Forecast
Market Outlooks

Q3 2019

Growth Moderates, but Expansion Continues

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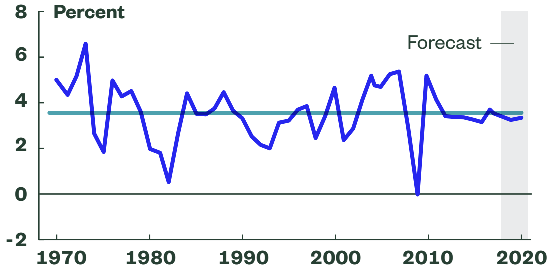
Figure 1
Global Growth Slows in 2019 Before Uptick in 2020

World Real GDP Growth, % chg y/y
Long-term Average Growth (3.67%)

Global Economic Outlook



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

- The synchronized global upturn of 2017 has given way to a synchronized global slowdown with growth set for 3.3% in 2019.
- Amid growth and trade uncertainty, the Fed and ECB have signaled looser policy is likely.

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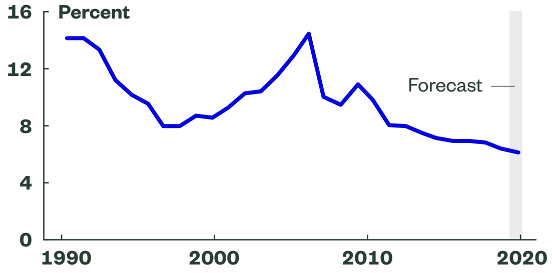
Figure 2
Chinese Economic Growth Edges Lower

China GDP Growth, % chg y/y

Emerging Markets Outlook



Source: IMF, State Street Global Advisors Economics. The above forecasts are estimates based on certain assumptions and analysis. There is no guarantee that the estimates will be achieved.

- Growth in emerging market economies is holding up better than developed countries, decelerating modestly in 2019.
- Pro-growth policies in India may re-energize the economy there, although Chinese growth will likely slip in 2020.

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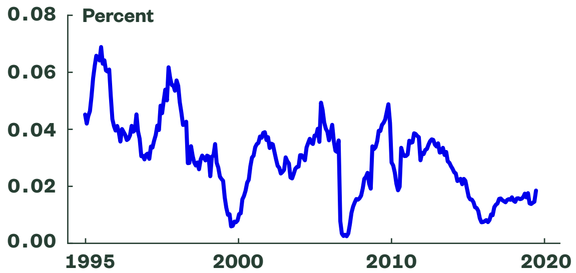
Figure 3
US IPO Gross Proceeds as % of S&P 500 Market Cap

Global Capital Markets



Source: State Street Global Advisors, FactSet.

- Most asset classes generated positive returns in the second quarter, despite volatility spiking in May.
- Equities still look attractive from a cross-asset perspective, while downward pressure on interest rates could see higher-yielding bond markets such as the US yields retest 2016 lows.

Global Economic Outlook

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The world economy has swung from a synchronized global upturn that saw global GDP growth accelerate to a six-year high of 3.8% in 2017 to a synchronized global slowdown set to reduce growth to a post-crisis low of 3.3% this year.

Heightened Uncertainties Hit Global Growth

The world economy has swung from a synchronized global upturn that saw global GDP growth accelerate to a six-year high of 3.8% in 2017 to a synchronized global slowdown set to reduce growth to a post-crisis low of 3.3% this year. The shift may appear drastic seen from this perspective, but the reality is that we had been inching this way for some time. Indeed, compared to three months ago, our estimates of 2019 and 2020 global growth have only been reduced by 0.1 percentage point (ppt) each, to 3.3% and 3.4%, respectively. The downgrades largely reflect the materialization of risks on the trade front, with additional escalation of tariffs relative to what we anticipated earlier in the year. More so than the tariffs implemented thus far, the breakdown of trade negotiations between China and the US in early May fueled expectations of further escalation and fears of a broadening dispute (as exemplified by Huawei). This, in turn, not only exacerbated the already sharp slowdown in global trade — mirrored in a similar pullback in global industrial production — but also undermined business sentiment and caused the capex cycle to fizzle out. Half way through the year, while the possibility of a trade deal is still alive, the reality is that more damage has been done to the global economy and any subsequent healing will take longer to materialize. Therefore, what had earlier looked to be a brief and shallow deceleration has taken on a more permanent hue.

Inflation Forecasts Edge Lower

Global inflation forecasts were also only minimally altered, but where changes were made, they were to bring estimates down. The key message remains that the much talked about inflation “deficit” persists across developed markets despite continued labor market healing that has brought unemployment rates to multi-decade lows. Having highlighted the inflation “mystery” a couple of years ago, the Federal Reserve (Fed) alongside other central banks, has engaged in a more focused review of concepts such as NAIRU (non-accelerating-inflation rate of unemployment) and the neutral interest rate. From the Fed to the Bank of Canada to the Reserve Bank of Australia, there is clearly greater openness to the idea that NAIRU may be quite a bit lower than previously thought, the implication being that central banks can afford to let economies run “hot” without risking an inflation event. And yet, it would be incorrect to assume that inflation is altogether dead; rather, we view it as “manageable”.

Changing central banks' views around NAIRU and the neutral rate help reconcile what might otherwise be viewed as an apparent contradiction in the evolution of our macro forecasts. Indeed, whereas growth and inflation forecasts were little changed, expectations about the monetary policy stance associated with these new forecasts changed meaningfully. In a sense, our biggest challenge this time around was trying to reconcile incoming macro data that, while signaling a slowdown, remains inconsistent with a recession, and current market expectations (and even central bank signals) of meaningful easing that seem better aligned with just such a recession scenario. Ultimately, we chose to acknowledge the seemingly changing reaction function of central banks while still calibrating the response in terms of the number of rate cuts incorporated in our central forecast. While a desire to "extend the cycle" is commendable, doing so by deploying monetary easing at a juncture which may not allow a subsequent unwind of such cuts before the next recession hits may leave central banks with less, rather than more, policy space at that future point.

