

# Mid-Year Outlook 2021

The winding path to a  
post-pandemic world

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# Overview

Like a garden welcoming the warmth of spring, the global healing process is gathering strength. The United States is now progressing through a durable recovery, moving quickly toward a full-fledged expansion. Globally, vaccine rollouts are underway, economic reopening is picking up steam and policy remains supportive.

At the same time, divergences among global economies are becoming evident. Growth momentum and policy support are likely past their peaks in China while approaching a peak in the United States. The eurozone and some emerging markets are further behind still, though will likely catch up as they bring the virus under control.

What does this mean for investors? Despite some heady gains in equity markets over the past year (global equities have delivered a 40% return over the last year), we think a few more quarters of above-trend growth will push risk assets higher. Our optimism reflects a new and generally accommodative framework from the Federal Reserve (Fed), the momentum in important global economic sectors and robust corporate earnings.

**That said, all investors need to grapple with important questions as we consider the outlook for the remainder of the year and into 2022:**

- Are we in for another period of U.S. outperformance, or will the rest of the world catch up?
- With global growth peaking and price pressure rising, is this as good as it gets?
- Can equity markets keep rising, especially with higher taxes on the horizon?



We'll tackle these one by one. But first let's revisit the five big forces we identified at the beginning of the year as key economic and market drivers. The bottom line: While all are progressing largely as expected, the pace of improvement has been stronger than our base case. We also note some important new developments.



### The virus and vaccines

The vaccine rollout has proven more swift and effective than we anticipated, especially in the United States, the United Kingdom and Israel, but some countries are still fighting coronavirus outbreaks and struggling to distribute vaccines. The market will continue to look through COVID-19.



### Policy support

Most central banks and governments are providing sufficient support, but policies are diverging as recoveries progress at different paces. A pivot toward less supportive policy is coming, but the recovery and expansion have sufficient momentum to continue when that happens.



### Inflation

Some prices are surging due to capacity and supply chain constraints in the face of strong demand, but the overall inflation picture still looks relatively benign. Short-term rates should stay low, and the yield curve should steepen.



### Equity markets

Global equity markets are near all-time highs, driven by earnings growth. But worries about inflation and tax policy changes in the United States are starting to permeate. For investors, sector and stock selection will be increasingly important. We are focused on balancing long-term secular growers with companies poised to benefit from cyclical acceleration.



### The U.S. dollar

The dollar is flat this year as the United States has taken the lead in the global recovery and out-vaccinated most other countries. We expect a range bound dollar from here.

**Bearing these in mind, let's turn now to the big questions we're asking about the outlook for the remainder of 2021 and into 2022.**

# Key questions to consider

1 Are we in for another period of U.S. outperformance, or will the rest of the world catch up?

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2 Is this as good as it gets?

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3 Can equity markets keep rising, especially with higher taxes on the horizon?

