Forecasts

Fourth Quarter 2018

Global Economic Outlook

By Christopher Probyn, Ph.D.,
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Pages 2–4:

- Global growth remains just below 4.0% this year before decelerating to 3.5% in 2019 on a broad-based slowdown. Despite the current momentum, the risks to growth appear skewed to the downside, reflecting the prospects for disruptions to the global trading system.
- Since slowing sharply in 2015 on the oil price decline, headline inflation in the advanced economies has picked-up on the oil price rebound that began in early 2016. Inflation likely slows slightly next year as oil prices drift sideways around current levels.
- A synchronous G7 tightening cycle looks set to emerge in 2019, except in Japan. Policy rates are already rising gradually in the US, UK and Canada, and they will begin to rise in the eurozone next year. Only in Japan will rates remain unchanged through the end of 2019.

Emerging Markets Outlook

By Simona Mocuta,
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- Under the weight of intensifying trade tensions, a strengthening dollar, rising financing costs, and less accommodative domestic policy settings, broad EM growth looks poised to moderate incrementally to 4.7% this year and more noticeably to 4.5% in 2019.
- Risks are skewed to the downside amid the escalating trade spat between the US and China and risks of a miscalculation in the tenuous dialogue surrounding the critical US-China trade relationship.
- As the cyclical component to the EM recovery in 2017 dissipates, attention is refocussing on fundamental challenges such as high debt levels and lack of structural reforms.

Global Capital Markets Outlook

By Jerry Holly,
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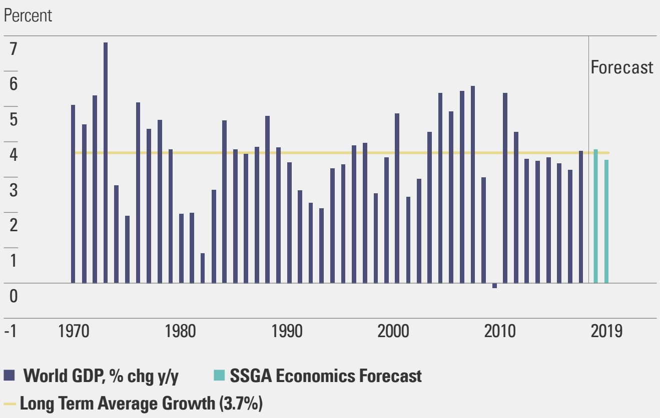
Pages 6–8:

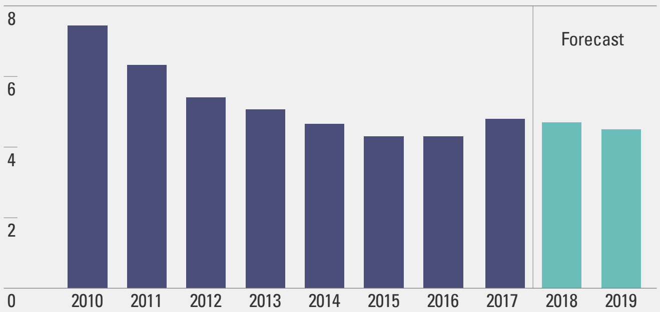
- Divergence across equity markets has been a persistent feature of the investing landscape in 2018 and the same was true of the third quarter with the S&P 500 Index up 7.7%, MSCI EAFE advancing 1.4% and MSCI Emerging Markets down 1.1%, all in US dollar terms.
- Emerging markets have started to attract some bargain-hunters, though they are still afflicted with lingering policy, economic and funding challenges that could lead to further weakness.
- While the motivation varies, interest rates are moving higher in many global bond markets presenting possible opportunities but also potential warning signs for bond and stock investors alike.

Figure 1: Global Growth Peaks



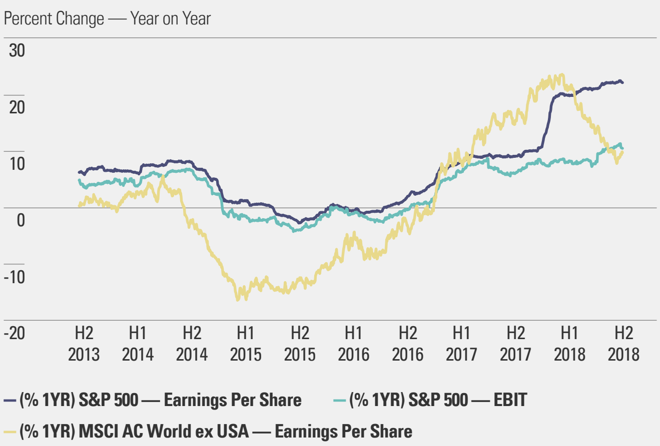
Sources: State Street Global Advisors (SSGA) Economics, Oxford Economics, International Monetary Fund (IMF). The above forecast is an estimate based on certain assumptions and analysis made by the SSGA Economics Team. There is no guarantee that the estimates will be achieved.