US: Extending the Cycle

The current US economic expansion has become the longest on record, bringing into sharper focus the question of how much longer this already-long economic cycle could continue. It is unclear exactly how much, but we are quite confident that there is "further to run", to quote the tag line of our mid-year Global Market Outlook. Admittedly, we've just come through a turbulent couple of months that saw investor sentiment swing widely from near-complacency about the almost "done deal" US-China trade agreement to outright panic over seemingly equally "sure thing" tariffs on Mexican imports. In the event, neither has yet materialized. There might be a lesson here for us all as we try to assess where we go from here...

There is no question that the US economy has slowed from last year's solid 2.9% pace. The combination of corporate tax cuts, the immediate expensing of capital expenditures and a broad deregulation effort pushed capital expenditure (capex) intentions sharply higher. High levels of capacity utilization and $800+ billion in repatriated profits also supported the capex cycle (even though a good chunk undoubtedly went into share buybacks). Unsurprisingly then, private nonresidential fixed investment grew 6.9% year-over-year (y/y) last year, the most since 2014. Business equipment investment grew 7.4%, while investment in intellectual property jumped 7.5%. By way of contrast, residential investment contracted for the first time since 2012 as high input costs, labor shortages, and softer demand amid rising mortgage rates took their toll.

Unfortunately, the capex cycle began to lose steam late last year as global growth slowed and trade uncertainty increased. Import tariffs on $200 billion worth of Chinese imports, consisting primarily of intermediate and capital goods did not help. By the first quarter of 2019, business fixed investment (private non-residential investment in equipment) actually contracted on a quarter over quarter basis, the first decline in three years. Capex intentions have definitely taken a hit amid the escalating trade conflict, though it is interesting to note that small business sentiment appears to have held up better in that regard (likely due to primary reliance on domestic demand and perhaps also a sectoral skew towards services).

US Consumption Still Strong

The good news is that consumer spending remains a solid anchor for the economy. Overall household consumption growth accelerated a tenth to 2.6% last year and despite a first-quarter wobble, seems likely to perform similarly in 2019. This is critically important given consumption's large share in the economy. Indeed, as we like to say, if the consumer and services hold, the US economy as a whole will hold.

So while the industrial sector seems to be once again on the downside of a mini-cycle, resilience elsewhere suggests the overall deceleration should not be extreme. In fact, our 2019 growth projection for the United States has not changed from the 2.3% rate we forecast in March. If anything, we see reasons to bring that figure a tad higher given performance so far, but heightened risks surrounding trade persuaded us against that option. Growth likely slows further still in 2020, but only to 1.9%, which is essentially the estimated potential growth rate for the economy and better than any other G7 economy.

The Fed's Dovish Tilt

The Fed will play a key role in extending the economic cycle. Indeed, having made a significant dovish pivot in March (when it did away with the previously expected two rate hikes in 2019), it has since turned more dovish still, opening the door to possible multiple rate cuts in coming months. The one obvious rationale for the shift has been the escalation in risks to the economic outlook; the data has certainly softened in places, and while not consistent with a recession, it does not refute the usefulness of some policy support. But this is not the only rationale for rate cuts that the Fed has advanced — Fed officials seem to have come around to the view that prior notions of what the neutral level of the interest rate or unemployment should be might need to be tweaked, even if the economy were to perform well.

Unemployment might fall further without causing inflation, implying that the neutral interest rate is lower than previously estimated. Indeed, the Fed's latest Summary of Economic Projections (SEP) puts that neutral rate at 2.5%; it was 2.8% back in March. Thus, the current level of the Fed Funds rate is right on that median estimate of neutral, no longer at the "lower end of the estimated range" as it had been previously believed to be. And maybe, given intensifying risks to the outlook, that's a bit higher than where the Committee would like it to be. So while we continue to believe that the multiple rate cuts currently implied by the bond market are excessive, we do see scope for two reductions over the next six-to-nine months. The Fed will likely go to great lengths to position such cuts as a minor calibration of the policy stance to a lower neutral rate out of a desire to not be "tight" when inflation is muted, rather than a signal of serious weakness in the economy.

On the issue of inflation: we do not believe it is dead…merely manageable. We agree with the Fed's earlier assessment that the recent deceleration is largely transient (although that characterization was dropped from the latest Fed statement). Admittedly, headline consumer price index (CPI) inflation touched a 28-month low of 1.5% y/y in February and the core personal consumption expenditures (PCE) inflation rate slowed to an 18-month low of 1.5% y/y in March (it quickened to 1.6% in April). However, core inflation remains at 2.0% and the Dallas Fed's trimmed mean measure of PCE inflation shows little signs of weakness. Meanwhile, wage inflation has strengthened over the past 18 months. While the ascent has recently paused, both the employment cost index and average hourly earnings (particularly for production and non-supervisory employees) are close to cycle highs. Although it took much longer than anticipated, it appears that the tight labor market is finally generating some genuine wage inflation.

Eurozone: Stuck in Low Gear

Not that long ago — as recently as 2017 in fact — the eurozone was the undisputed biggest positive surprise of the world economy. Growth accelerated to an impressive 2.5%, the best since 2007 and well above potential. Sadly, that outperformance did not last. Partly that was simply because it is very hard — almost impossible, even — to sustain that kind of momentum. But it was also because too many things conspired to buffet the regional economy: ongoing Brexit drama, new emission standards in Germany, threats of automotive tariffs and escalating trade tensions, Chinese slowdown, etc. Growth therefore slowed from a quarterly pace of 0.7% in 2017 to 0.4% q/q during the first half of 2018 and then to 0.2% in the second half. Full-year GDP growth — which in mid-2018 was seen reaching 2.2% — came in at 1.8%. Rather than a turnaround, 2019 is poised to bring further deterioration: we've reduced our growth forecast by a tenth in both 2019 and 2020, to 1.2% and 1.4%, respectively.

