

NAVIGATING A DOWNHILL CLIMB

2019 ETF Market Outlook

Michael Arone, CFA, *Chief Investment Strategist, US SPDR Business*

Matthew J. Bartolini, CFA, *Head of SPDR Americas Research*

The real danger starts once you reach the peak

For years market forecasters have been warning of the many potential pitfalls that could end the nearly decade-long bull market. Despite the growing chorus of warnings, investors, until recently, have simply shrugged while asset prices continued their climb to the mountaintop.

As 2018 gives way to 2019, investors may soon realize that reaching the mountain's summit is the easy part. The real risks are in the descent. According to a 2017 study, 75% of falls occur on the downhill climb. Loose terrain, uneven ground and exhaustion combine to make the descent a more treacherous journey than the climb. In fact, most climber fatalities on Mount Everest occur during the descent in an area below the summit called the "Death Zone."

Although there aren't many obvious signals to suggest that the bull market is entering the Death Zone, 2019 is likely to present a more challenging landscape for investors to navigate. For most of 2018, still easy global monetary policies and a massive US fiscal policy package delivered a brilliant disguise of continued economic and earnings momentum. However, as the year progressed, that facade slowly faded away, revealing an environment defined by much greater divergent global economic growth.

Watch your step as risks increase

Now, as investors gauge their prospects for 2019, a number of risks litter the mountainside. Frayed US-China relations, less accommodative monetary policies and slowing earnings growth have investors on edge. In addition, the stimulative effects of the huge US fiscal policy package are already showing signs of fatigue. After growing by 4.2% in the second quarter of 2018, US economic growth for the fourth quarter is forecasted at just 2.5%.

Similarly, according to the Bureau of Economic Analysis, business spending has slowed from an annualized pace of 11.5% in the first quarter to a skimpy 2.5% in the third quarter.¹ Trade strife and Fed rate hikes are finally biting into global growth, too.

Not surprisingly, given this increasingly challenging backdrop, the number of stock market corrections has increased and more normal bouts of asset price volatility have returned after a long and unusual absence.

Down, but not out

Slower global economic growth, higher volatility, less accommodative monetary policies and falling earnings likely mean lower returns for investors in 2019. As a result, more countries are likely to pursue aggressive fiscal policies to reignite growth and soften the blow from tightening monetary conditions.

However, the risk of a recession, particularly in the US, remains quite low. This should provide a backstop for market multiples which have already contracted notably in the past year. And, despite the fact that earnings growth will slow considerably next year, earnings are forecasted to grow at a still healthy 9%.

Therefore, discerning investors may be able to uncover a greater number of high quality investment opportunities in 2019. Consider these investment strategies to position portfolios for the demanding downhill climb:

- **Target quality over quantity of growth**
- **Get defensive in bonds**
- **Focus on fiscal policy beneficiaries**

TARGET QUALITY OVER QUANTITY OF GROWTH

US corporate profits in 2018 have been growing at the fastest pace since 2010, but that rate is unlikely to continue in 2019. Rising input costs, a tight labor market and gradually tightening financial conditions all point to the later stage of the business cycle.

Analysts' lower expectations on 2019 growth were one of the driving forces behind the October and November selloffs. Companies missing earnings expectations were punished more than average, while beats were rewarded less, underscoring increasing concerns that we have passed peak growth.²

From a valuation perspective, with declining growth prospects, investors have been unwilling to pay for stocks' lofty valuations, evidenced by high Book-to-Price stocks underperforming low Book-to-Price stocks by 3.6% since the start of Q3.³

This is not to say we expect an imminent economic contraction. Corporate earnings probably will grow in the high single digits in 2019. And the tight labor market and potential for more fiscal stimulus, such as a bipartisan infrastructure bill, may support domestic demand. Nevertheless, as economic growth decelerates, downside risks have increased due to tightening monetary policy, weakening global growth and prolonged trade tensions.

