2024

Global Market Outlook

Positioning the Pieces

STATE STREET GLOBAL ADVISORS

Contents

Positioning the Pieces

Global markets experienced a variety of surprises and shocks in 2023, including elevated inflation, muted growth, an abrupt banking crisis, and the continuation of the sharpest monetary policy tightening in decades. Looking at 2024, we anticipate uncertainty to persist, with sub-trend growth projected across the world's economies. While the path to a soft landing appears viable, with growth decelerating but not collapsing, the effects of monetary policy tightening are still working their way through the system. In addition, escalating geopolitical tensions and ongoing macroeconomic headwinds will continue to test economies. 2024 will likely be a year in flux with many factors pressuring the path to global recovery.

Outlooks

Geopolitical Risks Intensify as Inflation Angst Recedes

Disinflationary trends and decelerating growth support a soft economic landing. Central banks' hawkish stance and geopolitical conflicts pose viable threats to that outcome.

Bonds Take Center Stage

Given current yield levels, slowing growth, and continued disinflation, fixed income moves into the limelight, offering attractive prospects for investors.

Caution Warranted in Equities: Be Selective

Global fragility and heightened uncertainty are likely to weigh on equities. In a potentially more volatile landscape, investors should adopt a selective stance in their equity allocations.

Macroeconomic and Geopolitical

Geopolitical Risks Intensify as Inflation Angst Recedes

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Global markets experienced a variety of surprises and shocks in 2023, including elevated inflation, muted growth, an abrupt banking crisis, and the continuation of the sharpest monetary policy tightening in decades. Looking at 2024, we anticipate uncertainty to persist, with sub-trend growth projected across the world's economies. While the path to a soft landing appears viable, with growth decelerating but not collapsing, the effects of monetary policy tightening are still working their way through the system. In addition, escalating geopolitical tensions and ongoing macroeconomic headwinds will continue to test economies. 2024 will likely be a year in flux with many factors pressuring the path to global recovery.

We expect 2024 to be a time of "Positioning the Pieces" as we weigh multiple factors within the macroeconomic environment to assess how they converge in order to refine our outlook and portfolio views. We see fixed income as a bright spot for investors in 2024 given current yield levels, slowing growth, and continued disinflation. Amid heightened volatility and global fragility, we remain cautious on risk assets and favor quality stocks in equity markets. We believe emerging markets will remain vulnerable given the global landscape, but do see pockets of opportunity within emerging market debt and select emerging market equities.

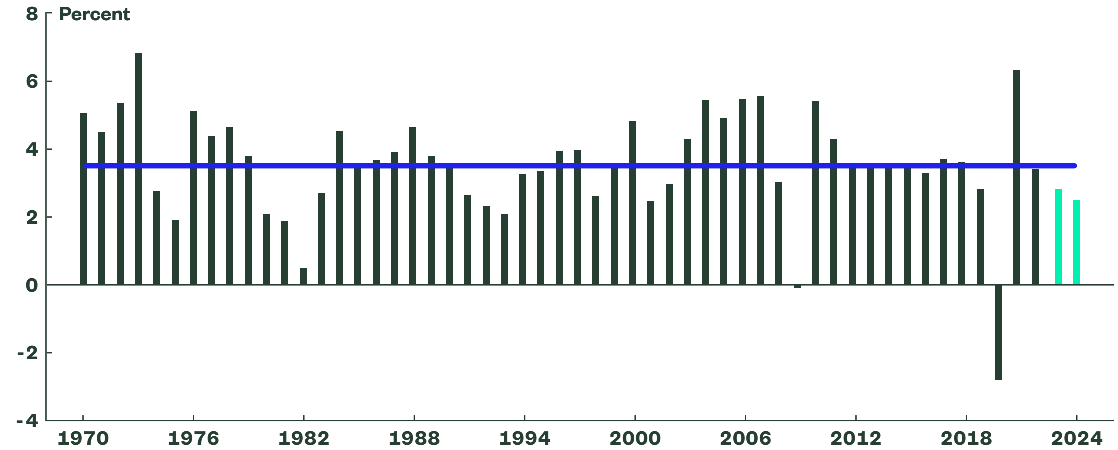
In such challenging markets, it is critical to strike the appropriate balance, get portfolio implementation right, and retain flexibility to respond as clearer signals develop. We explore these themes and more in our latest Global Market Outlook.

2024 Global Economic Outlook

Over the course of 2023, global economies have exhibited surprising resilience in the face of the sharpest tightening cycle experienced in decades. Despite this impressive degree of strength in the global economy, and in the United States in particular, growth is nonetheless slowing (see Figure 1). Resilience has largely exhausted itself. Global trade volumes are outright contracting, and global industrial production is essentially flat on a year-over-year basis (see Figure 2). Services demand has held up much better as post-pandemic pent-up demand was satisfied with a lag, but there are signs of plateauing. Resilience does not equal immunity, especially when it is derived from unsustainable fiscal spending.

Figure 1
US Resilience Aside, Global Growth Is Slowing

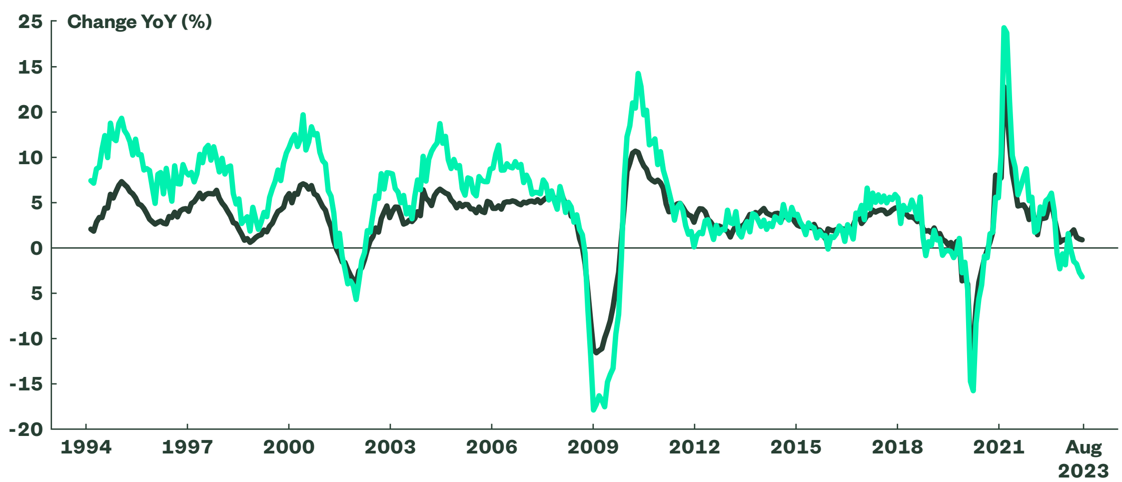
- World, Real GDP Growth (WEO)
- World, Real GDP SSGA Forecast
- Long-Term Average Growth (3.5%)



Source: Macrobond, International Monetary Fund, State Street Global Advisors Economics. Data as of October 23, 2023. The above forecast is an estimate based on certain assumptions and analysis made by the State Street Global Advisors Economics team and Oxford Economics. There is no guarantee that the estimates will be achieved.

Figure 2
World Trade, Industrial Production Struggling

- World, Industrial Production excl. Construction, SA
- World, CPB World Trade Monitor, Total, Volume, SA



Source: Macrobond, State Street Global Advisors, CPB, Economic Policy Uncertainty, S&P Global. Data as of October 23, 2023.

Disinflation Endures

Disinflation has been our highest conviction view over the past year and the incoming data bears witness to it being fulfilled. Despite intense anxiety over stubborn inflation, disinflation actually deepened and broadened over the course of 2023. Recent updates, for instance, have shown an impressive retreat in eurozone inflation. In the United Kingdom, inflation levels that inched lower a few months ago have declined more meaningfully. Disinflation will not run forever, but it is not over yet. Supply chain normalization and moderating demand speak to further price moderation in spite of the recent volatility in energy costs. There is a risk that a much larger spike could ensue either because hostilities in the Middle East widen or due to sabotage or other unforeseen events. In our view, unless oil prices stay above $110 for an extended period of time (i.e. three months or more), the disinflationary forces already in motion should overwhelm their inflationary impulse.

