Forecasts

First Quarter 2019

Global Economic Outlook

By Christopher Probyn, Ph.D.,
Chief Economist, Investment Solutions Group

Pages 2–5:

- Global economic growth is set to slow slightly from 3.7% in 2018 to 3.5% in 2019. However, the risks appear skewed to the downside, reflecting the prospects for a trade dispute that disrupts global supply chains.
- Headline inflation in the advanced economies could moderate from 2.0% in 2018 to 1.8% in 2019 as global growth slows and oil prices drift sideways from current levels.
- Among G7 economies, we envisage a synchronous tightening cycle emerging. The Fed and Bank of Canada may tighten further in 2019, and the Bank of England seems likely to move if Brexit goes smoothly. The ECB may tighten late in 2019 for the first time since 2011. And the RBA could even hike once. However, the Bank of Japan can likely do little more than tinker with monetary policy.

Emerging Markets Outlook

By Simona Mocuta,
Senior Economist, Investment Solutions Group

Page 6:

- Optimism at the start of 2018 dissipated as emerging markets' growth prospects were dimmed amid US Fed monetary tightening and intensifying trade tensions between the US and China.
- Emerging markets economic growth will likely decelerate further in 2019 and macro risks are probably still skewed to the downside — China's prospects are closely tied to how trade negotiations ultimately unfold.
- Lower oil prices will have an uneven growth impact across EMs, but they will be universally disinflationary — this should allow EM central banks to retain more pro-growth policies.

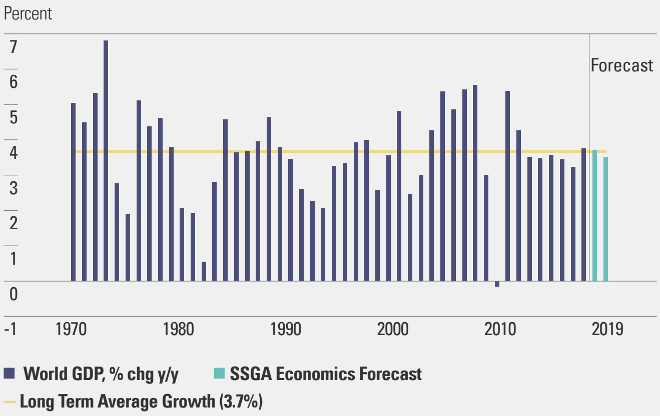
Global Capital Markets Outlook

By Jerry Holly,
Senior Portfolio Manager, Investment Solutions Group

Pages 7–9:

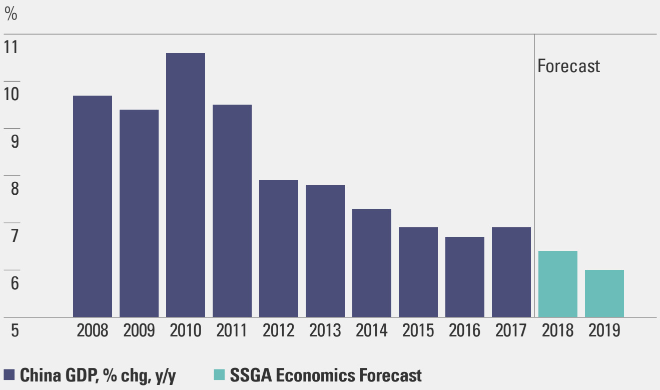
- Although the fourth quarter is often characterized by favorable seasonal tailwinds, this time around equity and credit assets were met with a risk-off environment that caused global equities to fall sharply and pushed most asset classes into negative return territory for 2018.
- Some markets and economies may be operating in a late-cycle environment, but cycles can be viewed in many ways across global capital markets and we continue to see good prospects in some areas normally considered pro-cyclical.
- Higher levels of interest rates in fixed income likely make sense over the intermediate term, but some flagging measures of growth coupled with heightened risk aversion suggest the recent rally in rates may have more room to run.

Figure 1: Global Growth Slows in 2019



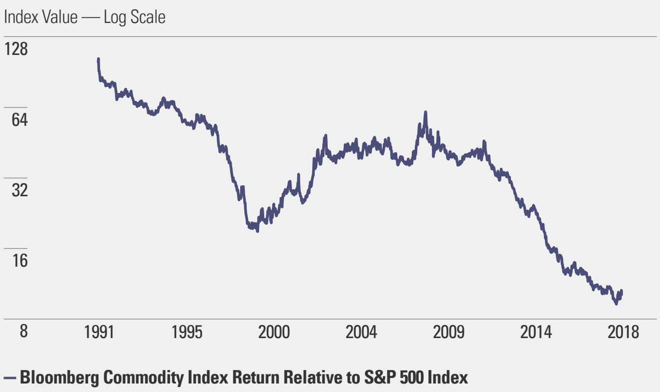
Sources: State Street Global Advisors (SSGA) Economics, Macrobond, International Monetary Fund (IMF). The above forecast is an estimate based on certain assumptions and analysis made by the SSGA Economics Team. There is no guarantee that the estimates will be achieved.

