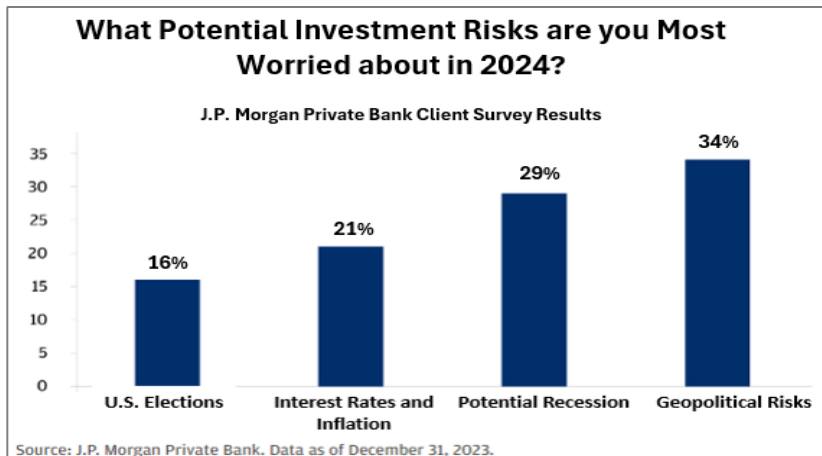
Re: Navigating Risk and Potential Opportunities

This past January, J.P. Morgan Private Bank published the results of a survey which asked its clients to rank the investment risks they were most concerned about in 2024. The greatest concerns in ascending order were the U.S. Elections, Interest Rates and Inflation, a Potential Recession and Geopolitical Risks. A lot has happened over the first six months of the year, and perhaps their concerns might be reordered if the survey were to be updated today. Nonetheless, given that prudent investment planning involves consideration of potential risks as well as potential rewards, in this quarterly letter we will review these major investment risks and how we believe our clients' portfolios are structured to mitigate those risks, while at the same time taking advantage of potentially favorable investment opportunities over the long term.

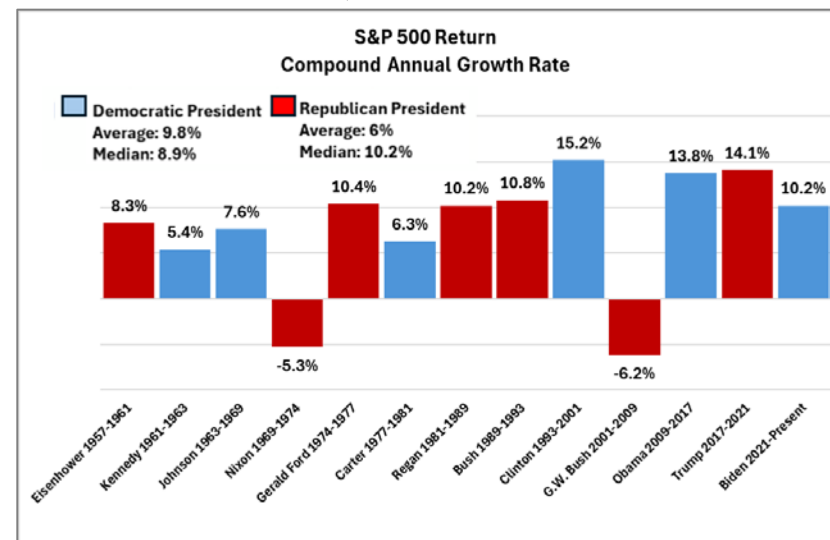


Source: J.P. Morgan Private Bank. Data as of December 31, 2023.