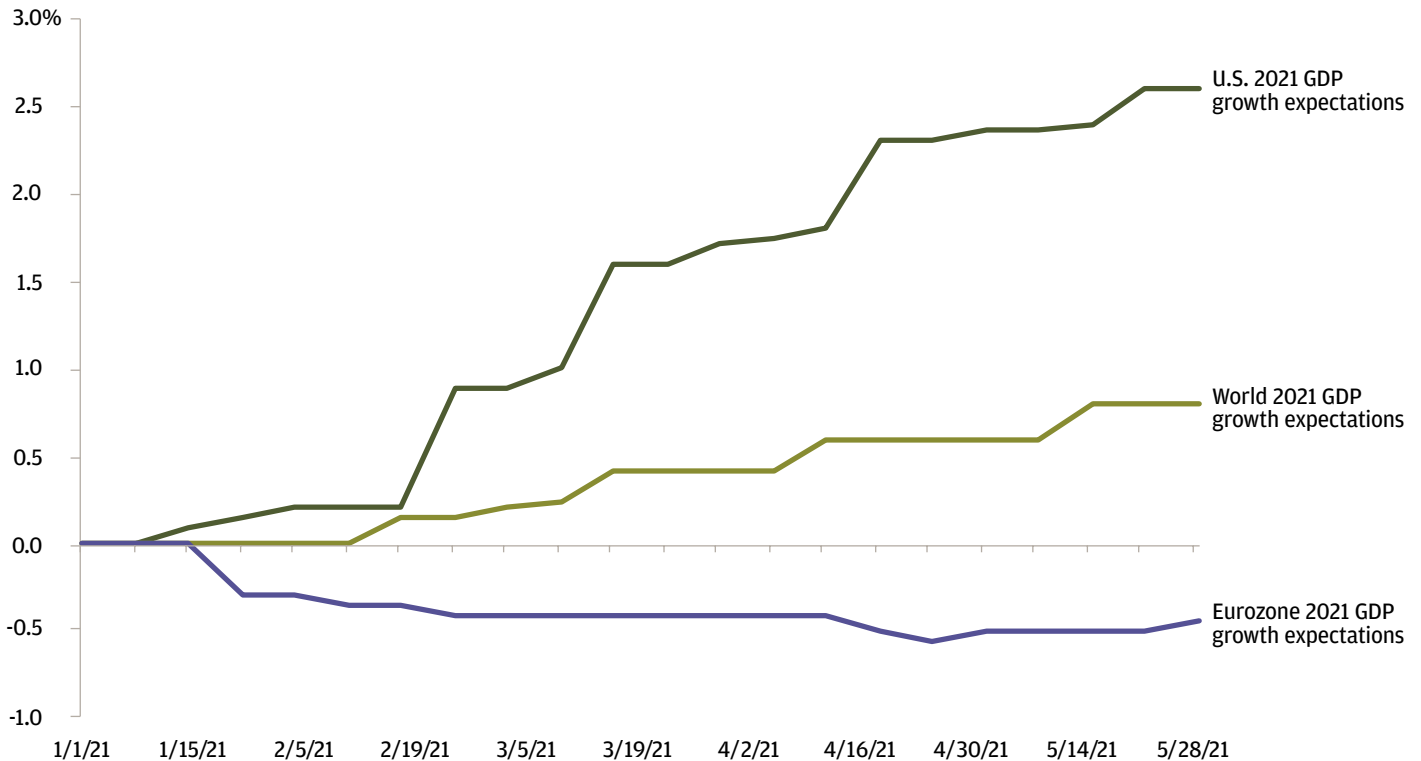
# 1 Are we in for another period of U.S. outperformance, or will the rest of the world catch up?

By most measures, the U.S. economy is booming. Among major economies, only the United Kingdom and Israel have vaccinated their populations more quickly. Notably, too, Democratic control of Congress and the White House has spurred a powerful fiscal boost to the U.S. economy. Following USD 1.9 trillion in pandemic relief, President Joe Biden has proposed over USD 2.5 trillion in infrastructure spending and around an additional USD 1.7 trillion for child care and education, among other initiatives. Congressional debate will be spirited, but we think a long-term infrastructure spending plan and related tax increases are more likely than not.



## GDP GROWTH EXPECTATIONS IN THE UNITED STATES HAVE SURGED, WHILE THE REST OF THE WORLD HAS LAGGED

Change in 2021 GDP growth expectations, % pt.



Source: Bloomberg Finance L.P. May 31, 2021.

While the U.S. economy will likely be the dominant growth driver for the next few months, prospects for the rest of the world may also improve. The Chinese economy has already fully recovered from the COVID-19 crisis, and GDP growth looks set to return to trend rates of 5%-6% by the end of the year. China's success at virus containment means that a mass vaccination campaign is less important, but officials believe they will have enough supplies of domestically produced vaccines from Sinopharm and Sinovac to inoculate 70% of the population by the end of 2021.

The European vaccination effort got off to a sluggish start, but many restrictions on mobility and travel are being relaxed. Forward-looking indicators of growth give us reasons for optimism, but the hard data is still depressed. Policymakers are keen to avoid prematurely removing support (as occurred during the global financial crisis and the sovereign debt crisis), but the results of elections later this year could challenge further policy support.

In some emerging economies, the coronavirus is far from defeated. Amid severe COVID-19 outbreaks, India and Brazil confronted full-blown public health crises. Along with Turkey, they struggle to contain the virus while balancing economic priorities—an impossible task.

Looking across global markets, expectations for robust U.S. GDP growth have powered the S&P 500, which has outperformed the rest of the world in USD terms, and also U.S. Treasury yields, which have risen much more quickly than their global counterparts. But international diversification is as important as ever, and we see attractive prospects in many parts of the equity markets of Europe, Japan, China and emerging markets.