Figure 2: Chinese Economic Growth Falters



Source: SSGA Economics, National Bureau of Statistics of China. The above forecasts are estimates based on certain assumptions and analysis. There is no guarantee that the estimates will be achieved.

Figure 3: Commodities — A Not-So-Super Cycle



Source: FactSet, SSGA. Past performance is not a guarantee of future results.

STATE STREET GLOBAL ADVISORS

Global Economic Outlook

By Christopher Probyn, Ph.D.,
Chief Economist,
Investment Solutions Group

Global Overview: As Good as it Gets

The global economy is going through a "mini-cycle," with growth slowing in 2016, reaccelerating in 2017–2018 partly on an oil price and fiscal policy related swing in the US, only to likely decelerate again in 2019 on a broad-based slowdown of the advanced and developing economies. Indeed, global growth accelerated 0.4 percentage point to 3.7% in 2017, the best since 2011. It is projected to remain unchanged for 2018, before slowing to 3.5% in 2019. However, the risks appear skewed to the downside, reflecting the prospects for a trade dispute that disrupts global supply chains.

Energy prices have assumed the dominant role in the evolution of inflation since mid-2014. Indeed, because of the extent and timing of the oil price decline, inflation in the advanced economies plunged to just 0.3% in 2015. Inflation subsequently reaccelerated as oil prices recovered from their lows, reaching 2.0% in 2018. However, we expect this to slow to 1.8% in 2019 as oil prices drift sideways and core inflation fails to accelerate appreciably.

We envisage a synchronous tightening cycle emerging in 2019, except in Japan. The US Federal Reserve (Fed) and Bank of Canada are projected to tighten twice in 2019. Assuming Brexit goes smoothly, with the UK entering a 21-month transitional period in April, the Bank of England seems likely to move once. The European Central Bank (ECB) has committed to leaving administered rates unchanged through the summer, but might sneak in a 25 basis point (bps) move during the second half of the year. And, most controversially, we expect the Reserve Bank of Australia to hike by 25bps late in 2019, leaving the overnight rate at 1.75%, but we admit this is an extremely close call. The Bank of Japan has not made sufficient progress on inflation to likely do any more than tinker with monetary policy, especially ahead of the VAT hike due to take effect from October.

US: Solid Fundamentals but Policy Risks

2018 was a good year for the US economy. Thanks to strong momentum across the industrial sector and a reacceleration in consumer spending, real GDP grew 2.8% year-over-year (y/y), on average, during the first three quarters. It seems poised to reach 2.9% for 2018 as a whole. The fiscal multiplier of the TCJA (Tax Cuts and Jobs Act) may not have been large — and is likely being partially offset by uncertainty over trade policy — but it has nonetheless been positive for growth. The combination of tax cuts, immediate expensing of capital expenditures, the mandatory repatriation of overseas profits (a little over $430 billion through the first half of 2018 versus $150 billion in all of 2017), and a broad deregulation push have helped incentivize capital spending, especially as these changes occurred against the backdrop of solid momentum, tight labor markets and high capacity utilization. Unsurprisingly then, business fixed investment grew at a 6.9% y/y average over the first three quarters, the most in four years. Moreover, there appears to be more life in this capital expenditure (capex) cycle. Its continuation, in fact, is critical to allowing the already-long economic expansion to continue without triggering undue inflationary pressures that force the Fed to tighten aggressively and perhaps hasten the cycle's end.

Unfortunately, there are three meaningful risks on the horizon. Perhaps the most important risk is trade policy. The trade spat with China has escalated in recent months, and while the G-20 meeting has raised hopes of a truce and perhaps even a more comprehensive deal, there remain considerable risks of further escalation. Uncertainty over trade already seems to be dampening business confidence, and the new tariffs are affecting spending decisions; the longer this situation drags on, the more significant the impact is likely to be. We are not talking about outright declines, rather about a "lost opportunity" for businesses to invest. The second risk stems from the modest, yet notable, deceleration in global growth that could detrimentally impact capital spending. If businesses perceive a loss of momentum, they are unlikely to invest to the extent they would otherwise. And finally, the recent plunge in oil prices, if sustained, has the potential to reduce capital spending in the mining sector (recall the industry's down-cycle following the oil price decline in late 2014). In addition to these three risks, we are closely watching the intensifying slowdown in housing activity — though we see this largely as an affordability issue that rising interest rates have exacerbated, rather than a serious imbalance that needs to be worked through. Still, given residential investment is unlikely to contribute much to growth in 2019, it is even more important to provide a favorable environment for non-residential investment.

