Newsletter

Fundamental Growth and Core Equity

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Investing in Sustainable Growth

STATE STREET GLOBAL ADVISORS

Contents

Investing in Sustainable Growth

Michael Solecki, CFA
Chief Investment Officer,
Fundamental Growth and
Core Equity

Following the synchronized global economic contraction in the first half of 2020, the world is beginning to recover with positive earnings and economic growth expected in 2021. However, the pace of the recovery is varied and considerable uncertainty remains. Asian markets such as China, Taiwan and South Korea were early to address the COVID-19 crisis and their economies and equity markets have led in the recovery phase. While the US and Europe have struggled to contain COVID, an unprecedented level of coordinated monetary and fiscal support has helped to moderate the economic impact. As we enter the final stretch of 2020, concerns regarding a second wave of COVID are apparent and expectations for a vaccine and an economic recovery have been important in sustaining market valuations.

For the Fundamental Growth and Core Equity team, the divergences we are seeing in the world today underpin more strongly than ever the argument for an active and long-term investment approach. We expect an ongoing trend of scarce growth and anchored interest rates. In this environment, we would expect quality companies with durable and established growth profiles that trade at reasonable valuations to outperform. This is our focus. Over the last year through September 30, 2020, eight out of our nine strategies have outperformed their benchmark indices. This is a testament to our seasoned team, disciplined process, and long-term perspective.

In this update, our thought leadership focuses on two areas. With the first, which we originally published in September, our Emerging Market team examines the sustainability and the drivers of the economic recovery into next year. We look at the implications of a weaker dollar and expectations for growth in earnings and the economy. The second piece takes a longer-term view — our research team shares their thoughts around hydrogen-based power. We examine the climate benefits of hydrogen as an energy source, potential applications and areas of disruption.

Answers to the Top Five Questions About Emerging Markets Today

George A Bicher
Emerging Markets CIO
and Senior Portfolio Manager

Laura Ostrander
Emerging Markets
Co-Portfolio Manager and
Macro Strategist

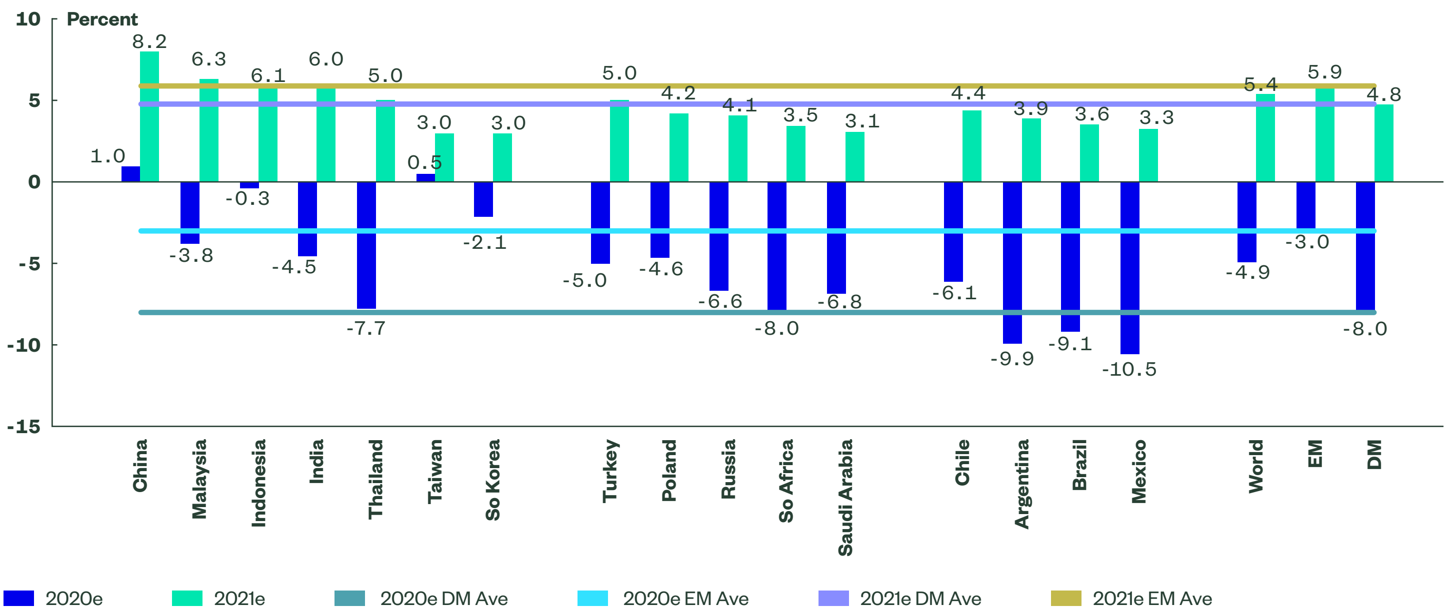
Emerging market (EM) equities have rebounded by more than 40% from the lows reached in March, due in large part to the tremendous monetary and fiscal stimulus in both developed and EM countries. While we all await clarity on a potential second wave of COVID-19, the timing of vaccine development, and the outcome of the US election, we'd like to discuss five questions that are shaping our thoughts on EM equities right now.