Figure 2: GDP Growth in the Developing Economies



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

Figure 3: US Earnings Strength Not Just from Tax Reform



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

Global Economic Outlook

By Christopher Probyn, Ph.D.,
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Global Overview

The global and advanced economies are going through "mini-cycles," with growth slowing in 2016, then reaccelerating in 2017–2018 primarily on an oil price and fiscal policy related swing in the US, before likely slowing again in 2019. In 2017, private domestic demand supported Japan, exports boosted the eurozone, and Brazil and Russia emerged from recessions, China growth continued to exceed the government's 6.5% target, and while India slowed, GDP still rose 6.3%. Not surprisingly then, global growth accelerated 0.6 percentage point (pp) to 3.8% in 2017, the best since 2011. It is projected to remain unchanged this year, before decelerating to 3.5% next year, on slowdowns in both the advanced and developing economies.

Energy prices have assumed the dominant role in the evolution of inflation over the last four years. Indeed, because of the extent and timing of the oil price decline that began in mid-2014, inflation in the advanced economies plunged to just 0.3% in 2015. It has subsequently reaccelerated as oil prices have recovered. But it is projected to slow slightly next year as oil prices drift sideways and core inflation fails to accelerate appreciably.

A synchronous tightening cycle likely emerges by 2019… except in Japan. We expect the Fed to hike once more this year and three times next year, given the current momentum in the US economy and the incipient effect of fiscal stimulus. The Bank of Canada should move again in October, and three more times next year. The Bank of England began tightening last November, hiked again in August and should move twice more next year (assuming a transitional period with the EU). The European Central Bank (ECB) is currently tapering its asset purchase programme, which will end altogether in December. It will then likely raise the policy rate twice during the second half of 2019. Meanwhile, inflation remains too far below target to allow the Bank of Japan to tighten even next year, especially given the scheduled VAT hike in October.

US: Leading the Way

Unlike Canada, the eurozone, and Japan, the US economy did not surprise to the upside in 2017. However, there was some improvement as growth accelerated to 2.2% from an anemic 1.6% in 2016. Growth was underpinned by consumer spending, which contributed 1.8 percentage points, although the actual acceleration reflected a pick-up in business equipment investment and a smaller drag from inventories.

But the US is clearly outperforming now. While the rest of the world has lost considerable momentum since the start of 2018, the US has undergone further acceleration amid broad-based strength in the industrial sector and a reacceleration in consumer spending. Growth averaged 2.7% year-over-year (y/y) during the first half (despite yet another disappointing first quarter) and seems poised to reach 2.9% for 2018 as a whole. The fiscal multiplier of the TCJA (Tax Cuts and Jobs Act) may not be large, but it will nonetheless be accretive to growth both this year and next. The combination of tax cuts, immediate expensing of capital expenditures, the mandatory repatriation of overseas profits (a little over $430 billion during the first half versus $150 billion for the whole of 2017), and a broad deregulation push should incentivize capital expenditures (capex). That these sweeteners are being extended against the backdrop of solid demand and already elevated levels of capacity utilisation should aid their effectiveness. Private non-residential fixed investment grew 6.9% y/y during the first half — the best two-quarter performance in four years — and seems set for further solid gains. Consumer spending will respond only modestly to fiscal stimulus because the bulk of the cuts benefit higher income individuals, who have relatively low marginal propensities to consumer. However, it does respond positively to the strong labor market. Meanwhile, the budget agreement lifts discretionary spending caps and leads to higher actual expenditures on defense and non-defense that add around 0.3 pp to growth this year, and 0.4 pp next year.

Trade policy is the single most important source of uncertainty going into 2019 and may act as a deterrent to both the capex wave currently underway and to consumer spending. But, there are some attenuating forces. The appreciation of the US dollar so far this year (and specifically against the Chinese yuan) blunts the immediate price impact of tariffs — it is worth noting that the price of imports from China has recently started falling again. Some degree of burden sharing between importers, producers, and consumers provides another cushion. And an augmented saving rate (benchmark GDP revisions over the summer essentially doubled previous estimates of the household saving rate) offers yet another. So while a full-fledged trade war is undoubtedly negative, how that negativity plays out in the end is subject to many competing forces.

