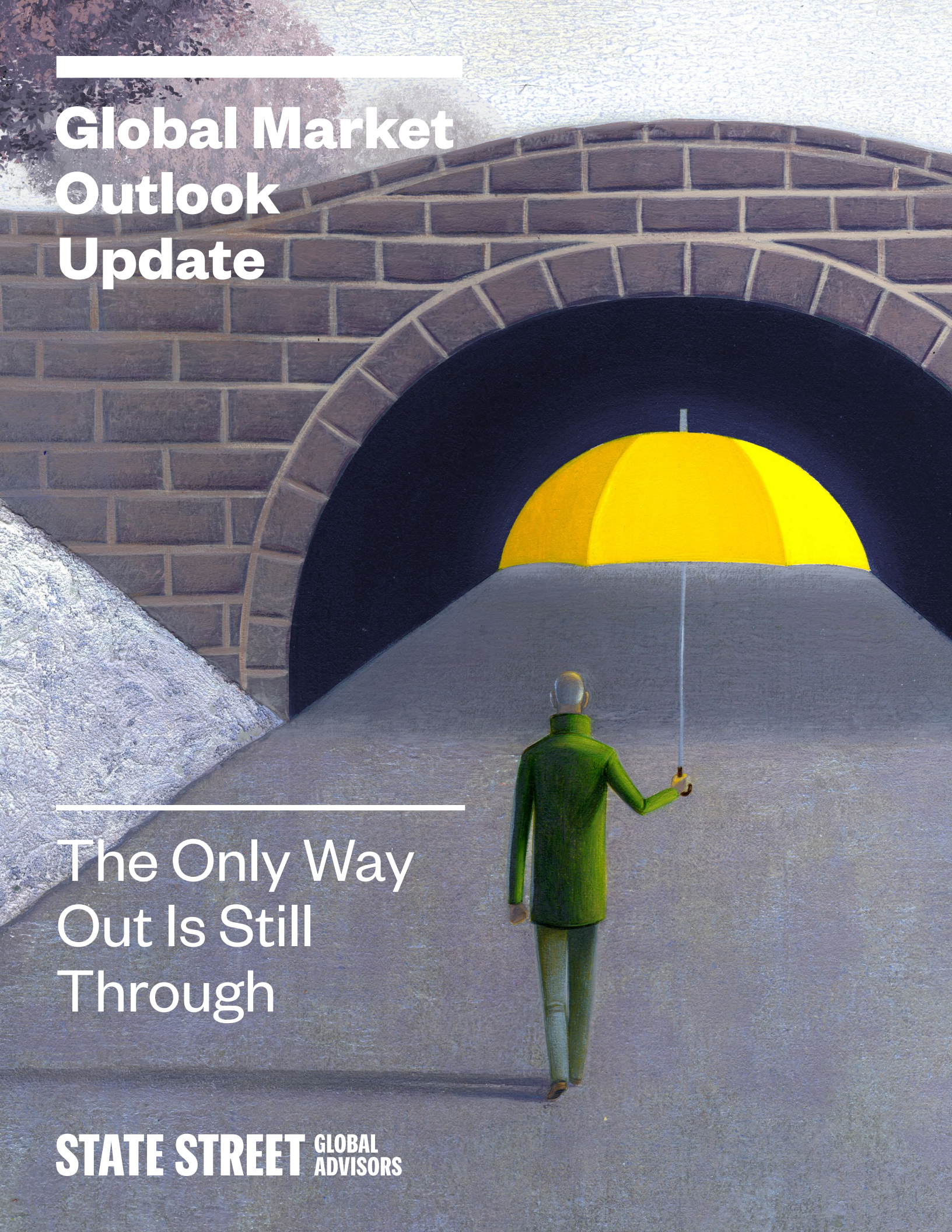
Global Market Outlook Update



The Only Way Out Is Still Through

STATE STREET GLOBAL ADVISORS

Richard Lacaille
Global Chief
Investment Officer

In our December 2019 Global Market Outlook, State Street Global Advisors argued that trade war de-escalation, consumer and service sector resilience, and accommodative monetary policies were poised to bring about a modest global growth acceleration in 2020.