Remarkably, the disinflation over the past year has come without much visible damage to the labor market. The outcome reflects the unusually strong starting point for labor markets across most developed economies. What was a hope a year ago has turned into reality: Central banks, in their rate-hiking anti-inflation fight, have managed to restrict increased job openings without eradicating any jobs. That said, the ground becomes shakier from here. Job openings have indeed been declining and the "margin of safety" is rapidly thinning. The time has now come for central banks to end the tightening cycle and allow prior hikes to filter through the economy. In the United States specifically, where the disinflation process is more advanced and where shelter inflation is bound to meaningfully moderate in coming months, we believe the Federal Reserve Board (Fed) should deliver not just the 50 basis points worth of 2024 rate cuts envisioned in the September dot plot, but at least double that figure. Absent such a calibration lower, there is a high likelihood that the soft landing morphs into something harder.

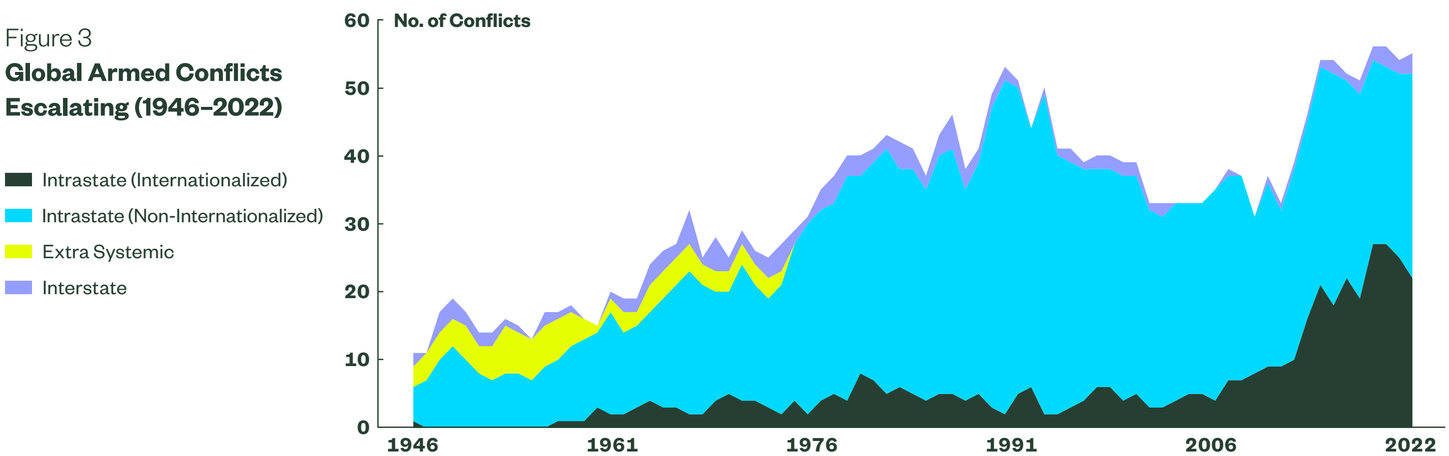
While we are confident about our assessment of the economic trajectory, making forecasts about the future is always challenging. This is particularly the case when the geopolitical outlook becomes more turbulent, with the recent spike in oil prices reflective of that. And as we face 2024, increasingly volatile geopolitical conditions will warrant investors' attention.

Geopolitical Outlook: Caution, 2024 Coming!

Coming into 2023, we held a relatively sanguine outlook in terms of geopolitics. We did not anticipate large market impacts following the Russian invasion of Ukraine in 2022 and an escalation in US-Chinese sanctions. Looking ahead into 2024, however, we consider that the coming year is fraught with potential fracture points, particularly around territorial conflicts and geopolitically critical elections. In total, we consider they pose enough risk to be more inflationary, thereby derailing the disinflation trajectory and disrupting terms of trade for large economies. In short, geopolitical events could deliver smaller stagflationary impulses.

Armed conflicts and violence are rising rapidly. Disturbingly, this trend also applies to the sheer number of global conflicts, and they are becoming deadlier — Figure 3 confirms conflicts hovering near all-time highs. The breakdown also shows the recent rise in internationalized intrastate conflicts — i.e., how civil wars are increasingly fought as proxy wars, such as in Syria or Yemen. This reflects an increasingly multipolar, unstable world, which suggests that interstate warfare is easier to imagine than in the past. Harder to capture is that these conflicts have gradually moved from the periphery toward the center of the global economy. Most notably, Russia's war in Ukraine delivered a global macroeconomic shock via the commodity supply channel.

Figure 3
Global Armed Conflicts Escalating (1946–2022)



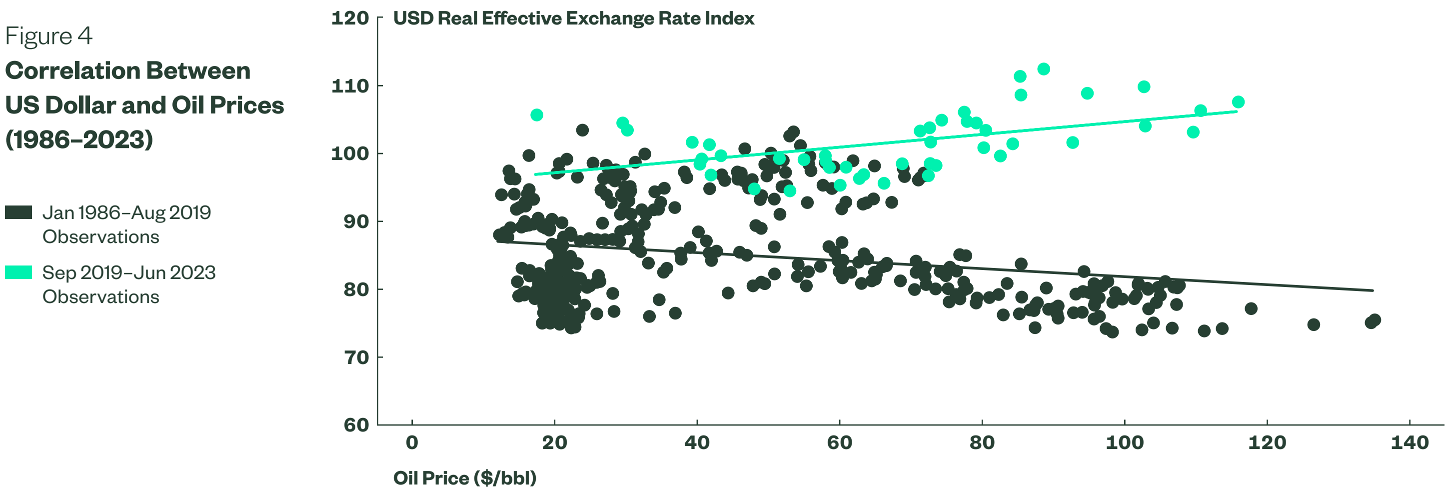
Source: State Street Global Advisors Macro Policy; UCDP via Our World in Data as of September 21, 2023.

Geopolitical Fracturing and Energy Markets

Focusing on possible outbreaks of war underestimates the risks to energy markets. The geopolitical fracturing of the global system means that all large energy producers have oil policy interwoven with other foreign policy objectives. In other words, there are more variables factoring into oil prices than in the past, and therefore also more sources of risk premia. In practice, this dynamic has made OPEC+[1] supply less elastic than pre-2020. That US energy production has also become more inelastic — even if for different reasons — suggests that energy prices are asymmetrically tilted upwards.