Inflation slowed quite sharply in the first half of 2017. Indeed, consumer price (CPI) inflation dipped from 2.7% to 1.6% y/y and consumer expenditure (PCE) inflation from 2.2% to 1.4% y/y between February and June. The Fed assumed the slowdown reflected transitory factors such as the introduction of unlimited wireless telephone plans, an unusual abundance of used cars coming off lease, and seasonal declines in apparel prices. This interpretation seems to have been correct, as headline CPI inflation has reaccelerated to 2.9% and headline PCE to 2.3%. Meanwhile, core CPI inflation and core PCE inflation — the Fed's favorite gauge of inflation over the near term — are now running at 2.2% and 2.0%, respectively, essentially right at the Fed's inflation goal. While the combination of 2.0% inflation and a 2.0% funds target would appear potentially 'dangerous' by historical standards, the Fed seems confident that it is not "falling behind the curve." And we agree, because the relationship between resource utilisation and inflation seems to have diminished since the early 1990s; or to put it another way... the Phillips curve has flattened. Indeed, wage inflation is not expected to exceed 3.0% despite an unemployment rate that slips below 3.8% this year, and 3.5% next year. Hence, as oil prices trend sideways, headline inflation settles slightly above 2.0%. Aided by a stronger dollar, more difficult base effects and some productivity gains, core inflation also trends sideways.

The Fed quickened the pace of tightening in 2017 and has continued in the same vein this year. It raised the funds target 25 basis points in March, June and September. A fourth hike also seems very likely in December, leaving the funds target at 225–250 basis points at the end of this year. The Federal Open Market Committee's (FOMC) median projection indicates three more rate hikes in 2019. This is plausible. However, given that oil prices are expected to stabilize and given the flatness of the Phillips curve, there is a fairly small chance of an impending inflation event. Amid uncertainties surrounding trade policy and given the proximity to the Fed's estimated level of neutral interest rates, we see scope for a pause in early 2019. With a press conference attached to every meeting, we see a distinct possibility that the Fed skips March in favor of May for next year's first move.

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

Europe: From Warm to Cool

Unfortunately for the eurozone, 2018 is not the same as 2017. Last year, the region was the undisputed biggest positive surprise of the world economy, with growth accelerating to an impressive 2.5%, which was not only the best since 2007 but also well above potential. This helped bring unemployment down nearly a full percentage point to the lowest since 2009 — although only to 9.1%.

The incoming data have weakened materially this year. A temporary pullback should not have come as a surprise — bursts of above-potential growth, especially when of such magnitude, rarely last very long. However, the general expectation had been that after a brief (and likely weather-related) deceleration in the first quarter, performance would improve again by mid-year. But the deceleration has lasted longer, with growth slowing to 0.4% q/q in both Q1 and Q2, compared to 0.7% in all four quarters of 2017. Moreover, there is little indication yet of any meaningful rebound. If anything, the third quarter has been especially challenging amid trade fears and what appears to be a deepening slowdown in Italy. Consequently, we've reduced our estimate of eurozone growth from 2.2% to 1.9% this year and from 1.9% to 1.6% next year.

While the performance of the Big Three economies has converged over the last 15 months, with all picking up in 2017 and all slowing in 2018, there has been a marked divergence over the longer course of the post-GFC recovery. Germany has boomed, with the unemployment rate falling steadily since mid-2014 to just 5.2% in August 2018 (the lowest in the near-30 year history of the series). France has generally lagged, with the (mainland) unemployment rate not beginning to fall until the second half of 2015, and still at an elevated 8.5%. And, Italy has really struggled. The labor market improvement did not begin until 2015, then stalled in 2016 (leaving the unemployment rate at an uninspiring 11.7% at the end of the year), before getting back on track in 2017. Even so, the unemployment rate has only just fallen below 10.5%, and youth unemployment remains chronically high.

As oil prices began to recover in 2016, headline consumer price (CPI) inflation accelerated sharply from around zero percent to 2.0% y/y, while core CPI inflation (which excludes food and energy) continued to drift sideways around 1.0%. Since then headline has oscillated with oil prices, while core has accelerated slightly but certainly not broken to the upside. Indeed, it was still just 1.0% y/y in August. Headline is currently running at 2.0% y/y (near the top of the five-year range) leaving it essentially at the European Central Bank's (ECB) "close to but less than 2.0%" target. Continuing progress on inflation is likely to be slow, particularly on the core measure, which is unlikely to move materially above 1.0% until next year. Meanwhile, headline flat-lines at 1.7% as the stabilisation of oil prices eliminates any contribution from the energy component.

