Forecast
Market Outlooks

Q1 2021

Forecasts Quarter 1, 2021

Global Economic Outlook

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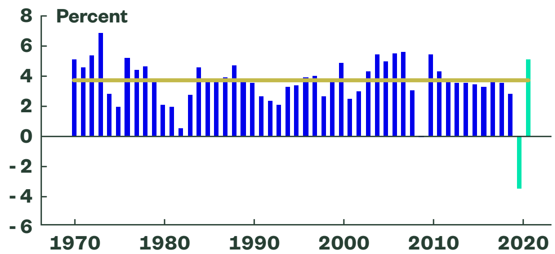
Figure 1
Global Economic Growth Rebounds in 2021



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.

- After an extraordinary contraction in 2020, the global economy will likely bounce back sharply in 2021 as vaccine rollout allows pent-up demand to materialize and supportive monetary and fiscal policies aid the recovery.
- The powerful cyclical recovery likely lifts inflation almost everywhere, but large output gaps will cap the rise.

Emerging Markets Outlook

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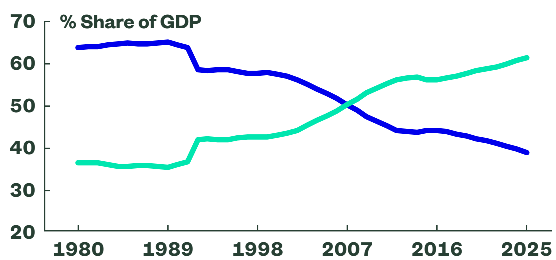
Figure 2
Emerging Markets to Continue Increasing Share of Global Economy



Source: State Street Global Advisors Economics, IMF WEO, Estimate, Share of World Total GDP Based on Purchasing-Power-Parity.

- Emerging markets will benefit from improved global demand and the rebound in commodity prices, although the pace of recovery will vary greatly across countries.
- The COVID crisis likely accelerated shifts in global supply chains, but the full impact will take years to fully materialize.

Global Capital Markets

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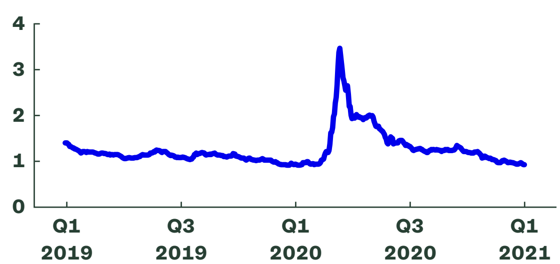
Figure 3
Corporate Spreads Back to Pre-Pandemic Levels



Source: FactSet as of January 11, 2020.

- Important forces across macroeconomic, political and public health dimensions continue to create tensions, but benign risk indicators and a mostly constructive outlook characterize our multi-asset portfolio positions.
- Despite losing some important support mechanisms alongside dramatically tightened credit spreads, credit assets across both investment grade and high yield markets remain attractive.

Global Economic Outlook

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The global economic recovery is underway but the road ahead will be bumpy and the process of healing will take years to complete. Nevertheless, 2021 will represent a big step along that journey.

The global economy is in the process of healing following the COVID crisis, but there is a lot more healing left to do. Our macro forecasts haven't changed much in the latest round. We've made incremental upgrades to several developed markets (US, Japan, Canada), small downgrades to others (UK, eurozone), and some downgrades to emerging markets ex-China. New International Monetary Fund (IMF) estimates have raised advanced economies' weight in global GDP (measured at purchasing power parity (PPP) exchange rates) by about three percentage points, and reduced the weight of developing economies by the same amount. The combination of all these factors resulted in a modest lowering of the 2020 GDP growth estimate (now at -3.5%), while projections for 2021 have been raised a little (now at 5.1%). It is worth noting that all things being equal, the IMF weight changes imply marginally lower trend growth for world GDP going forward (PPP weighted).

The lack of big forecast changes does not mean we've become complacent...on the contrary! We had been far out at the optimistic end of consensus expectations in the middle of 2020, but we now find ourselves pondering what will come after the big 2021 rebound and also what sort of volatility may lie underneath that headline figure. While the crisis part of the relay recovery might soon be over, thanks to vaccine deployment, the process of economic healing will take a lot longer. As part of that process, there will come a time for yet another transition, when economies around the world will need to revert to "autonomous growth". As fiscal and monetary stimulus eventually dwindles, will underlying economic momentum be strong enough to ensure a smooth transition? This is rarely an easy process to undergo, so we are watching for signs of vulnerabilities and bubbling volatility.

We recognize the impressive resilience that the global economy displayed in 2020 under utterly unprecedented circumstances. We look forward to a much better 2021 when global growth should rebound to a decade high. But we also expect that resilience to be retested at times.