Pursue quality at reasonable valuations

Against this backdrop, adding more quality companies with high profit margins and healthy balance sheets at a reasonable price may provide more resilience and cushion some downside risks. And blending differentiated factor exposures may create a more balanced profile to navigate this downhill climb. Notably,

the MSCI USA Factor Mix A-Series Capped Index — a blend of quality, value and minimum volatility factors — stood strong during the October and November selloffs, providing a smoother return path than single factors.⁴

Finally as Benjamin Graham observed, “One of the most persuasive tests of high quality is an uninterrupted record of dividend payments going back over many years.” Our research also shows that long-term dividend growth companies exhibit higher quality traits in terms of higher profitability, stronger balance sheets and less earnings variability than pure high dividend companies.⁵

These higher quality traits have translated into persistent outperformance over the broad market, as well as high dividend yield strategies, when the broad market was down.

Implementation Ideas

Seek companies with high profit margins and healthy balance sheets that trade at reasonable valuations.

SDY SPDR® S&P® Dividend ETF

QUS SPDR MSCI USA StrategicFactorsSM ETF

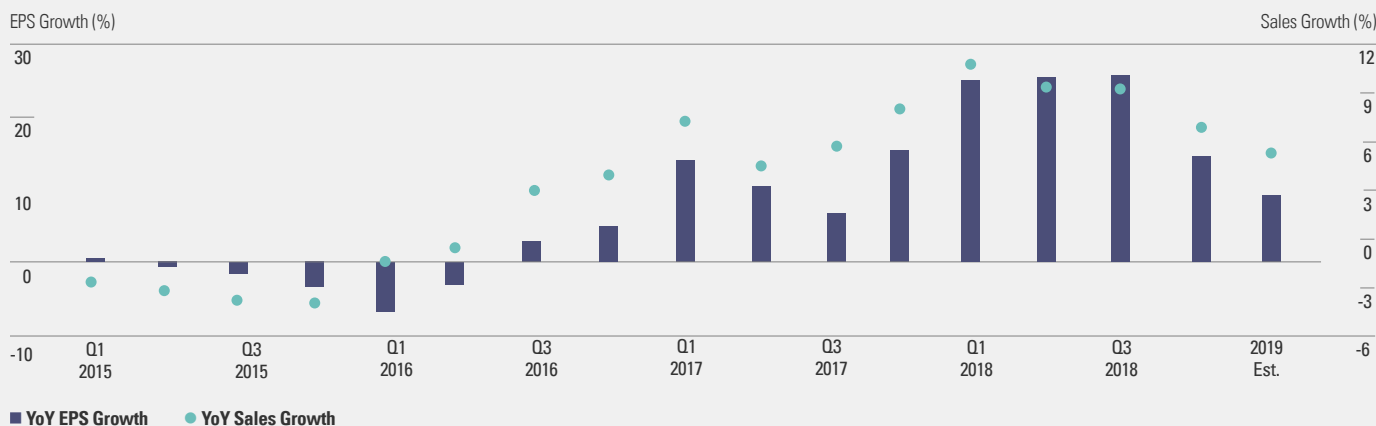
Consider rotating into more defensively oriented quality sectors with attractive valuations.

XPH SPDR S&P Pharmaceuticals ETF

XLP Consumer Staples Select Sector SPDR Fund

KBE SPDR S&P Bank ETF

Figure 1: A Slowdown of S&P 500® Earnings and Sales Growth



Source: FactSet, as of 11/16/2018.

GET DEFENSIVE IN BONDS

The problem with today’s bond market is basic bond math. As bond yields rise, bond prices fall. If, however, a bond’s coupon can cover the duration-induced price decline, then it’s not necessarily a loss generating event from a total return perspective. But that is not the current case for traditional bond exposures like the Bloomberg Barclays U.S. Aggregate Bond Index (the Agg). Given more rate hikes expected for the coming 12 months and record high duration of the Agg with yields below long-term averages, the drawdowns we have witnessed in 2018 bond markets are likely to continue. Because yields of shorter duration vehicles have risen along with broad bonds, there are more opportunities to generate income without taking on sizeable duration risks.

