STATE STREET GLOBAL ADVISORS

Global Market Outlook 2025

Finding the Right Path

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Finding the Right Path

From the outset of 2024, the economic environment proved more resilient than we had anticipated, with robust growth and inflation moderating at a slower-than-anticipated pace. We expect the narrative of rate cuts and resilience to hold in 2025, and for our projected soft landing to materialize. This landscape extends our favorable outlook for equity markets, while we expect government bonds across most advanced economies to provide attractive returns. However, uncertainty and the potential for higher volatility amid ongoing conflicts and political change means investors should be thoughtful about portfolio construction; incorporating alternative approaches aimed at improving diversification may help portfolio balance and mitigate risks.

Outlooks

A Soft Landing Beckons

Easing inflation and continuing policy rate cuts by most of the world's major central banks set the scene for a soft economic landing in 2025.

Slow-Moving Fragmentation Continues

The geopolitical landscape has come through a turbulent year of market-moving elections and ongoing conflicts. More volatility seems likely.

Searching for Pockets of Opportunity

US equities retain favored status heading into 2025, although there is potential for performance to broaden into small caps and emerging markets.

Favorable Environment for Sovereigns

Amid central bank rate cuts and easing inflation, the relatively generous government bond yields on offer provide support for fixed income investors.

Portfolio Construction: Beyond 60/40

The weakened foundations of traditionally balanced portfolios could be bolstered by improving durability and diversification.

Macroeconomic Outlook

A Soft Landing Beckons

Lori Heinel, CFA
Global Chief
Investment Officer

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Chief Economist

From the outset of 2024, the economic environment proved more resilient than we had anticipated, with robust growth and inflation moderating at a slower-than-anticipated pace. However, price pressures eventually relented to open the door for major central banks to embark on policy rate cuts. Against this backdrop, equity markets have delivered strong returns for the year to date, with leading indexes hitting multiple record highs along the way. The robust data and delayed start to rate cuts kept fixed income markets in flux, although returns for the period have so far been positive, if relatively modest.

We expect the narrative of rate cuts and resilience to hold in 2025, and for our projected soft landing to materialize. This landscape extends our favorable outlook for equity markets, with US large caps remaining in pole position, although performance should broaden into small caps and emerging markets. Within fixed income, we expect government bonds across most advanced economies to provide attractive returns, but credit seems fully priced at current spreads, albeit with solid fundamentals.

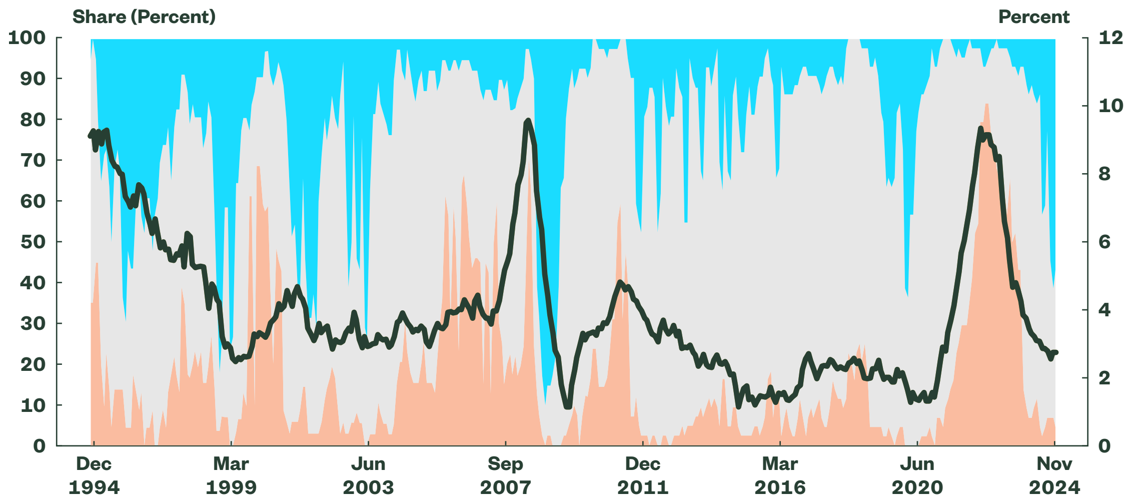
Emerging market debt offers value but investors need to be comfortable with a more volatile policy and currency backdrop. This uncertainty will likely be a constant in 2025, as a new Trump administration takes shape and conflicts in Europe and the Middle East continue. This persistent volatility, coupled with higher equity-bond correlations, means that investors need to broaden out beyond the traditional “60/40” portfolio and focus on risk/return, to deploy a range of approaches, strategies, and alternative asset classes to ensure their portfolios can achieve specific investment objectives.

We explore these themes and more in our latest Global Market Outlook.

Global Economic Outlook

Despite the many twists and turns in the macroeconomic mood over the past year, the underlying global story has remained largely the same. We have traveled further along the road of slowdown and disinflation that was always going to lead us to the interest rate cuts we see being implemented around the globe — Japan being a notable exception. We expect that this will continue for a while longer, although the Trump-led Republican victory in the US elections could result in some change to the narrative in the latter part of 2025 — more clarity on policy outcomes will be required before implementing forecast changes. But it is now not only possible, but even likely, that not all four of the quarterly US rate cuts we anticipate in 2025 will materialize.

Figure 1
Central Banks Easing as Inflation Subsides



Source: Macrobond, State Street Global Advisors Economics, World Bank, 34 developed and emerging market central banks. Data as of October 21, 2024.

Short-Term Outlook: A Lift From Lower Rates

A soft landing has been our long-standing forecast for the United States economy, but that view has at times come under considerable threat. And while plenty of risks to the outlook remain, three recent developments have combined to make us feel better about the economy's near-term prospects. First and foremost, the US Federal Reserve (Fed) has finally embarked on an easing cycle. Because we viewed the Fed staying "too high for too long" as the number one risk to the soft landing scenario, this is a significant and very positive development. Secondly, the Bureau of Economic Analysis (BEA) announced a big upward revision to US national domestic income such that the savings rate, previously estimated at about 3%, is now close to 5%. This in turn dampens the worries arising from the depletion of excess savings and rise in consumer debt delinquencies that had weighed on the soft landing narrative. These two factors essentially extend the economy's runway. Thirdly, China has announced considerable monetary stimulus and could add more fiscal supports as well. We do not see these measures as true game changers and question the value of defending a certain growth target, but they reduce downside risks in the world's second-largest economy and help ease near-term risks more broadly.

So, the economic road ahead looks a little smoother in the near term. The US election outcome may add a further boost to 2025 growth on business expectations of a lighter regulatory burden, but positives could be entirely mitigated should aggressive tariffs or deportation action stoke inflation pressures and keep the Fed on the sidelines. As investors shift from campaign rhetoric to analyzing policy announcements, recurrent volatility episodes should not be surprising. Whether it's the debt ceiling that comes back into play in January, the 2016 tax cuts that expire at the end of 2025, tariff or immigration policy changes, the triggers for market volatility will remain numerous even after the new president is inaugurated.

