Forecasts
Market Outlooks

Q4 2023

Market Forecasts
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Simona Mocuta
Chief Economist,
Global Macro and Research
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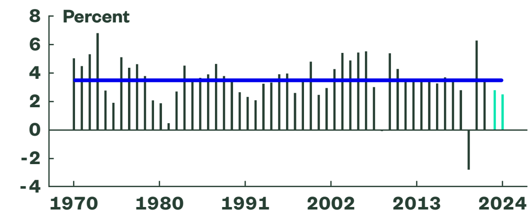
Global Economic Outlook

Figure 1
Global Growth is Slowing



World Real GDP Growth (WEO)

World, Real World GDP, State Street Global Advisors Forecast

Long Term Average Growth (3.5%)

Source: IMF, WEO, State Street Global Advisors, as at September 30, 2023. The above forecast is an estimate based on certain assumptions and analysis made by the State Street Global Advisors Economics Team. There is no guarantee that the estimates will be achieved.

- The global economic growth forecast has been nudged higher, but the upgrade is not universal and the expansion slows further in 2024 as high interest rates increasingly take their toll.
- That the disinflation trend has taken firmer hold without a recession is a key development. And while minimal additional tightening cannot be entirely discounted, we are essentially at the peak.

Simona Mocuta
Chief Economist,
Global Macro and Research
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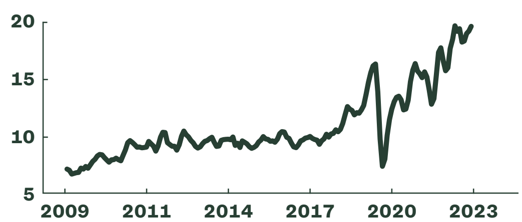
Emerging Markets Outlook

Figure 2
The Rise of India as an Export Base



US Imports from India as Share of US Imports from China (3mo ma)

Source: Macrobond, State Street Global Advisors Economics, US Census Bureau, as of September 30, 2023.

- China's sluggish growth remains front and center for the broader EM outlook, but India gains prominence.
- As disinflation broadens, select central banks embark on cautious policy easing.

Jerry Holly, CFA
Senior Portfolio Manager,
Investment Solutions Group
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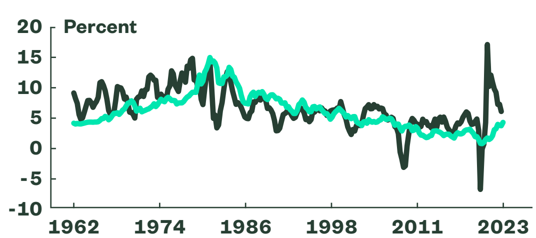
Global Capital Markets

Figure 3
Nominal GDP Falling Quickly as Yields Accelerate



Nominal GDP Growth

US 10 Year Treasury Yield

Source: State Street Global Advisors, Federal Reserve Bank of St. Louis as of July 2023. Past performance is not a reliable indicator of future performance.

- Although we anticipate steadily slowing global economic growth into 2024, we continue to see favorable opportunities in equities — even if the conditions are not as good as earlier in the year.
- Despite sharply higher interest rates and cooling economic growth expectations, we remain bearish on bond markets amid challenging market conditions and heightened focus on debt levels and fiscal deficits.

Global Economic Outlook

Simona Mocuta
Chief Economist, Global Macro and Research

Following some bumps along the way earlier this year, the global economy has proven impressively resilient and talk of recession has diminished considerably. However, sub-trend growth remains the theme. Central bank policy rates have largely peaked amid a quickening in the pace of disinflation, although there is lots of uncertainty over how soon rate cuts will happen across developed markets.

Three months ago, we noted that it would be surprising if no other similarly disruptive risk event to the (contained) US and European banking turmoil transpired during the second half of 2023. The year hasn't ended yet, but we are surprised by the global economy's ability to weather the ongoing monetary policy tightening without delivering more "victims". That said, not every region has enjoyed a surprise to the upside. Our forecasts for both the UK and the eurozone remain essentially unchanged from three months ago, while our growth expectations for China have been reduced slightly for both this year and next. The big upside surprise has been the United States, but we've also revised growth higher in Japan and Australia. In Japan, much better than expected Q2 GDP data prompted an upgrade to 2023 forecasts, though 2024 estimates are unchanged. In Australia, the fundamental story remains one of deceleration although the timing of that is pushed out: so while 2023 growth looks better, 2024 is a bit softer. As a result of all these permutations, global growth (PPP-weighted) is lifted by two tenths to 2.8% in 2023 and by one tenth to 2.5% in 2024.

Perhaps the best news since our last quarterly update is that the disinflation trend, already very evident in the US, has taken firmer hold in the eurozone and appears to have finally gathered pace in the UK as well. Disinflation without a recession is indeed something to celebrate. The pace of monetary tightening has naturally slowed given interest rates have already been pushed to highly restrictive levels. While some modest additional tightening cannot be entirely discounted, we believe the US Federal Reserve (Fed) and the European Central Bank (ECB) are both done. Attention is increasingly focused on the Bank of Japan (BoJ), whose careful exit from extraordinary policy accommodation is expected to involve an end to negative interest rates in 2024. At the other end of the spectrum, China is the most important economy where monetary policy has turned more accommodative this year as authorities seek to tackle persistent headwinds on both domestic and external fronts.

United States: How Secure is the Soft Landing Scenario?

The US economy has shown a surprising degree of resilience in the face of rising interest rates. As a result, 2023 growth forecasts have been universally upgraded, with some of that strength mechanically spilling over into 2024. We have also revised our forecasts: in a mark-to-market exercise not unlike that visible in the Fed's September summary of economic projections, we've raised our 2023 real GDP growth forecast from 1.2% to 2.0% and the 2024 forecast from 0.5% to 1.1%.