We expect the European economy will reopen this year, a few months behind the United States. Pfizer will deliver 600 million vaccine doses to the continent, and case growth seems to be slowing. Equity valuations look attractive. European earnings expectations are still about 10% below pre-pandemic levels, and the region's stocks are trading at a deeper-than-average discount to stocks in the United States. Similarly, Japanese stocks are trading at trough relative valuations, and would offer compelling upside if the global recovery continues. Further, the sector mix in both Europe and Japan provides more exposure to companies that could perform well during a period of above-trend global growth and rising inflation. Our preferred countries are Germany, the United Kingdom and Japan.

We believe it is crucial for investors to have exposure to Chinese assets. Opportunities can be found in a growing roster of onshore equities, as policymakers incentivize domestic production of higher value-added products such as semiconductors. In the offshore market, however, the specter of increased regulation challenges

the Chinese internet giants (which are down around 30% from peak levels). Finally, Chinese bonds could provide an interesting and relatively uncorrelated complement to more established sovereign bond markets.

Beyond China, selectivity is key in emerging markets. Russia provides a compelling option for a deep value play, given its exposure to energy revenues, but it also has a nascent and promising ecommerce sector. Taiwan and South Korea could be considered strategic holdings, given their importance in the global semiconductor supply chain. Latin America boasts some of the world's fastest-growing financial technology companies.

In sum, then, although the U.S. economy will likely drive global growth during the coming months, the rest of the world's prospects may improve, too. **Equity investors could revisit their regional allocations. Imbalances have probably developed after a decade of U.S. outperformance.**

600M

Pfizer will deliver 600 million vaccine doses to Europe this year, and case growth seems to be slowing.



# 2 Is this as good as it gets?

## IS ECONOMIC GROWTH PEAKING?

We think so, but it isn't a cause for concern. While the global GDP growth rate will likely peak in Q2, we still expect full-year growth of around 6%, the highest since 1980—amid disparate levels of COVID-19 spread and access to vaccines.

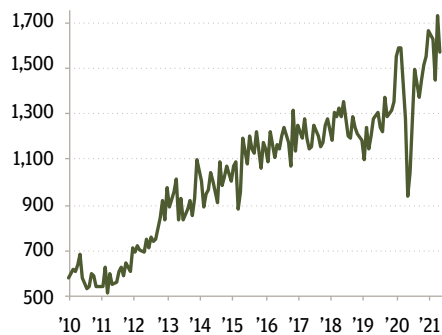
As we've noted, the United States is leading the boom. Consumer spending is robust, with retail sales 20% above pre-pandemic levels. U.S. home sales are soaring, and home construction starts hit their highest level since 2006. That growth follows years of underbuilding, suggesting the potential for continued solid activity. All in all, it's a fast recovery. At this rate, the U.S. economy will be solidly mid-cycle by the end of the year.

The stimulus-fueled boom in U.S. demand is also supporting regions outside the United States, where domestic demand remains tepid. The U.S. trade deficit is at an all-time high, as ports along the West Coast are inundated with ships waiting to offload goods from Asia. Trade and production in Taiwan, Korea and Vietnam are surging.



### U.S. HOUSING STARTS

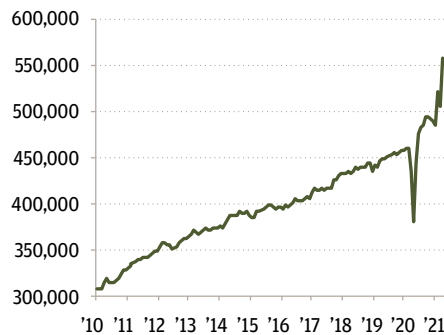
Thousand units, SAAR



Source: U.S. Census Bureau. April 2021.

### U.S. RETAIL SALES

Millions, USD



Source: U.S. Census Bureau. April 2021.

### KOREAN EXPORTS

Millions, USD



Source: KCS. May 2021.



The European services recovery has yet to get going, but business conditions seem to be improving. German capacity utilization is running at a two-year high; French consumer spending is impaired only in lockdown-sensitive categories such as transportation and hospitality. In the United Kingdom, lockdowns are lifting amid a very successful vaccine rollout, and the data suggests the U.K. economy has begun to normalize.

