Forecasts

Second Quarter 2015

Economic Outlook for Developed Markets

*by **Christopher Probyn, Ph.D.,** Chief Economist, Investment Solutions Group*

Pages 2–5:

- After slowing steadily over the last four years, global growth reaccelerates gradually in 2015 and 2016.
- World inflation slows this year and then picks up next year largely because of the movement in oil prices.
- Monetary policy decouples this year as administered interest rates begin to rise in the US and UK, while other major central banks continue to ease.

Views on Developed Capital Markets

*by **David Ely, CFA,** Senior Portfolio Manager, Investment Solutions Group*

Pages 6–7:

- The ECB's larger than expected Quantitative Easing (QE) program will continue through September 2016. ECB President Mario Draghi emphasized the ECB's willingness to continue with quantitative easing until inflation is steady near 2%.
- As the US dollar rises higher, USD denominated investors seek protection with dollar hedged strategies in advance of the Fed's expected rate hike this fall.
- Even after a bailout extension, Greece and international creditors remain at odds. Resisting austerity measures, Greece remains a default risk and a threat to leave the Eurozone.

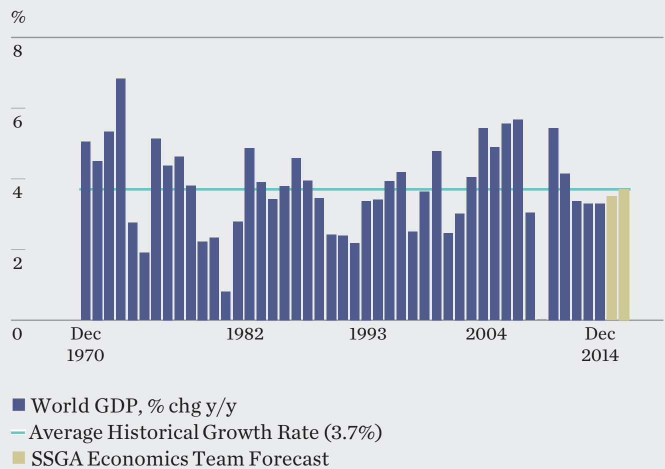
Perspectives on Emerging Markets

*by **George R. Hoguet, CFA, FRM,** Global Investment Strategist, Investment Solutions Group*

Pages 8–9:

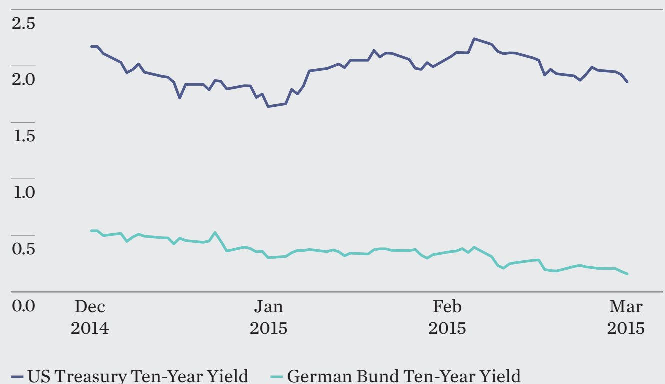
- Brazil and Russia are in recession and analysts have downgraded estimates of output growth in emerging markets in 2015. Nonetheless, emerging markets continue to outpace developed markets, and China (12% of the global economy) is expected to grow by at least 6.7% this year.
- A strong dollar has reduced emerging market equity returns for dollar-based investors in recent years, but the experience of Euro-based investors has been much more favorable. In the months ahead, emerging market equity investors face multiple geopolitical risks, gradual fed tightening, and likely further dollar appreciation. Current market valuations, however, are not demanding by historic norms.
- The slowdown in world trade growth over the past three years may represent a structural shift in the world economy and poses additional headwinds for some emerging markets. Current account surpluses in many Asian countries are declining.

Figure 1: Global Growth is Poised to Improve



Sources: IMF, Oxford Economics, SSGA Economics Team.
The above forecasts are estimates based on certain assumptions and analysis.

Figure 2: US & German Yields



Source: SSGA, as of March 31, 2015.
The information contained above is for illustrative purposes only.

Figure 3: World Trade Growth Has Slowed Over the Past Three Years
World GDP Growth and World Import Growth

Source: Citibank.

