Forecasts Q2 2020

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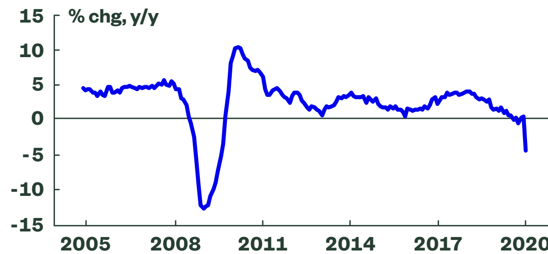
Page 2

Global Economic Outlook

Figure 1
More Pain Ahead



World, Industrial Production Excl. Construction, SA

Source: Netherlands Bureau for Economic Policy Analysis (CPB), Economic Policy Uncertainty, IHS Markit. Updated as of 04/14/2020.

- Global economic growth estimates for 2020 have been completely upended by the Covid-19 pandemic. So, instead of growth picking up pace in 2020, it is now likely to halve; and there are downside risks to that forecast.
- Policy responses have been swift but the scale of restrictions and halt in economic activity means that many countries will record negative growth for this year.

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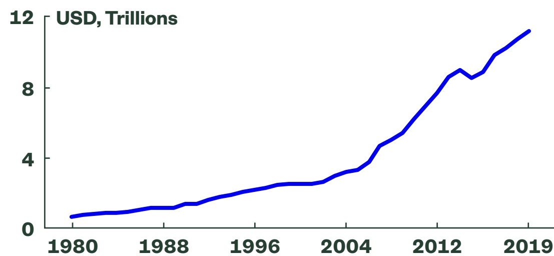
Page 8

Emerging Markets Outlook

Figure 2
More Than One Kind of Vulnerability



Emerging & Developing Economies, External Debt, Total, IMF WEO, Estimate, USD

Source: International Monetary Fund. The figure for 2019 is an estimate.

- Covid-19 is the sort of crisis that may, for now, negate many of the structural long-term advantages of emerging market economies while accentuating their shortcomings.
- Given wide dependence on commodities, lower global demand raises the risk that deteriorating fiscal and external balances drive currency depreciation, with knock-on implications for debt obligations.

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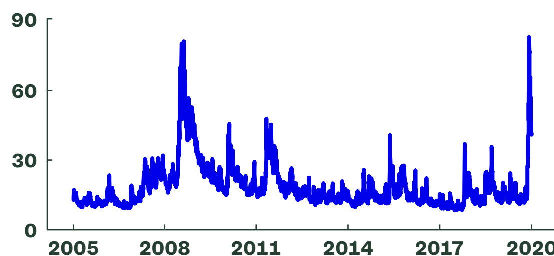
Page 10

Global Capital Markets

Figure 3
US Equity Market Volatility Hits Record High



CBOE Market Volatility Index — Price Index

Source: State Street Global Advisors Investment Solutions Group, FactSet.

- Near-term volatility will likely linger and a re-opening of the global economy will not happen overnight, but excessive fear coupled with an unprecedented policy response leads us to a constructive outlook for equities.
- Bond market forecasts adjusted to incremental data are likely to provide murky indications of future market conditions. Investment grade corporate bonds look attractive amid improving sentiment, liquidity and policy support.

Global Economic Outlook

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Start-of-year expectations for a pick-up in economic growth in 2020 have been dismantled by the emergence of Covid-19 and its impact on global economic activity. Policy responses have been swift, but the outlook remains uncertain.

A New Year, a New Reality, a New Macro Narrative…

Unfortunately, the green shoots of improvement that had become evident in global macro data early this year have since collapsed under the weight of the Covid-19 pandemic into a retrenchment of unprecedented speed and depth. What during the global financial crisis took months to transpire, we have experienced in the span of mere days and weeks. This is true, not only for financial markets which by their very nature are anticipative and move fast, but also for the real economy itself.

Severe restrictions on people movements and blanket "shelter in place" orders have caused service activity to swing, in many countries and within the span of a single month, from moderate growth to contractions so severe as to have never before been seen during peace time. In the United States, initial unemployment claims spiked from 282,000 in the week ended March 14 to 3.3 million in the in the week ended March 21 and 6.6 million the week after that! To put this in perspective, they never exceeded 675,000 in 2009. How can this be? The answer has to do with the nature of this crisis, not economic or financial at its root but health-related. Because of that, the economic resilience that individuals, firms, or countries may have exhibited previously does not matter at the moment. We had resilience, but we all needed immunity…and we did not have it.

"Whatever it takes" Policy Response

Confronted with these precipitous developments, policymakers around the world have quickly swung from the "happy where we are" messaging of early 2020 to a "whatever it takes" crisis mitigation mindset meant to limit the economic damage and prevent a liquidity crisis from morphing into a solvency one. The idea, well-articulated by former Bank of England Governor Mark Carney, is to "keep firms in business and people in jobs". But it is much easier said than done.