1. How robust and sustainable will the post-pandemic economic recovery be?

We are already seeing economic activity recover as economies re-open from pandemic-induced shutdowns. The decline and rebound in financial markets have been both sharp and swift, allowing for hope that economic recovery will follow the same path. It is likely too soon to tell just how robust and sustainable the recovery will be at this point, as damage to some parts of the economy will be lasting or even permanent. Moreover, the risks of a second wave of COVID-19 in the fall could imperil recovery trajectories and stimulus efforts.

The size and breadth of monetary and fiscal stimulus implemented in the wake of the crisis, globally, is unprecedented. The IMF forecasts shown in Figure 1 suggest sharp economic recovery in 2021, setting real GDP growth firmly back in positive territory. While this is good news, we still do not have much visibility into the sustainability of growth beyond that point. It is also important to keep in mind that not all emerging markets are the same, and that high economic growth doesn't always translate into great equity performance. A strong rebound in economic activity will naturally turn the spotlight toward economically sensitive companies. Further, the extent to which interest rates increase will begin to diminish one of the favorable catalysts behind the strong performance of growth stocks.

Figure 1
2021 Economic Growth Expected to Rebound Sharply from 2020 Decline
GDP Growth and Expected Economic Growth for 2020, 2021 and the Difference



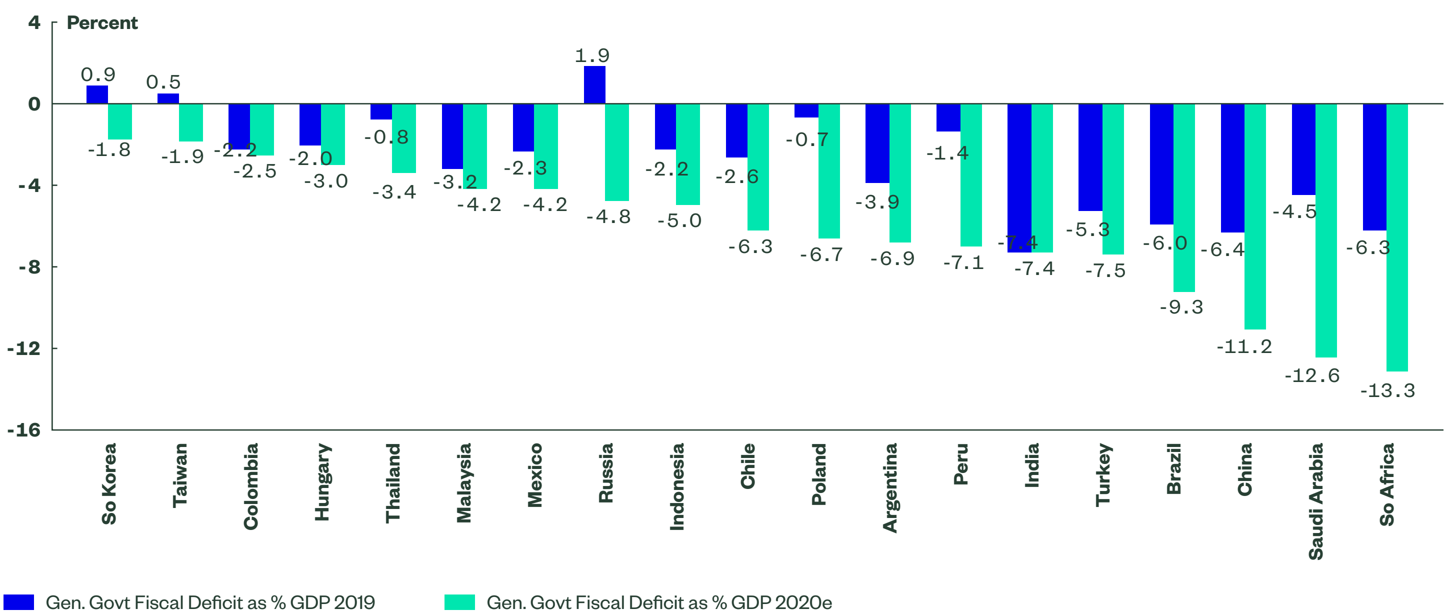
Source: International Monetary Fund WEO as of 24 June 2020.