STATE STREET GLOBAL ADVISORS

Economic Outlook for Developed Markets

by ***Christopher Probyn, Ph.D.,*** *Chief Economist, Investment Solutions Group*

Global Overview: Growth Slowly Improves, While Monetary Policy Decouples

World economic momentum waned steadily over the last four years. Indeed, from 2010, global real GDP growth slowed by around 2.0 percentage points to just 3.3% in 2013 and 2014, a sluggish pace below the long-term trend of around 3.7%. However, that should prove the nadir, with growth reaccelerating gradually to 3.5% this year on an improvement in the advanced economies and to 3.7% next year on an improvement in the developing economies.

The risks to global growth still appear skewed to the downside, but less so than before. The largest downside risk reflects geopolitical uncertainties, including Ukraine, the Middle East and even tensions between China and Japan. Moreover, a China hard landing remains a tail risk, and the Greek crisis was recently only kicked down the road and could flare up again at any time.

Despite this rather depressing list of problems, however, there is an upside risk, namely the potential for oil prices to break lower. The $50-plus drop in oil prices that has occurred since the end of last June should add approximately 0.4 percentage points to global growth in 2015, with any further sustained drop boosting it even further.

From mid-2011 to mid-2014, oil prices trended erratically sideways leaving core (excluding food and energy) prices to drive headline inflation steadily lower because of large output gaps. Since last June 30, however, oil prices have fallen around 50%, consigning them the dominant role in the evolution of inflation over the near term.

Because of the extent and timing of the oil price decline, inflation should decelerate quite sharply this year. Indeed, global inflation slows four ticks to 3.3% on a 1.0 percentage point deceleration in the advanced economies to just 0.4%. The risks appear skewed to the downside, particularly this year, when North American oil production is unlikely to be affected much by the drop in prices. However, as US and Canadian oil exploration is already beginning to slip and the depletion rates of fracking wells is quite rapid, the downside risks to inflation progressively diminish, even giving way to upside risks in 2016.

Monetary policy finally begins to decouple this year, with two central banks raising interest rates, and the rest, at least, holding the line, if not actually increasing the degree of monetary accommodative policy through additional asset purchases.

Having now ended its quantitative easing programs, the Federal Reserve (Fed) will probably begin raising interest rates beginning in September. The Bank of England (BoE) is also likely to follow towards the end of the year. Meanwhile, the European Central Bank (ECB) is expected to hold the line on rates, having launched its asset purchase program in March. The Bank of Japan (BoJ) remains in play to increase the pace of its asset purchases.

US: Poised to Accelerate

We expected the economy to accelerate quite sharply in 2014. But it did not happen, largely because of a weak start to the year caused by a combination of bad weather and inventory drawdown. Consequently, growth picked up by a meager 0.2 percentage point to 2.4% despite impressive GDP gains in the middle of the year.

Three months ago, we expected the economy to accelerate sharply in 2015. And we still do, but not quite to the same extent, because again, an unwanted inventory build and poor winter weather probably retarded growth in the early part of the year.

Pessimists can certainly point to areas of weakness. Retail sales have stalled over the winter even after abstracting the dampening effect of lower oil prices on nominal spending. Housing starts remain stuck between 1.0–1.1 million units a year. New orders for factory goods (a leading indicator of business investment) have fallen and unfilled orders (a leading indicator of industrial production) have flattened out. The inventory-to-sales ratio has risen sharply over the last four months, likely portending slower production growth over the near term. The (real) trade deficit jumped sharply in the December-January period. And wage growth remains sluggish, retarding personal income and consumer spending.

However, we feel that some of the recent weakness reflects special factors, such as the winter weather and port closures on the West Coast. Underlying private-sector fundamentals appear generally sound. Household financial situations and confidence have improved, coaxing consumers to assume short-term debt to finance expenditures on discretionary items such as autos. There are even signs that they are beginning to use their credit cards again. The labor market has tightened steadily, with the unemployment rate reaching 5.5% by February.

Corporations remain unusually profitable. And fiscal policy will not subtract from growth and could even contribute positively if there is any relaxation of the sequester. Consequently, we now expect growth to accelerate to 3.2% this year (compared to our higher estimate of 3.4% three months ago) before slowing slightly to 3.0% in 2016.