Fortunately, most of today's tools were conceptually incubated during the Global Financial Crisis (GFC) and thus were "off-the-shelf" options deployable within days. We have seen dramatic rate cuts, massive scale-ups of repo operations, re-activation of crisis-era liquidity mechanisms, resumption, expansion, and broadening of QE. New tools are being developed as well, with the Fed initiating a new facility that essentially amounts to direct business lending. Meanwhile, governments around the world are pushing through enormous fiscal packages (see individual country sections).

Policy Support not a Substitute for Economic Activity

Such speed of response is critical in an era when social distancing policies required to slow down the virus mean instantaneous, broad, and indiscriminate stoppage in economic activity. But policy stimulus can only provide a bridge, not a substitute, for the normal functioning of the underlying economy. The next big debate will have to be about how to safely bring people back to work. This is not a political debate, it is an existential debate. Asking "what are we going to need in order to come back and how are we going to get there?" is not only valid, but critical.

Macroeconomic Forecasts Completely Upended

Given the extraordinary degree of uncertainty about the evolution of the virus and the duration of business shut-downs, it may be better to view any numbers put forth by the analyst community as "best-guess estimates based on a certain set of assumptions". Our core assumption is that in each individual location, the Covid-19 crisis is a three-month peak event, rather than a six-month peak event. This does not mean we believe the outbreak will be over within three months, but rather that enough progress is made to bring it under control so that social distancing restrictions are gradually relaxed to allow for economic activity to selectively resume with that three-month horizon. Even so, the hit will be severe and many economies will experience deep recessions.

Global growth likely halves this year; the risks to that forecast remain to the downside. But in situations such as these, it is perhaps more useful to embrace a two-year view. After the dashed expectations of 2020, we anticipate conditions will be in place for a powerful rebound, similar to the "synchronized global growth" story we were talking about back in 2017.

Inflation: The Least of Our Worries, For Now

Despite likely supply chain disruptions and some bottlenecks in the months to come, we view Covid-19 as largely a deflationary force near term. Plunging oil prices alone are enough to drive inflation down across economies and our new forecasts reflect that. Whether it is also deflationary over the medium to long term remains to be seen. Reshoring of supply chains to higher labor cost locations will battle it out with tech-driven innovations to settle that question. Whether inflation flares up down the line will also be the litmus test on whether MMT-type policy responses are viable.

US: Dashed Expectations

To borrow a little from Fed parlance, there has been "a material change to the outlook" since our last Forecasts Quarterly publication in early January. At that time, we were quite pleased with how events converged to what had been our long-held view that eventual trade war de-escalation would allow economic activity to reaccelerate; so, at that point we had raised our 2020 US forecast from 1.9% (where it had been for nine months) to 2.1%. The first quarter of 2020 started very promising, with near-constant upside surprises in high-frequency data that ranged from stellar housing market reports to equally stellar employment reports. The "resilience" narrative was nicely coming along. And then, Covid-19 struck and OPEC/Russia disagreement sent oil prices tumbling. Essentially, two black swans entered the scene at once.

Everything changed overnight. Initial unemployment claims spiked to 3.3 million during the week ended March 21, up from 282,000 the week before and five times higher than the previous record in 2009. While these numbers won't last for more than several weeks, it could get even worse before they pull back in what will probably be equally dramatic fashion. Unemployment could easily touch 10% — it was at a 50-year low of 3.5% as recently as February. Consumer confidence (Michigan survey) plunged by nearly 12 points in March. The underlying reality is even bleaker as sentiment utterly collapsed in the last 10 days of the month. The two-month March-April declines could prove unprecedented in magnitude.

US Policy Response

Unsurprisingly, the policy response has been swift. One thing is clear: policymakers are in a "whatever it takes" mindset, willing to deploy all tools at their disposal, willing to improvise and adjust, and willing to seek additional legal authority to develop new tools tailored for the crisis at hand. Since cutting interest rates by 50 basis points in an emergency meeting on March 3, the Fed has lowered the Fed Funds rate by another 100 bp to 0.00–0.25%, has massively scaled up repo operations, has restarted and broadened what has essentially become unlimited quantitative easing (QE), has reactivated a range of crisis-era facilities aimed to provide liquidity and stabilize a broad range of markets, and is tiptoeing into what is effectively direct business lending. It is truly astonishing to behold! Most of the easing measures will stay in place for a while. We do not expect even a serious discussion about roll-backs until after the election and then perhaps only some timid moves in early 2021. If our baseline expectation of a broad-based global rebound proves true, that debate will intensify around mid-2021.

The fiscal policy response underwent a similar, extraordinary swelling in a matter of days. What started as a $750 billion stimulus bill morphed into a $2 trillion affair comprising direct payments to individuals, specific industry support, aid for small businesses, and loan guarantees. After passing through Congress, it is expected that funds will start flowing through the system around mid-April. The biggest questions about the fiscal package are no so much about whether the size is adequate but whether it will reach those most in need before the realities of no income and no revenues cause irreversible damage. The unemployment claims' spike speaks to the criticality of speed and also to the night and day difference between firms seeing a decline in revenues (as is typically even in the worst recessions) versus no revenues at all (under current shut-down orders).