Not only have both the weak and the strong been hurting in this downturn, but the traditional roles have even reversed somewhat. Germany is poised to grow just 0.8% this year, having narrowly escaped a technical recession in late 2018. And the road ahead remains exceedingly bumpy: Germany's manufacturing purchasing managers' index (PMI) has been stuck in contraction territory for half a year, with little signs of improvement so far. In fact, it has fared worse than Italy's, whose economy did undergo a mild technical recession in 2018. In contrast, France is shaping up to be the growth leader among the "Big-3" this year, an unusual situation that to some extent mirrors the dichotomy seen around the world between a weak manufacturing sector and a much more resilient service sector. France is still expected to manage 1.4% growth this year, whereas Italy will be flat.

Despite the current shared woes, however, there has been a marked divergence between the three big eurozone economies since the post-GFC (global financial crisis) recovery. Germany has boomed, with the unemployment rate falling steadily since mid-2014 to under 5.0% currently (the lowest in the near-30 year history of the series). France has generally lagged, with the (mainland) unemployment rate not beginning to fall until late 2015, and is still at an elevated 8.7%. Italy has really struggled, with the labor market improvement since starting 2015 proceeding at a very modest pace — it's taken four years to reduce the unemployment rate by 2.5 percentage points and it's still above 10%!

Muted Inflation Pressures

As has been the case everywhere, headline CPI inflation has closely reflected the evolution of oil prices over the last several years. In early 2017, it accelerated sharply to 2.0% y/y, while core CPI inflation (which excludes food and energy) continued to hover around 1.0%. Since then, the headline has continued to oscillate with oil prices, while core hasn't moved much at all. Indeed, it was still below 1.0% y/y in May. Progress on inflation is likely to be slow. The core measure is unlikely to move materially above 1.0% for some time yet given the backdrop of softer growth. Meanwhile, the headline likely dips to 1.3% in 2019, largely on account of oil prices and only moves up a couple of tenths in 2020.

ECB: Not Yet in Normalization Mode

The ECB eased progressively in the aftermath of the GFC, with the deposit rate falling to zero in 2012, -20 basis points in 2014,-30 basis points in 2015, and to -40 basis points in March 2016. It also introduced a genuine QE program in January 2015, and subsequently made a slew of adjustments and enhancements to it. Then, in early 2017, growth picked up and the threat of a broad-based deflation receded, prompting the Bank to change direction. In April 2017, it began by "tapering" the quantity of assets purchased. The program ended in December 2018 (although reinvestments will continue), shifting monetary policy focus away from quantitative easing (QE) and back to traditional interest rate policies.

And yet, the ECB's hopes of finally initiating genuine policy normalization have been thwarted once again. In response to the region's sharp recent slowdown, the Bank has repeatedly altered its forward guidance, extending the period when rates are expected to "remain at their present levels" all the way to mid-2020. It also announced a new set of quarterly targeted longer-term refinancing operations (TLTRO-III) scheduled to run from September 2019 to March 2021, each with a two-year maturity. And most recently, ECB President Mario Draghi delivered another powerful promise to use "all instruments" available to the Bank in the pursuit of the inflation target. Investors are now expecting a rate cut as the next move...and the ECB may well deliver it. We are, however, skeptical this would accomplish much since it is not the high cost of capital that we perceive to be eurozone's real problem, but rather the lack of productivity-inducing structural reforms.

UK: Closer to the Moment Of Truth?

The British economy proved quite resilient at first to the June 2016 Brexit referendum result shock. Despite the surprise, GDP rose 1.8% in 2016, thanks largely to consumer spending. And just as that faded, exports picked up on the lagged effects of sterling's devaluation to keep growth buoyant in 2017. However, momentum waned in the early part of 2018, although it reaccelerated in the second and third quarters on a combination of the World Cup, Royal Wedding, and unusually warm weather. Nevertheless, sluggish real wages and fragile home prices (particularly in London) have hindered consumption, while Brexit chaos weighed on business sentiment, causing fixed investment to come to standstill. Hence, the economy advanced just 1.4% in 2018, matching the lowest since 2012.

Unfortunately, we are no closer to having clarity on Brexit's final end point than we were at the start of the year, or a year ago, or two... At the core, this is due to the fact that the Brexit the UK seems to want amounts to an unsolvable puzzle (the equivalent of the "impossible trinity" in economics). The UK cannot retain full free access to the European market without also accepting the free movement of people (even though the EU may offer some concessions), and it cannot drive its own trade agreements without somehow imposing a border between Ireland and Northern Ireland. Therefore, while the delay in the Brexit deadline to October has bought some time, it has also prolonged the interim period of uncertainty. Additionally, Prime Minister Theresa May's resignation and the ensuing Conservative Party leadership contest have raised the likelihood that a harder "Brexiteer" would lead the country in the next leg of negotiations with the European Union. This could intensify frictions, so the future looks as uncertain as ever. And that's not good for growth!

UK Growth Prospects

Assuming a cliff-edge is eventually avoided, growth seems unlikely to slow much further from here. However, considerable damage to the economy has already been done. Fixed investment grew just 0.2% last year, the worst performance since the GFC. Although there was a surprising rebound in the first quarter of 2019, it is difficult to see that as the harbinger of a lasting acceleration. Moreover, sharply lower eurozone growth and the broad global growth deceleration handicap export demand, eroding the competitive benefits of a weaker sterling. Although the labor market remains healthy and wage growth has actually picked up, consumer sentiment remains gloomy, capping consumption gains. Chances are that a massive inventory build ahead of the original Brexit deadline in March will ultimately unwind, although the net effect of such an unwind is uncertain due to it being largely satisfied through imports. All in all, we expect growth to erode one tenth to 1.3% this year before picking up to 1.7% in 2020. There are considerable two-way risks to these projections, however, and we will revisit these numbers accordingly. Despite sluggish growth over the next two years, the labor market likely remains tight, with the unemployment rate having crossed below 4.0% for the first time since 1975.

