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# 2019 Global Market Outlook

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Not Over  
Until It's Over



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**CIO's View**

# **Not Over Until It's Over**

**Richard Lacaille**

Global Chief Investment Officer

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While global growth is expected to slow in 2019, with the balance of risks to the downside, we expect investors will still be able to find attractive opportunities in certain parts of the markets where fundamentals remain strong, especially US equities. Although the S&P 500 marked its longest bull run in August 2018, a severe correction in October reminded us that we are closer to the end of the cycle than the beginning and that investors should be prepared for heightened volatility. Still, we see sufficient economic strength and earnings momentum in the US to drive equity outperformance, at least in the short to medium term.

Despite rising inflation pressures, our base case does not anticipate excessive wage growth in 2019 or other imbalances that might tip the global economy into recession in the coming year. But elevated geopolitical and policy risks might easily unsettle markets, especially in the second half of the year.

Moreover, the maturity of the current cycle would suggest a more cautious return-seeking position in 2019, with a diverse combination of defensive equities, high-quality credit and emerging markets selectively across equities and local-currency bonds.

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## US Expected to Outperform

In the US, there are a number of levers that should send equities higher, including increased capital expenditure intentions as well as higher government and consumer spending. With the Democrats in control of the House of Representatives again, there is at least the potential for renewed focus on infrastructure spending. Earnings growth for US companies is forecast to remain strong in 2019, a year in which we expect investors will pay a premium for quality stocks. The US is leading other regions in earnings per share and sales growth expectations.<sup>1</sup>

The two biggest downside risks to this view are a policy mistake and a doubling down on tariffs with China. The Federal Reserve (Fed) faces a more challenging year in 2019. Having admitted uncertainty over where the neutral rate is, Fed Chair Jerome “Jay” Powell has said the central bank will remain data-dependent and move cautiously.

We have tentatively penciled in three rate hikes for 2019 though the Fed might slow the pace of tightening from every three months to every four or five months depending on the trajectory of growth and inflation. We should have more visibility halfway through the year on whether US fiscal stimulus can extend economic expansion beyond 2019, even as Fed moves to further tighten monetary policy and unwind its balance sheet weigh on global liquidity.

In the US-China trade dispute, one can only hope that cooler heads prevail, since the potential costs of a downward spiral in retaliatory measures are high. Research suggests that increasing tariffs to 25% on all goods traded between the two countries could shave as much as a full percentage point off global growth and more than two percentage points off US and Chinese growth.<sup>2</sup> President Trump still has broad discretion over tariffs even in the wake of a divided Congress. However, with the midterm elections now behind him, Trump’s ambitions for re-election in 2020 might lead him to try to accelerate trade deals with both China and the European Union (EU).

<sup>1</sup> According to MSCI forward EPS estimates, State Street Global Advisors, Bloomberg, as of September 2018.

<sup>2</sup> Stephen Letts, “Trade war escalation could smash global economy and equities: UBS,” July 12, 2018.

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## Politics Dampen European Sentiment

More than cooler heads will be required to restore investor confidence in European markets as the March deadline for the UK leaving the EU approaches. Brexit uncertainty weighed on UK markets for much of 2018, as a negotiated exit continued to elude the May government. Meanwhile, the EU faces more existential dissent from the populist government in Italy determined to ignore EU rules on budget deficits, as well as additional populist challenges from across the continent.

In the latter part of 2018, the spread between Italian and German bonds neared its widest in five years.<sup>3</sup> Both the euro and sterling have been driven lower by growing uncertainty, with the two staunchest defenders of the European project, Germany’s Angela Merkel and France’s Emmanuel Macron, entering 2019 politically weaker at home. Chancellor Merkel has already announced her departure from the political stage by 2021 after 13 years in office.

<sup>3</sup> Bloomberg, Reuters, as of October 17, 2018.

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## Emerging Markets Opportunities

We believe the guilt-by-association sell-off in emerging markets (EM) in 2018 has created some attractive buying opportunities. While EM equity valuations are roughly at their average level since 2003, their valuations relative to other markets are at all-time lows. In particular, EM consumer-related and tech sectors are much cheaper than their developed market counterparts. In EM bonds and currencies, the severe pullback in 2018 has also created attractive relative valuations.

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## China Matters Most

We expect all eyes will be on China in 2019, and not just because of its trade dispute with the US. The Trump administration has signaled that it is fundamentally shifting its position toward China, away from the “constructive engagement” of previous administrations toward “strategic containment.” This switch seeks to prevent China from increasing its competitive advantage in growth areas like artificial intelligence, quantum computing and biotech. While investors appear to have already priced in a particularly harsh trade environment for China and related emerging markets, we believe markets are only beginning to digest what a fundamental shift in relations between the US and China might mean.

Tariffs now appear to be just a first step toward reconfiguring supply chains that have become more intertwined and global since China joined the World Trade Organization in 2001. Five years after China joined the WTO, the US economy was still five times larger (in today's dollars) than China's; by 2017, the US economy was just 60% larger.<sup>4</sup> Still, the world's second-largest economy must navigate a delicate balance between managing an orderly deceleration and deleveraging process while maintaining social stability at a time when Chinese consumers are struggling with rising food and housing prices.

We still believe that China's long-term, consumer-driven growth story is intact, but a sharpening of competition with the US is likely to insert more event-driven volatility into markets. For global investors, the coming year will be especially significant, as major EM equity and debt indices begin to include Chinese securities. Given the growing importance of China in global capital markets and its outsized impact on EM indexes, we think investors should consider a stand-alone allocation to Chinese equities combining both onshore and offshore exposures in order to better manage risk.

<sup>4</sup> The Economist, October 18, 2018.

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## Prepare to Change Course

Going into 2019 there is so much bad news embedded in European and some EM equities that, if the worst outcomes are averted, we could see attractive upside opportunities toward the second half of the year. Indeed, Europe could stabilize or accelerate at the same time as the fiscal stimulus in the US is starting to fade and higher interest rates are beginning to apply the brakes on growth. Investors should therefore be prepared to reposition equity exposures into other regions at some point in 2019.

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## Reducing Risk in Fixed Income

Caution and quality are the watchwords for fixed income investors in 2019. With many of the advanced economy central banks expected to tighten and the Fed continuing to normalize its balance sheet, investors will need to proceed carefully. US rates are near a cyclical peak and the yield curve will continue to flatten as the Fed continues hiking. Pricing action in the market suggests caution in credit. Against this backdrop, we believe investors should begin to balance their overall risk posture, look to the front end of the US yield curve for opportunities and explore EM bonds and currencies for value.

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## Defensive Positioning for Extra Innings

Heading into 2019, we maintain our largest overweight in US equities in our tactical portfolios. We also favor the US dollar, short-duration bonds and higher-quality credit as well as local-currency EM debt and EM currencies. For investors with a longer time horizon, we recommend using pullbacks to add to positions in EM equities. Within Europe, there might be attractive trading opportunities at a micro level within countries and sectors, depending on how they are affected by ongoing trade disputes.

Amid so much geopolitical and policy uncertainty, investors should consider dry powder in the form of cash in order to be more opportunistic, especially in the US where three-month Treasuries are now yielding more than the dividend yield on the S&P 500. Now is the time to add flexibility to portfolios and diversify across regions and sectors. Seek defensive securities that protect on the downside and consider when it makes sense to hedge currency exposures. While the cycle isn't over until it's over, building in strong defenses now will help navigate late-cycle volatility and uncertainty.

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# The Macro Picture

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Global Growth Slows, With  
Trade Wars Biggest Risk

The United States is expected to outperform other regions on the back of fiscal stimulus.

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Geopolitics Drives  
Uncertainty and  
Downside Risk

The trend toward monetary tightening should continue and further unilateral sovereign actions promise more surprises.



# Global Growth Slows, With Trade Wars Biggest Risk

**Christopher Probyn, PhD**

Chief Economist

**Simona Mocuta**

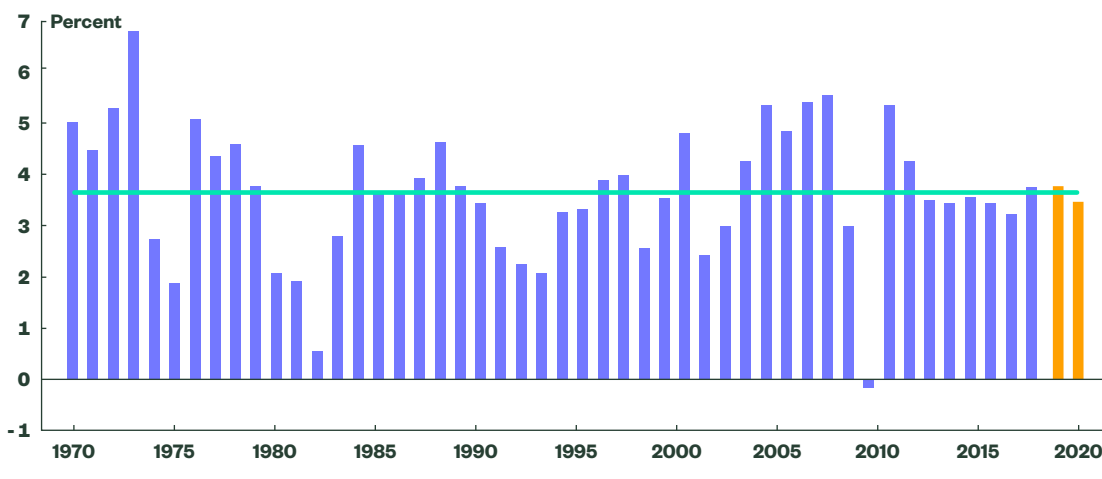
Senior Economist

We expect global growth to slow from 3.8% in 2018 to 3.5% in 2019, with risks skewed to the downside reflecting continued uncertainty around trade disputes, even after the US mid-term elections (see Figure 1). Amid one of the longest economic expansions in history, we have witnessed “mini-cycles” over the past few years; growth slowed in 2016 and reaccelerated in 2017–2018, partly because of the effects of the oil price rebound on US activity, and looks set to slow again in 2019, partially because the fiscally induced late-cycle “sugar rush” will end in the United States.

