-up in retail participation, strong balance sheets, improving shareholder focus, better consumer real income growth and still supportive policy backdrop.
- We expect a bumpy start to the year for **Emerging Markets** given high rates, geopolitical developments, lasting USD strength and poor historical EM Sharpe ratio versus DM. However, EM should become more attractive through 2024 on EM-DM growth divergence, demand for diversification away from the US, low investor positioning, steep discount to DM and USD weakness. For **China**, which has lagged meaningfully this year, there is a prospect of better performance if the growth momentum delivers on the upside, and the geopolitical risks stay contained. We see a more positive setup for **LatAm** equities with upside of ~10% helped mostly by lower inflation, lower financing costs and easy comps. Lastly, we have been cautious on EM vs DM in 2023, and think that certain parts of EM – China/LatAm – could surprise on the upside in 2024.
- **At the style and sector levels, we recommend investors overweight Bond Proxies and Quality at a Reasonable Price. Utilities are in a sweet spot of this mix, especially after the rapid 9.8x turn de-rating in PE NTM.** Defensive Sectors and Industries (Utilities / Staples / Non-Real Estate REITs, Aerospace Defense) were market darlings not too long ago (see Low Vol Bubble) similar to mega-caps today (see Market Concentration). We believe it is still early for investors to bottom-fish in beaten down Consumer stocks, Financials, Real Estate, and unprofitable companies. Instead we see plenty of room for Defensive stocks to re-rate higher (Defensives trade at only ~1x premium to Cyclicals).

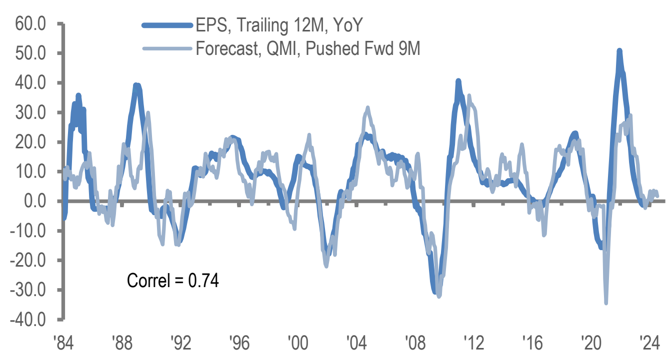
Table 5: 2024 Regional Style Views

Style Views	Value	Growth	Quality	Size (Small vs Lrg)
US	N	N	OW	N
Europe	UW	OW	OW	UW
Japan	OW	N	N	UW
EM	N	N	OW	UW
China	UW	OW	OW	UW
Asia ex-JP	OW	N	OW	UW
CEEMEA	UW	OW	N	N
LatAm	OW	N	UW	OW

Source: J.P. Morgan Global Equity Macro Research

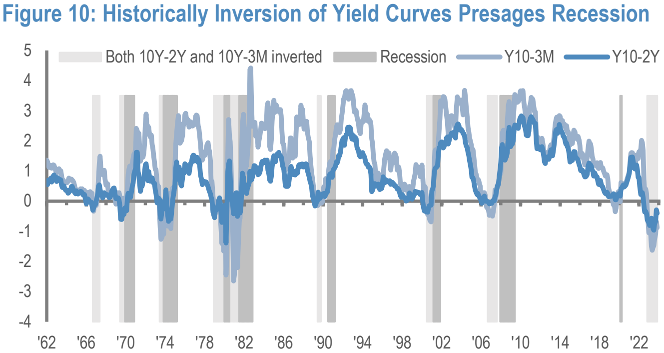
Global Macro and Business Cycle Outlook. JPM Regional Business Cycle Indicators (QMIs), which lead the business cycle by 3 to 6 months, **suggest a slowing global economy into mid-2024 at least.** For the last 19 consecutive months the US QMI has been below average, an extended pause typically associated with a recession. Meanwhile the European QMI has moved deeper into the 'Contraction' phase suggesting an increasingly challenging macro-drop. Economies of Japan, China, and India are also expected to meaningfully decelerate in 2024. In addition, geopolitical risks (e.g., Ukraine war, Middle East tension, US-China relations) remain a source of volatility for commodity prices and growth. Since QMIs' visibility extends to 1H2024 at best, a US recession next year remains a live risk contingent on policy actions and geopolitical developments. In particular, **the US QMI leads S&P 500 EPS year-on-year change by 9 months and foresees stagnant EPS till mid-2024** (Figure 9). The massive fiscal transfer and monetary injection that have supported households and businesses since 2020 are a diminishing counterbalance against rising real interest rate, declining household liquidity, and tightening financial conditions. Historically, earnings growth expectations rarely deviate from changes in economic growth. During 2023, we believe global consensus EPS revisions outpaced macro data (JPM's regional Quant Macro Indices) for two reasons: 1) high inflation, and 2) consumer strength. Unless corporates can continue to both control their supply chains and raise prices, the risk is that the 'sweet spot' is over. We believe both drivers (price inflation and the consumer demand) are now in the process of reversing, and very likely to lead to a significant downtrend in EPS expectations. Indeed, the latest revisions already appear to be moving in that direction. Moreover, the risk of this continuing is exceptionally high when interest rates are at their peak, and when bond yields are falling. **Bottom line, we expect profits to deteriorate more than the declining QMI macro trends as we progress into 2024.**

Figure 9: US QMI Leads EPS Growth by 9 Months



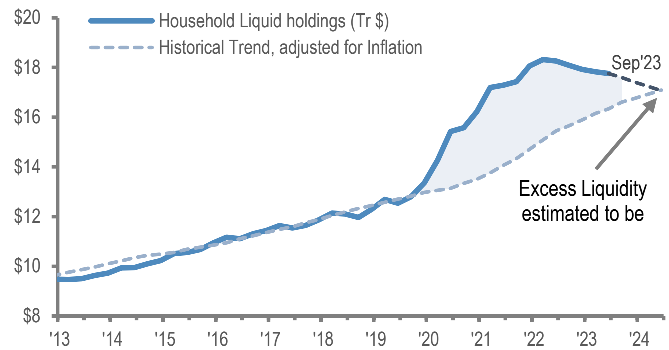
Source: J.P. Morgan Global Equity Macro Research

Figure 10: Historically Inversion of Yield Curves Presages Recession



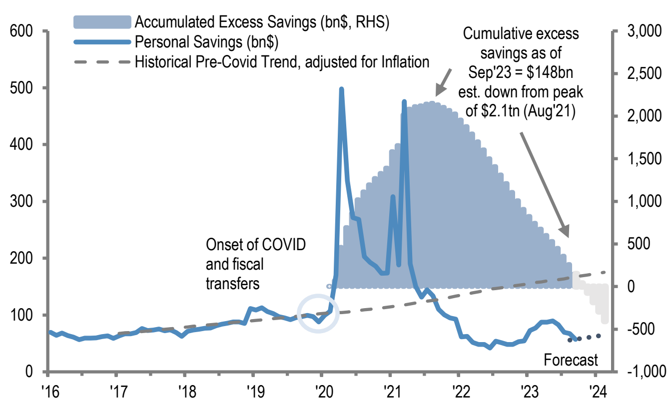
Source: J.P. Morgan Global Equity Macro Research

Figure 11: Household Excess Liquidity Declining



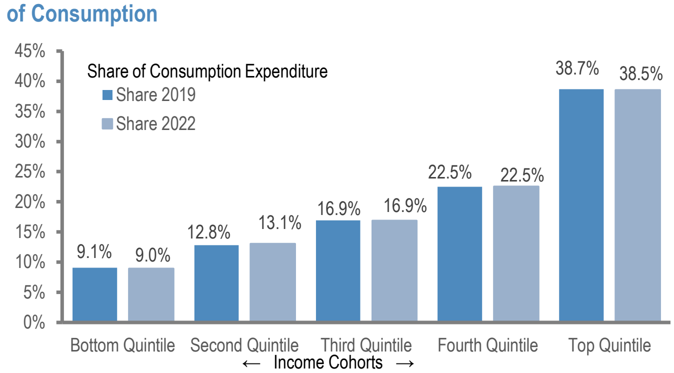
Source: J.P. Morgan Global Equity Macro Research

Figure 12: Household "Excess Savings" Almost Gone



Source: J.P. Morgan Global Equity Macro Research

Figure 13: Bottom 80% of Households by Income Account for 61.5% of Consumption



Source: J.P. Morgan Global Equity Macro Research

European and Regional Allocation

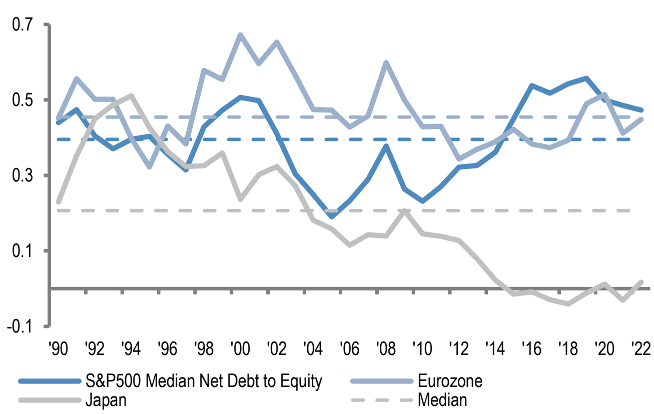
Click here for the full outlook.

For 2024, we look at the following equity drivers: lower bond yields, softening GDP growth vs this year - nearing stall speed in the US, and some downside risks to corporate profit expectations.

After 3 years of an upmove in bond yields, where US long bonds lost almost 50% of their value, and with central banks in DM largely done, yields are set to move lower - we called last month to enter long duration trade. This should optically offer support to equity valuations, but earnings momentum from here is at risk, in our view. In terms of activity, JPM base case is for US real GDP growth to soften in 2024, to 0-1% run rate for 3 quarters in a row. Recession is not our base case, but the margin for error is very slim at such low levels of activity. Eurozone GDP growth is expected to be 0.4% in '24, yoy, offering no acceleration vs 0.5% run rate for this year.

Crucially, we see signs of a rollover in corporate pricing, a trend that is likely to accelerate as we move through next year, and goes against the consensus call that has projections of earnings and margins expansion in 2024.

Figure 14: Key regions median Net Debt to Equity



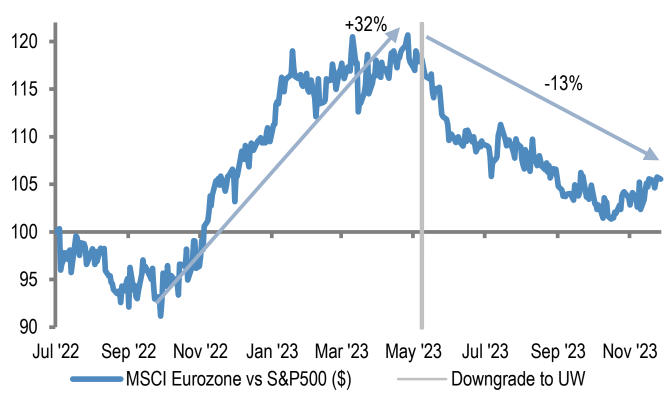
Source: Datastream

Put together, we expect flat Eurozone EPS growth in 2024 and 2% in 2025, vs consensus at 6% and 9%, respectively. Even though European P/Es are undemanding, we look for similar multiples to current next year, given earnings deceleration. In terms of trajectory, we believe Eurozone equities could have a weak first half and then some recovery as the Fed starts cutting rates, to end the year around current levels. Our end 2024 target for EuroStoxx50 is 4,250. We are relatively more optimistic on UK equities, where we see some valuation support and a more favorable sector composition.

Our target for FTSE100 is 7,700 for end of next year, about 3% higher from the current levels.

In a regional context, we have been OW Japan all through 2023 and believe that it remains attractive. Further, one would potentially not need to hedge the FX anymore. Among other factors, Japanese equities stand to benefit from increasing retail participation, strong balance sheets, improving shareholder focus, better consumer real income growth and still relatively supportive policy backdrop. We also like the UK market for 2024 (OW) and within it keep our longstanding preference for FTSE100 over FTSE250.

Figure 15: MSCI Eurozone vs US relative performance

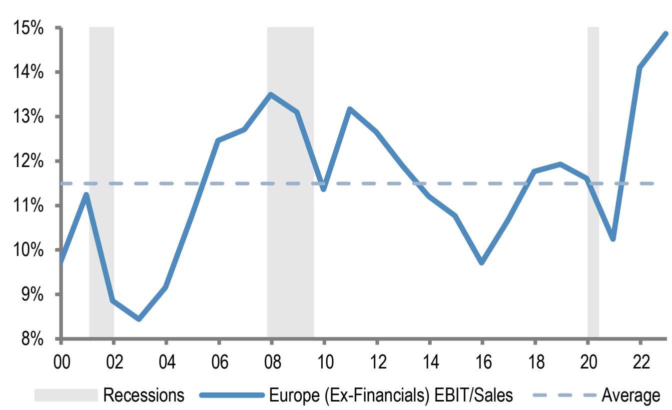


Source: Datastream

After favoring Eurozone entering this year, we have taken profits in early May, cutting it to UW, benefitting from the spell of strong outperformance, and stay cautious on the region for now.

We note that Eurozone equities screen cheap at present, at 12x Fwd P/E, so there could be an opportunity as we move through 1H to add back to the region.

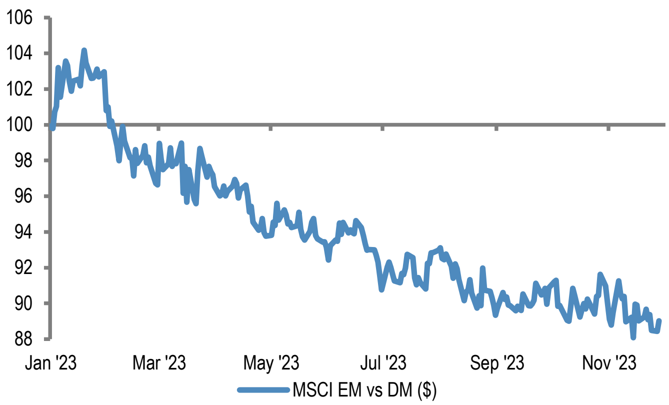
Figure 16: MSCI Europe - ex Financials EBIT margin



Source: Datastream

In the interim, we would wait for the bottoming out in Eurozone activity momentum and the potential resetting of earnings for 2024. We note that European profit margins are elevated, and at risk of mean reverting, given a rollover in pricing.

Figure 17: MSCI EM vs. DM



Source: Datastream

We have been cautious on EM vs DM in 2023, but believe that EM could deliver better returns in 2024 as Fed starts cutting rates.

Tactically, we have a few weeks back advised to close shorts on Chinese equities, and on Miners, given an already poor performance, and some stimulus coming through.

In terms of themes for next year, we believe stocks that saw outsized margin expansion will be at risk. We also think companies with imminent refinancing needs and weak balance sheets could trade weaker if interest rates remain elevated.

Highlights at a sector level: we believe long duration / bond proxies, such as Utilities and Healthcare, could trade better on peaking yields. We have recently upgraded Real Estate sector, from UW, taking advantage of the dismal performance over the last two years. We keep our OW on Aerospace Defense groups.

On the cautious side, we have recently downgraded Banks to UW, after a strong spell of performance, and stay UW Autos and Consumer Cyclicals more broadly.

Japan

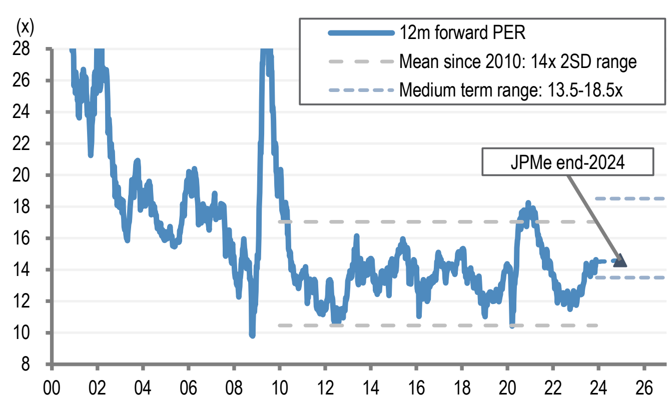
Click here for the full outlook.

Maintain bullish stance given structural changes. We expect 2024 to be a year of the global economy slowing and domestic demand expanding as Japan exits deflation. Our main scenario has Japanese stocks seeing a net positive impact, with pressure on external-demand sectors from a slowing U.S. economy and a stronger yen outweighed by positives including (1) expansion of domestic demand, (2) expansion of re-shoring investment, (3) improvement in corporate B/S, (4) fund flows, (5) higher dollar-denominated returns due to a stronger yen, and (6) resilient valuation during global economy slowing as deflation winds down. We believe that structural changes will come increasingly to the fore amid the expected global economic slowdown and therefore maintain bullish on Japanese equities.

At end-2024, we forecast TOPIX and the Nikkei 225 to be at 2,500 and 35,000 yen (+5% YoY). We expect investors to rerate Japanese stocks owing to the structural change, but given the outlook for downward pressure on global markets caused by economic slowing, we forecast the end-2024 P/E to return to its current level after falling during the year. Owing to yen appreciation, we think dollar-denominated investment (unhedged) in 2024 will result in total returns of 7–15%.

By sector, we are Overweight on personal consumption-related sectors and remain Overweight on the financial sector. We remain Neutral on autos, machinery, semiconductors, healthcare, and communications. Chemicals and internet/gaming are Underweight. We estimate that foreign investors' positioning in Japanese equities is still underweight, and we believe there is upside potential for foreign investors to buy Japanese equities on the back of structural changes in Japan.

Figure 18: TOPIX 12 month forward PER



Source: Datastream, J.P. Morgan
Note: PER solid line shows the 12-month forward I/B/E/S consensus, and the dotted line shows the medium-term fair value forecast of JP

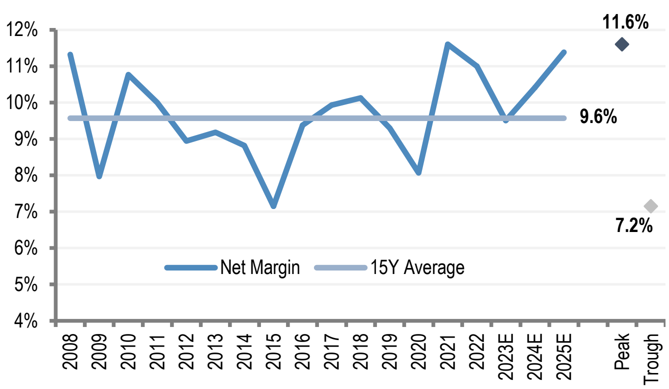
Emerging Markets

Click [here](#) for the full outlook.

We estimate EM equities will return 9% next year (MSCI EM 1,070), driven primarily by earnings growth, as lower US equity markets become a headwind for multiple expansion. Single-digit upside brings the question: why bother investing in EM equities when one can get +5% in US fixed income?

- **EM equities behave as an asset class requiring market timing skills for in and out – tactical rather than strategic allocation and next year looks to be no different.** We expect a volatile 2024, driven by a challenging global macro picture; and
- **We use more conservative earnings than consensus EPS growth** assuming no margin expansion and tempering risk of excessive growth in the Inf. Technology sector. Our EPS growth is c. 10% vs consensus EPS growth ranges of USD +13% to +18% for 2024 and USD +11% to +18% for 2025.

Figure 19: Optimistic consensus forecasts EM net margin to expand from 9.4% in 2023E to 10.4% in 2024E



Source: Bloomberg Finance L.P., MSCI, J.P. Morgan.

- **OW Markets.** We use our risk budget to focus on endogenous investment cases (**OW India, Saudi Arabia and Mexico**), gain indirect exposure to China GDP (**OW Brazil, Thailand and Indonesia**) and reinforce non-consensus call (**tactical OW China**); and
- **Bottom Up Thematic. (1) Defensiveness** via EM Dividend Nobles (consistent dividend paying stocks) and EM Value Creators (consistent value creators); **(2) Market Neutral via** stocks that might benefit from energy transition and secular near shoring trends; **(3) Bull-Biased via** stocks that would benefit the strongest from lower interest rates, indirect China exposure and stocks for bull / bear swings in the Broad USD.

China

Click [here](#) for the full outlook.

In 2024, China enters its 4th year post equity and property price peaks with a mild cyclical recovery. China has been the worst performing market in MSCI APAC since end 2020 by USD total returns on weakest relative EPS growth and valuation de-rating. But since end Oct 2023, with anticipated Fed rate cuts and easing DXY, MXCN started to stage a relief rally (JPM cut cash in the [model portfolio](#) from 9% to 1% on Oct 29th). With positioning light and sentiment weak, we see this relief rally developing into early 2024 on easing US-China tensions, China's easing deflation, revenue growth pickup and further cost and interest expense cuts by enterprises lending support to non-financial margins. JPM's Haibin Zhu forecasts 4.9% GDP growth y-y in 2024 (consensus 4.5%) with an end to deflation and Consumption/Investments/Net trade accounting for 3.3%/1.9%/-0.3% of the 4.9% growth. Consensus estimates on MXCN EPS are HK$5.3/6.1/7.0 over 2023/24/25 (+14%/16%/14% y-y). Our base index target for MXCN is 66 (P/E of 9.4x on 2025 consensus EPS) at -0.7xSD below mean.

Table 6: MSCI-China year-end target for 2024E

2024E MXCN Index Target (HK$)	Base (F)	Bull (F)	Bear (F)
Index level	**66**	**70**	**56**
Consensus 2025F EPS integer	7.0	7.0	7.0
JPM 2025F EPS integer estimate	6.4	6.4	6.4
JPM vs consensus (2025F EPS integer estimate)	**-8%**	**-8%**	**-8%**
JPM 2025F EPS growth y-y	10%	10%	10%
Implied P/Es on JPM forecast	**10.3**	**10.9**	**8.7**
Standard deviation vs FTM P/E median since 2010	**-0.3x sd**	**0x sd**	**-1.1x sd**
Implied P/Es on consensus forecast	**9.4**	**10.0**	**8.0**
Standard deviation vs FTM P/E median since 2010	**-0.7x sd**	**-0.4x sd**	**-1.4x sd**

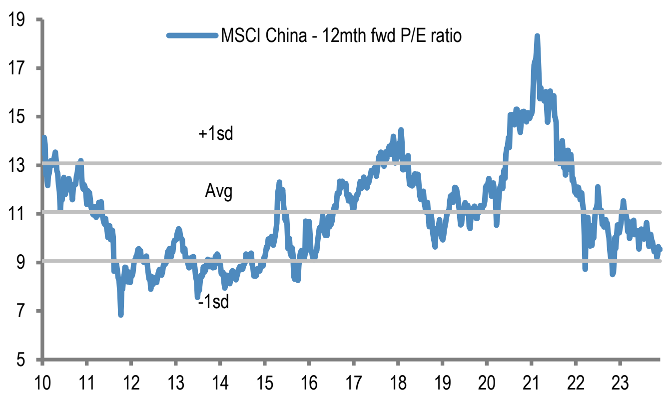
Source: MSCI, Refinitiv Eikon Datastream, J.P. Morgan estimates

Risk considerations: In the last six quarters, the G-5 central banks have reduced balance sheets by around US$5.2trn to combat inflation. For China, investors are keen to understand how Beijing may tackle the complex problem of property deflation, LGFV leverage, bank NPLs, low interests in A-shares among domestic households and weak private sector confidence. For 2024, JPM's Global Equity team views the recession as a live risk (though not a base case) with negative spillovers to growth and risk appetite.

We present five thematic [baskets](#) on the long side: "Value for money" exporter leaders **(JPCHWVBE <Index>)**; Niche market leaders **(JPCHWNML <Index>),** Home market leaders **(JPCHWHML <Index>); Greater China AI (JPCSCHAI <Index>),** Financial Survivors **(JPCHFNSV**

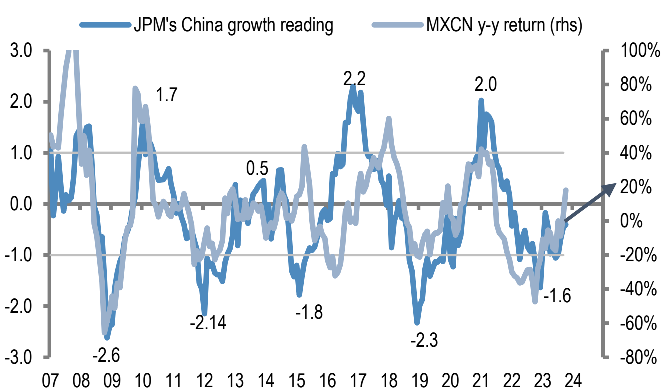
<Index>), and one Funding basket **(JPCHSHRT <Index>). Sector preference**. Around 39% of 31 subsectors we track (large cap biased, and mostly following GICS L2 classification) entered Recovery by end 3Q23. Specifically, ten flashed investment signals: 1) Timely buys in Consumer Electronics, Media & Entertainment, Pharma, and Semi, 2) Downside optionality in Banks, IPP, Software, and Telecom, and 3) Upside optionality in Brokers and Packaged Foods. We overlay these findings with real time sector allocation based on our re-priced model portfolio **for final sector recommendation. Top-3 OW sectors: Media & Entertainment, Discretionary and Industrials. Top-3 UW sectors: Banks, Materials and Transport.**

Figure 20: MSCI-China forward 12m P/E



Source: MSCI, Refinitiv Eikon, J.P. Morgan

Figure 21: JPM's China growth reading



Source: Wind, J.P. Morgan

EM Asia

Click here for the full outlook.

Our base case assumes returns will be front-ended in 2024 for MSCI Asia ex Japan taking into account YTD underperformance, normalization of sentiment/positioning, positive seasonality, inexpensive valuations and an apparent upturn in the memory cycle. **Equities may trade between our base case and bull case (Goldilocks) in early 2024, driven by shifts in market participants' views on the US outlook.** However, as we progress into 2024, a host of challenges will start to unlock – moderating growth, tight external financial conditions, strong dollar, restrictive/measured policy stance, domestic political & geopolitical uncertainty and structural issues in China. Thus, our current allocation in AxJ region walks the fine line by selectively embracing the tactical positive reality of today (where reinforced by endogenous upside), while being mindful that a high-for-long environment will gradually undermine the foundations of this resilience, making a recession a high probability event over the next 18 months. **We recommend being OW India, China, Financials, Consumer Discretionary, Consumer Staples; and UW Taiwan, ASEAN, IT, Materials**.

We reiterate our structural OW call on India. The key driver being the (well-known) high visibility of growth into multiple years ahead. In addition, we see in the financial market a virtuous cycle of investor participation, deepening and broadening liquidity, rising fundamental coverage and analysis, and capital issuance – supporting the strong (and unparalleled) track record of risk-adjusted returns. Besides structural promise, near-term factors that we believe will drive markets higher are robust activity data, impressive corporate earnings, easing oil prices, strong domestic flows and recently-light positioning by foreign investors. These developments should continue to support a combination of elevated valuations and low volatility.