However, this is far from an "all clear" signal on the outlook. Although near-term recession odds suggest it is unlikely, we still see a 30–35% chance of a US recession on an 18-month horizon.

We think the current monetary policy stance is very restrictive, but its impact on demand has been blunted by a very loose fiscal stance. The lingering fiscal impulse from previously-approved packages (Chips Act, Inflation Reduction Act) is probably the number one reason why growth has surprised so positively this year. Additionally, several other factors have further slowed the transmission of monetary policy. Household balance sheets remain strong overall, and while new credit is very expensive, debt servicing obligations as a share of disposable income are still historically modest. Many firms have borrowed at very low interest rates in 2020 and 2021 and still have those reserves untapped. It is not until late 2024 and, mostly, 2025, that the US corporate sector faces a meaningful refinancing "wall".

Given this backdrop and the apparent lack of "pain" in the economy at large, and the labor market in particular, there is a tendency to assume that the Fed needs to "do more". But it is precisely at times such as these that it is important to remember that monetary policy works with long and variable lags, and that the labor market is a lagging indicator.

Labor Market Strength to Ease Somewhat

With the personal savings rate below 4.0%, the resumption of student loan repayments, and cost of living adjustments to social security benefits considerably less generous in 2024 than in the prior two years, we find it hard to believe that consumer spending can sustain its recent growth rates. Admittedly, consumers have enjoyed a powerful boost from the intense disinflation experienced since the summer of 2022; the fall in CPI inflation from over 9.0% to slightly over 3.0% has been a boon for real incomes. However, that tailwind will fade going forward since the next step in the disinflation journey will be less about magnitude and more about rotation from headline to core. For consumer spending, it is headline disinflation that matters. A slowdown, therefore, does not seem like an outlandish expectation, even absent meaningful labor market deterioration.

We do not anticipate dramatic labor market weakening, but the projections embedded in the FOMC September summary of economic projections feel a little too good to be true. One has to really squint to find any evidence that several years of high interest rates have any dampening effect on labor market conditions. So, rather than barely exceeding the 4.0% mark by the end of 2024, we believe the unemployment rate will top 4.5%. And, conditional on the mere 50 basis points (bps) worth of rate cuts through end-2024 envisioned by the median dot (from the Fed's so-called dot plot of members' expectations), we'd argue that the risks to that number are to the upside.

Inflation Remains Key Factor

For our part, we continue to believe that sustained, broadening progress on inflation warrants more rate cuts in 2024. However, we acknowledge that the latest dot plot has widened the gap between what the Federal Open Market Committee (FOMC) signals it intends to do and what we believe it should do next year. The implicit message in the dot plot is that unless something breaks in the economy, the committee is disinclined to pre-emptively calibrate rates lower just on better inflation data. We think that would be a mistake. Overconfidence in the soft-landing scenario actually endangers the odds of the soft landing remaining soft. As some of the supports to demand discussed above begin to fade, the delayed effects of earlier monetary tightening could precipitate a sharper than necessary downshift.

Incoming inflation data remains as critical as ever, but we believe there is scope for the Fed to cut rates by 100–150 bps in 2024. For now, the FOMC continues to be highly circumspect that the inflation progress seen in the core Personal Consumption Expenditures (PCE) data in recent months can be trusted. Even so, enough progress had been achieved to allow the FOMC to, for the first time in a long while, lower short-term core PCE inflation forecasts in September. The end-2023 core PCE inflation forecast (Q422/Q423) was reduced from 3.9% to 3.7%. Our own forecast has been at 3.5% since June and still looks reasonable to us. On that note, while growth forecasts have changed meaningfully for both this year and next, inflation forecasts have not.

Divining Where the Neutral Rate Lies

The economy's resilience has fueled debate not only about how high the Fed should/will go in the short term, but also about whether the "neutral" rate has shifted higher. Interestingly, Fed Chair Jerome Powell seemed to draw a distinction between the neutral rate and the long-term equilibrium rate in September. To us, this seems like an odd distinction. It is true that, to the extent that exogenous factors temporarily slow the transmission of monetary policy, the implication is that the Fed needs to do more to achieve the desired dampening of demand. Is this the same as saying that the neutral rate is higher? Insofar as the practical implication is the same, perhaps it matters little whether the problem is framed in terms of a higher neutral rate or not. However, we believe a better approach is to acknowledge the exogenous factors as the key variable swaying the outcome as it implicitly builds in a faster monetary policy reaction to any changes in those factors. This nuance leads us to believe the Fed should pre-emptively lower rates as inflation recedes.

Eurozone: Underappreciated Resilience

It is unusual to make no changes whatsoever to a quarterly forecast, but that has been the case with the eurozone projections this time around. Admittedly, given steep upgrades to US growth, this widens the eurozone's underperformance relative to the US, but hidden underneath that gap is a degree of resilience that we believe is underappreciated by market participants.

To begin with, last quarter we wrote about a "de minimis" recession in the eurozone (contractions of -0.1% quarter-on-quarter (q/q) in real GDP in Q4 2022 and Q1 2023). Subsequent revisions then erased even that smallest of possible technical recessions as the economy inched 0.1% higher in both Q1 and Q2. Even so, consumer spending stalled in the second quarter and remains under pressure from still-elevated inflation. However, that lack of spending seems to be more a function of choice rather than necessity, as household savings remain robust and could support healthier spending. In fact, as headline inflation continues to moderate, consumer confidence should recover and spending along with it, especially given the labor market's continued strength.

