Forecast
Market Outlooks

Q2 2021

Forecasts — Quarter 2, 2021

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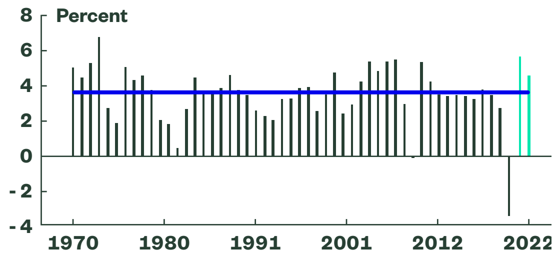
Global Economic Outlook

Figure 1
Global GDP Growth Accelerates in 2021

- World GDP Growth
- World GDP Growth Forcast
- Long Term Average Growth (3.65%)



Source: State Street Global Advisors Economics, Oxford Economics, International Monetary Fund. 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.

- As vaccine rollouts accelerate, we expect GDP growth to hit 5.7% in 2021, the fastest expansion rate since 1973; this is somewhat flattered by the low starting point stemming from the steep decline of 2020.
- The policy backdrop remains supportive in both fiscal and monetary terms, but change is likely to slowly begin over the course of the year as countries transition from COVID stimulus measures.

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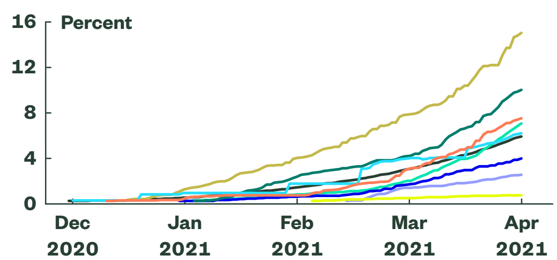
Emerging Markets Outlook

Figure 2
EM Vaccine Deployment Slow and Varies by Country

- World
- India
- Indonesia
- Poland
- Brazil
- Russia
- South Korea
- South Africa
- Mexico



Source: State Street Global Advisors Economics, Our World in Data, as of 04/13/2021. Percentage of people to receive at least one vaccine dose.

- Although set for GDP growth in excess of 6% in 2021, the EM outlook is somewhat muted relative to its own history — reflecting the challenges related to COVID-19 and vaccine deployment.
- The robustness of global manufacturing provides a positive tailwind for EM, even if the benefit is not uniform across countries. This will help offset the need of some countries to begin withdrawing monetary and fiscal policy support.

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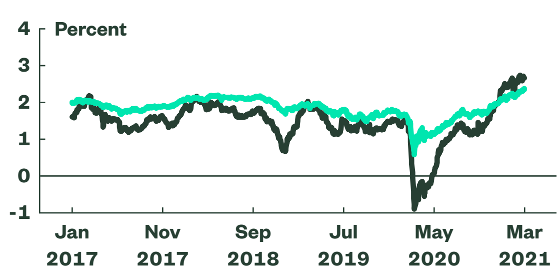
Global Capital Markets

Figure 3
US TIPS Signal Transitory Inflation Blip

- 2 Year Breakeven Inflation Rate
- 10 Year Breakeven Inflation Rate



Source: FactSet as of March 31, 2021. Past performance is not a guarantee of future results.

- Signs of froth exist in some parts of the economy and financial markets, but in our view they are not widespread enough to derail the powerful economic growth associated with economies reopening with ample policy support.
- The most likely path for interest rates continues to be to the upside; however, reflexive investor and central bank behavior is likely to limit the pace of future moves.

Global Economic Outlook

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Global economic growth is poised to accelerate in 2021, following the COVID-disrupted contraction in 2020. All economies are likely to participate, although it may be 2022 before some countries recover to pre-COVID GDP levels.

A Synchronized but Incomplete Recovery

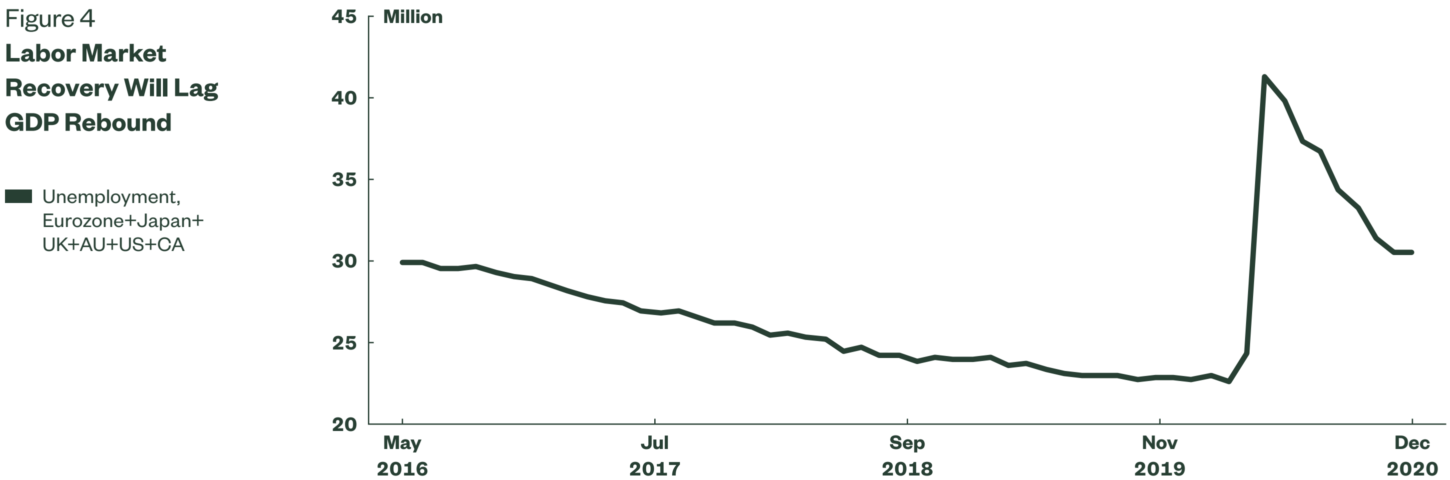
Following an estimated contraction of -3.4% in 2020, the global economy is poised for a sharp rebound this year. We expect global real GDP growth (based on purchasing power parity (PPP) weights) to hit 5.7% in 2021; if this materializes, this would mark the fastest expansion rate since 1973. It will be not only fast, but also broad, with essentially all economies participating in this rebound. While the pace of vaccine deployment varies widely across countries, we believe these disparities will narrow substantially during the second half of 2021 as the front-runners level off and the laggards catch up. Thus, the evolution of cases and vaccinations will have a bearing on how powerful the rebound will be, but should not preclude a recovery.