US: Gaining Traction

As we turn the page on a tumultuous 2020, we are pleased to remark that our optimism about the US economy has proven well-placed and our earlier forecasts extremely prescient. With seasonally adjusted annualized GDP growth of 33.4% in the third quarter and additional gains on track in the fourth quarter, we have settled on the same forecast number we published back in June — namely a GDP contraction of -3.4% for 2020. This represents a slight 0.3 percentage point upgrade relative to our September projections. That such a result was possible despite the worst economic shock of our lifetimes speaks to the effectiveness of early monetary and fiscal stimulus that has supported household incomes, confidence, and spending. It is indeed astonishing to note that in a year such as this, both household goods consumption and private residential investment are poised to have increased by about 4.5%! Of course, other areas of the economy are not doing as well: household spending on services, constrained as it has been by mobility restrictions, is headed for a record contraction.

The major escalation in COVID cases as 2020 came to a close poses notable near-term challenges, as evidenced in the increase in initial unemployment claims. However, given the economy's strong momentum at the start of the fourth quarter and the holiday-driven support for consumer spending, these headwinds are more likely to impact first quarter 2021 performance. However, even as the current COVID situation worsens, vaccine deployment has begun so the economic hit should be temporary. That hit will likely be softened further by an additional fiscal stimulus injection of close to $900 billion.

All this paves the way for a sharp rebound in GDP growth to 4.1% in 2021. We see both upside and downside risks to this projection, and that is precisely why we have settled at this point. On the upside, additional fiscal stimulus and accelerated vaccine deployment could unleash stronger pent-up demand faster than we anticipate in travel, leisure, entertainment, etc. On the downside, we worry that despite anticipated further improvements in the labor market, the typical associated improvement in household income may not materialize given comparisons with transfers-boosted 2020 levels. This could hinder growth when the economy eventually starts making the necessary transition back to autonomous growth, i.e., in the absence of additional stimulus. Finally, there is a question of timing as well since there may well be a delay between vaccine deployment and consumers' return to previous spending patterns, whether by choice or due to capacity constraints. As such, the release of pent-up demand may be spread over several quarters, well into 2022.

2021 Prospects: Still Not Business As Usual

We can't stress enough how unusual some of the key macro dynamics were in 2020! Personal income increased 6.9% year-on-year (y/y) during January-October, even as the unemployment rate spiked and remains twice as high than at the start of 2020. The personal savings rate, which jumped to 33.7% was still highly elevated at 13.6% in October; household net worth hit a record high in the second quarter and then yet another peak in the third. New home sales are hovering around 14-year highs. It is safe to say that there is nothing even remotely close to "business as usual" here! To say these metrics have exceeded expectations is more than just an understatement, and therein lie some of our worries about 2021: it will be a tall order to continue beating expectations after this sort of a run!

Inflation hasn't been a worry for some time, but may become one in 2021. Even with modest sequential price increases, base effects will be powerful enough that we expect to see headline CPI hit or exceed 3.0% y/y by May-June 2021. This should not come as a huge surprise to markets, but it may and could be a source of volatility. We do not anticipate a persistent overshoot of such magnitude and see consumer price inflation averaging a manageable 2.2% in the coming year. But the risk of a higher print is non-trivial: the release of pent-up demand in depressed service areas, building pressures on global supply chains, and a weaker dollar are all forces speaking to higher inflation. Admittedly, lower food prices and lower rental costs could prove to be a more than adequate offset, ensuring a goldilocks inflation dynamic — but the inflation outlook is more complex than it's been in some time.

Fed Content to Stay on Hold

The Federal Reserve (Fed) made big news last year, first with its aggressive easing at the onset of the crisis and then with its adoption of average inflation targeting (AIT). AIT adoption was accompanied by a considerably extended and expanded forward guidance that laid out the conditions for lift-off from the current 0.00-0.25% interest rate level: the labor market has returned to full employment, inflation has returned to 2.0%, and inflation is also on track to moderately exceed 2.0% "for some time". With these parameters in mind, the Fed seems content to remain on hold for a very long while indeed.

Eurozone: Strengthening the Foundation

The eurozone presents an interesting case in the current COVID-19 drama. Cyclically, it has been among the worst affected regions, its vulnerabilities stemming from high level of economic openness, dependence on tourism and luxury good demand, elderly populations, and macro policy constraints related to institutional rigidities in the eurozone and EU constructs. And yet, the crisis has also energized transformative integrational efforts to a larger extent than either the GFC or the euro crisis have done. After years when European Central Bank (ECB) rate cuts and quantitative easing (QE) seemed to mark the extent of macro policy support available to the region's economy, we are now witnessing a meaningful fiscal policy response. This is not just at the national level (and now including traditionally austere countries like Germany), but — most importantly — at the supranational level. The creation of the €750 billion recovery fund marks an important moment in EU macro policy and will be an important element in the 2021 recovery.

Meanwhile, the ECB continues to do its part. Having nearly doubled the size of its Pandemic Emergency Purchase Program to €1,350 billion earlier in 2020, it then boosted it by another €500 billion to €1,850 billion at its December meeting. It also extended and enhanced the TLTRO III bank lending program. Essentially, all hands are on deck to ensure progress towards achieving the inflation goal.