The United States has ceased being a net consumer and has emerged as a net energy exporter. This shift has flipped the historically modest negative correlation between the US dollar and oil (see Figure 4). The US dollar and oil correlation makes it worse for all importers (and better for exporters) as each boom/bust cycle is exacerbated. Relying on more recent data, the positive correlation is even more pronounced. This relationship has geopolitical implications, as it further increases the incentives for swing oil producers (namely key Gulf Cooperation Council (GCC) states) to underpin tight supply. The US's relationship with the Gulf states has had implications in global oil supply. The marginal supply is in fewer places that are less likely to deliver it, thus resulting in an asymmetric risk for prices to spike if demand holds up. Lower oil prices, therefore, require more pronounced demand drops, particularly in the two largest consumer economies, the US and China.

Figure 4
Correlation Between US Dollar and Oil Prices (1986–2023)



Source: State Street Corporation, Thiagarajan and Im, 2023.

A Riskier Horizon Ahead?

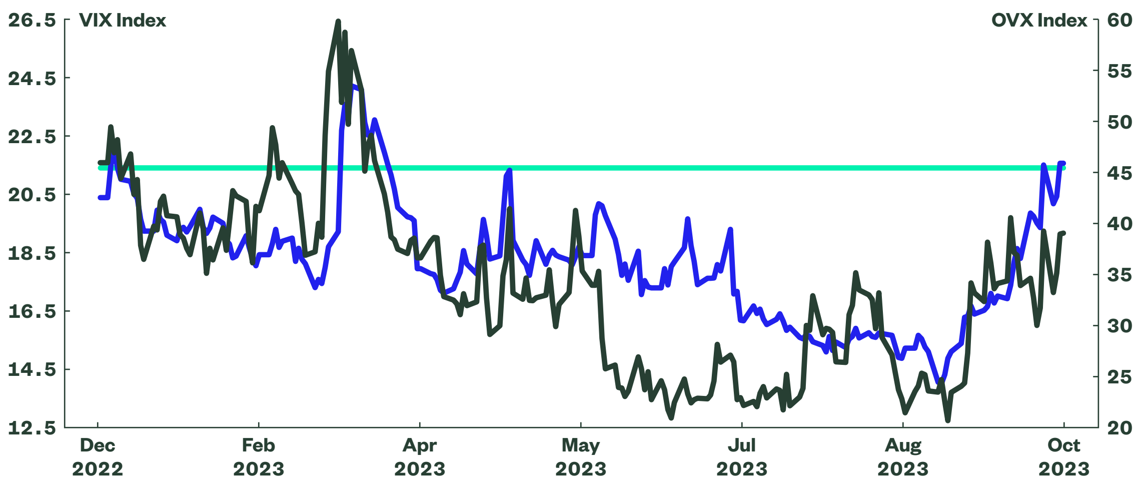
The United States and China are also the two main geopolitical poles where the 2023 détente could give way to more market-impactful tensions. The wars in Europe and the Middle East show how much tighter the respective geopolitical blocs are operating, namely G7 unity on extensive Russia sanctions, and Russia-China-Iran message coordination during the Israel-Hamas war. Hence, global fracturing in any remote place now has a transmission mechanism to global politics, in an echo of the Cold War. In this respect, we can identify several events on the horizon that pose risks to the status quo and could provoke disruption. Firstly, the war in Ukraine could engender the beginnings of a diplomatic process. While this holds promise for stabilizing the conflict, it also carries risks for further friction. In particular, EU-China relations are highly sensitive to Beijing's role in any potential peace process.

Secondly, the election calendar across the globe in 2024 is unfriendly. January's presidential election in Taiwan only carries downside risk. A variety of triggers could lead to deterioration in the status quo (e.g., big shifts in Taiwanese public opinion, miscommunication by any new administration, etc.). Taiwan's centrality in the global economy as the dominant producer of semiconductors means changes in perceptions of regional security alone could impact global risk positioning in financial markets. And lastly, the US elections in November offer another canvas for geopolitical turmoil. Highly polarized electorates like in the US mean that external powers could have outsized influence on election outcomes. This can invite foreign policy adventurism in the hope of tilting the election in one direction.

The above is a non-exhaustive list, but the financial expression should be higher average cross-asset volatility over the coming year. In particular, the past summer lulls in foreign exchange (FX), equity, and oil price volatility are not likely to return (see Figure 5). Meanwhile, bond volatility trends lower on reduced inflation uncertainty and safe haven buying due to geopolitical concerns.

Figure 5a
Comparative Volatility Metrics*

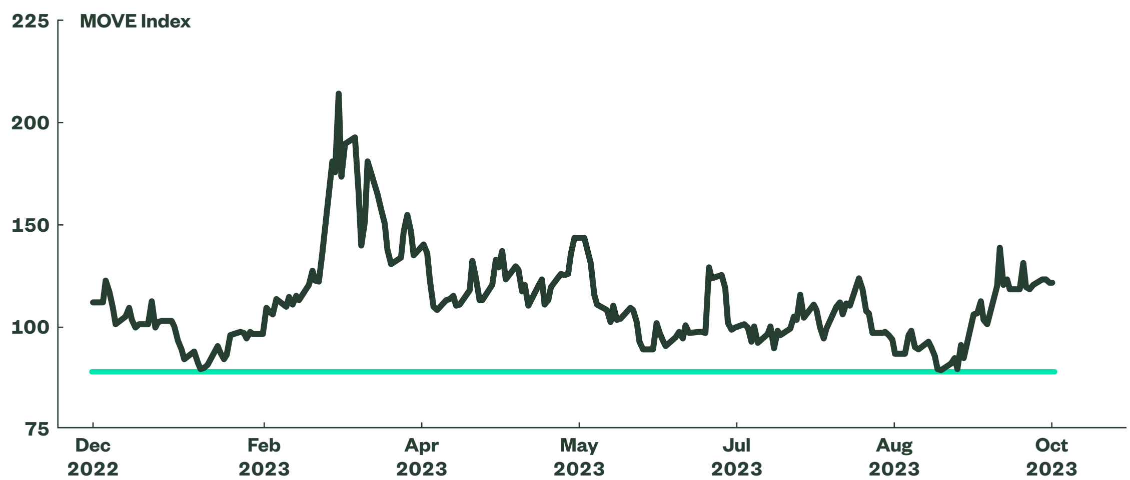
VIX (L.H.S.)
VIX Average (10/1/2020–10/1/2023) (L.H.S)
OVX (R.H.S.)



* Metrics: Chicago Board Options Exchanges' CBOE Volatility Index (VIX), Crude Oil Volatility Index (OVX).
Source: Macrobond, as of October 19, 2023. Past performance is not a reliable indicator of future performance.

Figure 5b
Bond Volatility in 2023

MOVE
MOVE Average (10/1/2020–10/1/2023)



Source: Macrobond, as of October 19, 2023. Past performance is not a reliable indicator of future performance. ICE BofAML MOVE (Merrill Lynch Option Volatility Estimate) Index.

The Bottom Line

Investors plotting a path through the coming year must do so amid sub-trend economic growth, a volatile geopolitical backdrop, and worries about the ability of central banks to manage the transition from a monetary policy built to bring down inflation to one that limits the recession risks. Our base case is that central banks will move more quickly to lower policy rates than markets are anticipating, particularly in the United States, but downside risks remain. The shifting geopolitical landscape also warrants close monitoring given the uncertainty around international/trade relations, the potential for violent conflicts to begin and/or escalate, and the ability of elections to reshape political rhetoric.