After an abortive attempt to raise policy interest rates early in the recovery, the ECB then eased progressively, with the deposit rate falling to zero in 2012, -20 basis points in 2014, -30 basis points in 2015, and to -40 basis points in March 2016. It also introduced a genuine quantitative easing (QE) programme in January 2015, and subsequently made a slew of adjustments and enhancements to it. Then, in early 2017, growth picked up and the threat of a broad-based deflation receded, prompting the Bank to change direction. In April, it began by "tapering" the quantity of assets purchased from €80 billion to €60 billion a month. And, in January 2018, it tapered to €30 billion a month. Recently, the ECB tapered further to €15 billion, and will end the programme in December. The Bank also committed to maintaining the current level of policy interest rates through the summer of 2019, but thereafter we expect it to tinker with the spreads between its three administered interest rates and to hike the refinancing rate twice in the second half of the year.

The British economy proved more resilient than anticipated following the result of the referendum on EU membership in June 2016. But momentum has waned recently and we expect growth to slow from 1.7% last year to 1.3% this year. However, growth does not slow any further next year so long as the remaining issues in the withdrawal agreement are resolved, and the UK enters into a 21-month transitional period following its formal exit from the European Union (EU) in March 2019. Inflation accelerated quite sharply last year on a combination of rising oil prices and the sharp depreciation of sterling after the 2016 referendum. But with oil prices forecast to trend sideways around current levels, wage inflation steady despite the tight labor market, and the pound stabilising, it should decelerate gently this year and next. The Bank of England cut Bank Rate to help bolster the economy in the aftermath of the referendum, but has since changed course, raising the policy rate 25 basis points last November and another 25 basis points in August. Moreover, barring negative surprises on the economy or Brexit negotiations, we expect the Old Lady to continue tightening gradually, likely hiking twice in 2019.

Japan: Lagging

There are some signs that “Abenomics” (Prime Minister Abe’s macro-economic policy package containing the so-called three arrows of monetary stimulus, fiscal stimulus and structural reform) may be starting to work, but the final verdict is not yet in, and recent data are eroding some of last year’s optimism. Growth certainly surprised to the upside in 2017, with GDP rising a much faster than expected 1.7% (roughly twice the pace of potential). Strength was concentrated in consumer spending and business investment, which benefited from rising confidence, falling unemployment, and the need to add capacity given such a tight labor market. So far this year, however, performance has been highly uneven, with an outright contraction in the first quarter followed by solid rebound in the second. Recent natural disasters will only add to data turbulence. In any case, 2017 was always going to set the high-water mark for growth. With potential output running at only 0.8%–1.0% a year, the labor market simply keeps tightening, limiting employers’ access to suitable workers and constraining growth; there are already 163 job vacancies for every 100 applicants. We anticipate growth will slow to 1.1% this year. Next year’s scheduled VAT hike does not occur until October, which limits its negative effect on the 2019 annual number, allowing growth to hold up at 1.2%. (2020 will be a different story).

Perhaps no area has been more frustrating for gauging the effectiveness of Abenomics than inflation. There have been multiple false starts, but so far inflation has not taken hold. We’d like to believe that “this time is different” — and there are some reasons for optimism — but it is still far too soon to draw a definitive conclusion. All three widely-used measures of consumer price inflation — headline, national core (which excludes only fresh food products), and the new Bank of Japan (BoJ) core (which excludes fresh food and energy) — were negative when the package was launched in early 2013. All three trended higher into positive territory last year and accelerated steadily through February. And all three then subsequently retreated, although they’ve recovered some of the lost ground in July and August. We expect additional progress, but it will be slow. Headline CPI is projected to rise 1.0% this year and 1.2% in 2019 (the latter partially reflects the October 2019 VAT hike). The good news is that there are finally signs that the ultra-tight labor market — the unemployment rate is 2.5% — may finally be boosting wage inflation. Monthly data is exceedingly volatile, but labor cash earnings rose by an average of 2.3% y/y in May-July, marking a two-decade high. Amid regulatory changes limiting overtime and generalized tightening of the labor market, one would expect wage inflation to become the norm rather than the exception. But this is Japan, and we’ve been disappointed too many times to get our hopes up too high.

Because of slow progress on the inflation front, the BoJ’s hands are pretty much tied. In 2016, the ongoing failure to boost inflation prompted the Bank to conduct a comprehensive assessment of its policy actions. And in light of that, it changed the policy framework yet again, introducing “quantitative and qualitative easing with yield curve control,” under which it tries to control the shape of the yield curve by establishing a negative short-term interest rate (of -10 basis points) while simultaneously targeting a zero percent yield on the 10-year Japanese Government Bond. In July 2018 the Bank made some technical adjustments to this framework meant to allow it to maintain ultra-low interest rates for longer. It also formally introduced forward guidance, all in an effort to override the effects of prolonged deflation on inflation expectations. It is a gargantuan task. And so, it should not be surprising that the BoJ is alone among the major central banks in not even discussing a future exit, let alone its specifics.

