Forecasts

Third Quarter 2018

Global Economic Outlook

By Christopher Probyn, Ph.D.,
Chief Economist, Investment Solutions Group

Pages 2–4:

- This year the global economy grows by 3.9%, its fastest pace since 2011, reflecting further small improvements in both the advanced and developing nations. This represents the high-water mark, as growth slows marginally to 3.8% next year.
- Headline inflation in the advanced economies slowed sharply in 2015 on the oil price decline in the second half of 2014. It has picked up since then on the oil price rebound that began in early 2016, but slows slightly next year as oil prices stabilise.
- Policy rates are already rising in the US, UK and Canada. And they will begin to rise in Australia and the eurozone next year. Only in Japan will rates remain unchanged through the end of 2019.

Emerging Markets Outlook

By Simona Mocuta,
Senior Economist, Investment Solutions Group

Pages 5–6:

- Last year's acceleration in world economic growth was primarily driven by developed countries. However, emerging markets (EMs) also partook in the improvement. Indeed, EM growth accelerated four tenths to 4.7% and still seems poised for a slight further improvement in 2018.
- Typically, such improvements would be cause for celebration. However, risks are to the downside and the mood is severely dampened by fears of escalating trade protectionism and concerns of a miscalculation in the tenuous dialogue surrounding the critical US-China trade relationship.
- The four factors that we identified last year as supportive of the near-term EM outlook have lost potency and some may be poised to reverse outright.

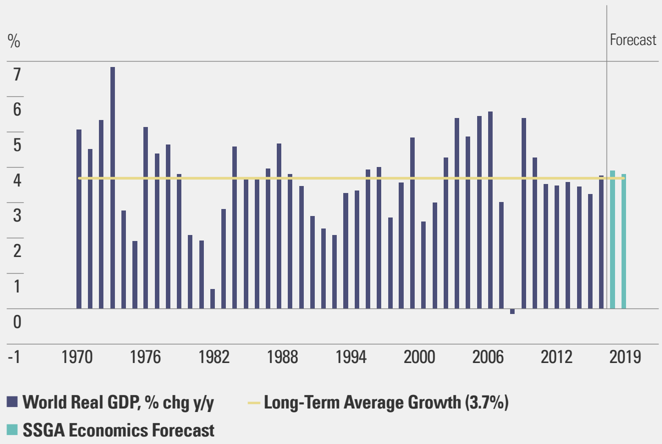
Global Capital Markets Outlook

By Lorne Johnson, Ph.D.,
Senior Portfolio Manager, Investment Solutions Group

Pages 7–9:

- Sitting at the halfway point of the year, year-to-date returns for the MSCI All Country World Index are just a little worse than flat, with considerable divergence across equity regions and styles; investors in US smaller-capitalisation shares have enjoyed 7.6% year-to-date gains versus year-to-date losses of 6.5% in global emerging market equities.
- American exceptionalism and populist politics have upended the synchronised global growth thematic that supported markets almost without interruption throughout 2017 and the first month of this year.
- The weakest quarter for emerging market stocks since the third quarter of 2015 is attributable to a broad list of contributing factors that adversely pressured the sector.
- For the second quarter, shares in US energy companies fared best among sectors, with a 13.5% gain aided by a 14% gain in crude oil prices.

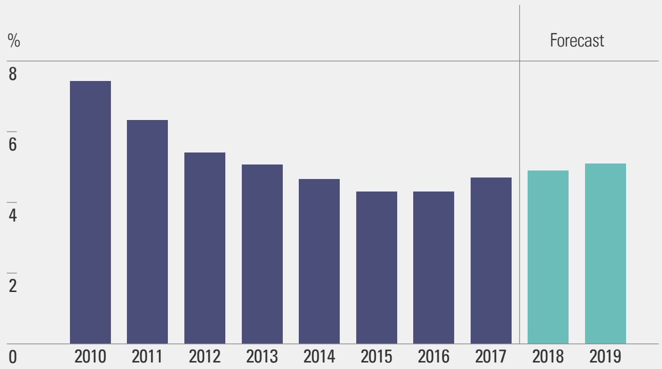
Figure 1: Global Growth Peaks Above Trend



Sources: State Street Global Advisors (SSGA) Economics, Oxford Economics, International Monetary Fund (IMF).

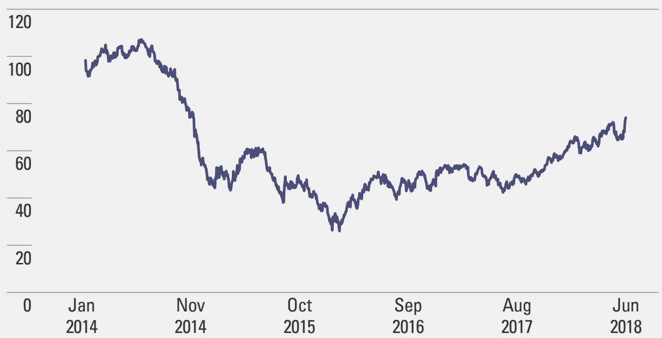
The above forecast is an estimate based on certain assumptions and analysis made by the SSGA Economics Team. There is no guarantee that the estimates will be achieved.

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: WTI Crude Oil Price at Highest Since 2014



Source: Bloomberg Finance LP.

