2021 Mid-Year

Global Market Outlook

A Kernel of Caution in a Robust Recovery

STATE STREET GLOBAL ADVISORS

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Since we issued our last Global Market Outlook in December, vaccination rollouts and robust monetary and fiscal support have accelerated the pace of economic recovery. COVID-related challenges remain acute in many areas, but the situation is improving, even in hard-hit emerging markets. As the US economy surges, European growth is poised to accelerate; emerging markets will soon follow. It appears that US market leadership may soon give way to international markets.

Positive signs abound as economic growth heads for multi-decade highs, companies report strong earnings, and volatility recedes. At the same time, rising input costs and strong demand are fueling inflation — which may settle in at higher levels than investors are accustomed to. Our own Market Regime Indicator suggests that markets are treading a fine line between optimism and a degree of euphoria that may be a sign of complacency. How will markets lulled by so many positive signs react to the inevitable shocks — including those related to inflation — that may punctuate the months ahead?

In this mid-year update to our 2021 Global Market Outlook, we refresh our macroeconomic outlook and our current tactical positioning. We also raise a set of key themes that arise from our outlook on fixed income and on equities, and identify the risks that we see on the horizon.

Macroeconomic Outlook

- Pent-up demand and easy money are fueling an impressive recovery in 2021; a meaningful rotation beyond manufacturing and toward services will fuel a broader continuing recovery in 2022.
- Europe and emerging markets are joining the United States in a robust growth trajectory; as the US hurtles past peak economic growth momentum, growth in Europe and in emerging markets is accelerating.
- The current inflation spike is likely to moderate in the second half of the year; however, we expect higher inflation over the next two years (compared to the pre-COVID regime).
- Markets may become more volatile as investors look past peak growth momentum and peak monetary accommodation.

The global economy has made considerable progress since the start of the year, despite COVID-related challenges. Momentum accelerated notably during the second quarter amid rapid vaccination uptake, especially in developed economies. Emerging markets may have lagged on the vaccine front so far, but material improvement is already visible there as well, and there will be further improvement in coming months.

The combination of easy base comparisons and a tremendous pickup in economic activity is driving global growth to multi-decade highs this year, to be followed by another impressive performance in 2022. The industrial sector is already operating at full speed, with global trade and industrial production at record levels. In fact, the strain on global supply chains is painfully clear — and painful for many manufacturing firms. According to IHS Markit, global manufacturing capacity utilization has surpassed the 2004 peak. Backlogs are longer today than they were at any time since 2004. Elevated household savings in much of the developed world (and even in parts of the developing world) suggest it will take more than just a few months to absorb this pent-up demand. This is partly why we are bullish on 2022 growth. So far, the release of pent-up demand has been heavily skewed in favor of tangible goods. During the second half of 2021 and going into 2022, a more meaningful rotation toward services will take hold and support a fuller, broader, continuing recovery.

In this context, it is not surprising to see commodity prices sharply higher across the board. Rising input costs and strong demand have contributed to much greater pricing power compared to the aftermath of the Global Financial Crisis. Importantly, this picture of healthy household finances is not a one-country story, even if the United States is perhaps the most extreme illustration.

From our perspective, it makes a tremendous difference that Europe is exhibiting a similarly impressive backdrop; with vaccination rates now rapidly escalating, we anticipate a powerful rebound starting in the second quarter. We have been upside to consensus on our European growth forecasts since late last year. The incoming data continues to support our positive view. China will continue to exert its steadying, positive influence on global economic growth this year, but its relative contribution will moderate as performance improves elsewhere. As the country refocuses on pre-COVID deleveraging efforts, domestic policy support will also likely diminish sooner in China than it will elsewhere.