2. Will EM policymakers be able to tighten monetary policy and tackle large fiscal deficits when economic conditions improve?

Not all emerging markets are alike, and not all emerging market policymakers responded to the economic crisis in the same way, with the same policy tools, or to the same degree. They all did, however, respond in the same direction by providing fiscal stimulus, lowering official rates, and freeing up liquidity in banking systems. The difference for emerging markets in this crisis, compared to past crises, is that EM policymakers were able to lower rates along with policymakers in advanced economies. In some cases, EM central bankers were able to use policy tools such as quantitative easing (QE) that were once only accessible to advanced economies. EM policymakers also announced fiscal stimulus packages of varying sizes and shapes.

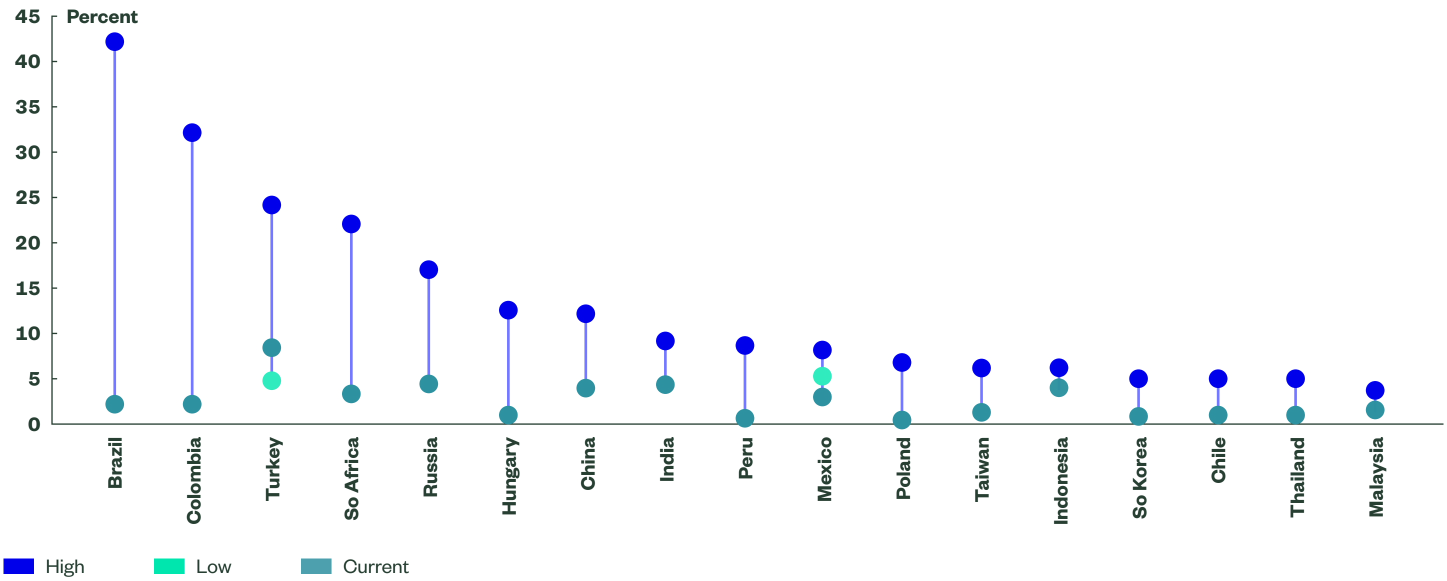
Because recent EM policy responses contrast with those that were afforded to EM in the past (e.g., higher rates, tighter fiscal policy to thwart capital outflow and currency weakness), we expect to see EM economic growth recover more quickly, but at the cost of higher fiscal deficits and potentially higher inflation. In some countries, this may lead to sharp upward adjustments in interest rates. Countries with strong institutions and credible policymakers should be best suited to normalize policy when conditions improve.