STATE STREET GLOBAL ADVISORS

Global Economic Outlook

By Christopher Probyn, Ph.D.,
Chief Economist,
Investment Solutions Group

Global Overview

The global economy has gone through a "mini-cycle" over the last three years, with growth slowing in 2016 then reaccelerating in 2017 primarily on an oil-price-related swing in the US, where growth plunged from almost 3.0% in 2015 to just 1.5% in 2016, before picking up to 2.3% in 2017. However, last year's improvement was not limited to the US. Private domestic demand supported Japan, exports boosted the eurozone, Brazil and Russia emerged from recessions, China continued to exceed the government's 6.5% growth target, and while India slowed, GDP still rose 6.4%. Not surprisingly then, growth accelerated 0.6 percentage points (pp) to 3.8% in 2017, the best since 2011. It is projected to pick up another 0.1 pp to 3.9% this year on further small improvements in the advanced and developing economies. But this year is as good as it gets, with growth slowing marginally to 3.8% in 2019 on generally modest decelerations around the industrialised economies.

Oil prices were quite stable from mid-2011 to mid-2014, but became increasingly vulnerable to the downside as OPEC kept its official quota of 30.0 million barrels a day (mmbd) unchanged, while US oil production ramped up by around 3.0 mmbd. In the second half of 2014, the growing supply/demand imbalance pushed prices sharply lower. Indeed, they fell below $50 a barrel by January 2015 and $30 a barrel by January 2016. Oil prices then began to recover — helped partially by OPEC's decision to cut production 1.2 mmbd in November 2016 — with Brent breaking through $60 by late-2017, and even flirting with $80 earlier this year. However, they have subsequently retreated to the mid-$70s on increased speculation of a production increase. We expect them to remain close to that level over the remainder of this year and next. 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, and core inflation fails to accelerate appreciably.

A synchronous tightening cycle emerges by 2019, except in Japan. We now expect the Federal Reserve (Fed) to hike two more times this year and three more next year, especially given the current momentum in the US economy and the impending effect of fiscal stimulus. The Bank of Canada began the renormalisation process last year, raising the policy rate in July and September as growth accelerated sharply. It added another hike in January but then paused as the economy weakened. It should resume with two more hikes later this year, and three next year. The Bank of England began tightening last November as the economy proved more resilient than anticipated to the Brexit decision. The Old Lady should move once late this year and twice next year, although that depends partially on the course of Brexit negotiations. The Reserve Bank of Australia may possibly begin tightening late this year, although we project it to start in 2019, with two hikes over the course of the year. The European Central Bank (ECB) will taper its asset purchase programme in October and end it 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 (BoJ) to tighten next year, especially given the scheduled VAT hike in October.

US: Momentum and Stimulus Equals Faster Growth

Unlike the eurozone and Japan, the US economy did not surprise to the upside in 2017. But there was some improvement, with growth accelerating to 2.3% from an anemic 1.5% in 2016. Growth was underpinned by consumer spending, which contributed 1.9 pp, although the actual acceleration reflected a pick-up in business equipment investment and a smaller drag from inventories. We expect a further acceleration this year given the current momentum in the mining and manufacturing sectors and the impending effects of fiscal stimulus, which together threaten to propel growth to around 4.5% (annualised) in the second quarter. Consequently, GDP picks up by 0.6 pp to 2.9% this year, but slows to 2.4% in 2019 as consumer spending and business investment begin to wane. Moreover, while we would describe the risks as balanced (at least this year) there is some chance that a tit-for-tat trade war (mainly, although not solely, with China) could erode confidence, disrupt supply chains and undermine growth.

The impact of the fiscal stimulus is not particularly big. Admittedly, the tax cuts are worth around $1.5 trillion over 10 years. But, the fiscal multiplier on this particular package is unlikely to be large; we expect it to add only 0.2 pp to growth in 2018, and even less in 2019. Interestingly, almost all of that improvement comes from business fixed investment, likely reflecting the immediate expensing of capital expenditures rather than the lower corporate rate. Consumer spending responds only modestly, likely because the bulk of the cuts benefits higher-income individuals, who have small marginal propensities to spend. 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 next year.

Inflation slowed quite sharply in the first half of 2017. 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 seems to have been correct, as headline consumer price (CPI) inflation has reaccelerated to 2.8% and headline personal consumption expenditure (PCE) inflation to 2.0%. Meanwhile, core CPI inflation and core PCE inflation — the Fed's favourite gauge of inflation over the near-term — are now running at 2.2% and 1.8%, respectively, essentially right at the Fed's inflation goal. While the combination of 2.0% inflation and a 2.0% funds target would appear 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. (Put another way… the Phillips curve has flattened). Indeed, wage inflation has not exceeded 3.0% despite an unemployment rate that appears set to slip below 3.8% this year, and 3.6% next year. Hence, as oil prices trend sideways, headline inflation settles slightly above 2.0%.

The Fed picked-up the pace of tightening in 2017, and has continued in the same vein this year, raising the funds target 25 basis points in both March and June. Moreover, the median projection from the latest "dot diagram" now suggests two more hikes during 2018. While the diagram has not been a good predictor of Fed behaviour in the past — typically over-estimating the amount of tightening — we believe, given current and anticipated economic conditions that it should be taken at face value now. Indeed, we expect the next interest rate moves to come in September and December, leaving the funds target at 225–250 basis points at the end of this year. The Fed also retained its median projection of three rate hikes in 2019, which seems highly plausible. Indeed, we expect 25 basis point hikes in March, June and September of next year.

