TIME TO PIVOT
Investment Ideas for a Changing World

OUTLOOK
What does 2017 hold for the world’s economies and markets?

FINDING YIELD
Targeting income in equity and fixed income markets.

UNCOVERING GROWTH
The equity sectors set to thrive in a reflationary environment.

POSITIONING FOR VOLATILITY
How can you address the new shape of volatility?

THE WHOLE PORTFOLIO
Managing the unintended consequences of asset allocations.

CURRENCY MATTERS
Risks and opportunities in international portfolios.
Seismic geopolitical events, most notably the Trump presidency and Brexit surprises, marked 2016 as a game changer across the global landscape, with significant implications for economies and markets. Populist politics and anti-globalization sentiment have set the stage for significant policy change in 2017 and beyond.

While there is still a great deal of uncertainty around final effects, we can already see that some of these changes will likely hasten shifts that were already under way (interest rate normalization in the US, for example). Others represent a significant departure from previous trends, such as an about-face on free trade.

For investors, these changes translate into a pivot on the kinds of approaches needed to achieve their growth, income, and protection objectives, as the global economy enters its eighth year of subdued recovery.

In our view, some of the leading themes that have served investors well over the past several years are shifting in the face of a changing investment backdrop. Investors will need to consider areas of the market that will benefit or suffer from a possible reflationary environment, altering, for example, the search for yield.

Valuations on income proxies have already expanded dramatically – leaving little room for error. Sector leadership in equities has been rotating from yield to earnings growth considerations. Volatility, as measured by the VIX, has been relatively low. However, episodic bursts of volatility indicate the potential for more dislocation, as markets adjust to new realities.

The potential for further political tumult to impact markets in 2017 abounds. Elections in Germany, the Netherlands, and France will be scrutinized for signs of populist and Eurosceptic influence, any growth of which will unsettle markets in Europe. At the same time, the region continues to grapple with the bumpy and uncertain path leading to Britain’s exit from the European Union, with speculation as to the nature and impact of subsequent re-arrangements of trade and political relations.
On the macro front, the capacity of the global economy to weather these potential storms is uncertain. Growth has trended below average for the past four years and we expect it to remain so in 2017 and into 2018. Late into the current cycle, it is unlikely we will see growth spontaneously ignite. Growth in the US remains tepid though labor markets are tightening; Europe continues to struggle to gain traction; and, while Emerging Markets appeared to have turned a corner in 2016, concerns over the potential impact of protectionism following the US election have created new headwinds.

After years of unconventional monetary policy to combat stubbornly low growth and inflation, the US is cautiously proceeding with rate normalization, while central banks in Europe and Japan have shown some hesitation to extend negative interest rates and asset purchase programs. With monetary policy perhaps at its limits to stimulate growth, a turn toward fiscal stimulus (which will also serve to appease social discontent in some countries) is likely in 2017. Resultant inflation and debt implications set up a very different potential opportunity set for investment strategies.

For investors, trends they have come to accept as the norm over recent years should be reassessed for impact and risk. By their very nature, shifts in the investment environment can be fraught with hazards. Translating rhetoric into action around fiscal expansion and infrastructure spending could spawn a virtuous cycle of increased spending, rising confidence, and perhaps reination of the US as the global economic engine. At the same time, faster inflation and rising interest rates will put pressure on bonds.

In the quest for equity growth, we believe investors should be particularly thoughtful about which sectors they choose, as certain areas of the market have been bid up to uncomfortably high valuations. Some investors may need to diversify to allocations that could benefit from a rising rate environment. For those seeking yield, the evolving profile of bond and equity markets will demand a more nuanced and cautious approach.

Meanwhile, patterns of volatility suggest heightened risks for equity markets in 2017, and the Federal Reserve’s capacity to temper extremes appears increasingly stretched. As such, investors should revisit their volatility management and currency hedging strategies. Tail risk hedging, dynamic or tactical overlays that deliver alpha or reduce risk, or other diversifiers can help to prepare for the uncertain environment ahead.

Overall, we see 2017 as a year that will continue to be punctuated by significant, and at times unpredictable, political and economic change. Investors will need to consider how best to position their portfolios for the opportunities and risk these bring.

Rick Lacaille
Chief Investment Officer

State Street Global Advisors 03
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THE OUTLOOK FOR THE MAJOR ADVANCED ECONOMIES
GLOBAL OVERVIEW

As the calendar flips to 2017, the world economy faces ongoing structural and cyclical challenges that could perpetuate the anemic and fragile global environment. Global growth has slowed progressively since 2010.

Following a thoroughly lackluster 3.1% expansion in 2015, the world economy is hovering close to that level again in 2016. Even with what looks likely to be a dose of fiscal stimulus in the US (and possibly elsewhere) it is unclear whether the world economy can avoid another sub-par performance in 2017. If not, that would make six consecutive years of below-average growth, an unusual event that has not happened since the early-to-mid 1990s.

The recovery from the global financial crisis (GFC) is approaching eight years old, not an age when cyclical forces are likely to strengthen on their own. On the contrary, growth has slowed in the US, and virtually ground to a halt in Japan. The UK appears unlikely to escape entirely unscathed from the uncertainties surrounding Brexit. And while Europe has gained a little traction, it seems unable to break out to the upside with some of its major economies hampered by a lack of competitiveness and no mechanism to fix it.

Meanwhile, in the emerging world, China continues to slow. Capital outflows are weakening exchange rates, increasing the burden of hard-currency debt. Terms of trade have deteriorated despite some recent uptick in commodity prices. Debt deleveraging and slower credit growth are restraining domestic demand. And, financial conditions are tightening as the Fed gradually normalizes interest rates.

In order to break through these many constraints on growth, we’ll need some policy support. But while the recent US election strongly suggests a change in policies is afoot, it remains highly uncertain for now what those changes will be.

On the one hand, things such as fiscal stimulus — particularly in the shape of high-multiplier infrastructure spending — could boost US economic growth, at least temporarily. On the other hand, any meaningful shift toward protectionism in the trade arena or an overly aggressive immigration stance would have long-lasting detrimental effects, triggering a bad combination of lower growth and higher inflation that leaves everyone worse off.

In short, while some fiscal stimulus won’t hurt and would indeed be quite welcome, what the world’s economies truly need is a refocus on the type of structural reforms that can boost long-term productivity and reignite self-sustaining higher growth.
World Trade – Globalization Under Fire

In the decade before the GFC — which broadly corresponds to the blip in productivity growth — world trade grew at an average 6.7% a year as value chains linking suppliers in many countries formed. This effectively forced firms to become super-efficient because they faced global, not just domestic, competition.

Since the GFC, world trade has grown at just 3.0% a year, suggesting that fewer such chains are forming. This makes the recent opposition to openness that now threatens a number of major trade agreements particularly serious. While freer trade is clearly not good for everyone, it has lifted hundreds of millions out of poverty in the developing economies, and benefits consumers in the advanced ones.

The balance to be achieved is one that acknowledges the demands of electorates for policies that protect those who lose out, while recognizing that the world economy will not reach its full potential without realizing the benefits of competitive advantages.

Productivity

There are a number of hypotheses ranging from simple mismeasurement to a dire “progress is over” to rationalize slowing productivity growth. The former reflects the difficulty of measuring productivity in an increasingly service-oriented economy. The latter — proposed by economist Robert Gordon — argues that productivity gains reflect innovation, and today’s innovations have much shorter-lived effects than those of the past. For example, the internet, computers, and mobile phones boosted productivity growth for just eight years (1996–2004), while electricity and the internal combustion engine together with spin-offs such as airplanes boosted productivity growth for 80 years (1890–1972).

OECD Labor Productivity

<table>
<thead>
<tr>
<th>Year</th>
<th>1980</th>
<th>1990</th>
<th>2000</th>
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<td>Percent</td>
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<tr>
<td>1980</td>
<td>1.5</td>
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<td>2015</td>
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Source: OECD, as of 31 December 2015
Running on Empty

This confluence of negative forces is occurring against a backdrop of limited monetary policy ammunition. The world’s major central banks have been almost solely responsible for fostering growth during the recovery and now have little capability to do more.

Moreover, until very recently, governments have been generally reluctant to employ fiscal policy, at least in a transformative way. However, fiscal policy has turned expansionary in Canada and Japan, targeted fiscal measures are being employed in China, and plans to balance the budget by 2020 have been abandoned in the UK.

The Trump victory has raised hopes of more meaningful stimulus in the US, while pressure to increase fiscal spending in Europe may arise from efforts to counter populist political movements.

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Global Trade Slowdown

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- World Trade
- GDP

Source: IMF, as of 31 December 2015
US – Fed to Make Move
Yet again, the US economy started the year slowly, with GDP rising just 0.8% (annualized) in the first quarter of 2016, as a slowdown in consumer spending, drag from inventories, and outright decline in business investment offset improvements in government purchases and housing.

But unlike previous years, there was no major second-quarter rebound, as GDP rose an uninspiring 1.4%. Third-quarter growth then surprised slightly to the upside at 3.2%, with inventories turning positive after five consecutive negative contributions.

Even though consumer spending, government purchases, and residential construction should continue to advance, the current global environment augurs poorly for exports and the orders data provide little encouragement on business investment.

Notwithstanding the better-than-expected third-quarter GDP print, the slow start means that GDP growth may come in at about 1.5% for 2016. That is about one percentage point lower than the last two years and even with growth accelerating modestly in 2017, it barely exceeds 2.0%.

The Federal Reserve eased aggressively in response to the GFC and has maintained an extremely easy policy since. But as the labor market continued to tighten, it ended the asset purchase program, began assessing the level of policy rates on a meeting-to-meeting basis, and ultimately hiked the federal funds range by 25 basis points to 25–50 basis points in December 2015.

The Fed appears eager to maintain the thread of the tightening cycle, but it has been frustrated by a combination of weak data, financial market volatility, and uncertainty about conditions overseas.

However, we believe conditions will allow the Fed to increase rates by another 25 basis points in December 2016, and make two more such 25 basis points moves in 2017. This would leave the funds target at 1–1.25% by the end of 2017, which is also in line with the Fed’s latest thinking.