Figure 1  
**Global Growth Is Set to Slow in 2019**

Percentage change, year on year, in World Real GDP

- World Real GDP % chg y/y
- State Street Global Advisors Forecast
- Long-Term Average



Source: State Street Global Advisors Economics, IMF, Oxford Economics. Data as of October 1, 2018.

Projected characteristics are based upon estimates and reflect subjective judgments, assumptions, and analysis made by (whatever source made them). There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

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## **Inflation Still Contained**

In 2018, we finally began to see some signs of wage inflation, as labor markets in major economies continued to tighten; however, this is still a very slow process. Together with our expectation that oil prices will hover around \$80 a barrel in 2019, we see no indication of a sustained pickup in inflation. Energy prices have assumed the dominant role in the evolution of inflation since mid-2014. Indeed, because of the extent and timing of the oil price decline, inflation in the advanced economies plunged to just 0.3% in 2015. Inflation has subsequently reaccelerated as oil prices have recovered. But it is projected to slow slightly next year as oil prices drift sideways while core inflation fails to accelerate appreciably.

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## **A Synchronous Tightening Cycle**

With advanced economies growing, though at a slower rate, and inflation contained, we expect to see a convergence of monetary tightening in 2019, with the notable exception of Japan. We expect the US Federal Reserve (Fed) to hike interest rates three times during the year, especially given the current momentum in the US economy. In addition, the European Central Bank, Bank of England, Bank of Canada and the Reserve Bank of Australia all look likely to raise interest rates in the coming year. Meanwhile, inflation remains too far below target for the Bank of Japan to tighten, especially given the country's commitment to a value-added tax (VAT) hike next October. With the Fed continuing to normalize its balance sheet, global liquidity should continue to diminish, adding to the challenges of higher rates.

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## **US Outperforms**

While the rest of the world lost considerable momentum in 2018, the US experienced further acceleration, with broad-based strength in the mining and manufacturing sectors. Growth looks set to slow to 2.6% in 2019 after a strong showing of 2.9% in 2018. (See Figure 2 for GDP forecasts.) The fiscal multiplier of the Tax Cuts and Jobs Act (TCJA) may not be large, but should nonetheless be accretive to growth in 2019. The combination of tax cuts, immediate expensing of capital expenditures, the mandatory repatriation of overseas profits and a broad deregulation push should incentivize capital expenditure.

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## **Trade Uncertainty**

Trade policy is the single most important source of uncertainty and may act as a deterrent to both the capex wave already under way and to consumer spending. But the appreciation of the US dollar against the yuan has thus far blunted the immediate impact of tariffs. Some degree of burden-sharing among importers, producers and consumers has also provided a cushion as has an augmented household savings rate. So while a fully-fledged trade war undoubtedly would be negative, how that plays out in the end will be subject to many competing forces.

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## The UK and Eurozone Struggle

Outside the US, advanced economies face stronger headwinds in 2019, mainly because of continued geopolitical uncertainty. In the UK, the most serious question as we head to the March deadline for leaving the European Union is whether a deal will be reached by a British government beset by internal dissent and Brussels negotiators with little incentive to make exit easy, lest they encourage further breakaways. Brexit uncertainty has certainly taken a toll on the UK economy, particularly business investment. Sluggish wage gains and slowing home price appreciation has hindered consumption, despite a tight labor market where the unemployment rate continues to hover around a multi-decade low of 4.0%. After UK growth slowed to an anemic 1.3% in 2018, the slowest since the global financial crisis, we see only a slight improvement, to 1.4%, in 2019. Our base case remains that a framework for leaving will be agreed, but all bets are off if a no-deal, “cliff-edge” Brexit occurs.

After surprisingly strong growth in 2017, which brought unemployment down to 9.1%, eurozone leading indicators weakened materially in 2018. We expect growth to slow to 1.6% in 2019 compared to 1.9% in 2018 and 2.5% in 2017. Europe continues to be challenged by the structural contradictions inherent in a monetary union without automatic fiscal transfers. Structural reform since the global financial crisis has been limited to a handful of countries, while Italy still faces enormous fiscal challenges. Nativist movements across the continent continue to attack the European Union because of chronically divergent economic performance and the absence of a coherent immigration policy. European parliamentary elections in May could see significant gains by EU-skeptic parties.

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## Japan Brings Up the Rear

Japan's economic performance was highly uneven in 2018, with an outright contraction in the first quarter followed by a solid rebound in the second. Natural disasters in mid-2018 only added to data turbulence. 2017 almost certainly set the high-water mark at 1.7%, but growth remained above potential in 2018 so the labor market simply kept tightening, limiting employers' access to suitable workers; there are already 163 job vacancies for every 100 applicants.<sup>1</sup> Because the October VAT hike comes so late in the year, it will have a limited effect on the 2019 annual number, allowing growth to hold up at 1.2%. But 2020 could be a very different story.

Elsewhere in advanced economies, we believe Australia and Canada will also slow in 2019, but overall fundamentals seem solid, although household debt as a share of GDP is higher in Canada today than it was in the US in 2007.

<sup>1</sup> Japanese Ministry of Health, Labor and Welfare

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## Emerging Markets on Shakier Ground

Under the weight of intensifying trade tensions, a strengthening US dollar, rising financing costs and less accommodative domestic policy settings, broad emerging markets growth looks poised to slow more noticeably in 2019, to 4.5%. While this remains a decent pace, risks are skewed to the downside amid the escalating trade spat between the US and China and potential missteps in that globally critical relationship. Moreover, the emerging markets recovery in 2017 had a very strong cyclical component, which has since dissipated, refocusing attention on fundamental challenges such as high debt levels and the lack of structural reforms.

Brazil, Russia and India all struggled against headwinds in 2018, which do not appear to be dissipating in 2019. In Brazil, disappointment over the lack of reform triggered a sharp depreciation of the real in 2018, so investors will be closely watching the new government's reform signals in 2019. Russia's recovery from its recession in 2015–2016 continues to be shallow and slow, and its long-term economic performance remains challenged by a stark lack of economic diversification and extremely poor demographics. Amid the broader emerging markets turmoil in the second half of 2018, India's rupee hit record lows against the US dollar, forcing the central bank to shift monetary policy gears in support of the currency.

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## Greater Downside Risks for China

But all eyes will be on China in 2019. Even before the ratcheting up of the trade dispute with the US, we were expecting growth to moderate amid a multi-year deleveraging effort. Trade tensions likely render that slowdown more acute as deleveraging efforts take a back seat to the more immediate need to stabilize the economy. We see growth slowing toward 6.0% in 2019, although the outlook is exceedingly murky because so much depends on how severe the trade dispute becomes. In any event, China's elevated debt-to-GDP ratio provides considerably less scope for aggressive debt-financed stimulus than several years ago. The longer the trade spat continues, the more likely we think it is that Chinese policymakers begin to diversify the response channels, deploying a range of other tools, including guiding the exchange rate lower and reassessing China's foreign exchange reserves policy.

While headlines in 2018 focused on the fiscal challenges of Argentina, Turkey and South Africa, we saw dramatic outflows from both emerging markets equities and debt. The big emerging markets question for 2019 is whether a faster-than-expected slowdown in China or other idiosyncratic risks in smaller emerging markets countries could lead to broader market contagion.

Figure 2  
**GDP and Inflation  
 Forecasts for 2018  
 and 2019**  
 Forecast annual  
 percent change

	2018	2019
<b>World Growth</b>	3.8	3.5
<b>Advanced Economies (Real GDP)</b>	2.3	2.0
US	2.9	2.6
Eurozone	1.9	1.6
Germany	1.8	1.6
France	1.6	1.7
Italy	1.1	1.0
Japan	1.1	1.2
UK	1.3	1.4
Canada	2.1	1.9
Australia	3.0	2.5
<b>Developing Economies (Real GDP)</b>	4.7	4.5
<b>Advanced Economy Inflation (CPI)</b>	2.0	1.9
US	2.5	2.1
Eurozone	1.7	1.7
Germany	1.9	1.7
France	1.9	1.6
Italy	1.3	1.6
Japan	1.0	1.2
UK	2.4	2.1
Canada	2.2	2.0
Australia	2.1	2.2
<b>Developing Economies (CPI)</b>	4.6	4.5

Source: State Street Global Advisors Economics as of September 21, 2018.

# **Geopolitics Drives Uncertainty and Downside Risk**

**Elliot Hentov, PhD**

Head of Policy and Research

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After years of indifference, in 2018, markets responded strongly to geopolitical events. Two simultaneous developments drove the change.

First, global central banks (led by the Federal Reserve) reversed years of monetary easing after peak liquidity in 2016–2017. While the pace remains unclear, the trend toward further tightening should characterize 2019 and may make markets more sensitive as liquidity declines further.

Second, geopolitical risk has increased as the world order continues to undergo a transformation. International organizations, treaties and laws have gradually begun to cede influence to the unilateral actions of major countries, based on raw political power. The lack of transparency around these unilateral decisions by executive administrations is likely to lead to regular market surprises. Volatile price moves are the natural consequence but may present opportunities, as well as risks, for investors.



## US Policy Impact

In both instances, these developments are led by the United States. While the US has been the main source of monetary and geopolitical volatility, US markets have been the beneficiary relative to the rest of the world. We believe this pattern will continue throughout most of 2019.

Trump's "America First" has upset the status quo on issues where a strong domestic constituency is lacking. As a result, there have been a number of geopolitical triggers in 2018 that could have further implications for investors in 2019. In Figure 1, we highlight several examples of geopolitical price action based on US policy moves.

Figure 1  
**Market Impact of US Policy**

<b>Geopolitical Trigger</b>	<b>Market Effect</b>
US-China Trade Tensions	Renminbi depreciation > 10%
US Withdrawal from Iran Deal	Crude oil prices rose > 12%
US-North Korean Summit	Korean won appreciation > 3%
US-Turkish Rift	Exacerbated currency crisis, with Turkish lira depreciating near 40% and Turkish rates jumping from 8% to 24%
US imposes further sanctions on Russia	Russian rouble decouples from oil prices

Source: State Street Global Advisors Research, 2018.

These moves are likely to have secondary and tertiary effects, for example, on companies within complex supply chains or those with specific regional exposures that may have to alter their business models or absorb additional costs.

## Hotspots for 2019

Other areas of the world are also likely to be affected by geopolitics in 2019. In the map below, we pinpoint the hotspots for geopolitical activity that could have an impact on markets in 2019.