Eurozone: A Disappointing Start to the Year

After slowing slightly in 2016, growth surprised to the upside last year, with GDP rising 2.3%. Moreover, GDP grew 2.8% year on year (y/y) in the fourth quarter, the best since early 2011. The quality of growth was also good, with inventories actually subtracting from the year-over-year advance, and both household consumption and business investment making sizeable contributions to final sales. But the improvement in 2017 largely reflected a pick-up in net exports, which contributed 1.3 pp, up from just 0.2 pp in the first quarter. Unfortunately, the incoming data have weakened this year, implying that momentum may be waning sooner than anticipated. Indeed, GDP rose only 0.4% in the first quarter, and the purchasing managers' index for manufacturing has retreated from a little over 60.0 in December to 55.5 in May, on widespread weakness across the major economies. Growth should moderate gradually over the next two years, with GDP rising 2.2% in 2018 and 1.9% in 2019, partially reflecting the lagged effects of the euro's 15% appreciation during 2017. However, given the soft incoming data the risks are clearly skewed to the downside.

As oil prices began to recover in 2016, headline 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, core was just 1.1% y/y in May. Headline is currently running at 1.9% y/y (the highest since early 2017), leaving it essentially at the ECB's "close to but less than 2.0%" target. The Bank has certainly become more optimistic about the prospects for inflation over the near-term, revising up its projection for this year by 0.3 pp to 1.7%. We also expect inflation to move a little higher this year, but then slow slightly next year 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 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 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 announced that it would taper further, to €15 billion a month in October, and conclude purchases by the end of December. In a surprise move, the Bank also committed to maintaining the current level of policy interest rates through the summer of 2019. We then expect the ECB to tinker with the spreads between its three administered interest rates and to hike the refinancing rate twice in the second half of 2019.

In the UK, we have slightly downgraded our GDP growth forecast for 2018 (by two tenths, to 1.6%) and for 2019 (by one tenth, to 1.8%), reflecting the weaker-than-expected first-quarter data and evidence of a sharper deceleration in eurozone economic performance. These projections are roughly in line with the Bank of England's own forecasts but are more optimistic than the consensus.

Two years after the Brexit vote, the UK and the EU have (sort of) agreed on a transition deal set to run through the end of 2020… but not on much else. In truth, the last couple of months have reflected battles within the UK government about what the nation's red lines are (assuming there are any left) and who has the final say about the ultimate arrangement. Prime Minister May was handed a pained tactical victory this month as an amendment seeking to give Parliament "a meaningful vote" on the final deal was defeated. But her victory was so narrow there is little doubt this issue will rear its head again in one form or another. Parliament wants a say and will make sure it gets its voice heard. Being overwhelmingly in favour of a soft Brexit, we see this as raising the chances for just such an outcome, after periods of intervening chaos and confusion.

Japan: Mixed Signals

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 labour market. Unfortunately, the data have weakened this year, with GDP contracting slightly in the first quarter, industrial production plunging in January and retail sales stumbling over the first quarter. Admittedly, production is getting back on track, and retail sales picked up in April, but 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 labour market simply keeps tightening, limiting employers' access to suitable workers, and constraining growth; there are already 159 job vacancies for every 100 applicants. Growth slows to 1.2% this year and to 0.9% next year, partially reflecting a 2.0% VAT hike in October 2019.

Last year, it seemed that Abenomics was even boosting inflation; this year the signs are mixed. All three widely used measures of consumer price inflation — headline, national core (which excludes only fresh food products) and the new 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. Headline accelerated late to hit 1.0% y/y in December and 1.5% in February, but has since fallen back to 0.6% in April. National core rose more steadily, hitting 0.9% y/y in December and 1.0% in February, but then falling back to 0.7% in April. And the BoJ core lagged, reaching just 0.3% in December and 0.5% in February before slipping back to 0.4% in April. We expect progress to resume, although it will be modest, with headline CPI projected to rise just 1.0% both this year and next (and that partially reflects the October 2019 VAT hike). However, the risks may be skewed to the upside, because there are signs the ultra-tight labour market — the unemployment rate is 2.5% — may finally be boosting wage inflation, although the volatility of the data make it difficult to be sure. Indeed, while labour cash earnings rose a multi-year high 2.0% y/y in March, they slowed to just 0.8% in April.

The BoJ continues to fire the first arrow of Abenomics. 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 "QQE (qualitative and quantitative) 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. The Bank also committed to expanding the monetary base until national core CPI exceeds and stabilises above 2.0%, thereby employing forward guidance to override the effects of prolonged deflation on inflation expectations. The emphasis on controlling the yield curve reflects concerns about financial sector profitability, while the commitment to overshooting the inflation target highlights the Bank's need to enhance its credibility on this issue. The Bank hopes to hits its 2.0% target during fiscal 2019 (April 2019–March 2020). But given the limited progress we expect, it will maintain its current policy stance at least through the end of 2019, and possibly longer.