UK Inflation Off Highs

Inflation accelerated quite sharply in 2017 on a combination of rising oil prices and the depreciation of sterling following the referendum result. Indeed, headline consumer price inflation jumped 2.0 percentage points to 2.7%, by far the highest in the G7. Oil prices rose about 80% between the beginning of 2016 and the end of 2017, contributing to an acceleration of inflation around the G7. But, the UK was simultaneously buffeted by a precipitous drop in sterling, which plunged from around $1.50 to $1.20 between June and September 2016. Fortunately, such an exchange rate movement had only a temporary effect on inflation and that is now beginning to fading. Lower oil prices have also contributed to a disinflationary push in recent months. The combination of more favorable base effects, stronger sterling, and weak growth help push inflation from 2.5% in 2018 to 1.9% this year and next. But a no-deal Brexit might send sterling tumbling, and it is worth noting that wage inflation has picked up of late, with average weekly earnings recently exceeding 3.5% y/y, the highest since the GFC.

Bank of England On Hold

The Bank of England cut the Bank Rate to help bolster the economy in the aftermath of the referendum, but has since changed course. Shortly after the referendum shock, the Bank cut its policy rate 25 basis points to just 0.25%. It maintained that rate for 15 months, before hiking 25 basis points in November 2017. It followed with another hike in August 2018, leaving Bank Rate at 0.75%, the highest since 2009. The Monetary Policy Committee (MPC) anticipates that, directionally, the next move will be another hike. However, whereas we had previously expected such a hike to come this year, the escalation in both domestic and global risks, coupled with the sharp dovish turn in global central bank rhetoric of late, suggests that the Old Lady might be forced to stay on hold for an extended period.

Japan: Structural Reforms Needed To Kick-start Growth

Japan's current expansion is set to be the longest since the post-war era, but growing domestic risks and global uncertainty will continue to weigh on growth over the next few years. The Bank of Japan's stance has been accommodative for a long time, and there remains very little space for fiscal policy. Structural reforms such as a more open migration policy, along with efforts to accelerate productivity are required to offset the aging workforce and revive potential growth.

GDP grew a decent 0.8% in 2018, despite outright contractions in the first and third quarter, due to a larger than anticipated rebound in the fourth quarter. However, exports are being increasingly challenged by slower overseas demand — both in specific markets such as semiconductors and autos, but also more broadly due to the second-hand effects of the US-China trade spat. In turn, the softer export outlook threatens to undermine capex spending, exacerbating downside risks. The Manufacturing PMI dipped to below 50 in February for the first time in three years, led by decreases in new and export orders components. Consumer spending has remained somewhat resilient, underpinned by a strong labor market. However, wage growth has been rather slow, with labor cash earnings having contracted for three consecutive months since the start of this year. Despite weak earnings, spending has been propped up by "front-loading" ahead of the VAT tax increase scheduled for October. Typically, a VAT tax hike tends to depress demand in subsequent quarters, but this is less likely to be the case this time around due to the offsetting fiscal measures the government is planning. The combination of weaker external demand and a net pullback in consumption in the fourth quarter should result in 0.7% GDP growth this year, while growth likely slows further to 0.5% in 2020. Increased spending surrounding the 2020 Olympics should provide some support, limiting the downside.

Inflation Remains Anemic

Inflation has been anemic, with false starts in 2013–14 and again in 2017–18. Inflation accelerated in late 2017/early 2018, with headline consumer price inflation exceeding 1.0% through March, and then again from August to October. However, it has since relapsed amid lower energy prices. Underlying inflation has also been languishing. Both the headline and national core (which excludes only fresh food products) continue to trend sideways between zero and 1.0% y/y. We retain the expectation that, eventually, the very tight labor market (unemployment is at 2.4%, lowest since the 90's) will translate into sufficient wage growth to push broad inflation higher. Wage inflation had reached a cycle high at 3.3% y/y in November, but has turned negative since the start of this year (partly due to a change in methodology), so it remains to be seen whether the 163 job vacancies available for every 100 applicants mean the labor market is tight enough to ignite wage inflation in a sustainable manner. While we await such evidence, we see headline inflation settling around 0.8% this year before accelerating to 1.1% in 2020 on the impact of the VAT hike.

Monetary Policy Change Unlikely

Because of the lack of progress on inflation, the Bank of Japan's (BoJ) hands are tied, with no meaningful change to policy anticipated before 2020 at the earliest. In 2016, the ongoing failure to boost inflation prompted the Bank to conduct a comprehensive assessment of its policy actions. And in light of that, it changed the policy framework yet again, introducing "quantitative and qualitative easing with yield curve control," under which it tried to control the shape of the yield curve by establishing a negative short-term interest rate (of -10 basis points) while simultaneously targeting a zero percent yield on the 10-year Japanese Government Bond. In July 2018, the Bank made some technical adjustments to this framework to allow it to maintain ultra-low interest rates for longer. It also formally introduced forward guidance, all in an effort to override the effects of prolonged deflation on inflation expectations. In the latest monetary policy meeting, the BoJ introduced further macro prudential measures to ease liquidity in the system. We do not anticipate any change in the BoJ's policy stance over the next two years, but a lack of progress on the inflation front might induce the BoJ to undertake additional stimulus measures in late 2019 or early 2020.

Emerging Markets Outlook

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We could accurately describe 2019 as the year of a synchronised global slowdown — in exact opposition to 2017. This is well understood. What is less appreciated, and somewhat surprising, is that this deceleration has largely been led by developed markets.

