



A Long-Term Perspective on Investing



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ABSTRACT

Despite the pandemic, the long-term paths of slow growth and low inflation remain intact, albeit with greater uncertainty around inflation. The pandemic has triggered even easier monetary policy, although fiscal policy is likely to take the leading role in promoting economic growth in the decade ahead.

Strong returns from equities and high-quality bonds through the pandemic have left valuations stretched. A traditional 60/40 portfolio of global stocks and U.S. bonds presents a very subdued frontier of potential returns. However, many other asset classes shine above this low horizon, including European and Emerging markets equities, high-yield and emerging market debt and an assortment of alternative investments. In addition, active management should be able to take advantage of distortions in relative valuations that have been created by years of central bank intervention and momentum investing.

Of all the challenges facing investors in this blighted year, maintaining a long-term perspective may be the hardest. In recent weeks, markets have swayed back and forth in reaction to case counts, vote counts, vaccine news and stimulus views, obscuring longer-term trends on economic growth, inflation, earnings and interest rates. It has also been tempting to ignore the crucial importance of current valuations in driving long-term returns or to underestimate the potential for recently unloved assets to reduce current portfolio volatility and enhance long-term returns.

Given all of this, it is particularly timely that last week we released the 2021 edition of our *Long-Term Capital Market Assumptions*. This project, now in its 25th year, draws from experts across JPMorgan Asset Management in developing investment themes, economic



forecasts and return and correlation projections across all major markets and asset classes for the next 10 to 15 years.

Among the key themes this year:

- Despite the pandemic, the long-term paths of slow growth and low inflation remain intact, albeit with greater uncertainty around inflation.
- The pandemic has triggered even easier monetary policy. However, fiscal policy is likely to take the leading role in promoting economic growth in the decade ahead.
- Strong returns from equities and high-quality bonds through the pandemic have left valuations stretched. A traditional 60/40 portfolio of global stocks and U.S. bonds presents a very subdued frontier of potential returns.
- However, many other asset classes shine above this low horizon, including European and Emerging markets equities, high-yield and emerging market debt and an assortment of alternative investments. In addition, active management should be able to take advantage of distortions in relative valuations that have been created by years of central bank intervention and momentum investing.

Digging a little deeper, it may seem surprising that growth forecasts have not been much altered by the very deep recession triggered by the pandemic, since the obvious assumption is that a weak starting point should imply a faster long-term growth rate. However, it's important to note that our forecast period began on October 1st, 2020 rather than earlier in the year. While global real GDP fell 8.1% (in non-annualized terms) between the fourth quarter of 2019 and the second quarter of 2020, a very strong surge in the third quarter cut the decline to just 0.5%, leaving a much smaller output gap to be closed.

As the pandemic ends, the global economy should move back towards full employment fairly rapidly, since most of the current economic weakness is centered in sectors where there is both pent-up demand and pent-up supply, ready to be unleashed once we are given the medical all clear. However, progress thereafter will be slow.

In the developed world, weak demographics should result in employment growth of just 0.6% per year in the U.S. and negative growth in Japan and the European Union. These trends will only partly be offset by moderate growth in the capital stock and advances in the efficiency with which capital is deployed. Labor supply and productivity growth should be stronger in emerging markets. Still, over the next 10 to 15 years, we are looking for average real GDP growth of just 1.8% in the U.S., 1.6% in developed countries overall and 3.9% in emerging market economies. These forecasts are unchanged from a year ago for

the U.S. and emerging markets and just 0.1% higher than last year's for developed countries in general. (see Table 1)

Table 1: Compound 10- 15-year GDP Growth and Inflation assumptions (%)

| Compound 10- 15-year GDP Growth and Inflation (%) | | | | | |
|---|--------|-------|--------|--------|--------|
| | DM* | U.S. | Europe | U.K. | Japan |
| 2021 LTCMAs | | | | | |
| Real GDP | 1.60 ↑ | 1.80 | 1.30 ↑ | 1.60 ↑ | 1.00 ↑ |
| Inflation | 1.60 | 2.00 | 1.30 | 2.00 | 0.70 ↓ |
| 2020 LTCMAs | | | | | |
| Real GDP | 1.50 | 1.80 | 1.20 | 1.20 | 0.60 |
| Inflation | 1.60 | 2.00 | 1.30 | 2.00 | 0.80 |
| | EM* | China | India | Brazil | Russia |
| 2021 LTCMAs | | | | | |
| Real GDP | 3.90 | 4.40 | 6.90 ↓ | 2.40 | 1.10 ↓ |
| Inflation | 3.30 | 2.50 | 5.00 | 4.30 ↓ | 5.30 ↓ |
| 2020 LTCMAs | | | | | |
| Real GDP | 3.90 | 4.40 | 7.00 | 2.40 | 1.20 |
| Inflation | 3.30 | 2.50 | 5.00 | 4.50 | 5.50 |