Considerable support will indeed be needed as headline inflation is barely seen exceeding the 1.0% mark, even in 2021 when economic activity will have rebounded strongly from the deep contraction of 2020. By and large, our forecasts haven't changed much since the middle of 2020, although the latest upsurge in COVID cases has trimmed a few tenths off our 2020 GDP projection. We anticipate eurozone GDP will have contracted by -7.3% in 2020 (more than twice the US rate) before clawing back about three quarters of those losses in 2021.

Growth Differentials Across the Region

Cross-country performance differences have been a staple in eurozone economics, and they persisted through the COVID crisis. We anticipate a notably smaller contraction in Germany than in either France or Italy on account of a larger stimulus injection, stronger consumer finances, lesser dependence on tourism and higher dependence on manufacturing (a sector that's better positioned to make a fuller/faster recovery). The extent to which structural differences in potential growth across countries will be alleviated in years to come will have a lot to do with the effectiveness of policy, especially fiscal policy. Ongoing tensions among EU member countries regarding the rules of engagement on fiscal policy remain a downside risks to the medium-term outlook.

UK: Beyond Brexit

More than four years after the Brexit vote, we finally have clarity on the future UK-EU trading relationship. It's nothing to get too excited about since it is a clear step down — a "skinny deal" as it has often been called — from the formerly smooth relationship. But at least there is a degree of certainty that businesses and investors have not enjoyed for a number of years. Historically, the UK has enjoyed a higher potential growth rate and has delivered better aggregate economic outcomes than many of its continental European peers. In recent years, that edge has evaporated: UK GDP grew by an average of 1.6% during 2016–19, which is 0.3 percentage points less than eurozone GDP — the outcome for 2020 further accentuated that underperformance. Among the developed economies we track, we would certainty put the UK's 2020 economic performance as the most disappointing.

Although the UK had 'good' start to the crisis with a swift and powerful monetary/fiscal response early on, it then somehow managed to squander that advantage to end up with a very sub-optimal lockdown case-count/economic activity balance. Its initial lockdown was among the most severe globally and the longest lasting among the G7 group of countries. As a result, the economic cost was far worse than its peers: while US, German, French, and Italian economies shrank by roughly -9–10% quarter-on-quarter (q/q) in Q2, the UK contraction was twice as bad. The country's GDP plunged -20.4% q/q in Q2 as private consumption dropped by 23.5% and fixed investment collapsed by over 25%! The third quarter rebound was also proportionally more muted, and the mobility restrictions re-imposed during the final quarter of 2020 were once again more biting than elsewhere. As such, even our (more optimistic than consensus) projection of a -9.6% GDP contraction in 2020 marks the worst performance among the countries we track.

Vaccine Deployment Offset by New Lockdown

Against the aforementioned backdrop, the UK's early vaccine deployment did not come a moment too soon. A race toward herd immunity is indeed warranted and likely one of the few things precluding an even bigger drag on economic activity as we move into 2021. It is partly on account of the positive vaccine news that we went with a fairly upbeat projection for 2021 growth. However, our 7.9%, forecast was concluded prior to the implementation of the latest lockdown; so in the context of a very weak Q1, it might be difficult to achieve. The risks are clearly skewed to the downside.

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, engaging in various liquidity operations and extending real-economy lending incentives. It has since looked closely into the implementation of negative interest rates. It has not yet taken that step although it has raised the target stock of government bond by £150 billion to £875 billion. Similarly, there was another injection of fiscal stimulus in the form of extended (and expanded) labor market protection measures. Neither monetary nor fiscal policy can compete with a successful vaccine (upside) or a disastrous Brexit (downside) in terms of potential economic impact, but they can and will help smooth out the cycle.

Inflation has taken a dive recently, with the headline measure at only 0.2% y/y in August and still at only 0.7% y/y in October. Base effects, higher oil prices and a release of pent-up demand speak to a reacceleration in inflation in 2021 when average CPI inflation could approach 2.0%.

Japan: Suga's Time to Shine

Japan's economy finally returned to positive growth in the third quarter of 2020 (5.3% q/q) after three consecutive quarterly declines. The recent strength in consumption has led us to upgrade our GDP growth estimate for 2020 by 0.2 percentage points to -5.3%.

We are also expecting a slightly stronger 2021 than in our September forecast. Our year-end growth forecast is unchanged at 3.3% despite the upward adjustment to 2020, and for good reason. The Q3 Tankan survey suggests that both manufacturing and non-manufacturing firms were extremely cautious, and as a result have been reluctant to ramp up production even after the end of the national emergency. This is probably the reason why Japan's manufacturing purchasing managers' index (PMI) has been lagging other developed nations. Given vaccine rollout, firms will look to stock inventories in anticipation of improved demand. This will provide a much needed impetus to manufacturing.

Improvement in services, on the other hand, is likely to be limited in the first half of 2021, especially for sectors like retail, restaurants, and accommodation. The "Go To" stimulus campaigns are critical in providing support to these sectors until the situation improves. The Suga administration approved an additional economic stimulus package on December 8, following two previous supplementary budgets under his predecessor. The headline figure of ¥73.6 trillion is notably lower, but the budgeted spending of ¥30.6 trillion (of which the third supplementary budget is ¥20 trillion) is broadly in line with the first and second budgets. Other than the three main objectives, which include — (1) prevent the spread of COVID-19 infection, (2) transform the economic structure in the post-COVID era, and (3) enhance infrastructure to secure resilience against natural disasters — it includes spending to promote digitalization and green initiatives which are priority areas for Suga. All are big potential positives for growth in the short to medium term.