Tight labor market stirs wage inflation

The chart shows the US Average Hourly Earnings and US Employment Cost Index from 2010 to 2016. The data indicate an increase in wage inflation as the labor market tightens. The source is IMF, Oxford Economics, SSGA Economics Team.
Trade
Donald J Trump’s election as the 45th President of the United States implies radically different economic policies, most notably on trade and the budget. While both presidential candidates opposed the Trans-Pacific Partnership (TPP), Trump also suggested he would seek to renegotiate or withdraw from NAFTA (North American Free Trade Agreement) and direct his Treasury Secretary to declare China a currency manipulator, a move that could ultimately lead to tariffs on Chinese imports.

However, while TPP and TTIP (the Trans-Atlantic Trade and Investment Partnership) are likely moribund, Trump will probably tread carefully on trade because scrapping NAFTA and/or imposing tariffs would lead to higher prices for a whole range of consumer goods, and possibly even spark retaliatory measures that could threaten American jobs.

Tax
Trump’s tax and expenditure proposals imply a substantial fiscal expansion. While both candidates proposed additional spending on infrastructure, Hillary Clinton also called for higher taxes, especially on the top one percent of household incomes. Trump would lower the top rate of personal income tax from 39.6% to 33.0%, cut the statutory corporate tax rate from 35% to 15%, and allow corporations to write off (depreciate) the cost of capital expenditures immediately rather than over an extended period of time.

Because Trump’s policies correspond closely to those of House Speaker Paul Ryan, and the Republicans control both the House and the Senate, there would appear to be every opportunity to reduce personal and corporate tax rates (although immediate, full depreciation may prove a little too radical). This would provide a near-term boost to consumption and investment, but would do so when the economy is close to full employment. This raises the specter of inflation and the need for the Fed to raise interest rates more quickly than previously anticipated.

Trillions
During the legislative process, proponents are likely to argue that the boost to the economy will be sufficiently large that the tax cuts pay for themselves. This was the argument used by President Reagan in the early 1980s. It did not work then — the deficit blew out and Reagan was forced to reverse course in 1986 — and it won’t work now. Indeed, the Committee for a Responsible Federal Budget estimates that Trump’s programs will add $5.3 trillion to the national debt over the next decade.
Europe – More of the Same

After crashing during the Global Financial Crisis (GFC) and double-dipping in 2012, the eurozone economy has been in expansion mode since the second quarter of 2013. A combination of monetary stimulus, a lower exchange rate, and lower oil prices allowed the recovery to gain a little traction in 2015, when Gross Domestic Product (GDP) rose 1.9%.

However, economic growth has stubbornly refused to accelerate further. Moreover, we do not expect it to. We anticipate a slight deceleration to 1.5% in 2016 and 1.2% in 2017, partly reflecting some modest fallout from the UK’s decision to leave the European Union.

With Germany highly competitive, France less so, and Italy even less so, it is not surprising that cyclical conditions vary widely among the Big Three. The recovery has been solid (albeit unspectacular) in Germany, lackluster in France, and non-existent in Italy. In terms of industrial production, which better reflects the chronic problems posed by relative competitiveness because much of GDP is non-tradable, the differential is even starker.

Since an abortive attempt to raise policy interest rates in mid-2011, the European Central Bank (ECB) has eased progressively, with the deposit rate steadily reduced to -40 basis points in March 2016.

Moreover, it introduced a genuine quantitative easing (QE) program that it subsequently extended. Then, in March 2016, it announced a range of new measures. These latest efforts include raising the quantity of asset purchases to €80 billion a month, adding corporate bonds to the assets eligible for purchase, and announcing four new 4-year targeted long-term refinancing operations (T-LTROs).

Further adjustments are possible, but will likely be limited to the asset-purchase program as ECB President Mario Draghi appears to have ruled out any further interest rate cuts.

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Since the Low of 2009

<table>
<thead>
<tr>
<th>GDP</th>
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<tbody>
<tr>
<td>Germany</td>
<td>+15.1%</td>
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<tr>
<td>France</td>
<td>+8.4%</td>
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<tr>
<td>Italy</td>
<td>-0.9%</td>
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<tr>
<th>Industrial Production</th>
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<tbody>
<tr>
<td>Germany</td>
<td>+26.1%</td>
</tr>
<tr>
<td>France</td>
<td>+5.8%</td>
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<tr>
<td>Italy</td>
<td>+2.6%</td>
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</table>

Source: IMF, Oxford Economics, SSGA Economics Team
UK – Flirting with a Hard Brexit

In the UK, growth is expected to slow as the decision to leave the EU delays construction projects, capital spending plans, and hiring decisions. However, we do not expect the economy to fall into recession, with GDP forecast to rise 1.8% in 2016 and 0.8% in 2017. This compares to pre-Brexit projections of around 2.0%.

The Bank of England responded to the referendum result by cutting the Bank Rate 25 basis points to 25 basis points in August, as well as resuming asset purchases. A further cut to around 5–10 basis points is certainly possible if conditions warrant, but the economic resilience seen thus far suggests the Old Lady will keep the second move in her back pocket for now.

The long-run implications of Brexit are hard to gauge because they depend critically on the nature of the new relationship between the UK and EU, and formal negotiations on that are not set to begin until the first or second quarter of 2017.

The UK would like to retain access to the single market, while scrapping the supremacy of EU law, free movement of people, and contributions to the EU budget. Needless to say, that is unlikely. Moreover, joining the European Economic Area (the Norway option) does not appear to work well for Britain. And negotiating a series of bilateral trade deals (the Swiss option) will take much longer than the two-year window granted by Article 50, especially given the UK’s lack of trade negotiators.

Rhetoric from Prime Minister Theresa May seems to suggest that a hard Brexit (reverting to World Trade Organization status) is more likely than a soft one.
Japan – Still Shooting Arrows

Japan has suffered one recession since the inception of the policy known as Abenomics in 2013. It is currently flirting with a second; the economy is at a virtual standstill. The so-called three arrows of Abenomics — monetary stimulus, fiscal stimulus, and structural reform — have had little discernible effect on growth or inflation since their introduction.

In an attempt to restart growth, Prime Minister Shinzo Abe announced a fiscal package in early August, which contained about ¥7.5 trillion of fresh-water spending (spending that directly stimulates the economy). The government projects a 1.3% boost to GDP over the near term, but we expect a more modest effect that leaves growth at just 0.5% in 2016 and 0.9% in 2017.

Firing the second arrow of fiscal stimulus is appropriate; providing a further nudge to aggregate demand that tightens the labor market and potentially generates some much-needed wage inflation seems worth trying.

But, firing the third arrow of structural reform must also be a priority. That has the potential to generate efficiencies in large sectors of the economy, thereby boosting productivity and the trend rate of economic growth. Unfortunately, such reforms generally inflict short-term pain for long-term gain, making them the most difficult for politicians to make.

The Bank of Japan (BoJ) continues to fire the first arrow of Abenomics. In early 2016, it introduced Quantitative and Qualitative Easing (QQE) with a Negative Interest Rate. This involved a tweaking of previous asset purchase programs in which the outstanding balance of each financial institution’s current account (reserves) would be divided into three tranches, one of which would be subject to an interest rate of -0.1%.

Unfortunately, even this had little positive effect, prompting the BoJ to conduct a comprehensive assessment of its policy actions, and ultimately adopt a new policy framework — yield curve control.

Specifically, it added a new target of zero percent on 10-year government securities. This partially reflected a desire to prevent an excessive flattening (inversion) of the yield curve that compromised bank, insurance company, and pension fund earnings, and partially the growing impracticality of ever increasing the size of asset purchases.

While the BoJ has not ruled out further changes to short-term rates and asset purchases, it seems that the primary focus will now be yield curve control.

Leading to Estimated GDP Growth of:

¥7.5 TRILLION Additional Spending

0.5% in 2016

0.9% in 2017
While some fiscal stimulus won’t hurt and would indeed be quite welcome, what the world’s economies truly need is a refocus on the type of structural reforms that can boost long-term productivity and reignite self-sustaining higher growth.
THE OUTLOOK FOR EMERGING MARKETS
Will They Ever Re-emerge?

That the global economy has failed to return to its pre-crisis pace of growth is well known. This deceleration has been remarkably broad-based, and Emerging Markets (EM) have lost much of their shine in the process. They had shone particularly brightly through the 2000s — a period that could easily be dubbed the Emerging Markets decade.

The EM growth premium (the positive growth differential relative to advanced economies) widened steadily to an all-time high of 5.8% in 2007-8. But by 2010, as the advanced economies enjoyed a post-crisis rebound, this performance gap narrowed to 3.6%. By the end of 2015, it stood at a mere 1.5%, the lowest since the Asian financial crisis of 1997. Put differently, the world has slowed, but the slowdown has been particularly obvious in EM.

Generalizations can be misleading, however. The performance range across the EM universe is extraordinary, not only far greater than anything observed among advanced economies but also greater than had been the case before the global financial crisis. For instance, violent conflicts in the Middle East mean Libya’s GDP is now less than a third of what it was in 2010; Syria’s is less than half. These are not large economies, but the magnitude of the downturn is staggering. Among the bigger Emerging Markets, plunging commodity prices left Russia and Brazil in the midst of their worst slumps in decades.

Every commodity-exporting country is feeling the pain: there will be virtually no growth in South Africa, Nigeria, or Mongolia in 2016. And while this sounds weak, it doesn’t sound entirely disastrous until placed in the context of Nigeria’s 8.9% average annual growth during the 2000s or Mongolia’s 11.1% growth during 2010-14.

Implications of the Trump Presidency for EM

President-elect Trump’s campaign promises indicate a more protectionist stance on trade and large-scale profit repatriation that would tend to be negative for EM assets because of implied dollar strength and lower export growth.

On the other hand, the presumed widening of the US budget deficit should tend to weaken the dollar; additionally, political realities may serve to keep protectionist tendencies in check.

Notwithstanding a sharp post-election escalation in inflation expectations, the Fed could choose to tolerate an inflation overshoot for some time, so it is unclear whether monetary policy will tighten more than previously forecast, at least through 2017. This should cap dollar appreciation and perhaps soften the detrimental impact on EMs.

The Trump victory means heightened uncertainty and intensifying headwinds for EMs, which is why the quality of the domestic policy response (read structural reforms) becomes even more critical; differentiation within the EM universe remains key to investment success.