U.S. Elections

While investors viewed this as the lowest risk of the four identified in the survey at the beginning of the year, the events which have unfolded over the past few weeks have turned the race upside down. First, there was the attempted assassination of Donald Trump during a campaign event in Pennsylvania which reminded us of how guns and disturbed individuals can change the course of history. And while many assumed Donald Trump would face President Biden in November, last weekend's announcement by President Biden of his withdrawal flipped the script and it now appears that Vice President Kamala Harris may become the Democratic Party's nominee. While it's too early to assess how a potential race between Donald Trump and Kamala Harris might end up, what we do know is that a lot can happen between now and November (hold on to your seats!). Regardless of the eventual outcome, as investors we need to consider both possibilities. But just how much impact does a president have on the markets? Of course, history offers some possible lessons:

- In the short term, an election year has often proven to be favorable for the stock market as it has thus far in 2024. In fact, according to SBC Online News, "….the benchmark [S&P 500] has risen in almost every election year since 1960, with the exception of 2000 and 2008. That record has improved further in recent years. In the three election years since 2008 — 2012, 2016, 2020 — the benchmark index rose at least 10%."
- Longer term, the stock market, as represented by the S&P 500, has posted positive returns during the tenure of every U.S. President since 1957 with the exceptions of Richard Nixon and George W. Bush. Nixon's term was impacted by the Vietnam War, the OPEC Oil Embargo, the 1973 Arab-Israeli War and double-digit inflation, plus the Watergate scandal and Nixon's subsequent resignation (of note, Robert F. Kennedy and Martin Luther King, Jr. were both assassinated during the Nixon and Humphrey presidential campaigns of 1968). Bush's tenure was impacted by the final bursting of the technology stock bubble which saw the technology-heavy NASDAQ Index fall by more than 50% between 2001 and 2002, the terrorist attacks on 9/11/2001, and the Great Financial Crisis of 2008. In

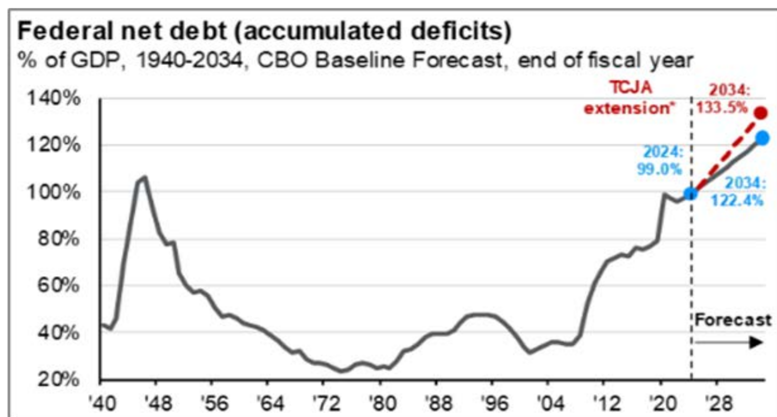


both Nixon's and Bush's tenures, the negative performance for the stock market was due to a combination of major economic and geopolitical events which were largely unattributable to their respective economic and foreign policies.

It is beyond the scope of this quarterly letter to delve into all of the policy differences between Biden and Trump, lest we point out that their proposed social, governance and foreign relations policies are vastly different. Instead, we'll touch upon key differences in their economic policies and how they might impact the markets. Economists have generally broken down the two candidate's policy differences into four major categories: Taxes (including the impact on the federal debt), Trade, Immigration, and Environmental.

Taxes (including the impact on the federal debt):