We must not confuse momentum and breadth with completeness, however. For instance, only China has so far exceeded its peak pre-COVID-19 GDP — having done so in Q2 2020. The United States (US) and Australia are expected to cross that mark by mid-2021, and Germany could reach it later this year (we are more upbeat on German growth than consensus). But for many other economies, including Japan, it could take until well into 2022. A permanent output loss due to the pandemic will be a long-lasting scar on the global economy. And so, despite its impressive pace, this will remain an incomplete recovery for a long while yet.

For now, the policy backdrop remains highly stimulative, both on the fiscal and monetary side, but this will slowly begin to change over the course of the year. Emerging markets, which have less scope to maintain ultra-loose policies by virtue of exchange rate, debt, and inflation vulnerabilities, will lead this shift, as we are already witnessing. By contrast, the US will trail this transition. The US is indeed an outlier, providing more fiscal support this year than in 2020. Nevertheless, even in the United States that “transition to autonomous growth” that we started talking about late last year will eventually arrive; it has been merely delayed by the “fiscal vaccine”.

There is another facet of the current recovery that warrants discussion: the evolution of the labor market (Figure 4). Global GDP may return to pre-crisis levels this year or in 2022, but labor markets will take longer to complete that journey. Indeed, between the start of 2016 and the end of 2017, the aggregate unemployment levels in the eurozone, Japan, US, UK, Australia and Canada declined by about 5 million people. As 2021 got under way, unemployment in these countries is up by 7.5 million compared with January 2020. To match the 2016-17 performance, we would need unemployment to drop by 12.5 million over the course of 2021, something that is quite unlikely.

Figure 4
Labor Market Recovery Will Lag GDP Rebound



Sources: Eurostat, Japanese Statistics Bureau, UK ONS, ABS, BLS, StatCan.

The US Economy: Testing the Speed Limit

Following a contraction of -3.5% in 2020, the US economy is set to reach its pre-pandemic peak by the middle of 2021. The big tug of war between COVID-19 infections, on the one hand, and stimulus and vaccinations, on the other, continues. However, every passing week strengthens the latter forces while the virus influence recedes. Still, since social distancing requirements persist and capacity restrictions have been maintained for some time, a full normalization of activity seems unlikely until Q3 at the earliest. It is for this reason that our full-year 2021 forecast of 5.3% (upgraded from 4.1% three months ago due to fiscal stimulus) is below consensus estimates. (The Bloomberg consensus stands at 5.6% at the time of writing, with several forecasters as high as, and even above, 7.0%).

It is strange to find ourselves trailing consensus, given that we spent almost all of 2020 at the other end of the scale. But we are genuinely concerned about capacity constraints in the services sector. Even though we anticipate a steady pick-up in services consumption over the course of the year, such that the H2 2021 average exceeds the prior two-quarter peak (Q2-Q3 of 2019) by a little over one percent, we are reluctant to presume an even stronger performance given the delicate three-way balancing act between mobility restrictions, demand, and supply required to make that happen. Instead, we believe spending will be spread out over a longer period of time, spilling well into 2022; this view drives our better than consensus 2022 forecast of 4.3% growth.

Spending and Investment to Fuel Growth

It is not that consumers lack the money to spend. Liquid household assets (cash and checking accounts) reached a record $3 trillion in Q4, up from $1.2 trillion in Q1 2020. And it should be noted that this was before the $600 checks approved in the December fiscal package, and before the $1,400 checks included in the $1.9 trillion fiscal package approved in March. Some of the additional fiscal stimulus will make its way into goods and services consumption (goods consumption already hit a record in 2020). Some will be retained as savings. Some will continue to fuel house purchases, driving up prices in the process, or other types of assets.

Fixed investment did better than might have been anticipated last year, contracting by just -0.8%. Residential investment surged during the second half and rose 6.0% in 2020 as a whole, the best performance since 2016. If things unfold as we anticipate, we might see double that growth rate in 2021; the only limitations being not housing demand but labor, land, and input constraints on the part of builders. Intellectual property (IP) investment managed a 1.6% increase as firms invested in technology to enable working-from-home arrangements. Gains in residential and IP investment helped offset most of the declines in equipment investment (-5.0%) and non-residential structures (-10.6%). While improving, the latter will continue to struggle with uncertainties surrounding the commercial real estate outlook and regulatory changes surrounding oil and gas drilling on federal lands.

A sizable inventory rebuilding cycle is underway and should support growth over the next several quarters. The downside here is that much of that inventory rebuilding will imply higher imports, such that the trade deficit will likely deteriorate further.