Inflation Outlook Remains Muted

Headline inflation has been remarkably stable in Japan considering the drop in private demand and the fact that inflation had limited momentum even in the months leading to COVID. Headline CPI averaged 0.2% y/y over the first ten months of 2020 and turned negative for the first time in four years in October, falling 0.4% y/y. Even after accounting for a substantial pullback over the latest two months, we revised our forecast for 2020 upward to 0.1% from -0.3%. Both the core measures of CPI (excluding fresh food) and the new Bank of Japan (BoJ) core CPI (excluding fresh food and energy) however, dropped by 0.4 percentage points and 0.2 percentage points to -0.7% and -0.2% y/y, respectively. The declines were expected, and partly an unintended consequence of the "Go To Travel" campaign. The medium-term outlook for inflation is still weak, due to lack of demand in the economy, and specific components like an anticipated drop in charges for mobile network carriers. Hence our outlook for 2021 remains unchanged at 0.0%.

We expect the BoJ to maintain status quo across all monetary policy parameters, including short and long-term policy rates (yield curve control), asset purchase programs (JGBs, ETFs, etc.), and forward guidance until the end of 2021, and possibly beyond. Some concerns are being raised about the sustainability of its substantive policy-easing stance as it is expected to take even longer now to achieve its 2% inflation target. BoJ Governor Kuroda has downplayed the concerns, which possibly keeps the door open for the bank to take rates deeper into negative territory if the currency were to appreciate sharply.

Emerging Markets Outlook

Simona Mocuta
Senior Economist
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After an unprecedented contraction last year, 2021 should bring about a robust 5.5% increase in emerging market's GDP growth. However, the lasting scars associated with the COVID-19 crisis will take a long time to heal.

Emerging Markets: COVID's Lasting Scars

As we've argued for some time, COVID-19 was the sort of crisis that temporarily negated many of the structural long-term advantages of emerging market (EM) economies, while accentuating their shortcomings. That will likely remain the case in 2021. Moreover, as vaccine distribution accelerates globally, demand for services is poised to experience a much stronger bounce-back than demand for goods in 2021. Part of this is simply a reflection that goods demand did quite well in 2020 as consumers shifted dollars away from unobtainable services. To the extent that this demand was to a large extent (especially in developed economies) supported by imports (primarily benefitting emerging market economies), that transition toward (largely domestic) services raises some challenges for EM exporters. As a group, emerging markets may also lag behind developed markets in the speed of vaccine deployment; and, as a group, emerging markets are likely to experience a more significant pullback in fiscal policy support relative to 2020. On the upside, however, the strong rebound in global demand has already triggered a sharp recovery in commodity prices, a development generally more favorable for the EM universe. And the depreciation of the US dollar, combined with very accommodative DM central banks — both of which should extend in 2021 — create a more supportive financing environment for EM economies, easing the path to recovery.

The COVID-19 crisis has greatly heightened the heterogeneity in EM economic performance. There are two layers to this heterogeneity. On one hand, there is a duality element (China versus the other EMs) and on the other an increased divergence among the remaining EM economies. China's exceptionalism could not be starker at this point in time. Its superior policy implementation capacity — both social and economic — places it in a unique position: it was the only large emerging market, in fact, the only large economy in the world, to have seen its GDP expand in 2020. It will likely remain a growth leader in 2021 as well.

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 could 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

Jerry Holly
Senior Portfolio Manager
Investment Solutions Group

Global equity markets ended 2020 on a high and the optimism surrounding the rollout of effective vaccines and prospects for economic recovery looks set to underpin markets in 2021. A constructive approach to equities is warranted, and a case can be made to widen regional exposures.

Financial markets are generally considered a discounting mechanism for expectations about the future. In that respect, it should come as little surprise that riskier markets have rebounded so quickly from the onslaught brought forth by the coronavirus pandemic, while economies are still trudging along, leaning heavily on the economic crutches of fiscal and monetary support. After all, with government authorities providing a bridge and the medical community having delivered a palette of vaccines that would have been unimaginable only some months ago, it seems natural to anticipate (and discount) better times ahead.

But the idea that financial markets have fully recovered, or more, while the economy continues to operate well below potential does not portray the complete reality of the situation. To be sure, labor markets the world over have a long way to go before assuming any semblance of pre-pandemic vigor. And measures of economic activity, both lagging (gross domestic product), as well as forward-looking (leading economic indices) remain well below prior peaks in most countries. However, there are also areas of economic activity that have accelerated significantly and financial assets that are still licking their wounds.