- High
- Moderate
- Low

### Washington DC

Global trade and security risks

### Damascus

#### Baghdad

Civil war and Kurdish secession

### Moscow

Russian cyber, political and military interventions abroad

### Beijing

US trade hostility and Belt & Road initiative

### Caracas

Economic meltdown

### London

#### Brussels

#### Rome

Brexit impasse & EU budget negotiations

### Tehran

Coping with US sanctions

### Pyongyang

Declining risk of conflict

Source: State Street Global Advisors as of October 2018.

At the global level, we expect the US–China dispute to continue as there is presently no obvious exit strategy for either country. Equally, Russian interventions in conflicts and external elections continue, and reciprocal sanctions are unlikely to ease.

In the Middle East, the confrontation with Iran is likely to loom large, with proxy theaters in Yemen and Syria. In a worst-case scenario, we could see provocations in international waters or inside Gulf countries—all of which could have an impact on oil prices.

Venezuela, too, is likely to continue to be a factor in commodity markets. It appears to have passed a point of no return from an economic perspective, triggering the largest refugee crisis in Latin America, and having spillover effects on Colombia. Further escalation of this situation could invite intervention from external actors, such as the US.

With regard to Korea, we expect the détente to last until 2020, assuming that there are no inflammatory moves by either side.

Finally, the European Union is strained on three levels:

1. **Brexit.** The need for the EU to maintain unity and strength as a trade/regulatory bloc while ensuring the UK meets its outstanding liabilities.
2. **Italy.** Ensuring the credibility of monetary union (the trajectory is either repeated bouts of economic crises or erosion of monetary orthodoxy).
3. **Poland/Hungary/Romania.** Facing down challenges to the legal and political order, with a sharp reversal of country fortunes possible with the renegotiation of the EU budget cycle.

Any resolution of these geopolitical themes could trigger re-ratings in the markets they affect and should be monitored over the coming months.

## Key Milestones in 2019

Date	Event	What to Watch
January / February	US trade: China tariffs and automobile imports	Does the US impose a 25% tariff on a wide swath of Chinese imports on January 1? What is the result of the Section 232 investigation into auto imports, due on February 17?
February 16	Nigerian presidential elections	Stability and outlook in the largest African nation and OPEC member.
March 29	Brexit—UK leaves EU	Nature and duration of transition period; tail risk of UK hard Brexit.
May 9	EU agrees new 7-year budget (2021–2027)	Levels of economic transfers granted to Poland and Hungary; measures of support for struggling southern European states.
May 23	EU Parliamentary elections	Performance of populist parties; constellation of majority bloc in EU Parliament; ripple effect on national politics in Germany, Italy and France.
May	Indian elections	Re-election of Modi or emergence of new national figure.
June 29	G20 Summit	Status of trade and geopolitical disputes among largest nations.
May–August	South African elections	Potential first loss of African National Congress majority.
October 27	Argentinian elections	Electoral test of economic liberals and new International Monetary Fund (IMF) regime.
October	Polish elections	Success of incumbent government and test of anti-EU sentiment.
November 1–December 1	New EU leaders of the European Central Bank (ECB), European Commission and Council	Political center of gravity in EU institutions; future of monetary policy and crisis-fighting ability of the ECB; relations among EU governments (especially North–South).

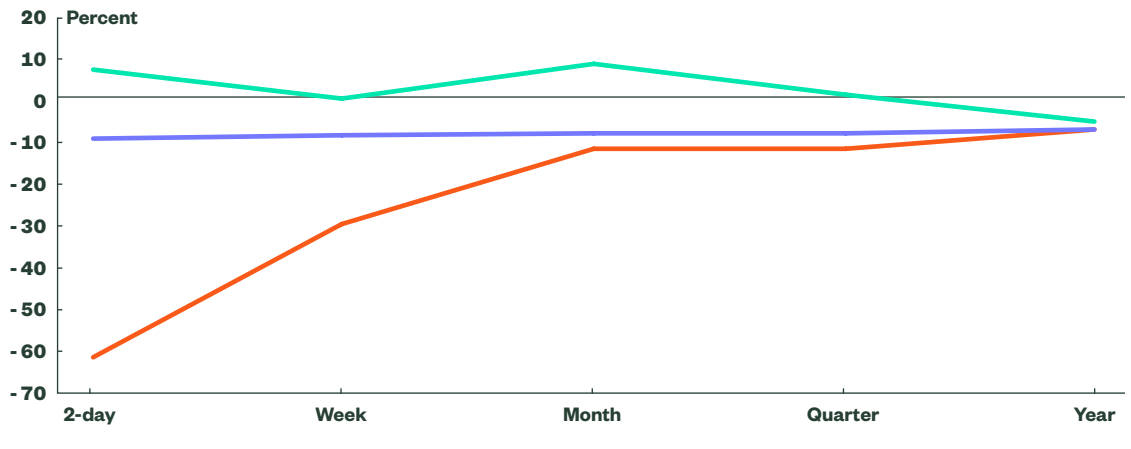
## What to Do as an Investor

To understand how investors might factor geopolitics into their investment decisions, we studied how emerging markets have reacted to geopolitical events over the past 30 years.<sup>1</sup> We found clear patterns in currency and equity markets but no consistent outcomes in bond markets.

For currency markets, negative events led to an instant depreciation, on average of -0.64% within two trading days, whereas positive events barely registered a market reaction. To add context, we note that the long-term average monthly performance of the currencies in the study was -0.66%. So in the wake of a negative event, currencies undergo the majority of their expected monthly fall in just two days. After this initial shock, currency trading reverts to normal patterns, but does not necessarily reclaim the original loss over the subsequent 12 months. As Figure 2 shows, currency performance normalizes, but even one year later, positive events have led to a 2% outperformance relative to the historical average.

Figure 2  
**Annualized Currency Performance<sup>2</sup>**

■ After Positive Events  
 ■ Historical Average  
 ■ After Negative Events

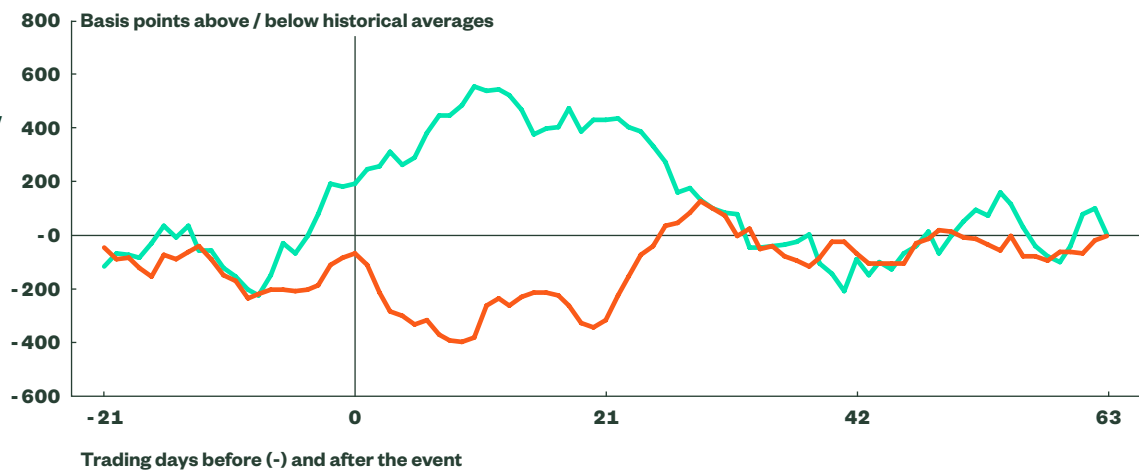


Source: State Street Global Advisors Research, 2018.

For equity markets, Figure 3 shows the effect of geopolitical events on returns for stocks within local MSCI indices. This chart illustrates the rolling monthly equity performance relative to historical averages. Instant reactions reflect the positive or negative nature of any event and are far more symmetrical than those in currency markets. Higher frequency data suggest that equity markets display a somewhat higher degree of anticipation for those events than currency markets. Weekly and monthly results are pronounced, both in absolute terms and in relation to historical returns. In other words, positive events lead to a consistent outperformance. For instance, one month after a negative event, equity indices tended to be, on average, 2.02% below their pre-event level.

Figure 3  
**MSCI Local-Currency Monthly Rolling Returns, Basis Points<sup>3</sup> Above/Below Historical Average<sup>4</sup>**

■ Positive Events  
 ■ Negative Events



Source: State Street Global Advisors Research, 2018.

The three-month point after events is critical to understanding the length of the event impact. At this point, on average, indices return in nominal terms to pre-event levels. The gap between performance after negative and positive events collapses, and performance begins to mean-revert for both types of event. Therefore, the effects of geopolitical events typically seem to last somewhere between one and three months, but the differential performance during those initial weeks is not erased.

This historical performance suggests several investment actions during periods of heightened geopolitical risk:

1. **Consider currency hedges.** Since negative geopolitical events primarily transmit via currency, periods of higher risk could justify currency hedging, depending on the base currency. This can be abandoned once geopolitical tensions dissipate.
2. **Consider buying stocks on the dips.** Eventually, geopolitical crises settle into a new equilibrium and equity markets then tend to mean-revert to historical performance, albeit from a lower base. Similarly, although positive events are usually telegraphed in advance, investors can capture the tailwinds from the de-escalation of conflicts.
3. **Don't necessarily rely on bonds as proxies.** US Treasuries aside, resident and non-resident investors treat bonds differently when an event happens, due to different base currencies as well as differing perceptions about what constitutes a safe haven during periods of stress.

- 1 Petrov, Alexander; Hentov, Elliot; and Zumbo, Fabrizio. "How Does Geopolitics Affect Financial Markets?" September 2018.
- 2 Note: Averages across all positive and negative events where data is available, weighted equally across four markets; results annualized. Source: Bloomberg, State Street Global Advisors Research, 2018.
- 3 One basis point (bp) is equivalent to 0.01%.
- 4 Note: Averages across all positive and negative events where data is available, weighted equally across four markets; results annualized. Source: Bloomberg, State Street Global Advisors Research, 2018.

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# Market Outlooks

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## Navigate Late Cycle Volatility with Defensive Equities

US equities are likely to outperform those in Europe and emerging markets in 2019, as investors face increased volatility amid rising interest rates and trade uncertainty.