Emerging Markets Outlook

By Simona Mocuta,
Senior Economist,
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Emerging Markets

On Shakier Ground

Last year's acceleration in world economic growth was primarily driven by developed countries. However, emerging markets (EMs) also partook in the improvement. Indeed, EM growth accelerated four tenths to 4.7% and seems poised for a slight further improvement in 2018. Typically, such improvements would be cause for celebration. However, risks are to the downside and the mood is severely dampened by fears of escalating trade protectionism and concerns 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 of the past year has had a very strong cyclical component. This is now losing steam and is giving way to renewed focus on fundamental issues such as demographic trends, debt levels and structural reforms (or lack thereof).

Last year, we identified four factors as supportive of the near-term EM outlook: reacceleration in global trade volumes, higher commodity prices, a weak US dollar/modest Fed tightening and pro-growth domestic monetary policy settings.

Unfortunately, most of these factors have lost potency and some may be poised to reverse outright. Indeed, having accelerated sharply in 2017, growth in world trade volumes has since plateaued and seems to be now turning lower (not surprising given intensifying trade tensions). Secondly, the weakening of the US dollar in 2017 has since given way to material US-dollar appreciation, which not only raises debt service costs but is also fanning inflationary pressures across EMs via local currency depreciation. As a result, many EM central banks have recently shifted gears, at the very least pausing the prior easing cycle and, in some cases, starting to tighten aggressively (see Turkey). The one area of support that may resist erosion seems to be commodity prices, which appear generally well supported absent a full-blown trade war (which we don't expect). Even if we don't see another leg higher from here, the fiscal healing that higher commodity prices facilitate will continue to be a positive for EM commodity exporters.

Longer-term, emerging markets still have a demographic advantage, have considerable room for catch-up growth and, relatively speaking, have more space for policy stimulus. By the same token, however, technological changes could end up undermining their comparative advantage (resource abundance and cheap labour) and, as of now, few countries have truly embarked on the sort of structural reforms that can sustain high and stable growth far into the future. So as always, we emphasise material performance divergence across individual EMs and highlight the importance of a differentiated cross-country approach.

China: A Careful Recalibration

Chinese growth surprised to the upside last year. Contrary to expectations of a modest but steady deceleration from the first quarter's 6.9% y/y growth, performance remained remarkably robust thereafter. In fact, the economy grew by 6.9% for the year as a whole — two tenths better than in 2016 and the first acceleration since 2010.

The question is: what comes next? Even before the latest ratcheting up of trade rhetoric (and action) we were expecting growth to decelerate modestly to 6.4% in 2018 as Chinese policy makers move in concerted yet incremental steps to address the problem of excess leverage. Managing such a complex process was going to be very difficult even in the best of times. In the midst of a trade dispute with a key trading partner, it becomes ever more so; the risks of policy error have therefore increased. Ironically, though, Chinese policy makers may seek to minimise risks stemming from the trade spat with the US by moving more slowly on some of the very structural reforms its trade partners demand (i.e., overcapacity reductions, etc.). Ultimately, though, just as we had been arguing in the case of the EU-UK Brexit negotiations, this is too important a relationship for the parties (and for the world) for either of them to turn their backs on it. So, despite what is clearly shaping up to be a bumpy road ahead, we do not expect the trade spat to devolve into a full-blown trade war. We expect the first salvo (i.e., tariffs on the first $50 billion worth of goods) to go into effect but additional meaningful action to be delayed until after the November mid-term elections in the United States.

India: Short-Term Pain for Long-Term Gain

The demonetisation move in late 2016 and the introduction of the Goods and Service Tax (GST) in 2017 contributed to a challenging recent economic performance in India. Economic growth, which had reached or exceeded 7.0% in each of the prior three years, slid to 6.4% in 2017. However, beyond the short-term dent to growth, both of these policies should induce material economic efficiencies across the economy, foundationally supporting future growth. We expect to see the positive effects as early as this year, when growth is likely to reaccelerate to about 7.5%.

India needs to engineer its own transformation away from excessive reliance on domestic consumption toward more investment and exports. At the moment, this lesser reliance on global demand shields it from downside risks surrounding a potential trade conflict with the United States. However, this by no means offsets the much bigger problem of low productivity, poor infrastructure and lack of international competitiveness. Prime Minister Modi's recent electoral successes strengthen his mandate and could accelerate progress with the sort of structural reforms that will eventually deliver not just high growth, but the type of transformational growth that would propel India into a global manufacturing powerhouse.

Russia: Turning the Corner

Russia's economic recovery is firming. Following contractions of 2.8% in 2015 and 0.1% in 2016, growth strengthened to 1.5% in 2017. 2018 should be at least as good. In many ways, Russia is the poster child for the favourable trends we mentioned earlier as having broadly aided the EM recovery this year: Russia is a major beneficiary of higher oil prices, it has experienced a powerful domestic disinflationary trend that means real household incomes are no longer being squeezed and its central bank has gradually embraced a more accommodative policy stance.

The retreat in consumer price inflation — just 2.4% y/y at last check compared with a peak of almost 17.0% y/y in early 2015 — has stabilised households' purchasing power. Meanwhile, the recovery in oil prices is supporting public finances, if not yet triggering much of an investment revival. Meanwhile, the Bank of Russia has stepped up its easing cycle over the last six months. It lowered its policy rate by 225 basis points over the course of 2017 and has already lowered rates by a further 50 basis points through the end of March. Although we do not think the easing cycle is over yet given real interest rates remain very high, the majority of easing is behind us at this point. However, while near-term economic clouds are slowly dissipating, the lack of economic diversification, compounded by poor demographics, remains a big challenge to Russia's medium-term economic performance.