Inflation Risks Evenly Balanced

A critical question is whether the extraordinary degree of pent-up demand, coupled with supply disruptions/constraints will cause inflation to spike. That inflation will accelerate sharply in the near term is a forgone conclusion simply due to base effects and the higher oil price path of late. But the most important question is not what happens to US (or global) inflation in the next two months, but rather, what happens in the next two years. There are enough peculiarities around US inflation — particularly the rental component and its measurement — that we are only making modest upgrades to our 2021 and 2022 inflation forecasts (to 2.4% each from 2.2% and 2.1%, respectively). However, it is important to stress that while inflation risks have been persistently skewed to the downside in recent years, the balance of risks seems much more evenly split at the moment. A lot of factors (fiscal and monetary policy backdrop, supply chains realignment, etc.) have shifted in ways that should be more conducive to higher inflation in the medium term, but it remains unclear whether they've done so by a sufficient degree to offset the secular deflationary forces of technology and demographics.

Much about the medium term inflation trajectory will also be a function of future macro policy. The Fed's shift to average inflation implies a much looser policy stance as the economy progresses on the path to full recovery. While a tapering of asset purchases will likely be announced later this year and begin in early 2022, no rate hikes are likely until 2023. The Fed itself is not penciling rate hikes until even later than that — according to the March 2021 "dot plot", only seven out of 18 FOMC members envision at least one hike that year. But we believe those expectations will be brought forward once enough data evidence has gathered to demonstrate that the Fed's criteria for lift-off will be met in 2023.

Eurozone: It's Complicated

While we are slightly below consensus in regard to US GDP growth in 2021, we are above consensus in our assessment of eurozone growth prospects. Once again, this is not an easy position to take given the general complexities of forecasting multiple economies evolving at different speeds, further compounded by slow vaccine deployment so far and variable social distancing restrictions across countries.

We take some heart in the fact that our above-consensus views on eurozone growth last year were validated by the better-than-anticipated 2020 outcome. There is no doubt that 2020 was a horrible year, when the eurozone economy contracted -6.8%, but this was considerable less dire than what consensus (and the ECB itself) had initially anticipated. In fact, even amid new significant restrictions, the economy only contracted -0.7% quarter-on-quarter (q/q) in the fourth quarter, besting not just the ECB baseline but even its optimistic scenario.

We believe that vaccine deployment will be scaled up sharply over the coming months, such that the current large gap relative to the US and UK will shrink dramatically by early Q3; this should allow for a quicker removal of mobility restrictions and a faster recovery in economic activity. In particular, we look for consumer spending to fare much better than ECB assumptions. Given the high level of savings, there exists considerable pent-up demand that should lift consumer spending by significantly more than the 3.0% assumed in the ECB's latest projections (from March 2021). The strong external demand recovery should provide continued impetus for exports and also help drive fixed investment. All things considered, we consider our 5.5% eurozone growth forecast for 2021 to be optimistic but achievable.

The eurozone's inflation deficit has been a perennial problem in the context of low growth and weak demand. Meeting the ECB's inflation target sustainably will remain very difficult, although cyclical and technical factors will likely lift headline inflation to around 1.5% this year (from 0.3% in 2020). However, we expect the uptick in inflation to be both less intense and less durable than in the United States, for instance, and for the ECB to retain a very dovish stance. The bank made that stance clear at its most recent meeting in March when it pushed back against the recent rise in bond yields. It promised to speed up the pace of asset purchases under the Pandemic Emergency Purchase Programs (PEPP) in order to prevent "a tightening of financing conditions that is inconsistent with countering the downward impact of the pandemic on the projected path of inflation".

UK: Rising From the Ashes

At the time of writing, 38% of the UK population has received at least one vaccine dose, putting the UK among the top global leaders in the race toward vaccinations and herd immunity. This compares with 23% for the US and less than 9.0% for the European Union at the same point in time. This progress comes not a moment too soon for the UK, given that the economy shrank nearly 10% in 2020, which is almost three times worse than the US and three percentage points worse than the eurozone contraction.

The repeated disappointments that have characterized the UK's handling of the pandemic so far (notwithstanding the good initial monetary and fiscal policy response), in addition to ongoing tough — excessively so, in our view — mobility restrictions does not make it particularly easy to take an upbeat view of UK's 2021 economic prospects. Nevertheless, we see current consensus projections of a 4.7% expansion as too conservative, especially in light on the recent budget that will add close to three percentage points worth of GDP in stimulus over the next two years. Thus, although we do anticipate a first-quarter contraction, we believe a strong rebound in the second and third quarters is possible to allow the economy to grow by 6.2% in 2021.

Releasing Pent-up Demand

Although the UK fiscal stimulus is not nearly as large as that passed in the US, and household finances are perhaps not quite as buoyant, there is enough firepower (the household savings ratio was 16.5% as of Q3 2020) to suggest a considerable degree of pent-up demand once the economy reopens. Indeed, we had long noted the divergence between UK consumers' bleak perceptions of broad economic conditions and their much better assessments of their own financial situations. That divergence should drive a faster than anticipated spending recovery in coming quarters. In fact, we also expect consumer spending to do very well in 2022 since even in our upbeat 2021 forecast, spending only retraces about half of its 2020 losses. The rest will be made up next year and should push GDP growth to almost 6.0%.

Fixed investment has been weak since the Brexit referendum, but it is trying hard to rebound after the COVID-related collapse during the second quarter. It still contracted -8.7% last year; in level terms, it is now roughly where it was in 2015. Investment incentives included in the new budget, combined with the broader recovery in demand and reduction in uncertainty now that Brexit is complete, should help revive investment spending. However, there remain considerable unknowns about the new underlying path of investment since there remain considerable unknowns around the medium-term potential growth level for the UK.

Oddly enough, only foreign trade was additive to UK GDP last year; this was mostly a reflection of how large of a drag it had been in 2019, rather than a sign of strong underlying performance on that front. It may well become a drag again if domestic demand picks up as quickly as we anticipate.