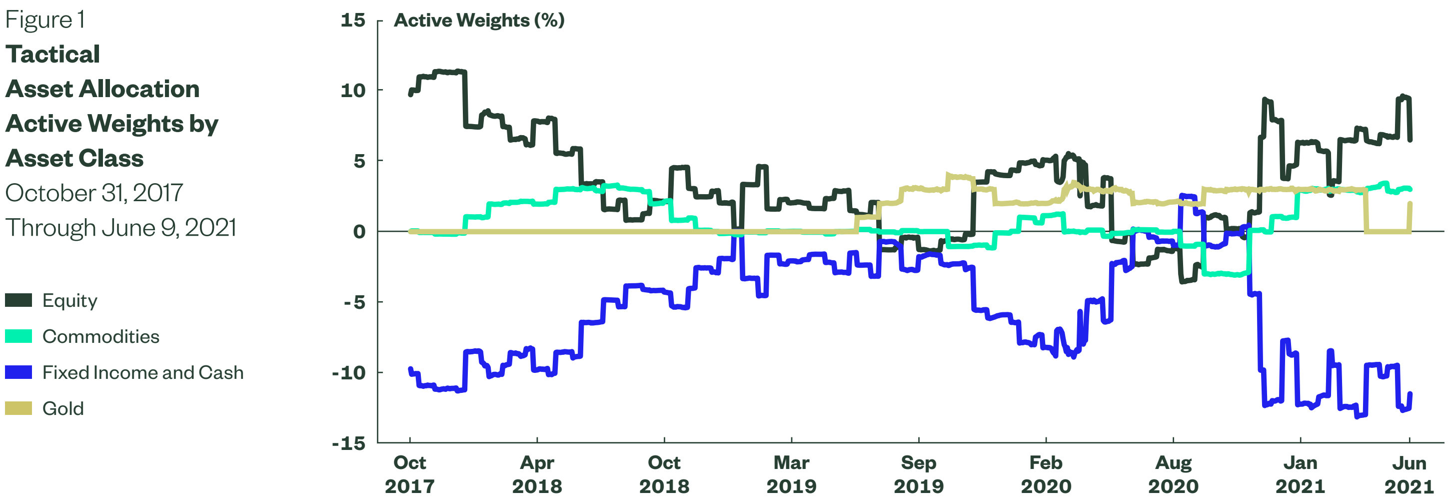
One implication of a broadening base of demand is that inflationary pressures may not be quite as transient as central banks currently anticipate. It is true that much of the inflation spike we are undergoing at the moment is likely to be transient in nature. Nevertheless, while the second half of the year should bring about a moderation from the peak, we suspect that the new normal for inflation over the next two years or so will be higher than the prevailing pre-COVID regime.

Global central banks continue to provide extraordinary levels of policy accommodation, but as we progress through the year, we will leave the moment of “peak accommodation” behind. The same is true on the fiscal side. While pent-up demand remains a powerful support and policy normalization will be very slow, markets may undergo some volatility as investors look past peak momentum.

Current Tactical Asset Allocation

An ebullient macroeconomic backdrop, paired with constructive quantitative forecasts, support our continued preference for growth assets — in particular, equities, credit, and commodities (see Figure 1). Recent changes in our Tactical Asset Allocation weights reflect our baseline assumption of economic recovery while expressing our regional outlook and asset class views. Our proprietary risk indicator suggests markets might be too complacent about potential risks, so we have pared back our overweight to global equities in favor of core bonds and gold. From a regional equity perspective, the US is our preferred region, but we hold a diversified position and recently extended our overweight to Europe, which reflects the improvement in our quantitative framework for the region; we also further underweighted Pacific equities as deteriorating sentiment scores and undesirable price momentum weigh on our forecast for the region. Gold is supported by low real rates and a negative short-term view of the US dollar. Finally, our overweight to broad commodities remains well supported by our quantitative framework as improvements in mobility data, economic reopening, and a weaker US dollar provide tailwinds to global demand.

Figure 1
Tactical Asset Allocation Active Weights by Asset Class
October 31, 2017 Through June 9, 2021



Source: FactSet and State Street Global Advisors Investment Solutions Group, as of June 9, 2021. Past performance is not a guarantee of future results. At State Street Global Advisors, the Investment Solutions Group positions its TAA portfolio based on a one- to three-month forward-looking horizon. Active weights change on a monthly basis.

Fixed Income Market Outlook

- Sovereign yields appear to have reached a ceiling for now as central banks in general hold policy rates steady.
- We continue to see opportunity in corporate credit, as robust growth bolsters credit fundamentals and investors forego low/negative yielding sovereign debt in favor of corporate bonds.

Strong economic data continues to roll in, and sovereign yields have reached what appear to be a ceiling for now as central banks remain generally unmoving with policy rates. Year-on-year inflation could exceed 3% due to base-comparison effects. But the current spike in inflation is likely to recede. Month-on-month inflation readings (especially for core inflation) reflect recovery rather than sustained higher inflation. Given these moderate expectations for inflation, rates are likely to remain range-bound. The 10-year US Treasury yield is having difficulty breaking above 1.7% despite numerous data releases so far in 2021, which may be due in part to the fact that fair value for 10-year Treasuries is aligned with the Fed's short-term rates projections. Until the prospect of Fed action becomes a dominant force, yields are unlikely to break through that threshold.