Consumer spending has responded modestly to fiscal stimulus — likely because the cuts primarily benefit higher-income individuals, who have smaller marginal propensities to spend. However, spending has been well supported by the tight labor market, which has provided not only employment opportunities but also a sense of employment security that has driven consumer sentiment higher. Meanwhile, a budget agreement has lifted discretionary spending caps, leading to higher actual expenditures on defense and non-defense. Having dipped slightly in 2017, government consumption increased an average 1.2% y/y during the first three quarters of 2018, while government investment is up 2.7% y/y, the fastest pace in three years.

As some of the positive effects of the fiscal stimulus start to wear off, and as base comparisons become increasingly difficult, GDP growth will likely moderate slightly from an estimated 2.9% in 2019 to 2.5% in 2019. This still leaves the US as the growth leader among the large developed markets, matched only by Australia and well ahead of the eurozone and Japan.

Inflation slowed quite sharply in the first half of 2017 when various measures of consumer price inflation decelerated some 0.8–0.9 percentage point between February and June. The Fed assumed the slowdown reflected transitory factors such as the introduction of unlimited wireless telephone plans, an unusual abundance of used cars coming off lease, and seasonal declines in apparel prices. This interpretation seems to have been correct, as CPI inflation subsequently reaccelerated, with headline CPI peaking at 2.9% y/y in June of 2018 and headline PCE (personal consumer expenditures) at 2.3% y/y in July. Meanwhile, core CPI inflation and core PCE inflation — the Fed's favorite gauge of inflation over the near term — peaked at 2.4% y/y and 2.0% y/y, respectively, in July. But most inflation metrics have since moderated slightly and the recent plunge in oil prices suggests that the downtrend could continue for a bit longer. Meanwhile, despite having strengthened, wage inflation remains modest by historical norms; we believe it will barely exceed 3.0% next year, despite an unemployment rate that may touch 3.5%. Thus, we believe that headline inflation likely moderates in 2019 in line with oil prices while core inflation trends largely sideways.

The Fed picked up the pace of tightening in 2017 and continued in the same vein in 2018. It raised the funds target by 25bps in March, June, September and December, leaving the funds target at 225–250 basis points. However, the combination of apparently less acute inflation risks and evidence of slower global growth could lead the Fed to slow down again in 2019. We are now penciling in only two hikes in 2019 — in June and December — with a pause early in the year as policymakers assess the health of the domestic economy and the evolution of trade policy. If these are resolved favorably, rekindling economic momentum, the Fed can of course adjust its trajectory. Monetary policy is always data dependent. In our view, further hikes will have less to do with a desire to "normalize" and more with economic performance.

The Fed also started reducing the size of its balance sheet in October 2017. It is gradually lowering its securities holdings by decreasing the reinvestment of the principal payments received when securities mature. Specifically, such payments will only be reinvested if they exceed the level of gradually rising caps. For Treasuries, the initial cap was $6.0 billion per month, increasing in steps of $6.0 billion every three months until it reaches $30.0 billion a month, where it is expected to remain. For agency debt and mortgage-backed securities, the initial cap was $4.0 billion a month, increasing in steps of $4.0 billion until it reaches $20.0 billion a month, where it is expected to remain. Obviously, this will drain banks' reserve balances, with the Fed expecting them to fall to a level "appreciably below that seen in recent years," but "larger than before the financial crisis."

Eurozone: The Pendulum Swings

In 2017, the biggest positive surprise in the world economy came from the eurozone, where growth accelerated to an impressive 2.5%, the best since 2007 and well above potential. Fast forward a year and the story has completely reversed amid materially slower incoming data. Some deceleration should not have come as a surprise — bursts of above-potential growth, especially when of such magnitude, rarely last. The trouble is that the deceleration has proven both more severe and longer-lasting than initially thought: growth slowed from a quarterly pace of 0.7% in 2017 to 0.4% q/q during the first half of 2018 and then further still to 0.2% in the third quarter. We expect that full-year GDP growth — which six months ago was seen reaching 2.2% — may come in at only 1.9%. 2019 will likely bring about a further, though much gentler, deceleration as the rate of expansion slows to 1.6%.

While the performance of the Big Three economies has directionally converged over the last two years, with all picking up in 2017 and slowing in 2018, there has been a marked divergence over the longer course of the recovery since the global financial crisis (GFC) of 2007/2008. Germany has boomed, with the unemployment rate falling steadily since mid-2014 to just 5.0% by end-2018 (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 the second half of 2015, and it still stood at an elevated rate of 8.8% in October. Italy has really struggled, with the labor market improvement not beginning until 2015 and 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%!

As oil prices began to recover in 2016, headline consumer price (CPI) inflation accelerated sharply from around zero percent to 2.0% y/y, while core CPI inflation (which excludes food and energy) continued to drift sideways around 1.0%. Since then, headline has oscillated with oil prices and while core has accelerated slightly it has certainly not broken significantly to the upside. Indeed, it was still just 1.0% y/y in October. Headline crossed a little above 2.0% y/y, though the decline in energy prices brought it back down to 2.0% y/y in November and could drive it lower still. Progress on inflation is likely to be slow; the core measure is unlikely to move materially above 1.0% until 2019, and even that delayed pick-up is under some threat from slower economic growth. Meanwhile, we see the headline rate dipping ever so slightly to 1.6% in 2019, largely on account of oil prices.