Fixed Income

Bonds Take Center Stage

Matthew Nest, CFA
Global Head of Active
Fixed Income

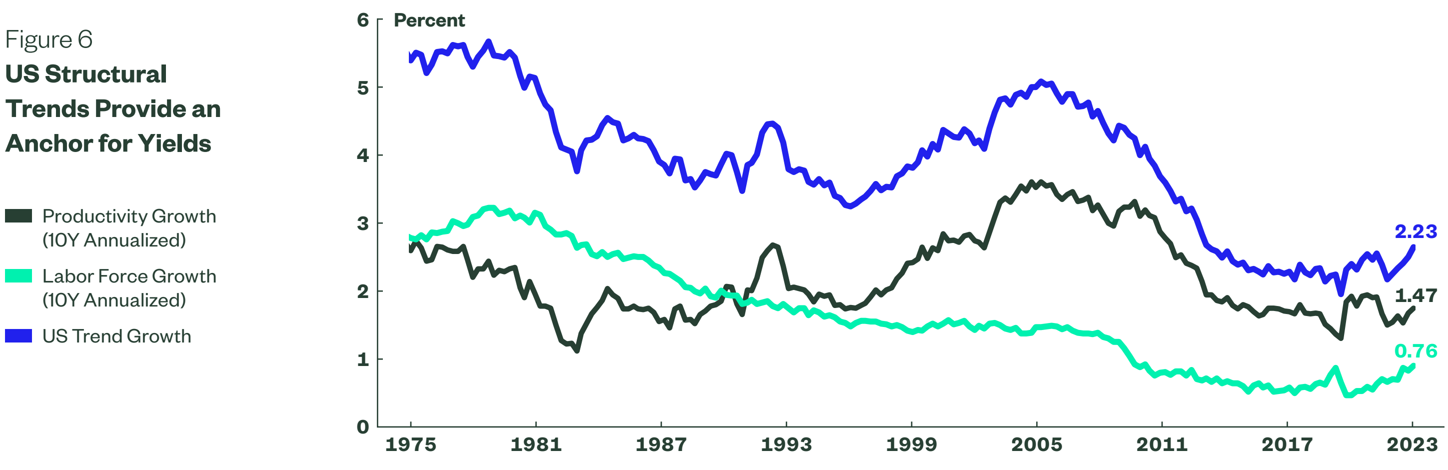
Desmond Lawrence
Senior Investment Strategist

As we look towards 2024 and the prospect of a significant slowdown in economic activity, we believe sovereign fixed income — and US Treasuries in particular — offers investors an increasingly attractive proposition over the medium term. As with several other asset classes, we expect recent choppiness to continue. The seemingly unrelenting strength of the US labor market and its implications for Federal Reserve Board (Fed) policy has been, and may well continue to be, a source of angst. Meanwhile, favorable tailwinds are coalescing as the slowdown and the anchor of long-term demographics start to take hold.

Sovereigns in the Spotlight

Most major central banks have ratcheted up policy rates at the most aggressive pace in decades. The transmission of such an aggressive policy response, however, is notoriously long and variable in nature. We can therefore expect that the most recent rate hikes have yet to take their toll on an economy already facing an inevitable slowdown. Concurrent with this is a disinflation dynamic that still has a bit further to run. This policy-driven cycle favors an overweight duration position in sovereign debt, as lower rates and a bullish steepening are ultimately priced in. We believe that the US Treasury market offers the cleanest way of capturing this move in market pricing. In addition to the cyclical element, the longer-term demographic trend is also supportive of our bullishness on bonds. Muted labor force and productivity growth, as reflected in the US experience in Figure 6, underscore the fundamental long-term value in real yields across major sovereign debt markets.

Figure 6
US Structural Trends Provide an Anchor for Yields

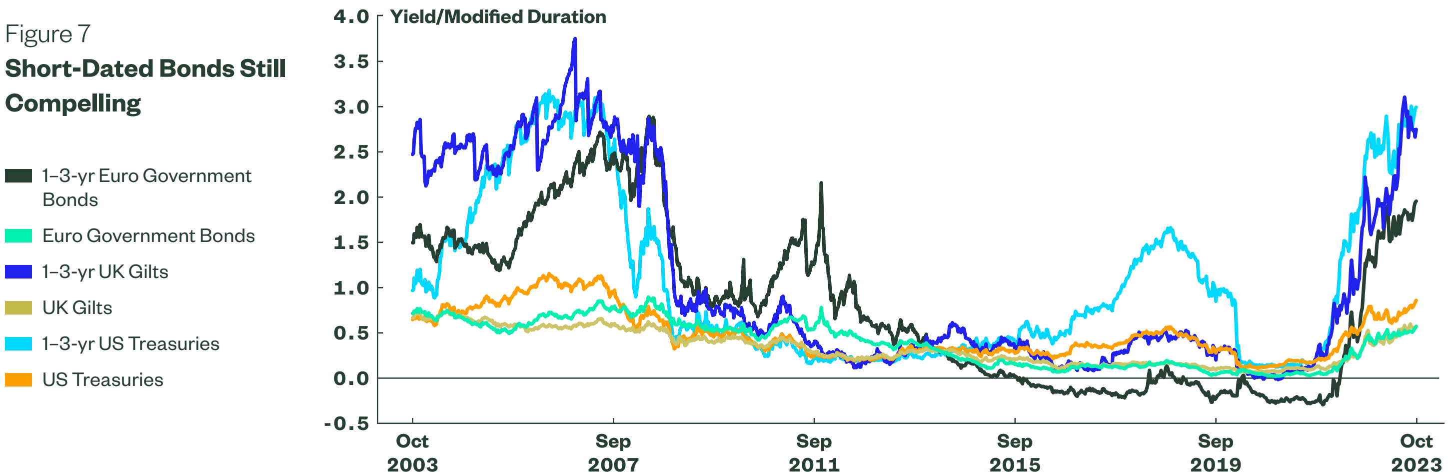


Source: State Street Global Advisors, Bloomberg Finance L.P. Data is quarterly from March 1975 to September 2023. Trend Growth of 2.23% = Productivity Growth of 1.47% plus Labor Force Growth of 0.76% (both 10-year annualized).

Outside the United States, this may play out slightly differently. For example, across the major markets in Europe, core inflation remains high or has shown signs of being sticky; there is the added headache of higher energy costs likely feeding through into headline inflation. A stronger US dollar further compounds the issue. While the market may move to discount rate cuts sooner than currently implied and perhaps more aggressively than central bank rhetoric might suggest, there is still a risk that inflation becomes more entrenched and that eurozone and other European sovereign debt investors remain on the sidelines until they can envisage a more decisive move in the disinflation dynamic.

The other side of the aggressive monetary policy response is that European investors have a compelling alternative if they remain cautious on duration in the near term. The dramatic rise in short-dated bond yields suggests that the risk-reward profile (yield per year of duration) across several European markets is at its most attractive level in a decade or more (see Figure 7).

Figure 7
Short-Dated Bonds Still Compelling



Source: Bloomberg Finance L.P. Data as of September 30, 2023. Past performance is not a reliable indicator of future performance.

Credit Waits in the Wings

Although investment grade corporate credit has benefited from relatively solid fundamentals, we expect them to soften in the coming quarters as revenue growth fades in a slowing economy and margin pressures challenge bottom-line growth. Against that background, spreads — slightly below the average level seen over the past 20 years — do not look inviting. A further point of caution arises in relation to the declining quality of the overall investment universe in US dollar, sterling, and euro corporate credit. A selective approach is persuasive, but at current spread levels, we feel investors can afford to wait for better entry levels.