While spreads on risk assets are near their tights of the past 10 years, we do think that investors in corporate credit have some runway available to clip the coupon along with the potential to benefit from modest additional spread tightening. Our rationale stems from two factors: robust global economic growth bolstering credit fundamentals and continued strong demand for credit amid meager sovereign yields.

As presented in the economic overview, global economic growth is expected to remain well above trend well into 2022, driven by vaccine-related reopening demand, the cumulative impact of stimulus programs initiated since the onset of the pandemic, and the prospect for expansion of government-sponsored programs. This growth will serve to bolster already strong corporate balance sheets that are armed with cash raised defensively over the past years and will lead to an expanding crop of upgrade candidates. “Rising stars” will be 2021 and 2022’s answer to 2020’s “fallen angels,” with an estimated $281 billion of BB-rated debt anticipated to move into investment grade territory through 2022,[1] more than offsetting 2020’s wave of fallen angels. With a spread of 147 bps as of May 31 over BBB-rated bonds,[2] BB-rated bonds offer compelling value in this context.

Global investors hungry for yield continue to buy up corporate debt as an alternative to low/negative yielding sovereign debt. With an estimated $13 trillion of developed market sovereign debt in negative yield territory, this makes a compelling case to take modest incremental credit risk and buy corporate bonds. This demand technical is expected to persist for the long term, which will keep corporate spreads low, especially on short maturity debt, and will likely dampen the impact of market sell-offs by prompting additional buying by yield-hungry investors.

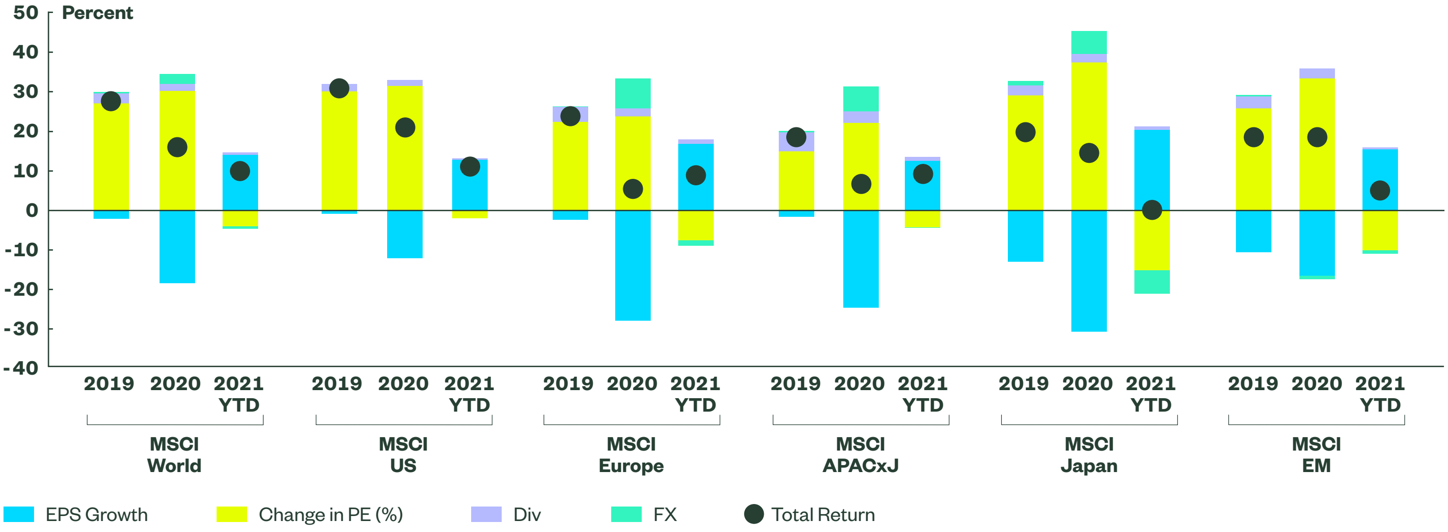
Those investors are likely to find additional opportunities in emerging markets (EM) debt. Emerging markets are currently benefiting from cyclical tailwinds, including the recovery in oil prices, relatively low inflation, and strong manufacturing PMIs. EM local currency debt offers upside through currency appreciation. And, although parts of the EM hard-currency sovereign debt universe are starting to look expensive, we believe there is room for spreads to grind tighter given the hunt for yield amid quantitative easing in developed markets.