In relative terms, the US outperformance of its developed market peers seems poised to continue; the Republicans' victory in November's US elections could sustain that for longer. The competitive loss that the euro area suffered following Russia's invasion of Ukraine continues to weigh on the region's economy. Despite solid household finances and employment prospects, European consumers appear unwilling to run down their excess savings to boost spending. A meaningful eurozone growth acceleration remains, for now, an unrealized potential.

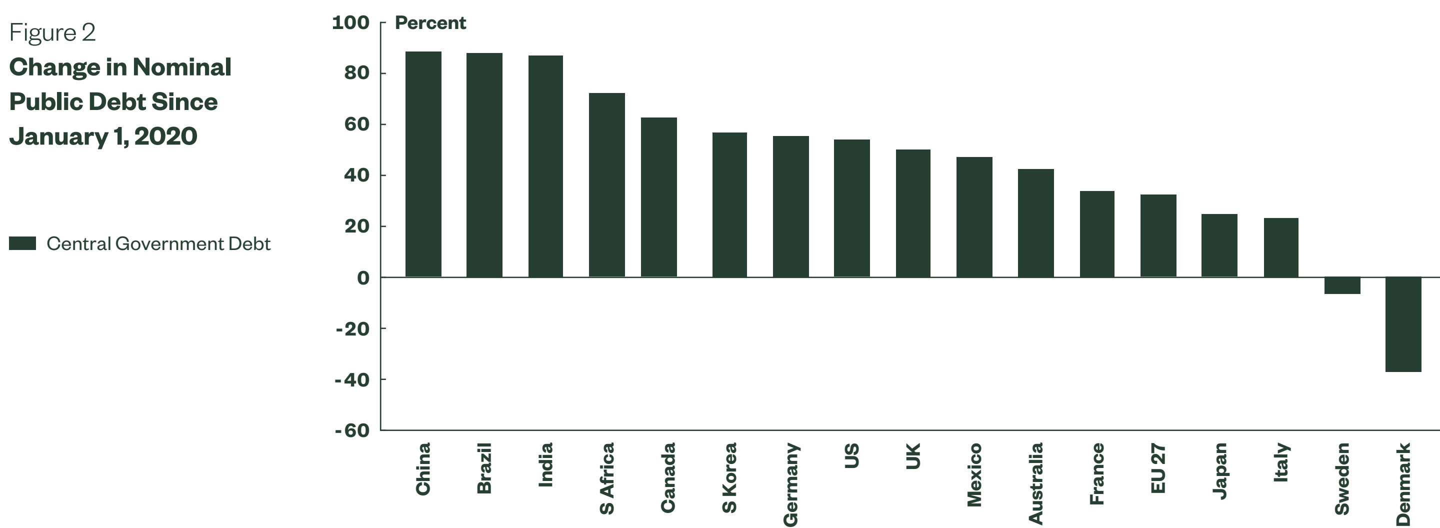
For Japan, periods of enthusiasm for a clean break from the deflationary forces of the past have given way to more cautious assessments of potential growth prospects in a country where the demographic backdrop worsens year after year. Tight parliamentary arithmetic following October's elections and ensuing political uncertainty ahead of Upper House elections in 2025 further complicates the outlook. In many ways, the sustainability of Japan's inflation and growth momentum remain an open question. Yet, international and domestic investors have demonstrated greater confidence in Japan's economy and markets in recent years, in part attracted by corporate reform efforts.

Medium-Term Outlook: The Drag From Debt

The Covid pandemic unleashed a global tidal wave of fiscal expansion that helped blunt the extent of, and shorten the duration of, the ensuing recession. That fiscal boost was welcome, but it cannot be sustained. Unsurprisingly, the fiscal trajectory has taken a more central role in elections around the globe, including in France, the United Kingdom, Japan, and the United States.

The accompanying sharp increases in global debt service costs are likely to continue as the initial Covid stimulus occurred during extremely low (and even negative) interest rates. Refinancing costs will thus increase even if policy interest rates come down from current levels. This is a particularly relevant dynamic in the United States, where the potential effects of President-elect Trump's expansionary fiscal plans are as yet unclear but could raise term premia.

Figure 2
Change in Nominal Public Debt Since January 1, 2020



Source: Macrobond, State Street Global Advisors Economics Team. Data as of September 30, 2024.

Markets can also reflect their assessment of countries' fiscal and debt sustainability pathways via exchange rates (recall the pound's plunge during the UK budget drama in October 2022). Yet, in a world where "everyone is doing it," investors' ability to differentiate is somewhat diminished. Depending on the fiscal pathway taken in the future, the implications for investors could be starkly different. To further explore different scenarios around rising public debt levels, our recent articles expand on fiscal sustainability themes.

Slow-Moving Fragmentation Continues

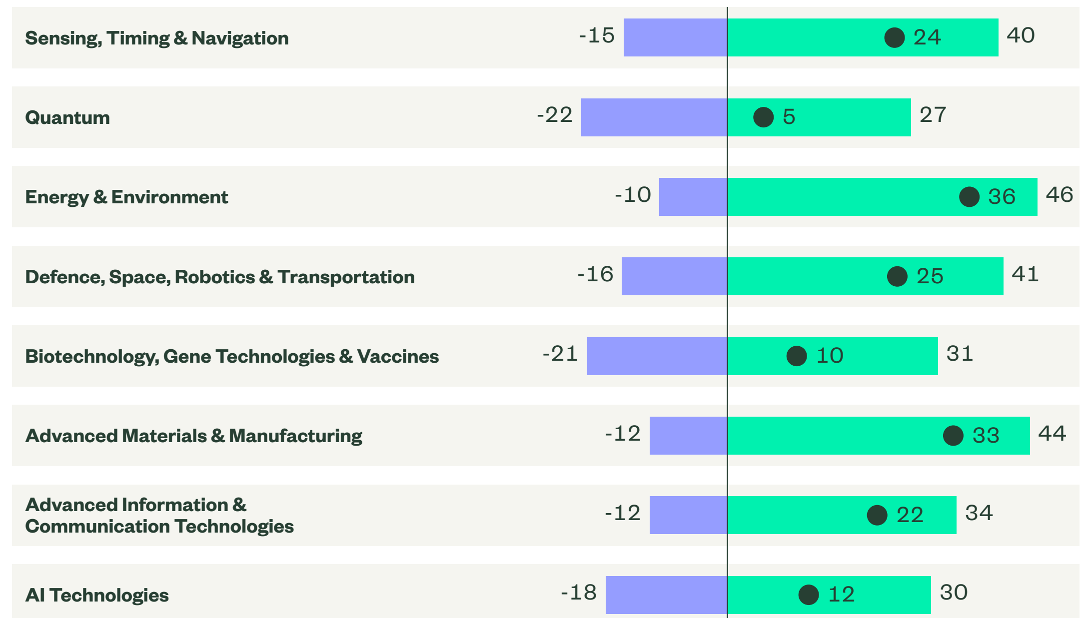
Elliot Hentov, Ph.D.
Head of Macro
Policy Research

The core theme of global geopolitics remains geoeconomic fragmentation. While the world economy may appear largely unchanged compared to the past few decades, this understates the geopolitical forces that risk rupturing long-standing economic and financial ties. Reflecting the shifting landscape, the twenty-first century is less focused on resource competition; territorial expansion (e.g., World War II); or ideological alignment (e.g., Cold War). Instead, it centers on power dominance, with technological superiority a key factor in enabling the dominant bloc to dictate the global economic and political order.