While the peak in global growth will likely occur in the second quarter, we still think the global economy can expand at an above-trend pace until the end of 2022. The excess savings that consumers in the United States and Europe have built up will likely be drawn down gradually. With generally reasonable debt loads, households also have room to add leverage. Inventories are low everywhere, and producers will likely have to expand capacity to keep up with demand.

Interest rates have risen, but we do not think they threaten the recovery. Mortgage rates are low enough to incentivize refinancing and/or borrowing to purchase a new home. Dividend yields of major equity indices are still higher than bond yields. Real interest rates across maturities are negative at a time when expected growth rates are positive. Sharp moves higher in bond yields could cause volatility in risk assets, but we anticipate a steady, gradual grind higher.

Although markets' returns tend to moderate after growth rates peak, we think analyst earnings estimates for corporate earnings are likely too low. We still prefer stocks to bonds, and think they can deliver average to slightly above average returns from here. Within equities, sectors that benefit the most from strong growth conditions, such as industrials, materials and parts of technology (semiconductors, for example), could do well.



## BUT WHAT ABOUT INFLATION?

In the United States, we see inflationary pressures. Shipping rates, lumber costs and used car prices are skyrocketing, and companies across industries are citing supply chain problems and cost pressures in their earnings calls. Consumer prices rose at their fastest pace in over a decade in April. Historically, we are close to a point in the cycle where the Fed would begin to remove policy support.

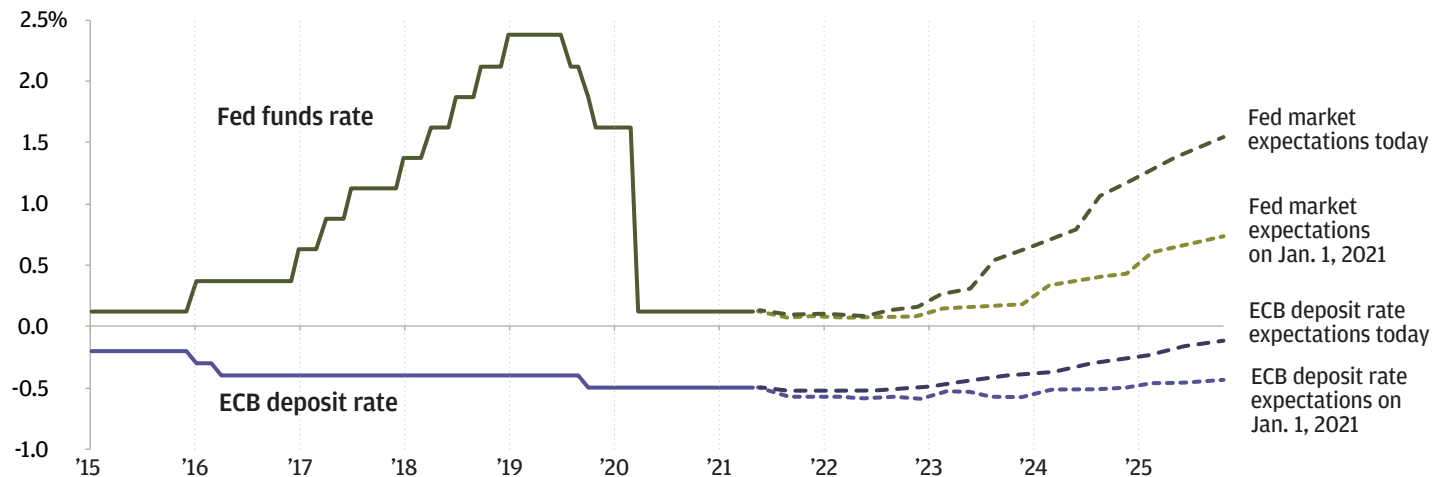
But history may not repeat. We believe policy rate hikes would now be at odds with the Fed's new framework, which aims for 2% average inflation and maximum employment. We don't expect those criteria will be met before the end of 2023. Raising policy rates to stifle demand at this point would be counterproductive, given that the economy is still over 10 million jobs short of the pre-pandemic employment trend. The most likely release for

cost pressures in the economy? An increase in capacity through investment or additional hiring.