Investment has held up reasonably well, and we remain comfortable with our real GDP growth forecasts of 0.7% for this year and 1.1% for 2024. In this respect, it was good to see the new ECB staff forecasts essentially converge on our numbers (0.7% and 1.0%, respectively, compared with 0.9% and 1.5% three months ago). In 2022, there was acute concern around the region's ability to secure enough energy supply to avoid broad disruptions to economic activity. In the event, none of the worst case (or even second-worst case) scenarios came to pass. That resilience is once again being rebuilt as natural gas storage levels are filled to roughly 90–95% of capacity in many countries. The combination of improved supply security and lower natural gas prices should begin to partly reverse the deterioration in eurozone competitiveness that followed the start of the Ukraine War. It is in this space that we see more room for healing relative to generally gloomy consensus views.

Is the ECB Done?

With inflation data coming in largely as expected, we have left the 2023 and 2024 headline inflation forecasts unchanged at 5.8% and 2.4%, respectively. Uncertainties around the outlook and risks related to the recent move higher in oil prices exist, but we see developments so far as being consistent with our assumptions. The ECB staff forecasts envision a slower inflation descent, although we consider its 3.2% forecast for 2024 forecast as too conservative.

With the main refinancing rate now at 4.5%, the ECB's policy stance is now quite restrictive. The transmission of monetary policy also appears faster in the eurozone than in the US — partly a function of a less supportive fiscal backdrop — and we believe the ECB's rate hike cycle is at an end. Following the September hike, the ECB's Governing Council said it "considers that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target." While not a promise, it strongly hints that the Council's preference (or perhaps, hope) would be to let the rate hikes already delivered work through the system. We share that preference and hope. Unlike in the US, where we believe there is room for multiple rate cuts in 2024, the ECB appears more constrained in that respect. Even so, we believe 50 basis points worth of cuts in the latter part of next year is a reasonable baseline.

United Kingdom: Tightening Policy Begins to Bite

We are maintaining our June forecasts, notwithstanding some downside risks to growth that have arisen. The BoE's Monetary Policy Committee (MPC) narrowly voted in September (by 5-to-4) to hold the policy rate at 5.25% after the seemingly relentless increase in interest rates since December 2021. The bank said that it will maintain a "restrictive policy stance" until "material progress had been made in returning inflation to the 2% target sustainably". It seems to us that the choice over the next few months is between holding or increasing the interest rates further; rate cuts do not seem likely any time soon.

Inflation has continued to fall but core inflation is proving sticky. However, the August data was a welcome surprise with the core CPI moving closely in line with BoE expectations. Headline inflation had dropped to 6.8% in July, before inching down to 6.7% in August, 0.4 percentage points (pp) below the BoE forecast. While lower energy prices up to July contributed mainly to the lower headline rate, the decline in August was driven by other components. In fact, while energy inflation rose in August, core CPI inflation fell to 6.2%, well below market expectations. Services CPI inflation also declined more sharply than expected to 6.8% in August from a 31-year high of 7.4% in the previous month. It's worth noting though that the August decline and July increase was more related to travelling. Excluding travel-related items, services inflation remained elevated. In addition, upward pressure on wages is set to remain an issue in the coming months.

Growth, But Only Just

The UK economy remains on course to avoid a technical recession but growth is likely to stay fragile even after a stronger-than-expected expansion in Q2. The weight of higher borrowing costs has resulted in housing investment and house prices continuing to fall. Household consumption and business investment were strong in Q2 but have since taken a turn for the worse. In fact, monthly GDP was estimated to have contracted 0.5% in July, on a month-on-month (m/m) basis. Meanwhile, the manufacturing downturn deteriorated further in August, with the manufacturing purchasing managers' index (PMI) down to a 39-month low of 43.0 — readings below 50 are indicative of contracting activity. The services PMI also dipped into contraction territory in August for the first time since the beginning of the year. Trade remains under pressure, with both imports and exports projected to be down sharply in 2023 due to soft global demand and the continuing impact of Brexit. Given the subdued global economic outlook and slow inflation descent, we expect the economy to flatline over the next two quarters, leading to overall growth of 0.4% for this year. As for 2024, downside risks have risen but we still expect GDP growth of just over 1.0% given moderating inflation and strong wage growth.

The tight jobs market is easing and vacancies continue to decline. The ILO unemployment rate for the May-to-July period rose to 4.3%, above the BoE's August projection. We expect the unemployment rate to increase modestly for the next few quarters. Despite the gloomy economic outlook, wage growth has continued to exceed expectations, keeping the BoE under pressure; growth in average total pay (including bonuses) accelerated to 8.5%, while regular pay (excluding bonuses) growth held steady at 7.8%.

Japan: A Requiem for Normality

Our outlook on the Japanese economy has improved (again); we have raised the 2023 growth forecast three tenths to 1.8%. We expect growth to be less reliant on household consumption though, given the inflation burden. Furthermore, domestic consumption is moving sideways and could rise just 0.9% y/y this year and 0.6% in 2024, below its historic average. This weak momentum is also captured in declining import volumes, which contributed the lion's share to sequential GDP growth in the past two quarters. This boost may diminish or even reverse at some point over the coming quarters.

That being said, higher government consumption expenditure (GCE) is the key addition to the outlook. Although GCE had contributed just 0.2 percentage points to growth since Q1 2022, the improved outlook is backed by potentially higher defense spending. The government is also expected to draw up a stimulus package aimed at boosting growth by incentivizing firms to invest in cutting-edge technologies and improve wages. Furthermore, the government proposed to increase its defense allocation by 13% in the 2024 fiscal year, and spending could be higher in the next five years as the allocation is set to double to 2% of GDP by 2027. Another significant tailwind could be exports, which may rise on the back of a strong machinery order book.

