Portfolio Positioning

Global Equities Have Room to Run

By Lorne Johnson, *Senior Portfolio Manager, Investment Solutions Group*

By the middle of 2017, investors who placed a diversified bet on global equities at the start of the year as a global reflation trade have been duly rewarded. The MSCI All Country World Index was up more than 10%,* on track for its best first half since 2007.

At the beginning of 2017 we were most positive across growth assets on prospects for US equities, given an improved earnings outlook and an incoming Republican administration expected to pursue pro-growth corporate tax relief legislation, deregulation and possible infrastructure spending. The return to strong earnings growth has held up, with first quarter earnings handily beating already high expectations. On the policy front, however, progress has been limited and expectations for legislative action on tax policy or new infrastructure spending this year have been tempered, as the Trump administration has found its agenda impeded amid deepening investigations of its ties to Russia. US growth has also come in on the soft side thus far in 2017, with the initial reading of first quarter GDP growth at just 0.7%. As of June, US equity markets have taken a pause to reassess the near-term outlook. After a 6% rally through February, S&P 500 performance has now flattened out.

Beyond a somewhat murkier outlook for US fiscal policy initiatives and less-than-stellar US growth, measures of global real activity and inflation overall were decidedly in line with the reflation theme in the early months of 2017. After decelerating sharply from 2014 through the middle of 2016, industrial production growth worldwide is estimated by J.P. Morgan to have surged to an annual rate of 4.5%[1] in the first quarter, the highest level in more than five years. Heading into the second half, the steady one-year rise in advanced-economy inflation has paused, after last year's increase in oil prices has faded and other catalysts for higher inflation have failed to materialize.

A reduction in European political uncertainty has also been supportive of growth assets, as both French and Dutch voters deprived populists of victory. The easing of electoral risk combined with better-than-expected Eurozone growth in the first quarter has contributed to a 17%* gain for the MSCI Europe Index year to date. Emerging market equities have also shined so far in 2017. Led by a near 19%* gain in the MSCI China Index and a 25%* gain in the MSCI Korea index, the MSCI Emerging Markets Index is up 16%* through the middle of the year.

So how does this market action line up with the market outlook we provided going into 2017? Below we review our main calls for the first half and where we see markets headed from here:

STATE STREET GLOBAL ADVISORS®

EVOLUTION OF MARKET CALLS

GENERAL RISK

JANUARY 2017

Overall neutral on growth assets, with global government bonds likely to fare worst amid a worldwide trend toward more protectionism at the expense of global growth

Following last year's Brexit vote and the election of Donald Trump on an anti-trade platform, there was a surge in the prospects for populist candidates in European elections this year. And we expected to see some paring back of global trade agreements in 2017.

JUNE 2017

Apart from the expected exit from the Trans-Pacific Partnership (TPP) by the US, we have not seen a concerted protectionist push, as President Trump has nuanced the anti-trade rhetoric of his campaign. Populist candidates in the Netherlands and France who threatened to pull away from European institutions were soundly defeated. While protectionism remains a threat to global growth in 2017 and beyond, we view the moderation in Trump's tone and the populist electoral defeats as supporting growth assets.

Overweight global equities, funded by bearish positions across fixed income

EQUITY

Overweight US equities, underweight non-US developed equities, neutral on emerging markets

Our view entering the year was cautiously optimistic toward US equities, given that we expected more follow-through on the growth-friendly Trump agenda and a transition to simulative fiscal policy as monetary policy tightened. We also upgraded our assessment of non-US developed market (DM) and emerging market (EM) equities. Our forecasts were for DM equities to gain 3.5% and EM equities 5.5% by the end of 2017.

At mid-year, our equity return forecasts have already been significantly exceeded. For the second half, we believe synchronized global growth and strong earnings will give equities more room to run. Accordingly, we have increased our overall exposure to global equities, further upgrading our view on EM, and we now hold a diversified overweight position across global equity markets.

Overweight large cap US and non-US DM equities in Europe and Asia Pacific, with a slight overweight in EM

FIXED INCOME

Overweight US credit and high yield

In 2016, the Bloomberg Barclays US High Yield Index posted a gain of 17% on 430 basis points of spread compression from its February highs. Likewise for 2017, we remained positive on high yield bonds as the credit cycle continued to elongate. We forecast a negative return in 2017 for global government bonds.

While the Citigroup Non-US Dollar World Government Bond Index has managed a 5%* return year to date, mostly due to currency appreciation against the US dollar, our outlook for the rest of 2017 remains negative. Returns in investment grade credit have fared better than government bonds, though only modestly, and the high yield sector has delivered an additional 4.3%* return year to date on further spread compression. We expect the US yield curve to flatten more amid continued monetary tightening and subdued inflation, while spread compression remains at near-cycle lows.

Underweight intermediate-term US bonds and non-US government bonds, neutral on US high yield and intermediate investment grade credit, slight overweight on long-duration bonds

Glossary

Citigroup Non-US Dollar World Government Bond Index An unmanaged, market capitalization weighted index that tracks 10 government bond indices, excluding the United States.

MSCI All Country World Index A market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. It comprises stocks from both developed and emerging markets.

MSCI China Index Captures large and mid-cap representation across China H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 150 constituents, the index covers about 85% of this China equity universe.

MSCI Emerging Markets Index A free float-adjusted market capitalization index designed to measure equity market performance in 23 global emerging market economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

MSCI Europe Index Captures large and mid-cap segments across 15 developed market countries in Europe.

MSCI Korea Index Designed to measure the performance of the large and mid-cap segments of the South Korean market. With 108 constituents, the index covers about 85% of the Korean equity universe.

Reflation A fiscal or monetary policy, designed to expand a country's output and curb the effects of deflation. Reflation policies can include reducing taxes, changing the money supply and lowering interest rates.

S&P 500 Index A market value weighted index of 500 stocks that reflects the performance of a large cap universe made up of companies selected by economists; the S&P 500 is one of the common benchmarks for the US stock market, and investment products based on the S&P 500 include index funds and exchange-traded funds.

*In US Dollars as of 5/19/2017.

[1] J.P. Morgan Global Data Watch, March 24, 2017.

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