Seeking the Upside

Is there any hope? Yes, there is. Let's not forget that the US consumer entered this crisis in good shape. The February data showed the personal savings rate at an elevated 8.2%. This can be quickly exhausted in an extended loss-of-income scenario, but it does provide some cushion. Moreover, if fiscal support reaches individuals and small business in a way that makes them as close to "whole" as possible during the period of activity shut-downs, there is reason to believe that both supply and demand can come back with a vengeance when movement restrictions are lifted.

Our current forecasts assume a deep decline in Q2 GDP of the order of 10–12% annualized, but followed by a similar-sized rebound in Q3 and further strong gains in Q4. Again, we assume that the peak restrictions episode does not last more than several weeks (the period may vary across different parts of the country), with some businesses currently under lock-down resuming operations during the second half of April and even more doing so in May. This leaves US GDP close to flat in 2020. We settled on an incremental positive figure more to make a point and push back against some of the apocalyptic scenarios out there in the market, but we do not claim false precision here. There are simply too many moving pieces here to say we have high confidence it won't be a negative print. But unless we move away from our core assumption of this being a three-month as opposed to a six-month peak hit, it is difficult to envision a deep annual contraction.

We see the temporary hit to GDP coming primarily from the consumption side. While shut-down businesses are unlikely to make investments, many firms continue operations and even small businesses might actually need to make investments in IT and intellectual property (IP) to facilitate operations. Thus, while we anticipate deeper declines in structures investment than during the 2015-16 episode (this investment category is closely related to the energy sector), and we see business equipment investment likely down for the year as a whole, we continue to expect annual gains in residential and IP investment. Government investment should also provide some offset.

Inventories and trade are genuine wild cards. They were already volatile prior the outbreak as the trade war skewed behavior. They should directionally offset each other somewhat as inventory drawdowns will also manifest themselves in lower imports.

Inflation is not an issue. Fed Chair Jerome Powell said as much in a rare TV interview this week. Lower oil prices and a temporary drop in demand for certain goods and services imply a notably weaker 2020 number. But some of that will be made up in 2021 as base effects become much easier and the anticipated global rebound lifts energy prices.

Eurozone: Deep Cyclical Downturn, Better Structural Outlook

The eurozone presents an interesting case. Back in December, we anticipated a mild cyclical improvement but expressed continued grave doubts about the structural institutional and policy set-up, which we had long seen as detrimental to optimal economic performance. Covid-19 turned that assessment on its head. Given recent developments in Italy, Spain, and the entire region, there is no point debating whether a recession is at hand. It is unavoidable. The question is only how bad it will get.

On the other hand, this may well prove to be the crisis that galvanizes the sort of heretofore absent political will to enhance the effectiveness of macro policy making across the eurozone. The ECB has for far too long been fighting the battle alone. New leaders at the helms of the ECB and the European Commission, operating in the middle of unprecedented crisis, seem poised to change that. The ECB may be the institution officially conducting a policy review, but we now believe the entire EU body politic is about to undergo a similar exercise. For now, the policy response still primarily involves the bending of existing rules. But there are signs that the rules themselves are under review.

Contracting Economies — Italy to Fare Poorly

We expect the eurozone economy to contract by about 1.0% in 2020 before rebounding in 2021. Italy's contraction could approach 3.0%, with France faring a little better and Germany better still. Germany's outperformance in 2020 is not the same relative competitiveness story that has underpinned its outperformance in years past. It is more of an economic structure story, with less reliance on services and especially tourism, than France or Italy. While manufacturing was a liability during the 2019 trade war episode, it may be an advantage insofar as manufacturing activity could undergo more limited shutdowns, plus has a greater capacity to make up losses on the other side of this when activity resumes. It also reflects its corporate sector's experience with the work subsidy programs that have yielded good results during the recession and should therefore be expected to prove effective this time around as well. And finally, it reflects its greater room for fiscal stimulus, which is now emerging.

The ECB Response

The ECB is doing what it can, which is primarily to boost QE further and broaden the types of assets it will purchase. In addition to increasing its existing asset purchase program, it launched a temporary €750 billion Pandemic Emergency Purchase Program (PEPP) and waved eligibility requirements so Greek debt could be included in the program. The ECB also expanded the range of eligible assets under the corporate sector purchase program (CSPP) to "all non-financial commercial paper of sufficient credit quality". It greatly sweetened the terms of its TLTRO III program slated to begin in June and launched additional weekly long-term refinancing operations to bridge the tome until then. It also temporarily eased some capital requirements and hinted that national macro-prudential authorities complement those by relaxing the counter-cyclical capital buffers.

As notable as what the ECB has done, is what it has not done; it hasn't cut interest rates further into negative territory. We look at this as indirect acknowledgement that negative interest rates don't really have the favorable impact they were hoped to have in terms of encouraging lending. So the ECB seems to be moving more towards a carrot approach vis-à-vis banks as it tries to incentivize lending rather than punish the lack of lending. This is a good change in approach in our view and may well ignite some fiscal concessions out of Germany, whose banking sector should benefit from ECB's change in tack. As Mme. Lagarde said during her first press conference at the ECB, the "ballet" of economic policymaking involves many dancers. Greater harmony would benefit all.