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## Time for Bond Investors to Position for Cycle End

We see a flattening yield curve and signs of concern in the US mortgage market.

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## Use Short-Term Moves to Hedge Long-Term Currency Exposures

While 2019 may initially provide more of the same for international currency markets, the potential for a significant shift should not be discounted.

# **Navigate Late Cycle Volatility with Defensive Equities**

**Gaurav Mallik**

Chief Portfolio Strategist



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Although global GDP growth is expected to slow in 2019, economic fundamentals should continue to support earnings growth in equity markets, most notably in the US. Even so, equity investors are likely to face increased volatility amid rising interest rates and trade uncertainty, not to mention the multiple changes occurring to global equity indices in 2019. Investors may wish to focus on defensive equities to navigate the late innings of this historically long cycle.

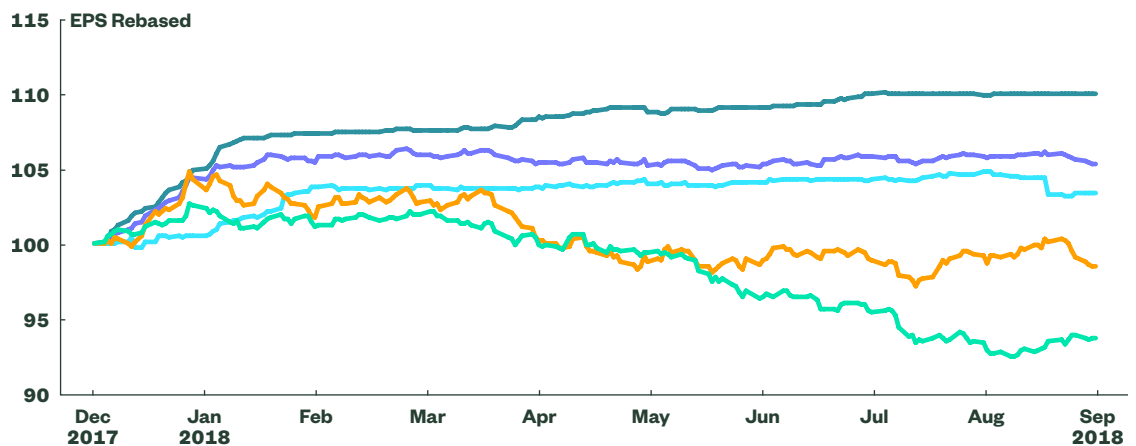
## Strong Fundamentals Support US Equities

While US equities saw a severe pullback in October 2018, we still expect them to outperform relative to the rest of the world in 2019, though with limited headroom for multiple expansion. To progress, we will need to see further advances in earnings across all sectors.

We expect earnings to advance for several reasons, albeit with some volatility in expectations. First, investors have demonstrated that they are prepared to pay for the greater expected return on equity of US companies and for economic stability, as demonstrated by the US's relatively contained inflation and robust GDP growth. Second, the US is currently leading the world in terms of expectations for earnings-per-share (EPS) growth in 2019 (see Figure 1). Third, US consumption is buoyant, thanks to rising disposable incomes and high employment.

Figure 1  
**US Leads EPS Expectations for 2019**  
 MSCI 2019 EPS forecasts—rebased to 100

- MSCI USA
- MSCI World
- MSCI Japan
- MSCI Europe
- MSCI EM



Source: MSCI, State Street Global Advisors, Bloomberg. As of September 2018. Rebase: to establish a new base level for (a tax level, price index, etc.)

US equity return drivers are well supported by several factors, including increases in intended capital expenditures due to US tax reforms and low unemployment levels as well as share buybacks, which reached a record high in 2018. While buybacks may not break further records in 2019, we expect US companies to continue to repatriate funds from overseas and return a portion of these to shareholders. Textual analysis of company statements shows that capex and shareholder payouts are likely to be key corporate themes in 2019.

Increased capital expenditure, in turn, should be supportive for cyclical stocks such as industrials, which typically gain momentum toward the end of the cycle. Moreover, we have seen interest in the US equity market broaden from a handful of large technology companies, offering investors more opportunities in other sectors. To that end, we are positive on healthcare as well as technology. We remain neutral on banks, as the US yield curve is likely to flatten further, perhaps even invert, in 2019, preferring insurers and other fee-paying businesses.

Meanwhile, political and economic uncertainty is causing risk aversion among global investors, who are demanding higher risk premia from non-US markets. This reflects a growing disconnect between these regions' share prices and their fundamentals. While we see no reason for this to alter in the near term, any US dollar weakness, downside surprises on US growth, signs of Federal Reserve (Fed) dovishness or a greater impact from China's looser fiscal and monetary policy stance could provide a catalyst for emerging markets and other risk assets to bounce.

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## **Emerging Markets (EM) Equity Valuations Offer Attractive Buying Opportunities**

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EM relative equity valuations traded at all-time lows in 2018, with a discount to developed markets of roughly 70%<sup>1</sup>, against a backdrop of trade conflict, idiosyncratic issues in countries such as Turkey and Argentina, fear of contagion and concerns about Chinese banks. While the Fed continues to tighten monetary policy and the US dollar remains strong, emerging markets are likely to struggle in aggregate. Earnings-per-share estimates continue to trend downwards for 2019 and will need to stabilize before investors are likely to re-enter emerging markets.

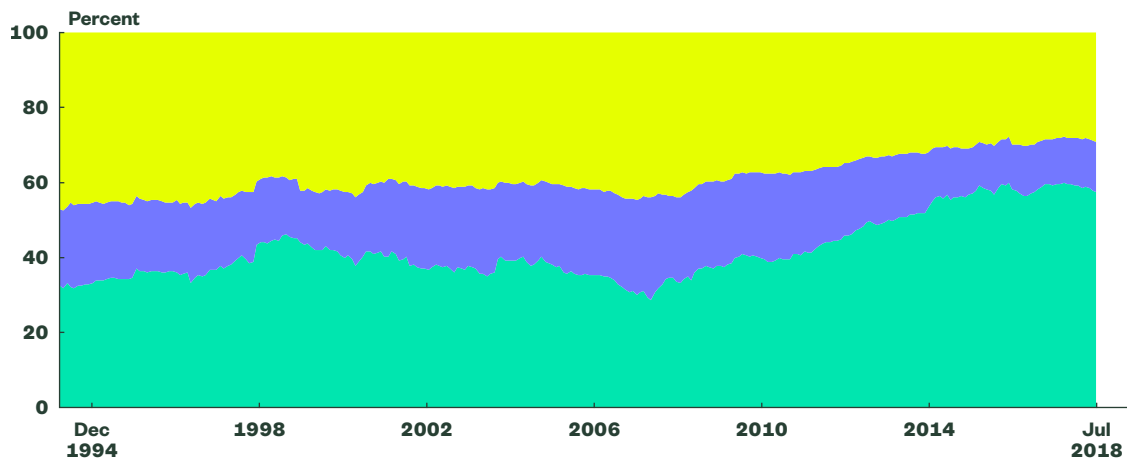
Nonetheless, specific EM opportunities could emerge later in 2019, if the risks already priced in to markets do not materialize. In this scenario, investors looking to increase their long-term EM allocation could consider buying the dips. If trade risks reduce, for example, we could see sentiment move sharply in favor of EM equities, debt and currencies. We have already seen the Mexican peso return to levels last seen prior to US President Trump's election following agreement on a treaty to replace NAFTA.

China has responded to the trade war with the US by loosening monetary policy to stimulate demand, while Chinese banks are trading close to the low levels last seen during the global financial crisis. Chinese equity valuations in general are very low, despite a 9% year-on-year growth in Chinese retail sales.<sup>2</sup> Fixed capital investment (e.g., factories and infrastructure) has gone from roughly 48% of GDP to 44% in just five years.<sup>3</sup> So while there may be defaults in China, many of the underperforming companies (e.g., those in metals and mining) have been cleared from the system and we believe the government has the capacity to manage higher levels of corporate debt.

EM sector composition has also changed, with consumption sectors now accounting for the largest proportion of the MSCI EM index. Despite this, EM countries are still treated by international markets as a play on resources rather than on consumption (see Figure 2). Sector-adjusted EM valuations still trail their developed market peers, especially in technology and consumer-related sectors. In addition, we are due to see significant changes to MSCI EM indices, with the phased inclusion of China A-shares and Saudi Arabian equities in 2019, which should bring significant flows to these markets but also prompt global investors to review their allocations.

Figure 2  
**Consumer Sectors Account for Largest Proportion of the MSCI EM Index**  
 Percentage of MSCI EM Index sector weightings by market capitalization

- Industrial, Financials, Telecommunications, Utilities and Real Estate
- Energy and Materials
- Information Technology, Health Care, Consumer Discretionary and Consumer Staples



Source: MSCI, SSGA, Bloomberg. As of September 2018.

Finally, institutional positioning in EM is now so light (even compared to historically underweight institutional allocations) that we would expect to see some reversion in due course, especially if EM growth picks up versus developed markets.

- 1 Ratio of MSCI World to MSCI EM in terms of price to book.
- 2 National Bureau of Statistics of China, as of September 2018.
- 3 [www.theglobaleconomy.com](http://www.theglobaleconomy.com), as of end 2017.

## European Uncertainty Weighs on Valuations

European equities continue to be hamstrung by regional politics. Leaders in countries such as Germany, France and the UK are preoccupied with their own political survival, Brexit and the immediate financial risks presented by countries such as Italy. This has weakened the impetus to implement much-needed structural reforms aimed at protecting the eurozone from the next crisis.