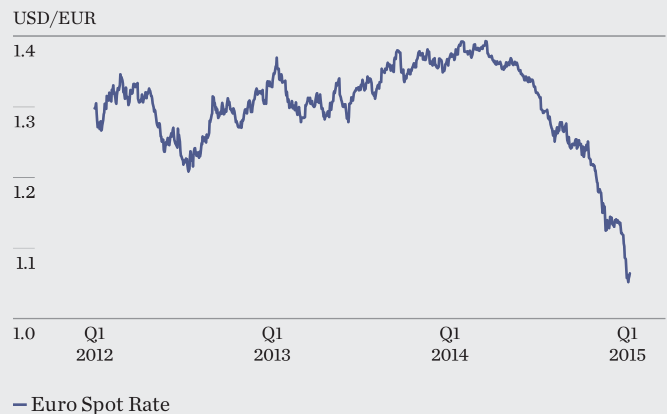
Oil prices dominated movements in headline consumer prices between 2008 and 2011, pushing inflation as high as 5.6% year-over-year (y/y) in July 2008, as low as -2.1% in July 2009, and then back to 3.9% in September 2011. At that time, oil prices stabilized, and the core component (which excludes food as well as energy) began to drive headline. Not surprisingly, with unemployment high and growth modest, inflation slowed before stabilizing at a benign level. Now, oil prices have regained the dominant role. Indeed, the 50% drop in oil prices during the second half of last year is projected to reduce headline inflation by 1.1 percentage point to just 0.5% this year, before accelerating wage and core inflation, together with some recovery in oil prices, push it back to 2.1% in 2016.

The Fed eased aggressively in response to the financial crisis and has maintained an extremely easy monetary stance since then. However, as growth picked-up during 2014, the Fed progressively "tapered" its quantitative easing program, ending it altogether last October. In December, it changed its forward guidance, replacing "considerable time [before raising interest rates]" to "patient [before raising rates]." Then in March, the Fed eliminated the word "patient," becoming entirely data dependent, evaluating the appropriate level of administered interest rates on a meeting-to-meeting basis.

However, the Fed faces a conundrum related to its dual mandate of achieving both full employment and price stability (2.0% inflation over the medium term). Based on the Fed's own estimate of full employment (4.9%–5.8%), the labor market criterion now justifies tightening. But, because of modest wage growth and the recent fall in oil prices, the inflation criterion has not been met. The Fed has stated it will not move before it is "reasonably confident" the inflation criterion will be met, and has even defined what would make it reasonable confident: positive headline inflation; core inflation headed towards 2.0% and real wage gains that are off their lows of recent years.

Based on our growth and inflation projections, we expect the conditions to be met in time for the Fed to move in September. It will then raise the funds target range to 0.75%–1.00% or possibly only 0.50%–0.75% by the end of this year, and to 2.00%–2.25% by the end of next year. But, given the inherent volatility of oil prices and the particular measure of wage inflation chosen by the Fed, there is no absolute guarantee that the three "confidence conditions" will be met and hence, that the Fed will tighten this year.

Figure 4: The Euro Continues To Fall As The ECB Expands QE



Source: Eurostat.

Europe: Finally Gaining Traction

After crashing during the Global Financial Crisis (GFC) and "double-dipping" in 2012, the economy has expanded since the second quarter of 2013. But growth has remained sluggish with seven consecutive anemic quarterly gains of 0.3% or less.

However, the recovery seems poised to gain some traction as the incoming data have improved. The purchasing managers' index for manufacturing has at least stabilized, while that for services has rebounded sharply over the last three months. Consumer confidence has revived. Retail sales have surged to their highest level in almost four years. Broad money growth has accelerated sharply. And, private sector loans have stabilized, following a prolonged decline.

A number of factors have contributed to the better near-term outlook. The euro has fallen over 20% since the middle of last year. Oil prices have fallen 50% over the same period. The Asset Quality Review removed a cloud hanging over the European banking system. And the ECB, delivered on its promise to introduce an asset purchase (QE) program.

Indeed, the size and composition of the program were all the market could have reasonably hoped for. Moreover, the region seems to have come to terms with the situation in Ukraine, and to have found a (temporary) solution to the Greek crisis. Hence, we are revising up our forecast of growth this year from 1.2% to 1.4% and expect a further pick-up to 1.6% in 2016.

However, we do not expect this improvement to represent the beginning of a sustained period of robust growth. Structural flaws revolving around relative competitiveness, and the lack of any workable mechanism to fix it or compensate for it, would seem to preclude that. In a monetary union like the eurozone, maintaining competitiveness against other members is crucial because there are no exchange rates to adjust for any loss,

dooming those countries that do become uncompetitive to underperform. Moreover, in the absence of fiscal transfers between nations within the union to compensate for the problem, such underperformance tends to persist.