Brazil: Missed Opportunity?

Perhaps nowhere have politics been so extraordinarily central to the economic outlook as in Brazil. With presidential elections scheduled for later this year, the country's political rollercoaster does not look likely to slow any time soon...and is going down at the moment. Disappointment on the reform agenda has triggered a sharp depreciation of the real in recent months 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. We have scaled back growth expectations from 2.2% to just 1.6% in 2018, although this is still a tad better than last year's meager 1.0% expansion.

Global Capital Markets Outlook

By Lorne Johnson, Ph.D.,
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Parsing the Signal from the Noise

As investors look ahead to the second half of 2018, the fundamental backdrop for growth assets remains broadly favourable at the aggregate level with both global economic and corporate earnings growth still gaining on what was an accelerating year for both in 2017. Whereas 2017 rewarded investors across the opportunity set of global equities with strong positive returns, 2018 thus far has required far more adeptness to identify winners and losers. Sitting at the halfway point of the year, year-to-date returns for the MSCI All Country World Index are just a little worse than flat, with considerable divergence across equity regions and styles; investors in US smaller-capitalisation shares[1] have enjoyed 7.6% year-to-date gains against year-to-date losses of 6.5% in global emerging market equities.[2]

Two factors in particular, American exceptionalism and populist politics, have upended the synchronised global growth thematic that supported markets almost without interruption throughout 2017 and the first month of this year. In many respects it was perhaps the non-exceptionalism of the US that provided the perfect backdrop for global equities to excel so uniformly in 2017. In terms of economic performance, the US economy accelerated from 1.5% growth in 2016 to 2.3% in 2017, though that was nothing exceptional relative to expectations, in contrast to global peers that saw even better economic performance than expected as 2017 progressed. In light of that economic performance relative to expectations, despite three interest rate increases by the US Federal Reserve (Fed), the US dollar declined 12% in 2017, resulting in a net overall easing of global financial conditions, particularly for emerging market economies continuing to finance in US-dollar denominated debt. Thus far in 2018, the tailwind of an unexceptional US economy has given way to one in which US economic performance has generally exceeded expectations, prompting the Fed to increase the pace at which it intends to raise interest rates in 2018 and beyond. That exceptionalism has contributed to a headwind in global financial conditions, with US policy rates rising faster than expected and the US dollar advancing 6%, a retracement of about half of the 2017 US dollar selloff.

Populist politics has taken perhaps its most disruptive form on markets in 2018 through an activist trade policy agenda by the Trump administration, resulting in a series of tariffs imposed on America's trading partners, the imposition of counter-tariffs against the US and further threats that the US was ready to impose additional tariffs of far greater magnitude in response. Continued uncertainty around trade policy is likely to remain a fixture in markets for the balance of this year as trade fights with the sheer number of trading partners engaged will require months of negotiation to resolve. In a further reminder of the impact populist politics can have on markets, following a year in which the threat of populism in Europe to the global economic order seemed to recede somewhat with establishment victories in elections in France and the Netherlands, markets were badly shaken at the end of May when the rejection by the Italian president of a populist right/left coalition candidate for finance minister caused a convulsion in European bond markets; Italian two-year yields increased by a record 190 basis points, to 2.8%, on May 29 after starting the month at a negative 0.3%. Yield spreads between Italian and German 10-year bonds also widened to the highest levels in six years, to better than 290 basis points on May 29, after starting the month at 123 basis points.

Another potential headwind investors will confront toward the end of 2018 is the upcoming inflection point in global liquidity that will be reached with an expected peaking in G4 central bank[3] balance sheets sometime in the final quarter of the year. Even as the Fed, the central bank of the world's largest economy, has been raising interest rates since the end of 2015 and trimming its balance sheet since October 2017, monetary policy globally has remained stimulative throughout this period, as measured by the continued expansion of the combined balance sheets of the largest developed market central banks. Continued bond buying by the BoJ and (ECB has more than offset the thus forth modest $90 billion quarterly reductions in the Fed balance sheet. The transition to balance sheet contraction at the end of the year will begin what is expected to be a multi-year process that will drain liquidity from the global financial system and test a global economy and markets that have become very accustomed to continued central bank stimulus.

Perspectives on Global Equity Markets

After declining for the first time in ten quarters in the first three months of 2018, global equities managed a near-symmetric positive outcome in the second quarter, leaving the broad MSCI ACWI Total Return Index at nearly a draw for the year, with return of negative 0.1%. That near-unchanged return at the aggregate level masks a considerable shift in the fortunes of the major regional indices, most notably, emerging markets, which shed 7.9% in the second quarter after leading global markets with a modest gain of 1.5% in the first quarter. The weakest quarter for emerging market stocks since the third quarter of 2015 was attributable to a broad list of contributing factors that adversely pressured the sector. Countries most acutely exposed to tightening financial conditions with current account deficits were unfavourably impacted by a 5% rise in the trade-weighted US dollar as well as rising US policy rates during the quarter. Turkey proved particularly vulnerable to this backdrop; the MSCI Turkey index declined 25.7% during the second quarter coincident with a 14% decline in its currency that was arrested only with the aid of 6.5% in interest rate hikes by the Turkish central bank. Electoral and political uncertainty weighed on economies such as Mexico and Brazil, which saw currency declines of 7.5% and 12%, respectively, against the US dollar during the quarter. Closing out the second quarter, escalating threats of more aggressive tariff measures than already announced by the United States contributed to a 5.2% decline in China, the largest constituent of the MSCI Emerging Markets Index, which had held on to a positive year-to-date gain through May, before closing the half way point of the year down 1.7%. Looking forward, both a pause in the US dollar's ascent as well as any reduction in tensions around global trade should provide relative support for emerging markets after the difficult second quarter.