After an abortive attempt to raise policy interest rates early in the recovery, the ECB eased progressively, 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 quantitative easing (QE) program in January 2015, and subsequently made a number 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, it began by "tapering" (or reducing) the quantity of assets purchased from €80 billion to €60 billion a month. By January 2018, it tapered to €30 billion a month, and by October to €15 billion. The program is scheduled to conclude at the end of December (reinvestments will continue), shifting monetary policy focus away from QE and back to traditional interest rate policies. The Bank has stated its intent to maintain the current level of policy interest rates through the summer of 2019 and, if anything, softer incoming data suggest that rate hikes could be pushed out even further. Some tinkering with the spreads among the three administered interest rates could occur earlier, but we currently do not anticipate more than one refinancing rate hike in 2019, and that is unlikely to arrive until the fourth quarter.

UK: It's all about Brexit

The evolution of the UK economy in 2019 depends critically on the path of Brexit. Our baseline forecast (described below) assumes the House of Commons ultimately votes to support an agreement that ushers in a 21-month transitional period. However, at the time of writing that outcome is far from certain, with the Northern Ireland backstop proving an especially thorny issue. Hence, a no-deal Brexit remains a possibility, skewing the potential heavily to the downside.

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 summer weather. Nevertheless, sluggish real wage gains and fragile home prices (particularly in London) are hindering consumption, while the chaos currently surrounding Brexit is weighing on business sentiment and retarding investment. Hence, the economy likely advanced only 1.3% in 2018, the slowest since the Global Financial Crisis. However, we see it picking up to 1.6% in 2019 as the favorable resolution of the remaining Brexit issues unleashes pent-up business investment.

Inflation accelerated quite sharply in 2017 on a combination of rising oil prices and the depreciation of sterling following the referendum result. But, as the exchange rate effect waned, inflation decelerated to 2.5% in 2018, and as oil prices stabilize this could slip to 2.2% in 2019. However, the inflation risks are clearly skewed to the upside. A no-deal Brexit would likely send sterling tumbling. And wage inflation has picked up of late, with average weekly earnings currently rising 3.3% y/y in October, the highest since the GFC.

The Bank of England (BOE) cut the Bank Rate to help bolster the economy in the aftermath of the surprise referendum result in 2016, but has since changed course, raising the rate in November 2017 and August 2018. Moreover, unless there is a no-deal Brexit we expect the bank to continue tightening gradually, although only one hike now seems likely in 2019 — and the market remains skeptical about that. (In the case of a no-deal Brexit, we expect that the BOE will almost certainly use what ammunition it has to help stabilize the economy, likely cutting the Bank Rate back to 25 basis points and possibly even restarting quantitative easing.)

Japan: Natural Disasters Take a Toll

There were some signs that "Abenomics" (Prime Minister Abe's macro-economic policy package containing the so-called three arrows of monetary stimulus, fiscal stimulus and structural reform) was starting to work in 2017, but a string of natural disasters (including the unusual combination of drought and floods) played havoc with the economy in 2018. Hence, while growth certainly surprised to the upside in 2017, with GDP rising a much faster than expected 1.7%, we estimate it has slowed to 0.7% in 2018. Because of the various disasters, recent performance has been highly uneven, with an outright contraction in GDP in the first quarter followed by a solid rebound in the second and then by another contraction in the third. However, because potential output is only running at around 0.8% a year, the labor market has remained red hot, which is limiting employers' access to suitable workers. Indeed, there were 162 job vacancies for every 100 applicants in October. Given the special factors that hindered growth in 2018, and the likelihood of increased spending and production ahead of the VAT hike scheduled for October, we anticipate some reacceleration in 2019, with GDP projected to rise 1.0%. (The negative effects of the VAT hike could show up in the annual growth rate for 2020.)

Inflation has been the most frustrating gauge for measuring the effectiveness of Abenomics in general, and monetary policy in particular. There were false starts in 2013 and 2015, and most recently in 2017. We were especially hopeful about the acceleration between March 2017 and March 2018 because it was accompanied by relatively rapid growth and an extraordinarily tight labor market. But so far, underlying inflation has failed to take hold, with the new core measure (which excludes fresh food and energy) drifting sideways around 0.4% y/y in 2018. However, it is important to recognize that some progress has been made over the longer term. All three widely-used measures of consumer price inflation — headline, national core (which excludes only fresh food products), and the new Bank of Japan (BoJ) core (which excludes fresh food and energy) — were negative when the package was launched in early 2013. All three rates trended higher into positive territory in 2017 and accelerated steadily through March. And while all three then retreated, they have since recovered much of the lost ground. Moreover, we expect additional progress, although we expect it to be slow. We project headline CPI to rise 1.1% in both 2018 and 2019 as we expect the effects of stable oil prices to just about offset those of slightly higher core inflation and the October VAT hike. The good news is that there are signs the ultra-tight labor market — the unemployment rate stood at 2.4% in October — may finally be boosting wage inflation, although even they are much less compelling than they were over the summer.