Emerging Markets Outlook

By Simona Mocuta,
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Emerging Markets: On Shakier Ground

Amid a synchronized global upturn, growth in emerging markets accelerated four tenths to 4.8% in 2017. Early in 2018, it seemed as though a further incremental acceleration might have been achieved but recent developments make that unlikely. In fact, under the weight of intensifying trade tensions, a strengthening dollar, rising financing costs, and less accommodative domestic policy settings, broad EM growth looks poised to moderate incrementally this year and more noticeably in 2019. At 4.7% and 4.5%, respectively, this remains a decent pace. But, risks are skewed to the downside amid the escalating trade spat between the US and China and risks of a miscalculation in the tenuous dialogue surrounding the critical US-China trade relationship. Moreover, just as has been the case among developed markets, the EM recovery in 2017 has had a very strong cyclical component. This has since dissipated, refocusing attention on fundamental challenges such as high debt levels and lack of structural reforms.

China: More Downside Risks

China surprised to the upside in 2017, when growth accelerated two tenths to 6.9%, but momentum has since slowed. Even before the latest 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 even if, as we anticipate and seems to be already happening, deleveraging efforts take a back seat to the more immediate need to stabilize the economy. We see growth slowing towards 6.0% in 2019, although the outlook is exceedingly murky given so much depends on how severe the trade dispute becomes. But in any event, given China's elevated debt to GDP ratio, there is considerably less scope for aggressive debt-financed stimulus than had been the case even several years ago. Therefore, the longer the trade spat continues, the more likely we think it is that Chinese policy makers begin to diversify the response channels, deploying a range of other tools, including guiding the exchange rate lower, a reassessment of foreign exchange reserves policy, etc.

India: Old Weaknesses Re-emerge

The demonetisation move in late 2016 and the introduction of the Goods and Service Tax (GST) in 2017 combined into a challenging recent economic performance in India. Conditions subsequently started to improve, but the more volatile external environment and the increase in oil prices in 2018 conspired to bring some of India's long-standing soft spots (dependence on imported oil, sizable fiscal deficits, etc.) back into focus. Amid the broader emerging markets turmoil of the past few months, the rupee hit record lows against the dollar, forcing the central bank to shift monetary policy gears in support of the currency. We believe that the recently initiated tightening cycle has further to run. The combination of less accommodative policy and the inflationary effects of higher oil prices and currency depreciation then combine to cap growth around 7.5% in fiscal year 2018 and around 7.0% in fiscal 2019.

Russia: A Difficult Recovery

Russia's economy has emerged from its 2015–16 recession, but the recovery has been shallow and slow. It is also becoming harder amid broader emerging markets jitters and country specific concerns around sanctions. Following contractions of 2.5% in 2015 and 0.2% in 2016, growth strengthened to 1.5% in 2017 and should top that by a little this year. But, unlike earlier expectations, this looks to be as good as it gets for now amid a shift to tightening in monetary policy that is likely to keep growth well below 2.0% over the next couple of years. Beyond these near-term constraints, medium- to long-term economic performance remains challenged by a stark lack of economic diversification and extremely poor demographics. Aggressive policy action to remedy these issues is needed, but this does not seem likely, especially in the near term.

Brazil: Missed Opportunity or Another Chance?

Perhaps nowhere have politics been so extraordinarily central to the economic outlook as in Brazil. At the time of writing, we are awaiting the outcome of presidential elections that may yet take the country's political rollercoaster around the sharpest bend. Disappointment on the reform agenda so far has triggered a sharp depreciation of the real since April as investors reassess economic prospects. This has brought forward the end of the previous disinflationary trend that Brazil, alongside so many EMs, had experienced over the course of 2017. Similarly, monetary easing has run its course following the 775 basis points worth of rate cuts since 2016. Against this background, growth seems unlikely to come in much above 1.0% this year. It should cross above 2.0% in 2019, but by how much depends entirely on the types of policies pursued by the new government.

Global Capital Markets Outlook

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The market environment during the third quarter in many ways mimicked what had already transpired throughout much of 2018. In the United States, at least according to conventional definitions, the S&P 500 Index surpassed the 1990s bull market to enter into the longest bull market ever — setting all-time highs along the way. But observers were quick to point out that this temporal turning point continues to elude many other equity markets around the world. To that end the third quarter delivered middling returns in non-US developed markets and deeper challenges across emerging markets. In part these divergent outcomes reflected the relative tenor of economic growth around the world, but policy issues including volatile trade conflicts and populist agendas have also been important factors in the dispersion of results.