With Germany highly competitive, France less so, and Italy even less so, it is not surprising that cyclical conditions vary widely among the Big-Three. The recovery has been quite robust in Germany, lackluster in France and non-existent in Italy. Indeed, German GDP is now 11.6% above the GFC trough of mid-2009. French GDP is 5.6% above. And Italian GDP is 2.3% below.

In terms of industrial production, which better reflects the effects of competitiveness because much of GDP is non-tradable, German output is now 27.9% above its GFC trough. French output is 6.5% above. And Italian output is just 0.1% above. We expect a modest pick-up this year. German GDP growth accelerates by 0.2 percentage point to 1.8% and then to 1.9% in 2016. France accelerates 0.5 percentage point to 0.9% and then to 1.3% in 2016. And Italy finally emerges from recession, accelerating 0.6 percentage point to 0.2%in 2015 and then to 0.8% in 2016.

Oil prices buffeted headline inflation from 2008 to 2011. Gyrations in the energy component were primarily responsible for pushing eurozone CPI inflation to a high of 4.0% y/y in mid-2008, a low of -0.7% in mid-2009, then back to 3.0% in the fall of 2011. However, when oil prices stabilized that year, movements in the headline began to reflect those in the core (which excludes food, alcohol, tobacco as well as energy). And, because the labor market just kept getting weaker, both trended sharply lower. Indeed, headline slowed to just 0.5% in the middle of last year.

Then oil began to play a larger role and has dominated movements since November, pushing headline inflation to as low as -0.6% in January. Moreover, the effects of lower oil prices "bled through" into core, with that measure decelerating to just 0.6% in January, the lowest in the history of the series. With oil prices first stabilizing and then recovering, headline should fall slightly negative this year before reaccelerating to 1.2% next year. Core inflation should be less volatile, remaining positive this year, and below 1.0% next year.

The ECB began to renormalize administered interest rates in mid-2011 but then reversed course when the recovery began to stall. It also engaged in a number of non-conventional measures and provided some rather explicit forward guidance, stating that, "… the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time."

In 2014, the dangerously low rate of inflation, slow money growth and the ongoing contraction of private sector credit prompted the Bank to make further moves, including rate cuts (with the deposit rate going negative) targeted long-term refinancing operations and asset purchase programs for covered bonds and asset backed securities. Earlier this year it introduced a QE program under which the Bank will purchase bonds (including sovereigns) worth around 60 billion euros a month through at least September 2016, with the goal of restoring the balance sheet to early 2012 levels (an increase of roughly 1 trillion euros). We feel this is a move in the right direction, with the positive economic effects most likely to be transmitted through the financial markets, by boosting stock and bond prices and weakening the euro.

Meanwhile, the UK recovery has hit its stride. GDP rose a solid 2.6% in 2014 and should remain solid at around 2.8% in 2015 as well. Although housing is cooling, domestic demand otherwise looks healthy, bolstered by easy monetary policy and lower oil prices. Moreover, growth improvement on the Continent should help external demand.

Looking ahead to 2016, growth moderates to around 2.5% as the BoE begins to tighten, the positive boost from oil fades and sterling strength versus the euro erodes competitiveness. The oil price drop likely pulls headline inflation down to just 0.5% this year. But the narrowing output gap should limit further downside inflation pressures, which along with well-anchored inflation expectations and stabilizing energy prices, should allow headline inflation to begin to reaccelerate back towards the BoE's 2.0% target as we move into 2016.

Solid growth and the narrowing output gap has the BoE looking for an opportunity to begin rate normalization. It believes low inflation to be temporary, but it needs to be reasonably confident that inflation is indeed on track to move back to the target. The Bank will likely develop this confidence before the end of this year, allowing a first hike in November. After that the BoE proceeds cautiously with further hikes.

Japan: Recovery from the Effects of the VAT Hike

Last year's data were heavily affected by the 3 percentage point increase in the consumption (VAT) tax on April 1. Indeed, after surging 1.3% in the quarter ahead of the tax hike, GDP plunged 1.6% in the second quarter and another 0.7% in the third quarter, before rebounding 0.4% in the fourth quarter, to leave it down 0.1% for the year as a whole. The data were distinctly upbeat in the fourth quarter, with household expenditures rising strongly over the last four months of the year and industrial production increasing in three out of the last four months.

But they have been strangely mixed in January with expenditures slipping but production soaring. While we expect the recovery will continue and even gain some traction over the course of this year—especially as the scheduled tax hike for October has been postponed until April 2017—we project growth to reach only 0.8%, before picking up further to 1.4% in 2016.