Our economics team has noted the aberrant ascent of personal savings in the United States during the pandemic. Some estimates put the accumulated stock of excess savings at $1.4 trillion[1] — a non-trivial sum whose disposition could easily float both economic growth and asset prices. Claustrophobic conditions in urban centers have also led to home sales that are close to rivaling their prior record in 2005. These are purchases that typically have significant follow-through for consumption levels. And stringent virus management and an accelerated pivot to virtual interactions have helped lift sectors such as Chinese industrial production and Taiwanese exports — indicators that old-school manufacturing and newer, more digital-based commerce, might both be in fine fettle.

On the flip side, not all asset markets have priced in this optimistic outlook. European stocks, which had finally reached new all-time highs right at the precipice of the pandemic, remain 10% lower than levels prevailing in February. US sectors such as REITs and energy have yet to recover to price levels seen earlier in the year. And even with a steady recovery from negative prices in April of last year, oil still has some way to go to reclaim early 2020 levels. All told, these are some of the cross currents that inform our view as we wish farewell to a turbulent 2020.

Risk Rally Ensures 2020 Ends on High

Notwithstanding potential cross currents, most assets exhibiting even a hint of growth exposure were catapulted upward during the fourth quarter. Stock markets around the globe made continued progress early in October despite a weak September payrolls report, news that President Trump had contracted COVID-19 and a system glitch leading to suspended trading on the Tokyo Stock Exchange. Equity markets and interest rates crept steadily higher up through Columbus Day amidst heavy futures buying ahead of flagship marketing events from some of the big US tech companies. Soon thereafter, however, risk-off sentiment driven by worsening COVID trends, increased restrictions in Europe and fading hopes for fiscal stimulus in the United States caused equities to pause as buyers shifted to fixed income assets. Not long after the US Justice Department sued Google for violating anti-trust laws, investor focus moved back to the pandemic with stocks selling off sharply as the US started to consistently post daily records in terms of new coronavirus cases and rising infections led to new lockdowns in Germany and France. Global equity markets reached their nadir at the end of October following mixed market reactions to earnings and guidance from a handful of big tech companies. This would also represent the quarterly peak in the US Dollar Index — which would go on to bolster all manner of non-US assets with its persistent depreciation through the end of the year.

A confluence of key economic, political and medical events helped to reinvigorate risk-taking and stimulate significant rotations across markets in early November. The ISM purchasing manager index for October reached a two-year high and the S&P 500 was up 2% on election day as it appeared Republicans would hold onto the Senate and investors would ultimately shrug off any risks emanating from the Trump administration's efforts to overturn Joe Biden's election victory. Other developments such as the United Kingdom's return to lockdown and the suspension of Ant Group's IPO by Chinese regulators highlighted ongoing risks to equity investors. But news on Monday November 9 that Pfizer/BioNtech had developed an effective vaccine against COVID-19 sent stocks higher and unleashed a tremendous rotation towards value shares and other sectors most leveraged to the reopening of economies. A number of travel, energy and real estate companies jumped by more than 30% on the day. Equity markets were choppy as positive headlines celebrating additional vaccines were countered by rising COVID cases around the world and additional mobility restrictions. But it was hard to contain the optimism associated with the myriad of effective vaccines, and the Dow Jones Industrial Average would go on to surpass 30,000 for the first time ever before the close of the month.

Markets entered the final month of 2020 on the upswing amidst a bipartisan stimulus proposal in the US Senate. And while there were continued oscillations with the pandemic intensifying, equity markets continued to rise up until a new and more transmissible strain of the virus was identified in the United Kingdom. Although that caused a serious sell-off, the dour mood did not last long. The US government ultimately agreed on a $900 billion pandemic relief bill and the UK Parliament approved a Brexit deal before the year came to a close. And while December proved to be the deadliest month of the pandemic so far, equities in the US went on to close the year at fresh all-time highs.