UK: A Risk Event Worse Than Brexit

It seems unreal to say it, but where are the good old times when Brexit was the biggest thing we had to worry about in regards to the UK economy? Well, everything is relative, and now the UK, alongside the entire world, has a much bigger crisis on its hands. By the way, Brexit did finally happen: the UK is in a transition period but officially no longer part of the EU. Ironically perhaps, effectively tackling the Covid-19 outbreak will require stepped-up international cooperation and coordination just as the EU and the UK parted ways.

If there was one moment in recent weeks that also highlighted the potential benefits of independent domestic policymaking, it was the impressive coordination of monetary and fiscal policy, so evidently displayed and so swiftly delivered by UK authorities. We wrote extensively in our March 13 Weekly Economic Perspectives about this, but the 50 basis point emergency rate cut and the range of liquidity operations and real-economy lending incentives announced by the Bank of England on the same day that the government put forth its budget was a genuine example of how policy should be done in a time of crisis. Since then, both monetary and fiscal responses have been topped up, with the BoE cutting the bank rate by another 35 basis points to 0.1%, resuming QE, and doubling the size of the term funding scheme. The government has also sharply scaled up fiscal stimulus given the rapidly deteriorating outbreak situation. It is notable that in the midst of this crisis the policy response has been so smooth that the change of leadership at the Bank of England passed nearly unnoticed — as of March 16, the BoE has a new governor in Andrew Bailey.

UK Recession on the Cards

We do not believe the economy will avoid a recession this year. Proximity to, and reliance on, eurozone demand are negatives in the current context. Generally speaking, we would view smaller, open, service-based economies as more vulnerable in this crisis than larger ones and those more dependent on manufacturing. It's not that the cost of domestic social distancing is necessarily different, but the more an economy is dependent on external demand, the more it is vulnerable to waves of impact and thus a longer-lasting demand hit. We therefore anticipate an outright, but modest, contraction in 2020 GDP, the damage reduced by what appears to be effective and sizable fiscal stimulus. As we hope to have made abundantly clear by now, these point forecasts have an unusually large margin of error and should be seen as the mid-point of a range of outcomes. This particular number reflects a sizable decline in both household and non-profit consumption this year (the latter in what will likely be a multi-year decline linked partly to changing funding pattern following Brexit), partly offset by rising government consumption. Fixed investment also likely contracts, but inventories, which had been an extraordinary drag on growth in 2019, should make a positive contribution. Net trade is a drag on growth.

We see these dynamics shifting dramatically in 2021, when we anticipate a sharp growth reacceleration as activity not only normalizes but some demand get pushed back into 2021. Manufacturing is best placed to accommodate such pent-up demand, but there is scope for such behavior even in some services. Assuming Covid-19 is fully under control (via a vaccine or other such development), there is a lot of scope for pent-up demand in areas like concerts, events, and even some travel, to overshoot in 2021.

Inflation had moderated quite noticeably at the end of 2019 and, while that was starting to turn around, the economic slowdown does imply weaker price pressures in the near term. Exchange rate movements have been extreme over the past month, but as the US dollar shortage seems to be easing, we would expect the pound to stabilize close to pre-Covid levels such that the exchange rate doesn't play a driving role in inflation this year. As demand rebounds and energy prices strengthen, overall inflation also moves higher in a non-problematic fashion in 2021. The BoE will eventually respond, but it will be in no rush to do so.

Japan: Virus To Blame But Fundamentals Are Weak Too

Japan is the locus of a large downgrade to 2020 growth, largely but not entirely driven by the Covid-19 epidemic. A weaker than anticipated performance in late 2019 already set the stage for softer than initially expected growth in 2020. While case-wise the Covid-19 hit to Japan has been delayed, it is now intensifying. Meanwhile, the country's demographic profile, reliance on global manufacturing value chains and external demand, and the delay in the 2020 Olympics add extra layers of damage and vulnerability to its near-term economic profile. Thus, 2020 is now likely to bring a sizable contraction in GDP despite considerable (mostly fiscal) policy support.

Risks Tilted to the Downside

Risks remain tilted to the downside. We still assume that the outbreak largely comes to an end in the second half of 2020, that nothing seriously breaks in the global economy and markets, and that Japan's economy begins to heal albeit at a weak pace. We forecast a somewhat muted recovery in 2021, with growth to pick up at 1.6%. A revival in external demand should help the export sector considerably, while inbound tourism around the Summer Olympics will boost the services sector.

Inflation has deviated considerably from target and the miss will intensify given declining global oil prices, whose deflationary impact will more than offset isolated price pressures in select in-demand healthcare-related items. But overall we see a deceleration in inflation extending well into the second half of 2020. We expect inflation to stay flat over 2020, before picking up marginally to 0.3% y/y in 2021.