Given the depreciation of the yen and rise in gasoline prices year-to-date, there is a strong probability of inflation reaccelerating in the months ahead. Hence, we now expect headline CPI inflation to average 3.0% y/y in 2023 and 2.2% in 2024. The BoJ may also sharply revise its forecasts in October in their outlook report. Finally, wage growth remains the most important factor for inflation and we expect next year's shunto negotiations to result in a 3.0% rise in overall pay, similar to this year, on stronger corporate profits.

Bank of Japan Nears Inflection Point

Since the BoJ tweaked its yield curve control (YCC) policy in July, the 10-year Japanese Government Bond (JGB) yield has risen sharply to end September at 0.77% and may rise towards 1.0%, the level at which the BoJ will conduct fixed rate JGB purchases. Together with interview comments from governor Kazuo Ueda that hinted at an end to negative rates, these developments put the onus on the BoJ to normalize monetary policy and we have brought forward our estimate of when the Bank amends the YCC from Q1 2024 to Q4 2023. We expect them to raise the YCC target to 0.5% or 1.0%, with a 100/50 bps tolerance band by Q1 2024, so that the BoJ could conduct fixed rate purchases at around 1.5%, if needed. An outright removal of YCC is still improbable, to avoid yields jumping to unmanageable levels. Timing wise, we see the October meeting as a live event, as it includes an outlook report and also because the Bank maintained policy without any new guidance in September. Furthermore, if Japan and the global economy endure this shift, we see a stronger possibility of Japan exiting from negative interest rates in the first half of 2024 rather than in H2 2024 as previously anticipated.

However, the most important development could be the BoJ reducing its JGB purchases to encourage higher domestic participation, as Japanese institutions recently turned net buyers of foreign debt for the first time since February 2022. Hence, there is an appetite for higher yields, but this is possible only by fewer JGB purchases by the central bank; if piloted successfully, the Bank could also consider tapering its holdings.

All in all, growth and inflation are expected to be firm, which might allow the BoJ to normalize monetary policy sooner than previously expected.

Emerging Markets Outlook

Simona Mocuta
Chief Economist, Global Macro and Research

Not much has changed on the emerging markets (EM) front over the last three months. China was a source of concern then and remains one now, even as more policy support has been rolled out to counter the pronounced and sustained housing sector slowdown.

Domestically, consumer sentiment (and demand) remains depressed while, externally, the contraction in global trade volumes and the re-orientation of demand away from China remain powerful headwinds. In this respect, the contrast in performance between Chinese and Indian exports to the US this year is stark. The latest monthly data show US imports from China down 28% y/y, whereas imports from both Korea and Japan are up marginally.

Perhaps even more impressive is the relative rise in India's importance as an import source for the United States. Mexico and India may well be the two emerging markets most likely to disproportionately benefit from the global trend toward re/friend-shoring. India's planned inclusion in global bond indices seems poised to boost capital inflows into the country and further support this process.

Despite some unease around rising energy prices, as disinflation broadens across emerging markets, more central banks are likely to join the few that have already begun calibrating interest rates lower. The speed and intensity of this remains constrained by a hawkish US Federal Reserve and a desire to avoid too much local currency depreciation, but the broad trend in EM countries over the course of 2024 will be lower, not higher. In that sense, the same as in developed markets, only sooner.

Global Capital Markets Outlook

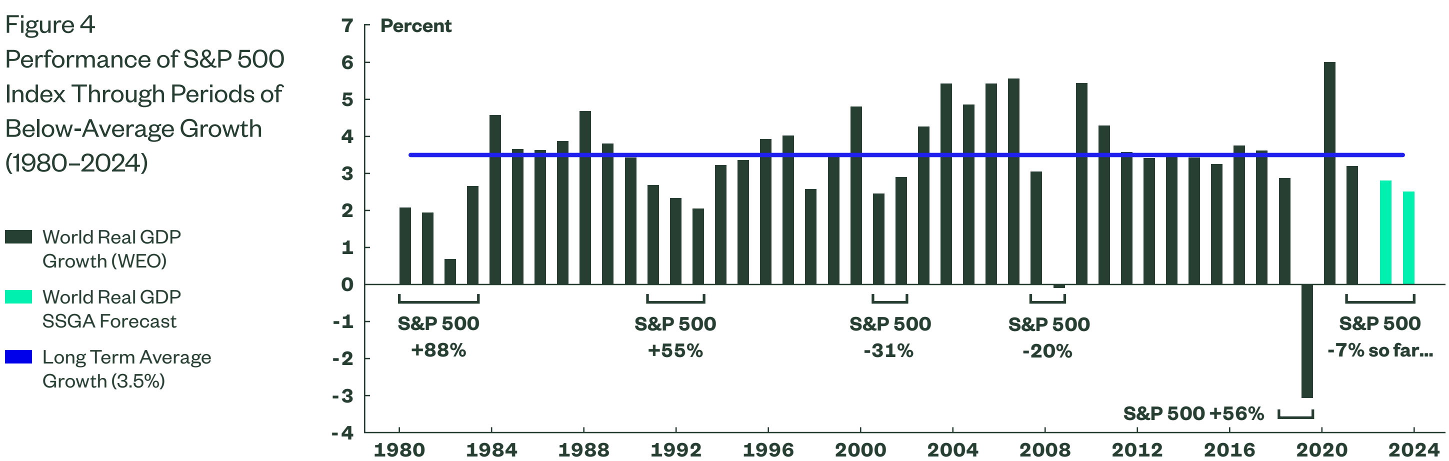
Jerry Holly, CFA
Senior Portfolio Manager
Investment Solutions Group

Although we anticipate steadily slowing global economic growth into 2024, we continue to see favorable opportunities in equities — even if the conditions are not as good as earlier in the year. And despite sharply higher interest rates and an expectation for cooling economic growth, we remain bearish on bond markets amidst challenging market conditions and heightened focus on debt levels and fiscal deficits.