Figure 2a
Large Fiscal Responses to COVID-19 Come at High Fiscal Deficit Cost
General Government Total Fiscal Balance, 2019 vs. Expected 2020



Source: International Monetary Fund Fiscal Statistics, June 2020.

Figure 2b
Large EM Central Banks Cut Rates Sharply in 2020
Range of Official Benchmark Policy Rates and Current Policy Rate



Source: Bloomberg Finance LP., as of 20 August 2020.

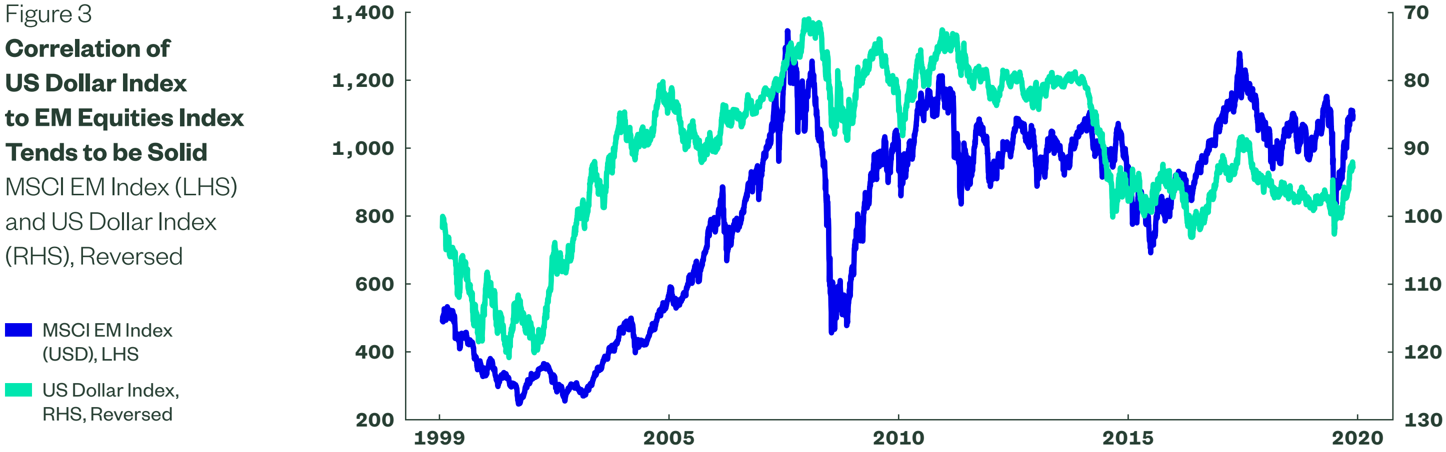
3. How supportive will a weaker US dollar be for emerging market equities?

The correlation of the US dollar index to EM equities tends to be quite solid. A decline in the value of the US dollar has historically provided a tailwind for EM equities and other riskier asset classes. We believe this remain the case going forward; however, the tailwind in not likely to be strong for three key reasons. First, as Figure 2b shows, rates in EM are currently at or very close to their lowest levels in history. In the wake of all past crises, interest rates in EM were higher and more attractive to both fixed income and speculative capital flows. In other words, FX "carry" was attractive. This is not the case now.

Also, large fiscal stimulus packages increased fiscal deficits and, ultimately, debt levels. In some cases, this debt is being monetized. This, too, will exert pressure on some EM currencies, preventing them from strengthening.

And last, the correlation between US dollar weakness and EM equities was, in part, due to the commodity and materials component of EM — a part that has decreased not only in size in the EM index, but also in relevance to the expected economic recovery. In the past, infrastructure spending played a big part in economic recovery, especially in China. Infrastructure spending in China and other countries is now less commodity- and materials-sensitive and more technology-driven (think 5G, cloud).