Developed market equities provided US-based investors with a modest gain of 0.8% for the first half of 2018, led by a gain of 2.9% in US equities, which benefitted on a relative basis from a 2.5% gain in the US dollar over the same period. European shares have fared worse among the developed markets so far this year, down 2.7% (+0.9% in local-currency terms) with second-quarter performance notably held back by a 5.2% decline in the euro that coincided with heightened political uncertainty in Italy at the end of May and more-dovish-than-expected ECB guidance on interest rates following the June 14 Governing Council meeting. European economic performance has also underwhelmed in the first half relative to expectations as measured by the Citibank economic surprises index, which declined to as low as -100 on June 13 after beginning the year at a reading near 50. That index recovered somewhat to -61 at the end of the second quarter, perhaps portending an improving trajectory for the balance of 2018. Shares in the Asia-Pacific region have also underperformed the developed markets benchmark, shedding 1.9% year to date as measured by the MSCI Pacific Total Return Index.

US equity markets[4] managed to post modest gains in each month of the second quarter, even as increasing tensions around a possible global trade war contributed to a two-week selloff in US shares to close the quarter. With less international exposure to potential counter tariffs than large-capitalisation stocks, small-cap stocks extended year-to-date gains over large-cap stocks to nearly 5%, with a gain of 7.7% in the second quarter. Growth stocks also continued to firmly outperform value stocks in the second quarter, with the Russell 1000 Growth Index gaining 5.8% against a gain of 1.2% for the Russell 100 Value Index, taking the year-to-date return differential to 9%. Across US equity sectors, the cyclical Consumer Discretionary and growth-heavy Technology sectors lead year to date, with gains of 11.5% and 10.9%, respectively. For the second quarter, shares in energy companies fared best, with a 13.5% gain aided by a 14% gain in crude oil prices. That contrasted with a decline of 3.2% in both Industrials and Financials, the former being hit by an initial round of tariffs and counter-tariffs announced in June and the latter unfavourably pressured by a flattening yield curve. Despite the noise around trade tensions, however, earnings growth expectations for the broad S&P 500 have continued to advance through 2018, increasing to an expected gain of better than 20% for calendar year 2018 as of June 29, compared to an expected gain of 18% at the end of the first quarter and an expected gain of 9.5% at the close of 2017.

Looking ahead to the rest of 2018 in our tactical positioning, our view of global equity markets continues to be broadly optimistic on the continuing positive trends in corporate earnings across regions, though we have reduced our overall overweight to equities in 2018 on a more diverse set of views across regions. For the US while we recognise the new uncertainties raised by a more aggressive trade stance by the Trump administration and possibility of foreign retaliation, we expect the actual economic impact to be contained. Our allocations include overweight positions to US equites and smaller overweight positions in international developed markets in Asia-Pacific and emerging market equities. We hold a small underweight to European equities on less-favourable earnings trends and neutral positions in US growth and value equities and US small-cap equities. Across broad asset classes, our portfolios continue to hold an overweight position in growth assets, primarily equities over fixed income and cash.

Perspectives on Global Bond Markets

Global government benchmark 10-year yields resumed their ascent higher during the first half of the second quarter following a partial retracement of eventual first-quarter yield gains amidst a surge in equity market volatility in February and March. Sovereign benchmark yield increases in the early part of the second quarter were led by something of a breakout in US 10-year yields to their highest levels in seven years, to a peak of 3.11% on May 17; this was an advance of 37 basis points from the end of March accounted for by a 25 basis points rise in real rates as breakeven inflation rates rose a more modest 12 basis points. German and UK benchmark yields also advanced, albeit by a more measured 14 basis points and 21 basis points, respectively through May 17 from the end of the previous quarter. By month end, however, the direction of yields on the highest-quality government bonds was sharply lower as political uncertainty around the formation of a new Italian government in the final days of the month re-established the safe-haven status of longer-term government German and US bonds in particular. Between May 17 and May 29, the most acute day of the Italian political mini-crisis, German 10-year yields declined 38 basis points to a better-than-one-year low of 26 basis points and US 10-year Treasuries declined 33 basis points over the same period. US and German yields rose somewhat in the last two days of the month as an agreement to form an Italian government ultimately moved forward.

US, German and UK 10-year sovereign yields again advanced to open June, but declined in unison through the end of the month following what was seen as a dovish ECB policy communication on June 14 indicating a later starting point for interest rate increases in 2019, and a generally deteriorating risk environment in the closing days of June as threats of tariff action by the United States were seen as more likely than not to be realised. For the second quarter, led by a firmer tone in economic data and a more hawkish central bank, US 10-year yields advanced 12 basis points to close the first half of the year at 2.86%. In contrast, German and UK 10-year yields declined by 20 basis points and 7 basis points, respectively. A firmer tone from the Fed also contributed to a 26 basis points rise in shorter-term two-year Treasury yields and a consequent further flattening of the yield curve to a 10-year/2-year spread of just 34 basis points.