Economics, Expectations & Empirics

Depending on one's baseline expectations, an investor could easily adopt different market views if they were told that they were looking at another year and a half of below-average (and slowing) global economic growth. Without any additional context, this would likely lead to a healthy dose of skepticism about the markets and, potentially, some conservatism in their portfolio construction. But if that same investor had been expecting a deeper downturn in the data, then sub-trend growth isn't that bad at all. In fact, some of the best periods for investments occur when the (contemporaneous) data are most grim. Our own economic outlook fits the mold as just described. Calendar year 2022 registered global economic growth that was just a hair below the long-term average. But we expect that to be followed up with a step-wise deceleration in both 2023 and 2024. From an empirical perspective, multi-year periods of below-average growth have transpired about 30% of the time over the past 50 years. Can we draw statistically significant patterns from these periods? Perhaps not, but intriguing inferences can still be had.

Figure 4
Performance of S&P 500 Index Through Periods of Below-Average Growth (1980–2024)



Source: IMF WEO and State Street Global Advisors. The above targets are estimates based on certain assumptions and analysis made by SSGA. There is no guarantee that the estimates will be achieved.

At the earlier end of our timeline (left-hand side of the chart), we can find a couple of examples of these persistently poor economic eras in the early 1980s and early 1990s. Both of these periods shared one critical attribute with the current environment, namely inflation problems. In the early 1980s, the market nearly doubled while facing inflation alongside weak economic conditions. The early 1990s episode also contended with moderate inflation risks and an oil shock from the Iraq invasion of Kuwait, but the S&P 500 managed to gain 55% over the course of two calendar years. Other below-trend growth episodes illustrate a starkly different relationship between economies and markets. For example, the tech bubble in the early 2000s and the Global Financial Crisis in 2008/2009 caused equities to re-rate to the tune of -31% and -20%, respectively. But then we see the relationship reverse yet again. Even a complete collapse of economic activity associated with the COVID-19 pandemic couldn't derail the stock market when viewed beyond the carnage inflicted at the very beginning of 2020. While the directional pattern couldn't be any muddier, what is striking is that historical periods of low economic growth tend to be associated with relatively extreme equity market performance — both to the upside and down.

How can this help to inform our outlook as we wrap up 2023 and head into a 2024 where major central banks are expected to begin cutting interest rates, where the war between Russia and Ukraine continues, and the United States has a presidential election on the political calendar? Past may not be prologue but there are some important differences between prior episodes and capital markets today that can help us assess the likelihood of outlier returns (up or down) as we move towards 2024. The early-1980s environment is an appealing one from which to draw parallels given the strong equity returns achieved as inflation was brought to heel. However, with forward price-to-earnings multiples in the mid-single digits, equity markets were far cheaper then they are today — suggesting super-sized returns will be harder to achieve. In the early 1990s, the US Federal Reserve (Fed) continued to ease monetary policy despite an oil price shock associated with the Iraq invasion of Kuwait. In the current environment, it seems quite unlikely that markets would receive any monetary policy support should an exogenous price shock occur. But on the flip side, the types of financial bubbles that were prevalent during the Tech crash in the early 2000s and the Global Financial Crisis later in that decade are also not apparent — suggesting that deep downturns in equity market valuations may not be warranted either. And while we shouldn't shortchange the tools that central bankers still have in their arsenal, as exhibited during the banking turmoil earlier in the year, it also seems that policy support (both monetary and fiscal) is much more handcuffed then it was during the COVID pandemic when stock markets recovered quickly and forcefully.

If we look at how equities (using the S&P 500 as a gauge) have fared in the current low growth environment — we're seeing modestly negative returns to the tune of -7% when counting 2022 and the 2023 year-to-date results. So far, that registers as a relatively benign outcome when contrasted with the earlier examples. And although bubble-like activity appears less widespread than in some of the thornier historical parallels where tech stocks and real estate markets led to broader downturns, we're also starting from a base that is not as supportive as some of the more constructive comparisons. More expensive equity valuations, negative term premia in fixed income, and much larger deficits and debt loads all point to caution. But there is a lot of room in between the halving of equity valuations witnessed during the depths of the GFC and the near-doubling seen in the early 1980s. From here, we'll explore why we remain cautiously optimistic about stocks as we head into the tail end of 2023.

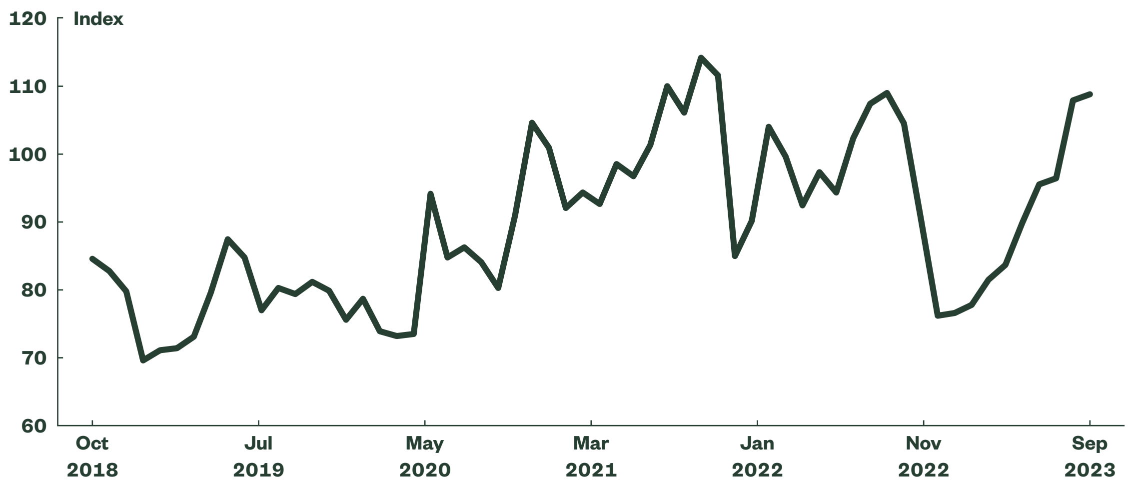
Sentiment Update — Is This Normal?