Developing Economies’ GDP to Improve in 2017

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP Growth</th>
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<tbody>
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<td>5.3%</td>
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<td>2013</td>
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<td>2015</td>
<td>3.8%</td>
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<td>2016</td>
<td>3.8%</td>
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<td>2017</td>
<td>4.1%</td>
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Source: IMF, Oxford Economics, SSGA Economics Team. Projected characteristics are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.
India

Despite some unexplained inconsistencies in its new national accounts data, India’s economy is undeniably powering ahead, with growth projected at 7.4% in both 2016 and 2017. India has been a big beneficiary of low oil prices. This has facilitated a moderation in structurally high inflation and allowed repeated interest rate cuts by the central bank, thus supporting private consumption.

The problem for both China and India, however, is the sustainability of their growth, and growth models. India’s recent outperformance has been heavily consumption-driven, with manufacturing and investment far weaker than one would expect in an economy growing at such a pace.

Having accelerated sharply in the mid-2000s, the share of fixed investment in India’s GDP peaked in 2008 and has since declined by roughly five percentage points. Exports have followed a similar pattern, suggesting little (if any) improvement in the country’s international competitiveness.

By contrast, private consumption now accounts for a larger proportion of India’s GDP than at any time since the early 2000s. A large, fast-growing population and extremely low levels of household indebtedness, alongside a steady broadening of financial services provision, suggest there may well be more room for consumption-driven growth. But this is unlikely to be the sort of transformative expansion that would propel India into a global manufacturing powerhouse.

The good news is that India’s government is trying to push through the sort of structural reforms that could also lift productivity and encourage a positive supply response. While we are skeptical of the most optimistic estimates of the positive growth implications of the goods and service tax (GST) expected in 2017, a more streamlined taxation system would speak to improved operational efficiencies, less red tape and general ease of doing business.

Ongoing efforts to bring the sizable cash economy “into the open”—including through the recent demonetization of certain high-value bank notes—should also broaden the tax base and help alleviate perennial fiscal deficits. While none of these measures is a game-changer in and of itself, the accumulated benefits of such reforms could be sizable over time.

China

Chinese policymakers appear to have successfully maintained the economy on a soft-landing path. It seems likely that the lower end of the growth target for 2016 of 6.5% will be achieved, if not exceeded.

China has the opposite challenge. In a sense, one could say the country is now a victim of its earlier success. Aggressive productive capacity expansion throughout the 1990s and the 2000s turned China into the world’s largest exporter; its share of world merchandise exports increased from 3% to 10% during the 2000s and escalated further to about 13% by 2015. No other country even comes close; the US is second with 9.2% (and modestly rising), while Japan’s share is less than 4.0% (and modestly falling).

However, China is now running into an unusual (if not unexpected) problem. The growth in China’s potential output has outpaced global demand for Chinese goods. Nor does this look likely to change any time soon, meaning China is facing a double-break on growth, both from exports and from associated investment. And yet, if any country stands a chance to engineer a transition from export-led to consumption-driven growth, it’s China, given its large domestic market.

Ultimate economic success will depend on the quality of policies put in place. In at least one respect—trade policy—it is worth noting China’s apparent continued commitment to regional trade integration at a time when other countries may be moving in a more protectionist direction. It will likely prove the wiser decision in the long run.
Closing the BRIC Gap

There are pockets of good news elsewhere. Taken together, ASEAN (the Association of Southeast Asian Nations) has over 600 million people whose GDP has grown by an average of 4.9% a year since 2012.

In fact, in this time the region has essentially closed the negative performance gap with the BRICs, the first time this has happened since the Asia Crisis decimated the economies of Indonesia and Thailand.

What does this all mean for the EM outlook? One thing is certain; performance will continue to vary greatly from country to country. This means that investors should take a differentiated approach to enhance potential outcomes.

Secondly, EMs as a whole are still likely to grow faster than their advanced economy counterparts. Out of every dollar of additional GDP created in the world economy between now and 2020, about 58 cents will originate in EM. Despite risks, it is not a part of the investment universe that can be ignored.

Finally, one cannot overemphasize the importance of good economic policies and stable politics. Many of the common favorable trends of the past two decades — namely, rapid labor force growth and globalization — are at the very least stalling and sometimes going into reverse.

With little low-hanging fruit left to harvest, the onus of reinvigorating growth rests squarely on structural reforms, steps taken to enhance human capital, to solidify the rule of law, and to spur innovation. It’s a message all countries would do well to heed.
2017 is likely to see a continuation of the backlash against the forces of globalization. The integration of global product, labor, and capital markets has contributed to higher economic growth globally, but socioeconomic disruptions on the local and regional level are generating political reaction. Three potential, inter-related factors could influence policy outcomes:

### 01 Protectionism and Governance
The most prominent and immediate victims are the large extra-regional trade agreements, such as the Trans-Atlantic Trade and Investment Partnership and the Trans-Pacific Partnership. Less international policy coordination and weaker global governance look likely. This could impact markets in the event of an economic or geopolitical shock as it will be harder to restore market confidence if global rules are continually undermined. Those economies most exposed to globalization have the most to lose.

### 02 Populist Politics
In developed markets, the current populist wave manifests in xenophobic and anti-business sentiment. Policy outcomes are not only protectionist but typically less supportive of market dynamism and competitiveness. They may disincentivize the investment needed to alleviate major structural challenges such as low productivity growth. By contrast, few EM countries appear able to accelerate reform momentum, partially due to weak global growth that limits the rewards of reform.

### 03 Fiscal Stimulus
There is growing recognition in advanced economies that monetary policy is reaching its limits and more fiscal intervention is needed. Public sentiment and populist pressure is adding to momentum toward more fiscal expansion and infrastructure spending. The US appears likely to concentrate fiscal stimulus on tax cuts. If poorly designed, they may not translate effectively into higher growth. Infrastructure spending can also be slow to make an impact. It is likely that most national politics will be unconducive to larger fiscal reform beyond short-term measures.

#### REFORMS
Policymaking in emerging markets has not suffered as much as in the developed world. Globalization has largely benefited those countries that have integrated into global markets, so there are fewer backlashes. At the same time, weaker global growth lessens the incentive for difficult reforms ahead.

#### KEY ELECTIONS
In 2017, notable elections to take place are in Europe and Asia. None of the elections are likely to bring a positive reform momentum, but each holds the risk of a destabilizing populist and/or Eurosceptic surge. Across Asia, a major policy reversal is unlikely, but could take place against a tense domestic political backdrop and therefore have market impact. Elsewhere, 2017 is relatively quiet for emerging markets, where only Iran and Argentina could deliver electoral surprises.

#### EMERGING MARKETS
Coping with a Stronger Dollar
Many emerging markets face the challenge of the gradual rise in US rates and a stronger dollar. Even countries without a pegged currency could be forced to tighten monetary conditions to limit exchange rate depreciation and inflation. Aside from China, more emerging markets are likely to constrain fiscal spending than expand budgetary outlays.
The inauguration of Donald Trump as US President could lead to new geopolitical tensions. Adversaries, such as North Korea or Iran, possibly even China, could seek to ‘test’ the resolve of the new US administration. This raises risks of misjudgment and crises that could lead to temporary asset price shocks.

**BRAZIL**
- **Entitlement Reform** Reform of entitlements, including raising the retirement age and slowing rising costs of benefits by de-indexing from minimum wage
- **Telecoms** Liberalization and streamlining of telecoms industry

In 2015, it was Grexit and in 2016, it was Brexit. In 2017, the Eurozone crisis could revive as Italy, Greece, and Portugal struggle to meet fiscal targets. The Brexit process will generate volatility as negotiations unfold. Elections (see below) also raise the risk of downside scenarios, as does a possible loss of confidence in the US security alliance.

**INDIA**
- **Banking Sector Reform** Consolidation and professionalization of state-owned banks
- **Subsidy Reform** Reduction of wholesale fuel subsidies
- **Labor Market** Simplification and relaxation of stringent labor regulations

In the absence of US involvement, the Syrian conflict could escalate. This could raise questions over stability in Turkey, which may fail to maintain the easing of refugee pressure, or Western sanctions on Russia.

**RUSSIA**
- **Business Climate** Goal to move into top 20 of World Bank’s Ease of Doing Business Index by 2018, requiring depoliticization of judiciary and cutting of red tape
- **Pension Reform** One pressure point of low oil prices is the public pay-as-you-go system, which will require higher retirement age

Although Latin America is generally exhibiting resilience, Venezuela’s bankruptcy and political change pose key risks. Another sovereign default could be relevant to both bond and commodity markets.

**INDONESIA**
- **FDI Opening** Sector-by-sector relaxation of barriers to foreign direct investment
- **Labor Market** Liberalization of labor regulations

In 2015, it was Grexit and in 2016, it was Brexit. In 2017, the Eurozone crisis could revive as Italy, Greece, and Portugal struggle to meet fiscal targets. The Brexit process will generate volatility as negotiations unfold. Elections (see below) also raise the risk of downside scenarios, as does a possible loss of confidence in the US security alliance.

**FRANCE**
- **Presidential & Parliamentary** Winner’s view of EU and ability to push economic reforms; performance of extreme-right candidate Ms. Le Pen
- **April-June**

**IRAN**
- **Presidential** Failure of Rouhani to secure re-election could lead to doubts about nuclear agreement and deeper engagement with the West
- **June**

**ARGENTINA**
- **Parliamentary** Test of support for President Macri’s reforms
- **October**

**NETHERLANDS**
- **Parliamentary** Mainstream coalition or inclusion of extreme-right wing into government and appeal of Euroscepticism
- **February or March**

**GERMANY**
- **Parliamentary** Stable coalition or hung parliament and performance of AfD party
- **September or October**

**THAILAND**
- **Parliamentary** First election since new constitution was approved by referendum in 2016. Uncertain outcome
- **October – December**

In 2015, it was Grexit and in 2016, it was Brexit. In 2017, the Eurozone crisis could revive as Italy, Greece, and Portugal struggle to meet fiscal targets. The Brexit process will generate volatility as negotiations unfold. Elections (see below) also raise the risk of downside scenarios, as does a possible loss of confidence in the US security alliance.
For global investors, 2017 is shaping up to be another year where top-down global, political, and policy developments will have an outsized impact on investment returns.
Protectionism on the Rise

Donald Trump's protectionist message and the UK's Brexit vote are perhaps just the most explicit examples of a reversal in the post-war trend toward globalization as uneven gains from trade become an incendiary political issue in many countries.