Equity Market Outlook

- As the growth differential between the United States and Europe starts to narrow and emerging markets continue to make progress against the COVID threat, US market leadership is likely to give way to a more international scope.
- Strong earnings prospects and less-stretched valuations will continue to add to European equities’ appeal.
- We see opportunity in emerging markets, which have the highest earnings-growth expectations in the world.
- Chinese equities offer advantages that justify particular consideration.

Equity markets demonstrated extraordinary resilience in 2020, as unprecedented monetary and fiscal intervention massively expanded multiples and propelled stock prices to historic highs. In an encouraging turn, the trend of ballooning multiples finally slowed in the first half of 2021, as earnings growth overtook multiple expansion as the primary driver of equity-market performance (see Figure 2).

Figure 2
Equity Return Decomposition



Source: State Street Global Advisors, Bloomberg, as of April 28, 2021.

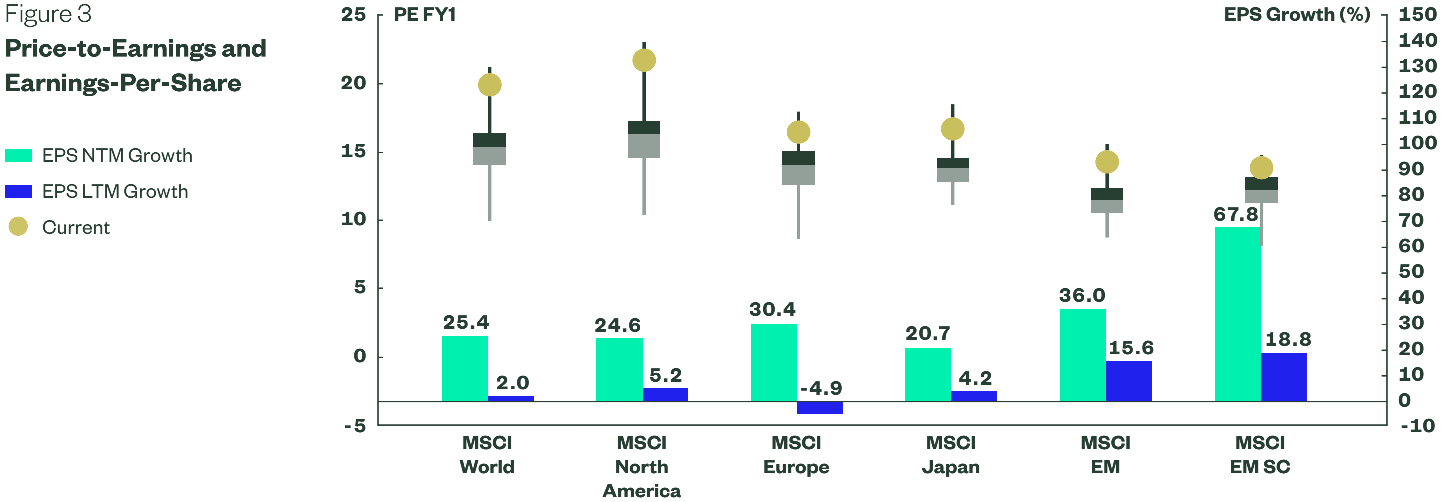
With earnings beginning to catch up with stock prices, we continue to see opportunity in equities. In part because the earnings gap is much wider in the United States compared to other regions, where stocks are more reasonably valued, we see the scope of that equity opportunity widening in the second half of 2021 to include European and potentially emerging markets.

An increase in bond yields has nudged equity risk premia lower in recent months, but rising yields have been accompanied by an uptick in inflation, leaving real yields[3] little changed and in negative territory. With quantitative easing effectively capping yields, risk assets — including equities — remain attractive.

As outlined in our macroeconomic outlook, we believe US GDP growth has peaked in the first half of 2021, while GDP growth in the eurozone is on the ascent. We expect the growth differential between the US and Europe to narrow toward year end. In general, in periods where US GDP growth compared to the rest of the world declines, equity markets in the rest of the world tend to catch up to the US. With European markets poised to continue their recent outperformance, provided progress toward containing the COVID threat continues, we believe this trend is likely to take shape in the coming months.