Table 7: Asia markets' base case index targets and implied upside

Market	MSCI Index	Current Level	End-2024 Base Case	Upside to Target	Implied Fwd P/E	Current fwd P/E	2024 EPS growth
AxJ	MXASJ	621	675	9%	11.5	12.1	14%
China	MXCN	57	66	15%	9.9	9.5	11%
Hong Kong	MXHK	10535	12000	14%	12.2	11.7	13%
Taiwan	TAMSCI	663	650	-2%	12.4	15.1	19%
Korea	MXKR	784	835	7%	9.2	10.8	68%
India	MXIN	2307	2500	8%	18.8	19.8	14%
Singapore	SIMSCI	271	290	7%	11.2	11.3	2%
Indonesia	MXID	7354	7800	6%	12.6	13.1	8%
Thailand	MXTH	461	550	19%	16.7	15.8	16%
Malaysia	MXMY	461	475	3%	13.0	13.4	8%
Phillipines	MXPH	1089	1150	6%	10.8	11.4	9%

Source: Bloomberg Finance L.P., J.P. Morgan , Price as of 30 Nov 2023

CEEMEA

Click here for the full outlook.

We forecast 9% upside for MSCI EMEA to end-'24, another year of returns below the cost of equity. Our **key OWs in the region remain Saudi Arabia, UAE and Greece**, but our Top 10 includes stocks in Poland and Türkiye - neutral does **not** mean zero. *Our* key UW remains South Africa. For the Top 10, we add **Bank Pekao** (more upside on new government and Pekao is a winner should rates stay higher for longer) and **ELM** (Saudi government contract exposure) and remove *Capitec* (less domestic SA exposure and downside risks to consensus EPS) and *Alarabia* (3Q earnings miss). We have 3 Saudi stocks (**SNB**, **Riyadh Bank** and **ELM**), 2 UAE real estate names (**Aldar** and **Emaar Prop**) plus **Alpha Bank** in Greece, **BIM** in Türkiye and **Bank Pekao** in Poland. We still have **Naspers** and **Bidvest** in SA. Among SA sectors, we retain our OW of offshore v domestics, but cut Industrial Metals from OW to UW given the limited positive catalyst for base metals.

The macro assumptions behind our Year Ahead asset allocation are … more of the same: a 4% stronger DXY in 1H24; a Fed that delivers a first cut later than is priced into the yield curve (3Q24 on our forecast); weak US and DM equity performance; Brent averaging $83/bbl in '24 and Saudi adding only 250k bbl/day production next year. If it sounds a lot like 2023, well, changing the calendar does not change the world.

Figure 22: MSCI Saudi outperforms EM when DXY gets stronger

Source: J.P. Morgan, Bloomberg Finance L.P.

Latin America

Click here for the full outlook.

We expect the MSCI LatAm to reach 2,700 in 2024, about a 10% increase from current levels. Different than in 2023, when the market upside came mostly from re-rating, in 2024 we expect earnings to move to positive territory (about 7% rise), helped mostly by lower inflation, lower financing costs and easy comps. There are three top down factors that should lift up LatAm markets.

(1) Lower interest rates: By 1Q24 all the countries in the region will be cutting interest rates. The process started early for Brazil and Chile, but Mexico is going to finally join the group. That in itself is a powerful catalyst for upside in our view.

(2) Cheap valuations: LatAm trades at around 9x 12 mo fwd PE, which is 1.3 SD below average and also 25% cheaper than EM.

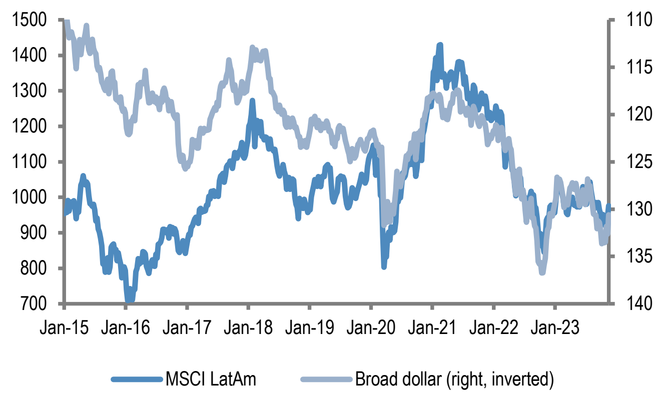
(3) No politics nor geopolitics: All in all, the region is relatively isolated from geopolitical risk, being well engaged with both China and the US. From a local standpoint, the election calendar is relatively light, with important elections concentrated in Mexico, where the likelihood for continuation of the Morena administration is high. Municipal elections in Brazil tend not to be a market moving event.

(4) Positive spillover from global conditions: In 1H24, LatAm should continue to be helped by the stimulus and recovery coming from China, especially if these are guided more directly to properties, boosting commodity prices. In 2H24, Fed rate cuts (JPM expects 100bp) should lead to global market upside and, as an optionality, a weaker USD, which would further help LatAm, not only on the gains from the currency side, but also on the commodity one, considering that more than 30% of the index is materials and energy.

From a sector standpoint we are **OW real estate, financials, discretionary and materials** and **UW staples,technology and industrials**.

Country views. **Brazil (OW)** is cheap, has earnings growth, benefits from lower rates and politics is on the backseat. We recommend a barbell with commodities on one hand and bond proxies on the other, but with a heavier weight on the latter as we think the optionality is for lower rates than consensus. **Chile (OW)** has the same tenets of Brazil: cheap, low rates, political de-leverage. SQM (22% of the index) dragged performance lower in 2023 but we are positive on the story. **Mexico (N)** has a great underlying story on nearshoring, but will face two headwinds next year: the US slowdown and elections. The first has immediate consequences considering the high level of remittances (~US$60bi/ year) and trade relations (80% of Mexican exports go to the US). With elections come an expansion of the fiscal deficit (from 3% to 4.5% of GDP) and potential policy issues (as with the airports in Oct-23). **Peru and Colombia (UW)** lack attractiveness on both top down and bottom up. We prefer the former rather than the latter, considering the growth recovery. Colombia is on a more troublesome macro environment. Higher oil prices could help, but even its extremely cheap valuations don't make for a compelling story in our view.

Figure 23: MSCI LatAm versus Broad dollar



Source: Bloomberg Finance L.P.; J.P. Morgan

Australia

Click here for the full outlook.

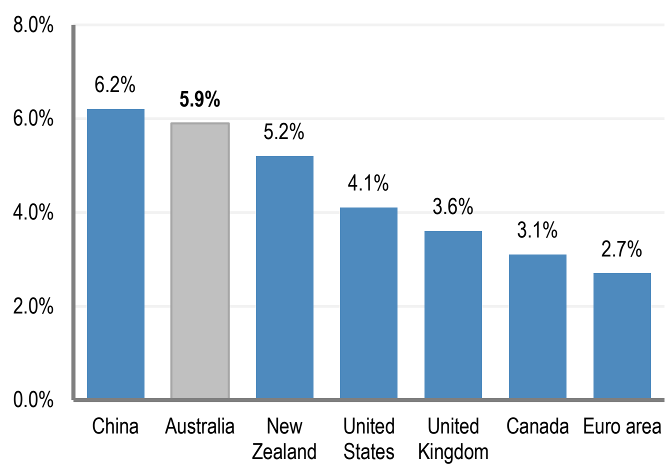
There's a hint of Australian exceptionalism permeating the economic landscape. Not only do our economists see the 'lucky country' generating near-potential GDP growth in 2024, they also foresee sufficient deceleration in inflation for the RBA to hold the cash rate at 4.35%. **Several positive forces are spurring the Australian economy**, including a near-record terms of trade, high immigration, and ongoing strength in employment. Australia stands out against a range of other DM economies in terms of growth projections for 2024 - the nominal increase in GDP is expected to be c.6%.

While the macro backdrop remains supportive, it's important to bear in mind the composition of the Australian equity market. Mining accounts for over 20% of the index and is dominated by BHP, FMG and RIO. As a result, a meaningful proportion of the ASX 200 is influenced by the fortunes of China, in particular housing activity. With policymakers in China maintaining a focus on stimulating housing, steel demand looks set to be supported over the next 6-12 months. **We remain OW the bulk miners (BHP, RIO).**

Banks are the other dominant sector, accounting for c.20% of the index. The dominant factors in the sector's performance are the state of the consumer and the intensity in the mortgage market. While the former is challenged on a per capita basis, aggregate demand is robust. Record rates of immigration and low unemployment are the key drivers. While the consumer backdrop is supportive, the same cannot be said for the mortgage market, where the battle for market share remains intense. Competitive pressures are set to exert downward pressure on earnings, with our team **projecting EPS declines of 8-10% for the major banks** in FY24.

Defensives and Tech make up a relatively small proportion of the Australian index, with **Healthcare** the largest component of the former at c.9%. Looking ahead, with most cyclicals (Banks, Discretionary) approaching fair value, we look to some of the rate-sensitive sectors (**REITS**, Healthcare) for outperformance, as well as **Tech.** For 2024, we project EPS growth of c.4%.and have an index target (ASX 200) of 7,500.

Figure 24: JPMe 2024 nominal GDP growth forecasts | AU leading DM



Source: J.P. Morgan estimates.

Global SMid Caps

Click here for the full outlook.

2024 has shaped up to be a year in which SMid investors will have to differentiate between absolute returns and those relative to large-caps, with the math also being potentially quite different in different regions. In short, since our Mar 1st, 2022 note ("The Math Says Careful") we have held a bearish view on SMid-Caps, which has played out within DMs ex-J where SMid indices are down close to 25% (down 16% vs their Large-Cap peer indices). As we head into 2024 and as we noted in our SMid View report published on Nov 3rd, **we remain cautious on SMid-Caps, which could still fall double-digits from here, while we see enough merit to turn OW SMid ONLY vs large-Caps for those investors who need to be invested in equities within DMs ex-J.**

4 reasons to OW SMid vs Large in DMs ex-J, even when we expect further downside in equities:

- SMid has already underperformed Large-Caps by more than ever, even compared to peak-to-trough performance during recessions.
- The valuation discount of SMid vs Large is also near historical highs, with history suggesting that such a discount should contract from here even if equities were to fall further from here while facing the side effects of recession.
- Most of the fundamental headwinds SMid faced in 2023, will ease in 2024 (i.e., rising salary and interest expenses), and
- It is a matter of not being penny wise and pound foolish (the next 30% of relative return vs Large will be up, not down... so it makes no sense worrying about whether or not they will underperform by another 100/200 bps).

4 themes to focus on until the market troughs and 1 theme to go after once it does. Going into 2024, we stick to the 4 themes we have focused on during much of '22/'23 as they highlight those companies most/least exposed to the current key sources of pain: 1) Focus on labor light businesses (JPSMSSWE/US) vs labor-intensive ones (JPSMIPWE/US). 2) Focus on solid balance sheets (JPSMCRWE/US) vs debt burdened ones (JPSMDBWE/US). 3) Focus on achievable ests (JPSMLDWE/US) vs demanding ones (JPSMPSWE/US). 4) Focus on pricing power (JPSMHFWE/US vs JPSMBFWE/US). Once we are closer to the trough… it's all about deep value… our rebound candidates screen is made up of those stocks that are a) down >40% already, or b) <10x P/E, or c) <1.0x P/B (JPSMRCWE/US).

Table 8: Average Perf of SMid vs Large in First 12 mths post a Recession-linked Equity market low

	UK	Cont. Europe	US	Japan	EM
SMid Index	FTSE 250	MXEMSC	RTY	TOPIX 100	MXEFSC
Large Index	FTSE All Share	MXEMLC	SPX	TOPIX Small	MXEFLC
Avg Rel. Perf *(SMid less Large)*	**18.60%**	**39.20%**	**32.20%**	**10.60%**	**28.50%**

Source: Bloomberg Finance L.P. and J.P. Morgan calculations.

Market Volatility

Click here for the full outlook.

US volatility outlook: Volatility was unusually low this year relative to high interest rates, slowing macro data, and elevated geopolitical risks. This disconnect was driven by a combination of longer than normal lags in the transmission of monetary policy and technical factors (e.g. persistent short-dated option selling flows). While the lags are longer than usual, much of the impact of monetary policy is likely still ahead, and elevated rates along with slowing economic growth should boost equity volatility over the course of next year. For 2024, we also expect a more challenging backdrop for stocks and believe risk-reward remains unattractive. Additionally, geopolitical and political risks remain high, with an ongoing shift to a multipolar world order, two major wars, and 40 countries holding national elections (including the US) that could add policy volatility.

As such, we expect the VIX to generally trade higher in 2024 than in 2023, and the extent of the increase depends on the timing and severity of an eventual recession, which remains a live risk, and the timing of a potential volatility surge that could alleviate the structural short-dated volatility selling flows. If markets remain relatively calm and we see an economic soft landing, we would expect the VIX to average in the mid-to-high teens next year, while if a moderate recession were to start in the 2nd half of next year, the VIX is likely to average in the low 20s for the full year. The VIX could of course realize even higher levels in case of a severe recession or geopolitical tail event.

0DTE options: In 2023, SPX 0D options activity has steadily grown to account for around 45-50% of all SPX option volume. The main driver of the volume growth is not retail investors, contrary to popular belief. Instead, we believe the 0D option market is dominated by algorithmic and high frequency traders, who are on balance net sellers of options. As a result, we observe some evidence of intraday volatility dampening, both in realized and implied, potentially due to market makers hedging their long gamma positions. At the same time, an exogenous shock in a short period of time can lead to not only large losses, but the ensuing disorderly unwind could result in far bigger market moves, a situation akin to the 2018 'Volmageddon' episode. Since our initial note in February, the risk is still very much live and present.

Europe: We expect a moderate increase in European implied volatilities in 2024, with an average level for the VSTOXX of 20. To put this into context, this target is slightly higher than the 2023 median and marginally below the long-term median for the VSTOXX (21.8 since launch in 1999). There are primarily three reasons why we think that volatility will increase from the current, depressed levels. First of all, we expect a further slowdown of economic activity in the region and the tighter monetary conditions to affect equity realized volatilities. Secondly, we think that investors' positioning will be less of a support into next year following the substantial improvement of positioning metrics over the last twelve months. Finally, we expect a pick-up in correlation between stocks, leading to higher index volatilities for the same level of average single stock volatilities. Event and geopolitical risks persist and are elevated, but with stable energy prices the transmission of these uncertainties into higher equity volatilities is limited, unlike in Q4 2022.

Japan: We expect a moderate increase in volatility within the Japanese equities market in 2024, with the average of the VNKY index likely rising beyond 20 pts (vs an average of 19 pts in 2023). The global macro risks could lead to heightened volatility, due to Japan's reliance on exports, increased foreign investment, and potential spillover effects from prolonged interest rate hikes. However, this is predicted to be moderate, owing to Japan's comparatively attractive valuation and factors not influenced by the global economic cycle, such as the end to deflation, the TSE reforms, and potential fund inflows from individual investors and corporate pension funds.

HK/China: We expect the VSHCEI will find support at the 5-year average of 26 pts (vs an average of 28 pts in 2023). Despite our relatively benign volatility forecast, we anticipate more frequent volatility spikes in 2024 as challenges related to debt restructuring and deflation that China currently faces are expected to persist into 2024. We believe that market volatility will more likely accompany a rebound rather than a sell-off. The theme of flow rebalancing driven by an increased allocation from mainland Chinese investors and stronger support from corporate buybacks will continue to shape China's equity markets next year. These dynamics will likely provide better support on the downside and stronger momentum on the upside, a trend that we have already started to witness this year.

Rates

US Rates: Treasuries

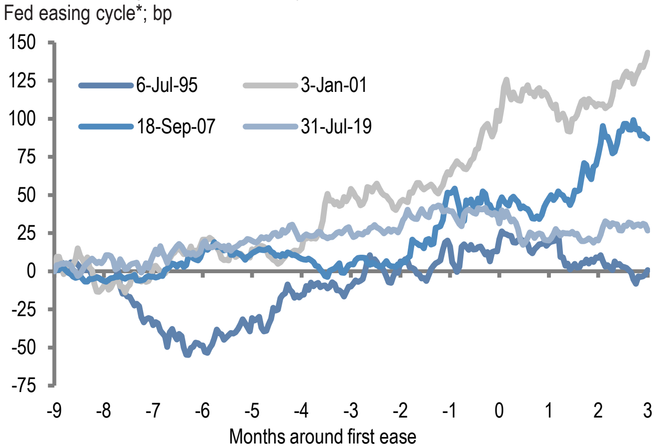
Click here for the full outlook.

As discussed earlier, we expect the US economy to grow at a sub-trend 0.7% pace next year, with the labor market loosening, and we expect further progress toward the Fed's 2% target, albeit slower than in recent quarters. **Against this backdrop, we believe the Fed is done raising rates and expect cuts to start in 3Q24, at a pace of 25bp per meeting, bringing the Fed funds rates to 3.5% by mid-2025.**

As we transition to an easing regime in 2H24, it's instructive to examine how Treasury yields and curves evolved prior to other easing cycles. Each cycle has unique traits, but, on average, 10-year yields have declined 115bp in the nine months leading up to the first ease, considering the 1995, 2001, 2007, and 2019 easing cycles. On average, the bulk of this move has occurred 6 months before the first ease. All else equal, if our Fed forecast comes to fruition, this should support yields declining further in 1H24. Turning to the curve, there is a discernible steepening trend in the pre-easing period, with the initial steepening concentrated at the long end, while the front end tends to take leadership only closer to the first ease (Figure 25).

Figure 25: The long end tends to steepen in anticipation of a Fed shift

Cumulative change in 5s/30s Treasury curve in the months around the first ease in a Fed easing cycle*; bp



Source: J.P. Morgan
*Dates used: 7/6/1995, 1/3/2001, 9/18/2007, 7/31/2019

If history repeats itself, the coming months should support a continuation of the most recent trends in the Treasury market, especially from late 1Q24 onward. However, we think there are unique traits to this cycle that could differentiate early-2024 from other pre-easing periods, for a couple of reasons.

First, while the policy rate tightening cycle has come to a conclusion, the balance sheet normalization cycle is ongoing in the background, with no end in sight. We project QT running through YE24 (see *Death cab for QT?*, 11/9/23). The Fed's declining footprint in the Treasury market, synchronized with QT across other DM central banks, should act as a ballast to easier Fed policy expectations, leading to a smaller decline in yields, all else equal. This QT process is also synchronized across the major DM central banks: the aggregate size of the G4 central bank balance sheet is on pace to shrink by \$1.5tn this year, a 7% decline, and we project a further \$1.7tn decline in 2024. This is meaningful because our prior work has shown that yields rise and broad curves steepen as the Fed's ownership share of the Treasury market declines. Accordingly, we recommend long-end steepeners, particularly in the form of 5s/30s, which we think is the most attractive iteration of this trade, given current curve valuations and the carry profile. However, we remain patient before engaging in duration longs given the recent Treasury rally and dovish Fed pricing and, instead, look to position for lower intermediate Treasury yields in 1Q24, particularly in the 3- to 5-year sector. **Second**, the ongoing rebalancing of Treasury demand toward more price sensitive investors should translate into higher term premium over time, which is consistent with steeper curves.

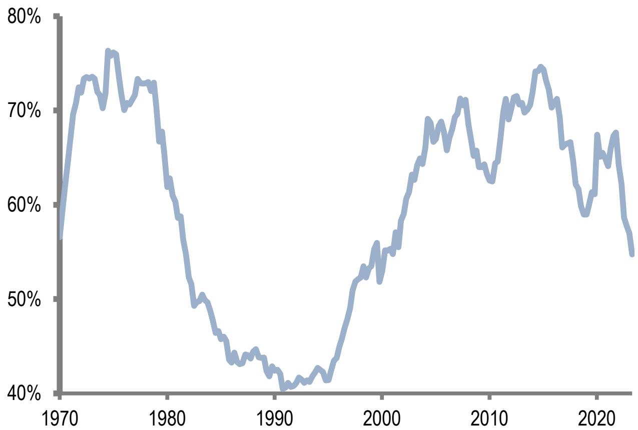
Overall, we expect Treasury yields to decline and curves to steepen into 2024, with the largest moves likely to occur from spring onward, if our growth forecasts are realized. **In particular, we see scope for 10-year yields to decline to 4.25% by midyear 2024 and 3.75% by YE24, respectively.** Further, given the expectation that term premium can continue to rise, we project 2s/10s will steepen into positive territory in 2H24, and forecast the broad curve will steepen 100bp over the coming year. Given the speed and magnitude of the recent Treasury rally and current Fed pricing, we are hesitant to recommend duration longs right now and instead favor 5s/30s steepeners, which tend to outperform prior to Fed easing cycles, should also be supported by rising term premium, and have superior carry profiles compared to front-end steepeners.

Away from Fed policy and QT dynamics, we think the outlook for supply and demand will also be impactful on the Treasury market in 2024. **Turning first to supply**, budget deficits have settled in at much higher shares of GDP than in prior cycles. Further, the combination of a larger stock of debt and higher interest rates makes it unlikely that we will see any fiscal consolidation anytime soon. We forecast Treasury will raise coupon auction sizes one more time, at the February refunding. We forecast \$2.580tn in net-privately held borrowing needs in 2024, with only 26% of this issuance coming in the form of bills, down from 63% in 2023. As a result, net issuance of coupons is expected to nearly double from

$1.094tn to $1.905tn in 2024. Given the increase in coupon supply that we have already experienced, and what we project through the spring, duration supply is likely to increase 21% to $2,807bn 10-year equivalents in 2024.

Figure 26: The ownership of the Treasury market is increasingly moving away price-insensitive hands similar to the 1990s

SOMA, US commercial bank, and foreign combined share of marketable Treasury debt outstanding; %



Source: Federal Reserve Z.1

Turning to demand, following two decades of strong support from the Fed, foreign investors, and US banks at various points, the price insensitive share of Treasury market ownership declined to its lowest level since the turn of the century (Figure 26). Over time, we see this share continuing to decline, and against the backdrop of increasing duration supply, we think this will contribute to higher term premium and steeper curves. Starting with the Fed, we expect SOMA Treasury holdings to decline by an additional $720bn in 2024, as RRP balances can continue to decline organically amid abundant supply of T-bills. We expect very modest commercial bank demand, given the combination of weak deposit growth and a preference for loans over securities. Foreign investors should be small net buyers: while we expect foreign official Treasury holdings to decline further in 2024 given declining EM FX reserves, foreign private investors should provide some support, as Treasuries now look more attractive on a FX-hedged basis than they did earlier this year. The pension fund community should provide some support, as funded ratios remain above 100%, particularly if the stock-bond correlation flips once again. Meanwhile, we see room for bond fund demand to firm, given outright yield levels, and particularly after fixed income returns stabilize and the portfolio construction benefits of core fixed income become clear once again. Finally, money market funds will remain important buyers, given attractive T-bill valuations and negative FHLB issuance.

Finally, the Treasury market exhibited resiliency and improved liquidity in 2023. Our modal view on the Fed supports further normalization, but there are more structural and regulatory driven reasons to think this may not be the case, and we expect to be more patient with relative value opportunities as it's likely off-the-run dislocations will widen in 2024. Against this backdrop, we describe three trading themes for the year ahead. **First**, we look to position for lower intermediate Treasury yields in 1Q24, particularly in the 3- to 5-year sector, but with markets priced to our modal forecast and pricing in more than one full 25bp ease by mid-2024, we recommend waiting for modestly better location before adding duration exposure. **Second**, we recommend 5s/30s steepeners to position for Fed easing dynamics and higher term premium. **Third**, we stay patient with relative value opportunities as it's likely off-the-run dislocations will widen in 2024.

US Rates: Short-Term Fixed Income

Click here for the full outlook.

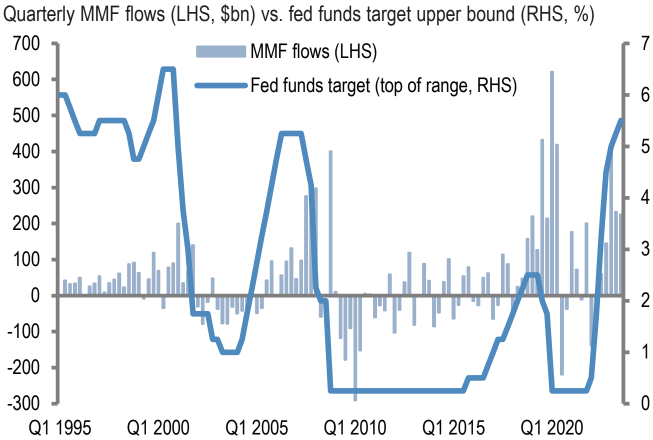
In contrast to the long end of the Treasury curve, it was a remarkably stable year in the money markets. Despite the regional banking crisis, massive T-bill issuance, finalization of MMF reform, and all the while QT going on in the background, spreads in the money markets traded mostly in a narrow range. That stability underscored the abundance of liquidity still in the financial system, most of which seemed to be sitting in the very front end. Indeed, MMF AUMs grew by nearly $1tn this year, with balances currently registering $6tn, as investors could not ignore the 5% yield on an overnight asset, a dynamic we haven't seen since 2007. To be sure, markets have made use of that liquidity, as Fed ON RRP balances declined by a substantial $1.3tn. It helped too that the Fed was nearing the end of its tightening cycle, giving MMFs a reason to rotate out of the facility and into T-bills. As of the time of writing, usage at the Fed ON RRP has fallen below $1tn.

The Fed is likely done hiking for this cycle, and we expect rates to be on hold through 2Q24, followed by 50bp of rate cuts per quarter beginning in 3Q24, until rates reach a terminal 3.5% in 2Q25. With this in mind, we think a meaningful shift from cash to fixed income next year is unlikely and that MMF AUMs will remain elevated. Indeed, a look at MMF flows going back to 1995, spanning over three easing cycles, shows that MMFs continue to see inflows even as the Fed is on hold and/or begins to cut rates (Figure 27). Moreover, flows into MMFs tend to continue even as the curve begins to disinvert/steepen; it's not until the curve more or less stabilizes that outflows begin to take place. We do not anticipate the relative value of MMFs versus deposits, short-term bond funds, equities, etc. to change dramatically in the near future (Figure 28). While there might be some rotation out the curve, we suspect the magnitude will not be as meaningful as the inflows seen this year. Overall, MMF AUMs are likely flat with a slight bias lower next year.

Meanwhile, total money market supply should increase by ~$1.2tn in 2024, with nearly $875bn in T-bills and repo. We see money market credit supply increasing by ~$350bn next year, driven by credit bonds rolling into the money markets and slightly higher CP/CD net issuance.