In this regard, some modern technologies are profoundly different in that they do not represent incremental innovation, but rather a technological leap. They also do not lend themselves easily to diffusion, meaning some technological advantages could become entrenched. We have attempted to quantify the position of different blocs in this technological race using the Critical Technology Tracker developed by the Australian Strategic Policy Institute. This tracker ranks patents and research levels across eight fields, and we have assigned a cumulative quantitative score in each category to compare the relative position of the two main antagonists, US and China.

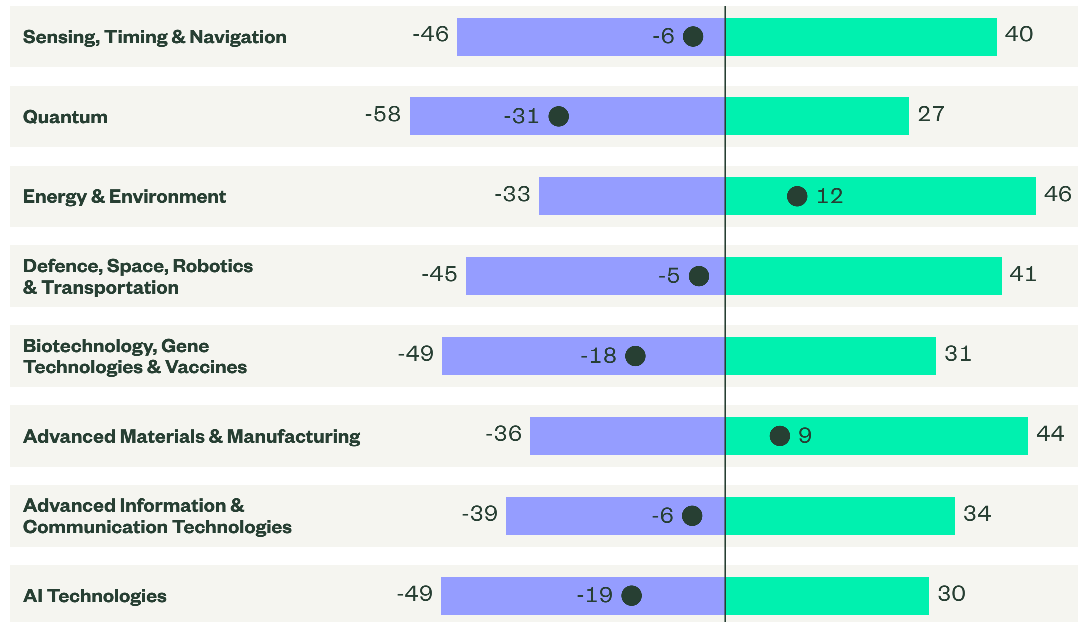
Figure 3 shows that in a direct bilateral comparison, China is well ahead of the US in all eight fields. However, that picture shifts dramatically when we include US allies from Europe and Asia-Pacific regions in the calculations, with China only remaining ahead in the two domains of renewable energy and advanced materials.

Figure 3
Share of Leading Patents & Research: China v US



Share of Leading Patents & Research: China vs. US + US Allies

US + Core Allies
China
Net US + Allies/China



Source: State Street Global Advisors Global Macro Policy using the Critical Technology Tracker of Australian Strategic Policy Institute. Research publications mapped to 100 for US+China, then for US+China+Core US allies (UK, France, Japan, Germany, Italy), thus understating full alliance benefit accruing to Western technology complex.

This overarching competition may be taking place in research laboratories, but it is being fought out in global channels that power the industrial-technological complex. These battles have material implications for financial markets. We consider three main arenas of competition: Real (Military) Wars, Trade Wars, and Fiscal "Wars." While one or other arena can go quiet for a time, the fundamental drivers of increased friction remain intact and are unlikely to dissipate in 2025.

Real (Military) Wars

We believe it makes sense for Real Wars, i.e., global conflicts, to be viewed through the lens of geopolitical bloc competition. Within limits, the Cold War is a useful analogy, though today's military alliances are looser and non-state actors play a more prominent role — the rationale of proxy wars as a tool to weaken the adversarial bloc still holds true. The wars in Ukraine and the Middle East have had a devastating human cost, while also draining bloc resources and eroding political capital. For example, support for Ukraine has involved the emptying of Western arsenals. This means that wars in regions which are geographically remote or seem economically insignificant could still matter for markets, mainly by drawing in major powers or through other spillover effects.

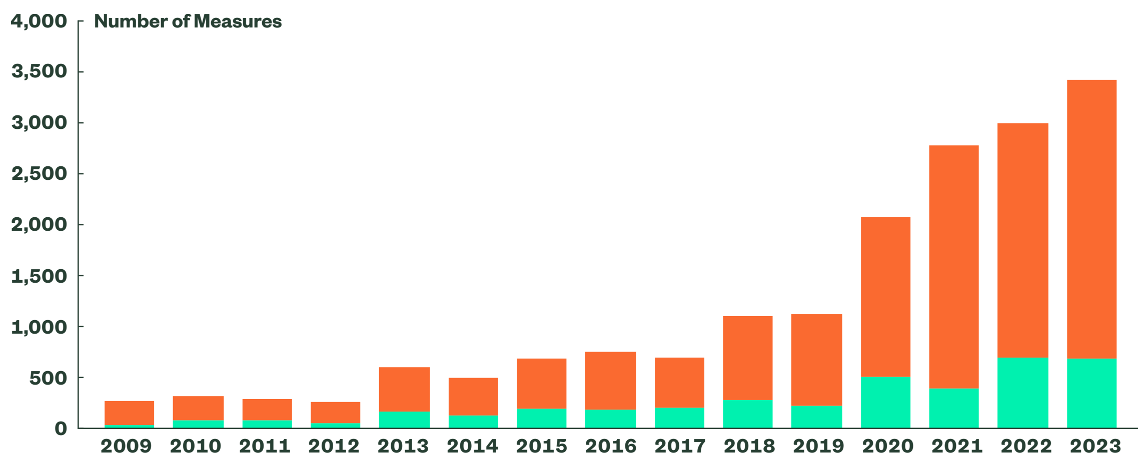
This should imply a broadly higher geopolitical risk premium, though we have thus far only seen it transmit into higher gold prices. And that too has direct linkages to conflict: the freezing of Russia's central bank reserves and secondary sanctions on non-Russian entities has catalyzed demand for gold among other central banks. Gold has long benefited from its status as a generic geopolitical hedge, but the remarkable price gains in 2024 suggest that much has been priced in and Trump's re-election poses short-term headwinds. In addition to gold, crisis periods may encourage more episodic capital flows and potential appreciation of classic safe haven currencies, too.