Earnings-per-share growth estimates underscore the point. Next-twelve-month EPS growth estimates for Europe are 30.4% — the second highest among major world markets, and ahead of North America by 5.8 percentage points (see Figure 3).

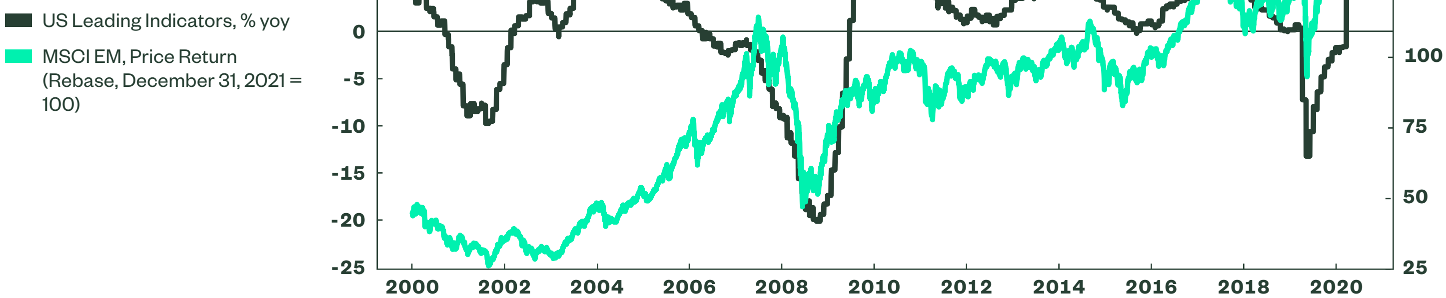
Figure 3
Price-to-Earnings and Earnings-Per-Share



Source: State Street Global Advisors, Bloomberg, as of May 19, 2021. Chart references MSCI regional indices. MSCI EM refers to the MSCI Emerging Markets index. MSCI EM SC refers to the MSCI Emerging Markets Small Cap. PE = price to earnings ratio; EPS = earnings per share; NTM = next twelve months; LTM = last twelve months.

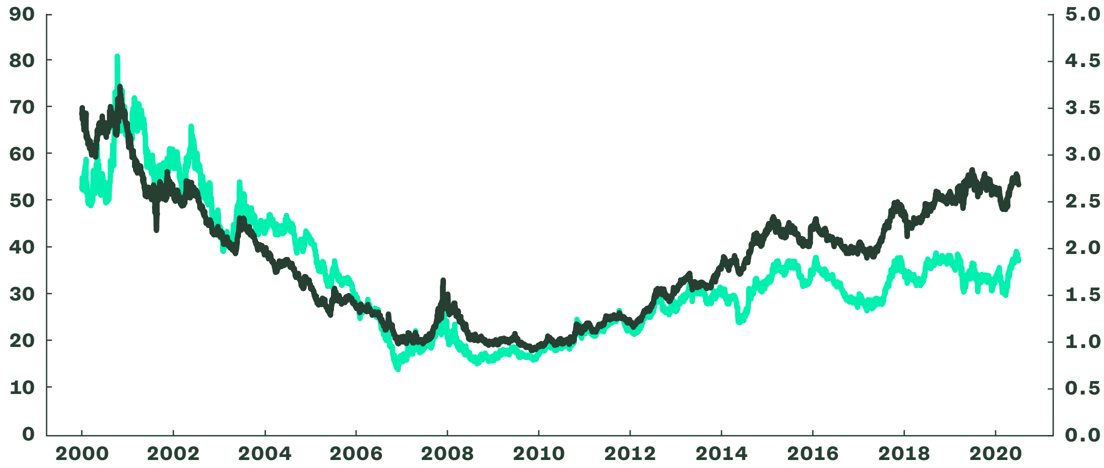
Emerging markets started 2021 strongly, but the rising US dollar and a downshift in relative growth have put pressure on EM equity market returns. As we look to the second half of the year, however, emerging markets warrant attention. EM equity valuations are relatively cheap in the wake of their recent underperformance. Earnings-per-share growth estimates for emerging markets swelled to 36% after a strong Q4 earnings season — the highest in the world. US leading economic indicators tend to be highly correlated with EM outperformance, as US economic growth fuels EM earnings growth and, ultimately, equity prices (see Figures 4a and 4b). We've already seen this relationship between US indicators and EM equity prices take shape this year.