Bank of England's Conservative Outlook

Inflation was a tepid 0.9% in 2020, but this should reaccelerate to twice that rate in 2021 as the combination of base effects, higher energy and commodity prices, and release of pent-up demand support normalization. Notably, although the Bank of England has laid out a rather conservative growth outlook for the economy, it nonetheless anticipates excess demand to develop by early 2022 and inflation to move to target in 2022 and 2023.

Early in the crisis, the Bank of England (BoE) cut the Bank Rate by 65 basis points to 0.1% and increased the QE program from £435 billion to £745 billion (and later to £875 billion), engaging in various liquidity operations and extending real-economy lending incentives. The BoE has also looked closely into the implementation of negative interest rates — in February, it instructed the Prudential Regulatory Agency (PRA) to "engage with PRA-regulated firms to ensure they commence preparations in order to be ready to implement a negative Bank Rate at any point after six months." The six-month period had been deemed a minimum preparatory period for regulated entities to prepare for negative rates implementation without increasing operational risks. Despite this action, the MPC "was clear that it did not wish to send any signal that it intended to set a negative Bank Rate at some point in the future". Moreover, even those MPC members who thought the PRA should begin preparations believed that a negative Bank Rate "was not warranted by the current conjuncture and the outlook described in the MPC's latest economic projections." Given that the economic backdrop should be far more favorable by the middle of 2021, our interpretation is that that negative interest rates are being added to the Bank's toolkit for use in a future economic cycle, not in this one.

Japan: A Stumble, Not A Fall

Japan's GDP in the fourth quarter of 2020 was at 99% of that in the same quarter a year earlier. However, we do not expect GDP to exceed pre-COVID levels before the third quarter of 2021. Activity in the first quarter is likely to have been very weak, given the impact of the state of emergency on consumption and the suspension of the "Go To" campaigns. Consumption, especially of service spending, should be a drag, although it is likely to be far more moderate than that in Q2 2020. The Bank of Japan's (BoJ) real consumption activity index shows January consumption falling 3.0% month-on-month (m/m), much lower than the 7% tumble in March 2020 which preceded a bad run. Restrictions were more targeted this time, limiting the drop in services consumption. Spending on durables has actually been rising, offsetting some of the damage. Mobility data show that retail and recreational foot traffic has been improving well ahead of the formal end of the emergency, pointing to a recovery in discretionary services spending from February onwards.

Growth will likely start to accelerate from Q2 with the vaccine rollout and a pickup of the global economy. Exports s continue the momentum given the improvement in global demand and a favourable tech cycle. The capex recovery should also pick up, given that it still lags the recovery in exports. Structural tailwinds such as digitalization, de-carbonization, and supply chain re-organization will further support investment. Hence, despite a Q1 setback, we expect GDP to grow 3.1% in 2021 (down from our earlier 3.3% growth forecast).

We also anticipate strong growth in 2022, reflecting the continued expansion in exports and the rebound in consumption. The vaccine rollout will lower risks of further disruptive virus waves, limiting downside risks for the recovery. We forecast GDP to grow 2.6% in 2022. Admittedly, the accumulation of government debt given the massive fiscal stimulus will be a concern once we are further along the recovery. The country has announced three pandemic-specific packages, worth a combined $3 trillion, equivalent to 60% of Japan's GDP. The International Monetary (IMF) estimates that the debt-to-GDP ratio is likely to have touched 266% in 2020 from 238% in 2019. Efforts to reign in debt levels could result in a pullback.

Inflation Pressures Remain Limited

Underlying inflation pressures should remain limited even as the COVID shock fades and the economy continues to recover. The government has committed to restarting the "Go To" stimulus campaign in phases and, assuming that it starts in full swing in H2 2021, that will be a drag on inflation. The launch of the campaign last August sharply lowered accommodation fees, reducing headline CPI by 0.3-0.4 percentage points. Policy directives targeting mobile network charges will also impact inflation adversely. Admittedly, higher global crude prices are likely to push inflation upwards, but probably not so much as to offset the drags. Hence, we keep our forecast for headline inflation for 2021 unchanged at 0.0%. In 2022, the impact of these idiosyncratic factors should dissipate to some extent. The output gap should narrow, but is likely to remain negative throughout 2021-22. A weak labor market and sluggish wage growth will also keep a lid on inflationary pressures in the longer term. We expect inflation to edge up to 0.3% y/y by the end of 2022.

Bank of Japan Flexibility

The Bank of Japan has long been at the forefront of monetary policy innovation in its quest to boost perennially weak domestic inflation. Naturally, as new policies are introduced, their effectiveness is also regularly assessed, and tweaks are made along the way. This is exactly what the BoJ did at its March meeting. While concluding that QQE with YCC (Quantitative and Qualitative Easing with Yield Curve Control) has been effective, the BoJ took some steps to reduce its undesirable side effects on bank profitability and to enhance the program's flexibility. Admittedly, the BoJ insists it did not actually widen the YCC range, but rather it simply "clarified" that the range is +/- 0.25%. We won't debate the language, but in practice this stated band offers increased flexibility to respond to economic conditions and a higher ceiling for yields.

Secondly, the Bank established an "Interest Scheme to Promote Lending" — essentially a subsidy scheme to encourage bank lending and cushion bank profitability. The scheme allows the BoJ to implement "nimbler" rate cuts down the line and it shields bank profitability while encouraging lending. This can be considered a win-win situation for all involved.

Finally, regarding securities purchases, the BoJ retained a ¥12 trillion upper limit for annual ETF purchases; the lack of a specific ongoing purchase commitment once again provides more flexibility in regard to how those purchases are distributed over time, thereby making them more counter-cyclical and more impactful in influencing financial conditions. We consider this to be a wise change that sharpens the effectiveness of an important policy tool. Overall, these changes were in line with expectations and do not mark a departure from BoJ's prior policy stance. Rather, they should be viewed as a fine-tuning of the instruments deployed by the BoJ to maintain that stance.