Trade Wars

When it comes to Trade Wars, the challenge is to identify where the cost of fragmentation will reside. As illustrated by Figure 4, trade disruption continues to rise, and it is not simply a function of tariffs. Non-tariff barriers and sectoral interventions are increasingly a factor and create pressure to alter existing trade and capital relations. Trade between the US and China will likely continue to deteriorate, but the speed and magnitude of that will determine who will feel the pain of adjustment (and who might benefit). Higher US tariffs on Chinese imports imply a stronger dollar and a weaker renminbi, but emerging market currencies will not react in a uniform manner.

Among EM countries, we see trade as the greater differentiator. Some countries will retain favorable trading conditions and become more competitive compared to Chinese exporters — Vietnam and Mexico have been beneficiaries of increased trade barriers since 2018. Other countries could attract greater investment from Chinese firms seeking to re-route production to evade tariffs. But the outlook for these countries is not identical given the risk that 'policy will chase trade' — Chinese foreign direct investment today becomes a political liability tomorrow as they attract punitive trade sanctions. It has become increasingly clear that what matters most is membership in a trade bloc.

Figure 4
New Trade Interventions Globally (2009–2023)



Source: Global Trade Alert. Measures include tariffs, export-related measures, subsidies, contingent trade-protective measures and trade-related investment measures.

Fiscal "Wars"

Lastly, we highlight the use of fiscal policy by governments to achieve their geopolitical aims. The combination of domestic politics and geopolitics implies continued loose fiscal policy across large economies. Reduced trade reliance and greater security risks will require governments to secure supply chains, invest in new technologies, and increase military preparedness. Much of this spending may enjoy a high fiscal multiplier, as defense expenditures tend to be highly localized within blocs, and are manufacturing-intensive and cluster-reinforcing. Higher public capital expenditure is likely to flow into energy and industrial infrastructure. As this spending supports growth, some of the positive impulses could raise real rates as potential growth estimates improve. However, as discussed in our macroeconomic outlook, increased government spending will result in fiscal deficits unless spending in other areas is cut.

Equity Outlook

Searching for Pockets of Opportunity

Dane Smith
North American Head of Investment Strategy & Research

To expand on the famous quote by the investor Benjamin Graham, in the short run, the stock market acts like a voting machine, driven by sentiment and flows, while over the long run, it functions as a weighing machine with fundamentals and economic realities shaping market direction.[1] These dynamics are now particularly relevant, with global equity markets navigating short-term uncertainties — such as the trajectory of policy rates and election outcomes — alongside deeper structural shifts like demographics, geoeconomic fragmentation, and the rise of transformative technologies. The impact of these forces on valuations and earnings shapes our view of equity return potential across geographies and sectors.

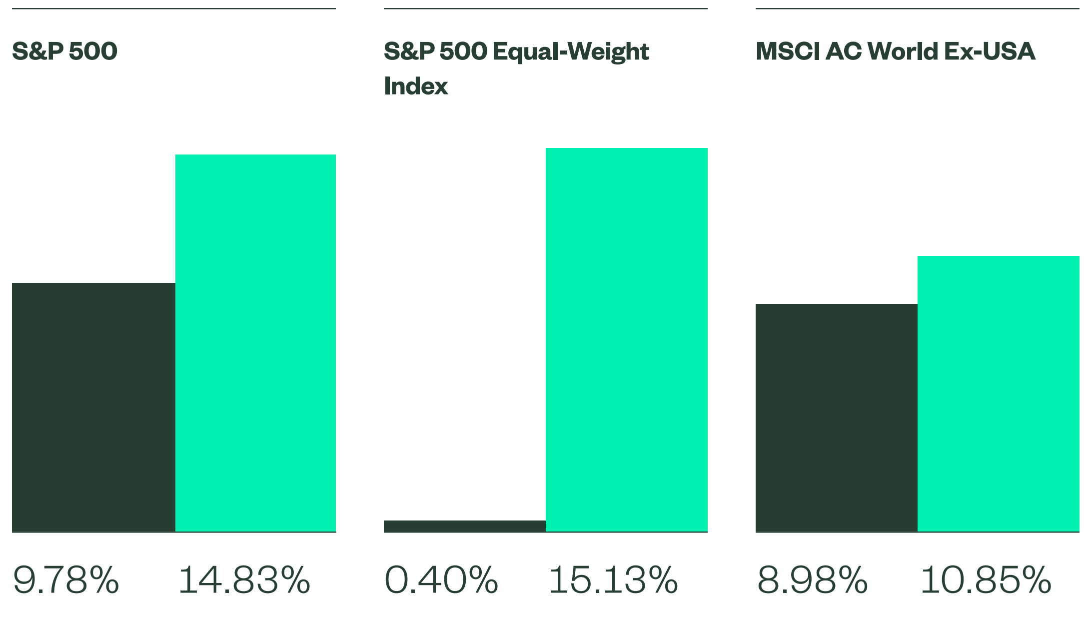
US Equities: Momentum Maintained

We anticipate that US Large Cap equity can maintain its structural advantage over developed markets (DM) equities. US companies continue to deliver on what the market values most — profitability and earnings growth, driven mainly by the technology sector and the so-called Magnificent 7, in particular. Consensus earnings growth of 15% is estimated for 2025, and we expect the positive momentum to continue against the backdrop of an economic soft landing.

Furthermore, these earnings appear resilient to monetary policy moves, and could further benefit from political tailwinds. Net interest payments as a percentage of profits are at historical lows, preserving the profitability advantage of the United States, and the new Trump administration and Republican-led Congress could extend the Tax Cuts and Jobs Act and adopt a more favorable regulatory stance toward big tech.

This would support large caps but could also help broaden performance into more cyclical sectors, perhaps amid a renewed focus on traditional energy production or deregulation of financials, and help lift earnings growth in smaller names (Figure 5). Confidence levels among US small businesses appear in a holding pattern — sentiment has moved sideways on hopes that risks abate as post-election clarity emerges on areas of government policy and the path of monetary policy. Should both prove favorable, and labor markets remain resilient, a bounce back in small caps could be on the horizon given relatively attractive valuations and the potential for higher earnings growth.