Figure 4a
US Leading Economic Indicators YOY Versus MSCI EM Index



Source: Macrobond, SSGA, TCB, MSCI. Updated as of May 21, 2021.

Figure 4b
MSCI US Versus China and EM



Source: Macrobond, SSGA, TCB, MSCI. Updated as of May 21, 2021.

Within emerging markets, Chinese equities call for particular focus. On a relative basis, Chinese stock valuations are below long-term averages when compared to US stocks; moreover, the twin risks of regulatory action within the tech universe and a slowdown in credit impulse appear to be priced in. Chinese equities are trading below long-term averages relative to the US and the rest of the world (as measured by the ACWI ex-USA IMI index). At the same time, correlations among Chinese stocks and other world markets have fallen in recent periods, which means that Chinese equities offer a diversification benefit.

The reflationary backdrop of 2021 has benefited cyclical stocks. Although we believe the current spike in inflation will be transitory, we are sanguine on cyclicals' performance. We anticipate continued momentum in cyclicals, driven by the prospect of fiscal spend in the US, along with strong consumption trends stemming from pent-up demand and supply constraints.

As vaccine rollouts continue and countries worldwide increasingly bring COVID under control, we continue to see opportunity in equities, and we believe it's important to look beyond the immediate headlines to consider all the corners of the globe where those opportunities might reside. As we move through 2021, we believe that strong earnings prospects and less-stretched valuations will continue to add to European equities' appeal. We foresee continued momentum in cyclical stocks, and we also see opportunity taking shape in emerging markets, which have the highest earnings-growth expectations in the world. Finally, we believe Chinese equities offer particular advantages that certainly justify consideration – and may justify a dedicated portfolio allocation.

Key Risks to Our Outlook

- Markets are awash with optimism, but they are also at risk of becoming complacent, leaving them vulnerable to shocks.
- The potential for sustained higher inflation poses a key risk, as does any move toward tightened monetary policy.
- Low-volatility equities, options overlays, Chinese government bonds, and real-asset strategies may be helpful approaches to manage risk.

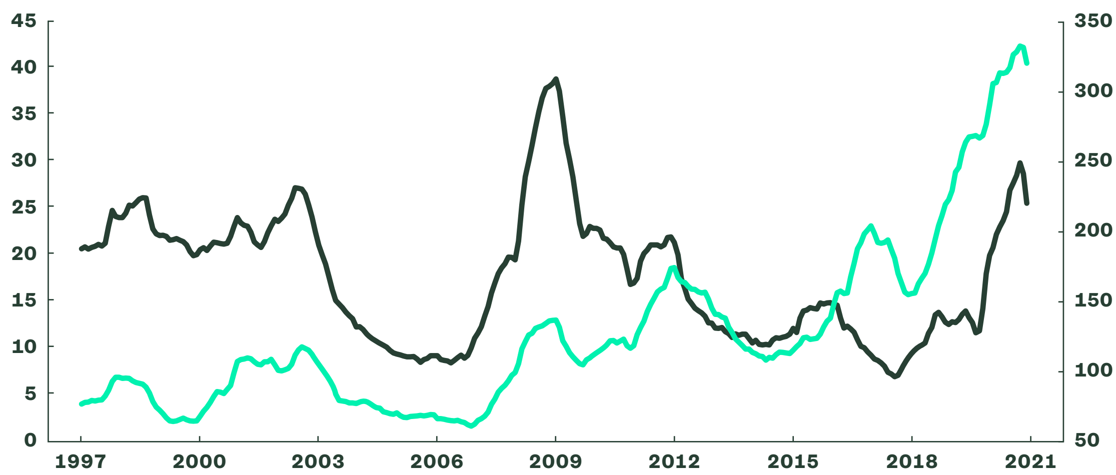
Our central thesis for risk assets is arguably the most optimistic we have held in recent years. A strengthening global economy – supercharged by pent-up demand unleashed as economies emerge from lockdown – and ultra-accommodative central banks represent a potent positive combination.