Figure 27: MMFs tend to see inflows even as the Fed starts to cut rates

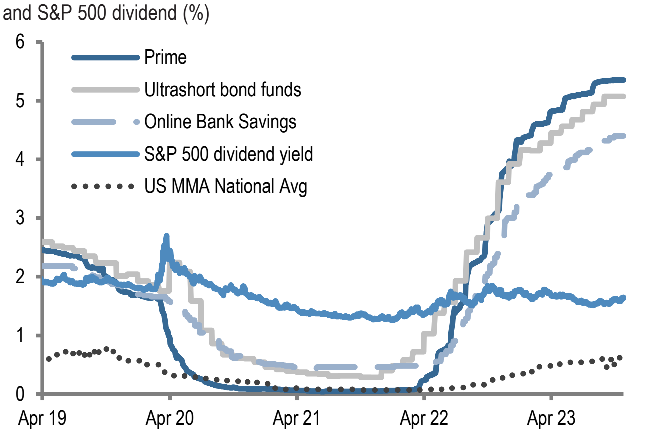
Quarterly MMF flows (LHS, $bn) vs. fed funds target upper bound (RHS, %)



Source: Crane Data, iMoneyNet, J.P. Morgan

Figure 28: We do not anticipate the relative value of MMFs versus deposits, short-term bond funds, equities, etc. to change dramatically

Net yields paid on ultrashort credit funds, high yield online deposits, prime MMFs, and S&P 500 dividend (%)



Source: Morningstar, SNL, Crane Data, Bloomberg Finance L.P., J.P. Morgan

Against this backdrop, we expect QT will continue through next year. We project reserves and total RRP (ON and foreign) will reach $2.9tn and $580bn by YE24, respectively. We estimate LCLoR to be around $2.75tn, above the median projection of dealers and market participants (Table 9), and well above where the New York Fed's 2022 projections expect reserves to stabilize in 2025 (8% of GDP, currently ~$2.2tn). Key to our forecasts is the expectation that Treasury will continue to rely on T-bills to fund its fiscal deficit and that government MMFs—the largest participants in the ON RRP—will continue to have capacity to absorb additional T-bill supply (we forecast $675bn of net issuance in 2024). Combined, this should continue to exert downward pressure on ON RRP. Specifically, with T-bill issuance expected to be concentrated in the shorter end of the money markets curve, we think MMFs can continue to absorb bills as their WAMs likely level off at around 30 days for the foreseeable future, particularly given our projection that MMF AUMs stay elevated next year.

Table 9: Market participants and primary dealers think reserve needs have grown since March and reserves are unlikely to fall below $2.6tn

2023 survey estimates of reserve balances when the SOMA portfolio ceases to decline ($bn)

Survey of...	Jan	Mar	May	Jun	Jul	Sep
Market Participants						
25th Percentile	2125	2125	2125	2188	2375	2375
Median	2375	2375	2375	2375	2375	2625
75th Percentile	2375	2688	2625	2813	2875	3000
Primary Dealers						
25th Percentile	2125	2375	2375	2375	2375	2375
Median	2625	2375	2625	2625	2625	2625
75th Percentile	2875	2875	2875	2875	2938	3000

Source: Federal Reserve Bank of New York

On net, we expect supply-and-demand technicals to become better balanced next year. But while demand from money market investors should persist, prices might need to adjust to incentivize continued absorption of additional supply, particularly as RRP liquidity continues to decline. As a result, we expect T-bills/OIS spreads to cheapen on the margin. CPCD/OIS spreads will likely trade in a narrow range, with a cheapening bias. Both T-bills/OIS and CPCD/OIS spread curves should flatten. Absent a liquidity shortage, we expect the EFFR/IORB spread to remain at current levels, with a bias that it trends higher as we approach LCLoR in late 2H24. Increases to repo supply should bias SOFR higher in the fed funds corridor.

Lastly, given Fed outlook, extending into short duration (1-3 years) from cash looks attractive as we approach the next stage of the interest rate policy cycle. Even if the very front end of the yield curve remains inverted, liquidity investors can still lock in high coupons and benefit when yields adjust lower and the curve normalizes, boosting total returns. Breakevens are also high, minimizing the penalty to extend should rates rise further. On balance, the risk-reward profile leans more towards extension, particularly when the 1-3y fixed income universe shows most assets currently yielding in the 5-6% range.

US Rates: Interest Rate Derivatives

Click here for the full outlook.

A year ago, our Outlook for this year was titled "From Tiger's Roar to Rabbit's Foot," partly as a play on names of the years in the Chinese calendar but also in anticipation of a softening in the Fed's stance from the super-aggressive hikes of 2022 to more modest hikes this year. That moderation in pace has indeed come to pass, but 2023 brought its own fair share of roaring tigers. As early as 1Q23, stresses emerged in regional banks, spurring emergency measures by the Fed and leaving permanent impacts in its wake with respect to deposit migration, banks' liquidity preference and securities demand. As markets moved past the worst of the crisis, the debt ceiling stalemate began weighing on markets. This was addressed by mid-June, but not before producing very large swings in the TGA, which fell to under $50bn at one point. The debt ceiling increase was followed by a dramatic reallocation in the Fed's balance sheet liabilities, with the TGA rising back by nearly $700bn and causing a reduction in RRP balances of over $1tn. Finally, the three months following the August refunding announcement brought about a somewhat sudden focus on UST duration supply, spurring a rise in term premium and producing a relentless selloff in the market and a steepening of the curve. Only this month has that begun to retrace, with the catalyst being Treasury's willingness to modify long end issuance in response to market conditions.

As we look to next year, **our macro outlook looks for the Fed to begin cutting rates in 2H24**, and we expect 25bp cuts in the funds rate at each meeting beginning in July. But the **policy rate outlook is only part of the story**, as the **regional banking crisis left behind lingering after-effects** that are likely to impact markets in several ways. **One**, inflows into money market funds (and out of bank deposits) continue to be strong, even though they are not at the levels seen during March (see *Short Term Fixed Income*). We expect this trend to continue into next year. **Two**, **the banking crisis will likely have a lasting impact on the response function of banks, and we look for them to continue to prioritize liquidity build-up and capital conservation**. This is already apparent in the stability of Reserves since the March crisis, as a cumulative ~$1.1tn change in liabilities (because of the $700bn rise in the TGA as well as Fed balance sheet runoff) was mostly absorbed by RRP with Reserves holding steady. Additional evidence of an abrupt change in bank behavior can also be seen in the flat-lining of aggregate banking system loans and leases and in the tightening of lending conditions since March. On the margin, regulatory developments such as FHFA's recent proposal to overhaul the FHLB system appear aimed at lessening the use of FHLB advances as a source of liquidity, which only appears likely to increase the attractiveness of Reserves for banks.

One implication of all this is that **given the stickiness of Reserves and the elasticity of RRP balances, we project that a full year of QT in 2024 will likely result in Reserves only falling to ~$2.9tn** (which is a touch above our $2.75tn guesstimate for the Lowest Comfortable Level of Reserves or LCLoR), **and RRP (including foreign) falling to just under $600bn** (Table 10). Of course, QT can be derailed for other reasons, but this makes is likely that QT can in fact continue all year in 2024.

Table 10: We look for narrower spreads in the front and long end and wider spreads in the belly; we anticipate declines in implied vol from a Fed on hold; RRP is projected to bear the brunt of balance sheet reduction in 2024 as Reserves remain stickier

Current (11/17), year end 2023, and 1st half 2024 forecasts for total Fed balance sheet* assets, RRP, TGA, and Reserves (each in $bn) as well as selected maturity matched swap spreads (bp/day) and implied volatility for selected swaption structures (bp/day)

		Current	YE 23	1H24
Fed B/S ($bn)	Fed Assets	7906	7240	6772
	RRP	1331	880	583
	TGA	739	775	800
	Reserves	3392	3140	2944
Spreads (bp)	2Y	-17	-18	-20
	3Y	-22	-22	-20
	5Y	-28	-22	-24
	7Y	-37	-36	-33
	10Y	-34	-31	-32
	20Y	-69	-71	-67
	30Y	-67	-76	-71
Vol (bp/day)	1Yx1Y	8.9	8.9	8.1
	10Yx1Y	5.9	6.1	5.9
	1Yx10Y	7.2	7.4	6.9
	2Yx10Y	7.0	7.2	6.7
	5Yx10Y	6.2	6.4	6.1
	10Yx10Y	5.1	5.2	5.1

Source: J.P. Morgan, FRED, Federal Reserve H.4.1
* Current values as of 11/16/2023 Fed H.4.1 release for Fed Assets, RRP, TGA, and Reserves

Another implication is that bank demand for securities appears quite impaired, because of large AOCI drawdowns in bank AFS portfolios in 2023 and a lack of broader public awareness of accounting asymmetries in the treatment of securities (a key source of asset side duration risk) and deposits (a key source of liability side duration risk). **This has likely caused banks to become much more focused on AOCI drawdown risk**, and has likely been a key factor driving significantly reduced demand for duration assets. **It is of course possible that banks will add USTs to AFS portfolios on an asset-swapped basis if/when spreads are attractive enough, but the duration buying that might normally occur at the end of a hiking cycle appears unlikely** to materialize. If it does, it is likely to be later on as the year progresses - if our Treasury strategists' yield forecasts were to be realized in 2024, large as well as small banks will begin to see AOCI gains in coming quarters, the accumulation of which could lead to better appetite for USTs later in 2024, especially as Fed easing becomes more imminent.

If bank demand appears likely to be lackluster, the outlook for UST demand from other classes of investors doesn't appear strong either. Our Treasury strategists discuss their forecast for the net additions of USTs by various investor classes, and highlight the relatively weak supply-demand backdrop. More broadly, they have been highlighting the steady shift of the marginal UST buyer away from price-insensitive buyers to price-sensitive buyers. Seen in that context, the **recent rise in term premium, though abrupt and down from its recent peak, could well be sustained into next year**. This factors into our thinking with respect to the yield curve going into 2024, and **we favor trades designed to isolate exposure to term premium as well as other "term-premium-aware" yield curve trading strategies**. Also on the yield curve, **carry trades will likely continue to be attractive given a Fed on hold, but we recommend hedging Fed easing expectations** via Fronts / Reds flatteners to improve carry-to-risk characteristics.

There is also one, somewhat under-appreciated source of duration appetite, and that has to do with the fact that fixed income portfolios age (and lose duration in the process) while duration targets may not age in a similar manner (at least for several investors). For instance, whether we consider banks managing deposit-driven duration risk (which has a constant maturity flavor) or pension funds and insurance companies managing to a liability (where the liability typically ages much more slowly than the asset portfolios do), **the gap between aging of bond portfolios and the (zero or near-zero) aging of their benchmark itself acts as a source of shadow demand**. As it turns out, duration supply net of such aging effects seems to matter with respect to impacting swap spreads, and we factor this into our swap spread fair value models. Factoring this, as well as other drivers, **we look for narrower swap spreads in the front end as well as the long end of the curve**. In the belly, **we are somewhat more sanguine, looking for widening from current levels but this is to a great extent simply a reflection of the current cheapness of spreads in the 5- and 10-year sectors**. Our near term as well as mid-year 2024 forecasts for swap spreads are presented in Table 10.

In the swaptions market, 2024 promises to bring lower implied volatility, given a Fed that is likely to remain on hold during 1H24 before easing in 2H24. Thus, we look for lower volatility going into the year ahead with shorter expiries leading the decline (Table 10). Unlike rate volatility, however, **yield curve volatility is likely poised to rise in 2024** as we approach eventual Fed easing, and we recommend trading curve volatility either via yield curve spread options or via a new strategy that we have developed based on swaption triads that is designed to create synthetic exposure to curve volatility.

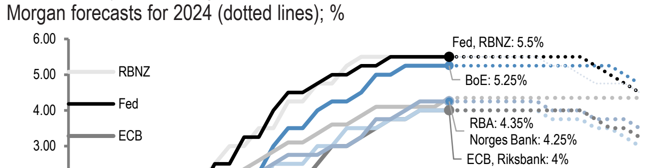
International Rates

Click here for the full outlook.

Our expectation is that DM central banks are now done with the tightening cycle and will remain on hold in 1H24, with the exceptions of the RBNZ and Scandinavian central banks (Riksbank and Norges Bank) for which we are calling the first 25bp cut in May and June, respectively. We do not see inflation remaining elevated enough to justify additional hikes over the coming months, although we acknowledge that risks remain biased towards further tightening in the DM space if the decline in core inflation proves to be too sticky with some heterogeneity across jurisdictions. The ECB is expected to start easing in 3Q24 and the BOE in 4Q24, while RBA would remain on hold for the remainder of the year (Figure 29). The Bank of Japan would be the only central bank to tighten policy in 2024, by putting an end to its negative interest rate policy and reaching 0% in 3Q24, meanwhile the other DM economies would be entering the easing cycle.

Figure 29: Heading downhill from Table Mountain: we expect central banks across DM to initiate their easing cycle towards 2H24/2025 with RBNZ and the Scandi central banks being the first ones to cut

Level of policy rate for major DM central banks since September 2021and J.P. Morgan forecasts for 2024 (dotted lines); %



	End-24 fcst
ECB	3.25%
Fed	4.50%
BoE	4.75%
RBA	4.35%
RBNZ	4.50%
Riksbank	3.00%
Norges Bank	3.50%

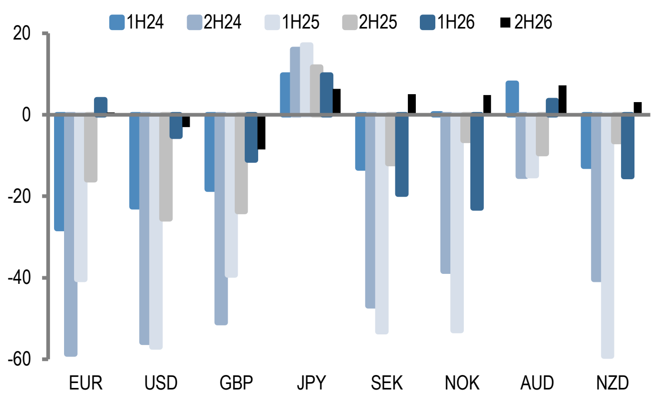
Source: J.P. Morgan.

The key factors driving the outlook for money market rates will be the start date of the easing cycle, its pace and the terminal level at which central banks will stop. In the recent rally, the money market curves have priced across DM a decent amount of frontloading of the easing cycle, with the bulk of the easing taking place in 2024. This frontloading appears excessive vs. the rhetoric of central banks who are still particularly reluctant to declare victory on the inflation fight and not opening the door to policy rate cuts in the short term.
Moreover, looking at the cumulative amount of cuts that are currently priced in the money market curves, we believe that a total of around 140-160bp as maximum across jurisdictions (for ECB and BoE) is on the low side given how much policy rates are restrictive at present. Our rates outlook is for more to be priced in with policy rates eventually priced close to neutral (around 175-200bp lower than current policy rates in the Euro area and more than 200bp lower in UK), and more back-

loading of it into 2025. While pushing back on imminent rate cuts, we acknowledge that central banks may be forced to cut earlier but that scenario, most likely driven from an abrupt turn in the macro outlook, should result nevertheless in a more pronounced cumulative ease priced in (Figure 30).

Figure 30: A total of around 140-160bp as maximum cumulative cuts across jurisdictions (for Fed, ECB and BoE) is on the low side given how much policy rates are restrictive at present; we remain biased for less front loading of easing in 1H24 and more to be priced for 2025

Cumulative change in OIS rate priced in the money market curve for mid-2024, end-2024, mid-2025, end-2025, mid-2026 and end-2026; bp



Source: J.P. Morgan.

In the *Euro area*, we forecast 10Y Bund yields to drift gradually lower towards 2.00% by the end of 2024, around 50bp lower than forwards. We maintain a strategic OW duration stance, especially over 1H24, on expectation of increased focus on owning duration and carry trades as market reprices ECB easing expectations. We prefer to express our strategic OW duration outlook in the intermediate sectors until early 2024 and then move the OW duration exposure to the short-end as we near the start of the ECB easing cycle. We find 10s/30s steepeners on the German curve as the most attractive once we take carry and RV into considerations.

We expect intra-EMU spreads to gradually tighten in 1H24 on expectation of easing financial conditions as ECB nears the start of the cutting cycle, limited idiosyncratic political risk in the Euro area, private sector to continue absorbing heavy EGB supply as improving risk-adjusted return offsets still weak supply vs. ECB flow dynamics, no further QT acceleration until end-2024 with PEPP-skew and TPI remaining credible policy back-stops and light investor positioning. Post summer-2024, we expect intra-EMU spreads, especially in periphery, to come under modest pressure, despite broadly supportive environment, as market start pricing weakening of the policy safety-nets with PEPP QT starting in 2025. We forecast 10Y Italy-Germany spread at 170bp by mid-2024 and 200bp by end-2024, and forecast 10Y France vs. Germany spread at 45bp by mid-2024 and 50bp by end-2024. In intra-EMU, OW Belgium vs. France until early 2024, UW Portugal vs. Spain, OW Austria vs. France, OW Greece vs. Italy and modest OW Ireland vs. France.

Our trade recommendations on the €STR curve follow along the main theme that too little cumulative easing is currently priced in over the next 2-3 years. In our view, current pricing reflects market expectation of an incomplete soft-landing scenario, where inflation moves only partially and gradually towards target forcing the ECB to keep policy in restrictive territory for longer. Given the risk bias, we believe that the market expectations would err on the pessimistic side, i.e., would likely price larger rate cuts to be delivered in 2025 and beyond with trough likely below the 2.0% neutral. To this effect we recommend receiving reds/greens €STR. We have a broad steepening view on the EUR swap curve. The steepening of the EUR 10s/30s swap curve is one of our strongest conviction themes for 2024. We recommend 10s/30s bull-steepeners implemented via 6M expiry receivers and then gradually roll these exposures into outright steepeners (10s/30s and/or 5s/30s) by end-1Q24/early-2Q24.

Our outlook for 2024 is for further narrowing in German swap spreads on the back of easier financial conditions, further availability of collateral with TLTROs rolling off and QT continuing, and likely receiving flows from financial institutions unwinding rates-paying hedging flows. We target Schatz invoice OIS swap spread vs. €STR at 30bp by mid-2024 and 23bp by Dec-2024. At the long end of the curve, we project Bund invoice OIS swap spread vs. €STR at 25bp by mid-2024, and 20bp by Dec-2024. The cumulative amount of narrowing expected in 2024 is modest and therefore warrants a short term tactical approach.

In *UK*, we have a bullish view on 1Yx1Y and 2Yx1Y SONIA as a medium-term view as valuations look cheap under our higher for longer and soft-landing macro scenarios and also offer a lot of protection for a hard landing/global recession outcome over the next 12M. We expect 10Y gilt yields to stay range-bound over 1Q24 and then to decline to 3.80% in 2Q24 and 3.45% 4Q24. We have a steepening bias on the 10s/30s gilt curve given valuations and carry profile, but look to trade tactically over 1Q24 given near term technicals. We expect intermediate swap spreads to grind narrower over 2024 with the 10s/30s swap spread curve steeper. Given stickier UK inflation and our view that the BoE will start to ease after the Fed, we think GBP rates can underperform USD rates over 2024.

In *Scandinavia*, our baseline view is for policy rates to remain on-hold before central banks start easing in 2Q24 and stop in mid-2025 after reaching 2.25% and 2.5% in Sweden and Norway, respectively. Under this framework, we find the cumulative cuts priced in by 2025 to be too little and recommend receiving 2Yx1Y In Sweden and 1Yx1Y in Nibor. Similarly, we find Jun24/Jun25 SEK FRA curve flatteners and Jun24/ Dec25 NOK FRA curve flatteners attractive. As cross-market trades in Sweden, we recommend receiving Dec24 SEK FRA vs Euribor but, in contrast to the front-end, recommend paying 5Yx5Y Stibor vs Euribor on the back of a faster easing cycle by the Riksbank than the ECB and concerning supply dynamics in Sweden.

In *Japan*, the BoJ will diverge from the rest of DM central banks by starting to tighten rates in 2024, while the other DMs are set to start another easing cycle. We forecast the BoJ will remove YCC by 1Q24 and exit NIRP by raising rates to 0% by 3Q24. As we expect the BoJ to under-deliver on hiking relative to market expectations, we keep receiving 1Yx1Y swaps. Stay long 5Y swap spread narrowers. On the curve, we recommend entering 2s/10s JGB steepeners given Rinban reductions affecting 10Y JGBs. Stay on the sidelines in 20Y.

In *Australia*, the RBA can sustain its hiking bias for longer than other DM central banks and we expect it to keep the policy rate on hold through 2024; we hold underweights/flatteners in AUD near-term, pay Dec-Feb RBA OIS dates, or hold 3s/10s ACGB curve flatteners. The AUD curve should remain relatively stable (+25-50bp range) as others in DM steepen around it.

In *New Zealand*, the economy looks more vulnerable and we forecast the RBNZ to be the first to cut among DMs, with 100bp to be delivered by year-end. Be received May 2024 RBNZ OIS, and hold the 2s/5s NZD-AUD IRS box steepener. The NZ curve can steepen more than 1 for 1 with US, so NZD overweights are best executed in the front-end. The NZD curve should be similarly steepening vs. AUD.

Table 11: We project positive returns across DM sovereign bonds for 2024, with US and UK expected to outperform mostly in 2H24. On a cross-market basis we prefer short JGBs vs. Euro area bonds as trading outlook theme in 2024

Quarterly breakdown for 2023 and projected return until the end of 2024

	United States	EMU ex. Greece	Germany	France	Italy	Spain	United Kingdom	Sweden	Japan	Australia	New Zealand
Fcst. return until end 2024	10.2%	7.7%	7.8%	9.0%	5.9%	9.0%	12.7%	6.1%	2.2%	6.6%	8.4%
Current index yield	4.6%	3.4%	2.7%	3.3%	4.2%	3.7%	4.3%	2.8%	1.1%	4.4%	4.9%
2023 YTD	0.1%	2.3%	1.0%	1.6%	4.9%	2.3%	-1.1%	0.2%	-0.3%	1.0%	2.4%
QTD 4Q23	1.6%	2.3%	1.7%	2.1%	3.2%	2.4%	3.4%	2.0%	0.2%	0.6%	3.5%
3Q23	-3.0%	-2.4%	-2.3%	-2.4%	-2.7%	-2.0%	-0.7%	-1.2%	-3.2%	-0.8%	-2.4%
2Q23	-1.3%	0.1%	-0.3%	-0.1%	0.8%	-0.2%	-5.7%	-1.6%	0.4%	-3.7%	-1.2%
1Q23	2.9%	2.4%	1.9%	2.0%	3.6%	2.2%	2.2%	1.1%	2.4%	5.1%	2.6%
Min	-12.0%	-17.9%	-17.4%	-18.5%	-16.9%	-17.1%	-24.6%	-11.7%	-5.7%	-10.6%	-8.7%
Max	14.3%	13.5%	12.4%	12.2%	21.3%	17.0%	16.8%	16.2%	5.0%	20.5%	17.8%
Average	3.6%	3.2%	2.9%	3.2%	4.0%	3.8%	3.7%	3.2%	1.5%	4.6%	4.9%

Source: J.P. Morgan.

Looking at the details, the performance of the DM Global Sovereign Bond Index has been quite choppy in 2023. Going forward, we have a strong bias to call for positive bond returns across DM for 2024. From now until the end of 2024, we project sovereign bond returns in around 11% for US, 13% for UK and around 8% in the Euro area (Table 11). We expect the JGB market to underperform across DMs making short JGBs an attractive leg for any DM cross market trades. While US Treasury and UK gilts are expected to deliver higher total returns in 2024, we prefer in 1H24 long in Euro area. Going into the first half of the year, our preference for cross market trade would be long Bunds, OATs or Bonos vs. JGBs.

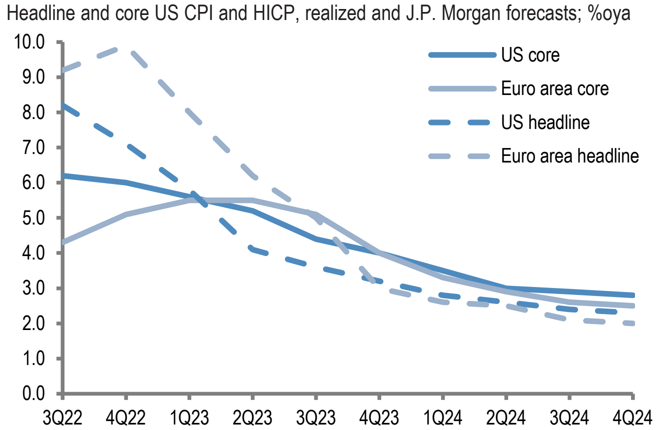
Global Inflation Markets

Click here for the full outlook.

Over the first half of 2024 we expect a decline in nominal yields to drive intermediate breakevens lower against a backdrop of an ongoing normalization in headline inflation (Figure 31). Front-end breakevens should similarly decline but with more volatility in the short term given geopolitical uncertainty and we see pockets of idiosyncratic value, for example in 2025 AGB breakevens.

Figure 31: Euro area and US headline and core inflation is expected to decline next year but core will remain above the 2% level

Headline and core US CPI and HICP, realized and J.P. Morgan forecasts; %oya



Source: J.P. Morgan.

In the **Euro area**, we expect headline inflation to decline to 2.5% in 2Q24 and 2% in 4Q24 and core inflation to fall to 2.9% in 2Q24 and 2.5% in 4Q24. This profile assumes a further significant decline in core goods inflation while services inflation moderates more slowly, as the labor market remains tight despite some signs of easing. Strong wages also suggest consumer purchasing power will increase as inflation comes down and saving rates remain high, softening the pace of descent. **We expect 5Yx5Y HICP to fall into a 2.20-2.40% range** as headline inflation continues to moderate and nominal yields decline against a backdrop of reduced underlying inflation hedging demand. 10Y EUR real swap yields look over 30bp cheap on our long-term low frequency framework vs. the level of front-end yields, slope of the ESTR curve and the size of the ECB balance sheet. **Given this and our bullish view on reds ESTR we have a bullish view on 10Y real yields over 2024.**

In the **UK**, headline inflation has continued to fall over 2023, from 10%oya in 1Q23 to 4.6%oya in October, with core inflation stickier in its decline. The key service CPI component has seen a large downshift since the middle of this year but we expect it to become stuck around the 5% level, at a similar level to our expectations for wage growth, over 2024. We project core CPI will average 4.5% over 1H24 and will remain above 3% by the end of next year, driven by service CPI inflation that remains above 5% until the middle of 2024. Our expectation of a rally in intermediate GBP yields and 5Yx5Y SONIA over the medium term should put downward pressure on 5Yx5Y RPI, especially in an environment in which inflation is falling, albeit in a sticky fashion. In addition, from a technical perspective, as RPI-CPI convergence creeps closer this should also put some downward pressure over the long run on 5Yx5Y RPI. **We have a medium term bearish view on 5Yx5Y RPI and target the 3.40% level**. **10Y real yields are 50bp cheap on our long-term fair value framework,** however, ongoing active QT gilt sales will put upward pressure on 10Y real yields, even if the BoE is on hold.