Because of the lack of progress on inflation, the Bank of Japan's (BoJ) hands are effectively 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 meant 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. It is a gargantuan task. And so, it should not be surprising that the BoJ is on its own among the major central banks in not even discussing an exit, let alone its specifics.

Emerging Markets Outlook

By Simona Mocuta,
Senior Economist,
Investment Solutions Group

Emerging Markets: On Shakier Ground

2018 started out as a promising year but ultimately proved to be rather difficult for emerging markets. Indeed, emerging markets growth had picked up in 2017 and it seemed that further incremental acceleration might be achieved in 2018. Unfortunately, two major headwinds converged to preclude this desirable outcome: liquidity drainage linked to persistent Fed tightening on one hand, and intensifying trade tensions between the US and China, on the other. Add to these factors a range of idiosyncratic events from Turkey to South Africa to Brazil, and we believe that 2018 EM growth will at best match the pace in 2017. We expect it will likely decelerate further in 2019. Macro risks persist and, on balance, are probably still skewed to the downside. However, there are also some reasons for cautious optimism. Having headed almost relentlessly in the wrong direction for months, trade negotiations between the US and China appear to have embarked on a more positive trajectory post the G20 summit. And the Federal Reserve has sounded a tad more dovish in recent weeks, suggesting the pace of rate hikes could slow in 2019. It's simply too soon to be certain, however, and that is why we retain a cautious view. There are, of course, EM-specific issues we need to watch, particularly progress with structural reforms — an area of many promises yet limited advancement so far.

China: Growth Deceleration is Baseline Scenario; Question is How Intense

China surprised to the upside in 2017, when growth accelerated two tenths to 6.9%, but momentum has since slowed. Even before the ratcheting up of the trade dispute with the US, we were expecting growth to moderate amid a multi-year deleveraging effort. Trade tensions rendered that slowdown more acute even though the government has announced some modest fiscal stimulus measures to limit the downside. Still, given China's high debt-to-GDP ratio of around 225%, deleveraging is necessary for securing medium-term economic stability and that is why we see the government's interventions to support GDP growth as fairly limited — limited not so much by a lack of ability, but rather by a lack of desire. Given this backdrop, we expect that growth may slow towards 6.0% in 2019, although the outlook is exceedingly murky given so much depends on how severe the trade dispute becomes. Conversely, a deal that precludes further escalation (and, perhaps even the roll-back of already-announced tariffs) will limit the downside to growth in the near term. However, the implications of such a deal for medium-term growth are less clear-cut; a resolution presumably would require significant Chinese concessions in regards to trade, investment, procurement, and other rules that may have favored national firms in the past.

India: Old Weaknesses Re-emerge

The demonetization move in late-2016 and the introduction of the Goods and Service Tax (GST) in 2017 challenged India's economic performance. Conditions subsequently started to improve, but the more volatile external environment and the increase in oil prices through September 2018 conspired to bring some of India's long-standing soft spots (dependence on imported oil, sizable fiscal deficits, etc.) back into focus. The rupee hit record lows against the dollar in early-October, before a reversal in oil prices helped it recover. The central bank raised interest rates twice to support the currency. But the most recent retreat in oil prices and the relapse in inflationary pressures may allow it to pause (at least for a while), supporting the economy and helping keep GDP growth above 7.0%.

Russia: A Difficult Recovery

Russia's economy has emerged from its 2015–16 recession, but the recovery has been shallow and slow. It is also becoming harder amid broad emerging markets turbulence, country-specific concerns around sanctions and, most recently, lower oil prices. Following contractions of 2.5% in 2015 and 0.2% in 2016, growth strengthened to 1.5% in 2017 and seems poised to slightly exceed that in 2018. But, unlike earlier expectations, this looks to be as good as it gets for now amid a shift to tightening in monetary policy and a relapse in oil prices that could keep growth well below 2.0% over the next couple of years. Beyond these near-term constraints, we believe 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 this does not seem likely, especially in the near term.

Brazil: Another Chance

Perhaps nowhere have politics been so central to the economic outlook as in Brazil. With presidential elections now out of the way, the country's extraordinary political rollercoaster has at least temporarily stopped, opening another window of opportunity for progress with structural reforms. Disappointment on the reform agenda had triggered a sharp depreciation of the real through September, which in turn hastened the end of a disinflationary trend that Brazil, alongside so many EMs, had experienced over the course of 2017. Monetary easing — which amounted to nearly 800 basis points worth of rate cuts — subsequently ran its course. Against this background, growth remained tepid near 1.2% in 2018. We think it should cross above 2.0% in 2019, but by how much depends entirely on the types of policies pursued by the new government.