Figure 5
US Maintains Its Earnings Advantage
EPS % Growth Estimates



Source: S&P, MSCI, FactSet, State Street Global Advisors, as of October 8, 2024.

Valuations are often cited as a risk to the market's progress, while the ongoing assessment of artificial intelligence (AI) and related themes present questions about momentum and monetization of these high-profile technology advances. However, the S&P 500's current price/earnings-to-growth (PEG) ratio is 1.5x, which is below the 10-year average.[2] Meanwhile, the Information Technology sector PEG of 1.7x is only slightly above the 10-year average, showing the market isn't *that* expensive relative to its growth potential. However, any misstep in earnings, particularly from the top names, would be cause for concern.

European Equities: Consumer Remains a Drag

On the surface, the European economy appears to have a lot going for it: Household savings rates are high, wage growth robust, unemployment low, and the effects of disinflation positive. However, the economy is still lagging due to a combination of weak consumption, poor domestic demand, and low fixed investment driven by a dearth of confidence in the region's growth prospects. Against this backdrop, earnings guidance has unsurprisingly been revised lower.

China's woes provide another headwind as revitalizing Chinese domestic demand will take time, and even longer to transfer to the eurozone. This drag is particularly keenly felt in Germany, for whom China is a major trading partner, and this is now compounded by fresh political uncertainty in Berlin.

Even so, at roughly 10% earnings growth for 2025 and at a forward price/earnings (PE) multiple of 14x — which is below the five-year average — there is opportunity to be found in Europe. For the eurozone, these opportunities may be found in global sectors such as Energy (attractively priced versus US counterparts), Health Care (Europe is home to leading global companies), and Industrials (leaders in clean energy infrastructure), that are less exposed to consumer-related weakness in their domestic markets.

Japanese Equities: Wariness Warranted

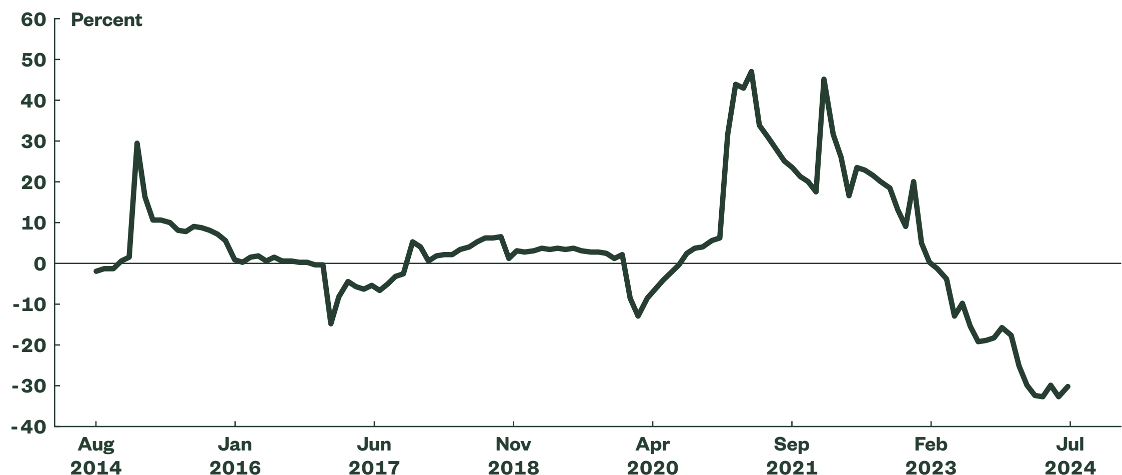
Notwithstanding recent success for Japan's stock market, we anticipate a move sideways given the potential for volatility as the market digests new unknowns. The strong tailwind from inflation and revitalized growth prospects that this year propelled Japan's stock market through its 1989 peak may be fading. Instead, hawkish monetary policy and political uncertainty present new risks and could offset the positives that have largely been priced in. The expectation of higher bond yields and declining yen repatriation are also likely to put downward pressure on the equity risk premium, creating a shift in investor risk appetite to favor fixed income over equities, especially amidst Japan's political transition. Although Japanese equities have typically experienced relief rallies following general elections over the past decade, this time might differ should the prime minister's post mimic the revolving door of recent predecessors.

Chinese Equities: Stimulus Is a Short-term Fix

While providing a boost for the country's stock market, China's recently announced stimulus provides only a short-term fix. It does little to address structural problems, causing us to doubt the stamina of the rally. China's chronically high debt levels, a housing overhang where consumers are 70% levered to the property market, and worsening demographics create structural issues that hurt consumer demand and sentiment. The People's Bank of China (PBoC) plan to recapitalize banks may not yield the long-term results it hopes for as the measures to date simply aren't sufficient to fix the underlying issue — a lack of demand as reflected by drying-up foreign direct investment (Figure 6), weak domestic consumption, and below-target economic growth. Until these core issues are addressed, we expect China to struggle in sustaining higher growth and strong equity market performance.

Figure 6
Diminishing Attraction of China

China Foreign Direct Investment (Year-on-Year % chg)



Source: Macrobond, China's Ministry of Commerce as of August 31, 2024.

Emerging Market Equities: Improving Prospects

Emerging markets look promising given economic growth potential, strong earnings growth estimates, and easing inflationary pressures. Falling interest rates, particularly in the US, could provide additional tailwinds, although this does not always pan out as expected.

Geopolitical risks will likely keep exuberance muted and the US dollar resilient, while economic fragmentation creates drag. Furthermore, despite attractive valuations, most emerging markets lack the high return on equity (ROE) and margins to excite investors. However, idiosyncratic country risks present opportunities for selective investors in broader emerging markets, which includes profitable stocks with higher growth potential, particularly in smaller names, as investors rebuild an underweight position back to neutral.