Emerging Markets Outlook

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Diverging prospects within the emerging markets landscape hinge on supply and deployment of vaccines and how soon some countries may need to begin tightening monetary and fiscal policies.

Emerging Markets: COVID's Lasting Scars

After an unprecedented contraction last year, 2021 should bring about a robust economic recovery in emerging markets. In fact, as we have done with developed markets, we have also upgraded emerging market (EM) GDP growth and now expect a 6.2% advance (versus our forecast of 5.5% back in December). However, due to the wider divergence in the path of vaccine deployment across EM countries, the outlook for EM growth is somewhat more muted relative to its own history. And, just like in DM countries, the lasting scars associated with the COVID-19 crisis will take a long time to heal.

Broadly speaking, there are several factors limiting the pace of the EM economic recovery this year. Vaccine availability is first and foremost among them. By and large, emerging market countries not only lag some of the key DMs in terms of current vaccine deployment, but their large populations create a challenge in terms of securing sufficient supplies in coming quarters to deploy vaccine at the necessary scale to inoculate a high share of the population. EMs as a whole are almost certain to lag DMs in the timeline to herd immunity.

Less Supportive EM Policy Stance Nears

The other challenge is that EM countries, in aggregate, will likely need to withdraw monetary and fiscal policy support sooner than many DMs, even as the recovery is stunted by COVID-related challenges,. There are two main reasons for this expectation, and is already borne out by rate hikes by several EM central banks. The first is that, as a group and with the exception of China, EM countries lack the advantage of global reserve currencies. With interest rates having hit record lows during the pandemic, the interest rate differential between EMs and DMs has shrunk, exposing local currencies to increased capital flight risk. The second important limiting factor is that, with inflation expectations less well anchored across EMs, the very loose monetary policy stance adopted at the height of the crisis risks stoking domestic inflation. Furthermore, the sustainability of debt, and especially foreign currency denominated debt, is an additional impetus towards the upcoming shift to a less supportive policy stance.

On the positive side of the ledger is the reality of booming global manufacturing activity — unlike services, global manufacturing appears to have already reached herd immunity. All else being equal, this should disproportionately favor emerging markets. This is both via the production channel itself, but also via demand for commodities. Of course, the picture is not uniform across countries, but the generalization stands.

Another positive is that, even as EM domestic policy support wanes, there is considerable external "leakage" in the ongoing fiscal expansion in DMs, perhaps particularly so in the case of the United States. As such, there should be an indirect benefit to EM producers, especially until the global economy is indeed fully re-opened, allowing for pent-up services demand to fully materialize. At that future point, it is possible that EMs could temporarily suffer from a diversion of spending away from goods and into services — but that may not happen for a few more quarters yet. In the interim, a massive global inventory rebuilding cycle could delay that transition further still.

COVID's Lingering Effects

Beyond these shorter-term considerations, we must acknowledge that many of COVID's long-term consequences will take years to unfold. Prime among the outstanding questions is how, and to what extent, it would impact global supply chains. One thing is clear: COVID has laid bare the vulnerabilities around long and complex global supply chains. Indeed, what in 2019 was primarily a bilateral US-China issue has since become a simultaneous and multilateral process of reassessing supply chains. One could think of it as a scaling up of the US-China trade tensions that had dominated headlines in 2019, albeit triggered by a different motivation. The changes may not be immediately apparent, but they could be quite significant. To the extent that the process of globalization has supported EM's relative growth outperformance, any change in trend here will make such an outperformance more challenging to accomplish. At the very least, we could see some degree of supply chain reshuffling within the EM universe, altering growth trajectories for individual countries.

Global Capital Markets Outlook

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Signs of froth exist in some parts of the economy and financial markets, but in our view they are not widespread enough to derail the powerful economic growth associated with economies reopening with ample policy support.

Bubble or Boom?

Just about one hundred years ago, the United States was in the midst of emerging from a severe depression in economic activity. It was a deflationary period during the infancy of the Federal Reserve System. When assessing the policy implications at his disposal, the President at the time (Warren Harding), is reported to have exclaimed "I listen to one side and they seem right, and then — God! — I talk to the other side and they seem just as right."[1] It's safe to say that a couple of things have changed over the course of the last century, but the overall sentiment is one to which many market participants and investors can likely relate. Are we currently operating within a fantastic bubble that is about to burst, exposing all of the ill-conceived ventures propped up by easy money? Or are we actually enjoying a boom that is closer to its beginning than its end?

As to the bubble argument, there is a good case to be made. Elevated equity multiples, inconsequential levels of interest rates and less depth in the liquidity of some capital markets are all sources of concern — even if these are not new phenomena. More recent signs of froth have also emerged in the economy and financial markets. Home purchases without inspections are a risky endeavor but those are on the rise. Investing in equities without earnings is something that occasionally leans more on hope than financial statement analysis, but the proportion of non-earners in small capitalization stocks is almost 50%, and that figure is close to 80% for initial public offerings (IPO).[2] And convertible bonds without coupon payments would, at first glance, appear to be an affront to the asset class itself.

But before we get ourselves into too sour a mood, the boom case beckons. While expectations about future monetary policy tightening have created headwinds in the markets, it should not be lost upon us that central bank balance sheets have expanded by more than $7 trillion during the pandemic, and this support is likely to underpin markets for some time to come. On the fiscal side, significant stimulus packages have been put in place everywhere from Spain to Singapore and they look set to accelerate meaningfully in the United States under President Biden and a Democrat-controlled Congress. And perhaps of most importance, the reopening of economies and progress in COVID vaccine distribution could awaken a voracious economic appetite following an extended period of hibernation. After all, if roaring kitties can brighten the prospects for select downtrodden stocks, perhaps facile comparisons to times like the roaring 20s are not so far off the mark.