Global Capital Markets Outlook

By Jerry Holly,
Senior Portfolio Manager,
Investment Solutions Group

The fourth quarter is often seen as a healthy season — as bountiful in its holidays as it is in its investment returns. That the market might think to do other than deliver on this year-end phenomenon of plenty could be viewed as sacrilege in some corners. But the favorable patterns were violated, and in a not-insignificant manner. Just about any asset class exuding a hint of credit risk or sensitivity to economic growth suffered during the fourth quarter. Some fell so severely that corrections were quickly usurped by bear markets. Of the hardest hit assets, US small cap equities declined 20% as investors shed exposure to higher beta assets while oil fell more than 30% on signs of abundant supply and high-profile forecasts of weaker demand. With risk assets whipsawing, global equity markets delivered their worst quarterly performance since the fall of 2011 when the eurozone banking crisis was in full force and the United States was contending with a debt ceiling debate and a credit rating downgrade. Government bonds afforded some protection, but given the severity of the equity market deterioration their performance was somewhat disappointing. While disappointing, the results in fixed income were not necessarily surprising since concerns around higher interest rates fueled some of the overall volatility that coursed through financial markets over the period. Extending the window to the entirety of 2018, it has been noted that a record number of asset classes registered negative returns for the year — an abrupt about-face from the more rewarding, and increasingly distant, returns garnered in 2017.[1]

Those looking for culprits responsible for the heightened volatility could do worse than to point to uncertainty associated with erratic policy decisions and pronouncements. Early in the quarter, Federal Reserve Chair Jerome Powell created cumbersome conditions with an off-hand comment that interest rates might be a long way from neutral. But the suggestion in November that those same short-term interest rates could be "just below" a neutral rate sent stocks soaring. In oil markets, concerns over sanctions on Iranian oil exports had supported the commodity leading up to the fourth quarter, but temporary waivers from the United States served as one catalyst for a meaningful re-think on an equilibrium price for oil. Italy's budget skirmish with the European Commission appeared to be as deadlocked as the World Chess Championship held in London, although it appears that the two entities may have finally reached a tentative compromise. Prime Minister Theresa May could only hope for a stalemate lasting a mere three weeks for her Brexit deal as it was swiftly met with cabinet resignations, a postponed vote in Parliament as well as a leadership contest initiated by her own party. And so as not to ignore an important and recurrent policy driver for 2018, trade relations between the United States and China looked to be on the mend following the G-20 summit in Buenos Aires. However, the sequentially suspicious arrest of Huawei's chief financial officer in Canada made investors question the durability of potential trade progress yet again.

But policy risks are not new and indexes measuring the degree of economic policy uncertainty do not appear particularly elevated. Might markets just be fatigued? Much has been made of the notion that we may be operating in a "late cycle" environment where equity market leadership is likely to transition and catalysts for downside vulnerability need not be as obvious as in other, more stable, phases of the business cycle.

Cyclical Caution Builds for Equities

So where might we be in "the cycle" and what does that mean for our equity market and cross-asset perspectives? A lot of eponymous work has gone into this question and the result has been anything but a unifying set of conditions to define a business cycle. Kitchin business cycles average three to four years and hone in on how inventories influence the economy. Juglar cycles get us closer to the average post-war business cycle duration of seven or eight years, but that work was centered on trade dynamics and was done in the late 1800s. Labrousse "intercycles" relate more closely to the duration of the current expansion, but that research was focused on explaining agrarian European economic history. And for longer-term viewpoints, we can look to work done by Simon Kuznets and Nikolai Kondratieff where repetitive swings and cycles have been observed that span multiple decades.[2]

On the one hand, it might seem that an analyst could pick their poison as to how or where they think a particular market or economy might stand in relation to a cycle. But we can also look to more contemporaneous features to try to distill some guidance. For example, the United States does appear to be operating in a late-cycle environment according to a number of factors. It is currently in the second-longest post-war expansion on record, monetary policy tightening is relatively mature with nine interest rate hikes since 2015 and labor markets are quite tight with unemployment below 4% and labor market inflation indicators trending higher. However, persistently strong profit margins and earnings growth suggest the end of this cycle may not be imminent. In Europe, the factors are nearly reversed as the duration of the cycle is not as long, labor markets aren't as tight, and equity market conditions in terms of margins and earnings are weaker. Japan is likely somewhere in between in the sense that labor markets are quite tight, but monetary policy is comparatively further behind and profit margins appear to be plateauing.