Meanwhile, with monetary policy perhaps at its limits, fiscal policy is likely to come into greater focus in 2017 as the preferred policy lever of governments to prop up subdued global growth, setting up a very different potential opportunity set for investors.

Proposed global trading agreements are losing support; the 12-nation Trans-Pacific Partnership (TPP) is opposed by the incoming Trump administration and seemed unlikely to get through the US House of Representatives under either election outcome. Meanwhile, a trade deal between the EU and Canada that was seven years in the making almost collapsed in October.

Impact on Trade and Growth

Hard data points to global trade and capital flows holding back global growth; imports have fallen as a share of GDP for four consecutive years for the 20 largest economies. Moreover, the number of protectionist trade measures imposed globally in 2016 is five times as many as through the same period last year.

A broad reversal in global trade is almost certainly a negative for global growth and is consistent with our modest return forecasts for global equities. For S&P 500 companies, 30% of revenues are derived from overseas operations, so limitations to growth in foreign markets will make it difficult to reverse the mostly negative trend in earnings over the last two years.

Within certain local industries, however, protectionism will be beneficial as firms become more competitive domestically, just as it will be a drag on companies with substantial overseas exposure.

POLICY SHIFT:

Game Changer for Investors?

As 2017 unfolds, the central role monetary policy has played to support markets and suppress yields will again be evident. Both the ECB and BoJ have acknowledged that low and negative rates impair savers and ECB officials recognize their adverse impact on lending and bank profits. However, with inflation well below target, the odds are still good that some further monetary policy easing is on tap in the eurozone and Japan in 2017. The question arises though: what additional tools, if any, are available to global central bankers if what has already been tried no longer works?

One risk to investors is a possible reversal of the lower-for-longer thematic that has supported bonds and bond-like proxies in the global search for yield. For a taste of what that could look like if expectations are not well managed, an expected ECB announcement on extending its asset purchase program that failed to materialize in September was quickly followed by higher US and German 10-year rates and falls in high-yielding equities and REITS and, to a lesser degree, growth assets generally.

This dynamic repeated itself immediately following the US election as bond yields surged on expectations that unified Republican control of government sets the stage for deficit-financed tax cuts and infrastructure spending.

The flip side to the sell-off in bonds was seen in equities, with an immediate post-election bounce. Equities rallied in anticipation that these same policies, along with some form of regulatory relief, could jump-start growth. It remains to be seen whether or not policymakers will fulfill these expectations and whether or not these policy prescriptions might resonate with leaders outside of the US.
Fiscal Policy Focus
As the wisdom of ultra-loose monetary policy support is being questioned, the discussion has shifted to the worth of government approaches such as those involving taxing, spending, and in all likelihood, a touch of borrowing for good measure.

Canada has announced a substantial infrastructure-focused fiscal stimulus package worth CAD$120 billion over 10 years, while Japan and China are among others to ramp up fiscal measures.

Even the International Monetary Fund (IMF) has endorsed increased government spending, recently stating that fiscal support “remains essential for generating momentum and avoiding a lasting downshift in medium-term inflation expectations.”

In the United States, the election of Donald Trump brought pledges of additional infrastructure spending of up to $1 trillion. UK policymakers appear to be targeting infrastructure and housing investment to subdue any economic turmoil related to Brexit.

And, while eurozone nations are nominally restricted as to their levels of deficit spending, additional leeway to countries such as Spain and Portugal has been allowed.

So, fiscal policy seems to be the wave of the near-future, but how much faith should investors put in the government purse and what areas of the market is it likely to impact?

Lorne Johnson,
Senior Portfolio Manager, Investment Solutions Group

Investment Impact
There are a number of angles from which a pivot toward fiscal policy could impact investors’ portfolios. In this case, infrastructure projects appear overwhelmingly favored and heavy equipment manufacturers and materials companies should benefit.

But be wary, as fiscal policy works over longer periods and, unlike monetary policy with its monthly and quarterly pronouncements, it may not hold the same level of investor attention as funds are disbursed in fits and starts. We are already starting to see some of these companies bid up.

To the extent that sizable fiscal programs are crafted into legislation, that would likely lead to upward pressure on borrowing costs, though from a very low base.
Opportunities and Risks

Our overall positioning as we head into 2017 is relatively risk neutral, with some pronounced underlying exposures. Our current positioning reflects some of the opportunities picked up by our models and analysts, as well as some of the concerns. We are more favorable to US equities versus Europe and APAC, and we maintain an overweight to credit versus term structure within fixed income.
Current Portfolio Positioning and One-Year Forecasts

**US EQUITIES**

Though our forecast return for US large-cap equities in 2017 is in the low single-digits (3%), we see some potential for upside and enter the year with an overweight position.

- After five consecutive quarters of negative earnings growth for the S&P 500, it turned positive in the third quarter of 2016 and we expect it to remain positive in Q4.
- Modest earnings growth for 2017 as the impact from lower energy prices abates. Better earnings growth could help offset relatively rich valuations.
- A strengthening US dollar in the first part of the fourth quarter of 2016 is one risk to a return to positive earnings; 30% of S&P 500 revenues are derived outside the United States.
- Fed interest rate increases should benefit Financials, boosting interest margins, but may limit sectors such as Consumer Discretionary that have benefited from an easier borrowing environment. Financials should also benefit from the looser regulatory stance anticipated from a Trump administration.
- Materials, Industrials, and Utilities could benefit from fiscal stimulus through potential new infrastructure spending.

**EMERGING MARKET EQUITIES**

- Our forecast for emerging market equities is 6% for 2017 on a stronger growth outlook as both Russia and Brazil emerge from recession and as the negative impact of falling commodity prices has abated.
- One important risk would be a faster-than-expected pace of global monetary tightening. This could result in relative currency underperformance for global investors and companies having difficulty refinancing in this highly indebted space.
- We currently hold a neutral position in Emerging Market equities with a look to go overweight in 2017 if improvement in the sector continues.

**INTERNATIONAL EQUITIES**

- Our 1-year forecast for developed equities outside the US is comparable to our US forecast at 3.3%.
- For our tactical positioning, we remain cautious toward international equities with underweight positions in both developed European and Asia Pacific regions.
- Our underweight to these regions in part reflects a perceived decline in the efficacy of monetary policy support in the eurozone and Japan.
- Europe is also likely to see downside risk as the details of a negotiated UK exit from the EU start to take shape.
- Financial stocks in both the eurozone and Japan seem set to remain volatile with continued downside risk in 2017 as the current negative interest rate environment persists.
GLOBAL GOVERNMENT BONDS

Near-record low yields provide a poor starting point from which to invest in global fixed income markets where an estimated $12 trillion in securities carried negative yields at times in 2016. Without price appreciation from even lower yields, this group of securities can only provide negative returns going forward.

• For US 10-year bonds we forecast a 1-year return of 0.3%, and a -0.3% return for developed market government bonds outside the US.

• A risk to our return outlook is a shift in central bank policy that results in reduced expectations for future bond purchases. This scenario would likely result in large capital losses on sovereign bonds as rates rise globally.

• In our tactical positioning, we currently hold a neutral exposure to global bond duration in recognition of the current inherent risks and are on the lookout for signs that monetary accommodation will be ratcheted back in any sooner than currently priced.

CREDIT AND HIGH YIELD

We remain favorable toward US Credit and High Yield with 1-year forecasts of 2% and 5.1%, respectively.

• We hold overweight positions in both sectors in our tactical portfolios.

• We expect credit to continue to outperform government bonds in a rate-normalizing environment.

• In investment-grade credit, we hold our overweight position in intermediate securities to avoid excessive duration exposure.

COMMODITIES

While oil has made an impressive comeback since the early-2016 lows, a continued supply glut, and modest global growth will probably keep energy range-bound with a slight upward bias in 2017.

Precious metals, such as gold, should continue to do well in an environment with widespread negative global interest rates and a gradual return to higher levels of inflation.

Source: SSGA, as of 30 November 2016
Opportunities remain, but the evolving complexion of bond and equity markets demands a nuanced and cautious approach.

FINDING YIELD

Investment Ideas

TARGET HIGHER-RATED CREDIT
Higher-rated high-yield credit sectors offer more attractive compensation for prevailing risks.

DON’T DISMISS EMERGING MARKET DEBT
Long-term case remains attractive with better yield relative to other fixed income sectors.

SEEK YIELD SUSTAINABILITY IN EQUITIES
Look beyond traditional defensive sectors to Resources, Telecoms, and IT.
Almost a decade after the global financial crisis, investors continue to contend with slow global economic growth.

Unprecedented intervention in financial markets by monetary authorities, seeking to bolster fragile economies, has had a deeply depressing effect on yields. As we extend into the latter stages of the economic cycle, this backdrop of diminished yields looks set to continue.

Where does this leave investors eager to fulfill the income objectives of their investment strategy?

The search for yield over recent years has drawn many to high-yield bonds alongside dividend equity-focused strategies. But as the complexion of markets continues to evolve, we consider how, in 2017, the quest for yield is even more nuanced.

**FIXED INCOME**

Credit markets have proven a popular recourse for yield in the fixed income sector. In the US, the relative strength of the economy has made the perceived risk/return offered by US corporate bonds particularly attractive.

Over the last two years, there has been a steady and consistent flow of foreign buyers of US corporate bonds. The trend has been supported by lower expectations for improvement in the global economy, reducing the probability of a rise in sovereign debt rates.

Although yields on the corporate market are near recent lows, in comparison to the government bond market (see chart below) the additional spread, or yield over comparable duration treasuries, has proven to be more attractive.

In particular, the lower-rated parts of both indices, namely credits rated BBB in investment grade and CCCs in high yield, have provided better returns from both yield and price appreciation.

**Yield to Worst**

<table>
<thead>
<tr>
<th>Year</th>
<th>Yield</th>
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<tbody>
<tr>
<td>2015</td>
<td>5</td>
</tr>
<tr>
<td>2014</td>
<td>10</td>
</tr>
<tr>
<td>2013</td>
<td>15</td>
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<td>2012</td>
<td>20</td>
</tr>
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<td>2011</td>
<td>25</td>
</tr>
</tbody>
</table>

Source: Barclays. SSGA. As of 31 October 2016. The Barclays US Corporate Investment Grade Index measures the investment-grade, fixed-rate, taxable corporate bond market. The Barclays US Corporate High Yield Index measures the USD-denominated, high-yield, fixed-rate corporate bond market.