Investor Sentiment Buoyant But Not Extreme

Bubbles do not burst overnight and the recognition of boom times is often replete with naysayers or proverbial walls of worry. In the interim, near-term indicators of market sentiment help guide us in our multi-asset portfolios. On this front, we continue to see mixed signals but our home-grown data points are mostly constructive.

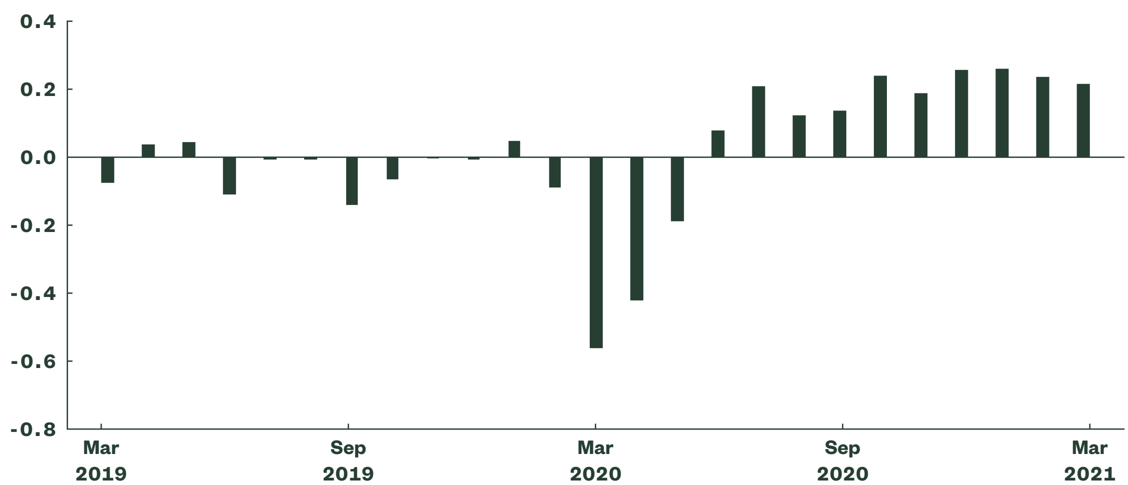
In options markets, aggregate put-call ratios are not particularly high or low compared to historical norms. However, survey-based metrics appear to be moving closer to levels that suggest there is too much optimism across markets. Among individual investors, the percentage that consider themselves bullish is quite elevated.[3] And in the institutional investor market, Bank of America's Fund Manager Survey is at its highest level in ten years. Both could be viewed as contrarian sentiment indicators.[4]

Our own Market Regime Indicator (MRI) is generally more optimistic. Low and declining levels of volatility measured across risky debt spreads, equity volatility and currency volatility suggest a mostly benign backdrop from a risk sentiment standpoint. However, even the MRI has dipped into thresholds so low that it has suggested a degree of complacency may have entered into the market. Such short-term changes have prompted us to lighten exposure to growth assets at certain points during the first quarter of 2021, but we retain a healthy overweight to equities and broad-based commodities as we head into the spring.

A Healthy Foundation for Equity Markets

In keeping with the question about bubbles and booms, there are pockets of equity markets that look frothy, some of which have cooled off during the latter part of the first quarter. But from a high level perspective, the market internals of late appear to reflect more robust growth and optimism surrounding economic reopening. Outside of any risk regime considerations, our quantitative models continue to prefer equities as strong sentiment with respect to both earnings and sales expectations, coupled with positive momentum factors, outweigh stretched valuations and softening quality scores.

Figure 5
Global Equity Earnings Diffusion Index

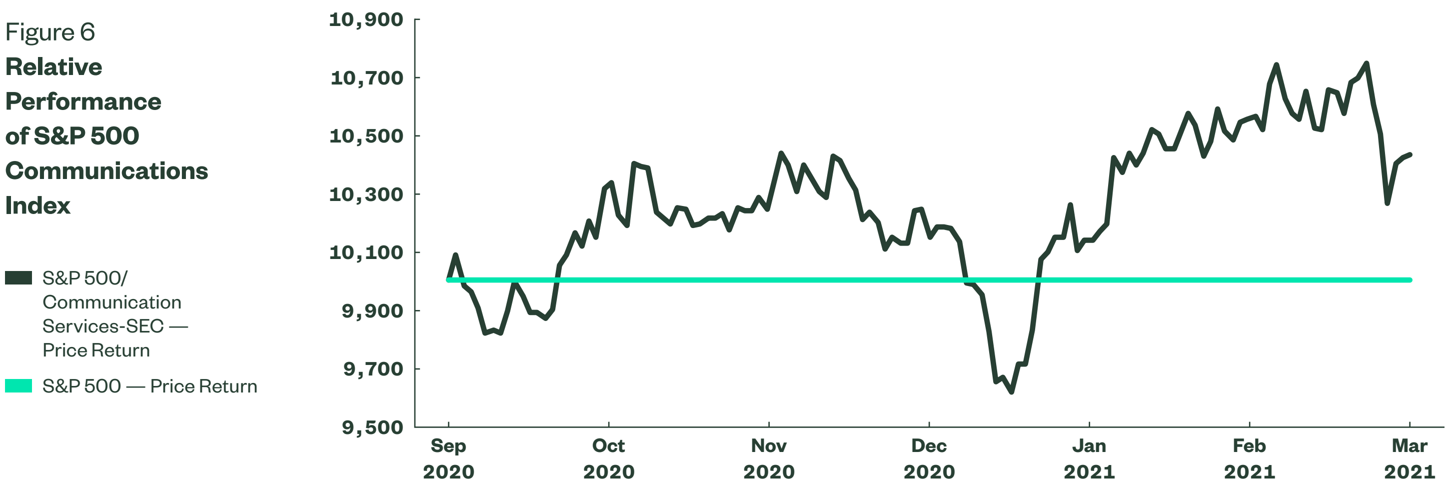


Sources: State Street Global Advisors Investment Solutions Group as of March 31, 2021. Based on analysis of analyst earnings estimate revisions. Values range from +1 to -1 with values above zero indicating more upward revisions than downward revisions and vice versa.