Emerging Markets: Keeping Pace

We could accurately describe 2019 as the year of a synchronised global slowdown — in exact opposition to 2017. This is well understood. What is less appreciated, and somewhat surprising, is that this deceleration has largely been led by developed markets. Indeed, while growth in advanced economies as a whole is set to slow from 2.2% last year to 1.7% in 2019, growth in emerging market economies likely only decelerates by one tenth to 4.4%. Somewhat counter to conventional wisdom, then, emerging markets are actually helping stabilize the performance of the global economy, rather than adding to volatility. While this is true in aggregate, it is certainly not always true on an individual country basis, which is why we always advocate that investors are selective in their approach to emerging markets. Still, it is notable that just as our forecast for the United States did not change this round compared to the 2.3% we anticipated back in March, nor has our 6.2% growth forecast for China. Thus, the near-term outlook for the two largest economies in the world (and the two economies at the core of the trade dispute) has not worsened compared to several months ago. In fact, had it not been for the sudden disruption in trade talks in early May (since partially contained following the G20 meeting), we would have likely raised our 2019 growth forecasts for both.

In big picture terms, emerging markets have been subject to two contrary influences in 2019. On one hand, there has been the negative impact of worsening trade tensions. This has been in play for some time and the results are material, with global trade volumes briefly contracting around the turn of the year and at the worst pace since the global financial crisis. On the other hand, global central banks have turned decidedly more dovish. The Fed's dovish pivot in particular is extremely important given the dollar's role in international trade and financial flows. Lower Fed Funds rates and a weaker dollar equate to a liquidity boost to the global economy and would additionally facilitate a more pro-growth stance among emerging market central banks. This dynamic appears to be taking shape.

China: The Trade War Hurts, But No Further Downgrades

Even before the ratcheting up of the trade dispute with the US, we were expecting China's GDP growth to moderate amid a multi-year deleveraging effort. With trade tensions hitting home, however, the domestic policy calculations have changed. Deleveraging has been put on the backburner, with fiscal and monetary policies turning more supportive in order to shield the economy — especially employment and domestic consumption. As an illustration of this new policy direction, reserve requirement rates have been sharply reduced over the last nine months, bringing them to the lowest levels since the global financial crisis. Various tax incentives aimed at boosting consumption have been announced. This multi-pronged domestic policy stimulus should help limit the downside, keeping growth a little above 6.0% this year. However, structural forces clearly suggest that the path forward for China is one of continued deceleration. We expect growth to slip to 5.9% in 2020.

India: Another Go at Meaningful Reforms?

The combination of a strong second-term mandate for Prime Minister Modi's administration and a central bank willing to embrace a more pro-growth policy stance should help re-energize India's growth. However, it may take a couple of quarters for this to materialize. Although relatively less impacted by the trade conflict given its reduced dependence on export demand, India's economy has also lagged recently: GDP growth slipped to a five-year low of 5.8% y/y during the first quarter of 2019. Performance would have been even worse if not for a boost from government spending. Fixed investment slowed sharply, and while high frequency data appears to have improved a little, the industrial sector as a whole remains weak. Against this backdrop, policy is clearly becoming broadly more supportive. Having raised interest rates twice in late-2018 as the rupee hit a record low against the US dollar, the Reserve Bank of India has since changed course, pushing through a modest 75 basis points worth of rate cuts since February. Further modest easing is likely. The new budget will undoubtedly inject some stimulus into the economy as well. And yet, of even greater importance for India's medium-term trajectory will be the government's ability to continue its push with structural reforms, including efforts to recapitalize the banking sector.

Russia: A Difficult Recovery

Russia's economy has emerged from the 2015-2016 recession, but the recovery has been shallow and slow. While growth picked up to 1.6% in 2017 and 2.3% in 2018, momentum has deteriorated once more — we now anticipate growth to relapse to under 1.5% this year amid lower oil prices. The central bank has walked back some of its recent tightening, but this is unlikely to have much of an impact in the short term. Beyond these near-term constraints, medium- to long-term economic performance remains challenged by a stark lack of economic diversification and extremely poor demographics. Aggressive policy action to remedy these issues is needed, but does not seem likely.

Brazil: Pension Reform Front and Center

Brazil's political drama is never entirely out of the picture, but for now it seems to have moved sufficiently to the sidelines to allow both politicians' and investors' attention to refocus on passage of the critical pension reform. The task at hand remains daunting as the magnitude of required fiscal savings is considerable, and so is the difficulty of aligning the needed political support. But, after some earlier derailment, tangible progress has recently been made. But, perhaps in contrast to many other emerging markets, the scope for monetary policy support has been depleted following almost 800 basis points worth of rate cuts from late 2016 to early 2018. Against this backdrop, growth likely fails to accelerate and instead continues to hover around the 1.0% this year, for the third year running.

Global Capital Markets Outlook

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Despite rising volatility in May and concerns surrounding the potential for seasonal headwinds, most asset classes were able to generate firmly positive returns in the second quarter.

Robust Quarter for Financial Markets

Seasonal patterns may be observed across many elements of financial markets and global economies. Retail sales pick up ahead of end-of-year holiday shopping. Activity in the housing market is more vigorous in the spring and summer. Even a quick look at the futures curve for natural gas illustrates how demand for heating fuel picks up each winter. As to the direction of stock prices or credit spreads, the seasonal patterns are far less clear. Our analysis suggests that, while these patterns may not be as obvious, they do still exist. And that, in loose terms, stock markets have a greater susceptibility to falter in the six months running from May through October. No surprise then that a catchy and rhythmically appealing phrase such as “sell in May and go away” has become mainstream market lexicon, if not a trading rule in its own right.

