Bond Compass

Q3 2024

STATE STREET GLOBAL ADVISORS SPDR®

A Leader in Fixed Income Index Investing

$580

billion in fixed income assets

The Scale to Specialise

- State Street Global Advisors' global scale enables our portfolio managers, traders and investment strategists to be sector specialists and based in their geographic markets
- Our dedicated capital markets teams provide 24-hour coverage across global markets, offering enhanced liquidity and cost-efficient* trading strategies
- Entrusted with $580 billion in fixed income assets, managing 30+ currencies across 40 different countries**

27

years of bond index investing experience

Proven Track Record

- 27 years of bond index investing — our first fixed income index fund launched in 1996
- Manage more than 100 fixed income index strategies, providing choice for investors
- More than 100 fixed income professionals dedicated to conducting research, managing risks and costs, and supporting our clients

100+

fixed income index strategies

Innovative Solutions for Bond Investors

- Comprehensive range of cost-effective* ETFs
- Offering access to government and corporate bonds across the yield curve, using a consistent index methodology

* Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

** State Street Global Advisors, as of 30 June 2024.

Contents

Investor Sentiment — Flows and Holdings

A snapshot of global fixed income flows, holdings and valuations, based on data provided by State Street Global Markets.*

* The fixed income flows and holdings indicators produced by State Street Global Markets, the investment, research and trading division of State Street Corporation, are based on aggregated and anonymised custody data provided to it by State Street, in its role as custodian. State Street Global Advisors does not have access to the underlying custody data used to produce the indicators.

Fixed Income Flows and Holdings

This data captures behavioural trends across tens of thousands of portfolios and is estimated to capture just over 10% of outstanding fixed income securities globally.

Demand for US Bonds Dwindles

After a first quarter characterised by consistently hotter-than-expected data prints, US data became more of a mixed bag in Q2. But more in-line inflation prints alongside signs of softness emerging in consumer activity don't appear to have bolstered confidence in imminent rate cuts by the Federal Reserve (Fed).

Rather, the mixed set of data seems to have exacerbated uncertainty around the timing and depth of the Fed's cutting cycle. And the added challenge of the US presidential election continues to weigh on institutional demand for US debt.

Aggregate US Treasury inflows have ebbed toward neutral alongside a dramatic drop-off in corporate debt flows (Figure 1). This moderation in US debt demand was initially accompanied by a surge in emerging market (EM) sovereign demand toward the end of May, with aggregate EM sovereign bond inflows reaching their highest level since February 2018 as the month drew to a close.