- The traditional thinking is that Republicans are more business-friendly and it's probably certain that a second Trump administration would extend the 2017 tax cuts for individuals and corporations implemented under the Tax Cuts and Jobs Act, or TCJA. There's a chance the corporate tax rate might be lowered further (from the current 21% to as low as 15%). Extending and/or expanding these tax breaks would likely be favorable for economic growth in the short run, but over the long run, the Congressional Budget Office (CBO) estimates that a reduction in tax revenue with no offsetting spending cuts would significantly increase the federal deficit.
- Biden would likely extend some of the 2017 tax cuts, but he has proposed raising taxes for wealthy individuals and corporations in order to finance various social programs. By allowing many of the 2017 tax cuts to expire and by increasing tax revenues, the CBO estimates that federal deficit would be smaller under Biden than under Trump.
- Comment: Neither candidate has proposed any significant measures for shrinking the deficit and bringing our national debt under control which we believe is imperative (the chart to the bottom left indicates how the CBO projects the national debt would grow if the TCJA is extended as Trump proposes, or not extended). According to the fiscally conservative Peter G. Peterson Foundation, "A nation saddled with debt will have less to invest in its own future. Rising debt means fewer economic opportunities for Americans. Rising debt reduces business investment and slows economic growth. It also increases expectations of higher rates of inflation and erosion of confidence in the U.S. dollar." While these risks are not front and center in the minds of investors today, in the coming years the implications of the ballooning national debt will undoubtedly become a major concern. (The CBO has proposed 17 major actions which would significantly reduce the deficit: www.cbo.gov/publication/58164.)



Trade:

- Trump promises to impose additional tariffs on all U.S. imports, especially from China, with a goal of protecting U.S. manufacturing workers and to narrow the trade gap.
- Biden has kept most of the prior Trump tariffs in place and has added new tariffs, including those on Chinese electric vehicles and solar panels.
- Comment: Many economists believe that tariffs end up costing consumers more in the long run and produce little lasting benefit. They can end up provoking trade retaliation and creating economic inefficiencies.

Immigration:

- Trump: Controlling immigration and securing the border are major campaign issues for Trump. He has promised to severely restrict immigration and has suggested he would deport millions of undocumented immigrants. On the other hand, he would likely promote a "merit-based" immigration plan.
- Biden: Biden has been criticized for the surge in illegal immigration and the crisis at the border. Following the failure of the bipartisan plan for immigration reform earlier this year, Biden has more recently proposed toughening border enforcement, adding more border patrol agents as well as immigration judges to expedite asylum seekers.
- Comment: As discussed in our last quarterly letter, the U.S. working-age population is shrinking and without new qualified immigrants, our nation's economic growth will suffer. According to an analysis of U.S. Census Bureau projections, we need a minimum of 1 million net new immigrants each year simply to maintain our current working-age population level, and 1.5 million net new immigrants to create a growing

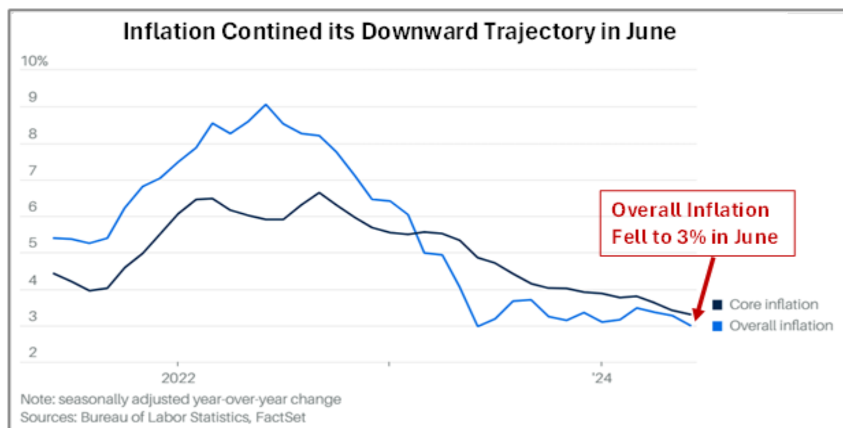
economy (which would create more taxpayers and help shrink the deficit as well). Our goal should be to create greater border security while also establishing an immigration process which is just, fair and expedient.