All three widely-used measures of consumer price inflation, headline, national core (which excludes fresh food products) and conventional core (which excludes food and energy) had turned positive prior to the spike caused by the consumption tax hike. National core CPI inflation was running at 1.3%y/y last March, not too far below the BoJ's 2.0% target.

However, the initial pick-up largely reflected the one-off effect of a lower yen, and there has been no progress since. Indeed, headline and national core inflation have decelerated because of the drop in oil prices. And even conventional core inflation has slipped slightly, so that after abstracting from the effects of the VAT, it is probably running at just 0.5% y/y. With oil prices having fallen so sharply over the second half of last year (and the VAT distortion dropping out of the calculations), headline inflation decelerates to 0.5% this year. But, wage inflation has picked up modestly, and oil has found its floor, which provides for a gentle acceleration to 0.8% in 2016.

By October 2009, the BoJ had lowered its overnight cash target to 0-10 basis points, where it remains today. The Bank also engaged in quantitative easing, introducing an asset-purchase fund that reached 76 trillion yen and a credit lending facility that reached 25 trillion yen in December of 2012. By international standards, however, the BoJ was relatively cautious, expanding its balance sheet much more slowly than the US Fed, for example. But that has changed over the last two years.

In January of 2013, the Bank announced a "price stability target at 2 percent in terms of the year-on-year rate of change in the consumer price index," thereby replacing its informal 1.0% goal. Moreover, three months later, the Bank introduced an"open-ended asset purchasing method" under which it would buy a certain amount of financial assets every month without setting any termination date, with the goal of hitting the 2.0% inflation target, "with a time horizon of about two years," by "doubling the size of the monetary base."

Indeed, to emphasize the change in policy, the BoJ abandoned its target for the policy rate and adopted one for the absolute increase of the monetary base. That was originally set at 60–70 trillion yen a year but was raised to 80 trillion yen in October of 2014 because of weakness in the economy and deceleration of inflation. We expect the BoJ to, at least, hold the line in 2015, and possibly increase the pace of asset purchases further, if growth or inflation disappoint.

Will "Abenomics work"? The twin goals are to speed up the long-term growth rate and end two decades of deflation. The fiscal stimulus package certainly helped boost growth in 2013. And should the economy fail to regain traction, the Abe government might employ another one this year.

But the goal of permanently speeding up growth depends critically on enacting structural reforms, and the commitment to them remains unclear. Meanwhile, the deceleration of inflation since last summer suggests that the verdict is not in, although the level of the unemployment rate and incipient signs of a pick-up in wage inflation provide some grounds for optimism.

Views on Developed Capital Markets

*by **David Ely, CFA,** Senior Portfolio Manager, Investment Solutions Group*

Liquidity and Divergence

So far in 2015, markets have digested a flurry of divergent Central Bank policy moves in response to an uneven global growth outlook, rapidly declining global inflation and a major expansion of quantitative easing by the European Central Bank (ECB). The Swiss National Bank delivered an early surprise for global markets by removing the peg between the Swiss Franc and the Euro in place since 2011. This unexpected tightening action sent the Swiss Franc up better than 20% against the Euro and the Swiss equity market down by 15% immediately following the move. The Bank of Canada (BoC) provided further shock therapy by unexpectedly cutting overnight rates. Canadian stocks and bonds rallied, but the Canadian dollar traded down 2.5% on the news.

The ECB announced a larger than expected Quantitative Easing (QE) program which began in March and is set to continue through September 2016. The commitment to continue buying bonds is open ended thereafter until it has achieved, as ECB President Mario Draghi said, “A sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term.”

In testimony to the European Parliament, Draghi underscored the notion that the Governing Council is not only concerned with inflation reaching close to 2%, but settling “around those levels with sufficient confidence thereafter.”

Since the beginning of the year, the Euro is down 11% relative to the U.S. Dollar. In January, Denmark, Singapore, India and Turkey also cut rates. In February, Australia cut overnight rates. Currently, 10 year Bunds trade with yields at 0.16% while Japanese 10 year bonds trade with yields at 0.37%.

Yield curves across the Eurozone have continued to push lower due to the ECB’s €60 billion a month bond buying program. Negative yields have prompted investors to go out further on the maturity and quality spectrum and have proven a sufficient impetus for U.S. borrowers to issue substantial amounts of debt in Europe. U.S. corporations have issued €3.28 billion euros of high yield debt this year, the most to start any year since the currency began over 15 years ago. Despite the current QE-induced optimism, the shift into longer duration bonds and lower interest rates may be setting the stage for longer term fixed income volatility in the future.