The COVID-19 crisis — a black swan event that has caused untold human suffering and hammered economies and markets around the globe — has clearly changed those dynamics. Nevertheless, while the baseline has shifted sharply lower, our assessment of how the global economy may fare as we emerge from this crisis is more optimistic than consensus. As this crisis unfolds, the sentiment we identified in our December Outlook seems, if anything, even more relevant now: The only way out is *still* through.

Macroeconomic Outlook

Worst hit to real activity is likely behind us; second half of 2020 brings gradual healing, 2021 should usher in a strong rebound.

By March, earlier indications of improvement in global macro data collapsed into a retrenchment of unprecedented speed and magnitude. What began as a regional crisis originating in China quickly became a global pandemic, forcing strict lockdowns across the world. Economic activity collapsed almost instantly, as evidenced by unprecedented deterioration in a wide range of indicators, including purchasing managers' indexes and US unemployment claims.

Confronted with a new reality, policymakers around the world quickly swung from the "comfortable where we are" message of early 2020 to a "whatever it takes to survive" mindset, focused on limiting the economic damage and preventing a liquidity crisis from morphing into a solvency crisis. The monetary and fiscal policy response to this crisis has been incredibly swift and powerful. Although stimulus always works with a lag, we believe this swift action will make a huge difference in how quickly economies will heal.

From the beginning, drawing on the experience of countries impacted early on, we described the COVID-19 crisis as a three-month peak impact shock, meaning that the worst of the economic collapse associated with it and the early stages of economic healing would be compressed within roughly a three-month timeline. As new case data shows infection curves bending in many places, and as the debate turns to the conditions and timeline for reopening, this remains our core assumption.[1]

Even so, the economic hit will be severe, with many countries experiencing deep recessions and 2020 global growth the weakest since the Global Financial Crisis (GFC). Annual average GDP will mask truly extreme performance variation as we move through the year. After a weak first quarter and a horrid second quarter, we anticipate US and European economies will rebound sharply in the third quarter, with additional gains in the fourth quarter. This assumes that even in the event of a second flareup of the virus, we will have built enough capacity within the health system and made adequate provisions for personal protective equipment in order to address the health emergency. In addition, this assumes we will have made some progress toward acquiring herd immunity, so that further outbreaks would no longer necessitate the sort of blanket lockdowns that were imposed in the first instance.

Easy base comparisons will likely translate into abnormally high year-on-year growth rates during the first half of 2021, as lingering policy support converges with pent-up demand (and, possibly, with a biotech breakthrough) to drive sentiment and activity sharply higher. Given the tumultuous trajectory ahead, we believe there is a lot of value in embracing a two-year view. After the dashed expectations of 2020, we anticipate a modest return to growth in some regions by the second half of 2020, and that conditions will be in place for a powerful, V-shaped rebound into 2021. Overall, we would argue that diversified economies with less dependence on external demand and an ability to effectively coordinate fiscal and monetary policies (especially those with well-established reserve currencies) will be best positioned to weather this crisis.

These expectations are based in part on the swift response of policymakers and central banks. Here economies are reaping the benefits of past experience. Most of today's tools were identified and incubated during the GFC and thus, in the current crisis, were "off-the-shelf" options that could be deployed within days. We have seen dramatic rate cuts, massive scale-ups of repo operations, re-activation of crisis-era liquidity mechanisms, and the resumption, expansion and broadening of quantitative easing. New tools are being developed as well; the Fed, for example, has initiated a new facility that essentially amounts to direct business lending. Meanwhile, governments around the world are pushing through enormous fiscal packages.

Even as vast sums are pumped into the global economy, inflation is probably the least of our worries, at least for now. Despite likely supply chain disruptions and some bottlenecks in the months to come, we view COVID-19 as largely a deflationary force in the near term. Plunging oil prices alone are enough to drive inflation down across economies; our new forecasts reflect this. Whether this crisis is deflationary over the medium to long term is unclear, as we wait to see whether reshoring to higher labor cost locations wins out over tech-driven innovation in the competition to bolster crisis-exposed supply chains. Whether inflation flares up down the line will also be the litmus test on whether MMT[2]-type policy responses are viable.

Emerging market economies, which tend toward greater dependency on commodities including oil, metals, and agricultural products, may suffer an especially deep decline in GDP. Steep capital outflows are driving currency depreciation, leading debt servicing obligations to become more onerous and increasing the risk of default. EM countries with the strongest capacity for policy implementation — for delivery of effective health care services and for effective and sizable stimulus — are likely to fare far better, through this episode and beyond.