Over the medium term, we think the economy can generate inflation slightly above 2% (commensurate with the Fed's target), but a damaging inflationary spiral is unlikely. Shelter cost inflation (which accounts for a third of the consumer price basket) has fallen by 50% from 2019 peaks, and healthcare costs (accounting for about another 10% of CPI) could come under pressure from changes in policy and regulation. The two most important secular forces that have kept inflation in check—globalization and technological change—are unlikely to reverse. These factors, along with still-substantial slack in the labor market and a credible Fed mandate to ensure stable prices, make an inflationary spiral unlikely, in our view.

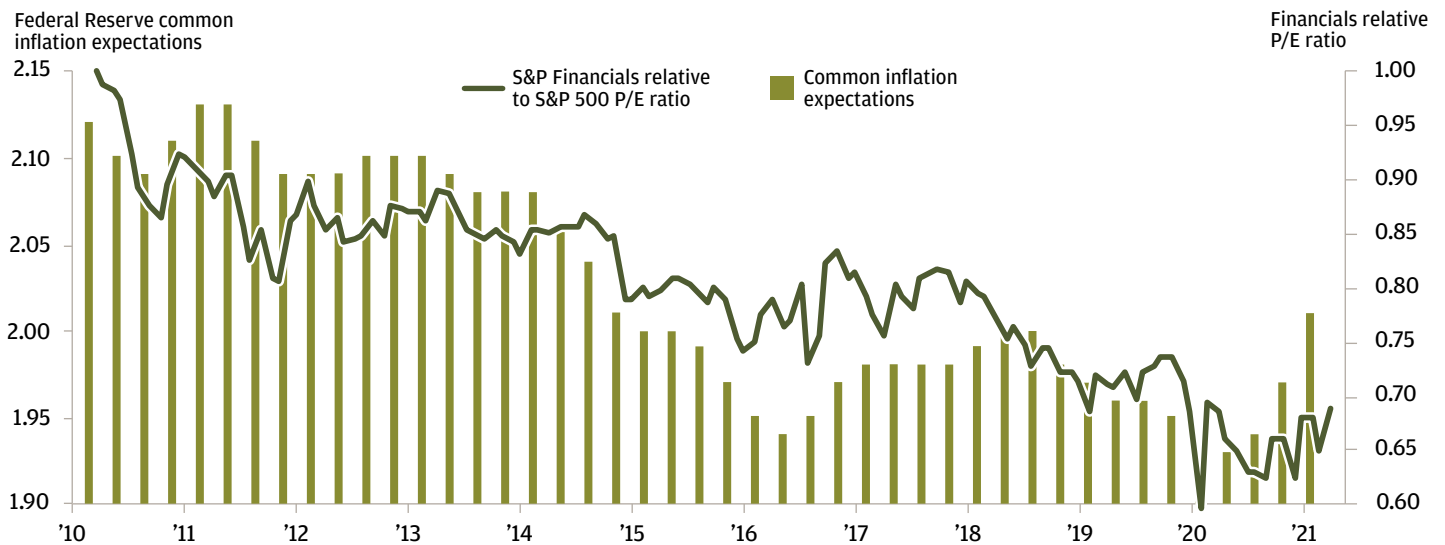
### A FASTER RECOVERY COULD LEAD TO A FASTER TIGHTENING CYCLE

Fed funds policy rate with market expectations



Source: Bloomberg Finance L.P., Federal Reserve, J.P. Morgan Asset Management. May 31, 2021.

## A SMALL CHANGE IN INFLATION EXPECTATIONS COULD MEAN BIG GAINS FOR FINANCIAL STOCKS



Source: FactSet, Federal Reserve Board. May 2021.

Meanwhile in the eurozone, the European Central Bank (ECB) seems to have considerable leeway to ensure that rates across maturities remain low. Core inflation is still very soft (running at just a 0.9% year-over-year pace). The EU recovery fund is an important incremental step toward unified fiscal support, but European stimulus will pale beside the massive fiscal spending in the United States. Thus the onus is on the ECB to maintain very easy policy for the foreseeable future. Not surprisingly, then, around half of eurozone sovereign debt trades with negative yields.

The story is very different in emerging market (EM) economies. Broadly, EM countries are running into the limits of loose monetary policy as their currencies come under pressure. Brazil, Russia and Turkey have all raised rates this year to offset inflation and currency weakness, and Chinese policymakers are focused on managing the domestic debt load while cultivating a consumer-driven economy.

For signs of what's ahead through 2021 and into 2022, investors will closely follow the Fed's path to removing policy support. Well before the first rate hike, the Fed will hint at winding down its asset purchase program. That could happen this summer, beginning the long road to higher policy rates.

