

This material is neither intended to be distributed to Mainland China investors nor to provide securities investment consultancy services within the territory of Mainland China. This material or any portion hereof may not be reprinted, sold or redistributed without the written consent of J.P. Morgan.

## Market and Volatility Commentary

### Positioning for Inflation

Inflation hedging was a big theme in 2010. At the time, the Fed's Quantitative Easing increased its balance sheet above \$2T. Many investors thought it will inevitably lead to inflation. There was a rush to buy commodities, gold and other inflation hedges. However, the post-GFC recovery was weak, and new crises kept on emerging – the European sovereign debt crisis, EM and China crisis, global trade war, global manufacturing recession and global pandemic. As no inflation materialized over the past decade, inflation hedgers threw in the towel, and inflation-sensitive exposures were shorted as investors piled on deflationary themes (e.g., secular growth, low volatility, ESG, etc.). Driven by deflationary trends, bonds nearly doubled and the S&P 500 quadrupled since 2010, while Commodity indices significantly declined. Since 2010, the Fed's balance sheet nearly quadrupled to \$7.8T, and outside of the US, central banks instituted negative interest rates. Fiscal measures ranging from infrastructure to direct payments injected trillions. For instance, just this year, the new US administration proposed \$6T of new stimulus measures.

If one stretches rubber too long, it eventually snaps. With the end of pandemic this year – global growth, bond yields, and inflation are making a sharp turn (see [here](#) and [here](#)). At the same time, easy monetary and fiscal policies will likely persist for a while. In addition, there are various temporary frictions related to supply chains, reopening, as well as political and business decisions that may compound inflation. On financial asset allocation, we expect the market to be late in recognizing the inflection, which we believe already happened in November last year. For over a decade, only deflationary (long duration) trades were working, and many of today's investment managers have never experienced a rise in yields, commodities, value stocks, or inflation in any meaningful way. A significant shift of allocations towards growth, ESG and low volatility styles over the past decade (all of which have negative correlation to inflation – see Figure 1) left most portfolios vulnerable to a potential inflation shock.

With inflation on the rise, the current debate is how long this trend will persist. The question that matters the most is if asset managers will make a significant change in allocations to express an increased probability of a more persistent inflation. We think that this shift in allocation will happen (regardless of how temporary inflation is), and new data points related to inflation will on margin cause investors to shorten duration, move from low volatility to value, and increase allocations to direct inflation hedges such as commodities. We expect this trend to persist during the reopening of global economies in the second half of this year. Given the still high unemployment, and a decade of inflation undershoot, central banks will likely tolerate higher inflation and see it as temporary. Portfolio managers likely will not take chances and will reposition portfolios. The interplay of low market liquidity, systematic and macro/fundamental flows, the sheer size of financial assets that need to be rotated or hedges for inflation put on, may cause outsized impact on inflationary and reflationary themes over the next year.

#### Global Markets Strategy

**Marko Kolanovic, PhD** <sup>AC</sup>

(1-212) 622-3677

[marko.kolanovic@jpmorgan.com](mailto:marko.kolanovic@jpmorgan.com)

**Bram Kaplan, CFA**

(1-212) 272-1215

[bram.kaplan@jpmorgan.com](mailto:bram.kaplan@jpmorgan.com)

J.P. Morgan Securities LLC

#### See page 4 for analyst certification and important disclosures.

J.P. Morgan does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Figure 2 below shows US CPI, S&P GSCI commodity index, and S&P 500 Energy index since 2007. One can see that they all closely track each other. After a decade of declines, the question is whether inflation will rise above its spike in 2008. Figure 3 shows the US Manufacturing PMI input and output price indices that have already matched their 2008 spike.

How can investors reposition their portfolio for the risk of more persistent inflation? First, one should shorten duration and reallocate from bonds to commodities and equities. Commodity indices (such as S&P GSCI) are perhaps the most direct inflation hedge. Commodities are also cheap in a historical context – they are the only major asset classes that declined in absolute terms over the past decade (underperformance is significant and largely due to the drop in energy prices). Since 2010, the S&P 500 quadrupled and S&P GSCI index declined almost 40%. Within equities, investors should buy value and short low volatility style. Growth and quality also have negative correlation to inflation. Investors should also be cognizant that by embracing ESG they introduced additional short inflation exposure into portfolios (e.g., via long tech and short energy exposure).

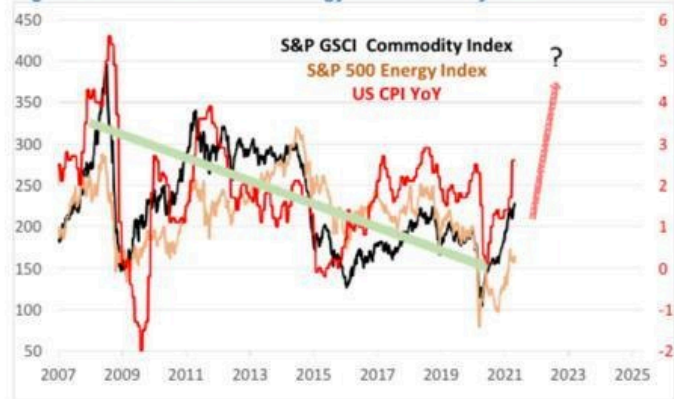
While our highest conviction is for rotation towards reflation, inflation, rising yields and reopening themes (see [here](#)), we remain overall positive on equities (S&P 500 YE price target of 4400). Exposure of Systematic investors has been gradually increasing, but is still in the ~35th percentile. Hedge funds reduced effective equity beta (net equity exposure) over the past few weeks from ~75th to ~45th percentile. Markets with higher exposure to value, cyclicals, commodities and inflation such as EM, Europe, and Japan should outperform the S&P 500 due to their sector and style composition. Our views on reflation also reflect our positive outlook on the pandemic – COVID-19 cases have been rapidly declining in the US. Cases are now declining in most of Europe and EMs (Brazil, Turkey). Growth of cases in India appears to be leveling off and we are hopeful for an improvement there in the near future.

Figure 1: Correlation of factors to inflation



Source: J.P. Morgan Quantitative and Derivatives Strategy

Figure 2: Commodities and Energy stocks closely track inflation



Source: J.P. Morgan Quantitative and Derivatives Strategy, BEA

Figure 3: US PMI Price series spiked like in 2008



Source: J.P. Morgan Quantitative and Derivatives Strategy, Markit