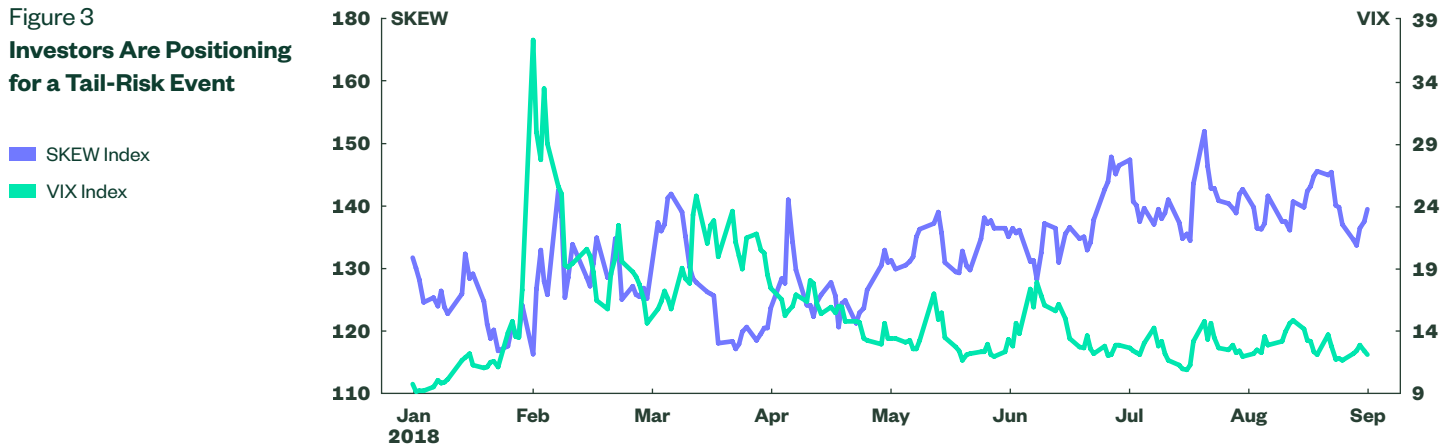
If Brexit negotiations result in a deal and populists fail to dominate May's European Parliamentary elections, European markets could make progress in the second half of 2019. European growth remains reasonable and the European Central Bank is set to wind down quantitative easing and may even raise rates towards the end of 2019. However, at the time of writing, we believe real political risks could weigh on European stocks and justify a defensive stance that seeks to mitigate market volatility.

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## Volatility Returns to Normal

Following unusually complacent market conditions in 2017, when equity markets made unobstructed progress with record-low volatility, 2018 brought more normal conditions with a higher probability of losses or tail-risk events. We expect this backdrop to continue in 2019: the longer the global equity market rally continues, the greater the probability that a market correction will materialize, in addition to nervousness around rising rates, diminished liquidity and US dollar strength. We see evidence of investors positioning their equity portfolios for a correction via the SKEW index, which measures the risk of extreme market moves. While volatility, as represented by the VIX volatility index, has trended downwards, investor positioning for a tail-risk event has been elevated for an extended period (see Figure 3).

Figure 3  
**Investors Are Positioning for a Tail-Risk Event**



Source: Bloomberg. As of September 30, 2018.

Investors worry about tail risk because a single-year correction of 20% can erase nearly 30% of the total portfolio value generated over nine years of strong equity markets. We therefore expect a shift in emphasis from return on capital to return of capital over the next 12 to 18 months. State Street Global Advisors analysis indicates that developed market (DM) equities will generate only 6% in returns over the next ten years compared to historical averages of 10%, while EM will return over 9%.

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## Investment Implications

Against the backdrop of the longest bull market in history, we believe there is a case for global investors to be overweight risk assets in 2019 while remaining alert to increased tail risks. In such an environment, we recommend adding to global strategies, focusing on equities with defensive characteristics. Investors should seek companies likely to benefit from US economic tailwinds. In addition, emerging markets equities should offer attractive entry points in 2019, given the discounts they offer to developed markets equities, particularly in the technology and consumer-driven sectors. In Europe, we remain cautious due to political headwinds and suggest a more defensive posture than elsewhere. Finally, because value stocks have underperformed for such an unusually extended period, we believe we should be close to an inflection point. As the greatest upside happens early in the turn of the cycle, we suggest investors don't give up on value now.

# **Time for Bond Investors to Position for Cycle End**

**Matt Nest, CFA**

Global Head of Macro Strategies

**Niall O'Leary**

Global Head of Fixed Income

Portfolio Strategists

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Global fixed income investors faced a challenging 2018, as yields moved higher, curves flattened and credit spreads widened. Furthermore, emerging markets currencies and bonds had their worst showing for several years. This price action is indicative of late-cycle behavior as markets feel their way through a monetary hiking cycle and vulnerabilities are exposed. Looking into 2019, we expect a similar dynamic as we move closer to the cycle's end.

While we will know more about further policy moves by the middle of 2019, the US fixed income market cycle going into 2019 already paints a pretty clear picture. US rates are near a cyclical peak, and the yield curve will continue to flatten as the Federal Reserve (Fed) continues hiking. While we do not believe credit poses any imminent threat, pricing suggests caution. The one major segment that looks abnormal is the agency mortgage market, which is why we have reduced our exposure. The rest of the world is simply behind the US cycle, because the US recovery began, and took hold, sooner. It is therefore not surprising that the US will reach the end of the cycle before other developed economies.

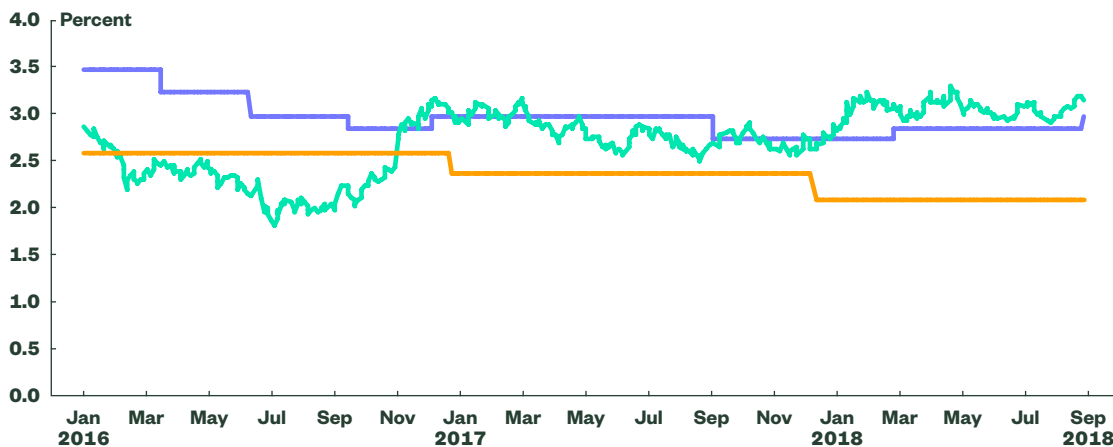
Given this backdrop, investors should seek to balance their overall risk posture, increasingly look to the front end of the US yield curve for opportunities and start to explore select emerging markets bonds and currencies for value.

## Inverting the Yield Curve

While there was a lot of excitement with respect to US interest rates in 2018, as US economic data consistently surprised to the upside, we think key structural constraints on growth and inflation—such as rising debt, aging demographics, low productivity and a lack of capital investment—will provide a cap on real rates (see Figure 1). As the Fed remains committed to its path of gradual monetary policy normalization and secular factors continue to anchor intermediate to long-end rates, the curve will flatten at or around the level consistent with the long-run federal funds rate, and perhaps invert by the end of 2019.

Figure 1  
US Rates Currently Offer Value

■ Fed Long Run Rate  
■ 5y5y  
■ Implied Neutral Nominal Rate



Source: Bloomberg and State Street Global Advisors as of September 30, 2018.

With global rates, the US has been a prominent driver of sovereign bond yield movements over the past two years. As growth and inflation fundamentals in the US and the rest of the world have diverged, the spreads between the regions have followed suit. The spread between the US 10-year Treasury bond and German nominal interest rates is now at its widest level since the euro was introduced. While the current move wider in spreads is reasonable given growth and inflation differentials, the spread between the US 10-year Treasury and the German 10-year Bund is unlikely to persist indefinitely.

While it is too early to expect convergence in policies and rates, we will keep a close eye on how this dynamic plays out, especially in the second half of 2019, as any significant changes will have major ramifications for fixed income investors. In the UK, the uncertainty surrounding Brexit continues to weigh on the gilt market. While economic activity has been relatively resilient, a hard Brexit is expected to have a resoundingly negative impact. The range of possible outcomes, from a hard Brexit, to a more measured one and even the remote possibility of another referendum, means that the direction of travel for gilt yields is still unclear.



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## Focus on Credit Quality

The global credit cycle remains in its later stages, but there are no immediate signs of a turn. Fundamentals remain constructive for the global credit market, especially in the US where tax reform has helped to elongate the current cycle. Key economic indicators within the Conference Board Leading and Coincident Economic Indexes point to the US continuing to make progress, offering further headroom for credit markets over the short to medium term. Coupled with the gradual removal of monetary accommodation on a global scale, tight spreads and favorable market technicals in the form of reduced supply, we feel that the next downturn in the credit cycle does not represent an immediate threat. Nonetheless, it may be prudent to take some, not all, risk off the table. Investors should be tactical with their allocations, opting for quality and moving higher up the credit spectrum in both high yield and investment grade.

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## Reduce Mortgage Exposure Amid Pricing Extremes

Current pricing in the implied interest rate volatility and mortgage-backed security (MBS) markets is extreme. Historically, interest rate volatility has been mean reverting and with the Fed's continued balance sheet run-off and a US economy in the later stages of the economic cycle, investors should position their portfolios to benefit from a repricing of the volatility market.

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## Look for Valuation Opportunities in Emerging Markets Bonds and Currencies

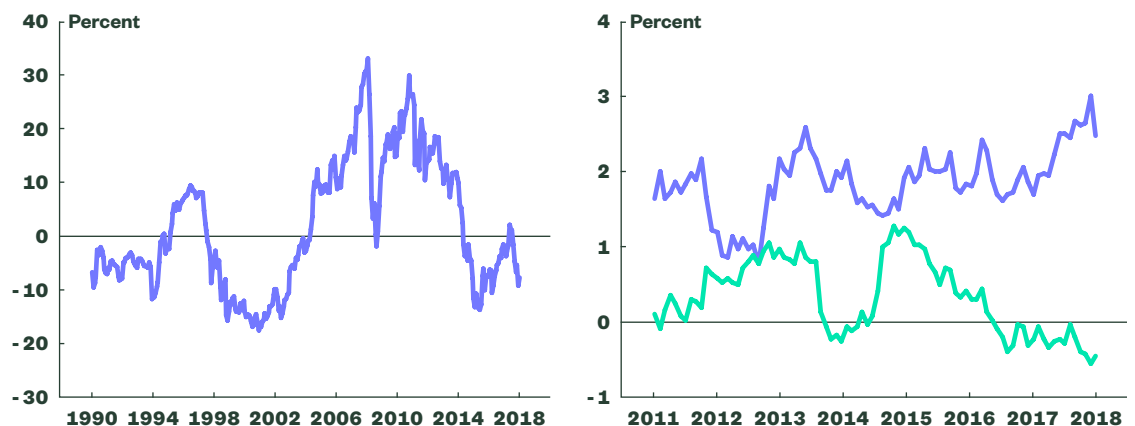
Emerging markets (EM) struggled last year due to idiosyncratic concerns in a few countries as well as increasing global trade tensions, a strengthening US dollar and higher US Treasury yields. However, economic fundamentals remain broadly supportive, inflation is still relatively under control and currencies are undervalued in aggregate. The growth differential between emerging and developed markets is expected to widen over the next few years, while higher commodity prices should bolster EMs in aggregate, and EM yields remain attractive (see Figure 2). As a result, we remain constructive on EM debt, with a preference for local currency bonds, and within EM currencies we favor an increasingly selective approach as the cycle matures.