* Yield to Worst (YTW) is the lowest yield an investor can expect when investing in a callable bond.
Valuations Too Low?

Given how late we are in the credit cycle, has the search for yield driven valuations too low? Is it still prudent for yield-seeking investors to focus on the corporate bond market?

The short response, for the first half of 2017, is yes. A prime motivator for this is our expectation of continued lackluster growth (albeit enough to allow the US Federal Reserve to hike rates).

“The caveat: emphasis should be on the higher credit quality segment of the high-yield market, rather than further down the credit spectrum.”

Chuck Moon, Global Head of High Yield

A careful eye toward developments in energy- and commodity-related sectors is also warranted, given recent volatility.

Caution – Credit Risk Rising

The obvious attraction of corporate bonds is the additional yield offered relative to other fixed income instruments. Theoretically, higher risk premiums compensate for various risks — credit being dominant in the case of high-yield bonds and actual default being the greatest risk.

Although we believe that focusing on total returns is the correct way to manage corporate portfolios, we recognize that yield is a primary driver for some investors. Even then, however, the yield derived can be severely eroded from defaults – possibly resulting in permanent loss of principal or coupon payments.

Defaults are highly cyclical, with large variations over a business cycle. Defaults also vary greatly by ratings, with lower-rated defaulting at a much higher rate than higher-rated credit, even within the high-yield universe. The chart above right shows credit losses by the lower-rated sectors over time. Credit loss is a function of a default and the recovery rate after a default.

*The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.

The Importance of Credit

An investor reviewing the Option-Adjusted Spreads* (OAS) of the lower-rated sectors to those of earlier years could be tempted by the relatively higher spreads that CCC-rated bonds now offer. However, defaults have moved significantly higher in 2016.

Historical Credit Losses

Adjusting for credit losses gives even more insight. In the chart below we look at the OAS levels at 31 December of each year and deduct the credit losses incurred the following year. For the current levels, we assume the OAS levels as of 30 September 2016 and that credit losses decline over the next year by 20% from the levels reached by that date.

OAS Less Credit Losses

On this basis, CCC-rated bonds offer little above the potential credit losses and would require defaults to decline substantially in order to prove attractive.

In this environment, higher-rated high-yield credit sectors offer more attractive compensation for the risk of credit losses at current levels. This also provides some cushion if rates were to rise further than anticipated.
EMERGING MARKET DEBT

Emerging market debt (EMD) recovered strongly in 2016 as concerns around emerging markets, and China in particular, abated.

But with the US presidential election signaling a sell-off in developed market government bonds and a risk-off attitude toward emerging markets, what does the future hold for EMD?

Bond Yields in Emerging Markets

The EMD universe has expanded steadily over the last number of years, especially in the local currency (LC) space, becoming a large and diverse universe. This increasing breadth and depth has enhanced liquidity and increased the accessibility of the sector.

At the same time, active managers have underperformed consistently. What is particularly fascinating is the fact that underperformance is not the result of a single bad year or a Black Swan event. Instead, they have consistently failed to navigate one-off credit events, such as the Russia/Ukraine and Brazil sell-offs in recent years.

Does EMD Exposure Make Sense?

The case for a passive exposure to EMD LC then is compelling but what is the case for EMD LC as an exposure per se?

We contend that the long-term case is attractive, centered on the attractive yield relative to other fixed income sectors (see chart left).

EMD LC has traditionally been a volatile asset class, and this volatility is driven primarily by currency fluctuations. The chart below shows how EMD currencies have weakened steadily over the last number of years.

Following the sell-off in recent years, EMD currencies provide a more attractive entry point for long-term investors. The short term will likely see more volatility as US Treasury yields rise and the dollar strengthens but, as this market matures, we expect to see increased allocations from investors.

With political risk on the rise in developed markets, the case for a narrowing of the political risk premium between developed and emerging markets in the long term is persuasive.

According to Morningstar, the 30 largest active EMD LC fund managers tracking the flagship index JPM GBI-EM Global Diversified Index have significantly underperformed their benchmark.

Percentage of Underperforming Managers

Average Annualized Manager Underperformance

Source: SSGA, Morningstar as of 30 September 2016. Data based on the 30 largest funds in the Morningstar database having the JPM GBI-EM Global Diversified as their primary benchmark. Past performance does not guarantee future results. It is not possible to invest in an index.
EQUITIES

Valuation and Dividend Profiles
The equity market rally witnessed over the past six or seven years has been characterized by an unusual pattern of sector leadership. Stocks traditionally considered low-beta, and hence more defensive have, thus far, led the rally.

This is particularly true of long-duration sectors where cash flows are more bankable, dividend yield pay-outs high, and the risk of a cyclical drawdown in earnings low. The Consumer Staples, Utilities, and Health Care sectors very much fit this profile.

Valuations in these sectors have, consequently, become extended. On the other hand, more economically sensitive sectors have registered less emphatic shareholder returns and market ratings. The chart below illustrates this point by charting the historic valuations of high-dividend-yielding stocks within US Consumer Staples, the US Information Technology and US Financial sectors.

Clearly we are witnessing the greatest disparity in valuations between US Consumer Staples and more-economically sensitive sectors than we have seen for 20 years. In fact, the Price/Cash-Earnings multiple of US Consumer Staples has just reached 26 times — or a sub-4% cash-earnings yield — a paltry implied return from risk assets, by any measure. Valuations of this sort were last seen in 1998.

The market ratings of the Financial and Technology sectors, on the other hand, are much more modest, and well below their 20-year averages. From a value investing standpoint, unusually, there appears to be more margin of safety in less-defensive sectors.

Historic P/E Rating of Highest-Yielding Stocks
Source: CSFB Holt.

Shifting Dividend Payout Profile
There has also been a significant shift in the dividend payout profile across global sectors in recent years. The dividend contributions from traditionally more defensive sectors such as Telecoms and Consumer Staples have been on the wane, whilst more cyclical sectors such as Information Technology, Consumer Discretionary, and Energy have seen their contribution to total market yield rise.

This point is evident in the chart below, which ranks dividend yield in each sector in the Global Value Index relative to its 10-year median. The dividend yields on offer in those sectors are well above their 10-year median levels. These include Energy, Consumer Discretionary, Materials, and Technology. Those on the left-hand-side are below their 10-year median levels, including Health Care, Utilities, and Consumer Staples. Again, this suggests a potentially richer seam of dividend yield in lower-cashflow duration sectors.

MSCI World Value Index – Dividend Yield by Global Sector
Source: SSGA, Factset. The sectors shown are as of the date indicated and are subject to change. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future. The MSCI World Value Index captures large and mid-cap securities exhibiting overall value style characteristics across 23 Developed Markets countries.

ssga.com
Dividend Sustainability

The appearance of high dividends is not, however, necessarily indicative of actual delivery of yield, or indeed of dividend yield growth.

Scrutiny of the sustainability of yield is important. For example, the high dividend yield seen in the Energy sector in the Global Sector Dividend Yield chart opposite is partly a result of depressed valuations.

Sustainability is very much in question given the moribund nature of energy markets in the short term. Investors need to zero-in on earnings-to-dividend coverage ratios to assess sustainability of yield.

Excessively cyclical sectors will carry some risk of a weakening in earnings power as the economic cycle progresses, with the attendant risk of a cut to dividend pay-out ratios.

Where to Find Dividend Yield?

We see more sustainable dividend yields in the Resources, Industrials, and Information Technology sectors.

“And there are big differences in yield potential across regions. The Asia Pacific and eurozone regions are currently presenting some of the more attractive yield opportunities.”

William Killeen, Portfolio Manager, Fundamental Equity

Again, in these regions, valuations and yields in traditional defensive sectors are not compelling, so income investors must employ a more nuanced approach in their search for dividend yield.

More heterogeneous sectors currently present interesting opportunities. Ultimately, investors must weigh the yield opportunities in shorter-duration stocks against the maturity of the current economic cycle.

LOOK FOR DIVIDEND YIELD SUSTAINABILITY

Evaluate two essential factors:

1. **Fundamental strength of the business** — factors that serve to protect revenue and margins. While more cyclical stocks will likely see dividend ratios flex with the economic cycle, idiosyncratic company fundamentals such as market share, scale, brand power, cost leadership, pricing power and barriers to entry can create a more predictable path for earnings.

2. **Strength of the balance sheet** — the absence of significant financial leverage often allows a company to absorb earnings shocks without a significant cut to the dividend. Low leverage combined with a conservative dividend-earnings coverage ratio increases the potential for delivering a consistent yield through the cycle. The absence of leverage can often translate into a more equity-centric capital return ethos.
UNCOVERING GROWTH

The equity sectors set to thrive in the new reflationary regime.

Investment Ideas

THINK BEYOND YIELD

Look for opportunities to pivot to underappreciated and underpriced market growth areas.

WATCH GROWTH STOCKS

Poised to benefit from stronger-than-average earnings prospects and attractive valuations.

SECTOR-SPECIFIC FOCUS

Innovation will favor secular, non-GDP dependent growth in sectors such as Health Care and IT.
From Yield to Growth

Even before Trump’s election, we saw that equities still had room to run in this extended economic cycle, but that a re-rating of certain parts of the market was driving a change in sector leadership.

Strong corporate balance sheets, low core inflation, strengthening labor markets, and manageable consumer leverage all point to further growth for equities this year.

We think, however, that 2017 is the year equity investors will pivot from a strong focus on yield sectors and their stretched valuations to the underappreciated and underpriced growth areas of the market. Moreover, as clarity grows around how much of Trump’s growth agenda he can accomplish, certain sectors are likely to benefit more than others in a new, reflationary environment.

Given the basic equation of stock returns (see below), it is not surprising to see a shift from yield to growth. The extended low-growth, low-rate environment drove yield-hungry investors into low volatility, dividend-paying stocks, bidding up sectors such as Utilities and Consumer Staples and driving valuations to all-time highs (see chart right).

That momentum in low-growth bond proxies vexed active managers focused on fundamentals in 2016 — many of whom found the combination of lackluster growth and high valuations in Consumer Staples and Utilities unappealing. Consequently, the majority of active managers underperformed their indices, choosing to weather short-term underperformance with the view that fundamentals matter most in the long term.

A Turning Point?