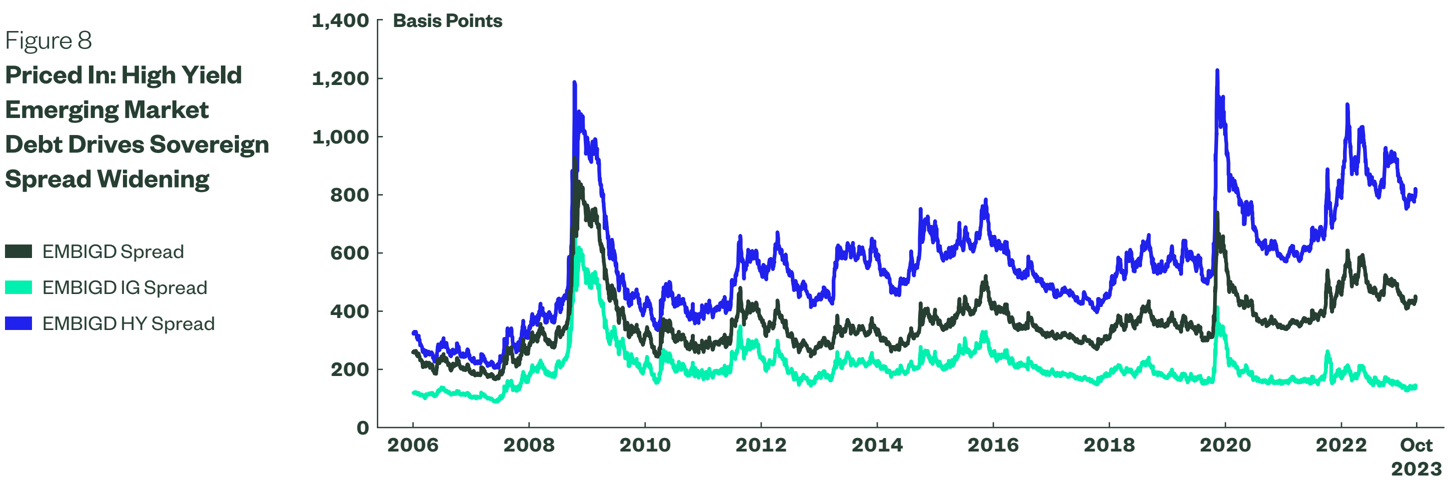
Absolute yields (broad benchmark level) for sub-investment-grade debt have risen substantially in recent quarters in line with the trend across debt markets in general. This pattern is not an immediate problem given the modest near-term refinancing needs, but it does raise the specter of borrowers having to issue debt at significantly higher coupons if yields are still elevated at the point of refinancing. Euro-denominated debt, in particular, faces substantial refinancing needs two to three years out. Consequently, the longer yields stay at these relatively high levels, the greater the risk of meaningfully higher refinancing costs for issuers.

Similar to its investment grade counterpart, high yield debt has been trading at relatively compressed spreads. Default rates are currently quite modest but can only rise as our predicted slowdown bites in 2024. In that environment, we anticipate a rise in distress ratios and in average index-level spreads. Consequently, we do not consider high yield debt a compelling proposition at current spreads.

Emerging Market Debt Commands Attention

Against a backdrop of heightened volatility and uncertainty, hard currency emerging market sovereign debt currently looks attractive in light of the spreads on offer. With spreads in the high yield subsegment trading well above their long-term average, markets have already priced in most credit events (see Figure 8). Credit quality has shifted as the credit rating composition of indexes has changed. In high yield, the proportion of the lowest-rated credits has increased as countries have defaulted, restructured their debt, and been downgraded. In investment grade, in contrast, the proportion of the highest-rated credits has grown largely due to the addition of highly-rated Gulf countries that have been large issuers of debt, resulting in a quality upgrade. Moreover, in the absence of a US recession, spreads have the potential to tighten further. There is also additional upside possible from a rally in Treasuries when the data does turn and the market starts to price in a dovish Fed pivot.

Figure 8
Priced In: High Yield Emerging Market Debt Drives Sovereign Spread Widening



Source: State Street Global Advisors, Bloomberg Finance L.P., J.P. Morgan as of September 29, 2023. Past performance is not a reliable indicator of future performance. EMBIGD = Emerging Market Bond Index Global Diversified.

On the other hand, the picture for emerging market local currency debt (EMD LC) has become a lot more complex. Firstly, emerging market monetary policy has decoupled from the Fed, so the differential between the yield on EMD LC and US Treasuries is around the lowest it has been in 15 years. Next, the strong US dollar is clouding the short-term outlook — not only because of its direct impact on emerging market currency returns, but also indirectly because of its impact on emerging market inflation. However, real yields have now turned positive for some of the largest constituents in the broader EMD LC Index,[2] and even though this is still below US Treasuries, it offers a pick-up versus the euro area.

The Bottom Line

As the impressive resilience of the US economy fades in 2024, we believe that sovereign fixed income offers investors a rewarding prospect. The US Treasury market is probably best placed to capture this opportunity. The short end of several sovereign debt markets also presents a compelling yield-duration profile for those investors unwilling to embrace duration more fully. A slowing economy and advancing credit cycle will present challenges to corporate income and balance sheets. Therefore, we expect that there will be more rewarding entry levels for credit investors in the coming quarters. There are attractive spread opportunities in hard currency emerging market debt, assuming a hard landing is avoided. The picture for local currency emerging market debt is more nuanced but still offers attractive pick-up potential for eurozone investors.

Equity

Caution Warranted in Equities: Be Selective

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EMEA Head of Investment Strategy & Research

Dane Smith
Head of North American Investment Strategy & Research

Against a backdrop of tightening monetary policy, stubborn inflation, and mixed economic data, equity markets fared better through much of 2023 than had been anticipated. However, a continuation of that advance might be more challenging to achieve in 2024.

Given the diminished equity risk premium and the high bond yields that have resulted from the gradual removal of liquidity, investors are under less pressure to reach for "riskier" returns that had until recently been considered necessary to meet portfolio objectives.

Clouding Equity Prospects

From a big picture perspective, the consumer will be less of a growth driver as excess savings and financial stimulus fade and households feel the strain of high interest rates. In the US, for example, auto and housing have held up well but the more acute pain is likely ahead — the symptoms are already there. US household interest payments as a percentage of interest income are the highest since 1959; credit card delinquency rates at small US banks are the highest since 1992; and personal savings are in decline. And this deterioration is occurring with an unemployment rate close to 50-year lows.

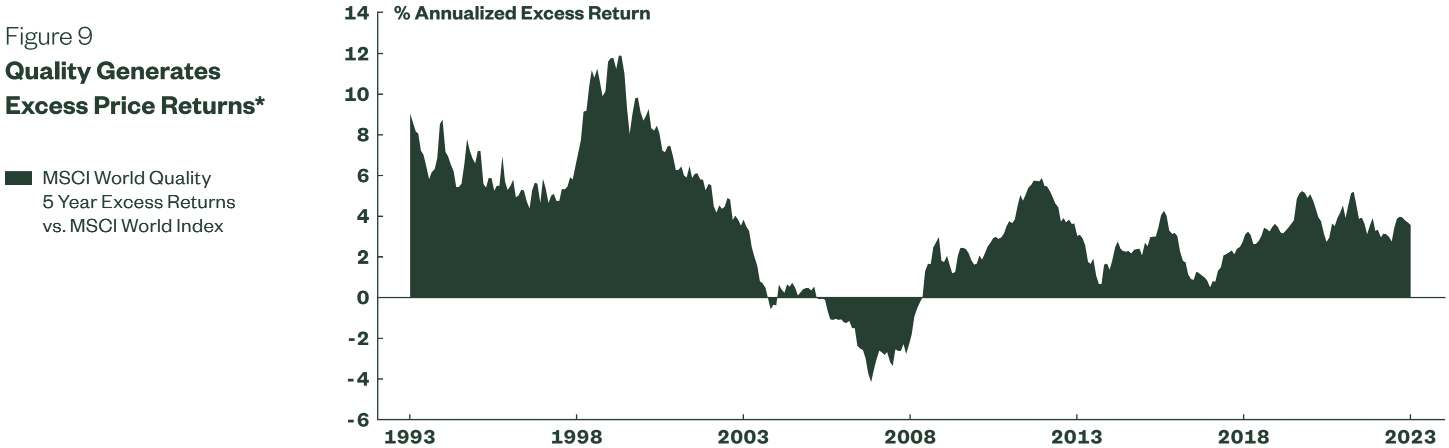
A more cautious and price-conscious consumer has implications for corporate earnings. Impacted sales revenue puts further pressure on equities as profit margins shrink. Discretionary goods and services that are aligned with more cyclical market segments appear at risk — we have recently seen substantial downward revisions to 2024 earnings growth estimates.