The Fed is in no rush and, indeed, seems ready to let the economy run hot. Short-term interest rates will likely stay anchored, but longer-term rates will probably rise as bond markets price in stronger growth, leading to a steeper yield curve. Investors could make sure they have appropriate exposure to the cyclical and value areas of the market (such as financials) to balance the winners of the decade of secular stagnation (secular tech growers). Just a small change in longer-term inflation expectations (and a steeper yield curve) could mean a material re-rating for financial sector valuations.

In fixed income, short duration bonds look like a much better option than cash for conservative investors. With higher bond yields, core fixed income can now better protect against equity volatility than it could when yields were lower, but we still advocate using hedge funds as a complement to buffer against equity volatility. Real assets such as infrastructure and real estate can also serve a valuable role, providing diversification and income.

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## 3 Can equity markets keep rising, especially with higher taxes on the horizon?

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Since 1928, the S&P 500 has risen 50% or more over the prior 12 months only 1.5% of the time, using weekly price return data. Outside of the Great Depression era, it has only happened 0.4% of the time.

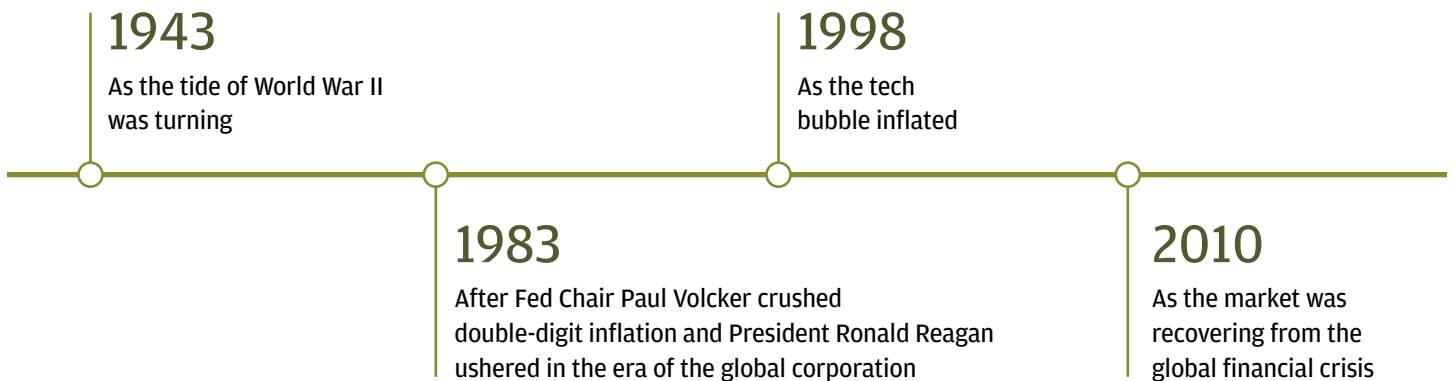
It's exceedingly rare—but it has just happened. From April 2020 to April 2021, the S&P 500 index rose 61%.

↑61%

The S&P 500 Index rose from April 2020 to April 2021.

## WHAT TENDS TO HAPPEN AFTER DRAMATIC RALLIES?

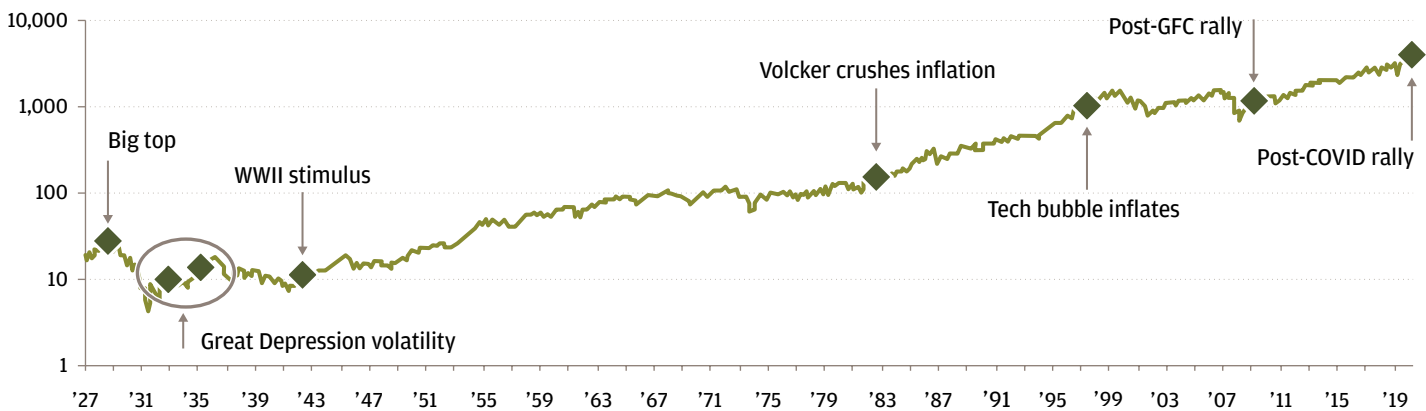
After the Great Depression, we note only four observations:



