Market Commentary
ETF Model Portfolios

Q2 2021

State Street Tax-Sensitive Strategic Asset Allocation ETF Portfolios

The global growth recovery broadened in the second quarter, aided by accelerated COVID-19 vaccine rollouts in the United States and Europe. Incoming data in the second half of the quarter points to a robust global recovery cycle despite persistent headwinds, including supply chain disruptions, new variants of the Coronavirus and the potential for central bank tightening on inflationary concerns.

The Market in Review

Risk assets continued to rally in the second quarter, aided by the strong economic recovery across key developed markets (DM). Commodities registered solid gains on the back of strong growth in energy prices. The US dollar remained flat for the quarter. Its decline in the first half of the quarter was offset by strong monthly performance in June. For the quarter, the yield on the US 10-year Treasury note fell to 1.47% from 1.74%, giving up some of the large gains made during the first quarter.

On the fiscal front, US President Biden secured a deal on an infrastructure package worth US$1 trillion, which fell short of the US$2.3 trillion plan proposed in March. The deal authorizes additional spending for roads, bridges, highway safety and electronic vehicle charging stations over the next eight years. In Europe, the European Commission started to publish its assessment of recovery plans for member states. Many countries, including Portugal, Spain and Greece, received the green light for European Union (EU) recovery funding.

On the monetary policy front, although the US Federal Reserve reiterated that the rise in inflation is transitory, its tone was more hawkish. The Fed acknowledged discussions around tapering and indicated the possibility of at least two rate hikes by the end of 2023 through its "dot plot" projections. In Europe, the European Central Bank (ECB) chose not to discuss tapering. It expected inflation to remain below target for the foreseeable future and committed to purchase €1.85 trillion worth of bonds until March 2022 as part of its pandemic emergency purchase program. In Japan, the Bank of Japan kept monetary policy steady and reiterated its view on subdued inflationary pressures. It also unveiled a plan to boost funding for climate change to be rolled out by the end of 2021.

On the COVID-19 front, over a fifth of the world's population received at least one vaccine dose, up from 3.0% in mid-March, with DM leading emerging market (EM) economies. The EU closed the gap on the vaccinations in the second quarter with infection rates falling and social and economic activities being eased in many countries.

On the economic front, incoming US data points to strong recovery momentum. US Q1 GDP registered solid 6.4% QoQ annualized growth though it was lower than consensus estimates of 6.7%. Leading indicators for both services and manufacturing registered record highs during the quarter with the IHS Markit US Composite Purchasing Managers' Index (PMI) moving to 63.9 in June from 59.7 in March. Though Eurozone GDP contracted in the first quarter, business activity picked up in the second quarter and expanded at its fastest rate in 15 years in June. Business activity in the United Kingdom (UK) also expanded in the second quarter with the IHS Markit Composite PMI interim number at 61.7 for June, the highest since the series began in 1998. Inflation continued to trend higher across regions as a result of supply-side constraints (in both manufacturing and services), resurgent demand and base effect. Inflation had already topped the targets of central banks across the US and Europe, but monetary policymakers expect price pressures to be transitory.

Positioning and Performance

Global Equities Equity markets had a strong quarter on quarter performance registering positive growth, and the MSCI All Country World Index rose by 7.53%. The performance was dominated by DM equities as measured by the MSCI World Index, which returned 7.89% during the quarter as the vaccination pace accelerated in developed economies. The MSCI Emerging Markets Index posted modest positive returns of 5.05% but lagged behind DM equities as some countries within the region still struggled with increasing COVID-19 cases.

In the US, the S&P 500 Index gained 8.55% during the quarter as the pandemic was reined in, consumer spending increased, growth stocks rebounded, first-quarter earnings grew strongly and the prospects of fiscal stimulus improved in the context of President Biden concluding a bipartisan deal to boost infrastructure spending by US$600 billion. The US president also outlined two more spending packages — a US$2.3 trillion American Jobs Plan and a US$1.8 trillion American Families Plan, with many key tax credits from the rescue bill being extended or made permanent. The plans are designed to bolster the country's infrastructure and ensure a more equitable recovery. The Chicago Board Options Exchange's CBOE Volatility Index (VIX) posted negative returns of -18.40% over the quarter, indicating reduced market volatility. Real Estate (13.09%) and Information Technology (11.56%) were the best performing sectors while Utilities (-0.41%) was the only sector posting negative returns on the broader index. Mid- and small-cap companies, which tend to be more domestically focused, lagged behind their larger counterparts during the quarter with the S&P Midcap 400 Index rising by 3.64% and the Russell 2000 Index gaining 4.29%.