Think Quality

Companies with more resilient earnings streams and stronger balance sheets are better positioned to withstand the pressures of still-tight monetary policy, rising debt, and a deterioration of consumer spending. In short, we favor Quality stocks, namely those assets which display these compelling characteristics.

The Quality style allows participation in upside growth, while also offering downside protection. The general definition of Quality is consistency of earnings, elevated profitability, and low debt levels — all easily quantifiable metrics. But there are qualitative considerations too, such as the trustworthiness of the management team, company culture, brand strength, competitive moat, strength of a business model, and catalysts that may unlock value or disrupt an incumbent.

Figure 9
Quality Generates Excess Price Returns*



*Quality as represented by MSCI World Quality Index. Price returns shown on a five-year rolling basis.
Source: State Street Global Advisors, MSCI. Data as of September 29, 2023. Past performance is not a reliable indicator of future performance. Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index.

US Large Caps

The US Large Cap segment contains an outsized portion of sectors and companies that exhibit Quality characteristics. In the US, many of the companies that exhibit Quality characteristics were heavily "re-priced" in 2022–2023 in response to aggressive interest rate hikes. Owning Quality in 2024 should come with a caveat though, given the potential for renewed market volatility: *Be selective*. To avoid the more severe drawdowns, investors should consider avoiding the cheap cyclical end of the market (for now at least), while also steering clear of those narrower pockets where valuations have become stretched.

By sector, information technology, industrials, and materials are major beneficiaries of recent US legislation that provides large fiscal incentives for clean technologies and new infrastructure investment (e.g. Inflation Reduction Act, Bipartisan Infrastructure Law, and CHIPS Act). International companies with US operations as well as US companies are also eligible for these incentives.

European Stocks Less Compelling

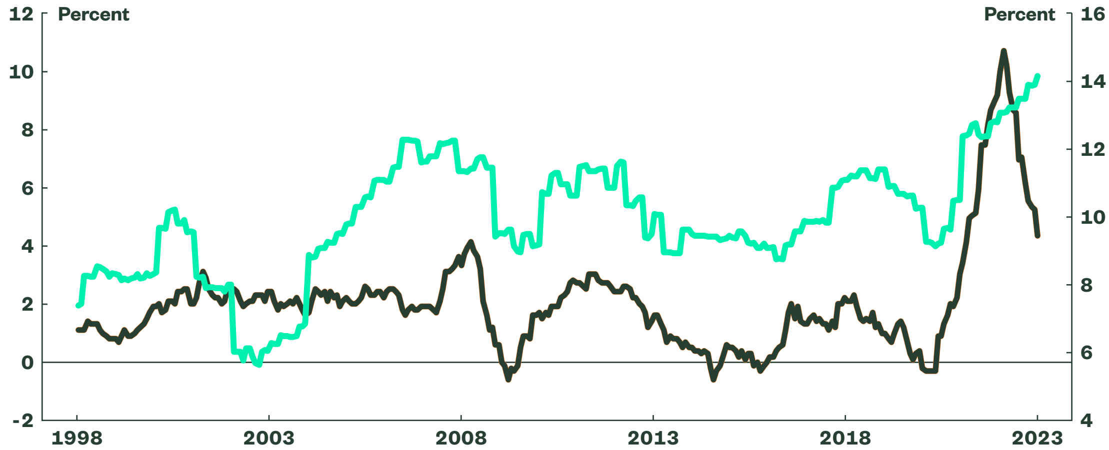
Monetary policy tightening has impacted the broader European economy quicker than in the US due to a comparatively less supportive fiscal backdrop. Even so, the European Central Bank (ECB) appears less likely to cut rates in 2024 in the same manner we expect from the Fed. The ECB's apparent preference is to let current rates work through the system. However, the threat of recession is rising — something the European Commission's latest forecasts acknowledged. It noted that "high and still increasing consumer prices for most goods and services are taking a heavier toll than expected." The provision of bank credit has slowed and the Commission sees "continued weakness in industry and fading momentum in services."[3]

Although the eurozone household savings rate is still relatively strong, deterioration is evident in other areas, including domestic fixed investment. As consumers adjust spending habits, company earnings will inevitably be impacted. While profit margins have been sustained at high levels, MSCI Europe margins have typically been correlated to inflation — lower margins have often followed a peak in inflation (see Figure 10).

Figure 10
Margins Correlated With Inflation

Eurozone — Harmonized CPI, All-items HICP (YoY%) (L.H.S.)

MSCI Europe (SR) (EUR) — Operating Margin — LTM (R.H.S.)



FactSet. Data as of October 13, 2023. *HICP refers to the Harmonized Index of Consumer Prices and is a measure of inflation in the eurozone and the European Union.

Japan's Continued Momentum?

The pick-up in Japanese inflation has given companies who have struggled to lift prices an opportunity to now do so, potentially boosting revenue and earnings. With the "shunto" negotiations in 2024 expected to deliver higher wages (a key factor for inflation), consumers may be encouraged to spend. Alongside government spending and export growth hopes, the case for Japanese equities has improved.

Another potential driver of growth is the Tokyo Stock Exchange's call for companies to improve corporate governance and capital efficiency, or face delisting. This could help to create higher-quality, more profitable companies and help push the market towards more sustainable growth. The benefits from this campaign have been evident in increased share buyback announcements.

Higher risk appetite amid rising Japanese yields could also support inflows into the stock market, while corporations, which sit on a large amount of cash, could look to reinvest in growth opportunities in order to keep pace with inflation.

Challenges Persist for Emerging Market and China Equities

Emerging market equities tend to outperform in "best case" environments of stable-to-rising global growth and global trade, adequate or abundant global liquidity (stable-to-declining US/global yields and inflation, stable-to-declining US dollar), and stable commodity prices. A soft landing for the US and developed markets may erase "worst case" fears, though it will not guarantee the best-case scenario either.

China's equity market is likely bottoming, setting up a potential near-term recovery. Meanwhile, policymakers seem to be taking time to create a stimulus plan that protects the economy without exacerbating structural problems. The longer-term growth outlook remains clouded by a heavy debt burden, limited fiscal policy space, property market overhang, worsening demographics and heightened geopolitical tensions. Real GDP growth is expected to slow from near 5% in 2023 to 3% over the next few years.

The Bottom Line

Tight monetary policy and slower economic growth dampen the outlook for equities in 2024. Amid heightened volatility, we favor selectively owning aspects of the market that exhibit characteristics of Quality investing. The US market is preferred due to its sector composition and the competitive advantage of its companies. For various structural reasons, we believe Japan should maintain its momentum of positive performance into the new year. However, investors looking for outperformance from Europe, broad emerging markets, and China will face headwinds due to the cyclical nature of their economies and deteriorating economic conditions.

Special Topic

Emerging Markets: A Nuanced Approach Matters

Emerging markets remain vulnerable given the global backdrop, yet pockets of opportunity exist, particularly in hard currency debt and select emerging market equities.

Emerging Markets

Emerging Markets: A Nuanced Approach Matters

Chris Carpentier, CFA, FRM
Investment Strategist

Lyubka Dushanova
Portfolio Strategist — Emerging Market Debt

The optimism surrounding emerging market assets diminished as 2023 progressed. Part of the initial enthusiasm was built on expectations of a reenergized China economy as it emerged from its zero-COVID policy, a weaker US dollar, and lower expected terminal rates. When this scenario did not materialize as envisioned, returns stumbled. As US yields hit new multi-year highs, the dollar restrengthened and China's recovery disappointed, investors' appetite for emerging markets assets diminished, with equity and bond performance both impacted, albeit to varying degrees.