In the U.S. in February, the Federal Reserve (Fed) released minutes from their latest Federal Open Market Committee meeting. At a time when market expectations and Fed rhetoric are already at odds, one might have thought that the Fed would make extra effort to clarify its intentions, but apparently not. The minutes only added to the confusion. Further testimony by Fed Chair Janet Yellen to Congress set the stage for removal of the word “patient” from future Fed statements.

Ten year U.S. Treasury interest rates ended the quarter at 1.88%, but have seen increasing volatility. The swing in interest rates in February was the biggest monthly change in rates since the “Taper Tantrum” in 2013 when rates moved from 1.67% in April of 2013 to 2.12% in May. In March, the Fed, in fact, removed the word “patient” from its statement as had been broadly telegraphed to the market.

What surprised the market was the “dots” which many market pundits took to mean that the Fed has pushed back the date of the first hike. Many pundits had thought that the first hike could come as early as this summer; most now expect lift off in September. The extension of the lower for longer scenario sent bond yields lower and U.S. equities modestly lower as markets begin to digest impending rate hikes. Recent economic data out of the US has also been weaker than expected, which may add further ammunition for the lower for longer viewpoint.

As one might expect from a growing versus a stagnant economy, bond yields between the US and EuroZone have diverged. (See Figure 2). The divergence in yields has started to shift several dynamics. The low level of interest rates in Europe coupled with a lack of supply of new bonds from European issuers have pushed many U.S. companies to issue debt in euros and take advantage of the low borrowing costs. The massive ECB purchasing will absorb any EZ sovereign liquidity and we would naturally expect that high quality corporates in the EZ will do well as investors move slightly out the credit spectrum to satisfy their fixed income holding requirements. Massive flows of cash out of the EZ also pushed the Euro lower as cash investors moved out of the Eurozone to avoid negative yields. Much of the flow out of the Eurozone has gone to US dollar denominated assets which has pushed the US dollar higher to levels not seen in many years. The flow into US dollars has also prompted USD denominated investors to seek dollar hedged strategies to protect against a strong and rising dollar as the Fed begins hiking rates this autumn.

With the liquidity that the ECB and BOJ continue to pump into their respective economies, we expect that European and Japanese equities will continue to outperform US equities. Our preference for large cap equities over small cap US equities has been spot on over the last year, but we are concerned that a strong US dollar will begin to crimp earnings and earnings power of large cap multinational firms. Therefore, we have been trimming our overweight to US large cap equity positions. It's not a currency war if everyone wins, but the strong dollar is clearly having an impact on US multinationals. The S&P 500 on average earns 46% of its revenue from foreign sales. Repatriation of foreign earnings back to dollars with the dollar up over 10% on a trade weighted basis will crimp earnings.

Equity market returns have also continued to decouple as investors digest the a-typical forces impacting the markets. The S&P 500 is up 0.44% while the German DAX Index is up 22.62% and Japanese Nikkei Index is up 9.08% all in local terms. And we expect this divergence to continue as tremendous amounts of liquidity get pumped into the Japanese and Eurozone financial systems. However, there are clouds on the horizons.

Drama in Greece began anew after a four month bailout extension agreement was reached. The extension had given the Syriza party time to implement required reforms. However, confrontational language by newly elected Greek Prime Minister Tsipras escalated a war of words surrounding Greek debt and required austerity measures, prompting the IMF to call Greece the most unhelpful country that they have dealt with in their 70 year history.

Despite the market's sigh of relief in February following the bailout extension, the country still remains at risk of default as it has yet to unlock new funds for the cash starved government. Even after the bailout extension, Greece and her international creditors still remain at odds about how to proceed. In the short-term, Greece faces more than €2 billion euros in debt payments, €1.5 billion of salaries and pensions by the end of March and on April 9th, a €450 million loan repayment to the IMF.

Late in the quarter, the ECB continued to weaken Greece's position to negotiate favorable terms and pressured Syriza to expedite the implementation of economic reforms. Even last week, the ECB ordered Greece's largest banks to not increase their exposure to Greek government debt. The restriction on Greek banks exerts further pressure on Greece to find foreign buyers of its T-bills in order to roll its short term government debt. Over the next two months €5.2 billion of short-term T-bills will come due.

As a counterbalance, the Governing Council provided some relief to Greek lenders by raising the cap on Emergency Liquidity Assistance (ELA) provided by the Bank of Greece to just over €71 billion. Greece remains increasingly dependent on the ELA program as bank deposits continue to plunge. Greek deposits dropped in February to a near 10-year low as €8 billion was withdrawn from banks as Greeks fear the potential of capital controls or a change in currency.