Investors in fixed income instruments, who have grown accustomed to stable and increasing bond prices have started to awaken to the fact that their regular coupon payments may be insufficient protection against principal losses. This distasteful development has been most pronounced at opposite ends of the safety spectrum with US and emerging market fixed income assets bearing the brunt of higher interest rates while bond markets in Europe and Japan — where monetary policy remains most accommodative — have been more stable this year. In the midst of these developments, markets crested across the 10-year anniversary of the depths of the global financial crisis — at least if you use the bankruptcy of Lehman Brothers as the point of demarcation. That ignominious anniversary, alongside trade policy concerns and perhaps some lingering reluctance due to early 2018 market volatility, has helped keep a lid on sentiment from the perspective of individual investors. But from our standpoint the base case is still reasonably sound, even if we are not as bullishly positioned as we have been in the past. Economic and earnings growth is unlikely to repeat 2018 in its magnitude, but should be robust enough to support stocks and probably nudge interest rates higher as well.

Trade — Bilateral Deals, Bifurcated Paths

Judging by the relatively benign price action at the latter end of the third quarter, investors might be justified in thinking that much of the fuss associated with global trade policy has already been meted out on share values. But a stark deterioration in global trade that dents economic growth or disrupts supply chains still poses risk to our base case. Developments in the third quarter offered mixed news on this front as trade relations between the United States seemingly improved with some trading partners but deteriorated with others. In late July, investors were reassured by a relatively positive meeting between President Trump and European Commission President Jean-Claude Juncker.

On the encouraging side, the two leaders agreed to work towards zero tariffs, zero non-tariff barriers and zero subsidies on non-auto industrial goods. However, skeptics might suggest that such "progress" bears remarkable similarity to the Transatlantic Trade and Investment Partnership (TTIP) which the President stepped away from in early 2017. While the news lifted sentiment overall, that pick-up was short-lived for European equities which marked their high point for the quarter in the wake of the meeting. In North America, the US and Mexico agreed to a bilateral trade deal which stipulated certain wage and geographical production thresholds for the auto sector. While there was some questioning of the merit of the terms of the deal, it nonetheless lifted a cloud that had been hovering over the key trade relationship and pushed Mexican equities to their highest level of the quarter on the day of the announcement.

However, if the winds of trade were a source of calm for Mexican assets, they turned far more disruptive as they shifted across the Middle East and Asia. The most notable developments were an intensification of trade disputes with Turkey and China. The Turkish troubles, which related to the detention of an American pastor as well as pent-up angst from prior tariffs, accelerated as the Trump administration announced a doubling of tariffs on Turkish steel and aluminum — news which triggered the worst single day depreciation for the lira in over a decade. The US/China trade conflict had many ebbs and flows but culminated with an additional 10% levy on $200 billion of Chinese goods. With US equities continuing to post new highs while Chinese equities continued to falter, it does not take a great leap of faith or imagination to envision additional tariff threats as a source of volatility through the end of the year — one of a number of factors that has us cautious on the outlook for equities outside the United States.

Perspectives on Global Equity Markets

As US equities continued their streak of outperformance and shrugged off any trade-related concerns, it begs the question of just how far and how long this exceptionalism can last. We have concerns on this front, but also see meaningful and fundamental support for the US market as compared to other developed or emerging markets. If we start with economic growth, the global synchronisation that propped up equity markets in 2017 has waned in 2018.[1] J.P. Morgan has noted that in 2017 80% of countries in their forecast universe grew at an above-potential rate. That figure has dropped to 60% for 2018. Our own forecasts for economic growth presented in this publication reflect this phenomenon as well with an upward revision for US growth and downward revisions for most other economies.

Just as we have witnessed better economic momentum in the United States we have also seen more constructive trends in terms of company earnings. While European and Pacific equity markets exhibited above-average earnings beats for the second-quarter earnings season, S&P 500 companies beat earnings expectations at the highest pace since 2009. Admittedly, some of the stellar performance from US companies has been due to lower corporate tax rates that are still flattering the year-over-year comparisons. But even if we look at pre-tax measures of earnings, as in Figure 3 on page 1, one can see a firmer trend and far more stability in the US when contrasted against a broad measure of equities such as the MSCI ACWI ex USA Index. Other drivers unique to US equity markets include additional tailwinds from the Bipartisan Budget Act of 2018 which lifted discretionary spending caps by $300 billion over 2018 and 2019 and also a surge in buyback activity which Goldman Sachs estimates will top $1 trillion for calendar year 2018.[2] For investors more focused on how efficiently firms turn sales into net income, profit margins are not only higher in the US but they have continued to rise while margins appear to be plateauing in Europe and rolling over in emerging markets.