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Figure 2  
**Emerging Market Bonds  
and Currencies Offer Value**

(Right hand chart)

■ GBI-EM Real Yield Estimate  
■ Global Treasury Real Yield



Sources: Left hand chart: State Street Global Advisors estimate of fair value versus the US dollar as of August 30, 2018. Right hand chart: State Street Global Advisors, Bloomberg Finance, L.P. as of October 11, 2018.

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# Use Short-Term Moves to Hedge Long-Term Currency Exposures

**James Binny**

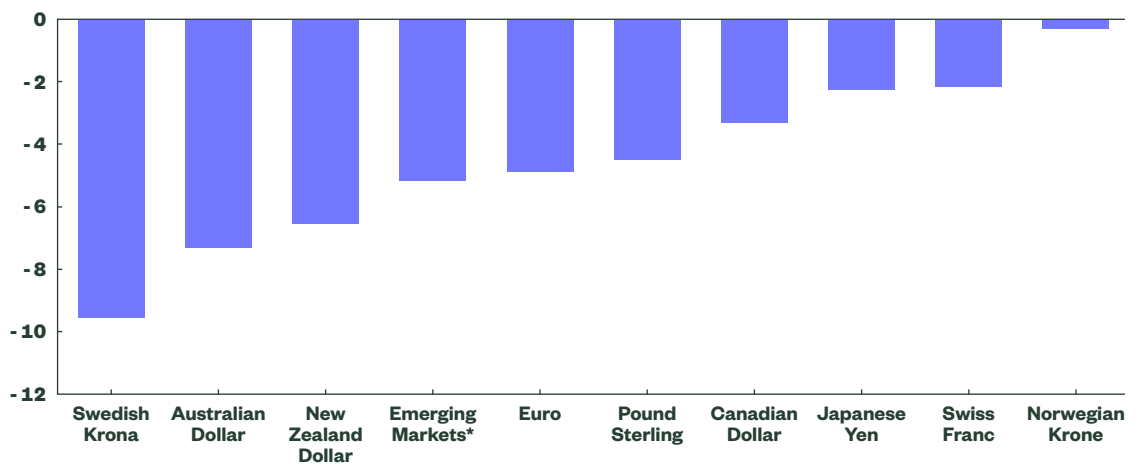
Global Head of Currency

**Aaron Hurd**

Senior Portfolio Manager, Currency

The US dollar showed unexpected strength in 2018, thanks to tightening monetary policy, strong US growth and trade uncertainty (see Figure 1). We expect these factors to continue to support the dollar into early 2019. By the second half of the year, however, the dispersion between the US and the rest of the world could start to peak, especially if trade disputes are resolved more swiftly than anticipated; as a result, we could see a rerating in currencies. Investors could aim to use these shorter-term dislocations as a means to capitalize on longer-term reversions to equilibrium through currency hedging.

Figure 1  
**The US Dollar Showed Unexpected Strength in 2018**  
 Currency return versus US dollar



Source: State Street Global Advisors, Bloomberg (December 31, 2017 to September 30, 2018).

\*Emerging Markets are represented by MSCI Emerging Markets Index currency returns weighted by equity-market capitalization.

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## US Dollar Strength to Persist Into 2019

US fiscal stimulus and additional Federal Reserve (Fed) rate hikes are likely to add to the already impressive US short-term yield advantage and support the US dollar (USD) in the first half of 2019, despite the dollar being expensive versus its long-run valuation. This could put further pressure on emerging markets and on less liquid, risk-sensitive G10 currencies such as the Swedish krona (SEK) and the Australian dollar (AUD).

The Norwegian krone (NOK) is extremely cheap despite improving growth, rising inflation and the start of the Norges Bank rate-hiking cycle (the first rate increase of 25 basis points<sup>1</sup> was delivered in September 2018). Thus, NOK appreciation is supported by both short-term cyclical conditions and long-run valuation.

The Australian dollar is susceptible to further escalation of the US-China trade war, but we believe much of that is already in the price. AUD still offers more than 2% positive carry to the Swiss franc (CHF), EUR and SEK, as economic growth has been extremely resilient and exports to China are holding up better than expected despite a softer Chinese economy. The Canadian dollar (CAD) is a relatively new member of our preferred group due to impressive growth, steadily rising interest rates and the resolution of NAFTA negotiations with the US, even as it has been slightly undervalued versus USD.

<sup>1</sup> One basis point is equivalent to 0.01%.

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## Negative Outlook on EUR, CHF and SEK

In Europe, issues such as Brexit, Italian political uncertainty and the erosion of Chancellor Merkel's support in Germany are likely to weigh on sterling (GBP) and the euro (EUR). At the same time, growth across the eurozone shows little sign of accelerating to 2017 levels. The European Central Bank (ECB) has all but promised to keep the rate of its deposit facility unchanged at -0.40% through the summer of 2019 and the Swiss National Bank is unlikely to increase rates until after the ECB begins to tighten.

Sweden appears to be the riskiest position. Growth and core inflation have been positive but erratic in 2018 and the central bank, the Riksbank, has held strong to its -0.50% policy rate. That said, the currency is extremely cheap to long-run fair value, the economic situation is improving and the Riksbank projects tighter policy by the first quarter of 2019. We remain negative on the currency for now, but will continue to monitor these upside risks carefully.

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## Potential for Step Change in Second Half

Toward the second half of 2019, markets may begin to anticipate that US exceptionalism has run its course as pressures on other regions dissipate. Our base case is a mildly negative US convergence, in which tighter monetary policy and the impact of trade tariffs slow global growth slightly, with the US rate and growth cycle slowing more than elsewhere. In this scenario, USD comes under pressure, but not to the same extent as in 2017, and low-yielding currencies outperform higher-yielding cyclically-sensitive ones.

Global growth remains above potential, which preserves expectations that low-yielding countries can begin to raise interest rates, sending EUR, SEK and JPY higher. (CHF is historically expensive and Switzerland is likely to lag the ECB in raising rates, so we would not expect as large a move.) On the other hand, slower global growth would limit the extent of gains in the higher-yielding, growth-sensitive currencies such as AUD and many emerging markets.

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## Risks to the Second-Half Outlook

Whether or not this step change is going to occur will become clearer after the end of the first quarter, as we get more insight into Fed behavior and whether US growth is strong enough to sustain US divergence. If Europe and emerging markets do start to show signs of catch-up as the year progresses, this could hamper USD, while EUR, AUD and SEK should outperform. Alternatively, if the rest of the world slows enough to spur fear of recession and the US slows even faster, then USD is likely to be better supported after an initial shock and the less cyclically-sensitive CHF and JPY will likely outperform the growth-sensitive AUD and SEK.

In such a scenario, it is difficult to predict EUR moves, as it usually holds up reasonably well in a negative environment, but investors will be quick to price out any hope of an ECB rate increase. On a related note, if we see too rapid an acceleration of monetary policy tightening in the US relative to growth, it is also likely to result in bouts of risk aversion, supporting JPY, CHF and, to some extent, USD regardless of the specific policies in those countries.

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## Strategic Hedging Focus on the Long Run

Short-term currency moves in 2019 could provide opportunities for strategic investors to adjust their hedge ratios in anticipation that currencies will revert to fair value over the medium term. Cyclical over- and under-valuations of currency directly alter the relative competitiveness of countries and their inflation rates, creating pressures that lead to a reversion back to equilibrium.

Importantly, the most appropriate hedge ratio varies by currency base and is not the same for all foreign currencies. This is illustrated in the heat map in Figure 2. The bottom line is that we recommend investors increase hedges on expensive (overvalued) currencies and decrease hedges on cheap (undervalued) currencies.

**USD-based investors.** The heat map shows that higher US rates and growth in 2018 have pushed the dollar up to expensive levels. So, for US-based investors, we recommend low hedges against all G10 currencies except CHF in 2019.

**EUR-based investors.** EUR is near fair value versus USD, resulting in a neutral USD hedge. We suggest low hedge ratios to the cheap GBP, JPY, NOK and SEK, and a high hedge ratio on the expensive CHF.

**GBP-based investors.** Brexit uncertainty has led to GBP being undervalued. We therefore suggest that UK-based investors have high hedge ratios to most G10 currencies, including USD, thereby locking in post-referendum profits made on any unhedged exposure.

**CAD-based investors.** CAD is modestly undervalued versus USD, suggesting a slightly higher USD hedge ratio. USD aside, we suggest low hedge ratios to the cheap GBP, JPY, NOK and SEK, and a high hedge ratio on the expensive CHF.