However, we believe we have reached a turning point in the cycle where investors will be shifting away from high-yielding sectors because it will be difficult to eke out additional P/E multiple expansion going forward, especially in a reflationary environment. We already began to see some capitulation in the second half of 2016, with Utilities, Staples, and Telecom stocks retreating as Financials and more traditional growth sectors outperformed (for example, S&P 500 Technology stocks rallied 12.5% in 3Q 2016).

Instead, we think investors will increasingly focus on areas of the market that exhibit less cyclical, above-average earnings growth. Such steady growth stocks have been out of favor for as long as investors have been barbell-ed in high-yield bond proxy sectors and hyper-growth stocks (e.g. the so-called FANG stocks: Facebook, Amazon, Netflix, and Google).

From a fundamental perspective, growth stocks look poised to benefit from stronger-than-average earnings prospects, attractive valuations, and the potential for share dividends or buybacks, boosting all three variables in the total return equation. These companies could potentially benefit from less regulation, lower taxes and cash repatriation in the Trump administration. Time will tell.

Valuations of low vol stocks are at all-time highs

Price/Earnings Multiples

Average 12.7x

Current 19.5x

Source: Factset, CRSP, Bernstein analysis

Stock Math: Shifting Focus from Yield to Growth

\[
\text{Total Return} = \text{Valuation Changes} + \text{Earnings Growth} + \text{Capital Return}
\]

Valuation Changes
P/E Multiple Expansion or Contraction

Earnings Growth

Capital Return
Dividends, Stock Buybacks

State Street Global Advisors 35
New Sector Leadership
We believe companies with organic secular growth potential based on strong balance sheets, high free cash flow, innovation-driven business models, and managements focused on shareholder value should regain historical valuation premiums.

While bottom-up investors can find organic growth opportunities throughout the market, the chart below illustrates above-average long-term EPS growth rates for traditional growth sectors like Consumer Discretionary, Information Technology, and Health Care. While consensus estimated growth rates are likely too optimistic, we agree with the order of the sectors.

Going forward, the defensive Utilities, Telecoms, and Real Estate sectors will be challenged with low growth rates. Materials, Energy, and Industrials rallied on the initial news of Trump’s presidential victory, based on his campaign rhetoric around infrastructure spending.

Likewise, Financials benefited from Trump’s pledges to roll back regulation. Financials are undervalued on a price-to-book basis and could enjoy further upside in a reflationsary environment. We will watch these sectors closely throughout 2017.

Where to Look?
Looking at relative valuations, Health Care and Information Technology at the end of 2016 were the cheapest sectors versus history on relative forward P/E (see table opposite).

These sectors have exhibited sustainable growth throughout the tumult of the past decade, and attractive relative valuations create the possibility of P/E multiple expansion. At this point, we view the superior earnings growth and lower valuations of IT and Health Care as a winning combination.

Trump’s plans to reform the Affordable Care Act are still nebulous, but could result in relative winners and losers. Biotech and pharmaceutical companies, on the whole, look less vulnerable to the curbs on drug price increases that Hillary Clinton had championed, although pharmaceuticals tend to be more global and therefore more susceptible to a strong dollar and trade dislocations.

Growth-oriented biotechnology stocks have been trading at comparable multiples to pharmaceutical companies for the first time in history.

Technology shares, while initially under pressure immediately following the election, could also receive a boost from additional capital spending.

After bond proxy re-rating, earnings growth should drive sector returns

Source: Factset, as of 30 September 2016. The sectors shown are as of the date indicated and are subject to change. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.
### Innovation and Consumer Demand Tailwinds

In addition to strong fundamentals, we believe innovation gives a protective moat of secular, non-GDP dependent growth to sectors such as Health Care and Technology. New therapies for cancer or orphan diseases, for example, will command pricing power and strong earnings growth within Health Care.

Safer, smarter, more fuel-efficient ways to drive cars are innovations creating investment opportunities across sectors (for example, Technology, Industrials, Consumer Discretionary).

A further tailwind for growth is steady consumer demand. Strong momentum and a lack of “value” have contributed to the rise of Consumer Staples in the growth indices. Consumer Staples, for example, has posted low-single digit profit growth in the years since the Global Financial Crisis.

### Consider the Options

Investors seeking steady, Consumer Staples-like characteristics with above-average earnings growth and strong free cash flow have other options in traditional growth sectors of the market. For example, cable companies within the Consumer Discretionary sector exhibit Utility-like features: many consumers would be loath to turn off their in-home internet connectivity even in an economic downturn.

In a year of shifting political and policy signals, we believe relative valuations and earnings growth potential rather than yield will take on renewed significance for equity investors.

As a result, we think 2017 will be a time to recalculate the opportunities available in out-of-favor areas within growth sectors to improve the total return results of investors’ equity equation of valuation, earnings, and capital return.

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**Table: Valuation and Earnings Growth**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Price to Book</th>
<th>Price to Operating Cash Flow</th>
<th>Forward P/E</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current</td>
<td>Average</td>
<td>Upside</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>2.89</td>
<td>2.85</td>
<td>-2%</td>
</tr>
<tr>
<td>Cons Disc</td>
<td>1.59</td>
<td>1.08</td>
<td>-32%</td>
</tr>
<tr>
<td>Cons Staples</td>
<td>1.72</td>
<td>1.75</td>
<td>1%</td>
</tr>
<tr>
<td>Energy</td>
<td>0.67</td>
<td>0.84</td>
<td>25%</td>
</tr>
<tr>
<td>Financials</td>
<td>0.40</td>
<td>0.62</td>
<td>56%</td>
</tr>
<tr>
<td>Health Care</td>
<td>1.30</td>
<td>1.78</td>
<td>36%</td>
</tr>
<tr>
<td>Industrials</td>
<td>1.48</td>
<td>1.08</td>
<td>-27%</td>
</tr>
<tr>
<td>Technology</td>
<td>1.59</td>
<td>1.33</td>
<td>-16%</td>
</tr>
<tr>
<td>Materials</td>
<td>1.28</td>
<td>0.92</td>
<td>-28%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>1.17</td>
<td>0.99</td>
<td>-15%</td>
</tr>
<tr>
<td>Telecoms</td>
<td>1.00</td>
<td>0.95</td>
<td>-6%</td>
</tr>
<tr>
<td>Utilities</td>
<td>0.66</td>
<td>0.61</td>
<td>-7%</td>
</tr>
</tbody>
</table>

*Energy P/E distorted due to depressed earnings on commodity pullback.

Source: FactSet, Compustat, BoAML, as of 31 October 2016.
Volatility patterns suggest heightened risks for equity markets in 2017 and the Fed’s capacity to temper extremes appears increasingly stretched.

**POSITIONING FOR VOLATILITY**

Exogenous threats abound, making it increasingly harder for the Fed to contain market falls.

**MONITOR RISK**

**REVISIT TOOLS**

Consider strategies that tactically rotate portfolios between cash and higher-risk assets.

**MANAGED VOLATILITY**

Equity allocations and strategies with a lower volatility profile than the market.
Volatility’s Continued Presence

Bursts of volatility continued to unsettle markets over the course of 2016, with the US election cycle and Brexit showing just how sensitive the markets are to geopolitical surprises. These unusual patterns of volatility, alongside concern over the Fed’s ongoing capacity to collar market moves, suggest that downside protection strategies should be a key component of investors’ 2017 toolkit.

The Central Bank Option Strategy

As we head into 2017, the ongoing capacity of US Federal Reserve policies to contain extremes in market moves warrants consideration.

There has been a long-held belief that if a market crisis arises, the Federal Reserve stands ready to provide support — a theory dubbed the ‘Greenspan Put’ and later the ‘Bernanke Put’. This implicit support of market confidence has led to conclusions that the Fed has a third mandate of financial market stability, beyond the congressionally mandated objectives of maximum unemployment and price stability.

Financial stability does not only mean protecting on the downside, however. It can apply to ensuring markets do not become overheated, particularly in an environment of sluggish economic growth.

This Fed approach, termed the ‘Yellen Collar’, has been in evidence over the past 18 months. When a crisis has forced markets lower, expectations of Fed policy guidance become more supportive: an example of the market exercising the ‘put’.

Conversely, we have also witnessed periods where markets rally and the Fed adopts a more hawkish tone to temper the gains as the strike price on the written ‘call’ draws near.

In August for example, the S&P 500 Index notched three new all-time highs by mid-month. Decidedly hawkish rhetoric from the Fed subsequently capped investor sentiment, leading to a sell-off heading into the US election. The chart above right shows the collar in action; losses have been limited and upside restrained.

The Yellen Collar approach seems designed to provide both a floor and ceiling to markets as earnings growth has been scarce since early 2015.

Prior to the financial crisis, the Fed did not curtail the aggressive lending in the housing sector that ultimately contributed to the housing crisis. Today, it is clearly attempting to remain accommodative to let the economy grow, all the while attempting to restrain irrational exuberance to mitigate asset bubbles. Comments from Fed Chair Yellen regarding the valuation of Biotech and small-cap stocks, in addition to high yield, underscore the Fed’s viewpoint on speculation-fueled price rallies.
As this current bull market ages, but not rages, there has been a clear divergence of two measures of volatility over the last year — with distinct implications for asset allocations to risk management or volatility harvesting strategies.

Through the first ten months of 2016, the average level of the CBOE SPX Volatility Index (VIX) for 2016 was 16.4, 17% below its 20-year average. A reasonable conclusion might be that 2016 was a year of low risk, and volatility harvesting or downside protection strategies were therefore less important.

However, an alternative measure of market sentiment on volatility, the CBOE SKEW Index — colloquially known as the Black Swan Index — presents a strikingly different picture.

The CBOE SKEW Index uses out-of-the-money options to calculate a barometer for the probability of a tail-risk event. This contrasts with the VIX, which uses a wide range of options, including at-the-money options, to estimate implied volatility.

The chart below shows that this Index has been elevated, even as the VIX has been contained to the mid-to-high teens.

As the current equity bull market is poised to enter its eighth year, it is apparent that investors are willing to pay in order to hedge tail risk.

Divergent levels of the VIX and SKEW indices have been observed historically. The last time was from 2004 to the summer of 2007, when investor concern about high levels of leverage in the economy materialized. Markets subsequently corrected in 2008, marking the end of the US housing market bubble and the start of the global financial crisis.
Volatility Spikes

So why are many investors continuing to seek downside protection, and pay for tail-risk hedges if current volatility is so low?