When looking at the prospects for European and Pacific shares, a favorable turn in trade relations could bolster those markets, but the relative underperformance and cheaper valuations exhibited by those stock markets are unlikely to serve as catalysts in and of themselves. In local terms, both European and Japanese equities and bonds are generally flat to modestly higher on a year-to-date basis. In Europe, with a heavy tilt toward the financial sector, higher interest rates might serve as a satisfying salve but that still looks to be some distance away. And, whereas the US may still ascend on the back of policy support, Europe is grappling with populist politics where the downside risks are more apparent. At the time of writing, the Italian government was due to release details on their spending plans with a full budget due in October. And developments on the Brexit front took on more volatility during the third quarter as the scheduled exit date in March of next year quickly approaches. Although the British pound found some support from comments made by EU negotiator Barnier during the third quarter, the September summit in Salzburg served as a reality check to the thorny issues that have not yet been ironed out.

For Japan, higher interest rates would also do well for the financial sector, but with core inflation running more than 100 basis points below the Bank of Japan's target, that prospect seems a long way off. And even if recent economic data has been held back by an unfortunate string of severe weather and natural disasters, the Japanese stock market would likely need more vigorous industrial production and a weaker yen to bolster local equities. Industrial production has been steadily decelerating since the spring of 2017 and the yen appears fairly range-bound at this juncture.

In emerging markets, longstanding economic imbalances have been met with more tangible downside catalysts in the form of a generally strong US dollar, rising interest rates in the United States, trade tensions and questionable policy actions and rhetoric. This backdrop has proved especially difficult for countries like Turkey and Argentina. Turkey's past credit binge coupled with delayed policy responses to worsening fiscal and external accounts has rendered it the worst performing stock market within the MSCI Emerging Markets universe for both the third quarter and 2018-to-date. Argentina's problems stem from past mismanagement and a series of more contemporaneous issues including deeply negative growth, recent droughts, as well as high inflation, a large foreign currency debt load and twin budget and current account deficits. Others have been caught up as well with South Africa entering a technical recession during the quarter and Brazil contending with a large fiscal deficit and uncertainty surrounding October elections. And no discussion of emerging markets would be complete without China, where more recent trade tensions have weighed on the local equity market and longer-term issues of decelerating economic growth and high levels of debt might serve as impediments to investors looking to buy ostensibly cheaper stocks. But emerging markets have taken a lot of pain, having shed roughly 1%* of their value during the third quarter and nearly 8% on a year-to-date basis. We view the risks as outweighing the upside opportunity, on balance, but it's a proposition worth considering. The valuation discount between emerging markets and the US is now roughly at the extremes of the emerging market downturn in 2015 and is wider than the levels seen during the global financial crisis. For those that prefer patterns and closely check their charts, technical analysts with a mind to identifying exhaustion in trends have started to outline opportunities in emerging markets as well.

Perspectives on Global Fixed Income Markets

It has been noted that the degree of economic synchronicity has been waning in recent months and quarters, but we've also taken note of a pick-up in the synchronisation of short-term policy interest rates around the world. The motivation behind rising rates in developed markets and those in emerging markets probably couldn't be further apart, but the trend is nonetheless evident. Solid economic growth and tight labor markets have allowed the Federal Reserve, Bank of Canada and the Bank of England to raise interest rates despite trade tensions and the myriad threats posed by Brexit. In emerging markets, a desire to lift currency values and tamp down inflation has influenced the likes of Turkey, Argentina, Russia and India to target higher interest rates.

Notably absent from the list of authorities promulgating higher and positive rates of interest are the European Central Bank and the Bank of Japan. It may then come as no surprise that those bond markets have held in relatively well in 2018 — even if they remain far from remunerative in absolute terms. The ECB is set to end asset purchases at the end of the year, but expectations for policy rates to move off of their capital-eroding rates are still anchored around late-2019 at the earliest. For the Bank of Japan there are no plans in sight to move away from asset purchases despite owning around half of all Japanese government bonds outstanding. While this level of accommodation may help local bond markets in a relative sense over the interim, the medium-term risks look more daunting as it will take much longer for higher reinvestment rates to counter the negative price impact of higher yields.

In our view, fixed income investments look risky in their own right but also pose potential challenges to real economy, stock market and other credit sensitive sectors of capital markets. Higher interest rates and a flatter yield curve characterized much of the third quarter. Going forward, we see a continuation of that trend as the path of least resistance and that may present difficulties on any number of fronts. In the real economy, rising interest rates may provide some relief to savers who have suffered the negative side-effects of easy money, but it will also make it difficult for the housing sector to shake its sluggish state and dent the spending typically associated with home purchases.