Fixed Income Outlook

Favorable Environment for Sovereigns

Desmond Lawrence
Senior Investment Strategist

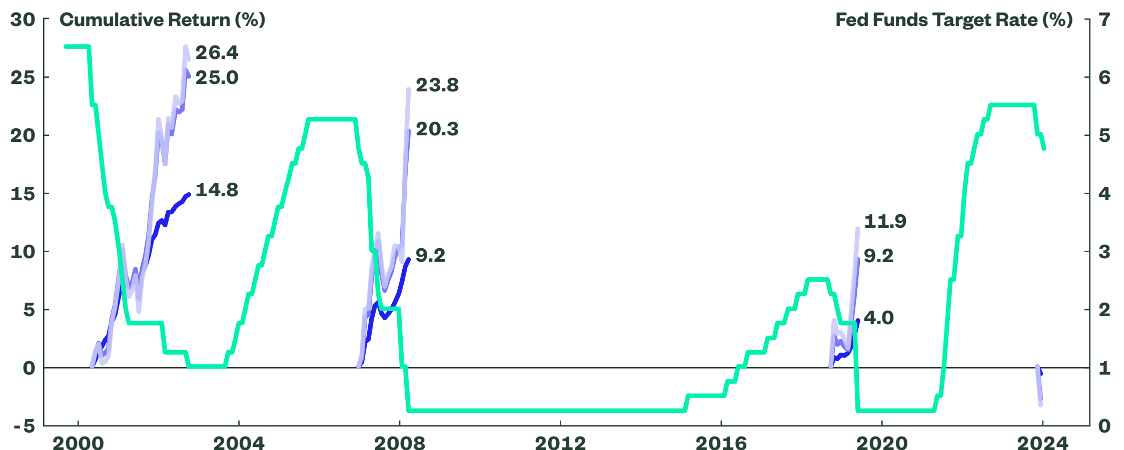
We retain our favorable outlook for fixed income assets as we move into 2025. Slowing economic output and tame inflation will allow central banks to cut policy rates further, and while the pace and scale may be even more uncertain under a Trump administration, the direction appears clear. That uncertainty may offer investors tactical opportunities to build or expand their duration positioning through the easing cycle.

Sovereign Bonds

We expect government bonds across most advanced economies to provide attractive returns as central banks can worry somewhat less about inflation and more fully align policy rates with weakening domestic demand and international activity. Short-term interest rate markets have priced in a soft landing with policy rates expected to fall towards 3.75% in the US and below 2.0% in the euro area. As rate cuts materialize, yield curves will be pulled lower, led by the short end in the classic bull steepening trade. Duration exposure is important, however: history shows us that rewards are typically much greater further out the curve as the cutting cycle begins (Figure 7). The journey will not be smooth, however, with the Treasury market fluctuating with policy pricing in federal funds futures and the evolving fiscal and trade policies of the incoming Trump administration. The direction of travel is clear though, and this opens the door for investors to get to their desired duration positioning at relatively attractive prices. One notable exception among the advanced economies is Japan, particularly for short-dated government debt given the different policy imperatives and direction.

Figure 7
Duration Rewarded as Rates Are Cut

- 1–3 Year US Treasury
- 5–7 Year US Treasury
- 7–10 Year US Treasury
- Fed Funds Target Rate (RHS)



Source: Bloomberg Finance L.P. Data as of October 31, 2024. Past performance is not a reliable indicator of future performance.

The longer-term demographics also support our bullish stance on bonds. Muted labor force and productivity growth place a soft cap on trend growth across many advanced economies and thereby provide a medium- to long-term anchor on sovereign yields.

We believe a soft landing can provide returns in the mid-single digit range as investors capture relatively generous yields and a generally favorable roll effect. This varies by country in line with current absolute yield levels; in that respect, US Treasuries look comparatively more attractive versus core eurozone bonds, where the starting position is very different and thus offer more moderate returns. A harder landing would amplify returns — potentially into double-digit territory.

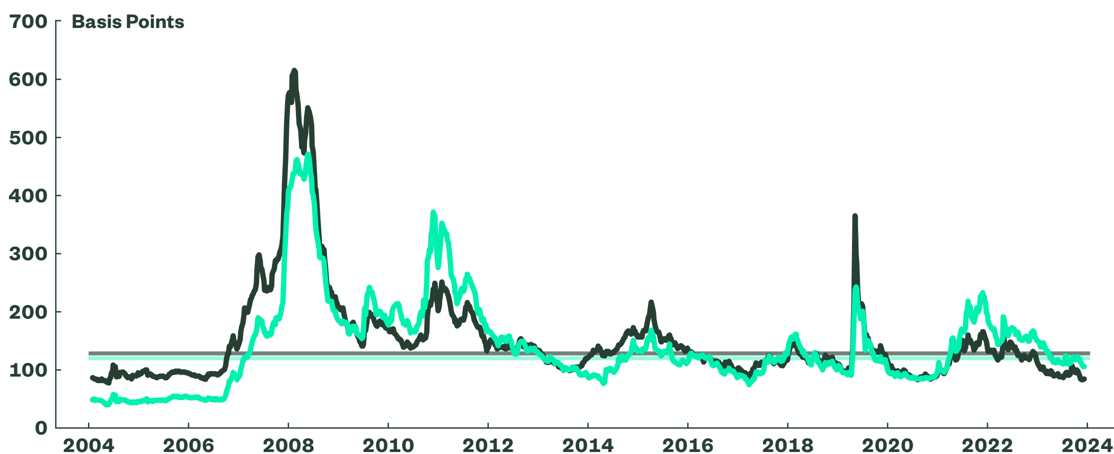
Substantial fiscal deficits and debt levels remain a distinct, and so far unaddressed, challenge. While the US captures most of the attention, especially considering the election result, aging populations make this just as pressing an issue in Europe and Asia. This represents the most obvious risk to an otherwise encouraging outlook.

Investment Grade Credit

With investment grade (IG) spreads close to historic lows, there is little prospect of further spread compression from here (Figure 8). Average credit fundamentals are still solid, but it seems reasonable to expect some deterioration in balance sheet strength and interest coverage as the credit cycle progresses. Indeed, there are already signs of this: although leverage among US non-financials has declined from its pandemic-era high it has risen once again from recent lows. Meanwhile, profit margins at those non-financials have recently reached an all-time high — unless that trend continues, it seems unlikely that interest coverage for this segment can improve and may weaken further.

Figure 8
Investment Grade Spreads Have Tightened

- US IG Corporate Spread
- EUR IG Corporate Spread
- US IG Median Spread
- EUR IG Median Spread



Source: Bloomberg Finance L.P. Data as of November 1, 2024. Past performance is not a reliable indicator of future performance.

High Yield Debt

We see high yield debt in a broadly similar position to its IG counterpart. With spreads at their tightest levels since 2007, returns will be driven more by declining underlying yields rather than further significant spread compression. Having previously faced legitimate concerns around an approaching maturity wall in the face of relatively high prevailing yields, many issuers have taken advantage of lower yields and tight spreads since then to refinance, thereby improving the technical outlook. This opportunistic refinancing has been more of a US dollar market phenomenon so far. That said, the fall in yields and tighter spreads are more widespread and those improved refinancing conditions could yet provide the same opportunity for euro (and other) issuers.

Emerging Market Debt

Although hard currency emerging market (EM) debt spreads have narrowed, most credit events have been priced in and a positive outlook for US Treasuries means that this debt segment has scope to add value for investors. Additionally, the turn in the US rate cycle should — in time — weaken another support for the external value of the dollar, which in turn would bolster sentiment towards emerging market assets.