In our previous Forecasts edition, we were facing a market regime that was pushing the bounds of what would typically be considered constructive and veering towards a bit too much complacency. Low and declining credit spreads, alongside similar trends and levels of implied volatility in equity and currency markets, were starting to suggest taking some risk asset exposure down, even if the timing of any upside volatility breakout would inevitably be uncertain.

As we kick off the fourth quarter, the overall market risk regime has continued to show signs of wear. Mixed messages from the Bank of Japan has caused USD/JPY implied volatility to rise — with other key currency pairs following suit. Although the same pickup in volatility has been notably absent from the Nikkei, most other equity markets are displaying some degree of heightened risk aversion. To be sure, these changes have not been massive, but they've been sizable enough to push our regime indicator towards "normal" territory — whereby a more neutral stance across equity markets would be our default positioning.

And if we look to broader measures of market sentiment, it becomes clear that markets have less of a wall of worry to climb today than they did earlier in the year when sentiment was excessively bearish. Our own State Street Investor Confidence Index portrays real money investors as having re-risked throughout the course of 2023. That is to some extent corroborated by survey measures from AAII and Bank of America that are more or less average at the moment. And other positioning indicators like CFTC futures positions and margin balances also suggest at least less bearish perspectives than in early 2023.

Figure 5
State Street Investor Confidence Index



Source: State Street as of 29 September 2023.

Does this mean investors should be battening down the hatches for a rough Q4? Not just yet, but the sailing looks a bit more challenging and we've taken down our risk allocations to lower levels.

High Beta Equity for Low Growth Economics?

We have already covered how, at least empirically, slower global growth periods do not necessarily lead to subpar equity market performance. But what about market internals and the relative performance of different market segments. From a logical perspective, it would seem to make good sense to reduce exposure to markets where exports play a larger role in the economy (emerging markets) or to favor more established companies if top line sales growth may be inhibited by broader macro forces.[1] But good narratives and appealing logic do not necessarily govern the direction of asset prices. So let's take a look at some of our relative value equity allocations and focus on areas that are a bit off the beaten path as it relates to consensus positioning.

First, let's take a look at emerging market equities. With a backdrop of slow growth, a real estate crisis in China, and levitation in the US dollar to boot — there are any number of factors to give an investor pause when allocating to EM. One of the proximate causes of the anticipated slow growth environment and strong dollar — high and rising interest rates — has led to some relatively "textbook" reactions in EM equities. Emerging market equities have underperformed developed markets by a relatively wide margin, earnings-per-share (EPS) estimates have been forcefully downgraded, and we've witnessed at least modest EM foreign exchange depreciation.[2] But much of that is now in the rear-view mirror and while we don't take lightly the forward-looking obstacles confronting EM, we also think that there is an opportunity for some tactical outperformance given very pessimistic sentiment, solid quality metrics and a macro environment that is at least balanced, if not outright supportive for EM in some ways.

As one example of the downtrodden sentiment across emerging markets, the Bank of America China Risk-Love Index has recently fallen into a "Panic" zone. In the past, such readings have usually been followed by positive performance. From a quality perspective, we've seen an improvement in financial statement health insofar as free cash flows have closely followed operating income, on balance. This relationship tends to support the sustainability of future earnings performance. And from a macro perspective, the relative stability of emerging market currencies alongside an expensive US dollar is encouraging — particularly as EM foreign exchange markets have held up during a period of sharply rising interest rates.

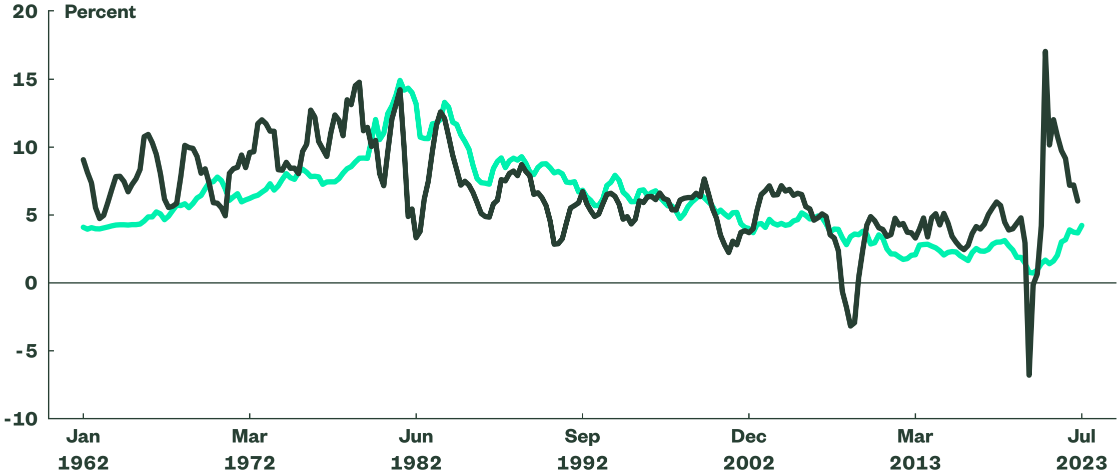
If we turn to US equity markets, we've recently turned more bullish on small cap equities than large caps. So far this year, US large cap equities have managed to deliver double digit returns, notwithstanding a weak third quarter. Meanwhile, US small caps were essentially flat through the end of Q3 as they suffered more acutely during the US regional banking crisis earlier in the year and have been unable to mount much of a relative comeback since.[3] Despite the recent weak performance and sluggish growth outlook, we think there are some compelling reasons to give small caps some consideration. For one, the valuations appear to have an advantage relative to large caps across all of the factors we analyze, with the exception of buybacks. Solid relative valuations are not a catalyst for outperformance in and of themselves, but we consider them to be a good tailwind nonetheless. We're also seeing better market internals, in terms of increased dispersion of stock returns, within the small cap universe. This type of behavior could be particularly telling if some of the high flying mega-cap tech stocks encounter any turbulence associated with persistently high real interest rates. And from a macro perspective, Federal Reserve backstops and benign money market conditions appear to have stemmed some of the worst case scenarios for smaller and mid-size banks. Since bottoming on a relative basis in May, small cap financials have actually outperformed the large cap financial sector, despite concerns around deposit flight and implicit government support for the larger systemically important banks.