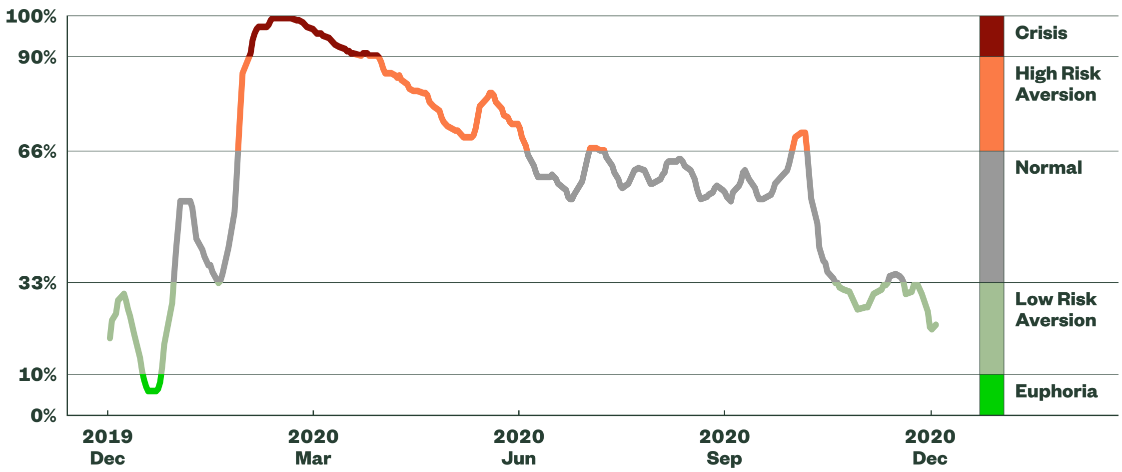
Sentiment in the Eye of the Beholder

Sentiment can be an amorphous term when it comes to capital market analysis. It may be good, bad or ugly depending on the context in which it is presented. Some market relationships that are frequently considered sentiment factors suggest investors should start heading for the hills. I would bucket put/call ratios and the Institutional Investor Bull/Bear Ratio in this camp as those metrics are currently in the 97th percentile of historical observations, or more — implying things can't really go anywhere but south from here.[2] Elevated flows into riskier assets like small cap stocks also bear watching.

Other data points and surveys have also picked up on improving investor attitudes, but are not yet pushing up against extremes. Bank of America's Sell Side Indicator and Bull/Bear Indicator are both in neutral territory, despite meaningful moves higher in recent months. The same goes for the Consensus, Inc. survey on investor bullishness which is elevated but suggests there is still room for markets to climb the proverbial wall of worry.

Closer to home, our own internal sentiment gauges — mainly measured through our Market Regime Indicator (MRI) — portray a more optimistic outlook. Steadily easing credit spreads have helped our MRI settle into a low risk regime, as has stability in a variety of implied equity volatility statistics. And while currency volatility (mainly in the British pound) has displayed some turbulence, that too has calmed down and leads us to a more favorable view of growth assets, supporting an overall risk-on stance in our asset allocation portfolios.

Figure 4
Market Regime Indicator in Low Risk Regime



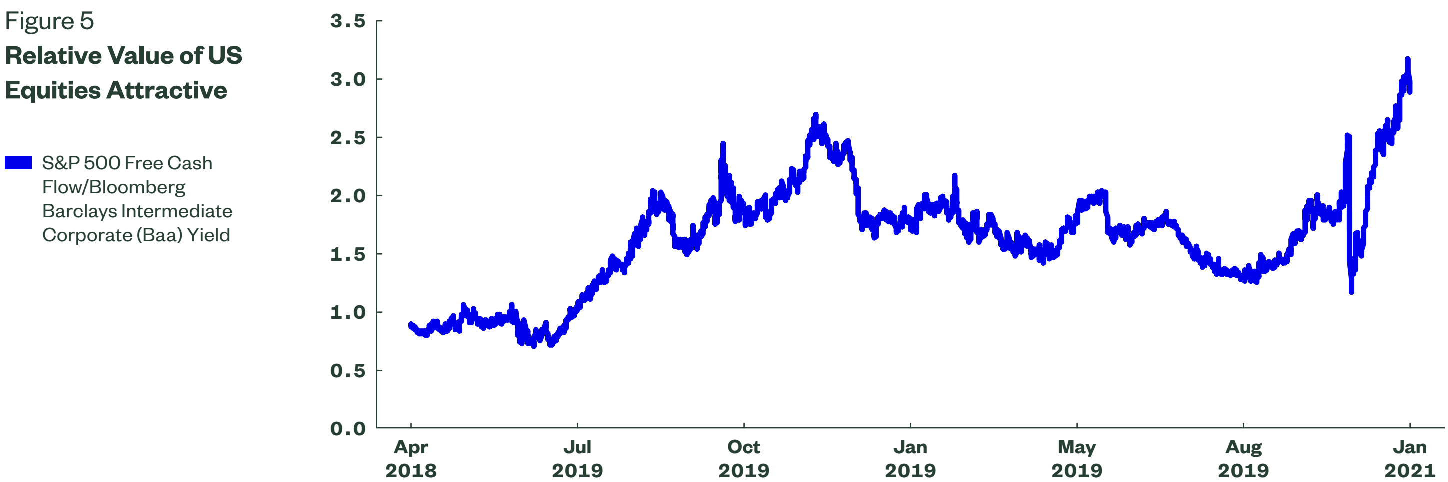
Source: State Street Global Advisors ISG, as of December 31, 2020. The data displayed is not indicative of the past or future performance of any SSGA product. The portion of results through 31 March 2011 represents a back-test of the MRI model, which means that those results were achieved by means of the retroactive application of the model which was developed with the benefit of hindsight. Data displayed beyond this date is not backtested, but is still generated by the model referenced. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The Market Regime Indicator (MRI) is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used, equity implied volatility, currency pairs implied volatility and bond spreads, are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views of those markets. These factors are combined to create a single measure and used to identify one of five risk regimes: Euphoria, Low Risk, Normal, High Risk, and Crisis. A slight calculation change was made as of 28 June 2019.