That same US rate cycle dynamic can also support an easing in domestic policy rates across emerging markets, with positive implications for local currency (LC) EM debt as well. This will be nuanced however — individual LC issuers currently face very different inflation pressures and domestic conditions, so we cannot assume that all the regions will be able to deliver a similar level of policy accommodation in the coming quarters. For example, China — a local currency heavyweight — has the resources to boost domestic demand, but the efficacy of current and potential future support is unclear.

As noted above, the evolving policy stance of the incoming Trump administration may have a bearing on US Treasury yields and the US dollar, with implications for both EM debt segments. Depending on how targeted they are, protectionist US trade policies could have significant consequences for sentiment towards individual countries.

The Bottom Line

We see a generally favorable environment for advanced economy sovereign debt. As fiscal, trade and monetary policies evolve, we expect to see swings in sentiment and bouts of volatility — potentially creating opportunities for investors to manage or extend duration. Credit investors faced with limited scope for further spread compression and a maturing credit cycle can also expect dispersion and volatility — a fruitful regime for an active approach to credit.

Portfolio Construction

Beyond 60/40: Improving Durability and Diversification in Portfolios

Matthew Bartolini, CFA, CAIA
Head of SPDR Americas Research

A high level of co-movement between stocks and bonds, and equity concentration risks, are two factors limiting the 60/40 (stocks/bonds) portfolio's durability during a time of idiosyncratic and asymmetric macro trends. In fact, the rolling 12-month correlation of US stocks and bonds has been positive for over 600 consecutive days — the longest streak since 1992-1995, the last time the Federal Reserve sought a soft landing.

600+

Consecutive days of positive rolling 12-month correlations

10

Stocks account for 35% of US S&P 500 market cap

66%

Weighting of US equities in MSCI ACWI

Moreover, stock contribution to balanced portfolio risk is also rising back to 'normal' levels. If turmoil was to strike while stock volatility is rebounding, the impact on traditionally balanced portfolio drawdown risks could be significant. Among equities, concentration risk has risen as benchmarks have become more top-heavy from a security, sector, and country perspective. The 10 largest companies in the US S&P 500 now account for a record 35% of the market capitalization. Meanwhile, the US weighting in the MSCI All Country World Index (ACWI) is at an all-time high of 66%.[3]

The key takeaway? Stock, sector, and geographical diversification attributes are as weak as ever for core equity exposures within the traditionally balanced portfolio.

Alternative Steps to Improving Durability and Diversification

Balancing beta risks should be the first step, with other strategies added for strength. Investors should evaluate public and private market exposures based on how they improve diversification, modify risks, or offer opportunistic — and potentially less correlated — alpha generation.

Real assets such as gold, Treasury Inflation-Protected Securities (TIPS), commodities, infrastructure, natural resources, real estate, and digital assets can help provide a potential inflation volatility hedge, generate additional yield, or act as a diversifier relative to broad equities and fixed income, either individually or as part of a multi-asset real return strategy.

On the opportunistic front, a tactical asset allocation (TAA) strategy that tilts toward favored asset classes to generate risk-managed benchmark-beating returns can diversify existing "betas" in a portfolio. In addition, hedge fund replication and derivative income strategies attempt to engineer asymmetric payoff structures that differ from traditional risk assets. Amid declining bond yields, derivative income has an added income overlay benefit.

Allocations to private assets also warrant consideration. Private equity, private credit, real estate, and infrastructure infuse non-traditional elements to the traditional mix of assets. These asset classes may offer higher returns, lower volatility, and enhanced portfolio diversification potential. The investment opportunities in private markets are vast, interesting, and growing.

Because information on private market investments is not as widely available as in public markets there is potential to capitalize on more widespread market inefficiencies. Yet, as the solutions and products are not publicly traded, illiquidity must also be an important consideration in portfolio construction, and a long-term perspective and careful selection of managers is key.

The Playbook for More Durable Diversification

While portfolios take many shapes, we believe that investors should consider:

1. Using modifiers (such as derivative-based strategies, private credit, or infrastructure) for income.

2. Seeking tactical or opportunistic unconstrainted strategies that can adapt rapidly to market conditions to target non-traditional premia/alpha opportunities.

3. Diversifying via strategies with lesser correlations to traditional markets — i.e., more balance across differing environments and asset classes, such as gold, multi-asset real return, and commodities.

Thematic Investing

GCC Region in Bloom: Expanding the Investment Horizon

Amid rapid economic expansion, the attraction of the Gulf region for investors is increasingly less about oil and gas and more about future growth.

Exploring Transformative Technologies: En Route to Peak Altitude

Confidence is growing that AI and Blockchain-related innovations are nearing a breakthrough to the mainstream.

Thematic Investing

GCC Region in Bloom: Expanding the Investment Horizon

Karine Kheirallah,
Head of Investment Strategy & Research — MEA

The Gulf Cooperation Council (GCC) region, encompassing Saudi Arabia, the United Arab Emirates, Qatar, Kuwait, Bahrain, and Oman, is undergoing a significant transformation. Historically tied to energy prices, the region is now actively diversifying its economies, enhancing its attractiveness for domestic and international investors, and this is being reflected in their equity and bond markets' performance.

GCC economies are projected to grow at a rate of around 4% per annum over the next five years, more than double the GDP growth rate of advanced economies.[4] This growth is fueled by the region's dominance in global energy markets but also by government-led initiatives aimed at diversifying local economies away from oil and gas. The Vision plans launched by each GCC country, with the goal of sustainable economic development, are central to this transformation.

4%

GDP growth over next five years

<50%

Debt-to-GDP ratio of three largest GCC countries[5]

$1.35T

Outstanding GCC bonds

Evolving GCC Equity Markets

GCC equity markets have evolved from limited access to greater global integration. The inclusion of GCC countries in the MSCI Emerging Markets (EM) Index and MSCI All Country World Index (ACWI) is testament to this progress. While the GCC's representation in the EM index has increased considerably, the region remains underrepresented in global indices, suggesting potential for further growth.

By sector, financials are dominant in GCC equity markets. However, we expect this sectoral concentration to shift as diversification efforts gain momentum and developments in areas such as healthcare, education, smart infrastructure, renewable energy, and technology present investors with a wider array of growth opportunities.

Historical Performance and Diversification Benefits

GCC equities have consistently outperformed the broader emerging markets index over the past decade, despite various global challenges.[6] What may be surprising for some is that GCC equities actually exhibit a lower-than-expected correlation with oil prices — relative outperformance is attributed to the region's resilience and strategic efforts to diversify its economic base and equity markets.

A key draw for global investors is the low correlation of GCC equities with both developed and emerging markets, as the region's distinct sectoral exposure differs significantly from technology-heavy global markets. Furthermore, lower currency risk stemming from the stability of its dollar-pegged currencies enhances GCC's attractiveness in a volatile global economic environment.