Fiscal policy has to be the frontrunner in this battle. The Bank of Japan which is thinly stretched, has already opened the floodgates — with a Special Fund-Supplying Operation to provide credit availability to small and medium enterprises and a step up in purchase of ETFs and J-REITS. The bar for a rate cut is rather high, given the adverse impact on bank earnings as net interest margins are squeezed. Moreover, low long-term interest rates risk dampens consumer sentiment by depressing the investment performance of life insurance and pension funds. Also, a muted reacted of the yen to earlier Fed cuts might have reduced the urgency to cut. Hence, we see the Bank of Japan on a prolonged pause through 2020 and 2021.

Emerging Markets Outlook

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The sudden abrupt drop in global demand has implications for export-driven emerging markets, with those more heavily dependent on commodities particularly at risk. The potential for diverging economic prospects for EM countries could be a feature going forward.

Emerging Markets: Least Prepared?

We perceive the Covid-19 outbreak to be the sort of crisis that, in the near term, negates many of the structural long-term advantages of emerging market economies while accentuating their shortcomings.

One of those advantages is demographic: abundant and relatively cheap labor resources have been a key advantage that has supported an export-led growth approach in many emerging market economies in Asia and beyond. But abundant labor is not an advantage when that labor is idled by the necessities of social isolation policies. In fact, high population density is a risk factor that can greatly exacerbate disease containment difficulties and escalates healthcare costs. If there is a silver lining here, it is that EM populations are generally younger, and that seems to greatly reduce Covid-19 mortality rates.

Another advantage often discussed in connection with EM economies is their scope for "catch-up growth", or the convergence over time towards higher income levels thanks to faster productivity and overall economic growth. But under current circumstances this can be interpreted in a completely different way as well, insofar as catch-up growth implies lower current incomes and lower healthcare expenditures. These less well-endowed domestic medical systems may then have an even harder time coping with this crisis than their DM counterparts.

While much less so than in the past, many emerging market economies remain very dependent on commodities, not just industrial such as oil and metals, but agricultural as well. This entire universe will be stressed by lower global demand, so EM may undergo an especially material decline in revenues. To the extent that deteriorating fiscal and external balances drive currency depreciation, debt servicing obligations may become more onerous and risks of default will rise. Credit risks will certainly not be a sole EM story, but to the extent that "capital goes home" during periods of financial market stress, EMs may experience increased capital flight. There remains a yield advantage in EM, but a more cautious approach towards capital preservation may make it less attractive to foreign investors in the near term.

Heterogeneity on Steroids?

We have long stressed the heterogeneous nature of Emerging Market economies. Covid-19 may highlight that differentiation to a much greater extent than normal. Specifically, countries with strong capacity of policy implementation — for delivery of effective healthcare services and for effective and sizable stimulus injection — are likely to fare far better, not only in this episode but also beyond.

Global Capital Markets Outlook

Jerry Holly
Senior Portfolio Manager
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The speed with which equity markets dropped into bear market territory was staggering, while the swiftness of policy response has been almost without precedence. Financial market volatility eased somewhat into the end of March, but the effects of the pandemic-driven dislocation will linger for some time.

Little in the way of diagnostics are needed to ascertain the source of the havoc that was wreaked upon capital markets during the first quarter of 2020. The spread of the Coronavirus Disease 2019 (Covid-19) served as the proximate source. But it was the response in the form of social distancing, temporary lockdowns and quarantines and other mobility restrictions that inflicted such significant harm to the global economy and financial markets.

The magnitude of the damage has been staggering, with unwelcome milestones turning up in every corner of financial markets. Libor exhibited its sharpest jump since the Global Financial Crisis. The yield on the 10-year US Treasury note slid below 1% for the first time ever (as would the yield on the 30-year US Treasury bond for a brief period). Oil prices fell to their lowest levels since 1999. The S&P 500 Index registered its third worst daily loss ever on March 16 — outpaced in infamy only by October 19, 1987 and October 28, 1929. And in terms of volatility, the VIX Index surged to its highest reading ever during the depths of the sell-off. While the magnitude of the slide across markets is meaningful, the speed at which markets moved from all clear to freefall was especially noteworthy.

It may be difficult to recall, but at the very start of the year stock markets were still in a reasonably good mood. Notwithstanding some geopolitical turbulence between the United States and Iran, global equity markets marched upwards until the end of January when concerns around the spread of Covid-19 from China began to negatively affect risk sentiment. But the early stages of risk aversion were fleeting as the People's Bank of China stepped in to support market liquidity and financial stability, and the US ISM Index jumped above 50 for the first time since July 2019. Equity markets continued to advance and many markets notched all-time highs in mid-February.

Risk Sentiment Turns

However, soon thereafter, a number of European countries started to report their first confirmed cases of Covid-19 and the proverbial wheels started to come off of the equity market. Markets sold off aggressively towards the end of February and briefly stabilized in early March amidst encouraging statements from central bankers and a strong showing by Democratic Presidential candidate Joe Biden at the Super Tuesday primary elections.

With risk aversion building, demand for the safety of government bonds sent interest rates lower and the US dollar weakened as well. The weaker dollar helped bolster gold, which rose to levels not seen since 2013. If Covid-19 concerns were not a sufficient catalyst for heightened market volatility, a breakdown in OPEC negotiations over the first weekend in March led to an oil price war between Saudi Arabia and Russia — a development which sent oil prices plunging and also triggered a market wide circuit breaker on the New York Stock Exchange shortly after the market opened. Trading would be halted on three more occasions before the end of the month. Soon thereafter, the World Health Organization (WHO) would declare a pandemic on the same day that the Dow Jones Industrial Average breached bear market territory.