Our Current Asset Allocation

Long growth assets with tactical hedges; opportunities in credit.

Bearing in mind our broad expectations for the global economy and the unprecedented monetary and fiscal support taking shape across many economies, our current portfolio allocation continues to be long select equities and other risk assets, expressing a view in global large-cap equities and credit. We are slightly short fixed income overall; within that fixed income allocation, we are neutral to slightly short duration with a preference for credit over rates as companies move to preserve cash. Even as we've built up equity exposures over the past several months, we've continued to construct tactical hedges in gold, Treasuries, and cash.

We have retained a small position in European and EM assets, not because we hold a strong near-term viewpoint on Europe and EM prospects, but rather in recognition of the fact that cyclical bounces can occur in this market environment. Our proprietary Market Regime Indicator[3] has persisted in crisis range for some time. When this is the case, we tend to position our portfolios for a short-term reversal.

In equity markets, we favor North American equities for three main reasons. First, although it will be some time before analysts' assessments of COVID-19's impact are fully reflected in earnings assessments, North American companies have so far downgraded earnings less often than their counterparts elsewhere. Second, North American equities tend to be overweight quality. In the aftermath of the GFC, balance sheet strength was a leading indicator of equity performance. We believe the same principle hold as this crisis unfolds. Finally, we expect the lower-for-longer interest rate environment to broadly benefit defensive sectors, where the US also has an advantage over other regions.

In fixed income, we see opportunities in both high yield (HY) and investment grade (IG) credit, as spreads between Treasuries and both HY and IG corporate issues have widened during the crisis. Prudent investors can find attractive opportunities in this environment that may allow them to benefit from the subsequent narrowing of spreads as conditions return to normal. It is, of course, important for investors to be well informed of potential outcomes when seeking to invest in times of crisis.

Liquidity issues are at the forefront in emerging markets, as investors have treated EM equities and EM debt alike as risk assets during the crisis, resulting in steep capital outflows. Valuations have improved across EM asset classes since we issued our last outlook, and EM economies have capacity to continue fiscal and monetary interventions, which should help to support fundamentals in the near term. But EM assets will require support from developed markets; resumption of growth in developed markets, a rebound in oil prices, and reduction in US dollar strength are critical for a rebound in EM. We prefer local-currency to hard-currency EM debt, and encourage investors to look closely at their EM equity allocations.

Closing Thoughts: Key Signposts to Watch

Looking ahead to the coming weeks and months, it's clear that a return to economic growth will depend on the trajectory and duration of this grave, global health crisis. As developments unfold, these are some of the signposts we're watching as key prerequisites of a return to investor confidence:

- How successfully countries and regions strike a balance between the public health burden and the timing of lockdown exits
- Whether we achieve significant biotech advances toward an effective drug treatment and/or vaccine
- Whether fiscal stimulus packages manage to mitigate the negative economic impact of the crisis
- How well central bank programs work to ensure liquidity
- What shape the recovery will take as economies operate in a semi-constrained environment

We will continue to update our outlook in the months and weeks to come.

Coauthors

Lori Heinel
Deputy Global Chief Investment Officer

Gaurav Mallik
Chief Portfolio Strategist

Simona Mocuta
Senior Economist

Endnotes

1 This does not mean that we believe that the pandemic will be over within three months, but rather that enough progress can be made within about three months to bring each localized outbreak that does occur under control. Progress in containing each outbreak allows for the gradual relaxation of social distancing restrictions in that area, which in turn allows economic activity to resume selectively.

2 Modern Monetary Theory. MMT argues, in very broad strokes, that countries that issue their own currencies should be able to print all the money they need to fund programs, provided they avoid generating inflation.

3 The Market Regime Indicator (MRI) is a proprietary multi-asset class model designed to characterize risk appetites within the capital markets. The "crisis" range represents extremely high risk aversion.

About the Global Market Outlook

As investment challenges grow more complex, State Street's Global Market Outlook was created to alert investors to portfolio risks and opportunities in the coming year, based on the research of our investment teams. Research around near-term and longer-term market issues is at the heart of who we are as investors. It drives the kinds of outcome-oriented portfolios we create for clients, drawing on the full range of our beta and alpha solutions as well as our asset allocation expertise.

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* AUM reflects approximately $50.01 billion USD (as of March 31, 2020), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

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