In our asset allocation portfolios, a number of factors have pointed to greater vulnerabilities as we have progressed through 2018 and we have reduced our exposure to equities on a fairly consistent basis. Some of the factors motivating our moves relate more to market conditions and sentiment such as elevated readings of cross asset volatility metrics and the wider distribution of outcomes that may accompany certain political risks, especially in Europe. But we have also taken note that certain momentum measures have exhibited characteristics that suggest forward market movements are likely to be choppier and adhere less to forces associated with firmly trending markets. This sort of development is consistent with an equity market approaching its later stages. However, our evaluation across equity sectors is more mixed and represents what would ordinarily be considered a mostly mid-cycle allocation. Our preference for energy, however, would be the one area that aligns with a late-cycle play. While the sector has suffered at the hands of swiftly dropping oil prices and an accompanying deterioration in margins, OPEC's decision to cut production by 1.2 million barrels per day could provide some resistance to further oil (and share) price deterioration.

Other sectors that almost certainly display more mid-cycle attributes are the consumer discretionary and technology sectors. While these sectors experienced real turbulence in the fall of 2018, we continue to see quantitative and macro support for their prospects into 2019. High return-on-equity, coupled with a breather in valuations, has lifted consumer discretionary. And while the benefits of tax reform may be set to fade for corporates, fiscal year 2019 is expected to hold greater tax benefits for the consumer than 2018.[3] A lower price for oil should also translate into improved consumer spending moving forward. For technology shares, even though they have recently experienced some of their worst relative performance since 2013, we believe the near-term future looks solid amidst undemanding valuations, still-favorable sentiment and strong capital expenditure intentions on the part of businesses.

Interest Rate Waves

For fixed income, the bigger picture suggests some cyclical tendencies that seem to fall somewhere in between the Kuznets "long swings" of 20-to-25 years and the more expansive Kondratieff cycle of approximately 50 years. This observation stems from nothing more than the long-term downward trend in interest rates that dates back to 1981 (as well as the comparable length of the bond bear market before that). But inside those longer-term cycles or waves are myriad mini-cycles related to economic growth, inflation risks, monetary policy and more. After all, we are already three years into a monetary tightening cycle from the Federal Reserve and the US yield curve has been on a nearly-uninterrupted flattening trend since late-2013. With that as background, our evaluation of fixed income markets has been persistent in calling for modestly higher levels of interest rates and continued flattening of the yield curve. And while the fourth quarter kicked off with an interest rate scare and steeper curves, the onset of equity market volatility, weakened growth expectations and cascading oil prices allowed the 10 Year US Treasury to close the year right around its average level for all of 2018. Meanwhile, the yield curve continued to flatten, with some parts of the curve inverting over the period. We continue to see flattening as being the more likely future path amidst still-strong leading economic indicators and higher survey-based forecasts for inflation. But as to the level of interest rates — on that, our view is less firm. In the medium term, higher interest rates make sense especially as many bonds in many markets around the world continue to offer negligible, if not negative, inflation-adjusted yields. But in the short term, momentum indicators and a deceleration in PMIs suggest the recent rally may have more room to run.

While the cost to borrow for sovereigns has been coming down of late, the same cannot be said for corporate issuers of debt. With credit spreads widening amidst the risk-off sentiment in markets, interest rates ticked higher for corporate borrowers during the fourth quarter. That divergence highlights one of the central tenets of the credit cycle — that being the availability of credit.[4] Some drivers of the usual credit cycle are fundamental in nature and include the stance of monetary policy, corporate confidence, corporate financial metrics as well as event risk and trends in corporate actions. On balance, these factors are mostly negative, but other structural conditions, more unique to this particular cycle, have helped to extend the cycle; tax reform, demographics and the rise of private credit are some to note. But these have also led to some attention that the industry would prefer to avoid. Politicians have cited leveraged loans as a lurking problem and the Federal Reserve's inaugural Financial Stability Report, released in November, made mention of the growth in lower-quality loans and elevated levels of leverage for risky firms. The flip side of these potential risks and the widening in credit spreads of course is relatively attractive yields. The last time that US investment grade credit yielded this much was in June 2010. While we haven't made any aggressive moves into credit assets, the trade-off from a cross asset perspective is beginning to look more interesting.

Super Commodities?

To the extent that obscure economist surnames fail to capture a reader's attention, commodity markets offer up a more straightforward cyclical descriptor. The ebbs and flows in commodity markets have come to be known simply as the commodity super-cycle — a phenomenon that was popularized (if not coined) by Jim Rogers of Quantum Fund fame. In this case, the caveat is that the cycle is in relative terms, namely an oscillating period of outperformance (or underperformance) compared with equities. And apart from a historically observed pattern that has averaged 18 years in duration, the intuition behind the idea rests in large part on the relative winners and losers as input costs rise and fall. If commodities represent an important input for industry, then commodity price inflation, while good for the commodity investor, is likely to dent the operating results for firms (and vice versa).