Environmental:

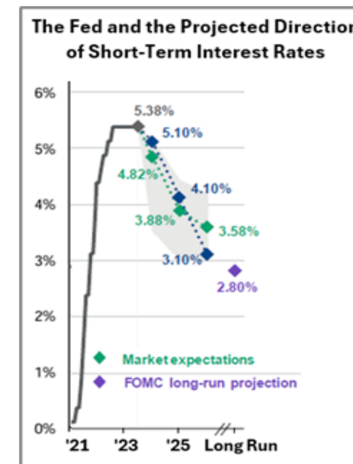
- Trump has promised to roll back most or all of Biden's clean energy initiatives and promote energy sources such as coal, oil and gas with a goal of bringing down energy costs for consumers.
- Biden would continue to press for further reductions in greenhouse gas emissions, including administering existing programs designed to drive down U.S. carbon emissions by 50% by 2050. (Note: the U.S. is *currently* producing a record amount of oil and is fully energy independent.)
- Comment: We believe that climate change is an existential threat requiring ambitious efforts to limit the extent of global warming. Studies estimate that the economic damage from climate change may end up consuming close to 20% of global GDP annually by 2050. Like the national debt, we need to focus on this long-term risk sooner rather than later.

Interest Rates and Inflation

At the beginning of 2024, investors were concerned about the direction of interest rates and inflation with the fear being that if the Federal Reserve kept interest rates elevated for too long, then the risk of a recession would rise. For the first four months of the year, the annual inflation rate appeared to have been stuck between 3.1% and 3.5%, but in May and June, prices resumed their downward drift. According to the latest inflation report, the broad CPI dropped by 0.1% in June bringing the annual inflation rate down from 3.3% in May to 3.0%. The Bureau of Labor Statistics attributed the monthly decline primarily to falling gas



prices and used car prices. Up to this point, the Federal Reserve has been messaging that it would likely keep the Federal Funds Rate higher for longer until it saw more progress in the effort to bring inflation down to its 2% long-term target. The favorable June inflation report has now raised market expectations that the Fed might begin lowering interest rates as early as September. The Fed's goal, of course, is to engineer a "soft landing" which would require inflation to continue tracking downward allowing the Fed to lower interest rates gradually in order to avoid a recession. In referring to the chart on the upper right of this page, the future expectations for the Federal Funds Rate are clearly pointing downward toward the Fed's long-term target of 2.8% (the green dotted line represents market expectations, and the purple line represents the consensus view of the Federal Open Market Committee). From an investor's perspective, the Fed Funds Rate is roughly equivalent to the yield on money market instruments, so we might anticipate that cash-equivalent yields will gradually fall from their present 5.38% level to around 3%. Long-term rates, on the other hand, are expected to remain in the 4% to 5% range over the next ten years. (As mentioned previously, should the federal deficit be higher under a Trump administration, one might expect upward pressure on interest rates and inflation.)



Potential Recession

One year ago, many economists were forecasting a recession in late 2023 or in the first half of 2024 which is probably why J.P. Morgan's clients ranked the risk of a recession as their #2 concern. Fortunately, economic growth has been stronger than expected and according to the most recent Global Composite Purchasing Managers' Index (PMI), in every major country and in most regions of the world economic growth is expanding with the exception of Japan. The PMI is a leading indicator of the direction of economic trends in both the manufacturing and service sectors. A score of 50 on a scale of 1 to 100 indicates no change from month to month in economic activity. A score

Global Economic Momentum

Purchasing Managers' Index (PMI)

	April	May	June
Global	52.4	53.7	52.9
U.S.	51.3	54.5	54.8
Euro Area	51.7	52.2	50.9
Japan	52.3	52.6	49.7
China	52.8	54.1	52.8
India	61.5	60.5	60.9
Emerging Markets	53.6	54.4	53.3