Figure 3
Correlation of US Dollar Index to EM Equities Index Tends to be Solid
MSCI EM Index (LHS) and US Dollar Index (RHS), Reversed



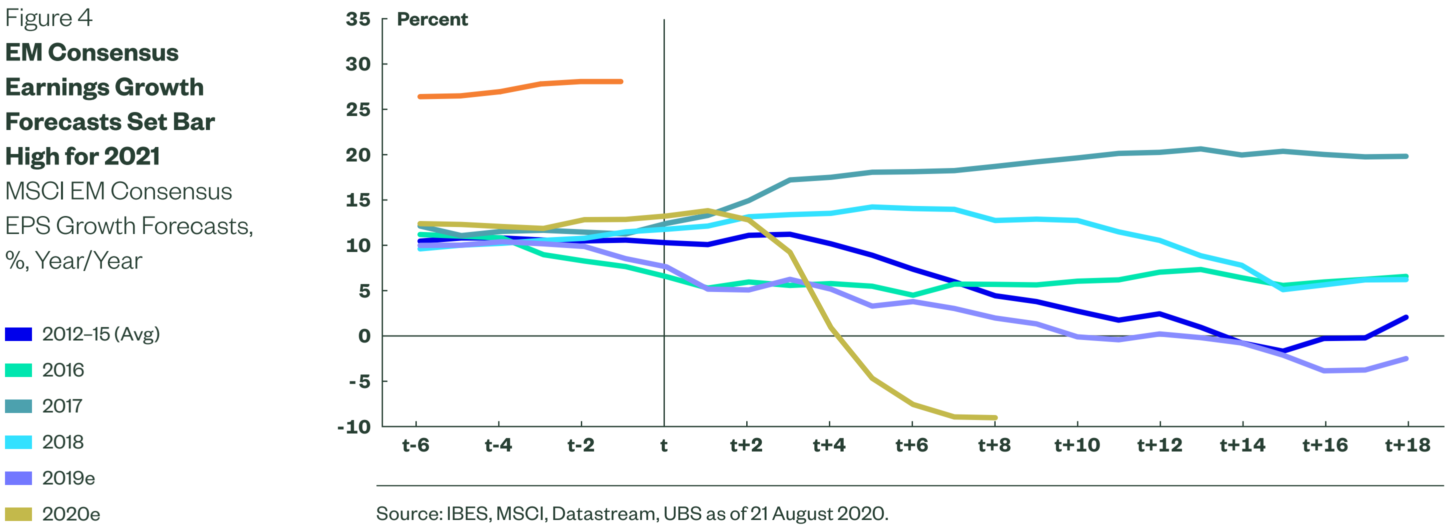
Source: Bloomberg Finance LP., as of 20 August 2020. Past performance is not a guarantee of future results.

4. Are emerging market earnings expectations for 2021 achievable?

MSCI EM consensus earnings growth expectations for 2020 at the end of 2019 were about 15%. At the time, 15% seemed a bit high but still reasonable because of an expected rebound in earnings from the large semiconductor manufacturers, whose 2019 earnings contraction was responsible for EM's negative earnings growth that year. The pandemic and following economic lockdowns erased all hopes for positive earnings growth in 2020. We are, however, beginning to see earnings, on balance, come in slightly better than feared, though still likely to be down in the range of 6–8% in 2020. Earnings growth expectations for 2021 are quite high at 30%. We expect a sizeable recovery in 2021 earnings, but we would be inviting a fair amount of disappointment if we believe the 30% 2021 consensus earnings growth expectation to be realistic at this point.

While 2021 earnings growth will be important, the perceived durability of the earnings recovery will also be a critical factor. It is likely we will return to the mode of modest global growth; however, select companies in a variety of countries with strong business models will provide interesting investment opportunities. Stock selection will matter.

Figure 4
EM Consensus Earnings Growth Forecasts Set Bar High for 2021
MSCI EM Consensus EPS Growth Forecasts, %, Year/Year



Source: IBES, MSCI, Datastream, UBS as of 21 August 2020.
Note: Time 't' is the start of the forecast year.

5. How worried should we be about a broad-based, indiscriminate rally in which EM value outperforms EM growth?

The EM Equity Select strategy looks to invest in quality growth companies, so we will always worry about a broad-based, indiscriminate rally that favors value over growth. At first glance, the EM growth-versus-value performance chart in Figure 5 suggests that we should be very worried.

Our 2019 paper titled "EM Equities: No Longer Only Beer, Banks and Cement" highlighted the changing composition of the sectors and stock in the EM benchmark. The weights of sectors such as energy, materials, and traditional telecommunication services — which include much of what makes up "value" — have been halved over the past ten years, while the weights of technology and consumer discretionary have more than doubled in size. These new-economy sectors are where we find quality growth stocks in semiconductor manufacturers, internet and gaming companies, as well as e-commerce. The COVID-19 pandemic has reinforced the trend toward e-commerce as well as the demand for internet, gaming, and healthcare. We continue to believe strong business models generating growth favorable to the benchmark at reasonable valuations will generate above-average returns over time.