In the **US**, we look for core inflation to slow further, as vehicle prices fall modestly, rent inflation softens, and wage inflation continues to moderate alongside a weakening labor market. Meanwhile, we see broad commodity prices holding near current levels through midyear, before exhibiting only a mild upturn in 2H24. Against this backdrop, the front end of the nominal yield curve is projected to decline materially, and TIPS breakevens are likely to narrow across the curve over 1H24. While typically in this environment we would expect front-end breakevens to lead the way narrower, the breakeven curve is already steep, with 30-year breakevens currently trading rich versus our fair value models, implying the narrowing is likely to be more parallel in nature in coming months. **We forecast 5-, 10-, and 30-year breakevens narrowing to 205bp, 210bp, and 220bp, respectively, by midyear** (Table 12). However, as the Fed begins easing and commodity prices recover, we think front-end and intermediate breakevens could at least partially retrace wider over the second half of the year, allowing the breakeven curve to flatten. We also think that a second half recovery could be supported by an improvement in demand for TIPS-focused funds, following an improvement in returns, and a relatively benign supply backdrop. **We like positioning for narrower 30-year breakevens into early 2024, given our macro outlook combined with rich long-end valuations.**

Table 12: We look for US TIPS breakevens to narrow in a relatively parallel fashion by midyear 2024 but see front-end breakevens widening modestly in 2H24 if recession is avoided and the Fed begins easing

Spot breakevens and real yields as of 11/17/23, breakeven targets, and real yield and curve levels based on those targets*; units as indicated.

	17-Nov-23	4Q23	1Q24	2Q24	3Q24	4Q24
Breakevens (bp)						
5Y	224	225	215	205	210	220
10Y	229	230	220	210	220	220
30Y	238	235	225	220	220	220
Real yields (%)						
5Y	2.22	2.35	2.15	2.10	1.75	1.35
10Y	2.16	2.30	2.15	2.15	1.80	1.55
30Y	2.24	2.40	2.40	2.40	2.25	2.10

Source: J.P. Morgan
* Targets for real yields are based on our nominal yield forecasts and breakeven targets

In **Japan**, we hold a mild bearish bias on the on-the-run BEI, but we do not recommend entering bearish trades. We expect the gross supply (ex. BoJ/MoF) in FY2024 to increase, which should weigh on the performance of Japanese breakevens. In **Australia**, headline inflation is forecast to move lower in 2024, although remain elevated and above the RBA's 2%-3% target band. In contrast to late 2022/early 2023 when goods inflation spiked, we expect most of the strength in the year ahead to be concentrated in the service sector, particularly rents and utility costs. Front breakevens continue to screen cheap versus fundamentals and we recommend long expressions in the 2025 tenor. The belly and longer dated lines are tracking high in the recent range and will likely narrow from here.

Credit

Global Spread Markets: Rates, rock, spreads roll

Click here for the full outlook.

As we end the year, we observe the same tension between credit spreads and all-in yields as we have, off-and-on, for the better part of the past 12-15 months. That is, while all-in yields remain at attractive levels for institutional investors – circa 5.75% and 8.75% for High Grade and High Yield bonds respectively – spreads if anything look pretty much fully-valued. As such over the next 12 months, it's the change in the all-in yield driven by moves in underlying government bond yields which will be much more important from a total return perspective than changes in credit spreads. Indeed, **it's the forecast decline in 10-year Treasury and Bund yields to 3.75% and 2.00% respectively which is the foundation for 2024 to be a high single-digit, low double-digit return year**.

We have considered alternative scenarios to the base-case 'Soft Landing' scenario. 'Big Squeeze' and 'Round #2, knockout' are both recessionary scenarios, the difference being timing. 'Big Squeeze' is a classic corporate-led downturn, with the economy contracting in 2024. 'Round #2, knockout' is where the economy continues to prove resilient as we head into 2024 and inflation is sticky, such that central banks re-enter the fray. In this case, it's the additional tightening that tips the economy into recession, possibly a deeper recession, but not till 2025. **While we generally see spreads wider across the board in a 'Big Squeeze' versus a 'Soft Landing,' it's interesting to note how total returns remain positive overall**.

A second-coming by central banks would be much more value destructive, however. We've had a number of previews over the past 12-24 months of what can happen when interest rate expectations become untethered, as would be the case in 'Round #2, knockout.'

Table: Global Credit Spreads & Total Returns Forecasts

Spreads, bp

	Current	YE24 Soft Landing	YE24 Big Squeeze	YE24 Round #2, knockout
US Corporate Credit:				
US High Grade	131	125	190	160
US High Yield	428	475	625	600
US Leveraged Loans	527	550	725	675
US AAA CLOs	170	160	250	180
US Taxable Munis	82	76	70	90
International Corporate Credit:				
European High Grade	160	140	250	225
European High Yield	440	400	675	625
European Leveraged Loans	550	500	750	700
Emerging Market Corporates	304	330	425	400
US Mortgage Credit:				
Agency MBS	45	35	30	90
Jumbo 2.0 AAA	70	85	80	160
MBS Credit	620	650	850	1200
US Commercial Real Estate:				
AAA Conduit CMBS	147	135	170	225
BBB- Conduit CMBS	944	850	1200	1700
US Consumer Credit:				
Bank Credit Cards	70	55	80	100
BBB Subprime Auto Loan ABS	250	225	275	425

Total Returns, %

	Current	YE24 Soft Landing	YE24 Big Squeeze	YE24 Round #2, knockout
US Corporate Credit:				
US High Grade	2.6%	12.0%	10.0%	-5.0%
US High Yield	8.0%	11.0%	6.0%	-2.0%
US Leveraged Loans	11.1%	9.0%	2.0%	2.0%
US AAA CLOs	7.4%	6.0%	2.0%	8.0%
US Taxable Munis	2.6%	12.8%	13.8%	-6.1%
International Corporate Credit:				
European High Grade	4.4%	9.0%	5.5%	-5.0%
European High Yield	8.7%	11.0%	3.0%	-1.0%
European Leveraged Loans	11.9%	9.0%	0.0%	2.0%
Emerging Market Corporates	4.5%	10.0%	7.5%	-1.5%
US Mortgage Credit:				
Agency MBS	-0.3%	10.6%	12.8%	-6.9%
Private Label MBS	-5.0%	9.6%	11.7%	-9.2%
MBS Credit	29.9%	9.4%	0.2%	-15.3%
US Commercial Real Estate:				
AAA Conduit CMBS	-1.0%	14.0%	13.0%	-9.0%
BBB- Conduit CMBS	-16.0%	32.0%	3.0%	-65.0%
US Consumer Credit:				
Bank Credit Cards	2.9%	9.4%	9.4%	1.3%
BBB Subprime Auto Loan ABS	8.1%	10.0%	10.3%	0.3%

Source: J.P. Morgan Global Spread Research.

US High Grade

Click here for the full outlook.

We forecast HG bond spreads to end 2024 at 125bp. We expect HG bond yields to decline to 5.2% in 2024. This should lead to 2% excess return and 12% total return in 2024. JPM's macro outlook of slow but positive US GDP growth, Fed funds lower by 100bp in 2H24 and UST 10yr yields at 3.75% at YE24 provide a supportive backdrop for credit. The strong total return that will come with lower UST yields will contribute to ongoing demand for the asset class. We forecast gross bond issuance to be nearly flat y/y at $1.2tr and net supply to decline 24% to $404bn. Coupons should be just $20bn less than net supply in 2024 vs. a $200bn gap in 2023. Credit metric trends should stabilize with better earnings after weakening this year. Credit ratings are at a 5yr high after two years of strong net upgrades. Next year this should slow but is unlikely to reverse. We recommend Overweights in US Large banks, Yankee Banks, Finance Co's, Consumer, Telecoms, and Autos; Underweights in Regional Banks, Technology, Healthcare, Retail, Media/Entertainment.

Table 13: 2024 YE forecasts

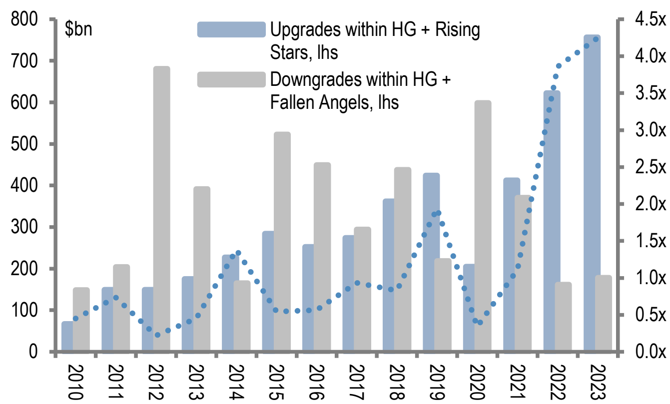
Theme	Current	2024 Forecast
HG bond spread	131bp	125bp
HG bond yield	6.0%	5.2%
HG bond total return	1.8%	12.4%
HG bond excess return	4.0%	2.0%
10s30s spread curve	19bp	20bp
Rising Stars	$98bn	$28bn
Fallen Angel	$20bn	$30bn
HG gross supply	$1.24tr	$1.22tr
HG net supply	$534bn	$404bn

Source: J.P. Morgan. Current is as of 11/16/23.
Current gross and net supply are 2023 full year estimates. 10s30s is Non-Fins ex-EM curve

Spreads are already tight when looked at over nearly any period of time (131bp as of this writing versus a YTD tight of 130bp, a cycle tight of 105bp in September 2021 and an all-time tight of 89bp in July 2005). The natural impetus when forecasting spreads for 2024 is therefore to expect wider levels. The catalyst for this could be when either: A) higher rates finally take their toll and the economy tips into the recession or B) an unforeseen macro shock leads to credit stress (akin to the regional banking & Credit Suisse crisis this past March). Both of these are plausible risk scenarios heading into 2024. However, HG issuers have been doing a good job of preparing balance sheets for these possibilities, as evidenced by the strong ratings trends.

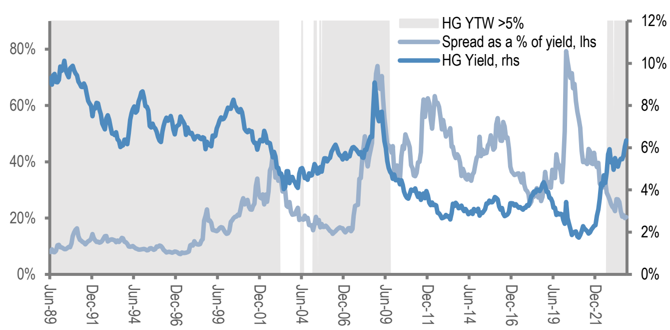
Importantly, yields at multi-decade highs leads to buying of HG credit and also constrains corporate issuance. This is because for the majority of both investors and borrowers, it is yield (and coupon) levels that matter first and spreads are second. The current high yields should lead to ongoing institutional buying, stronger retail buying as stable/declining yields lead to strong total return and a pickup in foreign buying as FX-hedged yields improve. This is why we expect tighter spreads in 2024. We are aware of the fundamental risks and recognize that spread valuations are expensive but believe these are more than offset by continued yield-driven technicals and, at this stage, yields are still quite cheap.

Figure 32: Upgrades have strongly exceeded downgrades recently



Source: J.P. Morgan, Bloomberg Finance L.P.

Figure 33: Spreads as % of yield similar to other periods of yields >5%



Source: J.P. Morgan.

US High Yield and Leveraged Loans

Click here for the full outlook.

We are forecasting moderately wider high-yield bond and leveraged loan spreads in 2024 as growth weakens (+0.7% q4/q4) and the Fed eases 100bp in 2H24. That said we are forecasting spreads at YE24 inside the long-term average as most corporate balance sheets are in a favorable position and the US economy is expected to avoid a recession. As well, historically elevated yields (and returns) will receive a forecasted tailwind from falling Treasury yields. We are forecasting high-yield bond spreads to widen 50bp to 475bp by year-end

2024, which includes a forecasted 100bp decline in 5-year Treasury yields and 50bp decline in the YTW to 8.35%. This equates to a full-year return of about 11%. With spreads underpricing our 2024/25 default forecasts, the expected widening yoy is due to our belief that an additional premium will need to be baked into spreads as growth slows, rates remain restrictive, the cycle matures, and uncertainty around 2025's landscape builds. Given an extended distressed/default cycle and lower forecasted growth and rates, we believe investors should position up-in-quality. As such, we recommend fund managers Overweight BBs, Neutral Single Bs, and Underweight CCCs. Sectors we favor (OW) are Cable/Sat, Financials, Telecom, Media, and Metals/Mining and sectors we would be selective in (UW) are Healthcare, Industrials, Housing, Chemicals, and Consumer Products.

For leveraged loans, we believe 2024 will offer attractive total returns and increased credit dispersion. And even with SOFR expected to decline, the pure carry on the loan product would still likely be more than 150bp above bonds. On the demand side, our CLO colleagues raised their 2024 net new US CLO supply forecast to $115bn. And on the supply side, we expect a rebound in issuance to levels comfortably below the past decades' trend. These conditions coupled with a rise in bond-for-loan takeout activity and continued private credit cannibalization should produce another contraction in outstanding. Our full-year 2024 return forecast for loans is 9.0%. We also forecast a year-end 2024 yield and spread to maturity for the loan index of 8.75% and 550bp. That said the loan product is expected to feel more fundamental headwinds from the transmission of rates and more aggressive capital market trends. We prefer B2 or better versus B3 or lower rated loans given eroding credit fundamentals.

Table 14: HY bond forecasts

	2021	2022	YTD	2024E	YoY % chg
Total Return	5.54%	-10.62%	7.91%	11.00%	-
Gross Issuance	$483bn	$106bn	$161bn	$225bn	42%
Net Issuance	$192bn	$56bn	$56bn	$85bn	52%
	YE '21	**YE '22**	**16-Nov-23**	**2024E**	**YoY chg**
Default rates*	0.36%	1.65%	3.00%	2.75%	-0.25%
Yield	4.44%	9.04%	8.89%	8.35%	-54bp
Spread	346bp	490bp	431bp	475bp	+44bp

Source: J.P. Morgan.
Note: Default rates include distressed exchanges and 2023 rates are as of November 16.

Table 15: Leveraged loan forecasts

	2021	2022	YTD	2024E	YoY % chg
Total Return	5.46%	0.06%	11.06%	9.00%	-
Gross Issuance	$835bn	$252bn	$305bn	$375bn	23%
Net Issuance	$409bn	$163bn	$73bn	$120bn	67%
	YE '21	**YE '22**	**16-Nov-23**	**2024E**	**YoY chg**
Default rates*	0.65%	1.64%	2.97%	3.25%	0.28%
Yield	5.32%	9.97%	9.46%	8.75%	-71bp
Spread	403bp	592bp	526bp	550bp	+24bp

Source: J.P. Morgan.
Notes: 1) Default rates include distressed exchanges and 2023 rates are as of November 16; 2) Loan yields and spreads are to maturity.

We expect high-yield bond and loan default rates to remain around their long-term averages over the next two years due to slower growth, rising corporate fundamental headwinds, restrictive rates, elevated distressed exchange activity, a contracting denominator for loans, and a few idiosyncratic issues. We forecast high-yield bond and leveraged loan default rates to decline modestly in 2024 to 2.75% (HY) and 3.25% (LL), respectively, which we preliminarily expect to rise in 2025 to 3.00% and 3.75%. For context, the 30yr and 25yr long-term average default rate for high-yield bonds and loans is 3.2% and 3.1%, respectively. Given weak forecasted 2024 US GDP growth and a rising maturity profile, we believe leveraged credit markets will become more vulnerable to increased defaults with the passage of time amid sustained higher rates, constrained capital markets, and as tight financial conditions weigh on fundamentals with a lag.

We expect an increase in capital market activity for HY bonds and loans in 2024 amid lower rates and with a record 23% of leveraged credit coming due in the next 3 years. That said 2024 should be another light year for B&L issuance relative to the past decades' standards. We forecast 2024 high-yield bond gross and net (non-refi) new issuance of $225bn and $85bn, respectively, which would represent a 25% and 35% yoy increase. Despite our view that capital market conditions will improve, ultimately, these volumes reside roughly 30% below the past decades' norm. And for institutional loans we are forecasting gross and net (non-refi/repricing) volumes totaling $375bn and $120bn, respectively, which represent approximately 10% and 50% yoy increases. Still, these anticipated loan volumes also reside 40% and 50% below the past decades' average.

Securitized Products

Click here for the full outlook.

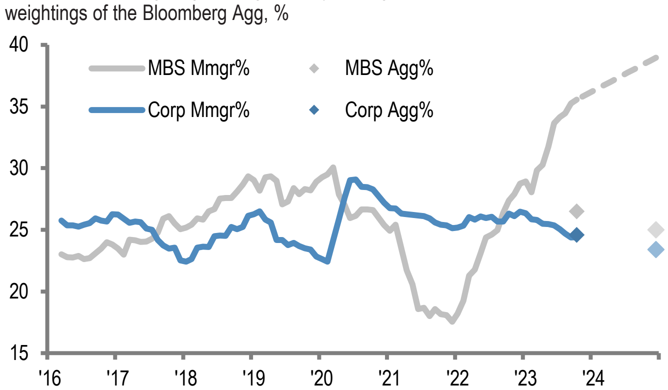
Agency MBS: I ain't in a slump, I just ain't hitting

In 2023, we saw mortgages offer some of their widest spreads on record, yet struggle to outperform Treasuries and IG corporates. Heading into 2024, mortgages remain wide by historic standards, though that's to be expected given the technical backdrop of Fed QT, positive net supply, and bank runoff—not to mention the inverted curve and high level of vol. Next year, we project modestly lower gross/net supply of $965bn/$175bn, respectively, and slightly lighter Fed runoff at $180bn.

We expect that banks will continue to let their MBS holdings pay down in the first half of the year; by the second half, their securities books will have shrunk to a somewhat more normal level, the Fed will likely have begun to cut, and the approaching end of QT should ease some of the pressure on the deposit outlook. Taken all together, they might become very modest net buyers later next year, which should help lighten some of the burden on money managers—barring some other unforeseen banking problem. Until then, bond funds will be in the driver's seat, and should demand relatively wide spreads to justify going even more overweight in a year where rampant Treasury issuance will shrink the spread product share of the Agg by 3% (Figure 34).

Figure 34: Money managers will need to go even more overweight next year, even as the MBS share of the agg shrinks

MBS and Corp weightings of large money managers versus the MBS and Corp weightings of the Bloomberg Agg, %



Source: J.P. Morgan, MorningstarDirect

Down the stack, lower coupons offer reasonably attractive OAS, but that spread is disproportionately earned in the future when speeds are expected to ramp; we still prefer higher coupons for their better current carry. Overall, we think spreads are fair given today's technical backdrop, but could modestly tighten if the year progresses in line with our base case forecast; outperformance vs. Treasuries is still likely, but will be earned gradually over time.

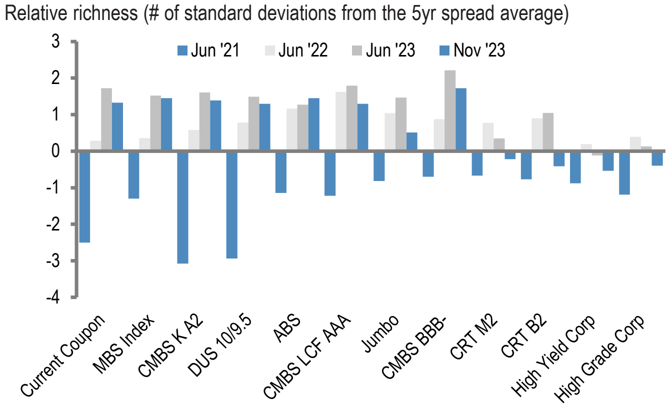
RMBS Credit: Sunny with a chance of rain

Private label MBS (jumbo 2.0) and non-QM spreads should remain relatively unchanged. The basis between private and agency MBS is generally at a neutral level and we see no reason for that to change if the soft landing narrative is played out. A recession could lead to some modest basis widening in 2.0 (more in non-QM), but nothing meaningful. Focusing on CRT as our proxy for lower-rated MBS credit spread performance, CRT B2s have tightened by more than 500bp in '23. The market is either not pricing in the risk of a recession or believes that home prices will hold up in this iteration of a recession. Currently, CRT B2s are about 0.5 standard deviation rich to their 5-year historical average (Figure 35) , making them the only securitized product segment that has shifted back to the rich end of the product spectrum since 2021. On the bright side, borrower fundamentals are still very strong with significant equity accumulation. We forecast home prices to be flat to down 5% in a soft landing or even mild recession.

However, one cannot ignore the correlation all credit spreads will have to the risk-off trade if a recession happens. We think such a scenario would actually end up being a meaningful buying opportunity for mortgage credit, albeit painful for current bond holders. Rest assured that GFC-aside, home prices have not declined in a big way in previous recessions. In fact, home prices increased in three out of the last five recessions. Home prices also increased during the small COVID-19 recession (not shown). As such, it is perhaps fair to say that if housing is not the cause of the recession, prices should hold up.

Figure 35: ABS the fairest of them all? Mortgage credit and corporate bonds stay firmly seated at the rich end of the spectrum

Relative richness (# of standard deviations from the 5yr spread average)



Source: J.P. Morgan

Home Price Outlook: The Deep Freeze!

We look for home prices to be flat in 2024 due to a frozen market (Table 16). Home prices have continued to creep up this year despite mortgage rates rising to a 7-8% range, and HPA now stands at 5.7% YTD. Much of this continues to be driven by record low housing supply. We are still seeing an underbuilding of homes, and do not anticipate an influx of supply to come from homebuilders or distressed borrowers in 2024. Existing borrowers are largely locked-in to their homes while the majority of renters cannot afford to buy. Additionally, the single-family investor community is likely to be less of an incremental buyer. Higher rates have made the acquisition and securitization of single-family homes less economical for investors as well. Consequently, we are unlikely to see meaningful demand or supply come from this segment of the market. See our full 2024 Home Price Outlook for more details.

Table 16: We look for home prices to be flat in 2024 due to a frozen market

Scenario	FY2022	2023 YTD	2023	2024	2025
Bullish	6.5%	5.7%	10.0%	7.5%	7.5%
Positive	6.5%	5.7%	8.0%	5.0%	5.0%
Base	**6.5%**	**5.7%**	**5.0%**	**0.0%**	**3.0%**
Negative	6.5%	5.7%	0.0%	-5.0%	-3.0%
Crisis	6.5%	5.7%	-9.9%	-17.1%	-1.5%

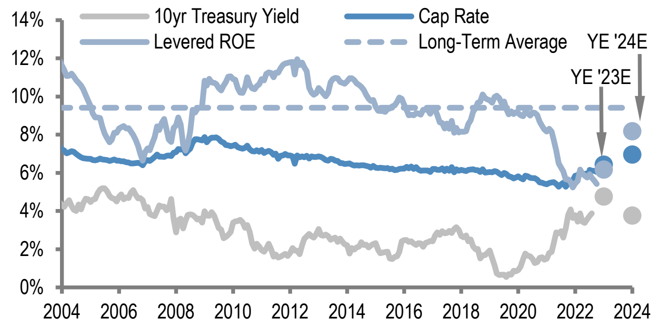
Source: J.P. Morgan
Note: 2023-2025 HPI is YoY% change of Q4 HPI a/o Sep '23

CMBS: It's all about cap rates

For our CRE outlook, we think private market cap rates can move another 50bp higher to 7%. If our rates colleagues' 10yr Treasury forecast of 3.75% by next year-end materializes, then there should be enough of a rate relief for CRE leverage to be accretive again for new acquisitions (Figure 36). A fuller mark-to-market (forced sales and additional cap rate pressure) is less likely in our view as lower rate expectations should continue to stave off a significant number of distressed sales and continue to push resolutions out via extensions / modifications. Pre-QT/ rate hike CMBS vintages will continue to see credit performance worsen with rising delinquency rates and heightened rating downgrades. New issue underwriting, however, has been conservative throughout 2023 with significantly lower office concentrations. We expect this to continue into 2024, which should catalyze more investor demand. As such, we think new issue/on-the-run spreads can tighten.

Figure 36: With the help of rates moving lower, cap rates can move only modestly higher in 2024 to restore more accretive leverage

CRE cap rates versus levered return on equity and 10-year Treasury yield (%)



Source: J.P. Morgan, MSCI Real Capital Analytics
Note: Leveraged ROE = (Cap Rate - LTV*Mortgage Rate)/(1-LTV)

ABS: Staying up in quality

As we look ahead to the ABS market in 2024, we recommend staying up in quality with expectations of wider spreads than the tights this year. To date, the ABS consumer credit trends have been well within expectations, even in subprime pools which show more credit deterioration than prime.

However, there remains a chance of recession, including soft/ hard landings. On the positive side, we note that even with a hard landing projection of a 6% unemployment rate 12-24 months out ABS structures are well-built to withstand such stress, particularly at the top of the capital stack.

For lower-rated ABS tranches, sponsor risk will remain the differentiating factor. Furthermore, ABS backed by nonprime/ unsecured receivables do have materially more credit enhancement than those backed by prime collateral. ABS structures should stand up very well against a slightly softer labor market in the year ahead. ABS sponsors have touted tight(er) underwriting/servicing standards during this Fed hike regime. Given the uncertainty of exactly if/how the US economy might break, we prefer staying within the relative safety of high quality ABS (e.g., investment grade rated subprime auto), where structures are robust and spreads are at/ near record wides, on an absolute and relative basis. Despite the possibility that ABS may cheapen along with rest of credit, ABS spreads are currently cheap particularly on relative basis to comparables. For example, our AAA credit cards ABS spreads currently stand cheap to JULI Financials AA unsecured corporates, having almost always been richer over the past twenty years and sold off less during periods of credit market dislocation. AAA rated ABS should outperform in the near term.

US Municipals

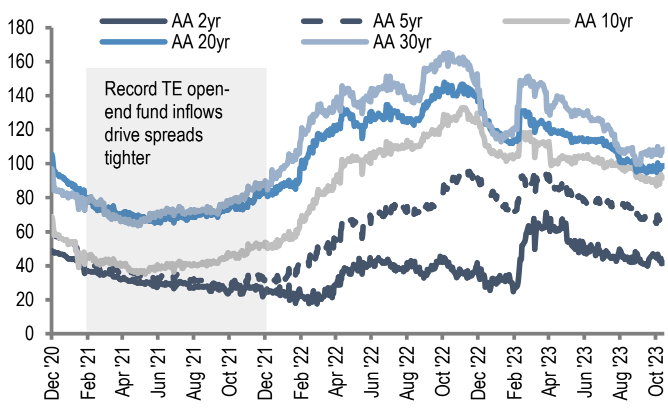
Click here for the full outlook.