In recent times, the 18-year alternating window of picking either stocks or commodities seems like it may have compressed to some degree. The last semi-durable period of commodity outperformance relative to equities ran from the late-1990s up to the global financial crisis. Since then the commodity rout has been unabated and likely exacerbated by the same easy monetary conditions that catapulted equity markets. From where we sit today, our analysis suggests some upside potential in the sense that a lot of negative developments have likely been priced in. But significant risks remain, including US/China trade relations, record US and Saudi oil production and rising inventories, and the possibility that the US dollar could continue to appreciate and dent demand from non-US markets. While we started to nibble at commodities throughout 2018, we remain neutral as we enter 2019. It may be the case that the past ten years of commodity market underperformance represents a sufficient setback to start a more virtuous cycle for the asset class, but we are hedging our bets for the time being.

* *Unless noted otherwise, all returns are in US dollars as of December 31, 2018*

1 JP Morgan Global Data Watch, December 14, 2018.

2 For additional detail on research associated with economic cycles, please refer to *The Great Wave: Price Revolutions and the Rhythm of History* by David Hackett Fisher (1996).

3 Wolfe Research Portfolio Strategy. Macro and Financials Webcast, November 7, 2018.

4 For a more complete briefing on credit cycle analysis, please refer to the SSGA Blog entry "Credit Cycle in Later Stages: Prepare for Landing" by Chuck Moon, Pete Hajjar, Chris Ingle and Arvind Narayanan, May 8, 2018.

Sources: Bloomberg, FactSet, J.P. Morgan, Citibank, Barron's, The Economist, The Wall Street Journal, MSCI as of December 31, 2018.

SSGA Forecasts as of December 31, 2018

Real GDP Growth	2018 (%)	2019 (%)
Global	3.7	3.5
US	2.9	2.5
Australia	3.0	2.5
Canada	2.1	2.0
Eurozone	1.9	1.6
France	1.6	1.4
Germany	1.6	1.5
Italy	1.0	0.7
UK	1.3	1.6
Japan	0.7	1.0
Brazil	1.1	2.4
China	6.5	6.2
India	7.6	7.5
Mexico	2.0	1.9
South Africa	0.7	2.0
South Korea	2.6	2.3
Taiwan	2.4	2.0

Inflation	2018 (%)	2019 (%)
Developed Economies	2.0	1.8
US	2.5	2.1
Australia	1.9	2.0
Canada	2.3	2.1
Eurozone	1.7	1.6
France	1.9	1.6
Germany	1.9	1.7
Italy	1.3	1.1
UK	2.5	2.2
Japan	1.1	1.1
China	2.2	1.8

Central Bank Rates	December 31, 2018 (%)	December 31, 2019 Forecast (%)
US (upper bound)	2.50	3.00
Australia	1.50	1.75
Canada	1.75	2.25
Euro	0.00	0.25
UK	0.75	1.00
Japan	-0.10	-0.10
Brazil	6.50	7.75
China	4.35	4.25
India	6.50	6.25
Mexico	8.25	7.75
South Africa	6.75	6.75
South Korea	1.75	1.75

10-Year Bond Yields	December 31, 2018 (%)	December 31, 2019 Forecast (%)
US	2.68	3.00
Australia	2.32	2.50
Canada	1.97	2.30
Germany	0.24	0.50
UK	1.28	1.50
Japan	0.00	0.05
Brazil ($)	5.16	4.90
Mexico ($)	4.61	4.30

Exchange Rates	December 31, 2018	December 31, 2019 Forecast
Australian Dollar (A$/$)	0.70	0.69
British Pound (£/$)	1.27	1.37
Canadian Dollar ($/C$)	1.37	1.33
Euro (€/$)	1.14	1.16
Japanese Yen ($/¥)	109.72	101.00
Swiss Franc ($/SFr)	0.99	1.05
Chinese Yuan ($/¥)	6.87	7.00

	Base Currency					
One-Year Return Forecasts through December 31, 2019	USD (%)	EUR (%)	GBP (%)	JPY (%)	AUD (%)	CAD (%)
S&P 500	4.8	2.9	-2.2	-3.5	6.3	1.7
Russell 2000	4.0	2.1	-3.0	-4.3	5.5	0.9
MSCI EAFE	4.3	2.4	-2.7	-4.0	5.8	1.2
MSCI EM	6.7	4.7	-0.4	-1.8	8.2	3.6
Barclays Capital Aggregate Bond Index	2.1	0.2	-4.7	-6.0	3.6	-0.9
Citigroup World Government Bond Index	0.9	-0.9	-5.9	-7.1	2.3	-2.1
Goldman Sachs Commodities Index	4.5	2.6	-2.5	-3.8	6.0	1.4
Dow Jones US Select REIT Index	4.6	2.7	-2.4	-3.7	6.1	1.5

Source: SSGA, as of December 31, 2018.

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

Glossary

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

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.

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

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

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

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

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

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

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

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

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

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

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

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

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

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State Street Global Advisors Worldwide Entities

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ID15253-2360066.1.1.GBL.RTL 1218 Exp. Date: 31/01/2020