Figure 2  
**To Hedge or Not to Hedge?**

Currency value heat map

- Undervalued Currencies
- Overvalued Currencies

		Foreign Currency (%)								
		AUD	CAD	CHF	EUR	GBP	JPY	NOK	SEK	USD
Base Currency (%)	AUD	0.0	-3.6	18.1	-2.6	-16.7	-23.9	-22.7	-30.3	2.1
	CAD	3.8	0.0	22.5	1.1	-13.6	-21.0	-19.8	-27.7	6.0
	CHF	-15.3	-18.4	0.0	-17.5	-29.5	-35.5	-34.5	-41.0	-13.5
	EUR	2.6	-1.1	21.2	0.0	-14.6	-21.9	-20.7	-28.5	4.8
	GBP	20.1	15.7	41.8	17.0	0.0	-8.6	-7.1	-16.3	22.7
	JPY	31.4	26.6	55.1	28.1	9.4	0.0	1.6	-8.4	34.2
	NOK	29.3	24.6	52.7	26.0	7.7	-1.6	0.0	-9.8	32.1
	SEK	43.5	38.2	69.4	39.8	19.5	9.2	10.9	0.0	46.5
	USD	-2.1	-5.7	15.6	-4.6	-18.5	-25.5	-24.3	-31.7	0.0

Note: Positive values (red) indicate currencies are overvalued against a counterpart, while negative values (green) show they are undervalued. For example, for AUD-based investors, CHF is 18.1% overvalued and GBP is undervalued by 16.7%. So those investors would want to have a high hedge against CHF and a low hedge against GBP.

Source: State Street Global Advisors as of September 30, 2018.

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# Investment Theme

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All Eyes on China

We see short-term risks but long-term investment opportunities in China.



**Investment  
Theme**

# All Eyes on China

**Laura Ostrander**

Emerging Markets Macro Strategist

**George Bicher**

Asset Class CIO and Portfolio Manager

**Andrew Xiao, PhD, CFA**

Senior Portfolio Manager, China Equity

**Abhishek Kumar, CFA**

Head of Emerging Market Debt

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Following an exceptionally strong 2017, China had a tough 2018 due to escalating trade tensions with the US and fears of a broader stand-off between the world's two largest economies. In 2019, we think security selection will be key as US-China relations fundamentally shift and the risk of a policy mistake increases. Longer term, China's consumer growth story should remain intact, provided that the US and China can resolve their differences and avoid a multi-year impasse. If relations start to improve, investors may wish to capitalize on the bad news already priced in to Chinese stocks. Moreover, given the index changes due to occur in 2019 and market inefficiencies, investors may wish to consider a stand-alone active Chinese equity allocation that allows them to fine-tune their exposure, especially if risks escalate.

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## Shift in US-China Relations

Beyond the implementation of tit-for-tat trade tariffs, we are witnessing a shift in the US-China relationship from “constructive engagement” (applied by the last three US presidents) to “strategic containment.” This reflects the US view that China has not played by the rules of open-market economies despite being in the World Trade Organization since 2001. While China has taken steps to open up its markets, it has not done enough to avoid the suspicion that its mainly state-owned enterprises enjoy advantages over private companies elsewhere.

Its plans to dominate the industries of the 21st century—Made in China 2025—as well as recent military moves in the South China Sea have alarmed not only the Trump administration but other national security experts as well. This suggests to us that this strategic shift might last beyond the Trump years, and while markets seem to have priced in the worst expectations around tariffs, investors are still absorbing the implications of this sea change in relations.

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## Weak Investor Sentiment

China has already taken some measures to counter the effects of the trade war on growth, but these have not prevented the impact being felt in China and around the world. Investor sentiment toward the country soured in 2018 amid concern that the government might not be able to deal with both a trade war and de-leveraging simultaneously without a hit to growth. Our active quantitative and fundamental equity teams are currently underweight China in their emerging market (EM) portfolios, while our multi-asset team has a small underweight to EM. China will therefore have to convince investors that it can stay on a path toward orderly deceleration while avoiding a hard landing. The IMF has reduced its 2019 forecasts for global, US and Chinese growth, specifically citing trade tensions as the reason and calling for de-escalation.

Despite expectations that growth will slow, in our base-case scenario China is expected to grow 6.5% in 2018 and around 6% in 2019. This compares favorably with an average of 2.4% for advanced economies in 2018 and 2.2% in 2019. Meanwhile, the economy continues to rebalance toward domestic consumption and services-oriented sectors as China continues on its path of economic reform and opening up.

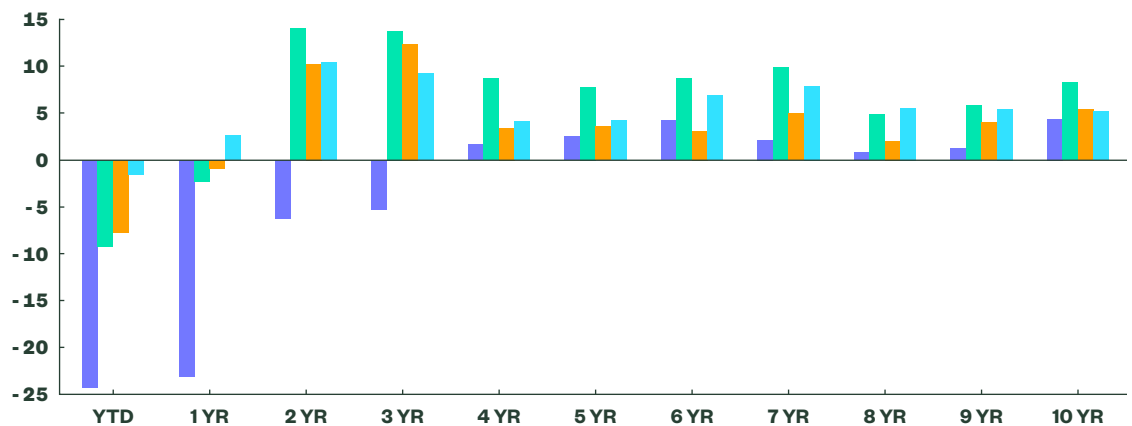
## Stock Selection Key in 2019

Following the sell-off in 2018, equity valuations across China have become much more attractive, with a forward price-to-earnings of 11x for the MSCI China Index, versus a historical average of 12x and developed market equities forward price-to-earnings of roughly 16x. While some may argue that these stocks are cheap for a reason, we think certain sectors look worth investigating within a framework of active management. Our active fundamental EM team is underweight IT, communications services, materials, industrials and real estate, but overweight consumer discretionary stocks, amid rising wealth in China and higher disposable incomes. The team also has small overweights to energy and healthcare.

From a value perspective, Chinese bank valuations are near rock bottom levels with price-to-book of well under 1x and a yield around 5%, limiting further downside. Moreover, EM earnings growth is likely to revert above that of DM as the impact of US fiscal measures dissipates. If the US and China can reach a settlement, the darkest cloud overshadowing global equity markets would lift, and Chinese equities would be among the biggest winners. China has tended to outperform most other emerging and developed markets in the last decade (see Figure 1).

Figure 1  
**China Outperforms  
Over the Long Term**  
Benchmark returns in USD,  
as of September 29, 2018

■ MSCI China A-Share  
■ MSCI China  
■ MSCI Emerging Markets  
■ MSCI World ex USA



Benchmark Name	YTD	1 YR	2 YR	3 YR	4 YR	5 YR	6 YR	7 YR	8 YR	9 YR	10 YR
MSCI China A-Share	(24.16)	(22.99)	(6.14)	(5.25)	1.67	2.58	4.21	2.22	0.80	1.28	4.42
MSCI China	(9.12)	(2.20)	14.07	13.69	8.69	7.85	8.65	9.88	4.93	5.88	8.26
MSCI Emerging Markets	(7.68)	(0.81)	10.22	12.36	3.44	3.62	3.17	5.03	2.12	3.99	5.40
MSCI World ex USA	(1.50)	2.67	10.42	9.31	4.09	4.25	6.93	7.88	5.59	5.43	5.18

## Chinese Bonds Offer Higher Yield with Shorter Duration

Chinese government bonds, meanwhile, have yielded about 3.6% on average with duration of 6.5 years compared to 1.5% yield and 7.9 years of duration for the existing global treasury universe.<sup>1</sup> Given its small foreign investor base, the Chinese bond market has a very low correlation with global bond markets, for example, they have a correlation of just 0.2 versus US Treasuries. While this correlation may increase as foreign ownership of domestic Chinese bonds rises, it should remain low enough to offer good diversification benefits for global investors.

<sup>1</sup> Bloomberg Barclays Point analytics

## Consider Standalone Allocation to China Amid Index Changes

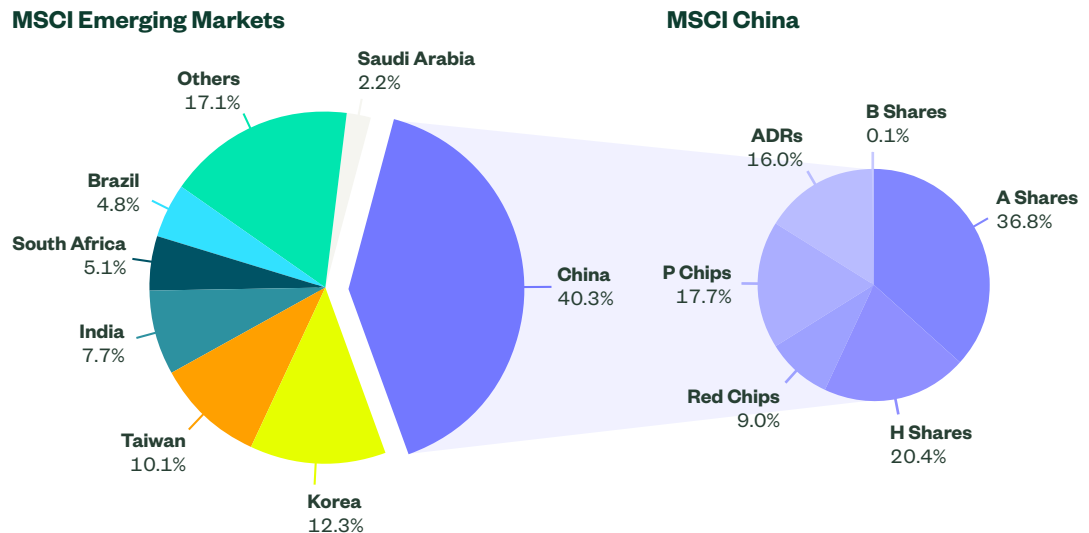
China remains one of the biggest underweights among EM investors, but has been swift to respond to the requirements of major emerging market equity and debt indices that wish to include, or that are considering including, onshore Chinese securities in a phased approach from 2019.

These potential changes could have significant effects on index composition and investor allocations. Given the risks and opportunities facing China in 2019, we think now is the time to consider a stand-alone Chinese allocation that encompasses both onshore and offshore Chinese securities as part of a long-term strategy to capture higher returns than those available in developed markets.