The ECB's move to disallow Greek banks from using Greek government debt as collateral for ECB loans last month and now restraining banks from increasing T-bill holdings are inherently aimed at pressuring Syriza to grudgingly implement economic overhauls. As of quarter end, the yield of 3-year Greek government debt was 22%. The most likely resolution of all of this Greek drama is for Greece to leave the Eurozone. While such a move hasn't been undertaken since the EU was formed, it seems unlikely that Greece will accept the required austerity to bring herself in line with demands from her creditors. EU leaders are also conscious of the moral hazard, the situation creates, as other countries have already taken their tough medicine in the wake of the financial crisis and have emerged stronger for it.

Perspectives on Emerging Markets

*by **George R. Hoguet, CFA, FRM,***
Global Investment Strategist,
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Recent revisions of estimates of economic activity in emerging markets in 2015 have been negative, but emerging economies, led by India (+7.2%) and China (+7%), are expected to grow by at least 3.8% this year, or 1.5 percentage points more than developed markets. A sharp contraction in Russia (-5%), and an unfolding political scandal and recession in Brazil (-0.6%) have dragged down estimates for emerging markets growth overall in 2015. However, growth in emerging markets is expected to pick up in 2016, with current estimates around 4.7–5%.

In the coming months, emerging economies and equity markets likely face further strengthening of the US dollar; a gradual firming of US interest rates; and multiple geopolitical risks including: a possible Greek default and/or exit from the Eurozone; a widening conflict in the Ukraine and increasingly aggressive Russian behavior in the former Soviet Union; and broadening conflicts in the Middle East, including a growing proxy war between Iran and Saudi Arabia.

Those countries with strong policy frameworks, including modest current account and fiscal deficits, a relatively low level of hard currency sovereign and corporate external indebtedness, and well regulated financial sectors are best positioned to withstand a possible repeat of the May/June 2013 “taper tantrum.”

As it is, many emerging currencies continue to fall against the dollar. For example, in the first quarter 2015, the Brazilian Real fell 16.8%, the Czech Crown 11%, and the Turkish Lira 10.1%. Should the dollar continue to strengthen (particularly against the Euro) in the months to come, some emerging currencies will continue to weaken. This development will contribute to growing inflationary pressures over time. Developments in China in 2015 will also heavily impact emerging markets.

The Outlook for China

Despite evidence of a growing slowdown in the manufacturing sector and continued weakness in the construction sector and property market, the average of estimates by 56 economists polled by Bloomberg for growth in China is 7% in 2015 and 6.7% in 2016. China benefits from both monetary policy and fiscal policy flexibility. Analysts expect two additional policy rate cuts by the People’s Bank of China in 2015, and a cut in the Required Reserve Ratio as well. China also has $3.8 trillion in foreign exchange reserves which it can use to shore up the financial system if need be.

China’s leadership continues to announce and begin to implement multiple economic reforms. At the Chinese People’s National Congress in March 2015, Chinese Prime Minister Li stated that the government would “do what it takes” to ensure that China meets its 2015 targets These are: growth of “about 7%”; inflation (CPI) of 3%; and M2 growth of 12%.

Mr. Li also announced several measures to further the “opening up” and rebalancing of the economy. These include: the removal of restrictions on foreign investment in certain sectors of the economy; the ability of the Town and Village Enterprises to issue municipal bonds directly to the public; and an enhanced tax system. Chinese policymakers have also made it clear the further internationalization of the RMB is an agenda item for 2015.

In sum, while risks to economic activity in China are to the downside, and while the continuing “anti-corruption” campaign could lead to political turmoil, given China’s policy flexibility and policy activism, there is insufficient evidence to reject the consensus view that China will grow by at least 6.5% this year.

The Outlook for the Regions

For the first time in many years, growth in India (+7.2%) in 2015 is expected to exceed growth in China. Inflation in India (+5%) has come down, and India’s current account and fiscal deficits are falling. EM Asia ex China and India is expected to grow 4%. The Philippines (+6.4%), which is a large exporter of labor, is the standout.

In Eastern Europe, the C-3 countries (Poland, Czech Republic and Hungary) should benefit from a weakening euro and a gradual pick-up in Western Europe. Russia, however, is beset by sanctions and a much lower than anticipated oil price. Developments there will play a large role in determining economic outcomes in the C-3 this year.