The best offense is a good defense

With rates rising and record high duration risk, we favor short duration corporate exposures and floating rates structures to lower interest rate sensitivity and deliver a more optimal yield and duration profile. This may lead to improved risk-adjusted performance and less drawdown than the broader fixed income market. Since the Federal Reserve began hiking rates more regularly in December 2016, floating rates exposures have had lower drawdowns among all the segments and a higher Sharpe ratio compared to the previous 10 years when rates were declining or flat, as shown in Figure 2.

Investors interested in boosting yield without taking too much credit risk or duration induced downside risks may be better served by a 1-3 year corporate bond exposure than a 1-5 year

corporate where the compensation for the 4-5 year corporate bucket provides little pickup in yield for the extended duration. An active short duration strategy may also be ideal to balance yield, duration and credit risks across many different bond sectors.

Target quality in credit

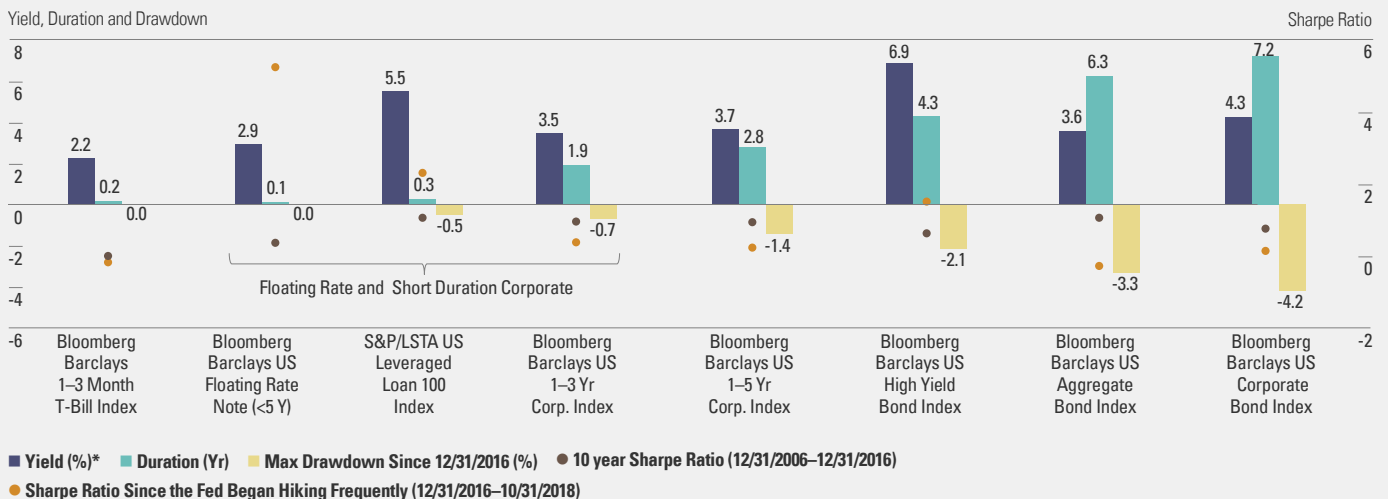
Solid but slowing economic growth may put the credit market under pressure when interest rates rise and nonfinancial corporate sectors become loaded with record levels of debt. For income-seeking investors who need a higher yield to satisfy income needs, moving up in quality in the credit space may be beneficial to position for a downhill credit climb. Senior to fixed rate high yield in the capital structure, senior loans have historically mitigated some of the downside risks in the credit market when spreads widened, while increasing income as rates rise.

Implementation Ideas

Shorten duration and move up in quality to mitigate duration induced price declines and credit risks.