Figure 5
EM Growth has Outperformed EM Value Significantly in Recent Years
MSCI EM Growth vs. Value Performance, Rebased to 100 = 12/31/1999

Source: UBS, MSCI, Datastream as of 21 August 2020. Past performance is not a guarantee of future results.

The Coming Hydrogen Fuel Energy Revolution

Patrick Bernard
Deputy Head of Research

Anthony Mariani, CFA
Research Analyst

Rajat Sarup, CFA
Research Analyst

Hydrogen-based power has the potential to solve a major issue for humankind — our dependence on fossil fuel. Stopping global warming and climate change requires us to transition to a low carbon economy. Hydrogen is abundant and when used as an energy source only emits water. This "green" energy has been widely known for decades, but it has never been scalable for large-scale use.

Our Deputy Head of Research, Patrick Bernard, and two of our research analysts, Tony Mariani, industrials analyst, and Rajat Sarup, chemicals and utilities analyst, shared their views on what could make hydrogen a more widely used fuel and why "this time could be different."

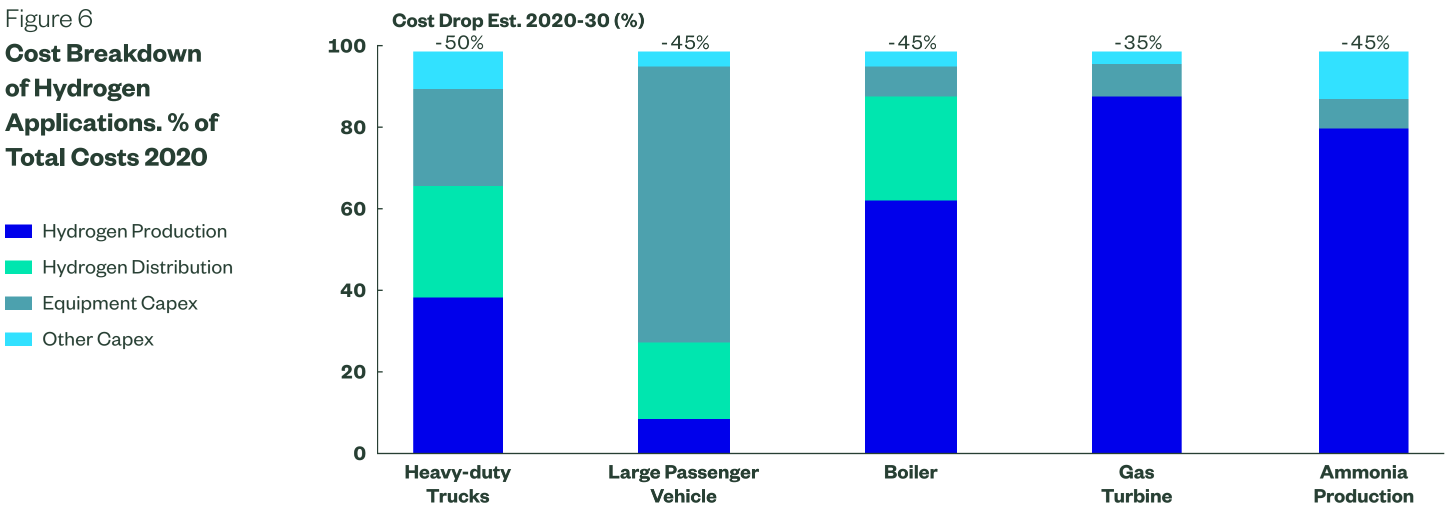
Is hydrogen a new energy source?

Patrick — When people think of hydrogen, the image of the Hindenburg zeppelin engulfed in flames may come to mind. But the technology for using hydrogen has evolved. Since the mid-60s, NASA has used hydrogen fuel cells to power satellites and other space engines. One of the main appeals of hydrogen-based energy is that the conversion of hydrogen gas into electricity does not produce carbon, only water. Though hydrogen-based fuel cells have been used for over 50 years, their adoption has been constrained by several concerns such as safety — hydrogen is highly reactive and flammable — and cost.