Source: J.P. Morgan Asset Management; estimates as of September 2019 and September 2020. *EM: Emerging Markets; DM: Developed Markets

On inflation, the pandemic has opened up an output gap that could reduce inflation as could the earlier adoption of some labor-saving technologies. Conversely, a greater emphasis on fiscal stimulus and potential government actions to reduce inequality and to battle climate change could add to inflation. While all of these pressures are extremely difficult to estimate in advance, we are willing to assume that they could be roughly offsetting, leaving us with a forecast of 2.0% CPI inflation in the U.S., 1.6% in developed economies overall and 3.3% across emerging markets, all unchanged from last year. It should be emphasized, however, that the effects of the pandemic economy in accelerating technological change and a more aggressive use of fiscal stimulus going forward have added to inflation tail risks in our forecast.

While an extraordinary year has had remarkably little impact on our growth and inflation forecasts, it has changed the policy landscape in a profound way. In the last decade, monetary policy was the primary tool deployed by governments around the world to stimulate economic growth and foster higher inflation. However, its relative failure to achieve these objectives, which we discussed in last year's Long-Term Capital Market

Assumptions has led to a greater acceptance of the use of fiscal stimulus. This has accelerated dramatically in the pandemic, as governments have expanded deficits to meet higher medical expenses and protect laid-off workers and shuttered businesses. Importantly, central banks have been co-opted into this effort and massive increases in government debt have been matched by almost equally massive increases in central bank government bond holdings.

This expansion in deficits will likely continue to shape the economic environment for years after the end of the pandemic. Nevertheless, there are limits, however ill-defined, to how much governments can borrow to finance deficits or how effectively they can deploy fiscal stimulus. We investigate this on a country-by-country basis in this year's Long-Term Capital Market Assumptions.

A second significant change in our long-term outlook derives from the pricing of assets themselves. In the year that ended September 30th, 2020, even as earnings cratered in reaction to the pandemic, the S&P500 rose by 13% and the MSCI World Index in U.S. dollar terms rose by 8.6%.

Even spaced out over 10 to 15 years, these higher prices today cut into future returns, which we now project at 4.1%, 5.2% and 6.8%, in Local Currency terms, for the S&P500, the MSCI Euro Area and the MSCI EM, compared to 5.6%, 5.8% and 8.7%, respectively, a year ago. (see Table 2)

Table 2: Euro Equity returns assumptions: 2021 vs. 2020

| Euro key equity market return assumptions, 2021 vs. 2020 | | | | | | |
|--|-------------------|---------------|-----------|-------|------|------|
| | Developed Markets | U.S large cap | Euro area | Japan | UK | EAFE |
| 2021 | | | | | | |
| Local Currency | 4.60 | 4.10 | 5.20 | 5.10 | 6.70 | 5.40 |
| Euro | 3.50 | 2.70 | 5.20 | 5.10 | 6.10 | 5.10 |
| 2020 | | | | | | |
| Local Currency | 5.70 | 5.60 | 5.80 | 5.50 | 6.10 | 5.60 |
| Euro | 4.40 | 3.70 | 5.80 | 5.30 | 5.70 | 5.30 |

| | Emerging Markets | China (H) | Korea | Taiwan | India | Brazil |
|----------------|------------------|-----------|-------|--------|-------|--------|
| 2021 | | | | | | |
| Local Currency | 6.80 | 6.60 | 5.60 | 5.50 | 8.90 | 7.10 |
| Euro | 5.80 | 5.20 | 5.00 | 5.70 | 8.00 | 6.70 |
| 2020 | | | | | | |
| Local Currency | 8.70 | 9.10 | 7.90 | 7.50 | 10.30 | 6.60 |
| Euro | 7.30 | 7.20 | 7.40 | 7.60 | 9.80 | 5.30 |

Source: J.P. Morgan Asset Management; estimates as of September 2019 and September 2020. *Unhedged FX translation

A similar pattern shows up in fixed income markets where rates are significantly lower than a year ago. Given very low starting yields and a slower pace of normalization, we now expect average returns from 0.2% from Euro cash, 0.6% from French 10-year sovereign bonds and 1.4% from U.S. investment grade corporate bonds, a further downgrade from projections of 0.6%, 0.6% and 1.8%, respectively, a year ago. (see Table 3)