Equities — Risk On, Mostly

Across equity markets, we can't help but notice the elevated tension between macroeconomic, geopolitical and public health variables and what those competing forces may mean for the path of equity markets. For instance, does the high savings rate and savings stockpile accumulated in 2020 mean that we are awaiting a flood of pent-up spending in 2021 or will households struggle to navigate an environment where transfer payments are fewer and farther between? Will democratic control of both the executive and legislate branches of government facilitate an economic boom or handcuff corporate America amidst higher interest rates, higher taxes and increased regulation? And from a public health standpoint, one can't help but look towards a day where widespread vaccine distribution allows for less restrictions on human interaction; but, in the meantime, the pandemic continues to rage — threatening both lives and livelihoods.

As referenced earlier with respect to risk regimes and sentiment, we have adopted a constructive outlook for global equities. A low risk regime does not guarantee additional equity market progress, but these periods often persist for longer than many investors think — even when daunting headline risks are at the forefront of the market's collective thoughts. Valuations continue to give us some pause as many measures of value look extended. Compared to history, the S&P 500 forward price-earnings multiple, enterprise value to EBITDA, and price-to-book values are all above 90th percentile readings. And US market cap relative to GDP is in the 100th percentile![3] But, as cross asset investors, one can't help but evaluate what other asset classes offer in this regard. And here we find historical comparisons that paint a completely different picture. Consider the chart in Figure 5, which depicts the free cash flow yield of the S&P 500 to the yield of Baa corporate bonds. Never before has this multiple been so high — implying that equity markets are a relative bargain.

Figure 5
Relative Value of US Equities Attractive



State Street Global Advisors ISG, Bloomberg Barclays as of December 31, 2020.

Widening Equity Preferences

Across regional equity markets, we continue to tilt in favor of US stocks; but we've also built up our exposure outside the US — particularly in Pacific and Emerging Markets. US equities are likely to shift gears as we move through 2021, focusing at times on the beneficial effects of additional government spending while paying more attention to the manner in which the government intends to raise the required revenue as policy proposals come forth. Notwithstanding this likely back-and-forth, US equities compare favorably to other regions across all factors we evaluate, with the exception of value. Relatively better trends in earnings and sales estimates for the Pacific region have led us to a more favorable outlook for that market. And in Emerging Markets, a constructive risk regime, continued strength in global manufacturing, as well as an expectation that the US dollar is likely to be biased to the downside lend support to our overweight stance. Our quantitative models see little in the way of attractive attributes when it comes to European equities. But fundamentally we think our models may be judging the continent too harshly. The sector mix for European stocks is one that may be able to deliver some solid performance as economies open back up, and with better trade and political relations with the United States, and Brexit uncertainty in the rearview mirror, the outlook does not seem so downbeat.

Across equity sectors our bullish view is less pronounced. Our top-ranking sector from a modeling perspective is consumer staples — not exactly what one might expect to anchor an equity sleeve inside of a portfolio with a sizable risk overweight. But the sector continues to display strong sentiment in both earnings and sales expectations alongside reasonable relative valuations. Elsewhere, we prefer higher beta sectors including consumer discretionary, technology and materials. The consumer discretionary sector received a new entrant in the form of Tesla late in 2020, a development that might create some excitement for momentum-oriented investors, and anxiety for those accustomed to basing investment decisions on valuations. In addition to solid momentum (and relatively pricey valuations) the sector overall is supported by strong earnings and sales revisions. Technology shares have looked more vulnerable since their early September sell-off and as vaccine optimism has allowed other parts of the market to recover. Yet tech shares have managed to hold their own, and PMI and inflation data suggest we are in a recovery phase of the market cycle — one in which technology is often a beneficiary. Materials represents one of the more cyclical sectors in our preferred mix. After steadily underperforming the market for approximately two years up through the spring of 2020, the sector's recent string of leadership looks like it may be durable, provided any headwinds to economic recovery are only temporary.

Fiscal vs. Monetary in Fixed Income

Not dissimilar to the diametrically opposed forces influencing the course of risk assets, fixed income has its own set of counterbalancing measures. A slight delay in publication has afforded us a window into the results of the Georgia run-off Senate elections in the United States — and the fuse that was lit underneath the level of interest rates as a result. The potential for increased stimulus and even larger fiscal deficits seems to have awoken investors to the risks of lending at fixed interest rates over longer horizons. Even without the political dynamics, our modeling for US markets was pointing towards higher interest rates as a result of anticipated mean reversion in currently low inflation figures alongside advancing PMI data. Globally, most government bond yields followed the move in the US to some degree. Even in Japan, 10-year JGB yields experienced a barely discernable bump. For the most part, we expect this trend to continue, albeit at a more modest pace. We envisage a couple of potential exceptions. however. In Italy, strong downward momentum in rates markets could very well lead to better bond returns in that market. And in the United Kingdom, depressed business confidence leads us to believe that any sell-off in Gilts could be met with buyers more quickly than elsewhere.