Still Bearish on Bonds

If there is any major asset class whereby a sluggish growth outlook might translate into profitable returns, one would think fixed income might fit the bill. After all, government bond yields have tracked changes in nominal GDP growth over long periods of time (see Figure 6). And with a ~1.5% real GDP growth forecast for 2024 (United States) alongside decelerating headline CPI figures, it shouldn't be too long before this relationship suggests that bond yields are just too high.

Figure 6
Nominal GDP Growth and US 10-Year Yield

Nominal GDP Growth
US 10 Year Treasury Yield

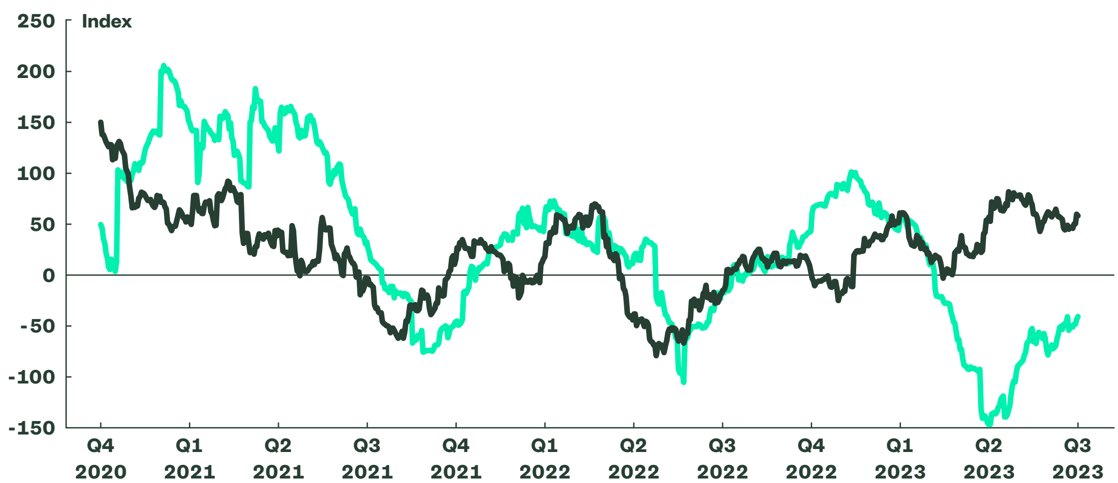


Source: State Street Global Advisors, Reserve Bank of St. Louis as of July 2023. Past performance is not a reliable indicator of future performance.

However, with near-term growth data continue to display resiliency, hawkish communications from central bankers and bond market investors pushing term premiums higher — we continue to see pressure on interest rates over the short term. In the United States, these concerns are magnified by persistent reminders that high debt levels and budget deficits are likely to matter more in an environment of positive real interest rates. Never mind the dysfunction on display in Congress that has caused credit rating agencies to implement or warn of potential downgrades. In Japan, with USD/JPY hovering around 150 there may be some tension around supporting both local equity markets and the value of the yen, but interest rate risks certainly seem skewed to the upside as the Bank of Japan gradually backs away from their yield curve control policies. Even where the data has been weaker (see Figure 7), such as in Continental Europe, some of the same fiscal and monetary concerns paint a difficult near-term picture for bondholders.

Figure 7
Economic Surprise Indexes for Major Countries/Regions

Citi Economic Surprise Index — United States
Citi Economic Surprise Index, EuroZone



Source: FactSet, Citi as of October 9, 2023.

The empirical record might be one channel to provide a more constructive near-term outlook for bonds as yield curve inversion has very rarely been followed by bear steepening as we have witnessed in recent months. Prior inversions that occurred in 1989, 2000, 2006 and 2019 all led to bull steepening in the yield curve with short-term interest rates easing. However, there is an historical fly in the ointment for this comparative analysis. If we peer back a bit farther, to the 1960s into the early 1980s, we do see several sustained periods of bear steepening following a yield curve inversion — a period that has come to be known as "the Great Inflation."

In credit markets, we continue to hold underweight allocations in our portfolios. Though we've seen at least some improved value with wider spreads on offer, more so in the below investment grade universe, we still see the high prevailing interest rates weighing on corporates. Additionally, the renewed corporate issuance that has come to the market following the usual summer lull in activity has seemingly reinforced the vicious circle of rising interest rates in government bond markets. For now, we'd prefer to bide our time on the riskier pockets of fixed income until we see some stability in rates markets.