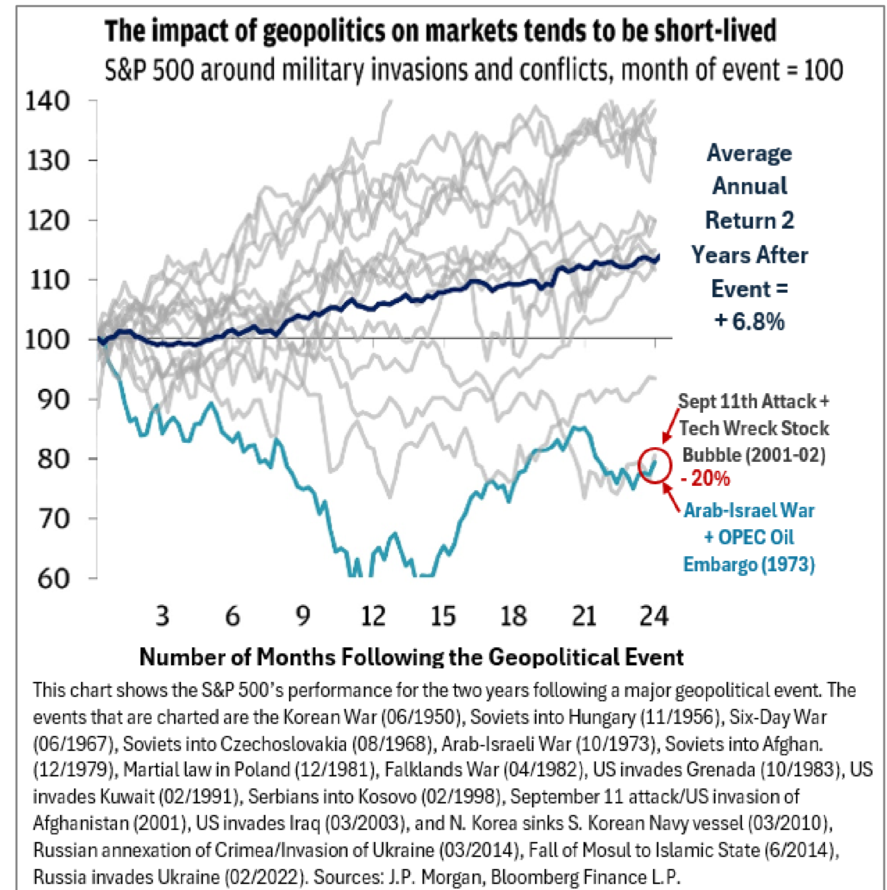
Green = Accelerating Momentum

50 = Neutral, >50 = Accelerating, < 50 = Decelerating

below 50 indicates an economic contraction, while a score above 50 indicates expansion (Green is good, Yellow indicates a slowing trend and Red would indicate recession conditions). The score for the global economy at the end of June was slightly lower than May, but still at a favorable 52.9 reading. Rarely do the scores reach the level of 60, but that has been the case for India which, at present, is one of the world's fastest growing economies. The score for the United States improved in June. The fact that most major economies are in an expansion mode suggests a low likelihood of a recession in the near term, although we will undoubtedly experience a recession at some point in the future (since the end of World War II, the U.S. has on average experienced one recession every 6.5 years with an average length of about 11 months). If the Federal Reserve is successful in engineering a soft landing, we may avoid a recession in the near term, but there's also the possibility the Fed might keep interest rates high for too long which might tip the economy into a recession. Of course, any surprise shocks to the system, including adverse geopolitical events, might trigger a more serious economic downturn (refer back to the confluence of economic and geopolitical factors which occurred during the Nixon administration in 1973-74, and twice during the G.W. Bush administration in 2001-02 and 2008).

