What does the second half of the year hold for the world’s economies and markets?
UPDATE ON THE MAJOR ADVANCED ECONOMIES

Projections Downgraded

In our 2016 Global Market Outlook, published at the beginning of the year, we opined that economic conditions would change little this year, projecting, “more of the same: lackluster growth, low inflation and limited policy tightening.” Moreover, we stressed that the risks were skewed to the downside, “likely fueling bouts of investor uncertainty and market volatility.”

Events went mainly as we predicted, but we’ve had to rethink some parts of the forecast. The loss of momentum in both the United States and Japan has led to us downgrading our 2016 growth projections for both countries. The US slowed more sharply than expected in the second half of last year, and, yet again, got off to a slow start this year.

Although the recovery should regain some momentum in the second quarter, it now appears unlikely that US growth will reach the 2.5% we projected at the start of the year. Rather, we expect the economy to advance by around 2.0%.

The Japanese economy performed even more poorly in 2015, essentially stagnating over the last nine months of the year. Moreover, the incoming data suggest no immediate turnaround, leading us to revise our forecast down from 1.2% to just 0.7%.

Meanwhile, the outlook for the eurozone has remained largely unchanged. Admittedly, growth surprised to the upside in the first quarter, but we expect it to moderate over the rest of the year, limiting the advance to 1.6% in 2016.

The larger-than-anticipated drop in oil prices in the fourth quarter of last year and first quarter of this has caused inflation to surprise to the downside, particularly in Japan and the eurozone, where the unexpected strength of the yen and euro have reinforced disinflationary forces.

The most notable change, however, is to the path of US-administered interest rates. We had projected liftoff in March 2016, followed by further hikes at alternate meetings through the rest of the year. But, of course, the Fed made the first move in December, although it has been unable to follow up thus far because of weakness in some of the US data and uncertainty about economic conditions abroad.

We now anticipate just one hike this year, most likely in September or December. Moreover, we think the risks around the four hikes projected in the Fed’s dot diagram for next year are skewed to lower for longer, because of the current asymmetries in monetary policy, namely the limited ammunition the Fed has to respond to a downside surprise, compared to the more than ample ammunition it has to respond to an upside one. We explore this theme in more detail later in this issue.

Growth Forecasts

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global</td>
<td>3.0%</td>
<td>3.2%</td>
</tr>
<tr>
<td>US</td>
<td>2.0%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Europe</td>
<td>1.6%</td>
<td>1.6%</td>
</tr>
</tbody>
</table>

Source: SSGA Economics Team, Oxford Economic, as of 31 May 2016. The forecasts on this and the following page are based on certain assumptions and analysis made by SSGA. There is no guarantee that the estimates will be achieved.
HISTORICAL GLOBAL GROWTH TREND 3.7%
The opening half of 2016 has been perplexing to navigate for global investors as many of the market trends that prevailed coming into the year have sharply reversed and consolidated through mid-year, leaving global equities near unchanged. Ushering in 2016 was a violent sell-off in global equity markets that saw the worst first week of the year on record for the S&P 500 and an eventual decline in the MSCI World Index of 12% though 11 February.

Front and center in the turmoil that opened the new year was a series of conflicting messages from China’s policymakers in both equity and currency markets, each iteration of which seemed to unsettle the markets more than the last. The surge in volatility resulted in rallies in safe-haven assets such as gold, US Treasuries and funding currencies such as the yen.

Then, around the second week of February, everything changed and growth assets began a strong rally that has mostly held as we reach the midpoint of the year, leaving the MSCI World Index up 2.1% YTD through 31 May. If there is a story to be told as to what was the clearest indicator that global sentiment had dramatically shifted around 12 February, there are few as compelling as the reversal in oil prices. Through 11 February, crude oil as measured by the front-month West Texas Intermediate contract was down 29% year to date.

This aggressive decline at the start of 2016, following large declines of 46% in 2014 and 30% in 2015, contributed to market volatility more broadly in the equity energy sector and US high yield, and conveyed a message of weak underlying global demand. Rhetoric and rumors from oil exporting states on possible production freezes or even cuts alongside lower expected capex spending in the sector provided the base for an 87% rally in oil from 11 February through the end of May.

While growth assets rebounded into the spring, safe-haven assets surprisingly held ground and in some cases continued to rally, suggesting continued demand for hedges by investors. Gold, long-maturity US Treasuries and the Japanese yen returned 15%, 8.5% and 9%, respectively through 31 May, all easily besting developed market equities. The relative sense of unease also appears to be keeping the US Federal Reserve in check and has pushed further interest rate hikes off until the later part of 2016.

How does this market action line up with the market outlook we provided going into 2016? Opposite is an overview of some of our main market calls, how they line up against the scrutiny of actual events and how we evaluate them for the rest of 2016.

**OIL DROPS**

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>46%</td>
</tr>
<tr>
<td>2015</td>
<td>30%</td>
</tr>
<tr>
<td>2016 Early Feb</td>
<td>29%</td>
</tr>
</tbody>
</table>

Source: SSGA, as of 31 May 2016.
Positive on Risk Assets
Equities look favorable over the remainder of 2016 with global government bonds likely to fare worst. Our 2016 forecast for developed world equities was 4.4%, which exceeded a barely positive forecast of 0.3% for global government bonds.

The initial sell-off in risky assets in 2016 led both to a flight to safety as well as policy support by global central banks that, in combination, buoyed global bonds relative to equities in the first half of the year.

Looking forward to the rest of 2016, however, all the reasons for a low expected return for bonds relative to equities still hold, with now lower yields in bonds as a starting point.

Commodity and Interest-Rate-Exposed Sectors
We initially expected that these were positioned to underperform. This did not play out in the first half of 2016 as a result of the sharp rally in oil and flight to government bonds profiled above.

Looking forward to the second half of 2016, however, the sharp rise in commodity and bond prices may be difficult to sustain, so we maintain our original outlook for the second part of the year.

Japanese and European Equities Move Towards Neutral
Our positive view on Japanese and European equities was supported by a belief that expansionary monetary policies would continue to weaken their respective currencies, improving relative global competitiveness, and providing support for nascent local economic recoveries and stronger corporate profits.

As predicted, policy support was extended with a move to negative interest rates in Japan on 28 January and deeper negative rates in the eurozone in March, along with an expanded bond buying program, to include corporate bonds.

The market reaction, however, has been somewhat counterintuitive, with the Japanese yen and euro both strengthening relative to the US dollar, and Japanese and European equities broadly underperforming the MSCI World Index.

Given the likely limits to policy support in a negative rate environment, we have downgraded our assessment of Japanese and European equities and now hold a more neutral view, though acknowledge that these regions continue to carry relatively attractive valuations.

Volatility will Remain Highly Unpredictable
This theme has been a feature of markets. Given the continued list of uncertainties confronting the markets we expect the tenuous environment to persist through the end of the year.

While China fell out of the headlines at the close of the first quarter, the challenges that China faces in supporting a slowing economy while maintaining a strong currency stance continue. They are likely to test market nerves again before too long.

As we examine later in this issue, in Pressure Points, sensitivity to political events remains heightened. Ongoing discord in Europe, exemplified by the imminent Brexit referendum, is a principle concern.

And finally, global economic growth is expected to further moderate in 2016 relative to 2015 accompanied by a persistent fall in developed market productivity that will restrain potential earnings growth.

Credit
Given the still mostly favorable policy backdrop as well as continued low default rates in high-yield bonds with high carry, we maintain a cautiously optimistic outlook on credit through a modest overweight to high-yield bonds and intermediate investment-grade credit.