Favor Precious Metals in Commodity Markets

Just as one might expect bond markets to fare well during periods of slower economic growth, it's easy to gravitate towards a bearish view of commodities in that same macroeconomic scenario. Add in some lackluster intermediate-term momentum in the market, headwinds from a generalized contango across commodity markets, and a persistently strong US dollar — and we're keeping our broad commodity exposure at minimal levels. However, we're carefully watching some of the burgeoning supports, particularly from the supply side, that are framing the commodity complex. Low and declining inventories of oil remain a key upside risk in the energy space and resilient demand for copper and aluminum despite Chinese growth concerns could prop up the industrial metals sector. While these trends bear watching, they don't yet outweigh some of the headwinds facing commodities in our view.

In contrast to overall commodity markets, which have seen favorable near-term performance and mediocre medium-term momentum, gold has struggled more recently but continues to hold up over intermediate-term horizons. Though gold is subject to the same pressures that a strong and rising US dollar exerts upon other commodity markets, we continue to see a relatively favorable environment for gold amidst debt and deficit concerns, in addition to still-strong technical indicators which suggest a positive trend is still in place despite recent headwinds.

A Fuzzy Finish

The global economy and financial markets operate in a reflexive relationship. Sometimes the pace and strength of economic growth dictate the performance of financial assets and sometimes pricing in capital markets exerts a greater influence on economic activity. For us, this is why economic forecasts and other macroeconomic factors are one piece of a broader mosaic that inform our portfolio allocations at any given point in time. Couple this important variable with other factors including valuations, sentiment, momentum, and others and we start to see a more complete picture of what might be transpiring. At the moment the portrait is quite fuzzy given competing influences across interest rates, foreign exchange, inflation, and policy impacts. We still see a modestly constructive outlook for equity markets, but with skeptical views across most other asset classes the overall environment seems shakier than it was just a couple of quarters ago.

Sources: Bloomberg, FactSet, J.P. Morgan, Barclays, MSCI, Morgan Stanley and The Economist as of September 30, 2023.

Endnotes

1 As it happens, emerging market equities actually have a negative beta to global economic growth (using MSCI Emerging Market Index returns and IMF Global GDP Growth data from 2002–2022). However, the beta coefficient is more or less meaningless as the R-Squared value is close to zero.

2 Special thanks to SSGA's Systematic Equity Team and Chris Laine for their work outlining risks and opportunities in emerging markets.

3 Using the S&P Small Cap 600 Index (+0.4% YTD in 2023).

State Street Global Advisors Forecasts as of September 30, 2023

	2023 (%)	2024 (%)
Real GDP Growth		
Global	2.8	2.5
US	2.0	1.1
Australia	1.8	1.4
Canada	0.9	0.6
Eurozone	0.7	1.1
France	0.6	1.0
Germany	-0.1	1.2
Italy	1.2	1.1
UK	0.4	1.1
Japan	1.9	1.1
Brazil	3.0	1.9
China	4.8	4.4
India	6.0	5.8
Mexico	2.8	1.0
South Africa	0.8	1.0
South Korea	0.8	1.3
Taiwan	0.4	2.7
Inflation		
Developed Economies	5.1	2.6
US	4.1	2.3
Australia	5.2	3.7
Canada	4.2	2.5
Eurozone	5.8	2.4
France	5.0	2.5
Germany	6.0	2.4
Italy	6.3	2.3
UK	7.2	2.9
Japan	3.0	2.1
China	0.4	1.7

	September 30, 2023 (%)	September 30, 2024 (%)
Central Bank Rates		
US (upper bound)	5.50	4.50
Australia	4.10	4.25
Canada	5.25	4.75
Euro	4.50	4.00
UK	5.25	5.00
Japan	-0.10	0.00
Brazil	12.75	9.00
China	4.35	4.25
India	6.50	5.50
Mexico	11.25	8.00
South Africa	8.25	7.00
South Korea	3.50	2.75
10-Year Bond Yields		
US	4.57	4.21
Australia	4.49	4.56
Canada	4.03	3.79
Germany	2.82	2.69
UK	4.40	4.30
Japan	0.76	0.92
Exchange Rates		
Australian Dollar (A$/$)	0.65	0.71
British Pound (£/$)	1.22	1.32
Canadian Dollar ($/C$)	1.35	1.25
Euro (€/$)	1.06	1.13
Japanese Yen ($/¥)	149.23	120.00
Swiss Franc ($/SFr)	0.91	1.00
Chinese Yuan ($/¥)	7.30	7.02

One-Year Return Forecasts	USD (%)	EUR (%)	GBP (%)	JPY (%)	AUD (%)	CAD (%)
S&P 500	7.0	0.3	-1.1	-14.0	-2.7	-1.1
Russell 2000	7.4	0.6	-0.7	-13.6	-2.4	-0.7
MSCI EAFE	6.7	0.0	-1.3	-14.2	-3.0	-1.3
MSCI EM	8.4	1.6	0.2	-12.8	-1.5	0.2
Barclays Capital Aggregate Bond Index	5.0	-1.6	-2.9	-15.6	-4.6	-2.9
Citigroup World Government Bond Index	2.5	-4.0	-5.2	-17.6	-6.8	-5.2
Goldman Sachs Commodities Index	1.1	-5.3	-6.5	-18.7	-8.1	-6.5
Dow Jones US Select REIT Index	5.8	-0.9	-2.2	-14.9	-3.8	-2.2

State Street Global Advisors Forecasts, as of September 30, 2023.
The above estimates based on certain assumptions and analysis made by State Street Global Advisors. There is no guarantee that the estimates will be achieved.

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 29 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $3.8 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2022.
† This figure is presented as of June 30, 2023 and includes approximately $63 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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Information Classification: General

Marketing communication

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