Regarding the internals, while one shouldn't overlook the fact that while many equity markets delivered in the first quarter what would ordinarily be considered respectable full-year results, it was the changing market leadership that truly stood out. From a global perspective, value indices jumped by close to double digits in the first quarter, while growth indices barely moved.[5] The output from our equity modeling started to change in complexion as well, with improving signals for sectors that embody greater sensitivity to economic growth and value characteristics. As things currently stand, our favored equity sectors include a balance of those that skew towards growth (technology and communication services) and some that rhyme with value (financials, energy and materials).

The technology sector continues to benefit from strong sales expectations and positive price momentum while looking attractive across all factors except value. The sector has had its struggles, particularly as real yields were rising sharply in February, but technology companies have a solid track record of delivering secular growth and a replay of February's rate action without intervention from the Federal Reserve seems unlikely in our view. We also like the communication services sector, which (with the exception of its slide to start the year) had bucked the tech-related sell-off until the Archegos Capital hedge fund implosion in late March took some of the sector's high-flying names down with it (see Figure 6). Nonetheless, with comparatively light debt loads and firm profits relative to total assets, the sector looks good from a quality standpoint as well as other factors like momentum and sentiment.

Figure 6
Relative Performance of S&P 500 Communications Index



Sources: FactSet, State Street Global Advisors Investment Solutions Group as of March 31, 2021. Past performance is not a guarantee of future results.

Financial stocks seem to be developing favorable seasonality around US Presidential election cycles, but questions remain regarding the durability of this strong performance. More recently, relative stability in interest rates and a decision by the Federal Reserve not to extend supplementary leverage ratio (SLR) exemptions took some of the wind out of bank stocks sails, but they still look good to us from an intermediate term momentum perspective and across earnings and sales sentiment. Energy stocks have also mounted an impressive rally since their relative lows recorded last November. The ongoing reflation thematic and recovery in demand (not to mention OPEC production cuts, stimulus bills and attempted port attacks) have boosted the outlook for energy, which ranks well due to positive price momentum and strong value and sentiment readings. Materials round out our picks across the more cyclical sectors. With exposure to companies engaged in everything from mining to paint manufacturing, materials appear relatively attractive, particularly on valuation and momentum metrics.

Fixed Income — Vicious or Virtuous Circle?

If there is (or was) a bubble in fixed income, the last few months of market action have already done a half-decent job of deflating it. And while the sudden increase in government borrowing costs can be unnerving, these types of interest rate scares have not been especially uncommon in the decade following the global financial crisis. Using the US 10-year Treasury as a barometer, we've had four instances where interest rates have jumped by more than 100 basis points in relatively short order. Thus far, none of these episodes have durably altered the longer-term trend of persistently lower rates of interest.

In late 2010, increased quantitative easing from the Federal Reserve bolstered inflation expectations just as firming economic data lifted real yields. But the bump in interest rates was short-lived as Greek debt concerns would soon send investors rushing toward high-quality sovereigns, notwithstanding an errant interest rate hike from the European Central Bank. The taper tantrum in the spring of 2013 sent shockwaves through all manner of interest rate sensitive assets, but interest rates would again grind lower through all of 2014 despite the start of Fed tapering. The rise in rates that accompanied President Trump's election victory in 2016 was more enduring, but also petered out eventually amidst weakening economic data, the US-China trade war and widespread central bank easing.

Is the current sell-off in rates markets different? Or in several months will we again be moving inexorably toward the zero barrier in US government bond markets (and back to more deeply negative rates in continental Europe)? At the moment, we continue to see some additional upward pressure for interest rates in most developed markets. Our views are influenced by improving economic data and also take into account possible over-reactions to prevailing and upcoming inflation prints. Risks of inflation appear to be more tangible than they have been for some time, at least from an intermediate horizon or secular perspective. But markets are signaling only a transitory bump, as can be seen by the breakeven inflation rate priced into two-year TIPS (Treasury Inflation-Protected Securities) as compared with longer-term inflation expectations embedded in 10-year TIPS (see Figure 3 on page 1). And there is the reflexive risk that, should interest rates start to move too far too fast, the Federal Reserve could easily step in with interventions akin to the 2011 Operation Twist, which was quite successful in calming long-term interest rates.

Cautiously Upbeat on Commodities

As tough as it was for bonds to cope with brighter prospects of economic reopening and elevated inflation risks, those same developments have been a boon to commodity markets. We continue to diversify our growth asset exposure with a healthy allocation to commodities, driven by improving macroeconomic fundamentals, better price momentum as well as favorable curve dynamics. The position is not without risk, and COVID complacency could arrest the market's momentum should lockdowns in Europe be extended, or if mobility restrictions were to crop up elsewhere. Similarly, if Chinese credit growth really starts to plateau, that would crimp an important source of demand for raw materials. But with plentiful stimulus funds as yet unspent in the United States, bold infrastructure spending plans in place and possibly more to come if the US Senate dismantles the filibuster, the outlook for commodities overall still looks constructive, in our view.

Unless noted otherwise, all returns are in US dollars as of March 31, 2021.