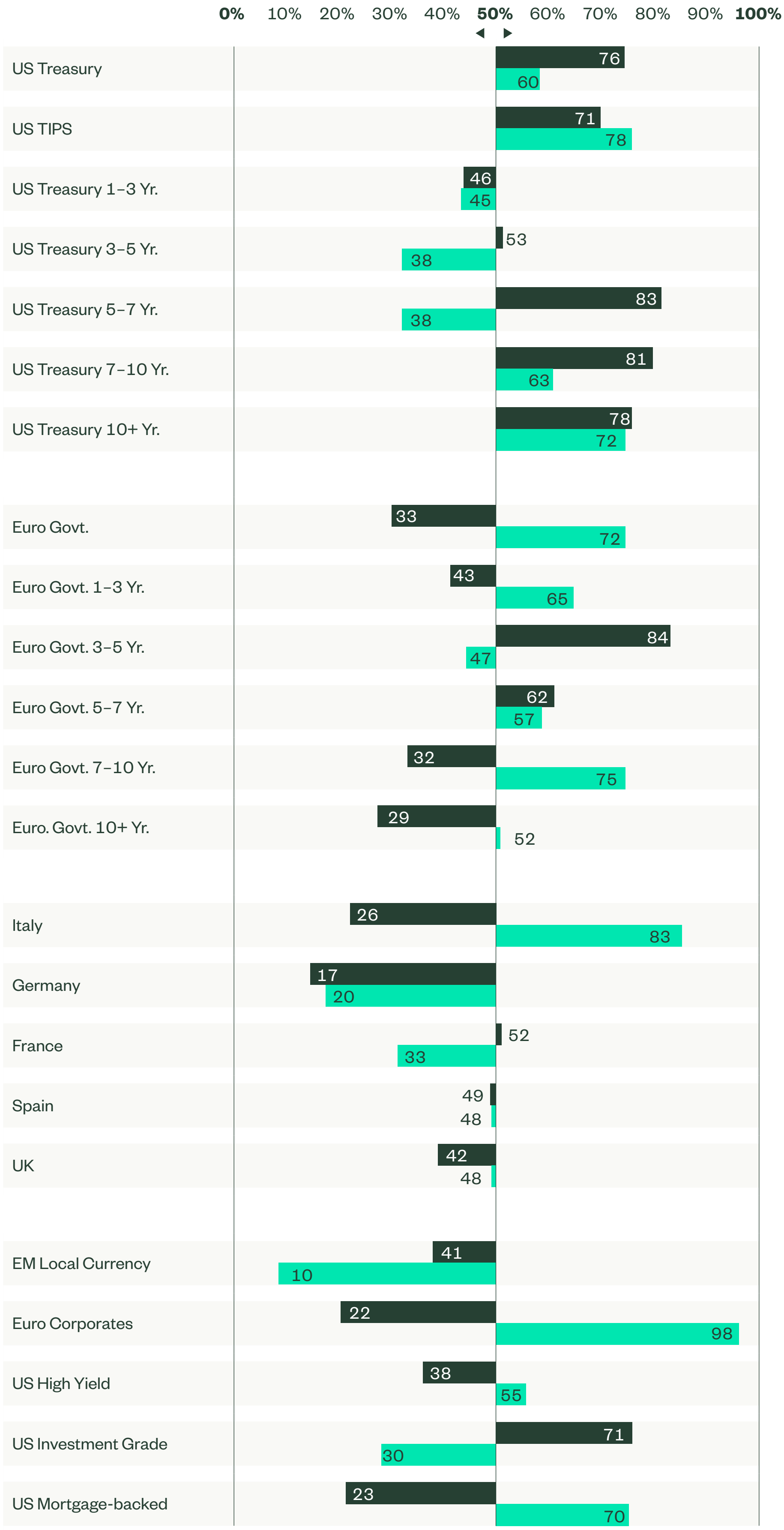
Inflows have since moderated, suggesting overall EM and developed market (DM) debt demand are now in a similar place. Elsewhere, appetite for European sovereign debt appears mixed against a backdrop of ongoing political uncertainty and several central banks in the early innings of their cutting cycles.

Figure 1
Q2 Flows & Holdings

Flows
Holdings

These metrics are generated from regression analysis based on aggregated and anonymous flow data in order to better capture investor preference and to ensure the safeguarding of client confidentiality. The figures are shown as percentiles, expressing the flows and holdings over the last quarter, relative to the last five years. The benefit of this approach is that it provides perspective on the size of flows and holdings compared to their historical trends, whereas a single, dollar figure provides less context.

For more information please visit globalmarkets.statestreet.com



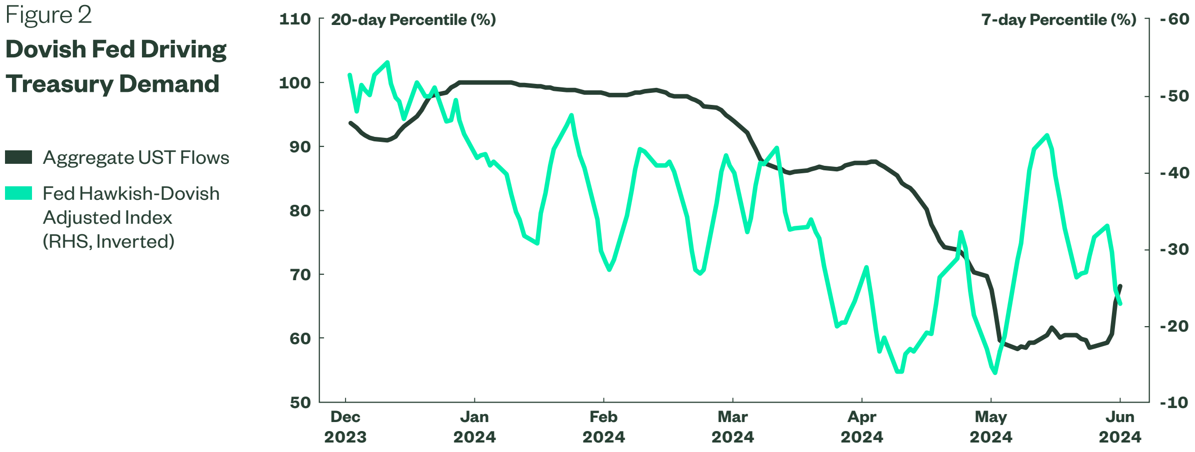
Source: State Street Global Markets, as of 30 June 2024.