The Rise of GCC Fixed Income

The GCC's economic diversification plans have driven substantial fixed income issuance to fund growth. Indeed, the total amount of outstanding bonds issued by GCC countries has more than tripled since 2019, reaching nearly US$1.35 trillion by September 2024.[7] Of particular note has been the surge in local currency bond issuance, indicating a deepening of local bond markets. There has also been a notable rise in Sukuk and green bond issues, reflecting the GCC's commitment to diversifying the economy and promoting sustainable development.

A key attraction for investors is the outperformance of GCC bonds versus the broader JP Morgan EMBI Global Diversified Index over the long term. They have also exhibited lower volatility and drawdowns compared to their emerging market counterparts.[8]

Vision Plans and Thematic Opportunities

The Vision plans are key drivers of the GCC's transformation. These plans encompass a wide range of objectives, including developing non-oil sectors, promoting private sector investment, and enhancing social and environmental sustainability.

Initial public offerings (IPOs) are playing a crucial role in the diversification efforts, providing opportunities for investors to participate in the growth of new sectors. We expect that the development of exchange-traded funds focused on GCC equities and bonds will further enhance investor access and liquidity.

The Bottom Line

Looking forward, the GCC region offers growth potential, diversification benefits, and evolving sector dynamics. Challenges such as liquidity constraints and a volatile geopolitical landscape should be noted but the GCC's ongoing transformation and integration into the global financial system make it an investment destination worth considering for any well-diversified portfolio.

Thematic Investing

Exploring Transformative Technologies: En Route to Peak Altitude

Jennifer Bender, Ph.D.
Chief Investment Strategist

Investors are increasingly abuzz around transformative technologies with the potential to disrupt the future of production and the nature of work. We believe two — Artificial Intelligence (AI) and Blockchain-related innovations — have passed a critical stage of discovery.

Artificial Intelligence Large-language-model-based AI applications like ChatGPT and other generative AI tools have changed the nature of the game by providing a way for corporations and individuals to tap into AI with minimal investment. That almost half of S&P 500 companies mentioned AI in their most recent earnings transcripts illustrates just how importantly this is viewed by businesses.

Arguably, the greatest promise of AI lies in the potential to improve productivity across the entire economy, complementing human insights and labor as "co-pilots". If previous experiences are anything to go by, the productivity gains and growth implications could be significant. That said, patience is warranted as, in the past, it has typically taken over a decade for benefits from the emergence of transformative technologies to be fully realized.

Within AI, we are seeing investors transition beyond hyper-scalers and semiconductors into infrastructure, as well as sector-specific applications. Our active equity analysts are identifying early movers in AI across industries, while our quantitative teams are incorporating AI to identify alpha signals and measure risk.

Blockchain In a similar fashion to the AI experience, blockchain-based applications have expanded beyond cryptocurrencies into areas which early enthusiasts of distributed ledger technology (DLT) envisioned. The ability to "tokenize" assets has many potential benefits, not least of which is lower barriers to hard-to-access assets. But even bonds (and money market funds) and commodities can potentially benefit from the power of fractional ownership. One of our recent papers explores asset tokenization in greater detail.

37%

Of survey respondents in 2024 have live DLT and digital asset projects[9]

$15.2B

Digital asset issuance in bond markets (as of 12/31/2023)

24/7

On-chain digital assets can settle instantaneously 24 hours a day

As investments, we are more optimistic on the promises of digitization for traditional asset classes, but there is potential for fully digital assets such as cryptocurrencies and non-fungible tokens (NFTs) to surprise us. These are still speculative assets in our opinion; but if sufficient numbers of investors come to see them as a store of value, they could take on a similar role in portfolios as gold, whose practical uses are far less important to investors today than in the past.

Implications for Investors

As investors, we believe it's helpful to think about the implications of AI, DLT, and other transformative technologies across three categories:

1. The macro implications — for example, how a technology might impact economic drivers such as inflation, GDP growth, etc.

2. The implications for investors who allocate capital, including asset managers and asset owners.

3. The implications for financial services more broadly.

Not surprisingly, our focus at State Street Global Advisors has been on number 2, though the others also impact investors, albeit in less directly visible ways at present.

One big unknown remains regulation. Governments around the world have been slow to determine how and what to regulate on this sphere, unsurprising given how quickly these technologies have evolved. Regulation will have a first order impact on their adoption and the eventual gains we are likely to see.

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Endnotes

1 'In the short run, the market is a voting machine but in the long run, it is a weighing machine.' Benjamin Graham, The Intelligent Investor.

2 Source: Bloomberg Finance L.P., as of October 31, 2024.

3 Source: Bloomberg Finance L.P., as of September 26, 2024 based on the S&P 500 Index and the MSCI ACWI Index.

4 Source: International Monetary Fund World Economic Outlook, April 2024.

5 Source: International Monetary Fund World Economic Outlook, April 2024.

6 Source: Bloomberg Finance L.P., as of October 31, 2024.

7 Source: Bloomberg Finance L.P., as of September 30, 2024.

8 Source: Bloomberg Finance L.P., J.P. Morgan, as of September 30, 2024.

9 Source: International Securities Services Association. Survey conducted in Q2 2024. The 2024 survey includes views from nearly 350 respondents globally.

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Marketing communication

State Street Global Advisors Worldwide Entities

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Companies with large market capitalizations go in and out of favor based on market and economic conditions. Larger companies tend to be less volatile than companies with smaller market capitalizations. In exchange for this potentially lower risk, the value of the security may not rise as much as companies with smaller market capitalizations.

Investments in small-sized companies may involve greater risks than in those of larger, better known companies.

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 REITs involves certain distinct risks in addition to those risks associated with investing in the real estate industry in general.

Equity REITs may be affected by changes in the value of the underlying property owned by the REITs, while mortgage REITs may be affected by the quality of credit extended. REITs are subject to heavy cash flow dependency, default by borrowers and self-liquidation. REITs, especially mortgage REITs, are also subject to interest rate risk (i.e., as interest rates rise, the value of the REIT may decline).

Asset Allocation is a method of diversification which positions assets among major investment categories. Asset Allocation may be used in an effort to manage risk and enhance returns. It does not, however, guarantee a profit or protect against loss.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices 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.

Investing in high yield fixed income securities, otherwise known as "junk bonds", is considered speculative and involves greater risk of loss of principal and interest than investing in investment grade fixed income securities. These lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

There are risks associated with investing in Real Assets and the Real Assets sector, including real estate, precious metals and natural resources. Investments can be significantly affected by events relating to these industries.

Hedge funds are typically unregulated private investment pools made available to only sophisticated investors who are able to bear the risk of the loss of their entire investment. An investment in a hedge fund should be viewed as illiquid and interests in hedge funds are generally not readily marketable and are generally not transferable.

Investors should be prepared to bear the financial risks of an investment in a hedge fund for an indefinite period of time. An investment in a hedge fund is not intended to be a complete investment program, but rather is intended for investment as part of a diversified investment portfolio.

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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