In Europe, the equity markets were supported by the reopening of regional economies and strong global goods demand. Increasing vaccination rates bolstered prospects for a strong economic rebound. Despite a 0.6% contraction in the first quarter, Eurozone PMIs reached multi-year highs in many regions as vaccination rates boosted confidence in the service sector, anticipating that resilient spending would boost retail sales. The ECB kept its monetary policy unchanged during the quarter but emphasized a faster paced liquidity injection going forward. MSCI Europe returned 7.74% in the quarter in US dollar terms. Health Care (12.66%) and Real Estate (10.94%) were the best performing sectors. Although Financials (3.95%) and Utilities (0.13%) posted positive performance, they were ranked at the bottom compared to other sectors. In terms of region, MSCI Denmark and MSCI Switzerland were the top performers during the quarter, returning 13.11% and 12.02%, respectively, in US dollar terms.

MSCI Pacific lagged other DM during the quarter and rose by only 1.36% in US dollar terms. With gains of 6.91% and 2.53%, respectively, MSCI Australia and MSCI Hong Kong were the top performers. MSCI Singapore had moderate gains of 0.49%. MSCI Japan and MSCI New Zealand were the laggards with negative returns of -0.25% and -5.07%, respectively. Japanese equity markets, in particular, experienced a sell-off as tensions between Japan and China, the emergence of new forms of the Coronavirus, reports of a fourth wave of the pandemic and the slow vaccination campaign all weighed on performance.

EM equities lagged behind their DM counterparts as many countries faced a spike in COVID-19 cases, the reimposition of lockdowns and a slowdown in vaccinations. Although the Chinese economy was less buffeted by the pandemic, it was weighed down by concerns over monetary policy normalization and tougher regulations on the Technology sector. China renewed its pledge to make its economy carbon neutral by 2060, which helped to boost investor sentiment. Most EM countries also faced logistical challenges in terms of vaccine supply. The MSCI Emerging Markets Index, the broad measure of the performance of EM, was up by 5.12% for the quarter in USD terms. At the country level, the top-performing markets included MSCI Brazil (22.93%) and MSCI Poland (18.72%). The markets that were ranked at the bottom were MSCI Egypt (-9.21%) and MSCI Chile (-13.72%).

Overall, the long-term annual return expectations for core US large cap equities and for global developed equities ex-US remain relatively favorable and may offer beneficial risk/return trade-offs in the context of a multi-asset class portfolio.

Global Fixed Income Global bonds (Bloomberg Barclays Global Aggregate Bond Index — USD Hedged) saw modest positive returns (+0.98%) in Q2. Spreads were flat overall, and bond yields were relatively range-bound over the quarter as markets saw a balance between improving global growth and the major central banks signaling potential tapering plans. Despite a more hawkish than expected outcome in the Federal Open Market Committee's June meeting, risk assets recovered after an initial slide and long-end Treasury yields fell to a low not seen since February.

The Bloomberg Barclays Municipal Managed Money 1–25 Years Index returned 1.32% for the second quarter of 2021. Investment grade (IG) spreads (Bloomberg Barclays U.S. Aggregate Corporate Index) tightened by 11 basis points (bps) to end Q2 at 80 bps over Treasuries. Spreads over the quarter were the tightest they've been since the global financial crisis, driven by positive earnings outlook and business sentiment. Upcoming IG bond supply is expected to be modest as heavy issuance in the first half of the year (IG net supply of US$345.2 billion) suggested significant frontloading. Also, companies still carry sizable cash and the M&A pipeline with issuance implications is relatively low. Demand has been solid as well given higher inflation uncertainty, but low rates volume supported flows into short-term IG funds.

High yield (HY) spreads (Bloomberg Barclays U.S. HY 2% Issuer Cap Index) tightened by 42 bps to end Q2 at 269 bps based on increased confidence in the global economic recovery and expectations that the recent inflation spike will prove to be transitory. US$140.5 billion worth of new HY issuance was priced in Q2, the third highest quarterly volume on record, and HY funds saw US$3.2 billion of outflows in Q2 compared with US$10.6 billion in Q1. Defaults have been coming down, with 2021 witnessing the mildest start to a calendar year for defaults/distressed transactions since 2011. US HY 12-month default rate ended Q2 at 1.87%, as large defaults from June 2020 exited the 12-month rolling window.

Market-based inflation expectations for the US, as measured by five-year break-evens, slightly declined over Q2, ending at 2.50%. The modest drop in inflation expectations contrasted the latest actual data, which saw the US Consumer Price Index rising 5.0% in the 12 months ended May 2021, the strongest level since August 2008. Both Treasury inflation-protected securities (TIPS) and nominal Treasury bonds saw positive returns over the quarter, with TIPS significantly outperforming Treasuries.

In an effort to maintain an attractive risk and return outlook for the strategic models, the models continue to favor senior loans, which offer favorable long-term return projections, and short-term corporates that allow for duration reduction. In the more growth-oriented models, the exposure to higher volatility fixed income instruments (namely long-term Treasuries, HY and EM debt) remains low in favor of less volatile aggregate bonds.