Finding sustained market consensus while navigating the end of the tightening cycle may be difficult in 1H24, which is why we suggest playing the long game, and buying municipal bonds with a longer term perspective, particularly in transitory periods where Treasuries sell-off on episodic data releases that suggest stronger inflation, growth, or employment data. We recommend positioning municipals early in the year, given that our rates forecast calls for an accelerated rally in the longer portion of the curve in the back half of the year. **We believe bouts of illiquidity should be viewed as an opportunity to add duration, given that our economics forecast suggests a cycle will become evident leading into mid-2024.**

For the year, we expect a total return of 12.8% across the AA portion of the taxable municipal market. Taxable municipals are expected to continue to rally given light primary market supply ($50bn), open-end muni fund inflows, and a push from asset managers to add duration given the backdrop of a sustained rally in the longer portion of the UST market. Further, the expected decelerating economic backdrop should drive added demand for relatively stable municipal ratings migration and the better historical default metrics associated with the asset class.

Figure 37: Current AA taxable municipal bond spreads are largely within 10bps of the trailing 3-year average, but are 24-48bps wide to average spreads amidst the inflow cycle in 2021

Taxable muni spread, bps



Source: ICE, J.P. Morgan. Note: Spread to Treasuries as of 11/14/2023.

Current AA taxable municipal bond spreads to Treasuries are largely within 10bps of the trailing 3-year average. The past 3 years is a reasonable comparison for spreads, as it includes the period of tighter spreads amid record inflows in 2021, wider spreads during record outflows in 2022, as well as the mixed/modest outflow environment thus far in 2023. In our view, and subject to our expected UST market rally, spreads will tighten again in 2024 as inflows into municipal bond funds regain momentum moving through the year.

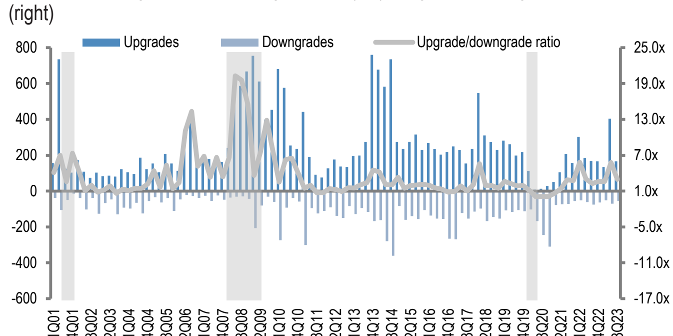
While current spreads are near the 3-year average, 5yr-30yr AA taxable municipal spreads range from 24-48bps wide of the average spread during the period of inflows in 2021. **We conservatively forecast 6bps of tightening in 30yr AA taxable municipals next year, but believe spreads could tighten far more if the rate rally gathers steam earlier in the year than we currently forecast, or end the year flat in an environment where the rally in the back end of the UST curve fails to materialize.**

From a credit perspective, the municipal bond market has been resilient through the post-pandemic period and is well positioned to weather the economic deceleration expected next year. Looking at the most recent rating agency metrics, we observe that positive municipal rating momentum continued in 3Q23, with S&P and Moody's municipal upgrades outpacing downgrades for the 10th and 11th consecutive quarter, respectively. **Year-to-date (through October), municipal upgrade-to-downgrade ratios for both rating agencies now stand at 3.5x, versus 2.9x (Moody's) and 3.3x (S&P) for full year 2022, respectively.**

At the same time, tax receipts show initial signs of slowing after years of strong growth, with available state-reported data showing collections down 3% YTD through September 2023, versus 2022. While the direction of recent tax receipts is negative, for perspective, we note that these YTD September totals are 29% above the comparable pre-COVID tax receipts in 2019. **For a broader credit discussion including state rainy day funds and pension reviews, please see our previously published 2024 Municipal Markets Outlook.**

Figure 38: Positive municipal rating momentum continued in 3Q23, with S&P and Moody's municipal upgrades outpacing downgrades for the 10th and 11th consecutive quarter, respectively

S&P count of upgrades and downgrades, # (left); Upgrades/downgrades ratio, x (right)



Source: S&P Global Ratings Research, J.P. Morgan. Gray shaded area indicates recessionary period.

European Credit: Safe Carry Redux

Click here for the full outlook.

Table 17: FY24 Forecasts

	EUR IG	EUR HY	EUR LL
Spread	175	500	
Spread, current	*162*	*423*	
Total Return	7.5%	8.0%	6.0%
Excess Return	1.2%	0.6%	
Default Rate		2.5%	3.0%
Fallen Angels	€20bn		
Rising Stars		€15bn	
Gross Supply	€515bn	€80bn	€55bn
Net Supply	€45bn	€5bn	€5bn

Source: J.P. Morgan.

Overall, we like owning euro corporate bonds even though we see credit conditions weakening next year. Our total return forecasts are strongly positive across all asset classes at +7.5% for investment grade, +8.0% for high yield and +6% for leveraged loans. However, we do look for some modest spread widening as investors price in a greater recession risk premium, with targets of 175bp in investment grade and 500bp in high yield, although this would still translate to positive excess returns.

On the upside, our economists' base case sees a 'soft landing' with headline inflation almost at target by the end of the year, leading to sharply lower sovereign yields. On top of this, return breakevens are extremely attractive due to healthy carry and low durations, which provides plenty of downside protection. Additionally, we expect credit spreads and sovereign yields to be negatively correlated as investors focus less on inflation concerns and more on recession probabilities, which will dampen total return volatility in contrast to the wild swings in performance seen over the past eighteen months. The technicals should also be strong, with very limited net issuance in either investment grade or high yield, although we do expect a busy year for refinancing transactions.

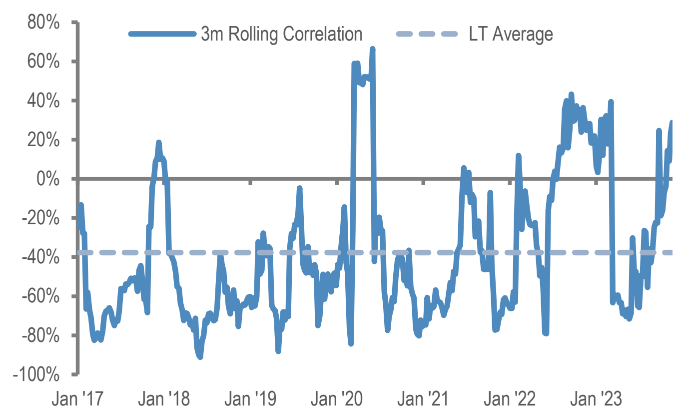
On the other hand, even in our base case, we think that fundamentals and ratings are set to deteriorate over the coming quarters. Recent corporate guidance has generally been poor, with a common refrain being that "end demand is falling." This is no longer confined to just industrial end users either, with weakness in consumer segments such as luxury and high street retail, furniture and home renovation, and goods packaging. We are also expecting to see softer demand for autos, due to the impact of higher monthly leasing costs, and airline and hotel bookings, as the "revenge travel" trend comes to an end. Altogether, we see the range of potential macro outcomes being broader than usual, and reflect heightened recession risk in our spread targets.

How would we trade this environment? In general, we have a preference for higher quality paper, positioning for an underweight to cyclicals versus non-cyclicals, mild investment grade / high yield decompression, and leveraged loan underperformance versus high yield. Similarly, we would rather take subordination risk on quality issuers than default risk, with a preference for corporate hybrids. Finally, we recommend extending duration into 7y+ single-A rated bonds.

Figure 39: EUR IG & HY Yield Breakevens, %

Source: J.P. Morgan, S&P Global. Yield / mod duration using current values.

Figure 40: Correlation of EUR IG Spread and 5y Bund Yield, %



Source: J.P. Morgan, S&P Global, Bloomberg Finance L.P.

Currencies

G10

Click here for the full outlook.

- **The top-down view is for USD to be bumpy but elevated. Preference is to buy on dips, but be tactical as markets vacillate between US exceptionalism and recession, narrowing the valley of the smile.**
- **Sustained USD weakness will require Fed cuts and better growth outside the US. Both conditions are not met yet.**
- **Central banks will move to synchronized rate cuts. USD impact will depend on the cyclical context, but size, sequencing and nature of cuts ("good" vs. "bad") should generate ample RV opportunities.**
- **2023 was the golden year for FX carry; 2024 should be the beginning of the end as high-yielders cut most. Declining yields will make carry less attractive and a narrower theme.**
- **Recession risk is well priced into low-yielding, G10 high beta FX, but not among high-yielders. Look for some convergence as yields compress.**
- **US elections will come into view next year. If current polling persists, USD risks are skewed to the upside as the market processes the possibility of new tariffs.**
- **We discuss FX in different macro scenarios; soft landings are not always USD bearish.**
- **China growth upgrades amid soggy global growth do not tend to deliver large, durable commodity FX gains.**
- **The baseline looks for the USD TWI to strengthen by 2.5% in 1H24; EUR/USD 1.00-1.05 in 1H; USD/CNH 7.30-7.35, G10 high beta ex-NZD to strengthen, but EMCI to weaken 6% in spot (+1% total).**

Heading into 2024, the baseline call is for USD to be bumpy but elevated. Preference is to buy on dips but with the recognition that one needs to be tactical on USD as markets vacillate between US exceptionalism and recession. Our top tradable themes stem from: (1) broad central bank rate cuts, (2) valuation convergence, and (3) recession sequencing.

Table 18: Macro scenarios for 2024 and implications for FX

Scenarios	FX implications
1. Big squeeze - no more hikes but gradual slide in high-for-long - margin compression, high rates drag down growth - Fed cuts 25bp/meeting starting 3Q in response to recession	**USD TWI** +3-5% **USD/JPY** 145 **EUR/USD** 1.00-1.03 **High beta** FX leads weakness
Best long and short candidates	Long USD, CHF vs. EUR, GBP, Scandis, AUD,NZD
2. Round 2 KO/ Fed at 5.5% is not enough - already-sluggish growth hit by higher rates - inflation slide is limited; 2025 deep recession - More pain outside the US	**USD TWI** +5-7 % **USD/JPY** breaks 155 initially, then lower on recession **EUR/USD** 1.00 **High beta** FX - worst case outcome for low yielders; double-digit drawdowns
Best long and short candidates	Long DXY, short high-beta FX
3. Goldilocks/ soft landing - inflation falls in 2024, no added tightening - US growth low 0.5%: no recession in EMU - central banks cut towards neutral	**USD TWI** -8 to -10% **USD/JPY** 140 **EUR/USD** 1.15+ **High beta** FX rebounds, funding currencies in G10 and Asia perform even better as shorts get unwound
Best long and short candidates	Most bearish USD scenario, especially for the funding legs of 2023's carry trades: Long Scandis, EUR, AUD, NZD, N.Asian FX vs. USD
4. Damage done/ Recession in 1Q24 - US and EU already in recession in 1Q - Fed peaks at 5.5% and cuts in 1H	**USD TWI** +5-7%, then down 8-10% **USD/JPY** low 130s **EUR/USD first weaker, eventually** 1.15+ **High beta initially** weakens led by high yielders, then rebounds
Best long and short candidates	Long JPY and CHF on crosses; Long USD vs. G10 high beta, crowded EM high yielders

Source: J.P. Morgan.

Central banks will move from synchronized hikes in 2022-23 to synchronized cuts in 2024. The start of cutting cycles which will be led by the highest yielders should create a myriad of new trading themes. Yields on carry baskets will fall to sub-average by mid-2024. This should:

(a) make FX carry a narrower theme as the year progresses,

(b) reduce the pressure on FX with highly levered economies and on funders, particularly the lower-yielding, G10 high beta FX that are now cheap,

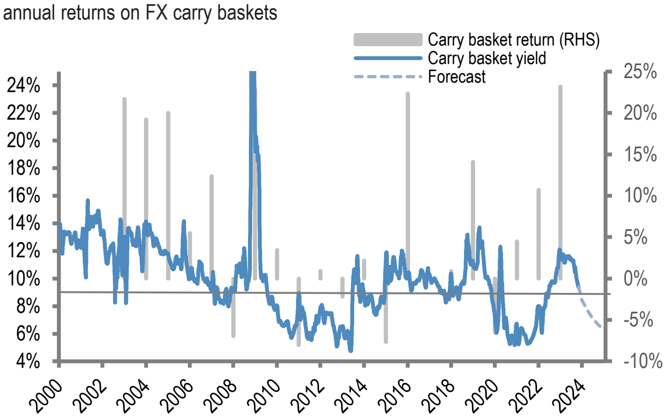
(c) allow FX markets to respond to other factors like growth or value,

(d) provide a fresh set of high beta FX hedges to underweight vs. USD as they traverse from being high-yielders previously to low-yielders, and

(e) generate RV opportunities motivated by relative sequencing of cuts (just as rate hikes did in 2023).

Figure 41: The FX carry trade is over as central banks cut rates: dispersion in FX yields is projected to decline to sub-average in 2024, from near two-decade wides

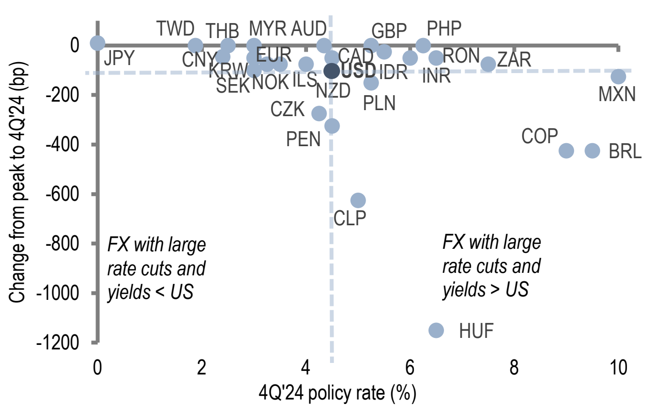
Dispersion in yields on FX carry baskets (i.e. gap between high and low yielders) vs. annual returns on FX carry baskets



Source: J.P. Morgan.

Figure 42: Several high-yielders are projected to have large rate cuts; some will traverse to being lower-yielding than the US (like CZK)

y: Projected decline in policy rates till Dec'24 from peak (bp); x: projected policy rate at end of 2024 (%)

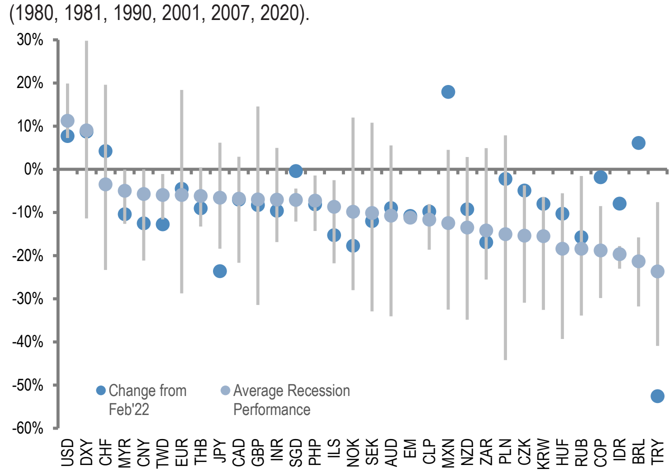


Source: J.P. Morgan

The nature of cuts will matter. In the last two years, we have been highlighting the differences between "bad" rate hikes (inflation driven in poor growth) vs. "good" hikes (growth rather than inflation driven). In this vein, FX with "good" cutting cycles (inflation declining, strong growth) should outperform vs. FX with "bad" cutting cycles (inflation declining amid a recession).

Figure 43: Where is a recession already priced? Low-yielders are more discounted the high yielders, which have benefited from strong carry

Recession returns for CCY/USD pair across past six NBER recession episodes (1980, 1981, 1990, 2001, 2007, 2020).



Source: J.P. Morgan.

Themes & Trades

1. Built different (RV on CB easing/ recessions sequencing). The UK is projected to be in recession next year with the worst growth globally and among the highest inflation rates in DM. On the other hand, Sweden will exit a recession next year, and SEK is likely to benefit from rate cuts given how rate-sensitive the economy is. New Zealand is expected to be the first and the largest DM cutter in 2024 (and is also expected to have the worst current account globally) while Australia is not expected to cut at all. Risks are towards more easing from BoC than Fed as well.

- **Sell GBP/SEK at 13.0730; stop loss at 13.50.**
- **Buy AUD/NZD at 1.0870. Stop at 1.06.**

2. Don't get carried away. Rate cuts mean that some rich high-yielders are now freer to weaken vs. the lower yielding G10 high-beta like AUD and Nordics that have borne the brunt thus far. CZK & SEK are on opposite sides of the valuation spectrum despite being similar on other macro attributes (manufacturing exporters, c/a surplus, strong fiscal), while CZK is expected to have an aggressive pace of easing that the FX is not fully adjusted to yet. FX intervention policy of the two countries is also in contrast.

- **Buy SEK vs CZK. Target 2.35; review at 2.02; Spot ref 2.1419.**

3. Fortune favors the USD, but patiently. USD is expected to appreciate in majority of potential global macro environments. US exceptionalism still lingers. Given tactical risks, we hold limited USD longs, and advocate patience in resetting new USD longs. Upcoming PMIs key.

- **Hold EUR/USD 1.0450 put.**
- **Buy USD/CAD 4m 1.37/1.41 call spread for 88bp. Spot ref. 1.3728.**

4. Euro bloc underperformance persists. Prospects for a convincing Euro-area recovery appear dim as the region is flirting with recession amid restrictive rates. EUR/CHF remains well-explained by sagging growth momentum on the continent. UK growth is expected to contract in 2024 and will have the most stagflationary outlook in G10.

- **Stay short EUR/CHF and GBP/CHF in spot.**
- **Hold EUR/JPY 155.5/151 put spread.**

5. You're saying there's a chance? Were a global soft landing to occur, optimal trades are long G10 high beta as these are well-priced for recession. EUR/SEK should weaken in a soft landing but be more insulated if US rates retrace higher.

- **Buy bearish EUR/SEK 4m at-expiry digi 10.85 put. Premium paid 8.7%. Spot ref 11.4338.**

6. Cost-effective JPY lotto ticket. While not the base-case, JPY looks cheap vs. rate differentials, and notwithstanding Japan vulnerabilities, USD/JPY could decline in either a soft landing or a recession. Consider cost-effective OTM JPY topside structures.

- **Buy USD/JPY 6m at-expiry digi put struck at 133. Spot ref. 148.40. Premium paid 10%.**

We are patiently downbeat on EUR amid restrictive rates and ongoing cyclical and structural drags. Ingredients for a EUR/USD rebound are rate convergence and growth; the latter is lacking. **The 1H24 outlook envisions that euro-bearish forces will remain intact which will make relief rallies in response to the US moderation fragile and keep downward pressure on the pair. EUR/USD targets are put between parity and 1.05 for 1H.**

The upfront caveat is that parity will require ongoing EMU growth underperformance vs. the US, or the Fed to hike further. The downside forces we emphasize are: ongoing cyclical weakness which is yet to be fully incorporated into ECB's outlook and may well be part structural; real rates which are already restrictive in the Eurozone vs. the US and result in further interest rate compression; and our view that the currency should carry some discount for regional geopolitical risks. **However, at some point in 2024, US-EU growth momentum should rotate and hence EUR/USD should eventually strengthen towards 1.10-1.15.** Conviction level on timing of this turn is low given the range of outcomes possible, but we maintain that the recovery in euro requires not just the Fed to be easing, but also improved prospects of regional growth.

Last year, our central thesis was that a Fed pause by itself is not a sufficient condition for a rebound in the EUR/USD, and that positive growth momentum in the region would be required; we maintain this stance. The evolution of EUR/USD around prior pauses in Fed hiking cycles informs this view and suggests that (a) historically, rate spreads typically improve sharply in favor of the euro after the Fed pauses and ECB lags, (b) even though EUR/USD is ultimately correlated with EU-US rate differentials and *eventually* strengthens after the Fed pause, (c) the FX convergence to widening rate differentials takes its cue from relative growth. In the near-term, we are emphasizing relative EMU cyclical underperformance and its bearish implications. Furthermore, the risk scenario of the ECB having to deliver more cuts than the Fed is a nontrivial probability outcome that would challenge whether these rate differentials should be rising in favor of euro in 2024 in the first place.

Our outlook on CNY FX is less bearish heading into year-end given favorable seasonality and still UW positions, moved MW CNY FX in GBI-EM (from UW). We anticipate only a lukewarm Chinese recovery as de-stocking in real estate continues. Corporate USD selling flows tend to pick up towards year-end/pre-LNY season and support seasonal strength in CNY FX. The fact that USD/CNY has not reacted much to the recent growth upgrades amid thin market liquidity suggests that seasonal corporate dollar flows are yet to hit with full force. A year-end rally in Chinese equities amid hopes of easing geopolitical tensions could also add a potential tailwind to the RMB. We scale back bearish positions in CNY FX by moving MW CNY FX in GBI-EM (from UW), but we emphasize that this is tactical neutralization that does not change our view of longer term CNY underperformance. If the DXY does indeed weaken towards the back half of next year as the Fed delivers rate cuts, we anticipate the CNY CFETS basket weakening towards 95, with the PBoC more likely to bless benign depreciation of the RMB on a TWI basis when the dollar is slipping than outright USD/CNY strength that can raise financial stability concerns.

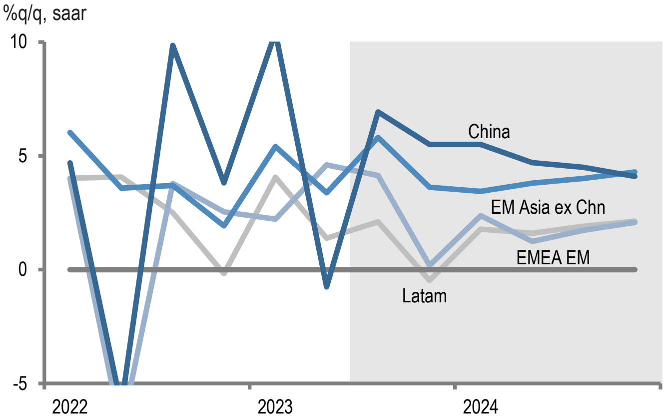
Emerging Markets

Economics

Click here for the full outlook.

We expect EM growth to moderate slightly to near-trend 3.8% in 2024. Much of this decline is in China, Russia, and Türkiye; excluding these, EM should hold steady at just above 3%. Such an outcome would be a major achievement in the face of still restrictive interest rates, fiscal consolidation, tight global financial conditions, and slowing DM and China growth. The sources of this resilience are similar to those in the US: a combination of high private savings and moderate starting leverage. Alongside the projected easing of monetary policies and a boost to real incomes from further declines in inflation, these supports should continue buffer EM growth in the face of slowing DM growth. This stability masks important regional differences as accelerations in EMAX and the CE-4 are expected to offset a slowdown in LatAm. In China, growth is expected to edge lower from 5.2% in 2023 to 4.9% in 2024 (Figure 44).

Figure 44: EM growth to remain steady but regionally dispersed

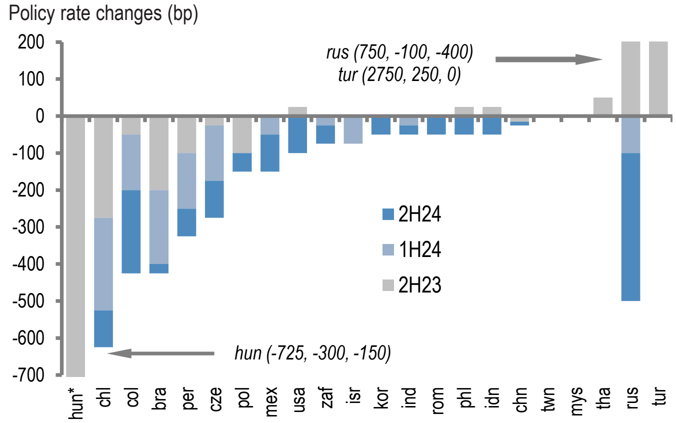


Source: J.P. Morgan, national statistical agencies.

After two-and-a-half years of overshooting, inflation is projected to return to central bank comfort zones for most EMs by end-2024. Our forecasts look for both headline and core inflation in EM ex-China and Türkiye to fall around 100bp between Dec-23 and Dec-24, converging near 3.5%oya by the end of next year. This decline is expected to be broad-based, with inflation falling within central bank (CB) comfort zones across much of EM. In a handful of EMs (e.g.: Poland, Romania, Hungary and Colombia), core inflation at the end of 2024 is still likely to exceed CB target midpoints by around 2%-pts. These overshoots reflect some combination of tight labor markets, loose fiscal policy, and still unanchored inflation expectations. While the overall progress on core disinflation has been impressive, it has been overly reliant on correcting core goods prices. Meanwhile, the latest run rates on core services inflation—a more reliable gauge of domestic price pressures—call attention to the underlying stickiness in core inflation in parts LatAm and the CEE.

EM easing cycles will broaden in 2024, but rate cuts are likely to remain measured as policymakers balance high domestic real rates against tight global financial conditions. LatAm and parts of CEE— where real rates remain elevated and/or growth has been sub-par—should continue to lead EM's easing campaign through 1Q24. We have penciled in 2Q24 cuts also in India and South Africa, while the rest of EM will ease only after the Fed begins cutting in 3Q24 (Figure 45). If global financial conditions soften on the expectations of greater Fed easing, the pace of easing in EM will also likely accelerate. The deepest cuts are expected among the early and aggressive hikers, while EM Asia's more limited easing cycles are a reflection of its record low rate differential versus the US. Overall, EM ex-China, Türkiye and Russia is projected to deliver another 100bp in rate cuts over 2024, broadly matching the projected fall in inflation.

Figure 45: Early hikers to lead EM's easing campaign



Source: J.P. Morgan. *For Hungary, 1-day deposit rate until Sept 2023 and base rate thereafter.

Solid EM macro fundamentals should provide a buffer in the event of a less benign 2024 US scenario. We anticipate that 2024 will be another year of EM resilience in which macro risks continue to moderate, including further normalization in inflation and a modest narrowing in fiscal deficits which should keep public debt ratios broadly stable, albeit still elevated. Encouragingly, only a few EMs are seen running a CA deficit above 3% of GDP—seen as a key vulnerability marker—and FX reserves remain adequate for most. If the US falls into a recession, LatAm with its ample rate cushion will likely be damaged the least; EM Asia would be the most vulnerable given its shallow rate protection. EM capital flows would likely weaken but are unlikely to turn into large outflows.

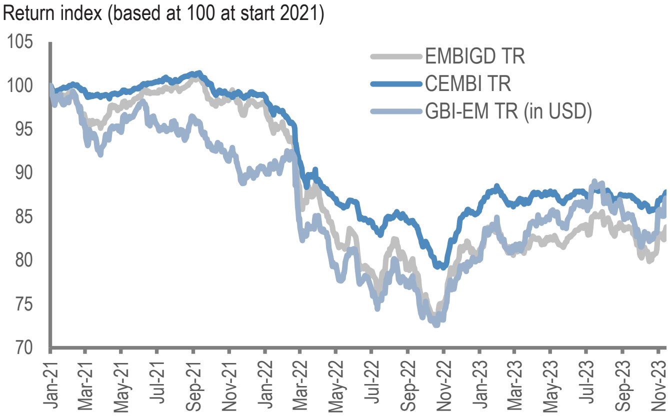
Fixed Income

Click here for the full outlook.