Can you expand on the factors that have prevented the adoption of hydrogen as an energy source and why do you think it different now?

Tony — Similar to other renewable energy technologies, the largest impediment to the wide-scale adoption of hydrogen fuel cells has been their cost and the lack of scale in hydrogen production compared to fossil fuel extraction. It has also had high transportation and storage costs, and fuel cells themselves are rather complex (see Figure 6). The flammability of hydrogen creates concerns about safety in transport and storage, as well as in its consumption. However, recognition of the increasing threat of climate change and the need to reduce global carbon emissions is spurring investment in fuel cell technology. These efforts are going to bring down costs and make it competitive with other technologies over the next decade.

Figure 6
Cost Breakdown of Hydrogen Applications. % of Total Costs 2020



Source: Hydrogen Council.

Rajat — Climate change is now firmly at the heart of global debate amid a growing realization that annual spend on decarbonization needs to expand dramatically. Moments like Greta Thunberg addressing the UN Climate Summit have contributed to its high profile. No single technology can address this need, so hydrogen represents one of the possible solutions. For many countries an additional draw is that it provides a potential path to energy self-sufficiency. Economies like Japan, Korea and Europe have led this charge as a means of reducing their dependency on nuclear energy or imported oil and gas.

Hydrogen production has been growing at about 3% annually for the last few decades. The Hydrogen Council estimates that it could grow from 1% of the energy mix today to 18% by 2050, which would require the production growth rate to increase from 3% to something closer to 7%.

There's an obvious need to adopt more green energy, but what has been done to lower costs?

Tony — Increasing commercial acceptance of fuel cells over the last 15 years has been partly driven by a significant reduction in the precious metal content of these cells, along with technological advances which have improved their durability and performance. We expect these trends to continue along with advances in assembly productivity.

Another potential game-changer would be a ramp-up in "green hydrogen" production, which means producing hydrogen through the electrolysis of water using renewable energy as a power source. Most current hydrogen production, also known as "grey hydrogen", uses fossil fuels and so produces carbon dioxide as a by-product. This then becomes 'blue hydrogen' in the limited number of cases where fossil fuels are still used to produce the hydrogen, but the carbon dioxide is not released because of costly carbon capture and storage processes.

Could you expand on how hydrogen is produced?

Rajat — Hydrogen is number one on the periodic table and the most abundant element in the universe. Interestingly though, it is not freely available as a gas. It is available in water, but almost 99% of hydrogen production today is derived from fossil fuels. We react hydrocarbons with water through something called steam methane reforming or gasification. This process releases carbon into the atmosphere.

The current excitement stems from optimism that carbon-free hydrogen, or green hydrogen, may be achievable, where the power source of electrolysis is going to be renewable energy.

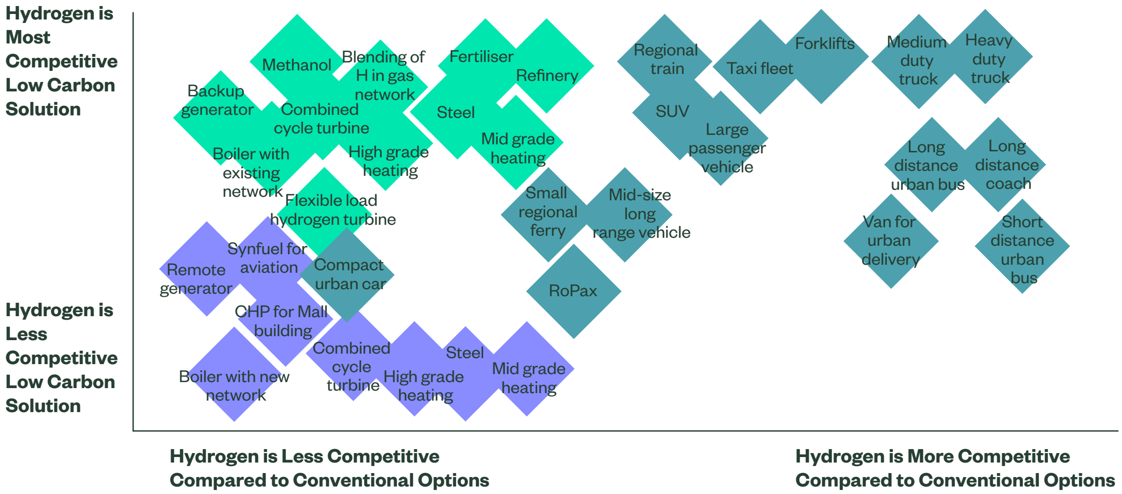
What are the most promising applications for hydrogen?