Against this surging economic backdrop, however, markets are laced with signs of fragility. As our Investment Solutions Group (ISG) colleagues point out, the market is currently tiptoeing the line between optimism and complacency, at risk of falling into the latter.[4]

This complacency is not new, but has reached extreme levels recently, as evidenced by the degree to which economic policy uncertainty now exceeds equity-implied uncertainty (see Figure 5). Looking back on the Global Financial Crisis, we see that equity-implied uncertainty exceeded policy uncertainty by a wide margin. This makes intuitive sense since stock markets price risk quickly and financial crises tend to hit stocks in the first instance. The COVID crisis is very different as it has hit major drivers of the world's economy, including consumption and trade. Elevated economic policy uncertainty probably reflects the reality that a pandemic can constrict whole economies despite our best policy responses. Relatively low equity-implied uncertainty, then, may simply reflect stock markets' eagerness to use the template from the last crisis.

Figure 5
Equity Uncertainty Versus Economic Policy Uncertainty
One-year Moving Average of VIX index Versus One-Year Moving Average of Economic Policy Uncertainty Index

Equity Uncertainty (lhs)
Economic Policy Uncertainty (rhs)



Source: State Street Global Markets, Bloomberg, State Street Global Advisors calculations, as of April 30, 2021.

Complacency may not constitute a risk per se, but it leaves the market in a fragile state, more prone to being rudely awakened by, and overreacting to, the shocks that will inevitably come.

Any number of shocks could shatter the market's fragile exuberance, from setbacks in progress against the pandemic, to market participants' failure to appreciate the full import of US President Biden's tax proposals, to cyberattacks, and to geopolitical conflict, among others. But we believe two risks are worthy of particular focus: the possibility that inflationary pressures become more sustained and entrenched, and the potential that interest rates and bond yields will rise even in the absence of pronounced inflationary pressure, in response to evolving growth or a change in policy.

Key Risk: Inflationary Pressures Become More Sustained and Entrenched

Despite coordinated rhetoric from central banks that inflation is a "transitory" phenomenon (a view we share), inflation risks have undoubtedly moved to the upside, focused in the United States.

The risk is that any move toward the Fed tightening in the market's fragile state could lead to overreactions; in the extreme, declining asset prices could plunge the global economy back into recession. The Fed could potentially be on the horns of a dilemma, as letting the market "run hot" has historically proven to be a bad idea (see Figure 6). The frequency and severity of negative real returns increase as inflation moves above 5%; this reaction could be magnified after more than a decade of easy monetary policy that has inflated multiples.

Figure 6
Real Annual US Equity Return Versus CPI YoY%
Annually from 1945

Source: http://www.econ.yale.edu//~shiller/data.htm, State Street Global Advisors calculations.

What could be the catalyst for inflation to move up and persist at a higher level? In her piece, Putting the Global Inflation Surge in Perspective, Senior Economist Simona Mocuta highlights five possibilities, the most immediate being supply chains/peak globalization. We have already seen evidence of this effect in the global supply of computer chips, particularly from Taiwan. As restricted supply meets explosive demand, the chance of significant price inflation becomes more real.

Inflation would also threaten our rosy view on corporate defaults, as companies without the ability to pass on rising input prices would see their margins squeezed — some to the point of insolvency. In addition, over a longer time frame, corporate equity and inclusion initiatives could cause more corporate profits to be allocated to labor. While undoubtedly a fairer outcome for all, this could also pressure some business models.

Key Risk: Interest Rates and Bond Yields Rise in Response to Evolving Growth or a Change in Policy