More of the same and then something different for EM in 2024. The US growth and monetary policy cycles will dominate EM price action again in 2024, meaning a likely resolution to cyclical uncertainty but with a current window for EM sub-cycles to drive opportunities. 2023 felt like "four seasons in one day" as we traded every cyclical scenario for EM fixed income; 2024 will start that way and then likely see either a US soft landing or a recession. 2023 began with a relief rally and 'goldilocks' data as inflation eased and growth held up, which then reversed with fears of more Fed hikes, followed by March's banking crisis. Since then EM has traded goldilocks again, higher rates for longer, too high rates as a headwind, and now a relief rally with slowing data. While there have been lots of EM idiosyncratic developments, these big cyclical drivers have been dominant. EM returns YTD are 8.7% for EM local currency bonds (in USD), 3.9% for hard currency sovereigns and 4.5% for hard currency corporates, with EM credit spreads 20-30bp tighter, EM FX spot returns of 1.2% but more with carry, and local bond yields falling 35bp even as UST yields rose. A year ago we felt the cycle was likely to end within 12 months and had to then adjust to the more resilient US economy.

Figure 46: Not a lot since January… EM returns have seen mini-cycles in 2023 and that looks set to continue into mid-2024

Return index (based at 100 at start 2021)



Source: J. P. Morgan

Into 2024 this cyclical uncertainty (Figure 46), looks set to continue as there is observational equivalence on the path between two very different scenarios of a US soft-landing and a US recession. For EM assets, the difference between these two scenarios in risk premia terms is likely in the hundreds of basis points. A key focus for us through 2024 is therefore on how the US economy resolves the cyclical uncertainty. In the meantime, EM monetary policy and default cycles should be the focus of investment opportunities until the big cycle dominates again.

Focus on the smaller (EM) cycles until the big (US) cycle dominates again. With the big US cycle unresolved, there will be space for EM monetary policy and default cycles to be the primary drivers of performance into 2024. Taken on their own, our EM economic 2024 forecasts are relatively benign for markets, showing continuing resilience. EMX GDP growth will be at 2.8% which is nearly flat to 2023's 3.0% forecast outcome. EM headline inflation (ex China and Turkey) will fall from 4.7% oya at end 2023 to 3.5% at end 2024, and core inflation will fall from 4.3% to 3.4%. This will allow EMX policy rates to be cut from 7.8% at end 2023 to 6.4% by end 2024, with some fiscal consolidation and marginally worse current account. In the near-term EM local markets investment themes will be driven by monetary policy cycles and the pace of normalization. EM credit tradeable themes will be driven by default cycles: post restructuring or post sell-off tightening, as well as not-yet-distressed credits that will worsen in a world of higher-for-longer rates and slowing growth.

Stay OW EM FX focusing in high carry, receive EM rates front-end but MW in GBI-EM local duration, stay MW in EM Sovereign and Corporate credit. We recently moved tactically OW EM FX after seeing a peak in US yields for now, upward growth revisions globally, a hawkish set of moves from EM central banks and low positioning. EM currencies have already rallied and positioning has turned more positive but we think this trade has some more to go. The hawkish turn from EM central banks, flat curves and a lack of risk premia further along EM local bond curves (Figure 47) keeps us MW in GBI-EM local duration, but we recommend front-end receivers and steepeners. In EM sovereign and corporate credit, the likely path of spreads is wider from current levels into growth weakness in 2024, but it is too early to position for this and we stay MW in both, focusing on thematic and specific opportunities.

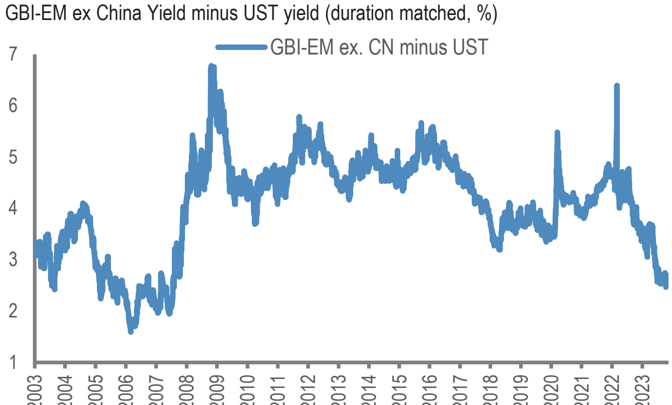
Rates

Click here for the full outlook.

For EM local rates, our investment themes into 2024 focus on alpha generated by central bank moves and fiscal risk premia in bond curves. The thematic backdrop for local markets heading into 2024 is largely about a maturing of the themes which have been developing through 2023: disinflation and a normalization of monetary policy amid decelerating growth; risks surrounding fiscal easing and slippage in select countries; and the ability of EM economies to withstand higher-for-longer US rates. A notable absence among these themes is China, which after a brief period of optimism around re-opening in 1Q23, was uncharacteristically absent as a major driver of EM asset prices in typically-China-sensitive high yielders and commodity exporters. This was in large part due to a breakdown in correlation between China's economic growth cycle and commodity imports, a link which is worth monitoring. These 'alpha' themes will be mostly about central-bank watching and calibrating fiscal risk premia in bond curves. The 'beta' and overall directionality of GBI-EM returns is ultimately going to be a function of the direction of UST yields and the dollar, given the low risk premia of EM local bonds to UST yields (Figure 47). On the former, our colleagues in the US interest rate strategy team see a significant but backloaded rally in UST yields (with a significant steepening trend) in 2024. This should eventually help duration across EM, particularly in EMEA EM and Latin America where local bond spreads to USTs are still high, but in the near term, given the significant degree of what's priced in (approximately 100bp of Fed rate cuts by December 2024), it is still worth being selective about the EM markets to be long duration.

Figure 47: The spread of EM local bond yields over UST yields is at the lowest since 2007

GBI-EM ex China Yield minus UST yield (duration matched, %)

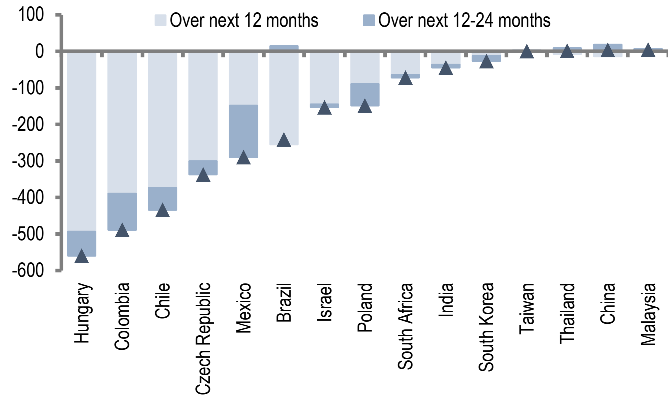


Source: J. P. Morgan

Rates markets already price large ongoing EM rate cuts through 2024 and 2025, requiring a selective approach to receiving front-end EM rates. The largest cutting cycles in the next 2 years are priced in LatAm and CEE; across EM, the majority of cuts are priced for 2024, though deeper ongoing cuts in 2025 are priced in Mexico and Poland (Figure 48). Compared to J.P. Morgan forecasts for end-24 policy rates, markets price more easing in CEE and Mexico, and less easing in Brazil and Korea; in Turkey, fewer hikes are priced than forecast by our economists. Given the extent of rate cuts priced in EM and inverted curves meaning high roll costs for front-end receivers absent swift delivery of cuts, a selective approach is required for receiving front-end rates. Regionally, we see clearest scope to receive CEE front-ends, where rate cutting cycles are imminent (Czech Republic) or underway (Hungary, Poland). We are receiving 12x15 CZK FRAs and 1y1y PLN IRS (against 6x9 FRA payers which make for positive roll FRA-IRS flatteners). In South Africa, we fade the pricing of cuts in the next 6 months with 6x9 FRA payers. Elsewhere, given how little is currently priced into EM Asia, we see opportunities to selectively receive (see *EM Asia Local Rates Strategy: Red Light, Green Light*).

Figure 48: Deepest cutting cycles priced in Latam and CEE

Market pricing of EM monetary policy rates over the next 2 years, bp



Source: J.P. Morgan.

Higher yielding EM markets can price lower terminal rates, providing opportunities to receive further out along the curve. In LatAm (Brazil, Mexico, Colombia), the lowest priced policy rates in the next 3 years are significantly above terminal US rate pricing (outright and versus historical spreads). South Africa's terminal rates are also high (this largely reflects premia for fiscal and FX risks), while in Hungary, rates are priced high versus ECB rates. Revisiting our simple analysis of 5y5y rate pricing of inflation premia suggests long-end rates are high in Mexico, Colombia and South Africa, with large implied medium-term inflation versus inflation targets. In these high yielding EM markets where a lot of rate cuts are already priced in the front-end, we see better opportunities to receive further out the curve for lower terminal rates and risk premia compression. We are received Jan26 DI, 3y2y HUF IRS and long 3y IndoGBs. We are also long 5y KTBs on cheap valuations, elevated forward risk premia, and a BoK that although is unlikely to shift immediately dovish can ease in the medium-term (see *Korea Local Rates Strategy: It's Time ...*).

Corporates

Click [here](#) for the full outlook.

The dichotomy between resilient corporate fundamentals and uncertainty over the macro trajectory remains in place. We have a fairly coherent view that standalone fundamentals for EM corporates can remain resilient, with credit metrics weakening only modestly off a very strong base. The baseline JPM macro view looks akin to a soft landing, as growth is forecast to slow together with inflation but not fall into a recession, enabling rate cuts from 2H 2024. However, the specter of a hard(er) landing hangs over, heightening macro uncertainty down the road.

Credit spreads have been on the tight side of the historical average for most of 2023, and we do not expect CEMBI to break out of the range in 2024. The long-term average spread since 2010 is around 330bp, and we set our end-2024 CEMBI BD spread target at this level. The total return for 2024 would amount to 10% assuming 7-year UST yield declines to 3.6%.

Thus, we head into 2024 Neutral the CEMBI, with more of a tilt to HY than in 2023, **adding duration in 10y to longer end IG bonds**. Across regions, we have higher positioning in countries with good or improving macro stories where valuations do not yet fully reflect such dynamics (India, Turkey, to some extent Mexico). We like defensive sectors (renewables and utilities), HY non-quasi oil & gas (Africa), recovery plays (i.e. Asia gaming), and financial T2s.

Regardless of the eventuality, we think the sentiment until the initial part of 2024 may still be constructive given the recent decline in inflation and modestly slowing economic indicators. CEMBI spread could continue to grind tighter in the near-term towards 280bp, until the macro narrative changes significantly. Hence, our expectation of wider spreads may be backloaded in the later part of the year, but also with risk of more meaningful widening depending on the recession risk.

Fundamentals resilient, default rate to decline. Leverage deteriorated modestly this year but remains in good shape, for the most part and way below prior peaks. We expect a recovery of top and bottom line metrics of mid single to double digit levels, but with a fair bit of differentiation by sector. Such fundamental trends are also translating into global EM corporate default rate expectations at a normalized 4% rate.

Technicals — supply supportive, demand subdued. We expect 2024 EM corporate new issuance at a lackluster $244bn, with net financing at -$190bn as maturities pick up to $288bn. EM corporate positions were reduced across dedicated and crossover investors to some of the lowest levels over the past 5 years, which is favorable from the standpoint of starting positioning. Hence, we think allocations are likely to be bottoming and may start to pick up, especially if rates fall meaningfully next year.

Table 19: Summary views on EM corporates going into 2024

	EM corporates overall	IG	HY
Macro	**Soft landing base case, but recession risk overhanging.** Base case of slower growth and declining inflation provides reasonable backdrop for credit of not too hot or cold, but recession risk down the road could lead to volatility as expectations gyrate. Market backdrop likely supportive in 1H24 with rising volatility thereafter.		
Fundamentals	**Resilient.** Credit metrics weakening from peak levels, but only gradually as corporates maintain conservative stance; banks also stable after improvement in recent years	Overall conservative behavior to remain in place, as capex and expansion plans continue to be modest	**Divergence, refinancing concerns.** More differentiation between resilient BB and vulnerable single-B & below. Default rate contained at 4% even as concerns around refinancing may rise
Technicals	**Supply supportive, demand subdued.** Issuance still depressed as issuers prefer funding from local sources, leading to negative net financing and supportive technicals; demand remains subdued	Supply concentrated in IG, with small positive net issuance. Some spillover benefit possible from strong inflows into US HG funds	Still very limited supply with sizable negative net issuance, but demand set to remain weak as well, both from dedicated and crossover investors
Valuation	**Mixed.** Overall spread below historical average with limited tightening potential. Spread over sovereign wider in select countries, opening up opportunities	Spread to US HG towards wider end of normal range at around 40bp led by BBB, single-A non-financial decent spread over US single-A	Relative valuations not compelling as HY and BB in the middle of range vs US HY, BB-BBB basis on the tighter side

Source: J.P. Morgan.

Table 20: CEMBI Segment top level, country, sector OW and UW calls

Segment Top Level Calls

	OW	UW
Region	Africa	
	Asia HY (ex. China)	
	EM Europe HY	
	Latam BBB	
	Latam BB (ex. quasi)	
Country	Indonesia IG (ID)	Egypt (EG)
	India HY (IN)	Philippines (PH)
	Ghana (GH)	
	Macau (MO)	
	Mexico (MX)	
	Peru (PE)	
	Singapore (SG)	
	Thailand (TH)	
	Ukraine (UA)	
	South Africa (ZA)	
Sector	Gaming	TMT
	Financial T2s	
	Oil & gas HY (ex. quasi)	
	Utilities	

Segment Country and Sector Calls

	OW	UW
Region/Sector	Africa O&G	ME TMT
	Africa Indust	
	Asia Consum	
	Asia Utils	
	Latam BB TMT	
	Latam Utils	
Country/Sector	BR steel	AE Fins
	ID Consum	BR Consumer
	ID Utils	BR O&G
	IN Fins	IN O&G
	IN Infra	MX Consumer
	IN Utils	MX TMT
	KR Fins	
	MO Gaming	
	SA O&G	
	SA Real Estate	
	SA Utilities	
	MX Fins Subs	
	PE Fins	
	SG Fins	
	TR Corps	

Source: J.P. Morgan.

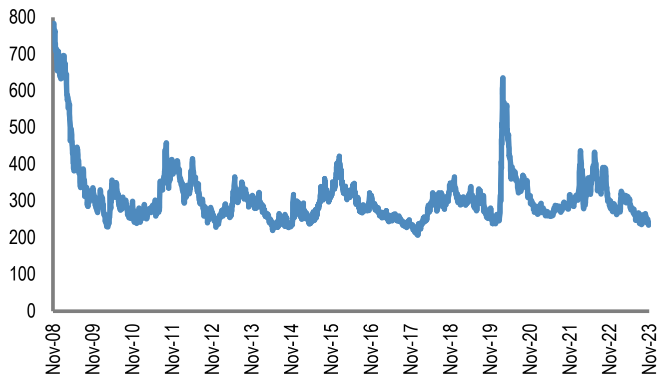
Sovereign Credit

Click [here](#) for the full outlook.

Stay MW the EMBIGD as spreads levels outside distressed remain tight. We stay marketweight the EMBIGD, with the same underlying caution that has prevailed for over a year—spreads remain too tight vis-à-vis the risk of recession. Even with a higher rate environment driving up all-in yields, and lingering fiscal challenges post-pandemic, EMBIGD ex-CCC spreads at 232bp are close to the lows of the last five years (Figure 49). The path to a potential soft landing has provided relief to US Treasuries and boosted all fixed income markets. But the Fed is expected to remain cautious for some time, and the surprisingly soft October inflation print may belie risks for ongoing stickiness. In this context, and with data already slowing in the US, recession risks are still lurking. Such an event—or even the uncertainty around it as data slows—would pose material upside pressure to spreads.

Figure 49: EMBIGD ex-CCC still screens fairly tight

Spreads, bp



Source: J.P. Morgan.

We are turning more defensive in the BB space and opportunistically constructive on single-B and distressed names. We have long highlighted that the headline EMBIGD spread is not particularly representative, given the stark divergence between IG and BB spreads on the one hand and the now highly populated group of distressed countries. Peering more closely into the ratings buckets, we have been highlighting the relative tightness of EM Sovereign IG spreads, both relative to history and versus US Corporate IG. But EM Sovereign IG has normalized a bit lately, coming off the tights during the 3Q sell-off in US longer-dated rates. Meanwhile EM Sovereign BB names have outperformed, both over the course of the last month's "goldilocks" rally and in year-to-date measures. We now choose to avoid IG UWs, while positioning defensively in the BBs. We still see more opportunities in the single-B and distressed space, where spreads remain elevated and we think almost all countries can continue to muddle through. We avoid most restructuring names for now (outside of an outright long in Zambia '27s) as timing concerns continue to be bogged down by Common Framework considerations of comparability of treatment.

In terms of country recommendations, cover UWs in Chile and Indonesia, while adding an OW in Honduras and an UW in Uzbekistan. Staying in the BB space, we remain UW Azerbaijan and South Africa (vs Eskom), while keeping an OW in Ivory Coast. In the single-B and distressed space we open an OW in Honduras alongside OWs in Angola, Ecuador, El Salvador and Mozambique. We stay UW Kenya and Iraq.

FX

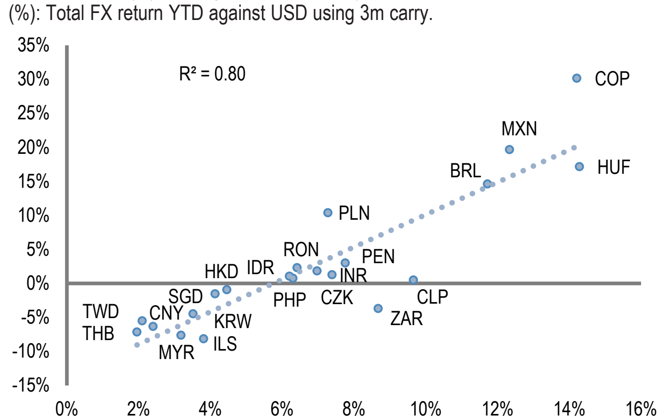
Click here for the full outlook.

We moved OW EM FX (from MW) at the start of November (see here). We saw a set of bullish triggers for EM FX in the form of a peak in US yields, upward growth revisions globally, a hawkish set of moves from EM central banks and low positioning. EM currencies have already rallied and positioning is turning less negative, but we think this trade has further to go.

Stay long EM FX carry and short currencies where carry is rapidly eroding. The FX carry trade has been the star of EM fixed income in 2023, following its historical relationship with financial conditions and US growth, and has explained 80% of cross currency differentiation in YTD performance (Figure 50). Despite higher UST yields, history suggests that good performance of EM FX currencies has, on average, taken place on quarters with US growth above median and loosening financial conditions (falling 10y UST TIPS yields) (Table 21). In our high carry basket, we are bullish BRL and MXN, two currencies we have been constructive on through most of 2023. Additionally we think carry is attractive in UYU and DOP. In EMEA EM, we are bullish on PLN and TRY, with a bullish bias in HUF (though tactically we took profits on our long position there recently). Stay short / UW FX where carry is going to erode rapidly due to rapid rate cuts. In this category we are UW COP and CZK; we also have had a short bias in CLP but took profits on this recently after the central bank paused its FX accumulation program.

Figure 50: Carry has driven EM FX performance in 2023

Horizontal axis (%): Average 3m FX implied yields since 01-Jan-2023. Vertical axis (%): Total FX return YTD against USD using 3m carry.



Source: J.P. Morgan.

Table 21: High carry currencies perform well when US growth is above median and financial conditions are getting looser

Average quarterly return of a top 20% (top 4) carry currencies (using sample from Figure 50).We split the sample according to US %q/q GDP growth based on median since 2000 and if change in 10y UST TIPS has been positive or negative in any given quarter.

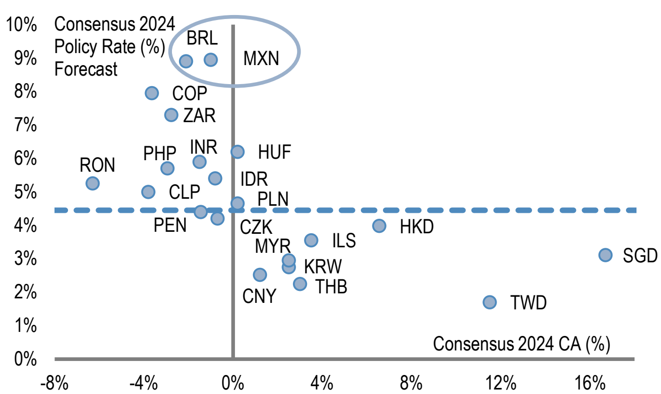
	Financial conditions loosening	Financial conditions tightening
US GDP growth above median	2.54%	0.10%
US GDP growth below median	0.36%	-0.03%

Source: J.P. Morgan, Haver Analytics, Bloomberg Finance L.P.

We believe the current rally in EM FX still has legs, with carry outperformance continuing. Looking ahead, even though we don't expect EM currencies to be driven as much by carry in 2024 as they have been this year, we still think the EM FX carry trade has room to deliver positive returns. Focusing on consensus expectations for policy rates and current account balances at the end of 2024 shows that high carry currencies have a premium in terms of compensation for their balance of payments profile, with BRL and MXN standing out as being the most attractive ones (Figure 51). We hold bullish recommendations in both BRL and MXN going into 2024. Long-term valuations also provide an additional layer of support for EM FX, with current bilateral real exchange rates being below historical levels for most countries. All together, we believe the current EM FX rally still has legs and we hold onto our EM FX OW in the GBI-EM Model Portfolio entered in early November (see here).

Figure 51: BRL and MXN offer the best carry compensation given consensus policy rate and current account forecasts for 2024

Horizontal axis (% GDP): Bloomberg consensus 2024 current account forecasts. Vertical axis (%): Bloomberg consensus policy rate forecasts for 4Q24.Dotter line shows 4Q24 consensus forecasts for US policy rates.



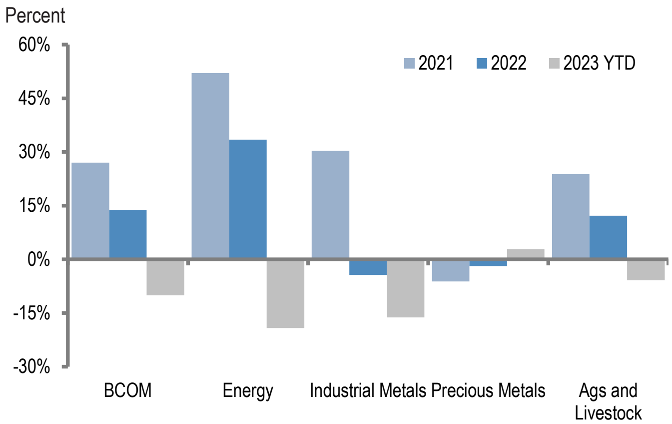
Source: J.P. Morgan, Bloomberg Finance L.P.

Commodities

Click [here](#) for the full outlook.

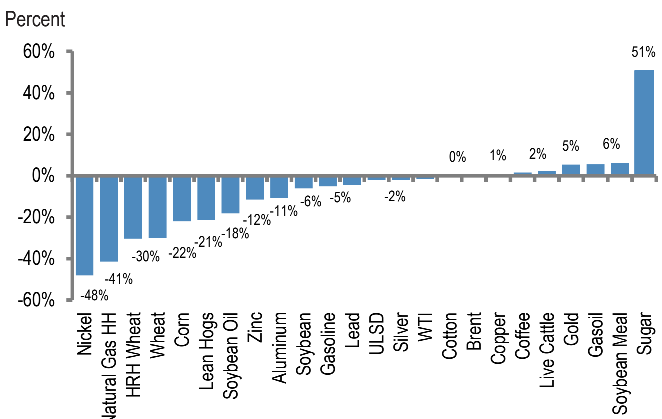
After two consecutive years of double-digit returns, the BCOM Index is on pace to deliver a 10% contraction in 2023 (Figure 52). Energy is the biggest loser, dropping ~20% year-to-date, pulled lower in particular by a ~60% ytd drop in the BCOM Natural Gas subindex. Industrial metals have fallen by 17% ytd as continued weak ex-Chinese demand have weighed on prices and amplified contangos and negative roll yield across the sector. The BCOM Agriculture and Livestock index is down by 6% ytd. Precious metals are the only major sector with positive returns ytd. Despite a stiff headwind of negative roll yields, the BCOM Precious Metals subindex is up by 3.5% ytd (Figure 53).

Figure 52: Performance of the BCOM ER Index and its sub-indices in 2021, 2022, and 2023 YTD



Source: Bloomberg Finance L.P.

Figure 53: Price performance of commodities underlying the BCOM Index, 2023 YTD

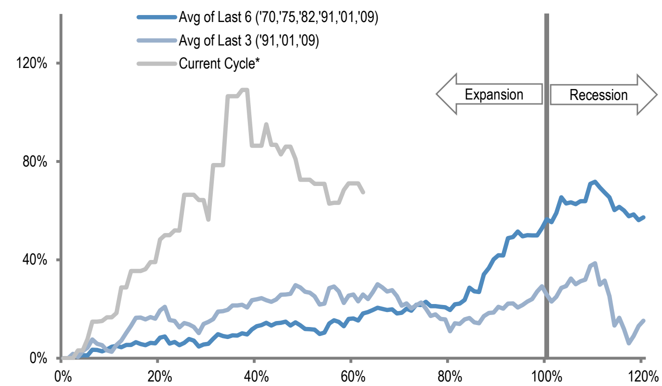


Source: Bloomberg Finance L.P.

As we have shown repeatedly, the maximum impact on returns of Commodities as a *broad asset class* (BCOM or GSCI) occurs in early or late stages of the business cycle or in episodes of rising inflation. First, as a highly cyclical asset class, **commodities exhibit reasonably consistent early- and late-cycle price behavior**, rising 20% on average over the first and last quintiles of recovery, the strongest segments for price appreciation by far (Figure 54 & Figure 55). The fundamental explanation for this performance is likely that above-trend growth during the post-recessionary recovery and near the end of expansion outpaces the growth in supply and erodes spare capacity, drawing inventory and boosting prices.

Figure 54: Bloomberg Commodities ER Index performance during expansions and recessions

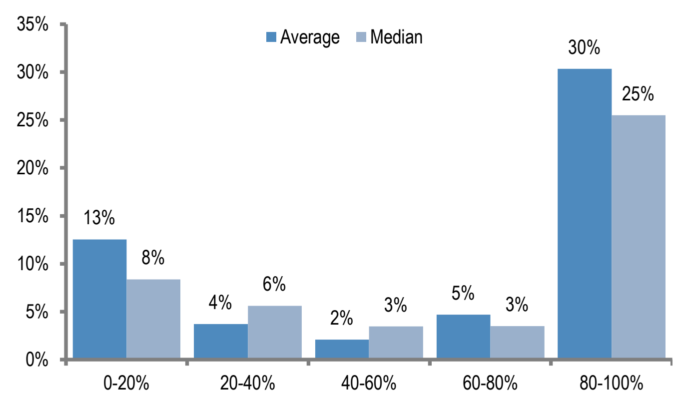
Measures change in BCOM ER throughout the cycle with the beginning of expansions normalized to zero. *Chart assumes end of current cycle in December 2025. Monthly data since Jan 1970.