Policymakers Respond

At that point, the policy response to the pandemic was well underway. The Federal Reserve had conducted an emergency 50 basis point rate cut early in March and the United Kingdom announced a coordinated response with the Bank of England reducing the bank rate by 50 basis points (among other measures) and the UK government announcing a budget with an additional £30 billion in fiscal stimulus. Extreme volatility and a surging US dollar characterized the middle of the month and the VIX index reached its peak just after the Federal Reserve implemented a second emergency rate cut and announced plans to restart asset purchases. The European Central Bank (ECB) launched a Pandemic Emergency Purchase Program (PEPP) to buy public and private sector securities as well.

But stricter isolation policies across several larger states in the US pushed stock markets lower just as the Federal Reserve launched a variety of support programs aimed at supporting a host of funding and credit markets. The sell-off on March 23 would represent the low point for equities for the first quarter as markets shifted their attention to the massive spending bill (CARES Act) that was ultimately passed and signed into law on March 27. Equity markets were able to recoup some of their losses as part of the relief rally at the end of March, but the overall results were stark. The MSCI All Country World Index (ACWI) fell by 21.4% — its worst quarterly showing since the fourth quarter of 2008. Government bond markets provided a degree of diversification and the FTSE World Government Bond Index (WGBI) added 2.0% in USD terms.

Equity Markets Capitulate

It requires little in the way of hyperbole to note that markets have been extremely volatile as investors reset their expectations and trudged through illiquid markets amidst the spread of Covid-19 and the ensuing mobility restrictions put in place all over the world. While the shock to markets has been acute and rapid, there has also been an unprecedented amount of stimulus introduced to improve the functioning of markets and provide stopgap funding to economies that are suffering from the effects of social distancing and quarantines in some cases. Fundamentally, we believe that the economic consequences from the coronavirus will be painful but short-lived; we also acknowledge the continuing uncertainty over how the virus will influence markets and economies — on the way down and on the way back up.

In times such as these, the data associated with public health trends takes on paramount importance when compared with price-to-earnings ratios, cross currency basis swap spreads or Fibonacci levels. But we don't think that the crisis renders investment analytics entirely impotent either. In our evaluation of the markets, we have turned up the volume on those elements of our investment process and quantitative models geared more towards market sentiment, which we think are likely to provide a better read on how the risks related to Covid-19 unfold — this is in contrast to incremental economic data which we know is going to get worse for some time to come.

Gauging Risk Appetite

One example of an important sentiment tool is our Market Regime Indicator (MRI). The goal of the MRI is to measure risk appetite based on inputs of implied equity volatility, implied currency volatility and spreads on risky debt. It is multi-asset and global, much like the portfolios we oversee. From an output standpoint, the MRI gives a reading on various regimes from risk seeking to normal and high risk environments. The current reading is what we refer to as a crisis regime. While this sounds negative, it is a contrarian indicator for us and suggests that markets may have become too fearful.

Other measures of sentiment or investment psychology seem to confirm what our MRI is signaling. During a time of crisis or market panic, certain conditions, behavioral or otherwise, will frequently develop in the face of a collective capitulation by market participants. Capitulation and a potential bottom in markets can be viewed within a few key dimensions: price extremes, selling urgency and an overwhelming bearish sentiment. As the events surrounding the spread of the coronavirus pandemic unfolded throughout March, all of these conditions were satisfied.

Investor Capitulation

The first stage of investor capitulation began with a sudden and violent selloff in markets that stretched prices heavily to the downside. The sell-off was broad-based and indiscriminate, leaving very few opportunities to protect capital. By March 16th, almost 70% of S&P 500 stocks were making one-year lows in price. The extreme selling pushed the S&P 500 price farther away from its long-term moving average, creating what is often referred to as an oversold condition. With evident price extremes in place, signs of selling urgency started to emerge. Normally tame commercial paper spreads surged to levels not seen since the depths of the global financial crisis in 2008, a sobering sign of overnight funding problems. Similar episodes of panic pricing played out across the entirety of fixed income markets, leaving exchange traded funds to trade at deep discounts in order to accurately price their markets.

All were tell-tale signs of selling urgency. From there, the final criteria for a capitulation low in markets comes in the form of depressed investor sentiment. The negative outlook was indeed reinforced by a surge in hedging and other capital protection measures. Put/call ratios (a good sign of investor nervousness) spiked to notably high levels in March, while the VIX spiked to its highest-ever levels (see Figure 3 on Page 1). By late March, bulls outnumbered bears in a number of relevant investment surveys — which was in stark contrast to the levels of optimism that prevailed earlier in the year.