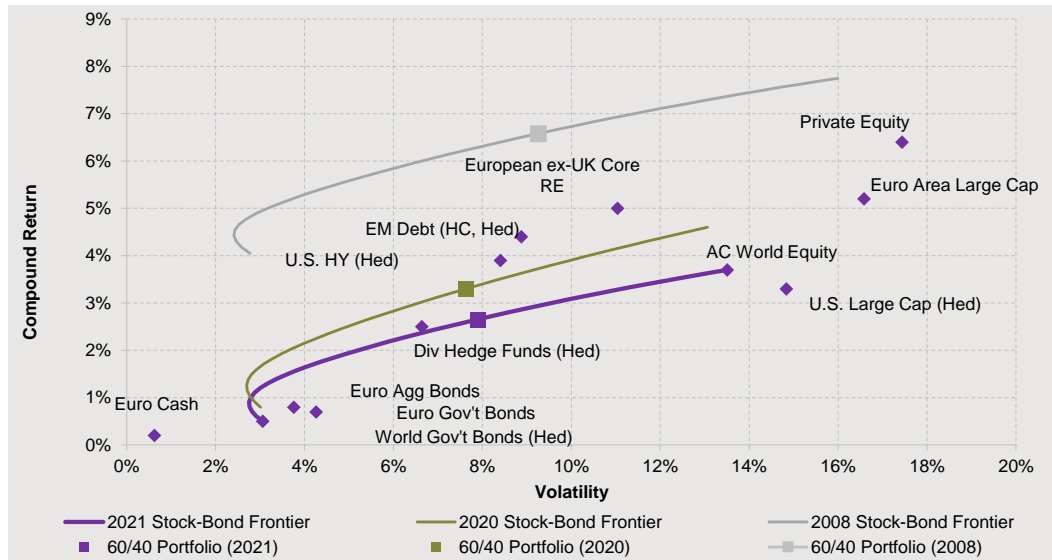
Table 3: EUR Fixed income assumptions: 2021 vs. 2020

| Euro key fixed income assumptions, 2021 vs. 2020 | | | | | | |
|--|---------------------|----------------|------------------|-------------------|---------|---------|
| | Euro Inflation rate | Euro Cash rate | 10-yr bond yield | 15+-yr bond yield | Euro IG | Euro HY |
| 2021 LTCMAs | | | | | | |
| Equilibrium Rate / Spread | 1.30% | 1.00% | 2.00% | 2.40% | 125 bps | 400 bps |
| Rate / spread on Sept 30, 2020 | - | | -0.24% | 0.15% | 115 bps | 490 bps |
| Return (%) | - | 0.20% | 0.60% | -0.40% | 1.40% | 3.60% |
| 2020 LTCMAs | | | | | | |
| Equilibrium Rate / Spread | 1.30% | 1.00% | 2.20% | 2.40% | 150 bps | 400 bps |
| Rate / spread on Sept 30, 2019 | - | -0.60% | -0.30% | 0.53% | 103 bps | 447 bps |
| Return (%) | - | 0.60% | 0.60% | -0.80% | 1.80% | 3.60% |

Source: J.P. Morgan Asset Management; estimates as of September 2018 and September 2019. IG = Investment Grade; HY = High Yield. Spreads are listed in bps terms.

Because of this, a plain vanilla 60/40 portfolio of global equities and U.S. bonds is now projected to provide an annual return of just 2.7% over the next 10 to 15 years compared to 3.2% a year ago. It is important for investors to take this on board when considering their long-term financial plans. (Chart 1)

Chart 1: Stock-bond frontiers: 2021 vs. 2020 and 2008 assumptions (EUR)



Source: J.P. Morgan Asset Management; estimates as of September 2020 and September 2019. *EM: Emerging Markets; DM: Developed Markets

However, it is also important to recognize that a number of assets appear to have the potential to outperform this average. In particular, we expect European and Emerging Markets equities in general to exceed these returns. High-yield bonds and emerging market debt should significantly outperform developed country government debt. In addition, alternative investments, such as private equity, core real estate and global infrastructure should be able to provide strong income flow, diversification benefits and, with skilled management, some superior performance.

Our 2021 Long-Term Capital Market Assumptions don't paint a particularly rosy picture for long-term investors, but we believe it is a balanced and useful one. More importantly, these long-term projections are not a landscape to be contemplated in complacency or dismay but rather a roadmap to be consulted with purpose. As the confusion from this year clears, it is important for investors to refocus on the long run, to acknowledge what has changed and to adjust portfolios accordingly to achieve their long-term investment goals.

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