The tendency to view emerging markets (EM) as a singular bloc is misguided given the numerous idiosyncrasies among the countries that populate the EM universe. While there are undoubtedly shared risks across the EM spectrum, such as the countries' sensitivity to continued heightened geopolitical risks along with broad risk-taking appetite, it is important for investors to recognize where the variations lie. Key differences among countries include whether an emerging market country is an energy exporter or an energy importer, and whether the country is a manufacturing-based economy or a services-based economy. These important distinctions between nations highlight the heterogeneity of the grouping. Moreover, within the different indexes — namely MSCI Emerging Markets Index for equities and emerging market debt indexes for both hard and local currency — there are divergent performance drivers, making it difficult to have one conversation to represent them all. For example, Chinese equities account for about 30% of the benchmark emerging markets equity index, while weighing 4.7% of the EM hard currency debt index and 10% of the local currency market. The arguments for investing in Chinese equities or bonds can be quite different.

Emerging Market Equity vs. Debt

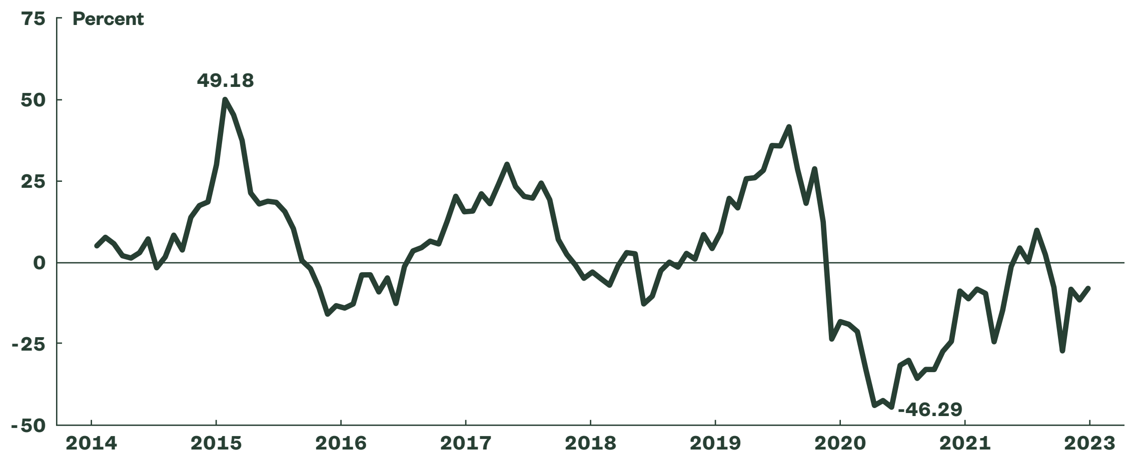
From an investment case perspective, we are generally cautious about emerging markets. While we do not see much value in emerging market equities in aggregate, there are still opportunities. A higher-for-longer interest rate environment has been priced into emerging market equities. As a result, we have witnessed EM risk assets underperform, EM currencies sell off, and earnings expectations come down. Overall, we have a relatively more favorable outlook on emerging market bonds, with an emphasis on hard currency debt. We are now in a familiar place where a data-driven Fed has become again the dominant driver of EM debt returns. Hard currency sovereign debt looks attractive as EM spreads still offer value and, in the absence of a US recession, have the potential to tighten further.

Emerging Market Equity Outlook

Despite China's continued challenges, we believe a relative opportunity exists. Active managers can focus their efforts on structural growth areas of the economy that have a government policy tailwind — such as technology independence, electrification, and other "new economy" areas. We also believe separating China from the rest of an emerging markets allocation warrants consideration, given the country's high weighting of roughly 30% in the benchmark emerging markets index, low correlations, and global importance. Beyond its sizable concentration, slippage in China's performance often leads to headwinds for other emerging markets, multiplying China's impact on EM index performance. For example, weakness in the technology cycle impacted EM manufacturing, while softer demand for international goods led to lower orders for EM countries to fill. However, the opposite is also true when the Chinese economy is performing strongly. A stand-alone China exposure allows investors the ability to dial their overall China allocation up or down as necessary. Figure 11 illustrates the diverging performance of China from the EM ex-China universe. Such an approach also adds flexibility around the type of exposures an investor may choose, whether it is the index/active split, investment styles, thematic, or small-cap tilts.

Figure 11
Isolating the China Return Differential

Rolling 1 Year Return Difference — MSCI China vs. MSCI EM ex-China

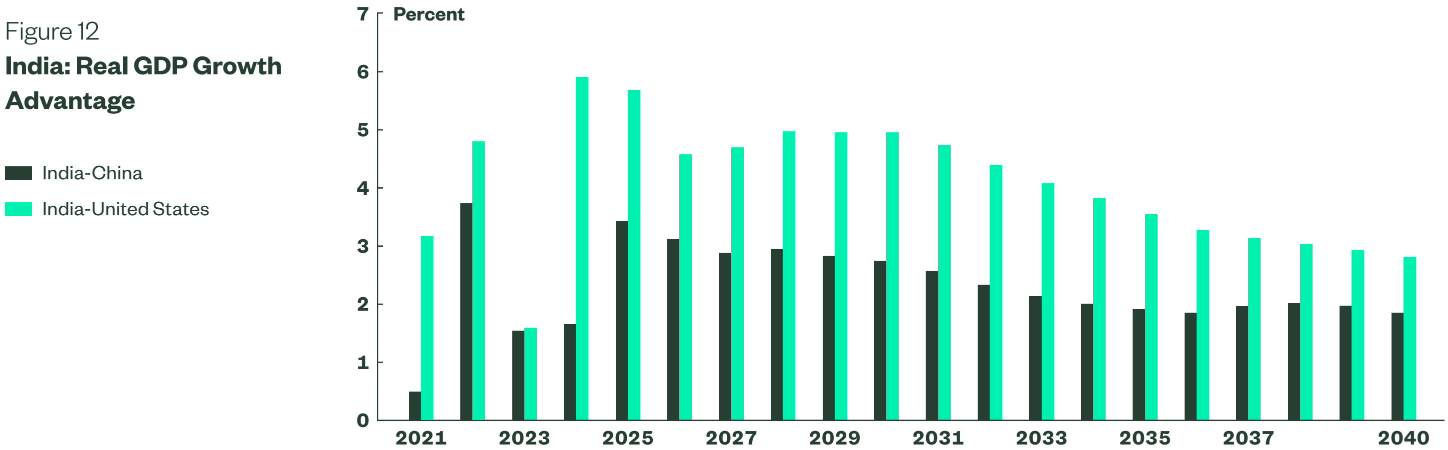


Source: State Street Global Advisors, MSCI, FactSet. Data as of September 29, 2023. Rolling 1 Year Return Difference — MSCI China vs. MSCI EM ex-China. Past performance is not a reliable indicator of future performance. Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index.

Outside of China, emerging markets tend to be heavy on cyclical companies and industries, making them especially sensitive to global economic activity. We expect sub-trend growth for the global economy in 2024, creating a headwind for emerging markets' prospects. Outside of China, allocators also need to be aware that concentration risks remain within the emerging market universe. India, South Korea, and Taiwan make up over 60% of the EM ex-China index. Furthermore, both Taiwan and South Korea have a single security that accounts for more than 30% of the countries' respective index weight.

India's ascent presents an interesting opportunity. With a young and growing population along with healthy economic growth (see Figure 12), the country has appealing investment characteristics. Its sector composition is well diversified and not reliant on any one particular industry; between them, financials, technology and energy sectors make up about half of the benchmark India equity index.