Looking Beyond the Near Term

So even if we think that market participants capitulated in March, does that mean we see an all-clear sign for equity investment? After all, global equity markets have already retraced approximately 40% of their peak-to-trough decline. And while signs of sentiment extremes and capitulation have been present, we're also cognizant that relief rallies and re-testing of lows are common features of the landscape when navigating in bear market territory. Volatility is still elevated and we suspect some degree of fear will return to capital markets in the interim.

However, from an overall positioning perspective, we maintain a small overweight to equities in our balanced portfolios. This is partly driven by the prevailing crisis regime in our MRI. Part of our rationale is a view that the economic impact will be painful but fairly short lived. And investors and markets will start to look past this crisis period and towards future recovery. It isn't going to happen overnight, but we believe at this point we need to position for that eventuality.

Bond Markets Anchored by Policy Intervention

To the extent that equity markets may have capitulated, it begs the question as to whether yields for credit-worthy sovereigns have already put in their lows, or if spreads for less credit-worthy borrowers have printed at their widest levels in this tumultuous market period. Regarding the general direction of interest rates, we certainly see less upward pressure than we did at the turn of the year. With the degree of degradation anticipated in near-term economic data, as evidenced by the surging levels of initial unemployment claims and deteriorating purchasing managers' indices (PMI), any rules-based system incorporating weekly and monthly releases is likely to point towards lower levels of interest rates in response to this economic shock.

But, as with our evaluation of equity markets, it may not be as appropriate to lean on macroeconomic equilibrium analysis to speculate on interest rate moves at this time. In credit markets, the move lower in interest rates that has characterized many (but not all) major sovereign debt markets should provide some support in terms of easier financial conditions. And for high yield issuers, we are right around the turn of the year where seasonality typically shifts from an asset to a liability. Central to the outlook for all of these pockets of bond markets, however, is the central role of policy in providing market support and influencing the outlook.

Central Banks Provide Critical Support

The expectation of significant support from a monetary authority in times of crisis is not a new phenomenon. In the oft-cited work *Lombard Street*, Walter Bagehot argued that:

"Theory suggests, and experience proves, that in a panic the holders of the ultimate Bank reserve (whether one bank or many) should lend to all that bring good securities quickly, freely, and readily. By that policy they allay a panic; by every other policy they intensify it."[1]

But this particular crisis has required much more than lending on good securities to avoid intensifying a panic. Near-zero levels of interest rates, unlimited purchases of Treasuries and mortgage-backed securities, facilities to promote the working of money market mutual funds and commercial paper markets, and even secondary market purchases of certain investment grade and below investment grade corporate bonds, have all been important policy tools that have helped stabilize markets and improve investor sentiment. Additional liquidity, regulatory and quantitative easing measures from central banks around the world have also provided critical support for markets as well.

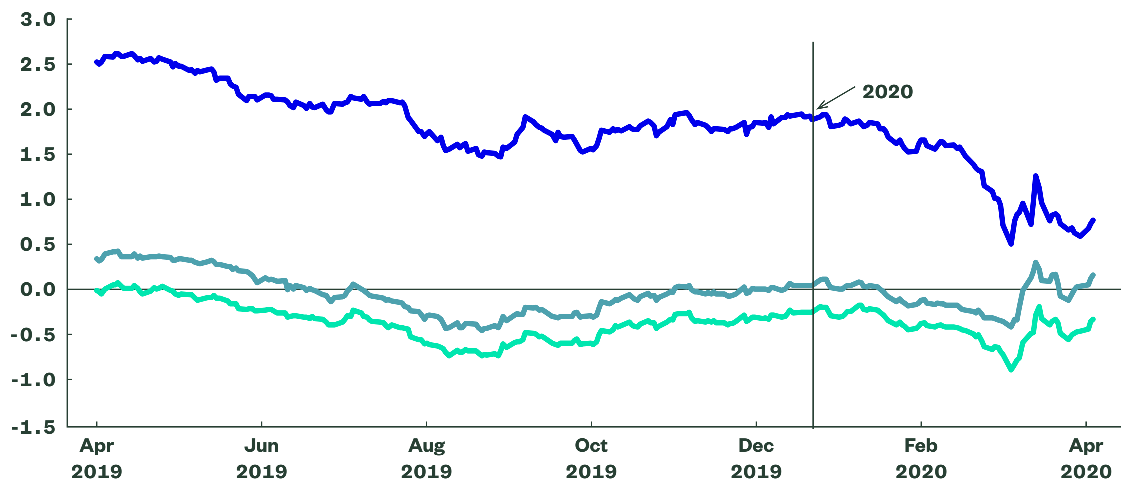
Differing Outlook Across Fixed Income Sectors

While investors can find ready central bank buyers for many types of debt securities, the outlook across fixed income sectors differs meaningfully in our view. For Treasuries and mortgages, the markets with the highest degree of central bank intervention, we hold the lowest degree of enthusiasm. It does appear likely that unlimited central bank buying has a good chance of fending off exceptionally large jumps in government benchmark interest rates, but the prevailing yield levels offer up little in the way of remuneration unless our cautiously optimistic outlook proves incorrect.