Real Estate Real estate investment trusts (REITs), as indicated by the FTSE EPRA Nareit Global Real Estate Index, gained 7.9% in Q2, while the Dow Jones US Select REIT Index returned 11.8% for the quarter. By the end of the second quarter, REITs total returns fully recovered from the initial losses recorded in early 2020. Nearly all property sectors registered positive returns during the quarter. Self-storage, residential and industrial REITs registered double digit gains, while lodging/resorts languished.

The current depressed levels of global yields continue to challenge income expectations for global REITs going forward. Additionally, the potential for bond yields to revert higher may challenge price returns for rate-sensitive REITs. We maintain low allocations to securitized global REITs due to the deterioration in the long-term expected return prospects.

Source for index returns: FactSet, as of June 30, 2021.

Glossary

PMI, or Purchasing Managers Index An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.
Developed Markets Refers to countries or market areas with relatively high levels of economic growth, market liquidity and transparency as well as political stability, rule of law and safety.
TIPS, or Treasury Inflation Protected Securities Refers to Treasury securities that are indexed to inflation in order to protect investors from the negative effects of inflation. TIPS are backed by the US government and are thus considered an extremely low-risk investment. The par value of TIPS rises with inflation, as measured by the Consumer Price Index, while the interest rate remains fixed.
High Yield A company or bond that is rated 'BB' or lower is known as junk grade or high yield, in which case the probability that the company will repay its issued debt is deemed to be speculative.
Yield The income produced by an investment, typically calculated as the interest received annually divided by the price of the investment. Yield comes from interest-bearing securities, such as bonds and dividend-paying stocks.
Volatility The tendency of a market index or security to jump around in price. Volatility is typically expressed as the annualized standard deviation of returns. In modern portfolio theory, securities with higher volatility are generally seen as riskier due to higher potential losses.
Large Cap A stock with a high level of capitalization, usually with a market value of more than $10 billion.
Emerging Markets Developing countries where the characteristics of mature economies, such as political stability, market liquidity and accounting transparency, are beginning to manifest. Emerging market investments are generally expected to achieve higher returns than developed markets but are also accompanied by greater risk, decreasing their correlation to investments in developed markets.
REITs or Real Estate Investment Trust Companies that own and operate commercial properties, such as office buildings and apartment complexes.
Bloomberg Barclays Global Aggregate Bond Index A benchmark that provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment-grade 144A securities.
Bloomberg Barclays Global Corporate High Yield Bond Index A multi-currency fixed-income benchmark of the global high yield debt market. The index represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices. The high yield and emerging markets sub-components are mutually exclusive.
Bloomberg Barclays Municipal Managed Money 1–25 Years Index A benchmark designed to track the U.S. long-term tax-exempt bond market, including state and local general obligation bonds, revenue bonds, pre-refunded bonds, and insured bonds. The index is comprised of bonds issued by states, cities, counties, districts and their respective agencies.
Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Cap Index The index measures the performance of high yield corporte bonds, with a maximum allocation of 2% to any one issuer.
VIX Index Often referred to as the equity market's "fear gauge," the VIX Index is a measure of market risk based on expectations of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options — both calls and puts. The VIX volatility measure is meant to be forward looking.
S&P 500 Index A benchmark for U.S. large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.
MSCI Europe Index A benchmark capturing large- and mid-cap representation across 15 developed market countries in Europe.
MSCI Pacific Index An index that captures large and mid cap representation across 5 Developed Markets countries in the Pacific region. The index covers approximately 85% of the free float-adjusted market capitalization in each country.
Dow Jones U.S. Select REIT Index The index tracks the performance of publicly traded REITs and REIT-like securities and is designed to serve as a proxy for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate.
FTSE EPRA Nareit Global Real Estate Index A free-float adjusted, market capitalization-weighted index designed to track the performance of listed real estate companies in both developed and emerging countries worldwide. Constituents of the index are screened on liquidity, size and revenue.
MSCI World Index The MSCI World Index is a free-float weighted equity index. It includes about 1,600 stocks from developed world markets, and does not include emerging markets.
S&P Midcap 400 Index A benchmark that seeks to target the mid-cap portion of the US equities market. The index covers more than 7 percent of the U.S. equities market. Included in the index are companies with market cap in the range of $1 billion to $4.5 billion. This range is reviewed from time to time to ensure consistency with market conditions.
Russell 2000® Index A benchmark that measures the performance of the small-capitalization segment of the U.S. equity universe. The Russell 2000® is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes about 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.
MSCI Emerging Markets Index The MSCI Emerging Markets Index captures large and mid-cap representation across 23 emerging markets countries. With 834 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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