Geopolitical Risks

Returning to the topic of geopolitical risks, that was the #1 concern coming into the year according to the J.P. Morgan client survey. Unfortunately, those risks have gone from bad to worse. With the prolonged conflict between Russia and Ukraine, the seemingly endless war between Israel and Hamas, and ongoing tensions between the U.S. and China, the world order is clearly in an unsettled and fragmented state. So how might investors factor in geopolitical risks into their portfolios, especially since these risks are ever present? Illustrated in the chart on the top right are seventeen major geopolitical events and their impact on the stock market. The two most severe, during the Nixon and G.W. Bush administrations, triggered stock market declines of between 25% and 40% during the twelve months immediately following the events, with stocks still being depressed by about 20% after two years. On the other hand, for the majority of the seventeen events, the stock market's performance was positive or became positive shortly afterwards with an average annual 2-year gain of 6.8% for all seventeen geopolitical events. For the two most severe combination of events, it took another twelve months (three years in total) for stocks to fully recover. For investors, having a balanced portfolio during each of the two most severe downturns helped significantly dampen the downside volatility. For example, in the 1973-74 downturn, stocks fell by about 42% over the ensuing twelve months and fully recovered after 3½ years. For a balanced portfolio investor with 50% in high-quality bonds and 50% in globally diversified stocks, the downside was limited to 23% (versus 42%) and the portfolio fully recovered in 2½ years, or one year sooner. Comparable results occurred during the 2001-02 downturn as well. The bottom line is that while geopolitical risks are ever present, having a balanced portfolio can help to significantly mitigate the downside risk.



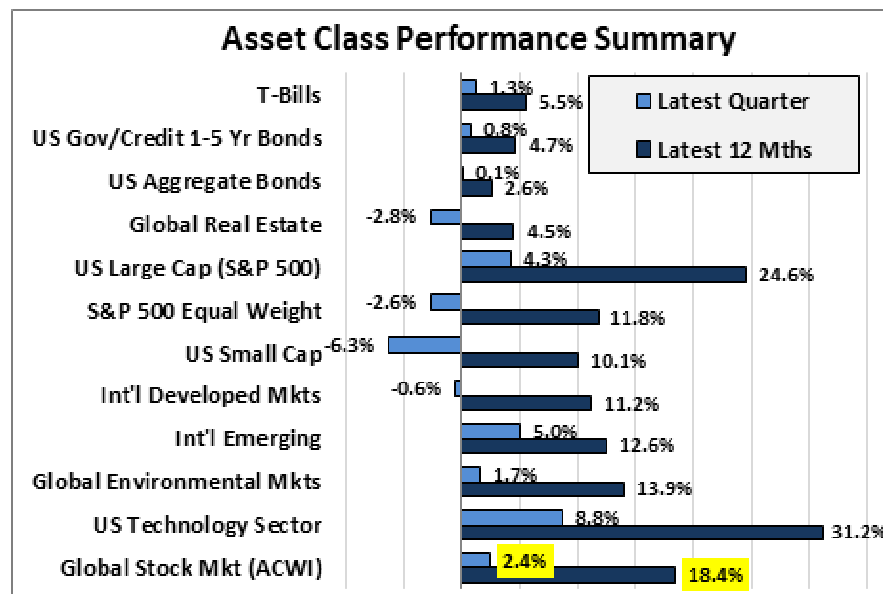
This chart shows the S&P 500's performance for the two years following a major geopolitical event. The events that are charted are the Korean War (06/1950), Soviets into Hungary (11/1956), Six-Day War (06/1967), Soviets into Czechoslovakia (08/1968), Arab-Israeli War (10/1973), Soviets into Afghan. (12/1979), Martial law in Poland (12/1981), Falklands War (04/1982), US invades Grenada (10/1983), US invades Kuwait (02/1991), Serbians into Kosovo (02/1998), September 11 attack/US invasion of Afghanistan (2001), US invades Iraq (03/2003), and N. Korea sinks S. Korean Navy vessel (03/2010), Russian annexation of Crimea/Invasion of Ukraine (03/2014), Fall of Mosul to Islamic State (6/2014), Russia invades Ukraine (02/2022). Sources: J.P. Morgan, Bloomberg Finance L.P.

Creating a Good Defense *and* a Good Offense

Managing risk is one of the greatest challenges faced by investors, and to prudently plan for the future in an uncertain world, we believe that our clients' portfolios should be structured to include both a good defense and a good offense.