Consider the performance of developed bond markets around the world in 2020. Yes, in the United States the yield on the 10-year US Treasury note has declined by over 100 basis points in the year-to-date period, but in Germany the benchmark 10-year bund yield has dropped by little more than 10 basis points, and in France borrowing costs have risen over the same period (See Figure 4), as of April 9, 2020. Beginning yield levels are important, and they have been inching ever closer to zero, even in the United States.

Figure 4
US-Europe 10-Year Yield Gap Narrows (9 Apr 2019– 9 Apr 2020)

US 10-Year Yield
Germany 10-Year Yield
France 10-Year Yield



Source: State Street Global Advisors, FactSet as at 9 April 2020.

Investment grade corporate bonds are closer to what we view as a sweet spot for fixed income in the current environment. While the economy will no doubt experience some pain in the near term, lower levels of interest rates and a steeper yield curve suggest that the current spreads in investment grade are reasonably attractive. And with a fairly extensive set of support packages from the Federal Reserve, we think that sentiment is likely to improve further for the asset class. Some similar arguments could be made for high yield bonds, especially as we hold a constructive outlook for equities; however, the balance of risk and reward is not as compelling at this juncture. High yield credit spreads in the vicinity of 800 basis points do look attractive in their own right. But with the Federal Reserve backstop much more selective in conjunction with the near sudden stop in economic activity that the world is experiencing, we are biding our time in stepping back into investments of the more highly leveraged borrowers.

Unless noted otherwise, all returns are in US dollars as of March 31, 2020.

Sources: Bloomberg, FactSet, J.P. Morgan, Barclays, Wall Street Journal, The Economist, MSCI as of March 31, 2020.
Special thanks to Tim Furbush, Senior Portfolio Manager in the Investment Solutions Group, for contributions related to investor sentiment and technical analysis.

SSGA Forecasts as of March 31, 2020

	2020 (%)	2021 (%)
Real GDP Growth		
Global	1.5	3.8
US	0.3	3.3
Australia	0.1	3.9
Canada	-0.7	1.9
Eurozone	-1.0	2.6
France	-1.7	2.0
Germany	-0.7	2.8
Italy	-2.7	3.0
UK	-0.3	2.7
Japan	-1.2	1.6
Brazil	0.3	2.0
China	4.0	6.2
India	3.5	5.5
Mexico	-1.0	3.5
South Africa	-1.8	1.7
South Korea	0.6	2.9
Taiwan	1.0	3.0
Inflation		
Developed Economies	0.8	1.8
US	0.8	2.3
Australia	1.0	1.5
Canada	1.5	1.9
Eurozone	0.4	1.4
France	0.7	1.4
Germany	0.6	1.2
Italy	-0.5	1.2
UK	0.9	2.0
Japan	0.0	0.3
China	2.5	2.8

	March 31, 2020 (%)	March 31, 2021 (%)
Central Bank Rates		
US (upper bound)	0.25	0.25
Australia	0.25	0.25
Canada	0.25	0.25
Euro	0.00	0.00
UK	0.10	0.10
Japan	-0.10	-0.10
Brazil	3.75	3.75
China	4.25	4.10
India	4.40	4.40
Mexico	6.50	6.50
South Africa	5.25	5.25
South Korea	0.75	0.75
10-Year Bond Yields		
US	0.68	0.73
Australia	0.76	0.83
Canada	0.71	0.76
Germany	-0.49	-0.42
UK	0.33	0.37
Japan	0.02	0.08
Exchange Rates		
Australian Dollar (A$/$)	0.61	0.71
British Pound (£/$)	1.24	1.44
Canadian Dollar ($/C$)	1.42	1.27
Euro (€/$)	1.10	1.18
Japanese Yen ($/¥)	107.96	98.00
Swiss Franc ($/SFr)	0.97	1.06
Chinese Yuan ($/¥)	7.09	6.85

Note: GDP, Inflation and Central Bank Rate estimates as at March 27, 2020.

One-Year Return Forecasts	USD (%)	EUR (%)	GBP (%)	JPY (%)	AUD (%)	CAD (%)
S&P 500	7.7	0.2	-7.2	-2.2	-7.1	-3.9
Russell 2000	6.2	-1.2	-8.5	-3.6	-8.4	-5.2
MSCI EAFE	7.5	0.0	-7.4	-2.4	-7.3	-4.1
MSCI EM	12.2	4.3	-3.4	1.8	-3.3	0.1
Barclays Capital Aggregate Bond Index	2.4	-4.8	-11.9	-7.1	-11.8	-8.7
Citigroup World Government Bond Index	0.1	-6.9	-13.8	-9.1	-13.7	-10.7
Goldman Sachs Commodities Index	3.6	-3.6	-10.8	-5.9	-10.7	-7.5
Dow Jones US Select REIT Index	4.5	-2.8	-10.0	-5.2	-9.9	-6.8

Endnotes

1 Bagehot, Walter. Lombard Street — A Description of the Money Market (1873).

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For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager with US $3.12 trillion* under our care.

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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.

Personal Consumption Expenditures (PCE) is the value of the goods and services purchased by US residents.

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.

Value Added Tax (VAT) is a broadly-based consumption tax assessed on the value added to goods and services.

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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