Source: Bloomberg Finance L.P., NBER, J.P. Morgan. Last Observation is October 2023. Framework adopted from J.P. Morgan Long-Term Investment Strategy team.

Figure 55: Bloomberg Commodities ER Index performance by quintile of expansion

Percent change. Monthly data since Jan 1970.



Source: Bloomberg Finance L.P., NBER, J.P. Morgan. Average and median of last six full cycles (commencing in ’70, ’75, ’82, ’91, ’01, & ’09).

Similarly, commodity returns, energy in particular, are strongly positively correlated with US CPI, making the asset class one of the preferred options for hedging inflation.

Since the start of the century, the BCOM ER Index performed the best (+1.4% MoM returns on average) when US headline CPI was above 2% and rising with *directionality* of CPI more critical than level (Figure 56). For example, in cases when US CPI was above 2% but *falling*, the BCOM Index has lost 1.9% of its value month-over-month on average.

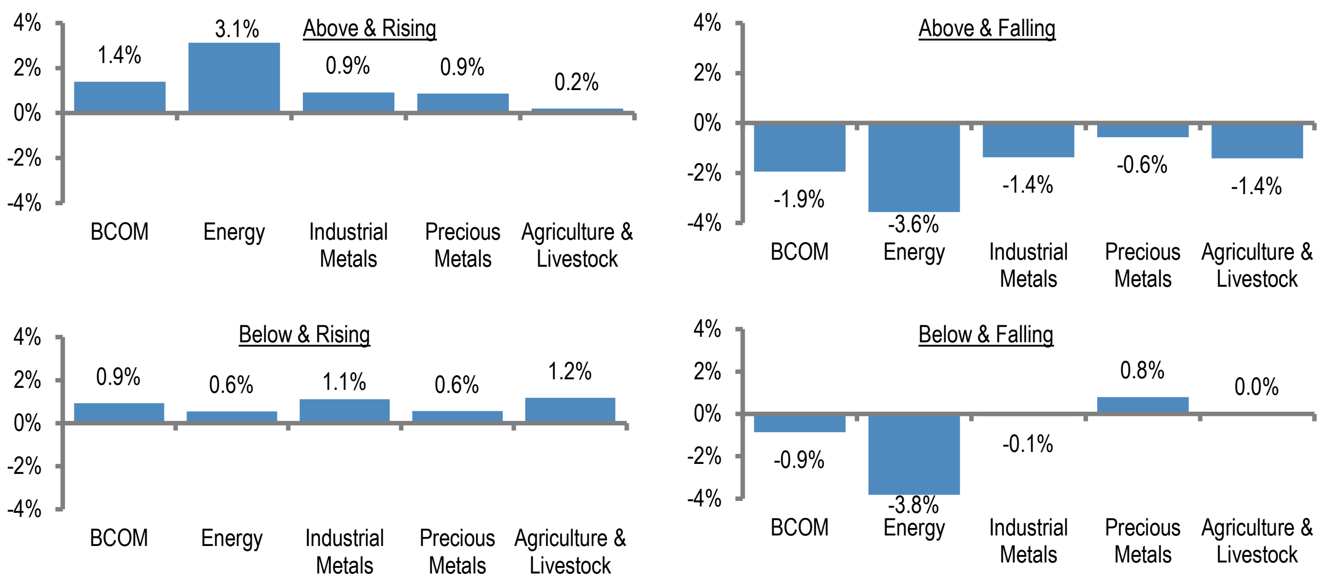
Accordingly, the reopening of the global economy and COVID stimulus drove the 27% return in broad commodity markets in 2021. In 2022, it was the Russian invasion of Ukraine and surging inflation that propelled commodity returns 14% higher. With the global expansion maturing but not yet in the last innings and amid sliding inflation, there was no single macro narrative to drive broad BCOM returns in 2023. Instead, the view became more sector-specific and tactical (*2023 Commodities Outlook: Oil and gold to drive commodity returns in 2023; precious metals upgraded*, 1 December 2022). We liked energy, but believed returns would be driven by oil and not US natural gas, where we projected a ~40% decline by year-end 2023—a call that has fully realized. In oil, being tactical has paid off, buying at the lows in July and exiting at the highs in September (*FOMO—time to raise tactical allocation to under-loved commodities*, 20 July 2023; *$90 in September, $86 in December*, 8 September 2023). Our structural bullish call on gold—last November we upgraded precious metals to a buy with an expected 8% return for the BCOM Precious Metals Index through 2023—has also worked out: precious metals are the only sector with a positive performance this year. We maintained a neutral outlook on industrial metals and turned less constructive on agricultural commodities.

In 2024, we expect more of the same *(Table: JPM Base Case Commodities Index Forecasts)*. Growth is poised to slow in 2024 to below-potential, and even if the global economy avoids recession in 2024-2025, commodities returns are likely to lose their strong early-cycle momentum. Importantly, a global economy gliding toward a soft landing and one that is heading down the road to recession are observationally equivalent until a potential break arrives, making it hard to make an overarching bullish or bearish macro call on commodities.

Similarly, commodities are unlikely to benefit from inflation next year. Global core inflation is down from 5.9% in 2022 to 4.1% in 2023 and more disinflation is in store next year. Although the normalization in goods and labor markets is now well-advanced, its full disinflationary effect is still playing out, and core inflation should fall further to 2.9% in 2024.

Figure 56: Average monthly returns for the BCOM ER Index and its subindices by US CPI environment (above/below 2% vs rising/falling MoM)

Monthly data since Jan 2000. Bold number = return (MoM), other number = realized volatility



Source: US Bureau of Labor Statistics, Bloomberg Finance L.P., J.P. Morgan Commodities Research.
Note: Rising and Falling refer to the path of US headline CPI, YoY. Flat MoM observations are included in Rising. Above and Below refer to a hypothetical target level of US CPI (2.0% yoy). Monthly observations at 2.0% are included in Above. Number of observations by regime: 104 for Above and Rising, 71 for Above and Falling, 57 for Below and Rising and 54 for Below and Falling.

Without one of these strong cross-complex drivers emerging from growth or inflation, investors need to continue to be tactical in commodities in 2024.

1. **We continue to hold a structural bullish view on gold and silver**. Ultimately, a Fed cutting cycle over 2H24 and 1H25 is expected to trigger a breakout rally around mid-year and push gold prices to new nominal highs with a targeted peak of $2,300/oz in 2025 while silver pushes above $30/oz. Importantly, we expect a re-strengthening in gold's inverse relationship to real yields will likely unlock a bit of bullish upside convexity in prices as real yields fall, amplified by investor inflows. This breakout higher in prices over 2H24 is expected to eventually more than offset high carry costs in precious, driving a double digit rally over 2H24 and a 6% forecasted return for the BCOM Precious Metals ER index through year-end 2024 from current levels.
2. **We remain tactically constructive on energy**, and believe that unlike this year, when energy returns were weighed down by a 40% drop in US natural gas prices, performance in 2024 will be driven by a reversal in natural gas losses but also by oil, where solid demand growth should push prices higher off current spot levels, with carry adding further to returns. We see Brent oil trading in a $80-90 range in 2024, with prices peaking in late 3Q24, $10 above today's spot price and the forward curve.
3. **Unlike last year, NYMEX natural gas prices are forecasted to increase by 44% by YE 2024 from current spot price**, with an increase in LNG exports marking the start of a more bullish narrative for the US natural gas market. However, with weather still dictating price formation for 2024 and LNG feedgas demand ramping higher more significantly in 3Q24, we expect this more bullish narrative to manifest only during 2H24. We emphasize that this bullish narrative is derived by regional dislocations, particularly the Southeast region. A combination of a slowdown in drilling and completion activity in the Haynesville with increased Gulf Coast demand from these export facilities will allow for the Southeast US natural gas balance to tighten significantly, lending support to Henry Hub price. Negative roll yield of this contango market will likely hamper any returns from natural gas in the BCOM Energy ER until 4Q24 when we expect US natural gas price to provide an uplift to the index of ~3% qoq.
4. **Looking into 2024, agri commodity price risk is skewed to the upside off current spot levels, particularly through 1H24**. In agriculture, sugar and wheat remain standout markets, where we have a prominent bullish risk bias and constructive price forecast. Soybeans and corn should be monitored closely amid threatening weather across Brazil which may yet constrain soybean yields and delay safrina corn plantings, in addition to existing disruptions to logistics and exports.

Table: JPM Base Case Commodities Index Forecasts

End of Period Index Levels

	Current							Return (vs current level)				
	Nov 27	3Q23A	4Q23	1Q24	2Q24	3Q24	4Q24	4Q23	1Q24	2Q24	3Q24	4Q24
Major Indices												
BCOM ER	101	105	103	102	102	107	108	2%	1%	1%	6%	7%
S&P GSCI ER	292	323	312	298	302	326	325	7%	2%	3%	11%	11%
BCOM ER Sub-indices												
BCOM Energy	33	38	35	32	33	36	36	5%	-2%	-1%	8%	10%
BCOM Industrial Metals	138	144	138	135	128	133	141	0%	-2%	-7%	-3%	2%
BCOM Precious Metals	222	205	211	211	213	228	237	-5%	-5%	-4%	2%	6%
BCOM Agriculture and Livestock	97	98	102	103	105	105	102	5%	6%	8%	8%	5%
GSCI ER Sub-indices												
GSCI Energy	144	166	157	145	147	166	164	9%	1%	2%	15%	14%
GSCI Industrial Metals	199	207	199	195	185	192	203	0%	-2%	-7%	-3%	2%
GSCI Precious Metals	226	209	216	215	216	229	236	-4%	-5%	-4%	1%	4%
GSCI Agriculture and Livestock	76	80	80	81	84	84	82	5%	7%	10%	10%	8%

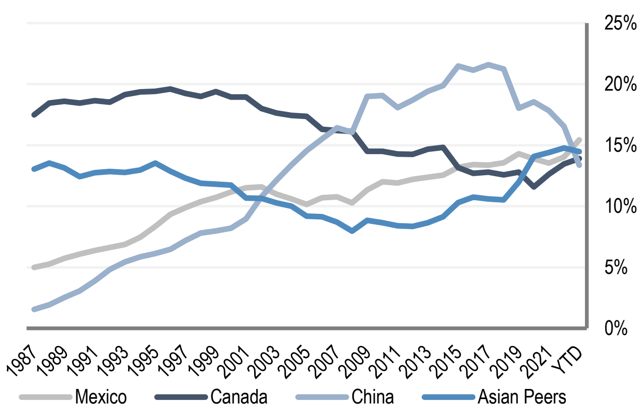
Source: J.P. Morgan. As of close on 27-Nov-2023

Thematic Research

Deciphering the 3 De's: De-global, de-dollar, de-carbon

De-globalization **remains a very gradual process, but geo-fragmentation is evident as the US-led, rule-based order continues to fray into a less cooperative and more competitive multipolarity.** Combined goods and services global trade flows have not declined as a share of the global economy, but trading patterns are shifting with new corridors emerging. Multinational companies are recalibrating their risk assessments to address national security issues related to their supply chains. The US and China are directing trade away from each other with both increasing their share of trade to emerging markets. Mexico's share of US imports is now close to converging with China, although Europe's reliance on China has increased. China is experiencing capital outflows with foreign net selling of Chinese bonds and equities by $124bn and $100bn, respectively, in the first half of 2023. BoP FDI turned negative in 3Q23, the first net outflow in the past 26 years. Industrial policy is globally resurgent, mostly taking the form of subsidies and state loans. The ongoing separation of the world economy into blocs amid geopolitical tensions could intensify—with more restrictions on trade (in particular, trade in strategic goods such as critical minerals and semiconductors) and on cross-border movements of capital and technology. WTO research shows that trade fragmentation could result in long-term losses of up to 5% of global GDP, with significantly higher losses for emerging markets.

Figure 57: Mexico and China share of US imports have converged



Source: U.S. Census and J.P. Morgan

De-dollarization **remains a long-run tail risk but higher use of RMB among BRICs is a clear trend.** Russia's war on Ukraine has permanently reshaped global commodity markets and Russia appears to be pursuing a three-pronged strategy where it is looking to build new trade routes that bypass waters controlled by the West, to de-dollarize its energy exports and to open new markets away from China. Settlement of trade in non-USD dollars, particularly for commodities, is on the rise and now accounts for ~20% of all commodity transactions. EM countries are also buying more gold. We point out that settlement in CNY is not a leading indicator to use CNY as a store of value or to accumulate CNY in FX reserves. CNY settlement is an attempt to secure settlement of payments for countries facing sanctions and unable to transact in US dollars.

Since its launch nearly 8 years ago, the world is not on track to meet the long-term *de-carbonization* goals of the Paris Agreement even though it has been signed by 195 countries.[1] Although progress has been made on scaling low carbon energy projects and technology, demand for fossil fuel has not yet peaked and the relatively high cost of clean energy remains a barrier to adaptation. The IEA estimates it will require $5trn/year in climate investment across the world to get to Net Zero by 2050 of which about $2trn will need to go to emerging markets by 2030, an increase from the current $400bn of climate investments planned over the next seven years.

Market Implications

Over the long term, geo-fragmentation suggests being OW countries with large domestic markets and UW multinational companies that are most reliant on trade. The rise of industrial policy is most likely to benefit returns in the US and EU. Since actual damage from climate change is spread over a century, we look to long-term investment strategies based on actions, regulations, taxes and subsidies. The sectors most at risk of the negative impacts of climate change, as defined by adaptation finance needs, are notably different to those with the highest GHG emissions (see related ESG note here). Real estate, Utilities, Oil, Mining, Autos and P&C insurers are most vulnerable. EM has fewer resources and less stable politics to defend against climate change.

We target EM exposure more selectively, holding EM equities ex China, EM USD credit (corporate and sovereign) and EM local bonds unhedged. China's financial markets are undergoing a structural re-rating and have underperformed due to a confluence of domestic and global factors that accelerated after the onset of Russia's war on Ukraine in March 2022. Geopolitical risks will persist, in our view.

1. https://unfccc.int/topics/global-stocktake

Will the 2024 election cycle be a game-changer?

2024 brings a record number of elections across DM and EM countries, with voters in 77 countries, comprising about half of the world population and nearly 60% of world GDP, going to the polls. Looking at history, elections have usually had little impact on underlying macro trends. Markets have typically been volatile in the run-up to an election, only to rally thereafter once the uncertainty is removed. There are reasons to believe that the 2024 cycle might be different with two wars raging at the same time that geo-fragmentation is taking hold with mounting concerns that the world economy is separating into blocs. As multilateral cooperation has become more contentious, there has been a resurgence of industrial policy and formation of commercial alliances based on political circles of trust.

Elections will take place in seven of the ten most populous countries in the world—Bangladesh, India, Indonesia, Mexico, Pakistan, Russia and the US—but the US elections are arguably the race with the largest global consequences. While it is too early to contemplate outcomes for the US elections a year out, if the current polling persists, it is worthwhile to examine Trump's policy record and the spectrum of possible economic implications. Decisions taken by the Trump administration included withdrawal from a number of multilateral agreements, including the Paris Agreement, the imposition of trade tariffs on China, the loosening of environmental regulations, immigration restrictions and the biggest corporate tax cuts on record. Beyond the geopolitical risks, there are also concerns that the upcoming election cycle could lead to less fiscal discipline in both developed and emerging markets, with debt sustainability remaining a source of market volatility in the high for long world.

The decline in democracy and global freedom has been a trend for 17 consecutive years, according to Freedom House, and remains a concern in the upcoming cycle. According to a recent study released by the Public Religion Research Institute (PRRI) in partnership with the Brookings Institution, 75% of Americans surveyed view the "future of American democracy as at risk in the 2024 presidential election." Regime change is clearly unlikely in the authoritarian regime in Russia although a political agreement between representatives of Venezuela's opposition and President Maduro could pave the way for Venezuela's presidential elections to take place in 2H24.

The prolific use of AI and lack of safeguards in generating deepfake images and spreading misinformation is also raising red flags on democratic governance. The recent election in Argentina had become a testing ground for AI in campaigns, giving a preview of what is to come in 2024. According to Freedom House, at least 47 governments deployed commentators to manipulate online discussions in their favor over the last year, while at least 16 countries used AI to sow doubt, smear opponents, or influence public debate. Authoritarian governments have also used AI to enhance and refine online censorship as legal frameworks in at least 22 countries mandate or incentivize digital platforms to deploy machine learning to remove disfavored political, social, and religious speech.

Market Implications

If current polling for US elections persists, USD risks are skewed to the upside as the market processes the possibility of new tariffs. The potential for changes in green energy spending programs as well as critical mineral supply incentives (IRA) could have the most direct impact on metals if the longer-term US supply and demand outlook across base and precious (palladium) metals is altered.

Table 22: 2024 global election and political calendar

Region	Country	Type	Date
US & Canada	United States	General	5-Nov
	Canada[1]	General	2024/2025**
Asia Pacific	Taiwan	General	13-Jan
	Pakistan	General	8-Feb
	Indonesia	General	14-Feb
	India	General	Apr**
	Mongolia	Legislative	Jun**
	South Korea	Legislative	10-Apr
	Sri Lanka	General	Sep**
	Australia	General	Earliest 3-Aug, latest 17-May-25**
Europe	Russia	Presidential	Mar**
	European Union[2]	European Parliament elections	6-9 Jun
	Romania	General	Oct-Dec**
	Uzbekistan	Legislative	31-Dec
	United Kingdom[3]	Parliamentary	Late 2024
LatAm	El Salvador	General	4-Feb
	Panama	General	5-May
	Dominican Republic	General	19-May
	Mexico	General	2-Jun
	Uruguay	General	27-Oct
		Presidential 2nd round	24-Nov
	Venezuela	Presidential	Dec**
Middle East & Africa	Senegal	Presidential	25-Feb
	Mozambique	General	9-Oct
	Egypt	Presidential	10-12 Dec
	Ghana	General	7-Dec
	South Africa	General	May**
	Tunisia	Presidential	2024**

Source: J.P. Morgan Strategic Research

Note: Ukraine presidential elections have been excluded as elections are suspended during wartime. *Date to be confirmed. 1. Media reports see an increasing possibility that elections could be called in 2024. 2. Elections for European Parliament will occur across all 27 member states. 3. Must be held no later than January 24, 2025, and thus likely to happen in 2024. Source: NDI, IFES, various media sources.

Geopolitical Shifts

Click here for the full report.

Most of the year, we have held a negative outlook for risk markets (our year end price target for the S&P 500 is 4200), and over the course of the year we have increased our model portfolio's allocation to cash. The market is currently about ~5% above our price target, which is roughly equal to current cash yields. There were two main reasons why we took a negative stance: 1) the unprecedented rise in interest rates (relative to the current levels of debt outstanding), which are slowly eroding economies and setting the stage for a market de-risking, and 2) geopolitical deterioration that has significantly increased tail risks for economies and global markets.

Following the regional banking crisis earlier this year, markets took an optimistic view: soft landing became a consensus, European stocks rallied at the back of China reopening (e.g. luxury goods, travel, etc.), and Japan stocks rallied as many institutions reduced exposure to China and moved money into Japan as a proxy. The US equity market rallied as investors extrapolated that AI will transform and boost the economy and corporate profitability in a short period of time; however, we see this as unrealistic. US tech stocks, particularly the largest ones, drove the market higher, as the NDX rallied ~50%. This rally was mostly a multiple expansion on the AI narrative, while in some cases revenue of key tech stocks declined, and overall corporate profits declined 6.5% YoY (as of June 30th). Furthermore, any theoretical market model (risk premia) would have expected multiples to decline given the increase of interest rates. Perhaps more significant than these narratives, systematic inflows into stocks were driven by a decline in market volatility, as both fundamental and quantitative investors re-levered from relatively low positioning at the end of last year.

The question now is where we do stand and should we analyze things differently seeing that the market was more 'resilient' than macro fundamentals warranted. As both premises for our cautious outlook (rates and geopolitics) turned more negative over the past few months, while positioning and valuations increased, we think there is now a higher likelihood of a crisis over the next 6 to 12 months, the severity of which could be higher than market participants anticipate. Risks of an interest rate shock and monetary tightening are clear: consumer credit (auto loans, credit cards, student loans, etc.), real estate globally (commercial and residential in both DM and EM), funding of startups and small businesses, increase of market volatility that comes with tighter monetary policy, and, eventually, impact on employment (construction, small businesses, etc.).

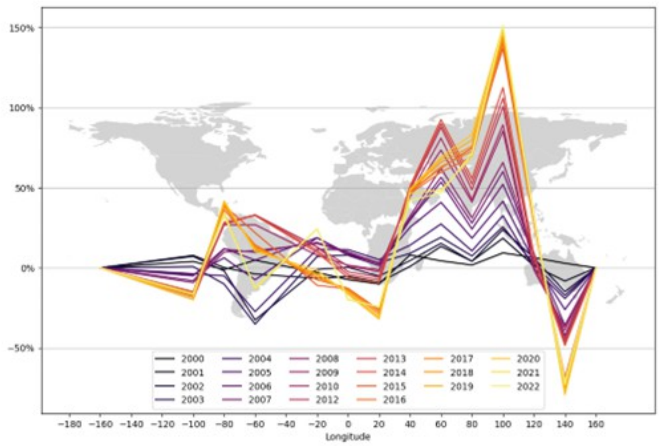
However, what is less clear are the risks and opportunities coming from significant shifts in the geopolitical landscape that we referred to in our previous notes. For this reason, in this note we will elaborate on these geopolitical shifts, as well as the risks and opportunities arising from them (we plan to address AI developments, positioning, and outline of a potential global market crisis separately). The pace of recent geopolitical developments hasn't been seen since the fall of communism and include: a major war with Russia, emergence of BRICS as a major political and economic bloc, major political and economic changes in the Middle East, cracks in global trade and energy security, and increased political and ideological divisions in the West. Before we elaborate on various geopolitical developments and risks, let's state what would make us reassess our view and turn more positive: again it is rates and geopolitics. We would turn more positive if interest rates start being reduced globally in the near future, and if we see de-escalation of the war with Russia, and easing of tensions and economic rapprochement with China. Our negative market view is based on seeing a low chance of either of these scenarios materializing near term – in short, we think that developments may first need to get worse before they get better.

Emergence of a multipolar world

After the fall of the Soviet bloc in ~1990, the world became unipolar. The fall of communism and transition to a unipolar world were facilitated by a number of factors, including the decline in oil prices (as a main source of revenues for the USSR), economic failings of big socialist governments, and other reasons. With the rapid global economic and military rise of China, some recovery of Russia's global reach, and increased economic importance and political independence of countries like India, Saudi Arabia, Brazil and others, the unipolar world is increasingly coming under pressure and possibly coming to an end.

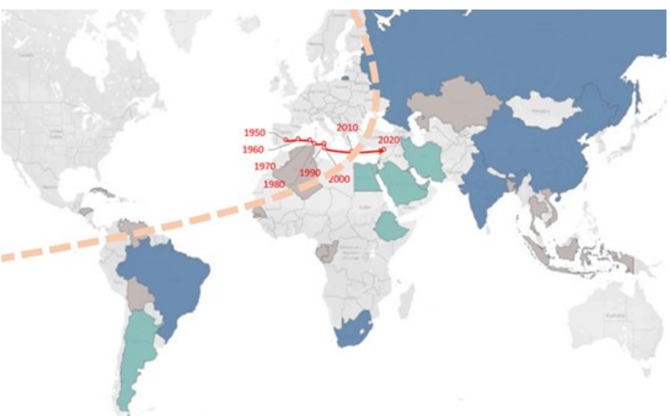
The relative economic rise of the East and South is illustrated in Figure 58, which shows the change in share of global GDP by geographic longitude over the past two decades. The share of global GDP in Western Europe and Japan declined and the US stagnated, while China, South Asia and the Middle East increased their global economic importance. From the former communist bloc and Non-Aligned movement, new alliances are growing, most prominently the BRICS initiative (Figure 59). Most recently, six new members were added to the group (two of which are also G20 members). BRICS now represent ~36% of global GDP (PPP), ~46% of the population, and ~36% of the land mass (as a proxy for the commodity resources), and combined are larger than the G7 (at PPP).

Figure 58: Cumulative change in share of global GDP by geographic longitude



Source: J.P. Morgan.

Figure 59: Economic 'center of gravity' (red), and BRICS members (blue = original members, green = new members, dark gray = applicants)



Source: J.P. Morgan.

The economic 'center of gravity', a measure of economic balance between West and East, is moving to the east and south (for instance, by 2030, one would expect that the 'center of economic gravity' will fall somewhere in the Middle East). While these developments have lifted billions of people out of poverty, and resulted in some new peace initiatives (e.g. recent developments with Yemen, Iran and Syria), in other parts of the world tensions are rising. The most significant of these are the risk of a global escalation of the war in eastern Europe, as well as rising tensions in the South and East China Seas. In our view, this geopolitical risk is essentially one of a Thucydides Trap. What are the developments and investment implications of these shifts in geopolitical balance? Some of these developments are region-specific and some are global:

Middle East: Over the past months, significant geopolitical shifts are happening in this region. Perhaps underappreciated in the news cycle are peace initiatives in Yemen, dialogue between Saudi Arabia, Iran and Qatar, signs of normalization with Syria, and initiatives to help solve conflict in Europe. Many of these are a result of leadership by Saudi Arabia – a country that is experiencing rapid economic growth and modernization. A significant and growing role is played by China, as a moderator and an economic and political partner to countries in the region. From a geopolitical angle, the Middle East is becoming a bridge between the East and West, as a region that has independent and balanced foreign policy with their allies in both hemispheres. In fact, the Middle East and countries like Saudi Arabia may, in these new developments, acquire a status analogous to Switzerland in 20th century Europe: not aligned with any one bloc or warring party, and facilitating trade and dialogue with all.

Rebalancing in the Middle East comes as a natural result of two decades of largely unsuccessful Western involvements (for instance, in Iraq, Libya, Afghanistan, Syria), the economic rise of China, the West's stance towards the energy industry, and other ideological divergences. Longer term, geopolitical leverage of the Middle East will likely increase given its natural resources, economic growth, and the strategic location between East and West and their respective interests in the region (e.g. energy security, security of some key US allies in the region, etc.). The current economic boom, and our view that commodity prices will increase and stay elevated for the foreseeable future, should bode well for investments in the region.