The green diamonds in the chart below show points at which the S&P 500 was up more than 50% over the previous year.

### POST GREAT DEPRESSION, STRONG RALLIES HAVE NOT INDICATED “BIG TOPS”

S&P 500 Index level, log scale



Source: Bloomberg Finance L.P., J.P. Morgan Private Bank Market and Asset Class Strategy. April 30, 2021.



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As you might expect, the pace of returns after these moments has tended to slow over the subsequent 12 months, to an average price return of 2% (versus 7.5% for all periods).

2%

pace of returns over 12-month periods after dramatic rallies

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However, over the medium term, after these strong rally periods, the S&P 500 delivered a stronger performance: On average, the three-year return was more than 42% (versus 23% in all periods).

+42%

S&P 500 average three-year return

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Past performance is not indicative of future results, but these findings also support our view that the market is transitioning to the “growth phase” of the cycle, where earnings growth drives average equity market returns. Historically, 50% price changes are more indicative of the beginning of strong periods for stocks, not the end.

50%

price changes are more indicative of the beginning of strong periods for stocks

## WE KNOW WHAT YOU'RE THINKING. WHAT ABOUT TAXES?

Higher corporate taxes clearly present a headwind to equity earnings and returns, but we do not think the proposed changes to the tax code will be enough to disrupt the medium-term case for equities. Let's walk through the numbers.

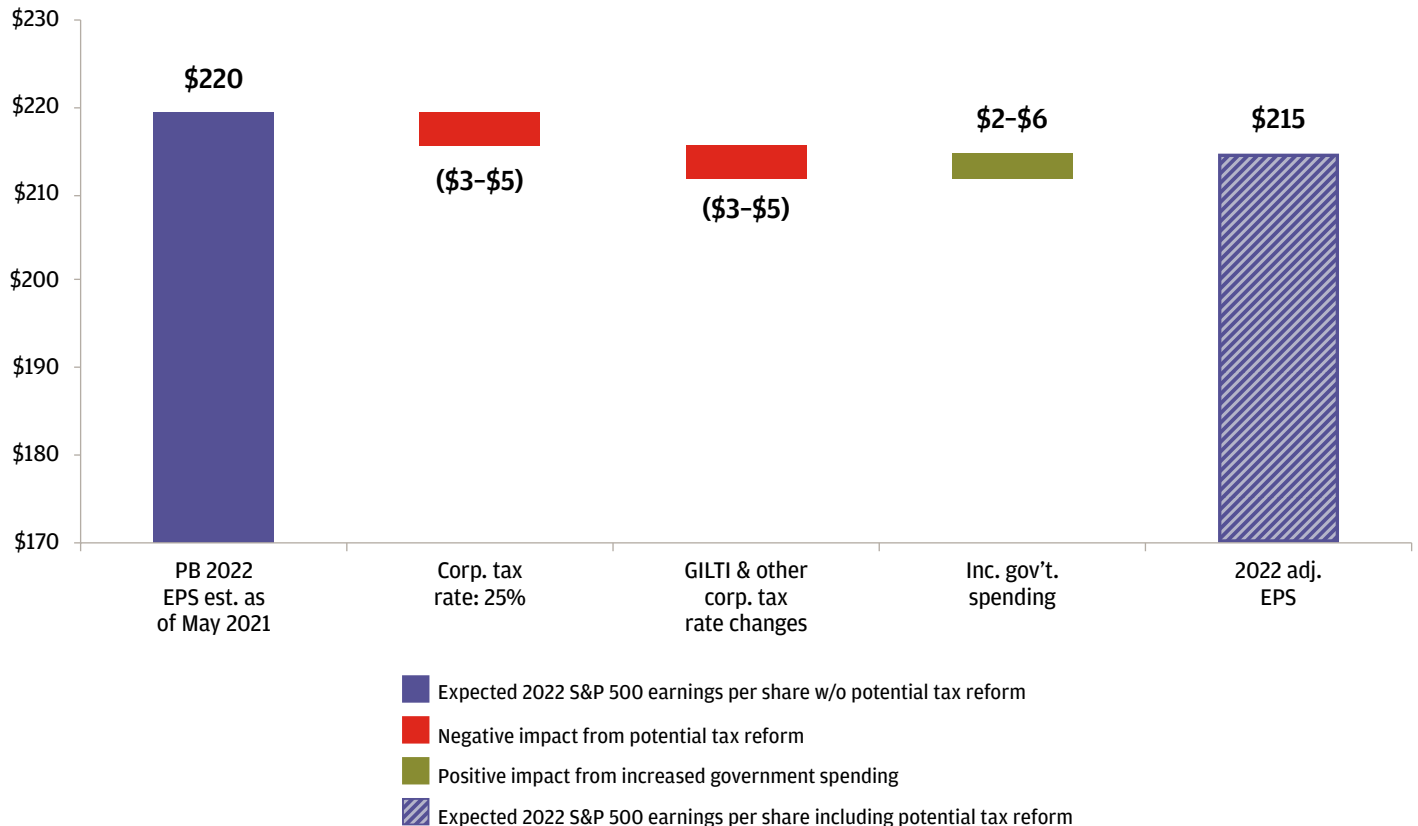
A 25% corporate tax rate (up from the current 21%) could slash \$3-\$5 from 2022 earnings per share. Changes to the global intangible income and other items could knock off another \$3-\$5. So at worst, that's \$10 out of what we expect to be about \$220 of earnings per share in 2022. But we can't stop there.