FLRN	SPDR Bloomberg Barclays Investment Grade Floating Rate ETF
SPSB	SPDR Portfolio Short Term Corporate Bond ETF
BIL	SPDR Bloomberg Barclays 1–3 Month T-Bill ETF
STOT	SPDR DoubleLine® Short Duration Total Return Tactical ETF
SRLN	SPDR Blackstone / GSO Senior Loan ETF

Figure 2: Rising Rates Alter the Relative Attractiveness of Bond Sector Hedges



Source: Bloomberg Finance L.P., as of 10/31/2018. Past performance is not a guarantee of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.*Yield to maturity is used for the S&P/LSTA Leveraged Loan 100 Index. Yield to worst is used for other indices.

FOCUS ON FISCAL POLICY BENEFICIARIES

Populism has the establishment on the run across the globe. Leaning both left and right, newly elected populists are advocating fiscal policies to strengthen domestic consumption and redistribute wealth. Mexico's newly inaugurated President Andrés Manuel López Obrador, known as AMLO, is pledging to increase public investment and enact pension reforms, and Brazil's far-right President-elect Jair Bolsonaro wants to simplify the tax code by slashing corporate rates and reducing the number of citizens paying income taxes. Additional populist policy proposals include Italy's Citizen's Wage that budgets 10 billion euros to combat poverty and Spain's proposed 22% increase in the minimum wage.

Fiscal policy also reaches outside the populist realm. China is discussing income tax cuts in the range of 1% of GDP. Canada's Prime Minister Justin Trudeau recently unveiled corporate tax breaks worth C\$14 billion over six years. And, with his popularity slumping, French President Emmanuel Macron is trying to push forward tax cuts for the middle class.

Given these proposals, the most significant domestic consumption shifts from fiscal policy actions likely will occur abroad as US growth will be on a downward, yet still positive, trajectory due to the short-term nature of the already enacted tax cuts, tighter monetary policies and the length of the current economic expansion. In particular, small-cap international firms with a greater percentage of domestic sales stand to benefit both from an uptick in local demand for their products and services and cost reductions. Smaller companies are also less likely than large caps to be caught in the crossfire of protectionism.

Ready for a global fiscal policy sugar rush?

Therefore, non-US small caps, with their domestic bias, may surprise to the upside in 2019. And notably, the recent downturn in equities has created potential value opportunities

for these segments. Emerging market small caps are trading at a larger discount to US small caps than they have historically, while international developed small caps are trading right at their 10-year median. Furthermore, these two segments are trading at a larger discount to broad-based US equities than normal over the past 10 years. Chinese equity valuations are similarly attractive, as on a relative basis they are trading in the bottom 10th decile below their historical discount to US stocks.⁶ As a result, they seem to be in a supportive position to rebound if the Chinese government takes the fiscal policy sugar rush path in this downhill climb.

Implementation Ideas

Target regions outside the US where fiscal policy is reigniting growth as monetary conditions tighten.

GWX	SPDR S&P International Small Cap ETF
EWX	SPDR S&P Emerging Markets Small Cap ETF
GXC	SPDR S&P China ETF

Consider a Strategic Allocation to Gold

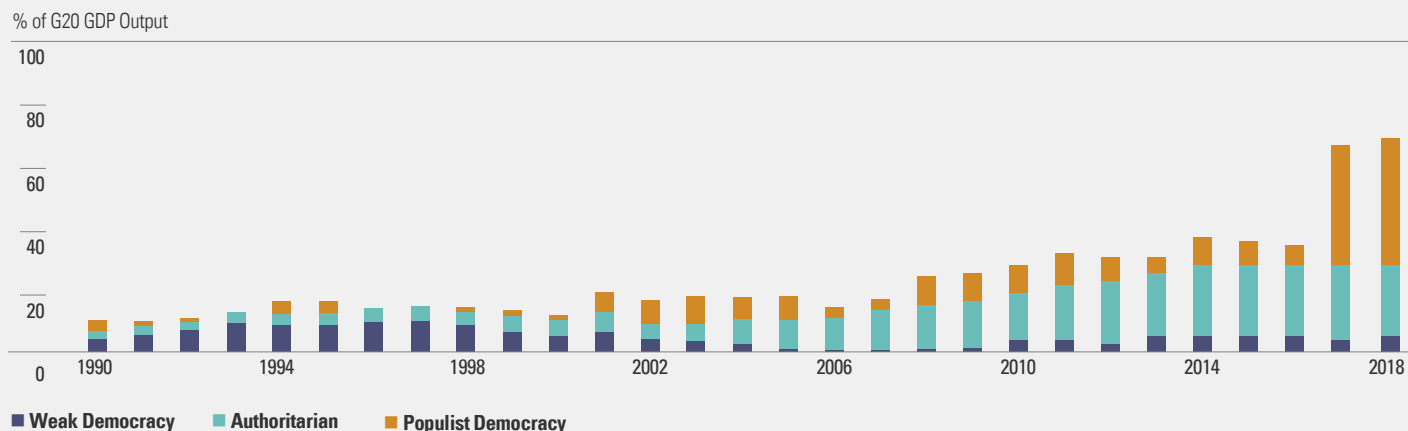
Adding gold exposure to a portfolio may help moderate the impact of market volatility and reduce portfolio drawdown through the following potential benefits:

- **Increasing portfolio diversification** – Gold has demonstrated a -0.01 and 0.06 correlation to the S&P 500 Index and Bloomberg Barclays U.S. Aggregate Bond Index, respectively, since the 1970s*
- **Mitigating tail risk** – Gold has historically delivered competitive returns and outperformed other asset classes during black swan events.**
- **Enhancing long-term returns** – Since 1971, when President Nixon removed the US dollar from the Gold Standard, the price of gold has appreciated at a compounded annual growth rate of 7.44%.***

Consider the suite of 3 SPDR Gold ETFs:

- **GLD**[®] SPDR Gold Shares
- **GLDM**SM SPDR Gold MiniSharesSM
- **GLDW** SPDR Long Dollar Gold Trust

Figure 3: Percent of G20 GDP Output by Political Regime



Source: Bloomberg Economics, Freedom House, International Monetary Fund. Note: Figures include G20 nations and Spain.

Past performance is not a guarantee of future results.

An investment in any combination of GLD, GLDM, and GLDW entails a risk of loss and the diversification offered by the Funds does not ensure a profit or guarantee against loss.

*Bloomberg Finance L.P. & State Street Global Advisors; S&P 500 correlation is from 8/31/1971 to 10/31/2018 and Bloomberg Barclays U.S. Aggregate Bond Index correlation is from 8/31/1971 to 10/31/2018.

** Analysis of Gold's Historical Performance in Market Downturns. Bloomberg Finance L.P., State Street Global Advisors, as of September 30, 2018. Notes: Dot-Com Meltdown: 2/29/2000–3/30/2001: LBMA Gold Price PM (-12.2%); September 11 Terrorist Attacks: 8/31/2001–9/28/2001: LBMA Gold Price PM (7.4%); 2002 Recession: 2/28/2002–8/30/2002: LBMA Gold Price PM (5.4%); Global Financial Crisis: 11/30/2007–3/31/2009: LBMA Gold Price PM (10.0%); Sovereign Debt Crisis I: 4/30/2010–8/31/2010: LBMA Gold Price PM (5.7%); Sovereign Debt Crisis II: 2/28/2011–10/31/2011: LBMA Gold Price PM (22.0%); Debt Ceiling Crisis: 7/22/2011–8/8/2011: LBMA Gold Price PM (5.7%); Brexit: 6/22/2016–6/27/2016: LBMA Gold Price PM (4.7%). **Past performance is not a guarantee of future results.**

Performance above does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling exchange traded funds. Performance is not meant to represent the performance of any investment product. Performance data derived from total return indices.

***Bloomberg Finance L.P. & State Street Global Advisors, dates from August 13, 1971 to October 31, 2018.

¹ Bureau of Economic Analysis, as of 11/30/2018.

² FactSet, as of 11/16/2018.

³ State Street Global Advisors, Bloomberg Finance L.P., as of 10/31/2018. Based on Quintile 1 — Quintile 5 of Book-value-to-price factor where quintile 1 has high B/P stocks and quintile 5 has low B/P.