During the second quarter of 2019, that simplified trading cliché appeared to be on to something. April marked another solid month for growth assets as investors embraced optimism about trade policy between the United States and China and earnings results continued to outpace analyst estimates. The S&P 500 Index closed the month at a new all-time high. But, as quick as the monthly calendar turned, investors were met with increasingly uncomfortable developments. On the very first day of May, US Federal Reserve (Fed) Chair Jerome Powell pushed back on market expectations for interest-rate cuts by suggesting that recent low levels of inflation were likely transitory. From there, trade conflict between the United States and the rest of the world took center stage, battering equity markets while flattering bonds. But, as May turned to June, liquidity-driven animal spirits returned and sent the S&P 500 Index to new all-time highs while many global bond yields plumbed new all-time lows. Another wave of central bank accommodation was the proximate source of the moves, with both the European Central Bank (ECB) and the Fed indicating that further policy tools and interest-rate cuts would be used to support economic growth.

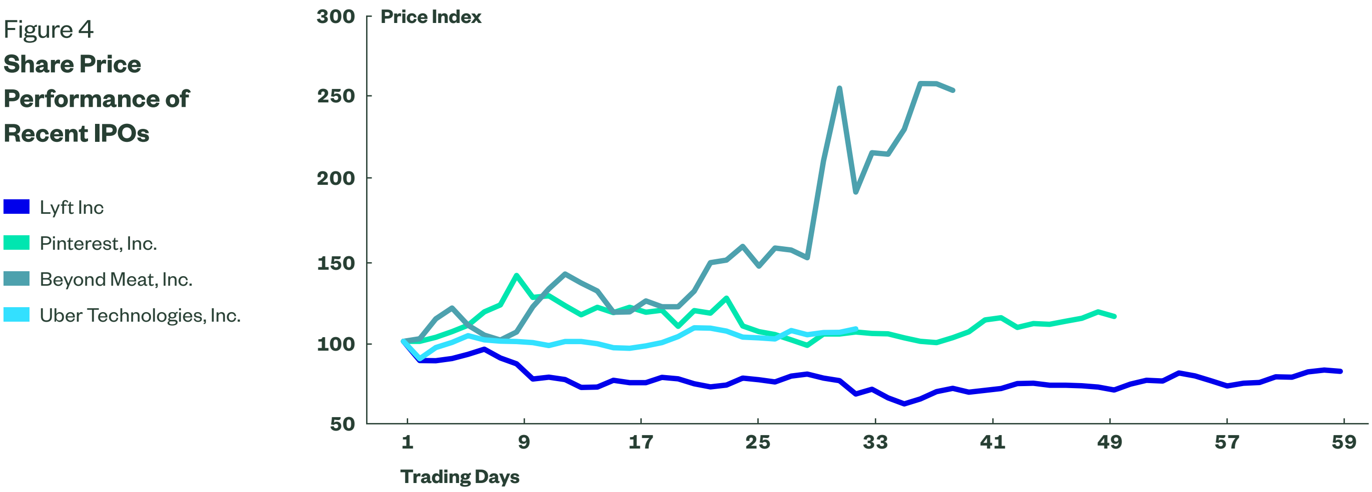
What might the market healing in June mean with respect to the more somber seasonal tendencies of this period? Was May’s malaise an isolated event triggered by tariff threats and other trade negotiations? Or might it reflect the start of something more sinister that has yet to fully play out? A closer look across major asset classes is warranted.

Stock Markets Topping or in Tip-Top Shape?

Even though equity markets have recovered from some of their recent setbacks, it may be worthwhile to extend our gaze back a bit longer in time. Because while it can be appealing to try to call a stock market top or a discrete low-point in interest rates, more often than not these turning points are part of a broader topping or bottoming process — of which the local minimums and maximums will be far easier to spot in hindsight. Consider though, that the S&P 500 Index is not all that far above the levels it reached in January 2018 and then again in the fall of last year. The early 2018 high was erased by festering concerns over inflation and the potential for interest-rate hikes, and the ensuing de-risking undertaken by systematic sellers. Last fall, questions pertaining to a monetary policy mistake and global recession loomed large. Elsewhere, equity markets generally can't lay claim to new highs at all. The Nikkei remains well below the levels reached in those periods (not to mention its 1989 all-time highs) and the Eurostoxx Index hasn't been able to mount a meaningful advance towards its peak reached in the spring of 2015 when the ECB launched its quantitative easing program. The FTSE 100 Index also remains roughly 5% off its highs reached in 2018 and is only around 5% above its price level from 1999. With this backdrop, perhaps a topping process in equity markets is in play — especially if seasonal headwinds provide another hurdle.

In terms of calling a market top, or even suggesting that the process is taking shape — we would not rush to judgment. Proprietary information, such as our Investment Solutions Group's Market Regime Indicator is certainly not flashing red at the moment. Its component factors, such as credit spreads alongside implied currency and equity volatility, appear fairly benign and are actually approaching levels that are typically more indicative of equity market rallies. It also does not appear that there is a tremendous amount of latent selling pressure — at least according to the flow of funds. According to the Bank of America/Merrill Lynch Fund Manager Survey, cash holdings are high enough to be in contrarian (buy stocks) mode and their Bull/Bear Indicator also leans bearish, hovering just above the threshold that suggests a contrarian buy signal.[1] Maybe it is in the primary markets where the signposts of a market top will be more evident? After all, we have witnessed an uptick in some high-profile initial public offerings (IPOs) of late. The likes of Lyft, Pinterest, Beyond Meat, and Uber have all gone public in the past few months — with very different receptions in the secondary market as can be seen in Figure 4. But, in terms of the gross proceeds raised in proportion to the market, IPOs are closer to cyclical lows than cyclical highs (see chart on page 1), which seems to suggest that primary market activity on that front is not very frothy.

Figure 4
Share Price Performance of Recent IPOs



Source: State Street Global Advisors, FactSet.