One answer could be that downside protection actually creates upside opportunities. Some of the best market opportunities occur immediately after a tail event, including the run-up in stock prices after the 1987 market crash, the bull market following the 2002 dot com unwind, and the “melt up” in stock prices subsequent to the 2007–8 Global Financial Crisis. Investors who protect the downside during these periods have saved “dry powder” to take advantage of market dislocations.

Some investors who protected the downside were able to reallocate, taking advantage of the 20% spread in high-yield bonds in early 2009.

But there may be another reason why investors are seeking downside protection in a low-volatility environment. Rather than trend-like volatility, this volatility environment is marked by single periods of episodic volatility.

As illustrated below, over the last 18 months markets have experienced small, but fierce, storms of volatility (Brexit, Post-Fed Rate Hike, China devaluing the yuan).

Unusual Patterns

In each instance, volatility spiked and then fell, as shown by the widening, and tightening, of Bollinger Bands – which plot an upper and lower band two standard deviations away from a simple moving average.

This is an unusual pattern. Historically, a spike in volatility would persist as volatility tends to cluster. But today, these brief bouts of volatility are dissipating quickly. While a decline in volatility may provide short-term relief, today’s erratic volatility behavior has led to erosion in investor confidence. This has heightened the imperative to seek to mitigate downside risk, and we believe this should continue. There has been a structural shift contributing to this divergence of volatility metrics, and the lack of volatility clustering.

Economic growth has hovered around 2% recently, well below the long-term average of 3.2%, and there has been a lack of fiscal stimulus with a decline in government spending as a percent of GDP, as shown below.

With slow growth and low levels of fiscal stimulus trending downward, it has been up to monetary policy to support growth, and offset any bearish sentiment as a result of any exogenous shocks. The process has been orderly, but not organic. Monetary policy can only be effective for so long if it is the main driver of growth and asset levels.

Widening of Bollinger Bands Illustrates Periodic Spikes of Volatility

Low Levels of Investment May Have Impaired Growth
MARKETS UNCOLLARED?

But what if the collar comes off? With each spike of volatility, the collar is perhaps stretched further and further – to the point where it may just come off for good, and markets enter into a bear market. As noted earlier, volatility tends to cluster or persist over time.

Certainly there is no shortage of uncertainty for investors to navigate: Fed policy, global central bank policy, fiscal gridlock, continued slow economic growth, and corporate growth at elevated valuations, to name but a few. More gridlock and low productivity will act to stretch the collar further, making it harder for the Fed to steer markets higher or to contain market falls.

Conversely, the collar could come off for positive reasons. Organic earnings growth returns with companies increasing investment, rather than conducting share buybacks and increasing cash stockpiles. Fiscal gridlock subsides and government spending increases with advancements in infrastructure, fueling job growth and wages for a sustainable recovery backed by organic growth, and not central bank accommodation of ultra-low rates from around the world.

SCENARIO 1

Collar comes off, with growth hitting its stride and markets move higher

Since the US election, expectations for tax reductions, regulatory relief, and fiscal stimulus have pushed equity markets higher.

Additionally, US corporations have posted negative earnings growth over the past five quarters, but posted positive growth in Q3 and we expect this trend to continue in the fourth quarter of 2016.

The intersection of stimulative fiscal policies and consistent earnings growth could give the market a sustainable lift. Of course, the risk is that the prospective policies do not get enacted and growth remains sluggish. The 114th Congress has been the least effective congressional body in the last 30 years, based on the number of bills passed into laws.

SCENARIO 2

Collar comes off due to a policy mistake

The Fed has the challenge of navigating the economy through the slowest economic recovery since World War II. Sensitivity to a return to rising interest rates is heightened.

Meanwhile, the effectiveness of Fed rhetoric to temper markets could reach its limits. Given the confluence of exogenous shocks from protectionist global political rhetoric and gridlock, a policy mistake and associated market fall is a possible scenario.
Navigating Volatility

Headline volatility has understated the risks in the market. The SKEW Index has demonstrated that investors remain concerned, even as the markets slowly grind higher after each episodic event.

Against this uncertain backdrop, what tools are available for investors seeking to protect portfolios, but still participate in market gains? Investors could consider equity allocations that feature downside protection along with some form of return-generation to catch market upswings.

These include strategies that either:

• Are managed to have a lower volatility profile than the market.

• Feature allocations that tactically rotate between cash and fully invested based on volatility triggers.

• Deploy some form of volatility harvesting options-based strategies, such as a rules-based covered call exposure (i.e. Don’t fight the Fed and the Yellen Collar)

The VIX has traded below its long-term average, and may be flashing the ‘all clear’ signal. However, other indicators suggest caution is warranted.

Investors will be wise to maintain a focus on downside protection strategies as a key portfolio component in 2017.
The Whole Portfolio

Managing the unintended consequences of asset allocation decisions.

- **Monitor Exposures in Low Vol Strategies**
  Be aware of unintended sector and currency exposures of low volatility strategies and hedge if necessary.

- **Evaluate Country Concentration**
  Unintended country risk in dividend strategies should be fully evaluated and managed at the total portfolio level.

- **Assess Correlations**
  Recognize that correlations vary over time, even for some presumed safe havens like treasuries.
Cause and Effect
As investors contemplate which strategies to employ in the search for income, growth, and protection in 2017, part of that consideration should also extend to understanding how various strategies within a portfolio will interact with one another.

Tilting an equity portfolio toward different exposures can help address particular growth or yield challenges, but it is important to recognize the unintended consequences that might derive from implementing such strategies.

Des Lawrence, Senior Investment Strategist

For multi-asset portfolios, awareness of the changing nature of bond–equity correlations is particularly valuable when combining assets to deliver true diversification.

Low Volatility Equities
Allocating a portion of the equity book to a low volatility equity strategy can help dampen total portfolio volatility. This approach is typically a good fit for investors faced with the challenge of pursuing the same long-term return but with less risk. However, return dynamics as well as unintended sector or currency exposures must be monitored.

Being low beta by design, low volatility strategies should typically outperform their parent index in down markets and underperform in up markets. While there have been occasions where excess returns have been particularly strong — well above what the regression line in the chart below would suggest — it must be emphasized that these are outside the norm. The strategy is primarily concerned with risk reduction, not outperformance in every market environment.

What to Consider

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**Factor Exposures**

**Country Concentration**

**Correlations**

**Currency**

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Excess Monthly Return of MSCI World Minimum Volatility Index (%)

Source: Bloomberg Finance LP, MSCI, SSGA as of 30 September 2016. Diversification and asset allocation does not assure a profit or guarantee against a loss. Past performance does not guarantee future results. It is not possible to invest in an index. The MSCI Minimum Volatility Indexes aim to reflect the performance characteristics of a minimum variance strategy focused on absolute returns as well as volatility. The MSCI World Index is a broad global equity benchmark that represents large- and mid-cap equity performance across 23 developed markets countries.
Sector Exposures

The design of low volatility strategies varies, with differing constraints producing varying degrees of diversification across industries, countries, and currencies. However, low volatility strategies can give rise to concentrated sector exposures with implications for portfolio risk and return.

For example, significant overweight exposures in Utilities and Consumer Staples at present are offset by underweight exposures to Technology and Energy (see chart below). The substantial rebound in energy stocks in the nine months to September 2016 provides a salutary lesson in the dynamics of low volatility investing — although the performance of other sectors more than offset the impact of underweight Energy exposure over the period.

Monitoring and Managing

Knowing the aggregate sector exposures across the entire equity portfolio and understanding the consequences of such positioning is important. For example, the impact of a rising rate cycle could be modeled to better understand the portfolio’s active exposure to Consumers and Utilities, or perhaps the impact of commodity prices on an active Energy position.

Assessing the volatility of holdings and non-holdings within each sector can also better highlight the contributors to active risk and the drivers of active return. For example, an analysis of the MSCI Minimum Volatility Index reveals that although the Information Technology sector has an active underweight almost three times that of Financials, active risk contributions are broadly similar.

Where excessive exposures exist in total, investors can consider hedging part of the undesired exposure, for example by using sector index futures contracts.

MSCI Minimum Volatility – Active Sector Exposure & Risk Contributions

Source: BarraOne, MSCI, SSGA as of 30 September 2016. Sectors shown are as of the date indicated and are subject to change. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

1 Contribution to Active Risk reflects contribution by sector to the total active risk of the MSCI Minimum Volatility Index relative to the MSCI World Index.
2 Active Exposure is the percentage point differential between sector weights in the MSCI Minimum Volatility Index compared to the MSCI World Index.
**Currency and Volatility**

Investors in low volatility strategies are not immune to currency risk and performance can be quite sensitive to the strategy’s base currency — particularly over shorter time horizons.

Over the last 10 years, as illustrated on the right, global minimum volatility index returns have exhibited lower volatility than the parent index for US dollar, euro, sterling, and yen investors. US dollar and yen investors benefited most with volatility declining by between approximately 4.5–5 percentage points (pp). Euro and sterling investors experienced a volatility reduction of around 2pp.

However, over shorter time periods the volatility benefit has been very sensitive to base currency. Yen-based investors captured a 6pp reduction in volatility, US dollar and euro investors achieved approximately 3.5pp reduction, while sterling investors suffered a rise in volatility of almost 4pp over the 12 months to September 2016.

The experience of British and Japanese investors is instructive: investing internationally has been a much less risky affair in absolute terms for British investors and a much riskier one for Japanese investors, at least in recent times. It’s easier to squeeze an improvement from a starting point of 18.8% absolute volatility (for the JPY investor) than 9.9% (for the UK investor).

In addition, the Japanese stock market has more than its fair share of lower volatility stocks at present — hence the current 5pp overweight in Japan. Additional yen exposure means zero currency risk for a Japanese investor, but for eurozone and British investors it can be the most volatile currency by a significant margin.

Depending on their investment horizon and home currency, investors in low volatility strategies should therefore consider hedging non-base currency exposures.