Stock markets may be able to grind higher amid gradually rising interest rates, provided the economic environment continues to support decent earnings growth; however, at some point higher real interest rates will have a more meaningful impact with respect to accessing credit and discounting future cash flows. And a flatter yield curve has been widely covered as a harbinger of recessions. During the third quarter, the US yield curve flattened only marginally, but with the 10-year Treasury yielding only 24 basis points more than the two-year Treasury there is not much breathing room before crossing that important psychological level. In the meantime, and without clearer signs of broad-based inflation, the firmly entrenched flattening trend may be the most pertinent signal that a bear market in bonds is still not an imminent affair.

* *Unless noted otherwise, all returns are in US dollars as of September 30, 2018.*

Sources: Bloomberg, FactSet, J.P. Morgan, Citibank, Barron's, The Economist, The Wall Street Journal, MSCI as of September 30, 2018.

[1] J.P. Morgan Global Data Watch, August 10, 2018.

[2] Goldman Sachs Portfolio Strategy Research, US Weekly Kickstart, August 3, 2018.

SSGA Forecasts as of September 30, 2018

Real GDP Growth	2018 (%)	2019 (%)
Global	3.8	3.5
US	2.9	2.6
Australia	3.0	2.5
Canada	2.1	1.9
Eurozone	1.9	1.6
France	1.6	1.7
Germany	1.8	1.6
Italy	1.1	1.0
UK	1.3	1.4
Japan	1.1	1.2
Brazil	1.1	2.3
China	6.4	6.0
India	7.5	7.1
Mexico	2.0	2.3
South Africa	0.7	2.1
South Korea	2.6	2.5
Taiwan	2.4	2.1

Inflation	2018 (%)	2019 (%)
Developed Economies	2.0	1.9
US	2.5	2.1
Australia	2.1	2.4
Canada	2.2	2.0
Eurozone	1.7	1.7
France	1.9	1.6
Germany	1.9	1.7
Italy	1.3	1.6
UK	2.4	2.1
Japan	1.0	1.2
China	2.3	2.6

Central Bank Rates	September 30, 2018 (%)	September 30, 2019 Forecast (%)
US (upper bound)	2.25	3.00
Australia	1.50	1.75
Canada	1.50	2.50
Euro	0.00	0.25
UK	0.75	1.25
Japan	-0.10	-0.10
Brazil	6.50	7.50
China	4.35	4.25
India	6.50	7.00
Mexico	7.75	7.00
South Africa	6.50	7.25
South Korea	1.50	2.25

10-Year Bond Yields	September 30, 2018 (%)	September 30, 2019 Forecast (%)
US	3.06	3.40
Australia	2.67	2.80
Canada	2.42	2.75
Germany	0.47	0.77
UK	1.57	1.80
Japan	0.13	0.20
Brazil ($)	5.82	5.50
Mexico ($)	4.39	4.00

Exchange Rates	September 30, 2018	September 30, 2019 Forecast
Australian Dollar (A$/$)	0.72	0.71
British Pound (£/$)	1.30	1.39
Canadian Dollar ($/C$)	1.29	1.27
Euro (€/$)	1.16	1.16
Japanese Yen ($/¥)	113.70	103.44
Swiss Franc ($/SFr)	0.98	1.07
Chinese Yuan ($/¥)	6.87	6.96

	Base Currency					
One-Year Return Forecasts through September 30, 2019	USD (%)	EUR (%)	GBP (%)	JPY (%)	AUD (%)	CAD (%)
S&P 500	5.0	4.9	-1.4	-4.5	6.9	3.1
Russell 2000	3.8	3.7	-2.5	-5.6	5.6	1.9
MSCI EAFE	4.2	4.1	-2.2	-5.2	6.1	2.3
MSCI EM	7.1	7.0	0.6	-2.6	9.0	5.1
Barclays Capital Aggregate Bond Index	2.4	2.3	-3.8	-6.8	4.2	0.5
Citigroup World Government Bond Index	1.1	1.0	-5.1	-8.0	2.9	-0.8
Goldman Sachs Commodities Index	6.8	6.7	0.3	-2.8	8.7	4.8
Dow Jones US Select REIT Index	3.6	3.5	-2.7	-5.8	5.4	1.7

Source: SSGA, as of September 30, 2018.

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

Glossary

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

Citigroup World Government Bond Index The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies.

Consumer Price Inflation (CPI) A widely used measure of inflation at the consumer level that helps to evaluate changes in cost of living.

Deflation A decrease in the general price level of goods and services over a given period.

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

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

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

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

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

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

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

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

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

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

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

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

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

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Marketing communication.

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