On balance, we continue to have a modestly optimistic view across equities in general and in the higher-risk segments of fixed income as well. While our net equity position is not much changed from earlier in the year, the composition of our equity book has evolved, with increasing investments in relatively more defensive and yield-oriented parts of the market and less exposure to some of the most cyclical plays. Real estate investment trusts (REITs) serve as a useful example of an asset class which has performed very well so far in 2019, but which also appears likely to continue benefiting from low interest rates and plentiful liquidity. The swift slide in interest rates not only eases funding conditions for the interest-rate-sensitive asset class, but also makes it attractive to other fixed income assets from a comparative yield perspective. Our view has turned less constructive on the more cyclical technology sector, which happens to be the only sector beating REITs on a year-to-date basis. Trade tensions, mixed earnings results, and longer-term concerns pertaining to a litany of antitrust rulings and investigations have weighed on the outlook for technology companies. Upside risks for the sector remain, especially if planned trade discussions between the United States and China prove fruitful, but the deterioration in business capital expenditures suggests that a durable recovery in tech may require more than a nicely-worded communique from Osaka.

Rates — The New World Revisited

If equity markets are able to break through and stave off the cyclical conditions associated with topping processes, what might that mean for fixed income? Is it possible that bond markets are finally working through a process of finding a bottom in interest rates?

A step back in time may help provide some context for this particular issue and shed light on the possible evolution of the market going forward. A useful turning point to frame our thinking is the 2015 introduction of quantitative easing on the part of the ECB. By that time, interest rates were already quite low and almost unfathomable historical comparisons could be drawn. After all, Dutch bond yields were hovering around levels not seen since around the time that Christopher Columbus was setting sail for the New World. And not too long after the ECB began purchasing bonds, it was reported that global bond yields had sunk to 5,000-year lows![2] The collective fall in the level of interest rates led to a surge in the volume of bonds sporting negative yields. By June 2016 the stock of negative-yielding fixed income securities had risen to just over US$12 trillion, which represented more than 25% of the global bond market at the time.[3] But the ECB's purchase programs were not without controversy and, with the Federal Reserve nudging interest rates higher late in 2016 alongside an election victory by a free-wheeling and potentially free-spending President Trump, interest rates shot higher at the tail end of 2016 — which helped to arrest the growth of non-remunerative bonds. From that point forward, the amount of negative-yielding bonds oscillated between US$6-8 trillion, as can be seen in Figure 5.

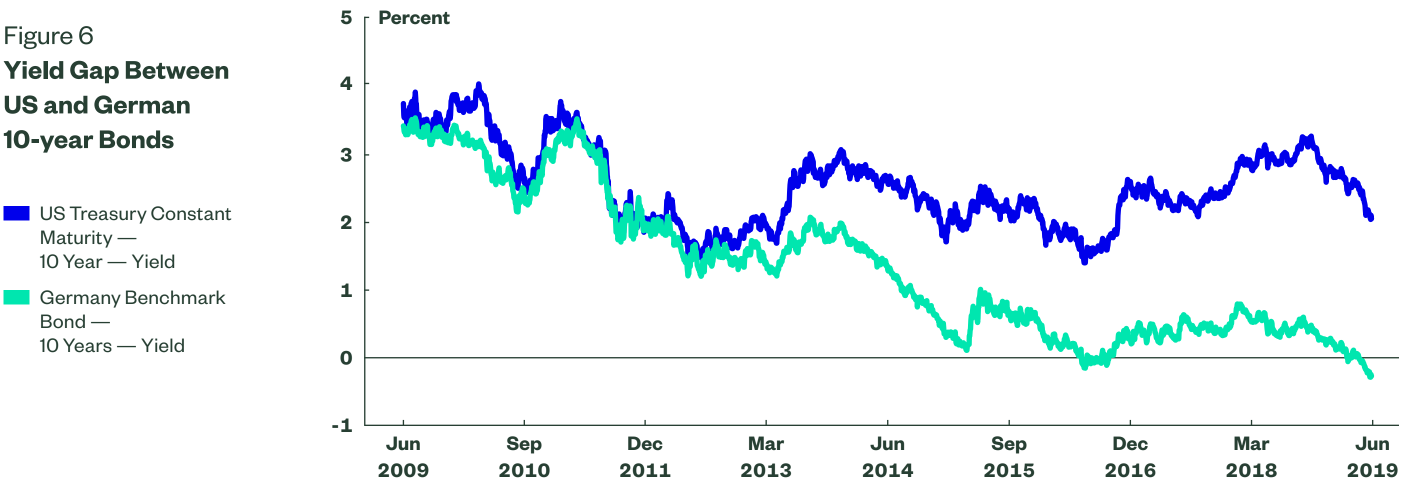
Figure 5
Bond Yields Turn Increasingly Negative

Source: State Street Global Advisors, FactSet.

However, the latest turn in guidance from monetary policymakers has sharply reversed any trend that might have been developing for positive nominal interest rates and scarcer supplies of bonds priced to deliver sub-zero total returns. Whether one points to the Fed becoming more patient and suggesting that it is ready to act to sustain the expansion or ECB President Mario Draghi and the ECB pushing back on the notion that their hands are tied, the end result has been clear. Interest rates have plummeted and the stock of negative-yielding debt has now ballooned to over US$13 trillion in market value.