Europe: Recent geopolitical developments could have a particularly negative long-term impact on Europe. While the US is largely self-sufficient in terms of energy, food, and demand for goods and services, Europe has a meaningful dependency to the global East and South for imports of raw materials (energy, metals, soft commodities, etc.) and exports of finished goods (e.g. luxury goods, autos, etc.) and services (e.g. tourism).

With the increasingly firm resolve of the European Commission to confront Russia (and perhaps even China), Europe is upping geopolitical risk factors for its economy. This increased risk exposure and economic impact can be contrasted to the somewhat puzzling reaction of European financial markets, which are near their highs, despite key economies weakening (e.g. recession in Germany, Netherlands), interest rate increases driven by inflation, and the energy crisis that will likely have a negative economic impact this winter again. Potential setbacks in the conflict with Russia and transition to a multipolar world likely would exert further political and economic pressures within Europe. One should keep in mind that with the fall of the Soviet bloc and transition to a unipolar world, some 25 new countries (as political entities) emerged. It should not be inconceivable that a partial reversion to a multipolar world could similarly lead to a reshaping of geopolitical arrangements.

Far East: Tensions between the US and China in the East and South China Seas are perhaps the biggest source of risk for the global economy and markets. The reliance of US and European companies for revenues (and revenue growth), as well as dependence of the same companies on the supply chains and production in China, are such that the economic and market fallout of a potential conflict likely would be dire. It is hard to imagine that both sides are not aware of this, and the question is which side has more determination and appetite for hardship in order to achieve national or geopolitical goals.Decoupling, as an alternative to cooperation or conflict, would likely lead to a prolonged period of global inflation and depressed growth, equally risky given the stock and flows of global debt. After the start of the war in Eastern Europe last year, an increasing number of Western institutions decided to reduce exposure to China equities for geopolitical (rather than company fundamental) reasons. Instead of China assets, these funds ended up flowing in 'China proxy' trades, i.e. markets outside of China that would benefit from China's reopening and growth – the two most popular being European and Japanese stocks this year. In the context of geopolitical favoritism in investing, India was also touted as a geopolitical beneficiary or a substitute to Chinese assets. This has revived new interest from Western institutions, and resulted in high valuations and a bubble of speculative trading. For instance, few appear to be aware that India index options are now the most actively traded derivatives market in the world (with higher volumes than the S&P 500 – see here).

Should tensions with China escalate, apart from the obvious risk to Chinese stocks or MSCI Taiwan index, the highest risk likely would be for large cap US stocks, many of which derive significant revenues or supply chains from China. Europe and Japan would also be likely to experience significant outflows due to revenue exposure and recent speculative inflows. On the flip side, should the tensions ease, we believe the biggest beneficiary probably would be China equities, which are currently trading at very attractive valuations.

Global market risks

In the context of recent geopolitical shifts, there has been a lot of talk about de-dollarization of the global economy. We believe that in the next crisis, USD will most likely strengthen, and the potential decline in global use of USD will be a more gradual and complex process in which geopolitics will indeed play a big role. A likely goal of competitors and adversaries of the US is to remove its so-called 'exorbitant privilege' – the benefits the United States has due to its own currency being the international reserve currency. For emerging powers, that is essentially a risk of their trade surplus and reserves invested in US assets being used against them or even possibly seized in an extreme scenario.

De-dollarization risk is not that all of a sudden emerging powers stop using USD or even replace it with some new, perhaps commodity-based joint currency. Rather, de-dollarization risk for Western economies mostly relates to inflation and their debt burden. Historically, imported deflation via trade with the global South and East, outsourcing less profitable segments of economy, recycling of trade surpluses into USD assets, and domestic energy independence (US shale growth), were key ingredients to the USD supremacy. Imported deflation and debt demand has allowed Western central banks to successfully navigate every recent economic crisis with a combination of monetary and fiscal measures. In a world of economic de-coupling or outright conflict and more expensive energy, all of these should be at risk, and could trigger inflation and a debt spiral for Western economies. The recent US debt downgrade is a reminder that, albeit low, there is a risk of such a scenario. This risk is magnified by environmental 'arbitrage', where carbon intensive industries such as manufacturing, commodity production, etc., were outsourced to the East, leaving the West industrially fragile and susceptible to inflation shocks. Some of this manifested the past year, e.g. with an inability to produce enough natural gas, cheap food, or artillery shells.

What is the course of action?

There are a number of strategies and measures that current and emerging powers employ. These range from diplomatic, economic/market, industrial, and value/propaganda, to military measures. To forecast potential outcomes, risks and opportunities, one can assess the prospects of these measures.

On a diplomatic front, various initiatives such as the Quad, AUKUS, Indo-Pacific, 2U2I, and others have in common some form of wedging into OPEC+, BRICS, BRI/OBOR, and influencing trade with or between the Middle East, India, Russia and China. Eastern initiatives likely have a goal of removing 'exorbitant privilege' while maintaining a growth advantage. As most diplomatic alliances are based on interest, and geopolitical parties are increasingly more pragmatic, these measures are unlikely to yield quick or predictable results. For instance, despite all the attention, India maintained their energy trade with Russia, economic ties between the Middle East and China are only growing, and despite attempts to move away from USD, it is still the main global reserve currency now and for the foreseeable future.

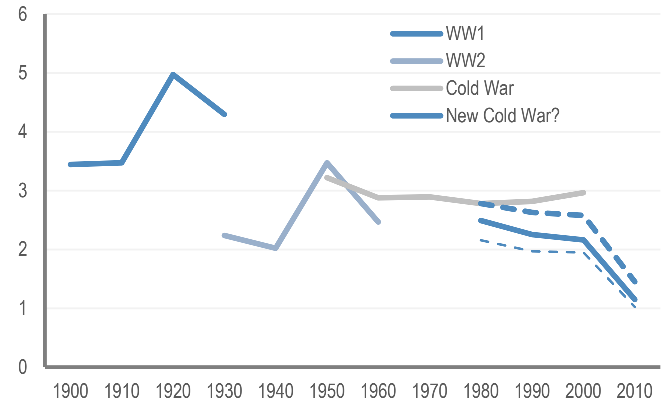
Economic/market measures include trade tariffs, trade restrictions, investment restrictions, divesting, stock de-listing, supply chain decoupling/onshoring, etc.; the commonality of these measures is that they hurt trade, economies and financial markets on both sides (e.g. energy markets, corporate profit margins, inflation, etc.). In totality, Western democracies and political order are likely more exposed to an economic downturn and asset valuations, so these measures are unlikely to be successful either (e.g. historically, US trade policy towards China was more aggressive in up markets and more conciliatory in down markets).

Industrial initiatives include energy transition. One geopolitical aspect of Net Zero policy is the elimination of demand for fossil fuels, which would eliminate a significant part of revenues for Russia and long-term set back its economy (similar to the fall of the Soviet Union that was facilitated by a decline in oil prices in 1980). At the same time, a transition to renewable energy would help reinvent and reinvigorate the Western industrial base. However, this had unintended consequences as it increased the long run price of energy (giving geopolitical leverage to Russia and other commodity rich countries), alienated traditional US allies in the Middle East, and alienated energy-poor third world countries. At the same time, these industrial initiatives boosted the economy of China, who is becoming a leading producer of EVs and solar panels, etc., given its industrial efficiencies and energy pragmatism.

During the fall of the Soviet Union, the US was projecting soft power and had a great influence via values that were broadly embraced by the population of the communist bloc (e.g. free speech, anti-socialism, small governments, support for religion, etc.). This has changed over the past decade, and current Western values are often perceived as too progressive and out of synch with the values of more conservative/religious populations of the global South/East. Finally, there is a military aspect of this global conflict – an ongoing war in eastern Europe of a scale not seen since WW2, and constant tensions in the East and South China Seas. Both of these pose a risk of intended or unintended escalation, with potentially dire consequences for the world.

What are the prospects of a potential escalation? For a historical context, in Figure 60 we show the ratio of PPP GDP of both sides in major wars in the last century: Entente vs Central powers in WW1, Allies and Axis powers in WW2, NATO vs Warsaw Pact in the Cold War, and compare it to the ratio of PPP GDP of China vs US (along with their respective potential and likely allies). With GDP ratios above 3 for WW1, above 2 for WW2 and about 3 in the Cold War, it is clear why the Allies were almost certain to win. In a hypothetical new conflict between East and West, this ratio is well below 2 and likely on its way to 1 (one should additionally note the proximity of disputed territories to Russia and China).

Figure 60: Ratio of PPP GDP of both sides in major wars in the last century vs. current West/East ratio



Source: J.P. Morgan, World Bank, UN data.

Is there a better course than confrontation and what is a likely endpoint of this tense global competition and conflict? It is probably one of more dialogue, cooperation, acknowledgement of differences (culture, histories, and development needs), and acknowledging of new economic and geopolitical realities. Certainly there are some points where West and East can agree and work together (e.g. nuclear non-proliferation, global health, mutually beneficial trade, etc.), and on the points of disagreement compromise or go their own paths. The current state seems to be one of insufficient dialogue, and escalation. One should also note that there is little consensus in the West of what the right policy should be towards Russia and China. For instance, views of some US candidates (e.g. Ramaswamy, Trump) or European countries (e.g. Hungary) are different from the current consensus in the West – indicative of uncertainties in the year ahead. Global investors should agnostically assess all possible outcomes, including one that we think is more likely – that things may become worse before getting better.

ESG

Click here for the full outlook and referenced baskets.

After a difficult 2022 that saw Sustainable AuM decline by 14%, 2023 has seen global ESG AuMs grow by 6% to $2.7tn in the first three quarters of the year, driven by inflows of 3%, according to Morningstar data. Global quarterly flows have so far been positive, driven by Europe, although October has seen outflows across both equities and fixed income. Furthermore, after peaking in Q1 at 6.3%, the market share of Sustainable AuM has been declining, led by Asia and the US.

Performance has been challenging, with sustainable funds having underperformed the broad fund universe by 1.5% in the first three quarters of the year. This has been driven by equity funds, where sustainable funds underperformed the broad fund universe across all main regions (US, Europe and APAC).

Our quantitative analysis however indicates that **2024 could present a highly favorable backdrop for ESG assets in general, as the defensive profiles of these strategies are well equipped to navigate the challenging environment that is likely to manifest over the coming months.**

As we look ahead, we believe ESGQ, JPM's proprietary ESG stock selection metric, is likely to perform much better than the overall equity market and typical investment strategies. Our backtesting shows that ESGQ has several defensively geared aspects: it performs well during the Contraction phase of the cycle, it favors falling yields, rising dollar, falling inflation, falling equity markets, a rising VIX and a bull steepening yield curve. Our Strategy and Economics colleagues see many of these conditions playing out over the next few months. The Treasury yield projections of the US rates strategy team imply a bull steepening of 50bps. Further, the FX strategy team projects the DXY to rally into 1H, before moderating in H2. Finally, our US Economics team expects moderation in both GDP and PCE inflation. These forecasts altogether suggest a slowdown in economic growth and are consistent with JP Morgan's Quantitative Macro Index, which is currently positioned in the Contraction phase of the cycle.

Sustainable themes for the year ahead

The past eight years have been the hottest on record globally, each posting temperatures at least 1°C above pre-industrial levels. In June 2023 global-mean temperature breached the 1.5°C threshold of the Paris Agreement for the first time, highlighting the urgency of not just mitigating GHG emissions but also the importance of learning to live and adapt to a warmer planet. Adaptation strategies can help avoid future losses and deliver positive economic returns, as well as social and environmental benefits. Adaptation solutions span multiple sectors: infrastructure, insurance, staples, utilities, technology, etc and thus can provide a source of diversification away from the focus of traditional climate finance. Furthermore, clarity provided by taxonomies and regulation, together with increased focus at COP, will accelerate investment into adaptation, in our view. Our basket JPADAPT (link) includes OW-rated companies aligned to adaptation solutions with on average 19% upside to analysts' target price.

We expect investing in biodiversity will come of age over the next few years (link). We believe COP 15 will end up representing for biodiversity what the Paris Agreement was to climate change from an investor focus and flows perspective. Second, biodiversity matters for long-term returns, with some models estimating that over half of the world's GDP depends on nature, and that partial biodiversity collapse could trim global growth by 2.3% p.a. by 2030. Third, universal owners care, as shown by the number of investor initiatives supporting the integration of natural capital into investment decisions. Fourth, new regulations with real impact on the bottom line, such as the EU deforestation directive, are emerging. Finally, new disclosure requirements such as the EU CSRD, alongside increased adoption of TNFD will improve the quality of data substantially, addressing possibly the biggest hurdle for investors to engage more deeply in biodiversity. Our basket JPBIODIV (19% upside) is composed of OW-rated companies resulting from screening our analyst coverage universe across fifteen different themes that address the five main sources of biodiversity loss: changes in land/sea use, overexploitation of natural resources, pollution, invasive species and climate change.

Climate remains top of mind in Europe (link). We have built three baskets that reflect the most pressing concerns in the region: JPSCOP12 gathers stocks which are reducing their scope 1+2 emissions at an accelerated pace, JPEUTRNS is made of stocks from high impact sectors with Paris-aligned targets or high green capex / revenue ratio and JPSCOPE3 is comprised of leaders in their management of their scope 3 emissions. These baskets offer 28%, 22% and 33% upside, respectively, to our analysts' published price targets.

In Japan we expect improvements in governance to continue to support equity performance (link). Our basket JPGOVWIN offers exposure to our Japan analysts' top governance picks, with 28% upside to their TPs. We have also gathered the stocks where our Japan analysts see the largest potential for improvement in governance in the JPGOVIMP basket, with 26% upside to analysts' published target prices.

Our Asia renewables team expect China ESS demand to grow at >40% CAGR over 2022-30 driven by policy push and improving economics, underpinned by the power market reform (link). Feedback from power operators points to an inflection in ESS demand growth in 2023/24, as local governments are pushing for 10-20% ESS attachment with an average duration of ~2 hours, resulting in strong ESS growth (150%-250% yoy) in FY23. Based on our forecast, ESS attachment rate on the power generator side will rise from 3% in 2021 to 28% in 2030E. We expect power market reform and some other economic incentives will boost ESS demand on the grid company side and on the user side, while this demand may start to make meaningful contribution beginning 2023. Accelerating demand growth in China in 2023/24 should benefit Chinese ESS equipment makers. Our basket JPESTORE includes OW-rated ESS related names under JPM coverage in Asia, with average upside of 57%.

Policy and regulatory developments

In the EU we expect a 'regulatory sprint' in H1, as policymakers attempt to finalize as many policies as possible ahead of the EU Parliamentary elections. After the successful implementation of the 'Fit for 55' package to reduce GHG emissions, the EU's focus will likely partly switch from creating new sustainability norms to implementing existing ones. Also, recent polls showing a substantial decline in Green party support hint at a potential slowdown of the sustainability agenda under the next Parliament. Several sustainability policies adopted under the EU's current legislature will start applying over the next three years, with the reform of the EU ETS and the regulation on alternative fuels infrastructure most immediate, followed by the deforestation regulation, CSRD, and regulations on e-fuels at the end of 2024/early 2025.

US elections will be a binary event for global climate policy. Even though 2023 saw some progress on regulatory disclosures with an ambitious bill being passed in California, agreeing the appropriate focus on ESG continues to polarize, with a flurry of anti-ESG legislation making headlines and the SEC climate disclosure proposal still being delayed. In any case, no event will be more pivotal to US climate policy than the presidential election to be held in November next year, given the opposed views between the Biden administration and most Republican candidates.

EM policymaking remains supportive of sustainable investing. Brazil is seeing a build-up of regulatory activity related to its sustainable taxonomy, the development of carbon markets, sustainability reporting requirements and progress on a disclosure regime for ESG funds. Moving to Asia we expect 2024 to continue to bring tighter ESG fund rules as shown by the examples of South Korea and Australia. Despite delaying ESG disclosure requirements, HK and South Korea remain committed to ISSB. Taxonomies are becoming mainstream with Australia the latest to issue a draft.

Governance improvement in Japan has legs. The triennial revision to the Japanese Corporate Governance Code will be due in 2024. We expect recommendations with respect to gender diversity and disclosure of non-financial information to be added. With TSE asking Prime and Standard Market-listed companies to target a P/B ratio over 1x, we expect companies' medium-term business plans and dialogue with the market in 2024 and beyond to place a greater emphasis on growth, profitability, sustainability, and better governance, and thus continue to support equity performance.

Sustainable fixed income

ESG financing patterns continue to look very different across both sides of the pond: while GSS+ instruments accounted for a quarter of YTD 2023 IG issuance in Europe, the equivalent figure in the US was shy of 3%. We do not see this materially changing going into 2024. Neither do we anticipate significant growth for ESG securitized products in 2024, with investors still preoccupied with inflation and recession. On the more positive side we do see MBS and ABS issuers continuing to take steps towards ESG programs and in sovereign GSS+ we are seeing renewed issuance momentum, particularly in Sustainability bonds. According to analysis by the Climate Bond Initiative in H1 2023 green bonds achieved on average higher book cover and spread compression than their vanilla equivalents at the moment of issuance.

Led by investors, the ASCOR (Assessing Sovereign Climate-related Opportunities and Risks) Project aims to create a common understanding of sovereign exposure to climate risk and how governments plan to transition to a low-carbon economy. A key deliverable for the project is to publish climate assessments of 25 countries against the framework by the end of 2023.

The quarterly ESG Index Forums introduced in 2023 have paved the way for key enhancements such as more robust data inputs and new score thresholds to reduce turnover. We expect this iterative feedback process with our clients to inform the continuous improvement of our JESG index suite, with the Q4 set of meetings focusing on corporate and sovereign climate benchmark methodologies.

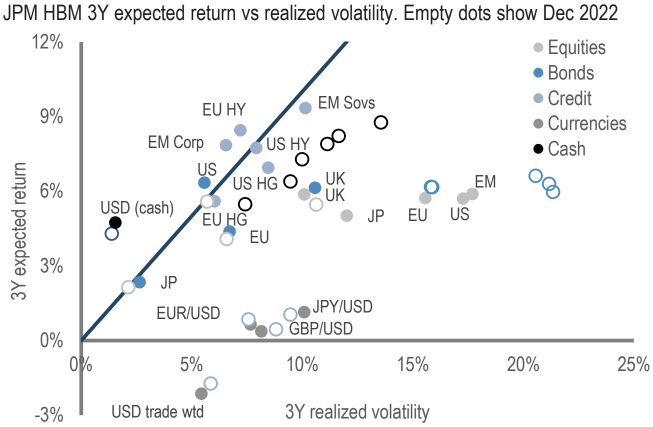
Longer Term Views

Click here for the full report.

Our Hierarchical Bayesian Modeling (HBM) framework for 3Y to 5Y expected returns is fully systematic and captures the message that valuations, positioning and the cycle have for expected returns. **JPM HBM suggests headwinds for Equities, attractive returns for Bonds/Credit and a challenged USD**. Equities' total returns are forecasted to be around 5%-6% so below their long-term averages (9%-10%). Returns for Fixed Income are close to their long-term average and sit above the starting yield for Bonds and HG Credit. Regionally, USTs and UKTs should do best over the next 3Y-5Y period with returns in excess of 6%. For Credit, returns range from 5.5% to 9.5%, making it the asset class with the highest expected returns. In this update, we also added EUR/USD, GBP/USD and JPY/USD to HBM. While the expected returns for the USD trade wtd are negative over a 3Y-5Y horizon, the EUR, GBP and JPY are all expected to appreciate vs the USD with the JPY seeming to offer the largest upside. Relative to Dec 2023, expected returns for Equities have compressed by 0.6%-0.7%, while expected returns for Bonds/Credit have increased by 0.3%-0.4%. Hence, the return to risk profile of Fixed Income markets has turned even more attractive compared to Equities (Figure 61). Putting everything together, **our benchmark multi-asset portfolio expected to return 5.8% ar over the next 3Y years**, a slight drop from the 6% figure from Dec 2022.

Figure 61: The return to risk profile of Fixed Income markets has turned even more attractive in 2023

JPM HBM 3Y expected return vs realized volatility. Empty dots show Dec 2022

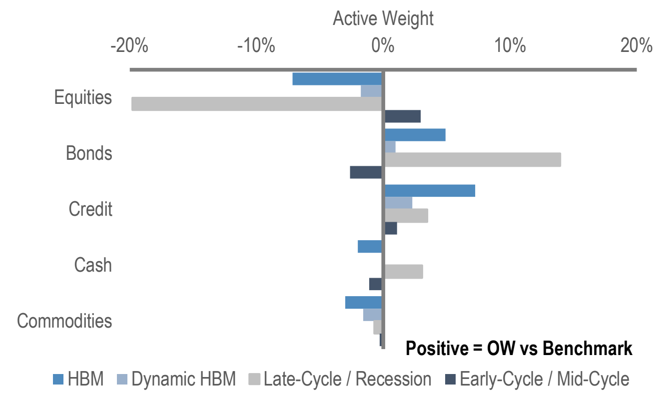


Source: J.P. Morgan

Our multi-asset portfolios give clear messages to the asset allocator (Figure 62). The baseline HBM optimal portfolio is defensive and does not sit too far from what's implied by the Late Cycle/Recession regime case. Relative to the benchmark "Market" Portfolio, it is UW in Equities and OW in Bonds and Credit. Our Dynamic HBM portfolio has a similar allocation but deviations are smaller and there is a small Cash OW.

Figure 62: Our multi-asset portfolios give clear messages to the asset allocator

Active weights for HBM, Dynamic HBM and Early Cycle/ Mid Cycle and Late Cycle/ Recession portoflios. BL used for all cases.



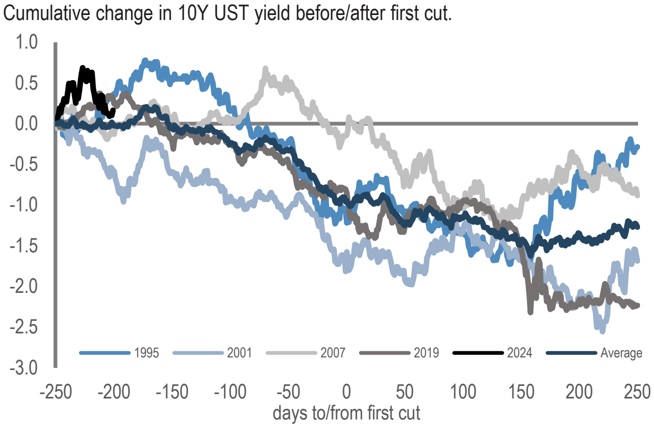
Source: J.P. Morgan

Our tactical house view is a necessary complement to the strategic signals to time the portfolio shifts optimally. Regardless of the numbers produced, no one is recommending static allocations over the prediction interval. Instead, the recommendation is to seek the opportune time to commit to the strategic allocation. To relate this to current market conditions, investors will be overweight cash relative to bonds relative to history, which is not surprising given the massive hiking cycle and still inverted yield curves. Given that yields top-tick near the end of the hiking cycle, we believe we are at the cusp of locking in a peak in yields (Figure 63).

Similarly for Stocks, we have a bearish view but that doesn't mean we are calling for an UW for the entire window. In the coming year, stocks have two scenarios to take them lower. The milder of the two scenarios initially assumes no recession, with moderation in jobs and inflation numbers are interpreted as Goldilocks, albeit with perilously low growth. While proponents of this view will celebrate a faster path to cutting rates, the disinflation that would bring this about will also be bad for the margins of companies. So even with cheery economic growth projections, the current consensus earnings growth projections of ~10% do not seem achievable (Figure 64). What also look stretched, is the market expectations for a higher profit margins in 2024 in a scenario where wage growth should exceed headline CPI and PPI should decline. Our own US economic outlook for 2024 sees growth at 0.5% in 1H24, so the gap between falling economic growth and rising earnings expectations magnifies. The worse of the two scenarios is growth risk, which is where we are headed according to the global growth outlook (60% recession vs 40% goldilocks). While it is difficult to pick one catalyst, the combination of rising interest expenses, rising taxes, worsening pricing power, less capex, dividends and buybacks, worse top-line numbers as economic momentum slows, etc. Regardless which of the two scenarios we get, both involve moving earnings growth downwards and re-rating multiples lower. Once we have lived through this worst-case scenario, our currently bearish tactical and strategic view will reset, and we can happily commit to a strategic long allocation.

Figure 63: We believe we are the cusp of locking in a peak in yields

Cumulative change in 10Y UST yield before/after first cut.

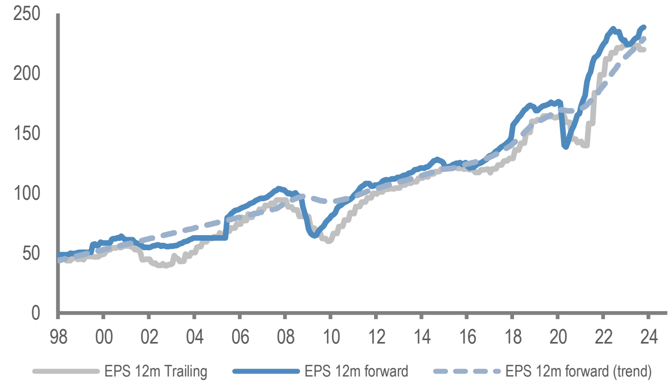


Source: J.P. Morgan

Our assumption continues to be that the past will continue to have lessons for the future, where it is asset class expected returns comparisons, economic regimes, recession probabilities, or diversification benefits. What's the same and what's different? For expected returns, assets should still flow towards higher risk adjusted returns, but relative to earlier end-of-cycle periods, the stock vs bond risk premium, while unattractive enough to UW risk assets, is not as bad as other episodes e.g. the 1st internet bubble. As for economic regimes, we continue to take the view that regimes should guide the tactical asset allocation, but this has been a year when we've jumped between regimes e.g. hard landing, soft landing, no landing, regional banking stress, goldilocks. For recession probabilities, we continue to follow signals with a long and successful track record, such as yield curve steepness and our composite of monetary/liquidity signals, even as many have written them off as past their due date. It is worth noting that despite the monetary policy tightening, many in the US in particular are shielded from the impact, firstly US mortgage borrowers locked in at much lower levels and second, large-cap borrowers with 90% fixed rate borrowing at WAM's out close to a decade. The result is that the transmission mechanism for higher rates is hobbled.

Figure 64: 12m Forward EPS are above trend and 10% above trailing

S&P500 EPS, 12m fwd (actual and trend) vs 12m trailing



Source: J.P. Morgan

As for diversification benefits, this is another area where it is worth questioning the historical data. For ~15 years or so, we lived in the world of TINA, where investors were pushed towards stock allocations at the expense of bonds. Then to pay the price for the QE party, the painful hiking cycle produced a period where cash was the only place to hide, and bonds, rather than being the diversifier for stocks, were themselves the problem as yields had to come up. Despite this quirky ~20y window, we would not throw in the towel on what we think of as the normal stock vs bond relationship. Instead, now that fixed income is now competitive again, we would assume that bonds do have the room to perform their traditional diversification role for stocks, as US 10y bond yields have gone from ~0.5% in the COVID trough to touching 5% in mid-October 2023.

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