⁴ Bloomberg Finance, as of 11/20/2018. **Past performance is not a guarantee of future results.** MSCI USA Minimum Volatility Index, MSCI USA Enhanced Value Index, MSCI USA Quality Index, MSCI USA Equal Weighted Index, MSCI USA High Dividend Yield Index and MSCI USA Momentum Index were used compared to the MSCI USA Index. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

⁵ "Fundamental Quality Characteristics in Dividend Strategies", May 2018, Daniel Ung, State Street Global Advisors.

⁶ Bloomberg Finance L.P., as of 11/15/2018 based upon MSCI EAFE Small Cap Index, MSCI Emerging Markets Small Cap Index, Russell 3000 Index, Russell 2000 Index and MSCI China Index data from 10/31/2008 to 11/15/2018.

Glossary

Bloomberg Barclays 1-3 Month U.S. Treasury Bill Index A fixed-income benchmark including publicly issued dollar-denominated zero-coupon US Treasury Bills that have a remaining maturity of less than three months and more than one month. They must be rated investment grade, have \$250 million or more of outstanding face value and be fixed-rate and non-convertible.

Bloomberg Barclays U.S. 1-3 Year Corporate Bond Index A benchmark designed to measure the performance of the short-term US corporate bond market. It includes publicly issued US dollar-denominated and investment-grade corporate issues that have a remaining maturity of greater than or equal to one year and less than three years.

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

Bloomberg Barclays US Corporate 1-5 Year Index A benchmark designed to measure the performance of US corporate bonds that have a maturity of greater than or equal to 1 year and less than 5 years.

Bloomberg Barclays U.S. Corporate Bond Index A fixed-income benchmark that measures the investment-grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

Bloomberg Barclays U.S. Dollar Floating Rate <5 Years Index A benchmark consisting of debt instruments that pay a variable coupon rate, most of which are based on 3-month LIBOR, and have a fixed spread. The index may include US-registered, dollar-denominated bonds of non-US corporations, governments and supranational entities.

Bloomberg Barclays U.S. High Yield Index A rules-based, market-value weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable, corporate bonds. To be included in the index a security must have a minimum par amount of 250MM.

Price-to-book value The ratio of market value of a company's shares (share price) over its book value of equity, the value of a company's assets expressed on the balance sheet.

Sharpe Ratio A measure for calculating risk-adjusted returns that has become the industry standard for such calculations. It was developed by Nobel laureate William F. Sharpe. The Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. The higher the Sharpe ratio the better.

S&P/LSTA U.S. Leveraged Loan 100 Index A benchmark that is designed to reflect the largest loan facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads, and interest payments. The index consists of 100 loan facilities drawn from a larger benchmark, the S&P/LSTA (Loan Syndications and Trading Association) Leveraged Loan Index (LLI).

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State Street Global Advisors One Iron Street, Boston, MA 02210.
T: +1 617 664 7727.

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Passively managed funds hold a range of securities that, in the aggregate, approximates the full Index in terms of key risk factors and other characteristics. This may cause the fund to experience tracking errors relative to performance of the index.

Foreign (non-U.S.) Securities may be subject to greater political, economic, environmental, credit and information risks. Foreign securities may be subject to higher volatility than U.S. securities, due to varying degrees of regulation and limited liquidity. These risks are magnified in emerging markets.

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

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Equity securities may fluctuate in value in response to the activities of individual companies and general market and economic conditions.

Investing involves risk, and you could lose money on an investment in GLD.

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Funds investing in a **single sector** may be subject to more volatility than funds investing in a diverse group of sectors.

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Commodities and commodity-index linked securities may be affected by changes in overall market movements, changes in interest rates, and other factors such as weather, disease, embargoes, or political and regulatory developments, as well as trading activity of speculators and arbitrageurs in the underlying commodities.

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Currency exchange rates between the U.S. dollar and non-U.S. currencies may fluctuate significantly over short periods of time and may cause the value of GLDW’s investments to decline.

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