Mexico (+2.7%) is benefitting from the acceleration of economic activity in the US. However, in Brazil, where President Dilma faces possible impeachment charges over large scale corruption at Petrobras, the situation will remain very unsettled.

The Outlook for Emerging Market Equities

Emerging market equities currently sell at 11.4 times forward 12 month earnings and yield 2.6%. Earnings are expected to grow around 6.5% this year. In the first quarter of 2015, the Morgan Stanley Capital International ("MSCI") EM Index returned 2.2%, vs 0.95% for the Standard and Poor's 500 Index.

Investors are understandably cautious given slowing growth in three out of the four BRICs, and the slowdown in world trade. But valuations are not demanding by historic norms, and it is hard to argue that an improving US economy is a negative for emerging markets.

Sources: Bloomberg, Factset, JP Morgan Chase, Morgan Stanley.

SSGA Forecasts

Real GDP Growth	2015 Forecast	2016 Forecast
Global	3.5%	3.7%
US	3.2%	3.0%
Australia	2.6%	3.0%
Canada	2.1%	2.3%
Eurozone	1.4%	1.6%
France	0.9%	1.3%
Germany	1.8%	1.9%
Italy	0.2%	0.8%
UK	2.8%	2.5%
Japan	0.8%	1.4%
Brazil	-0.6%	1.6%
China	6.9%	6.5%
India	7.2%	7.8%
Mexico	2.7%	3.5%
South Africa	2.3%	2.3%
South Korea	3.0%	3.7%
Taiwan	4.1%	3.4%

Inflation	2015 Forecast	2016 Forecast
Developed Economies	0.4%	1.6%
US	0.5%	2.1%
Australia	1.8%	2.8%
Canada	0.8%	2.0%
Eurozone	-0.1%	1.2%
France	0.0%	1.0%
Germany	0.2%	1.6%
Italy	-0.2%	0.8%
UK	0.5%	1.8%
Japan	0.5%	0.8%

Central Bank Rates	March 31, 2015	12-Month Forecast
US	0.25%	1.00%
Australia	2.25%	2.00%
Canada	0.75%	0.75%
Euro	0.05%	0.05%
UK	0.50%	1.00%
Japan	0.10%	0.10%
China	5.35%	5.10%
Brazil	12.75%	12.50%
Mexico	3.00%	4.00%
South Africa	5.75%	6.25%
South Korea	1.75%	1.75%

10-Year Bond Yield	March 31, 2015	12-Month Forecast
US	1.92%	2.40%
Australia	2.32%	2.40%
Canada	1.36%	1.75%
Germany	0.18%	0.20%
UK	1.58%	1.80%
Japan	0.41%	0.40%
Brazil ($)	4.52%	5.07%
Mexico ($)	3.29%	3.76%

Exchange Rates	March 31, 2015	12-Month Forecast
Australian Dollar ($/A$)	0.76	0.72
British Pound ($/£)	1.48	1.47
Canadian Dollar (C$/$)	1.27	1.30
Euro ($/€)	1.07	1.01
Japanese Yen (¥/$)	120.13	126.00
Swiss Franc (SFr/$)	0.97	1.03

	Base Currency					
One-Year Return Forecasts	USD	EUR	GBP	JPY	AUD	CAD
S&P 500	3.1%	9.5%	3.9%	8.1%	8.9%	5.7%
Russell 2000	-0.2%	6.0%	0.6%	4.7%	5.4%	2.3%
MSCI EAFE	4.8%	11.3%	5.6%	9.9%	10.7%	7.4%
MSCI EM	2.9%	9.3%	3.7%	7.9%	8.7%	5.4%
Barclays Capital Aggregate Bond Index	1.1%	7.4%	1.9%	6.0%	6.8%	3.6%
Citigroup World Government Bond Index	0.2%	6.5%	1.0%	5.1%	5.9%	2.7%
Goldman Sachs Commodities Index	0.9%	7.2%	1.7%	5.8%	6.6%	3.4%
Dow Jones US Select REIT Index	2.6%	9.0%	3.4%	7.6%	8.4%	5.1%

Source: SSGA, as of March 31, 2015.

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

Past performance is not a guarantee of future results.

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Risk associated with equity investing include stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise bond values and yields usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

Investing in commodities entail significant risk and is not appropriate for all investors. Commodities investing entail significant risk as commodity prices can be extremely volatile due to wide range of factors. A few such factors include overall market movements, real or perceived inflationary trends, commodity index volatility, international, economic and political changes, change in interest and currency exchange rates.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

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ID3626-INST-5471 0415 Exp. Date: 04/30/2016