After reaching cycle lows in January this year, spreads on both investment grade and riskier debt continued to move higher in the second quarter, even as developed global equity markets were able to post local market advances. Not surprising given the pressure on a number of emerging market currencies and equity markets, emerging market debt has exhibited some of the most aggressive spread widening; spreads on the JPMorgan Emerging Markets Bond Index are now up 87 basis points year to date, to 388 basis points with 63 basis points of that gain taking place in the second quarter. In the US investment grade sector a 38 basis points year-to-date widening in long-term corporate spreads to 1.75% along with rising long-term Treasury yields has translated into a year-to-date return decline of 6.4% for the Bloomberg Barclays Long U.S. Credit Index, worst among the U.S. Barclays Aggregate primary sectors. A more modest year-to-date widening of 27 basis points for intermediate corporate spreads contributed to a decline of 1.4% in the corresponding Intermediate Credit Index.[5] In U.S. high yield bonds, year-to-date spreads have widened a more modest 24 basis points, to 3.63%, with interest rate carry contributing to a modest 0.2% year-to-date return gain for the Bloomberg Barclays U.S. High Yield Index.

For our tactical positioning in fixed income, we are anticipating global government interest rates will continue to gradually rise as policy is normalised across regions. We hold an underweight position to US intermediate investment grade bonds and a similar underweight position to global government bonds outside the US, where long-term rates relative to fundamentals appear even less aligned. We expect some continued modest flattening in the US yield curve as near-term policy tightening will have a greater impact on short-term rates while longer-term inflation and growth expectations that determine longer-term rates are more firmly anchored. We are neutral in both intermediate and longer-term investment grade credit as spread compression to near cycle lows may limit further gains in these sectors as the cycle matures. In high yield bonds, we hold a small underweight as our view of the sector has deteriorated at this more mature stage of the business cycle with underlying government yields rising.

Perspectives on Real Assets

Real assets present perhaps one of the most promising sectors looking forward to the rest of 2018 and beyond as global inflation pressures continue to build after years of falling far short of central bank targets. The year-over-year gain in the core US personal consumption deflator, the Fed's preferred inflation measure, advanced to the central bank target of 2% in May for the first time since 2012 after years of undershooting that level. Through the first half of 2018, however, performance in the real assets space has been challenged by a number of the headwinds impacting growth assets and income sectors alike. Broad commodities as measured by the Bloomberg Commodity Total Return Index sit unchanged at the midpoint of the year following a 3.5% decline in June, the worst performance for the index since July 2016. Despite a year-to-date gain of 23% in crude oil[6] and a 13% year-to-date gain in the energy sub-index, the threat of tariff action and a stronger US dollar have resulted in year-to-date losses of more than 5% for both the metals and agriculture sub-indices. Real estate investment trusts (REITs), which have shown considerable interest rate sensitivity in recent years, posted a return of 10% in the second quarter, the strongest quarterly gain since 2014 following a 7.4% decline in the first quarter; a slower pace of interest rate advances in the three months through June would appear to have given the sector some room to recover. Longer-term inflation expectations, as measured by 10-year breakeven Treasury yields, advanced as high as 2.20% on May 16, near coincident with the peak in nominal yields on May 17. Breakeven rates then drifted lower to end the first half of 2018 at 2.13%, a modest rise of 15 basis points from the end of 2017.

Looking forward we would expect real assets to continue to provide an important diversifying inflation exposure in a balanced portfolio. In our tactical positioning we have established a modest overweight to broad commodities as we view them as a diversifying exposure likely to benefit from the improving growth and inflation backdrop. We have also maintained an underweight position to REITs, which we expect to continue be challenged in the anticipated rising rate environment, and note that the asset class did not perform well in the otherwise favourable environment for risk assets in 2017.

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

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

1 Russell 2000 Total Return Index.
2 MSCI Emerging Markets Total Return Index.
3 US Federal Reserve, European Central Bank, Bank of Japan and Bank of England.
4 S&P 500 Total Return Index.
5 Bloomberg Barclays U.S. Intermediate Credit Index.
6 WTI First Month Contract.

SSGA Forecasts as of June 29, 2018

Real GDP Growth	2018 (%)	2019 (%)
Global	3.9	3.8
US	2.9	2.4
Australia	2.7	2.8
Canada	2.0	2.0
Eurozone	2.2	1.9
France	1.9	1.7
Germany	2.0	1.8
Italy	1.3	1.1
UK	1.6	1.8
Japan	1.2	0.9
Brazil	1.6	3.1
China	6.4	6.0
India	7.5	7.1
Mexico	2.4	2.3
South Africa	1.5	2.2
South Korea	2.7	2.6
Taiwan	2.4	2.3

Inflation	2018 (%)	2019 (%)
Developed Economies	2.0	1.8
US	2.4	2.0
Australia	2.1	2.4
Canada	2.2	2.0
Eurozone	1.6	1.4
France	1.6	1.5
Germany	1.9	1.7
Italy	1.3	1.1
UK	2.4	2.1
Japan	1.0	1.0
China	2.3	2.7