A Good Defense is characterized by the following:

- Creating an adequate liquidity reserve by setting aside funds in cash-equivalent securities to cover short-term financial requirements.
- Establishing a "safe haven" portion of the portfolio invested in high-quality bonds equivalent to 8 to 10 years of future cash flow needs.



- By earmarking portions of the portfolio for short and intermediate-term financial requirements, the balance of the portfolio can be more confidently invested in riskier assets designed for long-term capital appreciation. Such a strategy helps eliminate the need to sell assets when their prices are depressed.

A Good Offense is characterized by the following:

- Diversification across a spectrum of asset classes to capture the various returns within the global stock market.
- Periodically rebalancing the portfolio to take advantage of the inevitable stock market downturns, i.e., the systematic process of buying when prices are depressed and selling (trimming) when prices are elevated.

Asset Class Performance Review

Before examining forward-looking expectations for the investment markets, in reviewing the most recent results, the last twelve months through June 30th were extraordinarily positive for most of the major asset classes as indicated in the performance summary at the top right of the page. The leading sector was US Technology which gained 31.2% followed by US Large Cap stocks (the S&P 500) which gained 24.6%. It's important to note that 35% of the weight or capitalization of the S&P 500 is in the technology sector which eerily ties its record high of March of 2000. Furthermore, stock market concentration is at a record high level given that the top ten stocks in the S&P 500 comprise more than 37% of the index's capitalization (refer to the line graph below). There's been much discussion about whether technology stocks are in another bubble which has been inflated most recently by enthusiasm for stocks of companies related to the development of Artificial Intelligence (AI). While AI has the potential to create great efficiencies and advancements in productivity across most industries, many of the AI-related stocks have soared to perhaps unsustainable valuation levels. From a fundamental valuation standpoint, we believe it is prudent to underweight these high-priced stocks and overweight stocks with more favorable valuations which is how our model investment strategy is positioned today. Such a strategy worked very well for clients of the firm following the bursting of the original technology stock bubble between 2000 and 2002, and over the ensuing five years.

In reviewing performance of the other asset classes over the past twelve months, the Global Stock Market gained 18.4% and all but Global Real Estate (+4.5%) posted double-digit gains of between 10.1% (US Small Caps) and 13.9% (Global Environmental Markets). Within the Fixed Assets, T-Bills earned 5.5% reflecting the monetary tightening strategy of the Federal Reserve, while 1-5 Year Bonds earned 4.7% and the longer-term Aggregate Bond Index earned 2.6%. All in all, a great twelve months.

For the trailing three months, the picture was mixed. The Global Stock Market gained 2.4%. The stock asset classes with the biggest gains were US Technology (+8.8%), followed by Emerging Markets (+5.0%) and US Large Caps (+4.3%). Those with losses were US Small Caps (-6.3%), Global Real Estate (-2.8) and the Equal-Weighted S&P 500 Index (-2.6%). Within Fixed Assets, T-Bills gained 1.3% followed by 1-5 Year Bonds (+0.8%) and US Aggregate Bonds (+0.1%).

Future Expectations

Despite the potential risks and uncertainties on the horizon, we expect that investment returns over the next 10 years will be favorable, especially in those asset classes which are attractively priced today (these would include lower-priced stocks as well as bonds based upon their relatively high current yields). In

10-Year Future Annual Rate of Return Forecasts as of 6/30/24		
Equities	10 Year "Expected" Return	Risk Level (Standard Deviation)
Emerging Markets	9.2%	20.2%
Non-US Developed Markets	9.2%	16.5%
US Small Cap Value	9.0%	19.2%
Global Equities Mix	**6.4%**	**15.5%**
US Large Cap Value	6.2%	15.4%
US Small Cap Growth	4.9%	22.5%
US Large Cap Growth	2.3%	17.3%
Fixed Assets		
Diversified Bonds	**5.3%**	**3.3%**
Cash (Money Market Funds)	3.6%	0.8%
Balanced Portfolios		
20% Fixed - 80% Equities	6.3%	12.5%
40% Fixed - 60% Equities	6.2%	9.8%
50% Fixed - 50% Equities	6.1%	8.4%
60% Fixed - 40% Equities	5.9%	7.1%
Inflation	2.6%	NA