Incremental government spending could add at least \$2, and up to \$6, to earnings, on top of the already stellar results we expect, given the latest reporting season. In other words, the negative impact of higher taxes would be offset by the positive effect of margin expansion and government spending.

More importantly, the tax changes do not come close to wiping out all the earnings growth that we expect in 2022. Higher capital gains or dividend income taxes could also cause acute selling pressure and pressure valuations, but we expect the impact to be short-lived.

### POTENTIAL IMPACT FROM PROPOSED INCREASE IN CORPORATE TAXES

Forecasted S&P 500 EPS impact per potential Democratic agenda item



Source: Bloomberg Finance L.P., FactSet, J.P. Morgan Private Bank. May 31, 2021.



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# Nearing an important crossroads

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A booming global economy, still-supportive monetary policy and impressive corporate earnings are powerful tailwinds to markets. But if inflation soars, onerous tax rates damage profits and the Fed pivot proves disruptive, the headwinds could be equally powerful. For now, we think the tailwinds will prevail.



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## WHAT ARE THE IMPLICATIONS FOR INVESTORS?

For one, we have a preference for stocks over bonds. Within equities, we believe portfolios could be more balanced across regions and styles than they may have been in previous years. The answer to the question “value or growth?” should be “value and growth.”

We continue to find sound investment ideas in companies that drive innovation. Next-generation vehicles, financial technology and healthcare innovation are exciting areas driving growth.

Bond yields have moved higher, which makes fixed income incrementally more valuable as a buffer in portfolios. For conservative investors, core fixed income looks better than cash. For income-focused investors, extended credit is our preferred area for yield, but high yield bond valuations are not attractive. Instead, we have a positive outlook on preferred equities and private credit. Real estate and infrastructure investments are also compelling to add diversification, inflation protection, and income.

Hedge funds have proved their mettle so far this year, outperforming core fixed income by around five percentage points. We continue to believe hedge funds can play a powerful role in portfolios as a complement to core fixed income. Non-strategic cash remains our least favorite asset class and will almost surely deliver a negative real return over the next two to three years.

Finally, as investors move through the transition from recovery to expansion, our [key investment themes](#) can serve as a guide. They can help you consider our views within the context of your goals-based plan, so that you can discuss with your J.P. Morgan team what adjustments might be appropriate as we near an important market crossroads.

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