Tony — In the near term, the most immediate opportunity for hydrogen is on the industrial side in warehouse logistics and material handling, especially in forklifts. This area is enjoying strong growth as a result of increasing ecommerce, changing consumer habits, and growing post-pandemic trends towards reshoring supply chain.

Interestingly, fuel cell powered forklifts are already economical compared to diesel fuel and has made inroads in the US, while activity in Europe and Asia has started to ramp up. In the medium to long term, there's a large opportunity in commercial transportation, particularly long-haul trucks, buses and waste trucks. Fuel cell powered electric vehicles have greater range and shorter refueling time than those that run on batteries. Beyond that, rail locomotives are also an obvious application. Europe has shown some progress in this area, and North America will as well once the infrastructure is ready. Finally, buildings and distributed power represent an even longer-term opportunity. The US, Japan, and Korea are currently farthest ahead on industrial and building development, but this technology is at an early stage. It may be over a decade before we see it being fully developed.

Rajat — In the near term, we anticipate the most relevant applications for hydrogen being as a blend with natural gas and then being used as a feedstock, which helps to decarbonize the natural gas. For example, there's a power plant in Utah, which is converting from coal to natural gas. The plant intends to blend 30% hydrogen into that natural gas with the hope that it will eventually become a 100% hydrogen facility. Utility companies are adopting this approach because there is an existing natural gas infrastructure.

Figure 7
Competitiveness of Hydrogen Applications vs. Low Carbon and Conventional Opportunities



Source: Hydrogen Council.

What companies do you see as the potential winners and which will likely be disrupted?

Tony — There are several large diversified companies as well as small-scale pure play players focusing on different types of fuel cells for various industrial end-markets. Toyota, Hyundai, Ballard, Plug Power, Powercell, and Cummins are among the leading manufacturers of Polymer Electrolyte Membrane (PEM) fuel cell, the fastest growing type of fuel cell best suited for transport applications. Bloom Energy and Ceres Power are leading players in solid oxide fuel cells (SOFC), which is used in stationary power. Doosan Fuel Cell is a leading player in phosphoric acid fuel cell (PAFC), primarily used in distributed generation. In materials handling and warehouse logistics, the leading global forklift manufacturers are Toyota and Kion, which have invested in their own PEM technology. One of the largest forklift purchasers is Amazon and they have a substantial investment in Plug Power.

Within the highway transportation market there is huge potential for disruption and intense competition between the conventional diesel engine manufacturers and the PEM manufacturers. Ballard, a leading PEM player, has made inroads in China and Europe. Nikola Motor, which recently announced a partnership with General Motors, is developing long-range fuel cell electric vehicle trucks. Cummins, the leading maker of conventional diesel engines, is the most vulnerable to disruption, but the company has also been investing in alternative energy technologies. There will be a lot of change, a lot of disruption, and ultimately consolidation.

What's your approach to evaluating these companies?

Patrick — The Fundamental Growth and Core Equity team uses its proprietary Confidence Quotient (CQ) framework to evaluate companies. We apply this even to a very nascent industry such as hydrogen. There are five criteria we evaluate in the CQ, one of which is management, something that particularly applies in this area. We look for visionary management that can clearly articulate their strategy and business model. Another is financial condition — we want to make sure that companies have funding to execute their business plan. A third is transparency, where we want clear signposts to evaluate the company's progress and determine if it's on track to achieve its targets. And perhaps most important, we look at market position to ensure that these companies have true and defendable competitive positions — this can be via technology, manufacturing processes, or other aspects that underpins a strong market position.

In conclusion, we are looking at a technology that developed decades ago but finally seems to be reaching an inflection point. Its widespread adoption will create winners as well as disruption. Using our CQ framework, we believe we are very well positioned to identify those companies and make great investment decisions for our clients.

This information should not be considered a recommendation to invest in a particular security or to buy or sell any security shown. It is not known whether the securities shown will be profitable in the future.

Contributor

Thomas Kronzer
Portfolio Strategist, Fundamental Growth and Core Equity

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* This figure is presented as of September 30, 2020 and includes approximately $80.51 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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