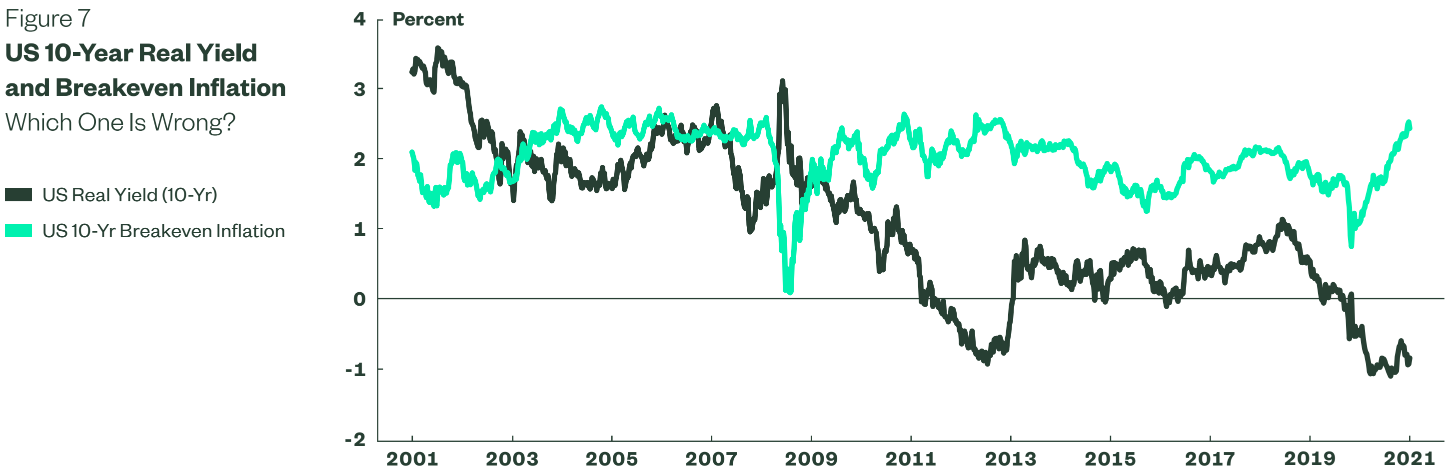
Our base case for bonds is that sovereign yields appear to have reached a ceiling for now, as central banks generally continue to hold policy rates steady. There are, however, some scenarios that may prompt a re-assessment of that view.

If we consider the real yield on US Treasury Inflation Protected Securities (TIPS) a proxy — admittedly a crude one — for real economic growth prospects across the broad US economy, it seems inconsistent that investors would accept a deep negative yield compared with positive consensus GDP growth forecasts. This conundrum is reconciled by the assured appetite of a large, price-insensitive investor in the form of the Federal Reserve.

There is a further unsettling contradiction, however, in a market that has confidence in an economy sustaining inflation at well above 2% per year over the next ten years against a fairly anaemic growth profile (see Figure 7). Naturally this mismatch can be maintained in the short term by investors' liquidity preferences, relative issuance, and supply of real assets, but a snapback to the real yields of the early 2000s is not inconceivable.

It's probably fair to assume that policy missteps are more likely to happen at turning points in the cycle, and the Fed has outlined its view of the turning point clearly in its forward guidance. If self-sustaining growth takes shape at a higher level than currently assumed, and the Fed leans toward (even if it does not say) the dreaded word, "taper," there is potential for extreme volatility. The current experiment of letting the economy run hot places a legitimate question mark over the market's apparent confidence in a perfectly smooth exit from one of the biggest monetary policy exercises in history. A misstep from the current position could take some time to materialize, but it also seems that the Treasury market attaches a high level of confidence in the Federal Open Market Committee's communication and navigation skills.

Figure 7
US 10-Year Real Yield and Breakeven Inflation
Which One Is Wrong?



Source: Bloomberg, as of May 21, 2021.

Addressing the Risks

For investors seeking to manage the risks we've identified here, we offer the following summary of a few implementation ideas that may prove useful. For more information on our mid-year outlook, key risks, and the approaches we would recommend to help you take full advantage of current opportunities while managing against potential downsides, please contact your State Street Global Advisors relationship manager.

Figure 8
Summary of Key Risks

Key Risk	Approach
Investor complacency gives way to higher levels of market volatility	**Low-volatility equities** • Relatively attractive versus pre-COVID levels
	Options overlay on existing equity portfolio • Falling implied volatilities have pushed options prices lower • Higher interest rates would make put options relatively more attractive
Inflationary pressures become more sustained and entrenched	**Multi-asset strategy combining exposure to a broad array of liquid real-asset securities** • Designed to perform best during periods of increasing inflation • Complements equity and bond assets; can provide further diversification
Interest rates and bond yields rise in response to evolving growth or a change in policy	**Chinese government bonds** • Low and stable correlations to both developed market and even other emerging market bonds • Offer positive real yields in a stable, managed currency • Will benefit from ongoing structural support as their weight in benchmark indexes increases

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Endnotes

1 Source: JPMorgan, as of May 31, 2021.

2 Source: Bloomberg Barclays Indices.

3 Nominal bond yields less the rate of inflation.

4 In recent weeks, ISG's Market Regime Indicator has dipped from the "normal" range to the "euphoric" bracket, which can indicate that a degree of complacency is creeping into markets.

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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