Sources: Bloomberg, FactSet, J.P. Morgan, Barclays, Wall Street Journal, The Economist, MSCI as of March 31, 2021.

Endnotes

1 Grant, James (2014). *The Forgotten Depression — The Crash that Cured Itself*.
2 Strategas Asset Allocation Strategy, 3/19/21 (for small cap non earner reference); Wolfe Research Portfolio Strategy, 3/23/21 for IPOs.
3 According to the American Association of Individual Investors. The percent of respondents who were bullish was 51% as of March 26, 2021.
4 Bank of America Global Fund Manager Survey as of February 11, 2021. Refers to survey question which shows the percent of respondents who indicate they are overweight equities.
5 For Q1 2021 MSCI World Value advanced 9.6% while MSCI World Growth advanced 0.2% (in USD terms).

SSGA Forecasts as of March 31, 2021

	2021 (%)	2022 (%)
Real GDP Growth		
Global	5.7	4.6
US	5.3	4.3
Australia	3.8	3.1
Canada	5.6	4.0
Eurozone	5.5	4.0
France	5.7	3.7
Germany	4.7	3.2
Italy	5.6	4.7
UK	6.2	5.9
Japan	3.1	2.6
Brazil	4.0	3.2
China	7.7	5.6
India	9.0	7.5
Mexico	4.7	3.0
South Africa	3.3	2.6
South Korea	3.3	2.7
Taiwan	4.5	2.7
Inflation		
Developed Economies	1.8	2.0
US	2.4	2.4
Australia	2.0	1.7
Canada	1.9	1.9
Eurozone	1.5	1.6
France	1.2	1.3
Germany	2.0	1.6
Italy	1.0	1.0
UK	1.9	1.9
Japan	0.0	0.3
China	1.8	2.6

	March 31, 2021 (%)	March 31, 2022 (%)
Central Bank Rates		
US (upper bound)	0.25	0.25
Australia	0.10	0.10
Canada	0.25	0.25
Euro	0.00	0.00
UK	0.10	0.10
Japan	0.00	0.00
Brazil	2.75	5.00
China	4.35	4.35
India	4.00	4.25
Mexico	4.00	4.00
South Africa	3.50	4.00
South Korea	0.50	0.50
10-Year Bond Yields		
US	1.74	1.90
Australia	1.79	2.00
Canada	1.58	1.68
Germany	-0.30	-0.18
UK	0.83	0.96
Japan	0.09	0.16
Exchange Rates		
Australian Dollar (A$/$)	0.76	0.79
British Pound (£/$)	1.38	1.46
Canadian Dollar ($/C$)	1.26	1.21
Euro (€/$)	1.18	1.19
Japanese Yen ($/¥)	110.50	100.00
Swiss Franc ($/SFr)	0.94	1.00
Chinese Yuan ($/¥)	6.56	6.65

One-Year Return Forecasts	USD (%)	EUR (%)	GBP (%)	JPY (%)	AUD (%)	CAD (%)
S&P 500	6.3	5.0	0.5	-3.8	2.5	2.3
Russell 2000	6.3	5.0	0.5	-3.8	2.5	2.3
MSCI EAFE	5.8	4.5	0.0	-4.3	2.0	1.9
MSCI EM	8.2	6.9	2.2	-2.1	4.3	4.2
Barclays Capital Aggregate Bond Index	1.0	-0.2	-4.6	-8.6	-2.6	-2.8
Citigroup World Government Bond Index	-0.4	-1.6	-5.9	-9.9	-4.0	-4.1
Goldman Sachs Commodities Index	7.1	5.8	1.2	-3.1	3.3	3.1
Dow Jones US Select REIT Index	3.2	1.9	-2.5	-6.6	-0.5	-0.6

Forecasts are as of March 31, 2021.
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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- Build from breadth
- Invest as stewards
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Marketing communication.

Glossary

Basis Point One basis point is equal to one-hundredth of 1 percent, or 0.01%.

Capital Expenditure (Capex) Refers to investment by a company to acquire or upgrade physical assets, such as a building, IT hardware or a new business.

Citigroup World Government Bond Index The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies.

Consumer Price Inflation (CPI) A widely used measure of inflation at the consumer level that helps to evaluate changes in cost of living. Deflation A decrease in the general price level of goods and services over a given period.

GFC The global financial crisis, or GFC, refers to the period of extreme stress in financial markets and banking systems between mid-2007 and early 2009.

Goldman Sachs Commodities Index GSCI is the first major investable commodity index and includes the most liquid commodity futures.

Gross Domestic Product (GDP) The monetary value of all the finished goods and services produced within a country's borders in a specific time period. Economic growth is typically expressed in terms of changes in GDP.

Group of Seven (G7) A group consisting of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

MSCI EAFE Index An equities benchmark that captures large- and mid-cap representation across 22 developed market countries around the world, excluding the US and Canada.

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.

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.

Organization of Petroleum Exporting Countries (OPEC) 13-member group of oil exporting nations founded to manage global supply and coordinate pricing.

Purchasing Managers' Index An indicator of the economic health of the manufacturing and services sectors compiled from a survey of purchasing executives.

Quantitative Easing (QE) An extraordinary monetary policy measure in which a central bank buys government fixed-income securities to lower interest rates, encourage borrowing and stimulate economic activity.

Russell 2000 Index A benchmark that measures the performance of the small-capitalization segment of the US equity universe.

S&P 500 Total Return Index The benchmark that reflects returns after reinvestment of dividends of the 500 large cap stocks in the S&P 500 Index.

The US Dollar Index Measures the performance of the US Dollar against a basket of major currencies.

Yield Curve A graph or line that plots the yields of bonds with similar credit quality, typically from shortest to longest duration.

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