From a forward-looking perspective, it is difficult to conjure a positive total return in markets like Germany where starting yields are more than 30 basis points in the red. The calculus is a bit more balanced in the United States, notwithstanding the massive bond rally that occurred in the second quarter of this year. Nominal GDP progressing at a pace of growth that is roughly 3 percentage points higher than the 10-year US Treasury yield suggests interest rates are too low. But the slowing in economic data, especially in industrial and manufacturing sectors as represented by purchasing manager indices, could foreshadow a slower-growth environment, which bond markets seem to have embraced. Should weaker data start to turn up in otherwise healthy parts of the economy, such as consumer spending, the associated momentum of higher bond prices (and lower yields) is one that could prove to be a powerful force as well. But the relative value argument may be the most compelling, especially looking at the evolution of US and German interest rates over the past several years (as can be seen in Figure 6). As recently as 2012, there was no difference between the yield on offer from a 10-year US Treasury and a comparable maturity German bund. Today, the yield advantage for US Treasuries is more than 200 basis points. With growth slowing, central banks expected to ease, and many major bond markets at all-time lows from a yield perspective, one can imagine stranger scenarios than US bond yields retesting their 2016 lows and the more-than-adequate total returns that would be earned as a result.

Figure 6
Yield Gap Between US and German 10-year Bonds



Source: State Street Global Advisors, FactSet.

Endnotes

1 If the contrarian positioning data were not enough, the title of the June 2019 Bank of America Merrill Lynch Global Fund Manager Survey sums it up — "The Most Bearish FMS since the GFC."

2 Bank of America Merrill Lynch *Global Investment Strategy — The Longest Pictures*. June 7, 2016. Michael Hartnett and Brian Leung.

3 As measured by the Bloomberg Barclays Global Aggregate Index.

SSGA Forecasts as of June 30, 2019

Real GDP Growth	2019 (%)	2020 (%)
Global	3.3	3.4
US	2.3	1.9
Australia	1.9	2.5
Canada	1.4	1.7
Eurozone	1.2	1.4
France	1.4	1.5
Germany	0.8	1.5
Italy	0.0	0.4
UK	1.3	1.6
Japan	0.7	0.5
Brazil	1.0	2.0
China	6.2	5.9
India	6.8	7.1
Mexico	1.3	1.8
South Africa	0.0	1.0
South Korea	2.0	2.2
Taiwan	0.8	1.2
Inflation		
Developed Economies	1.6	1.8
US	1.9	2.0
Australia	1.6	2.1
Canada	1.9	2.0
Eurozone	1.3	1.5
France	1.3	1.5
Germany	1.4	1.7
Italy	0.8	1.1
UK	1.9	1.9
Japan	0.8	1.1
China	2.3	2.4

Central Bank Rates	June 30, 2019 (%)	June 30, 2020 Forecast (%)
US (upper bound)	2.50	2.00
Australia	1.25	1.00
Canada	1.75	1.75
Euro	0.00	0.00
UK	0.75	0.75
Japan	-0.10	-0.10
Brazil	6.50	6.00
China	4.35	4.25
India	5.75	5.50
Mexico	8.25	7.75
South Africa	6.75	6.50
South Korea	1.75	1.50
10-Year Bond Yields		
US	2.00	2.00
Australia	1.32	1.60
Canada	1.46	1.70
Germany	-0.33	0.20
UK	0.83	1.30
Japan	-0.16	0.05
Brazil ($)	4.77	4.50
Mexico ($)	3.64	3.60
Exchange Rates		
Australian Dollar (A$/$)	0.70	0.73
British Pound (£/$)	1.27	1.35
Canadian Dollar ($/C$)	1.31	1.26
Euro (€/$)	1.14	1.18
Japanese Yen ($/¥)	107.74	95.92
Swiss Franc ($/SFr)	0.98	1.05
Chinese Yuan ($/¥)	6.87	6.80

One-Year Return Forecasts through December 31, 2019	Base Currency					
	USD (%)	EUR (%)	GBP (%)	JPY (%)	AUD (%)	CAD (%)
S&P 500	5.7	2.0	-0.4	-5.9	1.6	1.9
Russell 2000	5.9	2.2	-0.2	-5.7	1.8	2.1
MSCI EAFE	5.8	2.1	-0.3	-5.8	1.7	2.0
MSCI EM	9.0	5.2	2.8	-3.0	4.8	5.1
Barclays Capital Aggregate Bond Index	2.7	-0.9	-3.2	-8.6	-1.3	-1.0
Citigroup World Government Bond Index	0.8	-2.7	-5.0	-10.3	-3.1	-2.8
Goldman Sachs Commodities Index	5.9	2.2	-0.2	-5.7	1.8	2.1
Dow Jones US Select REIT Index	5.0	1.3	-1.0	-6.5	0.9	1.2

Source: State Street Global Advisors, as of June 30, 2019.

The above forecasts are estimates based on certain assumptions and analysis made by State Street Global Advisors. There is no guarantee that the estimates will be achieved.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

Start with Rigor We take a highly disciplined and risk-aware approach built on exhaustive research, careful analysis and market-tested experience to meet client needs. Rigor is behind every decision we make.

Build from Breadth Today's investment problems demand a breadth of capabilities. We build from a universe of active and index strategies to create cost-effective solutions.

Invest as Stewards We help our portfolio companies see that what is fair for people and sustain-able for the planet can deliver long-term performance. As fiduciaries, we believe good stewardship is good investing.

Invent the Future We created the first ETF in the US and are pioneers in index, active, and ESG investing. Using data, insights and investment skill, we are always inventing new ways to invest.

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $2.8 trillion* under our care.

* AUM reflects approximately $32.7 billion (as of March 31, 2019), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

ssga.com

Marketing communication.

Glossary

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

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

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

Consumer Price Inflation (CPI) A widely used measure of inflation at the consumer level that helps to evaluate changes in cost of living.

Deflation A decrease in the general price level of goods and services over a given period.

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

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

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

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

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

MSCI Emerging Markets Index The MSCI Emerging Markets Index captures large and mid-cap representation across 23 emerging markets countries. With 834 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI World Index The MSCI World Index is a free-float weighted equity index. It includes about 1,600 stocks from developed world markets, and does not include emerging markets.

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

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

Phillips Curve a graphic representation of the relation between inflation and unemployment which indicates that as the rate of either increases the rate of the other declines.

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.