## Implications for Equity Investors

From an equity perspective, MSCI is proposing to add a higher proportion of China A-shares (traded onshore in China) to its broadly followed MSCI Emerging Market and China indices. A hypothetical full China A-share inclusion would take the proposed May 2020 total China weight (A-shares plus H-shares) from 32.16% to 40.3% of the EM index (see Figure 2). It would also increase China's weight in the MSCI All Country World Index from 3% to 5%.

Figure 2  
**Full Inclusion of China A-Shares Would Greatly Increase the Total China Weight of the MSCI EM Index**  
 Pro-forma weight of China in the MSCI EM Index by 2020



Source: MSCI, SSGA, 2018.

Such index changes plus the advent of the Stock Connect program (that links onshore and offshore markets) should render the distinction between the two types of shares (A and H) irrelevant. This would make it feasible for global investors to run a unified all-share China equity strategy. We think this is preferable to running a separate A-share only strategy as higher quality and investable Chinese companies tend to be listed offshore and the valuation differences between the two types of shares can be large.

Given the potential inefficiencies in this market, we would recommend investing in China with a skilled active manager who is able to capture the maximum alpha available. For a typical portfolio, we would recommend adding a dedicated China all-share equity strategy within an EM allocation, which would enable flexible and direct top-down control of the portfolio's overall China exposure, an increasingly important equity-allocation parameter.

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## Implications for Bond Investors

Bond Connect, the fixed income equivalent of Stock Connect, has made it easier to invest in onshore Chinese bonds. If China is added to all fixed income indices, including the Bloomberg Barclays Global Aggregate index, there is scope for about USD 420 billion<sup>2</sup> of inflows. However, it is worth considering that most of the bonds being added are not liquid, and a bulk of the flows would be used to buy Chinese government bonds (CGBs). Liquidity constraints will drive a larger share of foreign flows to the on-the-run (that is, those most recently issued) CGBs, which could trigger a rally in these bonds and a consequential repricing of other bonds as well.

With more offshore investors involved in the Chinese bond market, we are likely to see an improvement in the market's efficiency, which could further attract foreign interests and increase the global asset allocation to China. There is a structural demand for Chinese bonds purely from the weight of the yuan in the IMF's SDR.<sup>3</sup> The yuan is the third-largest component of the SDR basket, with a weight of 10.9% as of August 2018; however, the yuan represents only 1.4% of the Composition of Official Foreign Exchange Reserve (COFER).<sup>4</sup> If the gap between the two closes, this would likely generate structural demand for Chinese assets, which could be captured with a beta allocation to Chinese and EM local currency debt. Including China in major bond indexes should reduce overall exposure to developed countries' debt, which might put upward pressure on developed market yields.

2 State Street Global Advisors estimates using the Barclays Global Aggregate, JP Morgan GBI-EM and FTSE Russell World indices and based on the assumption that active managers will buy stocks in anticipation of index flows.

3 The IMF's Special Drawing Right (SDR) is an international reserve asset to supplement its member countries' official money reserves. It represents a basket of five currencies: the US dollar, the euro, the Chinese renminbi (or yuan), the Japanese yen and the British pound. The renminbi was added most recently in 2016.

4 The IMF's COFER database tracks end-of-period quarterly data on the currency composition of official exchange reserves.

## Contributors



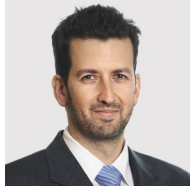
**Richard Lacaille**  
Global Chief  
Investment Officer



**George Bicher**  
Asset Class CIO and  
Portfolio Manager



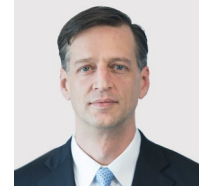
**James Binny**  
Global Head of Currency



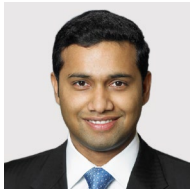
**Elliot Hentov, PhD**  
Head of Policy and Research



**Patricia Hudson**  
Global Head of Investment  
Communications



**Aaron Hurd**  
Senior Portfolio Manager,  
Currency



**Abhishek Kumar, CFA**  
Head of Emerging Market Debt



**Gaurav Mallik**  
Chief Portfolio Strategist



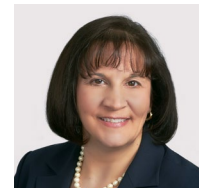
**Simona Mocuta**  
Senior Economist



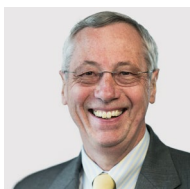
**Matt Nest, CFA**  
Global Head of  
Macro Strategies



**Niall O'Leary**  
Global Head of Fixed Income  
Portfolio Strategists



**Laura Ostrander**  
Emerging Markets  
Macro Strategist



**Christopher Probyn, PhD**  
Chief Economist



**Andrew Xiao, PhD, CFA**  
Senior Portfolio Manager,  
China Equity



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As investment challenges grow more complex, our Global Market Outlook is designed to alert investors to portfolio risks and opportunities in the coming year, based on the research of our investment teams.

Research around near-term and longer-term market issues is at the heart of who we are as investors. It drives the kinds of outcome-oriented portfolios we create for clients, drawing on the full range of our beta and alpha solutions as well as our asset allocation expertise.

In this issue of the Global Market Outlook for 2019, we have sought to improve the user experience through more intuitive digital formats (visit [ssga.com/gmo](http://ssga.com/gmo)).

We hope this new approach makes it easier for you to quickly access relevant content to help you plan for 2019 and beyond.



# Glossary

## **5y5y**

The five-year forward expected inflation rate. It reflects the market's inflation expectations of average inflation over 5 years, 5 years from now.

## **Bloomberg Barclays Global Aggregate Index**

Is a flagship measure of global investment grade debt from 24 local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

## **Emerging Market Debt (EMD)**

Bonds Issued by governments of developing countries.

## **Fed Long Run Rate**

The Fed's expectation of where long-run real interest rates should be, absent economic shocks.

## **GBI-EM Real Yield Estimate**

An estimate of real (inflation-adjusted) yield based on the JP Morgan GBI-EM Global Diversified Index weightings (excluding Argentina, Uruguay and Dominican Republic which account for 0.9% of the index) and on an estimate of real yield using approximations of the average maturity for each country.

## **Gilt**

A UK government bond.

## **Global Treasury Real Yield**

A measure of cash flow an investor receives for investing in government bonds, expressed as a percentage and adjusted for inflation. Global Treasury Real Yield uses Bloomberg Barclays index weightings as of August 31, 2018 excluding emerging economies and also uses approximations of the average maturity for each country.

## **Hike**

An increase in interest rates by a central bank.

## **Implied Neutral Nominal Rate**

State Street Global Advisors' estimate of the neutral real interest rate.

## **MSCI China A Share**

Captures large and mid-cap Chinese stocks listed on the Shanghai and Shenzhen exchanges.

## **Mean**

The simple mathematical average of a set of two or more numbers.

## **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 461 constituents, the index covers about 85% of this China equity universe. Currently, the index also includes Large Cap A shares represented at 5% of their free float adjusted market capitalization.

## **MSCI Emerging Markets**

Captures large and mid-cap representation across 24 Emerging Markets (EM) countries. With 1,151 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

## **MSCI EM Index**

Includes large and midcap stocks across 24 Emerging Markets (EM) countries. With 1,151 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

## **MSCI Europe**

Represents the performance of large and mid-cap equities across 15 developed countries in Europe.

## **MSCI Japan**

Is designed to measure the performance of the large and mid-cap segments of the Japanese market. With 322 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

## **MSCI World**

Is a market cap weighted stock market index of 1,649 stocks from countries throughout the world.

## **MSCI World Ex USA**

Captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries—excluding the United States. With 1,015 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

## **MSCI USA**

Is a market capitalization weighted index designed to measure the performance of equity securities in the top 85% by market capitalization of equity securities listed on stock exchanges in the United States.

## **SKEW Index**

Is a measure of potential risk in financial markets. Much like the VIX index, the SKEW index can be a proxy for investor sentiment and volatility. The SKEW Index measures perceived tail-risk in the S&P 500.

## **Tightening cycle**

An environment in which a central bank is raising interest rates.

## **VIX Index**

Is a trademarked ticker symbol for the CBOE Volatility Index, a popular measure of the implied volatility of S&P 500 index options; the VIX is calculated by the Chicago Board Options Exchange (CBOE).

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

### **Start with rigor**

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

### **Build from breadth**

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

### **Invest as stewards**

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

### **Invent the future**

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

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third largest asset manager with US \$2.81 trillion\* under our care.

\*AUM reflects approximately \$28.32 billion (as of September 30, 2018), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated

# State Street Global Advisors Worldwide Entities

ssga.com

## Abu Dhabi

State Street Global Advisors Limited, Middle East Branch, 42801, 28, Al Khatem Tower, Abu Dhabi Global Market Square, Al Mayah Island, Abu Dhabi, United Arab Emirates. T: +971 2 245 9000

## Australia

State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240-7600

## Belgium

State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036, SSGA Belgium is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom.

## Canada

State Street Global Advisors, Ltd., 770 Sherbrooke Street West, Suite 1200 Montreal, Quebec, H3A 1G1, T: +514 282 2400 and 30 Adelaide Street East Suite 500, Toronto, Ontario M5C 3G6. T: +647 775 5900

## Dubai

State Street Global Advisors Limited, DIFC Branch, Central Park Towers, Suite 15 -38 (15th floor), P.O Box 26838, Dubai International Financial Centre (DIFC), Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority (DFSA). T: +971 (0)4-4372800

## France

State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00

## Germany

State Street Global Advisors GmbH, Briener Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400

## Hong Kong

State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288

## Japan

State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan, T: +81-3-4530-7380 Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association.

## Ireland

State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered number 145221. T: +353 (0)1 776 3000

## Italy

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## Netherlands

State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. T: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom.

## Singapore

State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore) T: +65 6826-7555

## Switzerland

State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00

## United Kingdom

State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000

## United States

State Street Global Advisors, 1 Iron Street, Boston, MA 02210 T: +617 786 3000

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ID14779-2293667.1.GBL.RTL 1118 Exp. Date: 11/30/2019