Credit assets continue to look attractive, though it is not lost on us that some of our prior operating assumptions surrounding the asset class are no longer as relevant. Coming out of the crisis period earlier in 2020, credit returns were buoyed by a wide array of factors including remunerative yields, the Federal Reserve's special purpose vehicles, improved liquidity conditions, as well as our own shorter-term quantitative models. As can be seen in Figure 3 on the cover page, investment grade credit no longer provides above-average return compensation as yield levels have already retreated to pre-pandemic levels. The support from the Federal Reserve has also eroded to some degree, as the Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility expired as of the end of 2020. However, should there be a need to support these markets in the future, it seems likely to us that incoming Treasury Secretary Janet Yellen would be quick to reauthorize programs such as these. More constructively, liquidity conditions remain stable and our modeling continues to prefer credit, particularly longer-term corporates (as some carry advantage remains), the yield curve is already relatively steep and we're in the midst of a more beneficial seasonal period for credit. While longer-term corporates are also more subject to interest rate risk, should the move in rates become more dramatic it seems likely that the Federal Reserve would step back in to arrest the advance.

More Constructive on Commodities

Across the commodity complex, we've held a favorable view of gold since the middle of 2019 while being less enthusiastic about the prospects for broader commodities. Gold has run into some speedbumps as interest rates have moved higher, even though most of the rise has resulted from a steady grind up in breakeven rates of inflation. Our view on gold is not much changed, however. Technicals remain firm in terms of trend identification, real yields still remain low and, if heavy government spending leads to some concern about the value of the US dollar, then gold should be in good stead on that front as well. In broader commodity markets, we have adopted a more constructive tone. Near-term risks abound as the COVID crisis continues to weigh on economic activity and any additional lockdowns would choke off burgeoning demand. But a variety of drivers support the complex as we move into 2021. From a financial market perspective, price momentum has gained steam and there is less of a carrying cost with the average commodity futures curve having moved into a state of slight backwardation. Commodities are also likely to benefit from intermediate-term USD weakness, a renewed focus on infrastructure projects and continued recovery in China's economy — which should help boost sectors such as industrial metals and agricultural products. Overall, whether we look towards 2021 as a year of recovery, reopening or renormalization, diversifying our growth asset exposure into broad commodities looks like a compelling risk/reward proposition.

Sources: Bloomberg, FactSet, J.P. Morgan, Barclays, Wall Street Journal, The Economist, MSCI as of December 31, 2020.

SSGA Forecasts as of Q1, 2021

	2020 (%)	2021 (%)
Real GDP Growth		
Global	-3.5	5.1
US	-3.4	4.1
Australia	-2.8	3.9
Canada	-5.4	5.5
Eurozone	-7.3	5.5
France	-8.6	5.7
Germany	-5.1	5.2
Italy	-8.8	6.0
UK	-9.6	7.9
Japan	-5.3	3.3
Brazil	-4.7	4.8
China	2.5	7.2
India	-7.0	8.5
Mexico	-8.7	5.6
South Africa	-3.8	4.0
South Korea	-1.0	3.0
Taiwan	2.5	3.7
Inflation		
Developed Economies	0.9	1.7
US	1.2	2.2
Australia	0.6	1.7
Canada	0.9	1.8
Eurozone	0.4	1.1
France	0.6	1.2
Germany	0.7	1.4
Italy	-0.1	0.5
UK	0.9	1.9
Japan	0.1	0.0
China	2.5	1.8

	December 31, 2020 (%)	December 31, 2021 (%)
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	2.00	2.50
China	4.35	4.35
India	4.00	4.00
Mexico	4.25	4.25
South Africa	3.50	3.50
South Korea	0.50	0.50
10-Year Bond Yields		
US	0.92	1.06
Australia	0.97	1.11
Canada	0.67	0.76
Germany	-0.58	-0.50
UK	0.20	0.24
Japan	0.04	0.11
Exchange Rates		
Australian Dollar (A$/$)	0.77	0.80
British Pound (£/$)	1.37	1.45
Canadian Dollar ($/C$)	1.27	1.23
Euro (€/$)	1.22	1.25
Japanese Yen ($/¥)	103.25	95.00
Swiss Franc ($/SFr)	0.88	0.94
Chinese Yuan ($/¥)	6.53	6.50

One-Year Return Forecasts	USD (%)	EUR (%)	GBP (%)	JPY (%)	AUD (%)	CAD (%)
S&P 500	6.9	4.6	0.7	-1.7	3.1	3.2
Russell 2000	7.8	5.5	1.6	-0.8	4.0	4.1
MSCI EAFE	4.9	2.7	-1.1	-3.4	1.2	1.3
MSCI EM	8.1	5.8	1.9	-0.5	4.3	4.4
Barclays Capital Aggregate Bond Index	0.7	-1.4	-5.1	-7.3	-2.9	-2.8
Citigroup World Government Bond Index	-0.4	-2.5	-6.1	-8.4	-3.9	-3.8
Goldman Sachs Commodities Index	5.3	3.1	-0.7	-3.1	1.6	1.7
Dow Jones US Select REIT Index	3.5	1.3	-2.4	-4.8	-0.2	-0.1

Forecasts are as of December 31, 2020.
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

Endnotes

1 Source: Wolfe Research.

2 Source: Strategas. Quarterly Review in Charts, January 4, 2021.

3 Source: Wolfe research. 2021 Outlook — The Fed Remains Committed to the Bubble, December 2, 2020.

About State Street Global Advisors

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 $3.15 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.

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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