Figure 12
India: Real GDP Growth Advantage



Source: Macrobond, State Street Global Advisors, Oxford Economics. Data as of October 17, 2023. The above forecast is an estimate based on certain assumptions and analysis made by the State Street Global Advisors Economics team, Oxford Economics. There is no guarantee that the estimates will be achieved

Emerging Market Debt Outlook

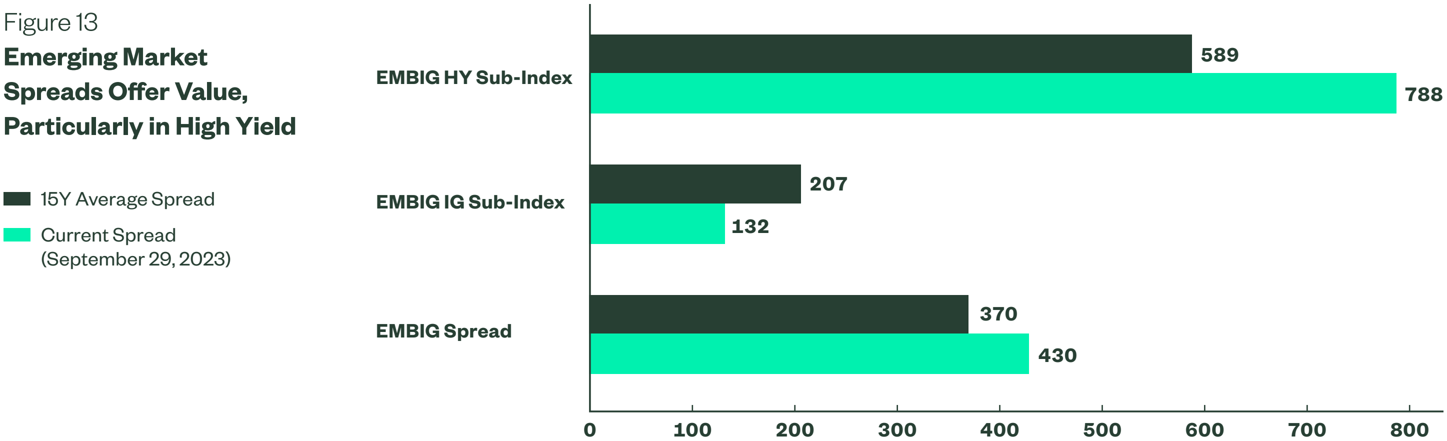
To understand the outlook for emerging market debt, it is important to distinguish between local and hard currency and to understand the key performance drivers of each. Local currency debt performance is driven by emerging market rates and currencies, while hard currency debt returns are driven by US Treasury and emerging market spreads. The resilience of the US economy has seen markets adjust their expectations, with the resulting sell-off in US Treasuries and strengthening in the US dollar having a negative impact on both hard currency and local currency debt performance and reversing gains achieved earlier in the year.

Hard Currency Debt

Given an evolving backdrop of heightened volatility and uncertainty, hard currency sovereign debt looks relatively more attractive because emerging market spreads, particularly high yield spreads, still offer value and, in the absence of a US recession, could tighten further (see Figure 13). The geopolitical landscape has become more unstable, but if the Israel-Hamas war does not develop into a broader regional conflict, the spread widening that it brought about, which remains limited, could represent a good entry opportunity into the asset class. A concern about hard currency debt is that it can be expensive in a climate where the US dollar is strengthening. If the US dollar weakens, then a more supportive environment would be found for hard currency debt. Moreover, while US Treasury volatility presents a short-term risk to the asset class, a potential rally in Treasuries once the US economy does turn presents added upside potential for hard currency debt.

Figure 13

Emerging Market Spreads Offer Value, Particularly in High Yield



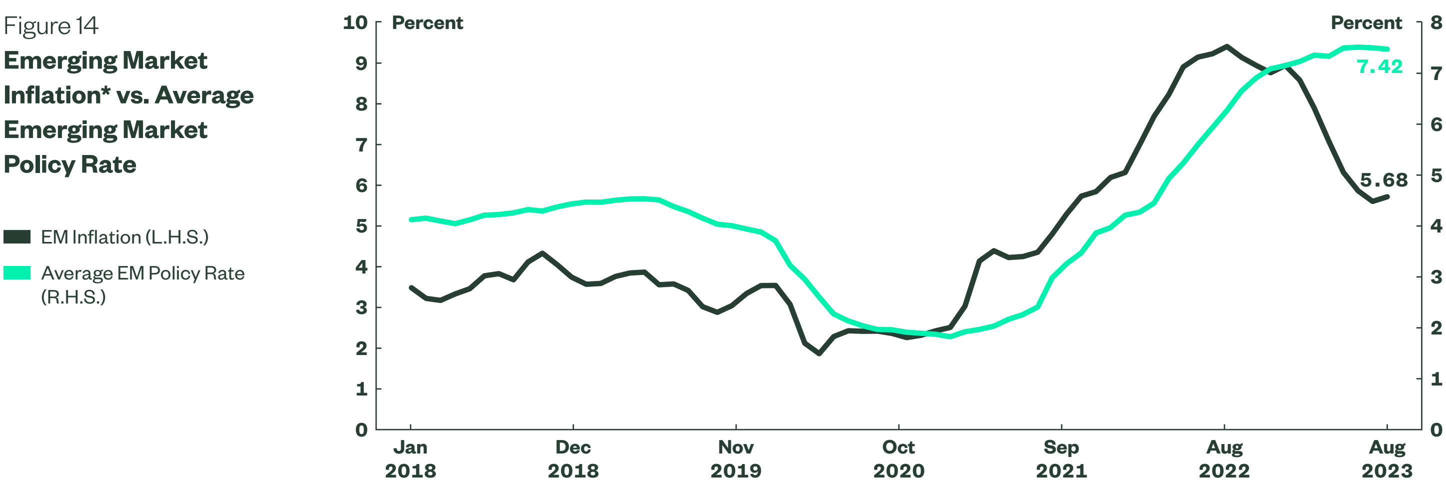
Source: State Street Global Advisors, J.P. Morgan, Bloomberg. Data as of September 29, 2023.

Local Currency Debt

After outperforming through the first half of 2023, the outlook for local currency debt has become more complex. It is noteworthy, and unusual, that emerging market monetary policy has decoupled from the Fed in recent years. Emerging market central banks had responded quicker to inflation than developed peers in raising rates, and since emerging market inflation peaked late in 2022, the banks have been primed to start cutting rates earlier than their developed counterparts (see Figure 14). However, the outlook for emerging market inflation is clouded by a spike in oil prices and a stronger US dollar, which could drive inflation by way of the foreign exchange channel. Therefore, in addition to the negative impact that a strong US dollar has on emerging market currencies, a key question to consider for local currency debt is: How long can emerging market central banks diverge from the Fed?

Figure 14

Emerging Market Inflation* vs. Average Emerging Market Policy Rate



*EM inflation = weighted average inflation of countries in the JPM GBI-EM Global Diversified Index. Average Policy Rate = weighted average policy rate of countries in the JPM GBI-EM Global Diversified Index. Source: State Street Global Advisors, J.P. Morgan, Bloomberg. Data as of August 31, 2023.

An important recent development in the local currency space was the decision to include India in the flagship JPM GBI-EM Global Diversified Index from the second half of 2024, which will enable it to reach the index weighting cap of 10% once it is fully phased in. India's inclusion brings much-needed diversification to the local currency index, while also allowing investors to participate in the growth potential of this large, investment-grade-rated country.

The Bottom Line

Even though emerging markets are affected by broader market volatility, we believe that there are still opportunities across this broad investment universe, notably in emerging market debt. Within equities, an active approach that focuses on structurally growing parts of the market is preferred. Overall, both emerging market debt and equities offer exposure to countries with superior economic growth and lower leverage compared to developed market economies, delivering diversification benefits as part of broader portfolios.

Endnotes

1 OPEC+ refers to the Organization of the Petroleum Exporting Countries plus 10 non-members (including Russia).

2 J.P. Morgan Global Bond Index Emerging Market Global Diversified (GBI-EM GD).

3 https://ec.europa.eu/commission/presscorner/detail/en/ip_23_4408.

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