the table to the left, we have updated the expected returns for various asset classes as well as several balanced portfolio combinations of bonds and stocks (the underlying data in the table is based upon the analytical work of Research Affiliates, www.researchaffiliates.com. Note that the expected annual return over the next ten years for US Large Cap Growth stocks is just 2.3% which is primarily attributable to the fact that this asset class includes many of the largest technology stocks which are priced significantly higher than their long-term historic valuation levels. In the style box below, note that the Price-to-Earnings Ratio of US Large Growth stocks are 60% higher than their 20-year average. Assuming their prices fall to historically normal valuation levels (i.e., reversion to the mean), their future returns will likely be sub-par, hence the reason for the low 2.3% annual return expectation. The most attractively priced U.S. asset classes are within the red box and include Small and Mid-Cap Blend and Value stocks which is the group of stocks we are currently overweighting in our model portfolio. Non-US stocks both in the Developed and Emerging Markets also appear particularly attractive from a comparative valuation perspective. In fact, non-U.S. stocks are trading at a record-high 37% discount compared to U.S. stocks based on comparative current Price-to-Earnings Ratios. We believe that the strategy of tilting portfolios toward Small and Mid-Cap stocks, Value Stocks and Non-U.S. stocks will increase the odds of a successful investment outcome over the next ten years.

Current P/E as % of 20-year avg. PE	Value	Blend	Growth
Large	112.4%	136.3%	160.1%
Mid	100.0%	99.6%	129.2%
Small	94.1%	106.0%	155.1%

The Two Other Longer-Term Risks

Neither the growing national debt nor the potential costs related to climate change made it to the top of the list of J.P. Morgan's client survey. In subsequent quarterly letters and in future meetings we will address these longer-term risks further. In the meantime, we are very mindful of these two risks in our conference calls with economists and our investment committee's research. Below are a few comments:

- Federal deficit: It will require a bipartisan effort to tackle the federal deficit problem, and while the solutions are clearly defined and achievable, the sharp divide between the two political parties leaves little room for hope in the short term. As the Peter G. Peterson Foundation points out, high levels of debt will likely lead to higher interest rates, higher inflation and slower economic growth.
- Environmental risks: 2023 was the warmest year on record and 2024 is on a trajectory to be another record-breaking year. The potential costs to deal with climate change damage could be staggering according to credible estimates. On this front, however, there is some hope. Currently, our model portfolios include core positions in sustainably invested mutual funds and ETFs which are designed to provide a meaningful reduction in carbon emissions exposure while also providing favorable investment returns. From a bigger picture perspective, we would encourage our clients to visit the website of the Grantham Foundation (granthamfoundation.org) which was founded by Jeremy and Hannelore Grantham (Jeremy was a co-founder of GMO, a renowned investment firm headquartered in Boston) Following his retirement from GMO, Grantham dedicated 98% of this personal wealth (approximately $1 billion) and all of his energies to fighting climate change. On their website is a list of more than 60 innovative companies which are developing solutions to the climate crisis and producing encouraging results. The foundation believes "….there is hope – more than before. People are more concerned about climate than ever; now, for the first time, we have the technology to back that hope up. Technology exists to break free of fossil fuels and build a sustainable society." (Now if we could only get these innovators to work on the national debt!)

Closing Comment

There is much uncertainty and conflict in the world today and the risks appear unusually high. However, we believe that the most practical way to deal with investment risks is to establish a good defense and a good offense offered through a highly diversified balanced portfolio structure. As investors, we cannot avoid all the potential risks, but we can prepare for them through prudent portfolio construction within the framework of a sound financial plan (history has also taught us some important lessons).