Central Bank Rates	June 29, 2018 (%)	June 30, 2019 Forecast (%)
US (upper bound)	2.00	3.00
Australia	1.50	1.75
Canada	1.25	2.25
Euro	0.00	0.00
UK	0.50	1.00
Japan	-0.10	-0.10
Brazil	6.50	7.00
China	4.35	4.25
India	6.25	6.75
Mexico	7.75	6.50
South Africa	6.50	7.00
South Korea	1.50	1.75

10-Year Bond Yields	June 29, 2018 (%)	June 30, 2019 Forecast (%)
US	2.86	3.20
Australia	2.63	2.90
Canada	2.13	2.45
Germany	0.30	0.60
UK	1.28	1.60
Japan	0.04	0.10
Brazil ($)	6.00	5.50
Mexico ($)	4.47	4.10

Exchange Rates	June 30, 2018	June 30, 2019 Forecast
Australian Dollar (A$/$)	0.74	0.74
British Pound (£/$)	1.32	1.45
Canadian Dollar ($/C$)	1.31	1.25
Euro (€/$)	1.17	1.20
Japanese Yen ($/¥)	110.76	93.64
Swiss Franc ($/SFr)	0.99	1.05
Chinese Yuan ($/¥)	6.62	6.74

	Base Currency					
One-Year Return Forecasts through June 30, 2019	USD (%)	EUR (%)	GBP (%)	JPY (%)	AUD (%)	CAD (%)
S&P 500	4.3	1.4	-5.0	-11.8	4.9	-0.6
Russell 2000	3.9	1.0	-5.4	-12.2	4.4	-1.0
MSCI EAFE	7.0	4.0	-2.5	-9.5	7.6	1.9
MSCI EM	8.0	5.0	-1.6	-8.7	8.6	2.9
Barclays Capital Aggregate Bond Index	2.2	-0.7	-6.9	-13.6	2.7	-2.6
Citigroup World Government Bond Index	3.0	0.1	-6.2	-12.9	3.5	-1.9
Goldman Sachs Commodities Index	5.4	2.4	-4.0	-10.9	6.0	0.4
Dow Jones US Select REIT Index	1.6	-1.3	-7.5	-14.1	2.1	-3.2

Source: SSGA, as of June 29, 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%.

Bloomberg Barclays Long U.S. Treasury Index A benchmark that includes dollar-denominated publicly issued US Treasury securities that have remaining maturity of 10 or more years.

Bloomberg Commodity Total Return Index A broadly diversified commodity price index that tracks 22 commodity futures and seven sectors.

Bloomberg Barclays U.S. High Yield Index A fixed-income benchmark of US dollar-denominated, high-yield and fixed-rate corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Bloomberg Barclays Intermediate and Long Credit Indices Benchmarks designed to measure the performance of US corporate bonds that have a maturity of 1–10 years (Intermediate) or more than 10 years (Long).

Bloomberg Barclays Intermediate and Long Corporate Index Option Adjusted Spreads The measurement of the spread of the fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.

Bloomberg Barclays U.S. Aggregate Bond Index A benchmark of the performance of the US dollar denominated investment grade bond market, which includes government and corporate bonds, mortgage pass-through securities, commercial mortgage backed securities and asset-backed securities.

CBOE VIX Index A measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

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.

Dow Jones U.S. Select REIT Index A benchmark of US REITs and REIT-like securities that screens for market capitalisation, liquidity and percentage of revenue derived from ownership and operation of real estate securities.

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.

Implied Volatility Implied volatility rises when the market is falling when investors believe that the asset's price will decline over time, and it falls when the market is rising when investors believe that the price will rise over time.

Inflation An overall increase in the price of an economy's goods and services during a given period.

MSCI All Country World Index A free float-adjusted market capitalisation weighted index that is designed to measure the equity market performance in the global developed and emerging markets.

MSCI China Index An equities benchmark that captures large- and mid-cap representation across China H shares, B shares, Red chips and P chips. It does not include A shares listed on the mainland.

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 Europe Index A benchmark capturing large- and mid-cap representation across 15 developed market countries in Europe. The gross total return version reflects returns after reinvestment of dividends.

MSCI Korean Index A benchmark designed to measure the performance of the large- and mid-cap segments of the Korean equity market.

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.

MSCI Pacific Gross Total Return Index The index of large and mid-cap stocks across 5 Developed Markets countries in the Pacific region reflects returns after reinvestment of dividends.

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.

Real Estate Investment Trusts (REITs) Companies that own and operate commercial properties, such as office buildings and apartment complexes.

Realised Volatility The magnitude of a security's price movement, regardless of direction, over a specified period of time.

Reflation A fiscal or monetary policy designed to expand a country's output and curb the effects of deflation.

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

Russell 1000 Index A benchmark that measures the performance of the large-cap segment of the US equity universe.

Russell 1000 Value Index A benchmark measuring performance of the portion of the large-cap segment of the US equity universe that exhibits strong value characteristics.

Russell 1000 Growth Index A benchmark measuring performance of the portion of the large-cap segment of the US equity universe that exhibits strong growth characteristics.

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.

Shadow Banking A term to describe financial activities that take place among non-bank financial intermediaries often outside the scope of federal regulators.

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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ID13455-2169585.1.1.GBL.RTL 0718 Exp. Date: 31/07/2019