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**Volatility Variation — MSCI Minimum Volatility vs MSCI World (in select base currencies)**

<table>
<thead>
<tr>
<th></th>
<th>1 YR</th>
<th>3 YRS</th>
<th>5 YRS</th>
<th>10 YRS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>USD</strong></td>
<td>13.2</td>
<td>9.7</td>
<td>11.2</td>
<td>12.0</td>
</tr>
<tr>
<td><strong>EUR</strong></td>
<td>13.9</td>
<td>10.3</td>
<td>12.0</td>
<td>10.5</td>
</tr>
<tr>
<td><strong>GBP</strong></td>
<td>9.9</td>
<td>13.8</td>
<td>9.8</td>
<td>11.3</td>
</tr>
<tr>
<td><strong>JPY</strong></td>
<td>18.8</td>
<td>12.6</td>
<td>16.3</td>
<td>17.3</td>
</tr>
</tbody>
</table>

Source: Bloomberg Finance LP, MSCI, SSGA as of 30 September 2016
High Dividend Yield Strategies

High dividend yield strategies are a logical and popular choice for equity investors seeking to improve income generation. The MSCI World High Dividend Yield Index offers investors an additional 1.3pp dividend yield compared to that of the conventional market-capital-weighted index, an attractive prospect in the current investment environment.

Country concentration

Dividend yield varies significantly across countries. For example, US stocks offer a modest 2.1% yield on average, while those in the UK offer a relatively generous 4.0%. These variations give rise to significant active country exposures in global high-yield strategies and investors should be aware of the implications. As illustrated below, relative to conventional indices, UK and Swiss stocks tend to be more heavily represented at the expense of US and Japanese stocks in the MSCI World High Dividend Yield Index.

Country Under/Overweights: MSCI World High Dividend Yield Index versus MSCI World

- US: -10.00
- Japan: 5.00
- Denmark: 0
- Australia: -5.00
- Israel: -10.00
- New Zealand: -5.00
- Norway: -5.00
- Sweden: -5.00
- Singapore: 0
- Hong Kong: 0
- Canada: 10.00
- Eurozone: 10.00
- UK: 10.00
- Switzerland: 10.00

Source: BarraOne, MSCI, SSGA as of 30 September 2016

The True Picture: Active Local Market Risk and Interaction within Regions (%)

North America: 79.10
North America Interaction: -4.41
EMEA: 21.34
EMEA Interaction: -3.05
Asia Pacific: -3.05
Asia Pacific Interaction: -3.54
Global Interaction: 100

Source: BarraOne, MSCI, SSGA, as of 30 September 2016

It’s not unusual for local market risk to dominate total and active risk in diversified portfolios. In high-yield equity strategies, it can become more concentrated in regions and national markets.

Naturally the large underweight exposure to US stocks dominates the active risk in such a strategy, but a closer look is fruitful; Canadian and US markets tend to move in opposite directions and provide some diversification (with a negative interaction of -4.41%).

The True Picture: Active Local Market Risk and Interaction within Regions (%)

This is also the case among Asia Pacific markets (-3.05%). However, the positive interaction in Europe means individual countries in the region tend to reinforce each other and therefore increase risk (+17.53%). Further digging shows that UK and Swiss stocks account for the lion’s share of active market risk in EMEA.

Central bank policies and political tides can thus potentially exert a much greater influence on performance than fundamentals such as yield.

A few notable events come to mind: Britain’s politically motivated commitment to hold the referendum that resulted in Brexit; the pursuit of Abenomics in Japan; and the Swiss National Bank’s decision to abandon its currency floor against the euro. Each of these events had considerable impact on both currencies and national equity markets.

Unintended country risk should be fully evaluated and managed at total portfolio level. Excessive national market risks can be hedged using a tailored futures overlay – although some country-specific risks may not be easily rectified without negating the originally desired yield exposure. Meanwhile, significant currency mismatches can be addressed relatively easily with an appropriate currency hedging policy.

Source: BarraOne, MSCI, SSGA as of 31 October 2016

The MSCI High Dividend Yield Index aims to capture the high dividend yield equity opportunity set within a standard MSCI parent index. The MSCI World Index is a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries.

*Source: MSCI as at 31 October 2016.
**Bond–Equity Correlations**

As liabilities and obligations draw closer, many investors implement a de-risking strategy, typically with a higher allocation to government bonds. The prospect of a low or negative correlation between equity and treasury market returns presents attractive diversification potential.

However, correlations vary over time and the diversification properties wax and wane accordingly. As illustrated below, UK gilt and eurozone government bond investors have seen correlations with global equities jump dramatically in recent years.

Equities and respective UK and eurozone sovereign debt have tended to move in lockstep more often than before — deceptively attractive when equities rise, but deeply unsettling when equities fall.

For respective global equity investors, US Treasuries offer yield and diversification; Japanese government bonds offer diversification but negative yields; Gilts offer yield but less diversification; core eurozone bonds offer neither yield nor traditional diversification benefits.

The heightened correlations observed between equities and eurozone government bonds are unlikely to be permanent, although they may persist for some time (ECB policy may not provide relief any time soon). Eurozone investors seeking to de-risk could therefore consider an allocation to US or global treasuries on a currency-hedged basis — these provide the low or marginally negative correlations absent in their home market.

**How to Approach It**

The sell-off in US Treasuries following Trump’s victory is a reminder, however, that investors should keep a watchful eye on evolving policy. And while cash may be unpalatable given negative yields, it does offer the lowest possible duration for the diversification it provides.

For investors looking to move the dial and consider an even broader spectrum, a modest allocation to gold could provide some diversification (although it clearly represents a more volatile alternative to sovereign debt!)

Tactical Asset Allocation (TAA) and target volatility strategies can also help investors address the issue of higher correlations. While not managing total portfolio risk, TAA can add excess returns by taking benchmark-relative decisions on allocations to treasury, credit and various growth assets.

Target volatility strategies, meanwhile, allow investors to directly address equity market volatility without relying on the diversification properties of other assets to buffer the portfolio’s exposure to equity risk.

Whether searching for scarce yield or trying to manage portfolio risk, many of our best intentions have attendant consequences that, at a minimum, ought to be appreciated and, where appropriate, addressed and managed.

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**Rolling 36-month correlation of global equities with respective domestic government bonds**

Currency swings and volatility were particularly pronounced throughout 2016, highlighting the need for investors to monitor exposures and understand the major forces influencing currency movements.

### Investment Ideas

**KEEP CURRENCY IN CHECK**

Currency volatility is likely in 2017. Consider reducing concentrated risks via basic hedging.

**WATCH DOLLAR STRENGTH**

Any continued dollar strength makes currency hedging particularly important for US investors with international currency exposures.

**CARRY-TRADE POTENTIAL**

High-yield currencies are not presently overvalued and continue to have favorable growth fundamentals.
What’s Driving Currency Fluctuations?

While purchasing-power parity* (PPP) anchors exchange rates to relative inflation and productivity trends, cyclical and political forces are notorious for pushing currencies well beyond equilibrium for extended periods, sometimes measured in years. Monetary policy, a function of growth and inflation, directly drives currency volatility around fair value by changing the relative interest rate return to foreign currency deposits.

Beyond the direct interest rate effect, currency markets provide a price to help clear all cross-border trade and capital flows. Any economic or political factor that realigns the relative risk or return of assets among countries will induce cross-border flows and drive exchange rate movements. The result is often significant volatility and the potential for large, extended moves — sometimes in response to rather minor changes in fundamentals.

Sensitivity to Regime Change: From Monetary to Fiscal Policy

Expected changes to both fiscal and monetary policies in 2017 raise the volatility risks for currencies. The failure of monetary policy to achieve the desired impact on growth or inflation in recent years (see chart below right) has introduced the likelihood of a regime change in policy. Changes in Fed and ECB policies in particular could generate significant currency volatility.

In the US, President-elect Trump has been critical of low interest rate policy and will have the opportunity to nominate four, presumably hawkish, new members of the Fed board of governors by early 2018. Meanwhile the ECB is likely to extend its quantitative easing (QE) program through most of 2017, but the inflation outlook and resistance to QE from German policymakers make a further extension into 2018 questionable.

Fiscal stimulus, alongside tightening monetary policy, is historically a major driver of currency appreciation. Trump has advocated aggressive fiscal stimulus for the US, and European elections generally favor increased fiscal deficit spending as governments seek to win favor with the electorate. The combination of fiscal easing and monetary tightening increase the upside risks for the USD and possibly the euro during the latter half of 2017.
Any continued dollar strength makes currency hedging particularly important for US investors with international currency exposures.

Aaron Hurd, Senior Portfolio Manager, Currency Group

The Carry Trade: Beware the Steamroller

Since late 2015, the cross-currency carry trade — that is, buying high-yield currencies and selling low-yield currencies — has performed extremely well.

Historically, periods of easy monetary policy, suppressed volatility, and positive global growth favor cross-border yield-seeking strategies. As the cycle matures, two things tend to happen:

1. High-yielding currencies become very expensive to fair value pushed up by yield-seeking investors.
2. Economic fundamentals of less cyclical, low-yielding countries tend to catch up to those of high yielders that grow strongly early in the economic cycle.

The result: Late-stage carry trades bring the risk of sharp falls back to fair value. For this reason, carry strategies have sometimes been likened to “picking up pennies in front of a steam roller”.

Is the Long Run Over?

We’re eight years into the post-GFC recovery and the carry strategy has done well over the past year. Should we be worried?

Unlike past cycles, high-yield currencies are not presently overvalued relative to low-yield currencies and continue to have much more favorable growth fundamentals (see charts opposite). As a result, we see strong potential for further gains and an attractive risk reward profile.

But an attractive risk/reward profile doesn’t mean no risk – there are risks to monitor for carry strategies in 2017. Decent fundamentals and valuations may prevent a repeat of the near-35% losses to carry during 2007–2009, but a 15% loss could easily happen given regime change in monetary or fiscal policy, election uncertainty, and the upcoming specter of trade wars.
Don’t Ignore Currency

The current low-yield environment — with low levels of expected return — affords little room for incidental risks. Currency volatility is now a much more significant factor in proportion to total expected portfolio return. A near-20% move, such as we saw in GBP and JPY this year, can wipe out even the most optimistic cross-border investment thesis.

Reducing those concentrated currency risks via basic hedging is a great starting point. From there, investors can consider moving from simple one-size-fits-all currency hedging into targeted hedges on specific currencies. This approach can be ideal when the downside risk appears high relative to the hedging cost.

Finally, consider the possibility of harnessing currency exposure as a potential source of added return via active management or passive factor-based (smart beta) currency portfolios.

Source: SSGA. Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.
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*Assets under management were $2.4 trillion as of 30 September 2016. Please note that AUM totals are unaudited.

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