US Treasury Inflows Ebb

Institutional investors' demand for US Treasurys waned throughout the quarter, as reflected by 20-day aggregate US Treasury (UST) inflows moderating to the 68th percentile. Inflows drifting down to their lowest level since a Treasury sell-off spurred by regional banking collapses in the spring of 2023 is notable given that they had remained above the 90th percentile for much of the past year. In fact, aggregate UST inflows printed in the 94th percentile as recently as the end of the first quarter. During this time, robustness reflected in growth and inflation data did little to quell investor conviction that cuts were forthcoming as Fed messaging was interpreted as extremely dovish. It appears UST demand fell in Q2 only as the Fed's tone grew increasingly less dovish throughout the quarter (Figure 2).

Looking under the hood at sovereign bond flows by key maturity, this pullback in increasing exposure to USTs was consistent across 2-, 5-, and 10-yr USTs. But the move down has been most pronounced in 10-yr UST inflows, which have fallen dramatically to the 13th percentile from the 97th at the start of Q2. In a similar vein, aggregate US corporate bond inflows are currently in the 33rd percentile, a steep decline from the 98th as investor confidence in corporate resilience continues to diminish the longer policy remains restrictive.

Figure 2
Dovish Fed Driving Treasury Demand



Source: State Street Global Markets, as of 30 June 2024.

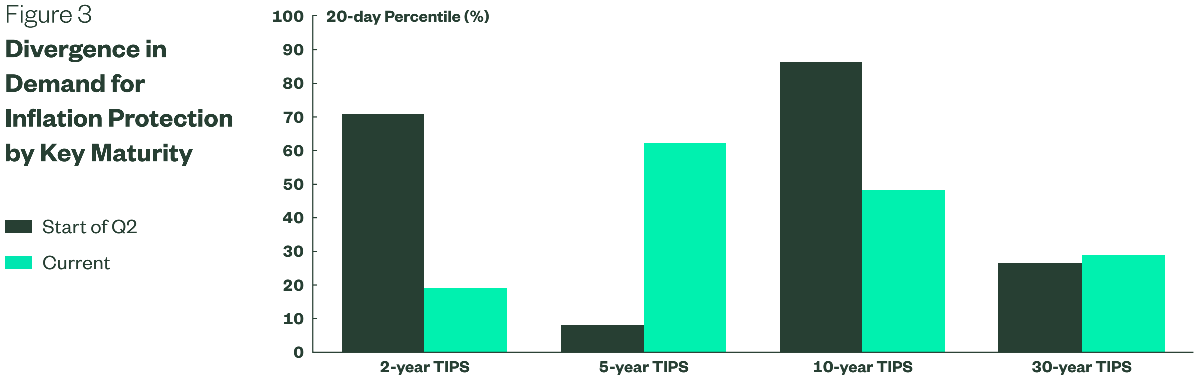
Demand for Inflation Protection Diverges

Institutional demand for inflation protection surged at the start of the quarter on the back of an upside surprise to March's CPI print. Since then, aggregate inflows to US Treasury Inflation-Protected Securities (TIPS) have eased back to the 35th percentile alongside in-line to slightly weaker-than-expected April and May price prints.

A breakdown of TIPS' inflows by key maturity reveals that demand for inflation protection has dropped off the most sharply for a two-year time horizon (Figure 3); 2-yr US TIPS inflows have fallen to the 19th percentile from as high as the 98th in April. Meanwhile, 5-yr US TIPS inflows have risen to the 62nd percentile from the 8th at the end of Q1. And inflows for 10-yr UST TIPS are not far behind, hovering around the 50th percentile. This divergence in demand for TIPS by maturity suggests a more sanguine short-term inflation outlook among institutions as activity begins to moderate while greater uncertainty emerges around demographic and debt sustainability issues that threaten to perpetuate upward price pressures in a 5- to 10-year time horizon.

Figure 3

Divergence in Demand for Inflation Protection by Key Maturity



Source: State Street Global Markets, as of 30 June 2024.

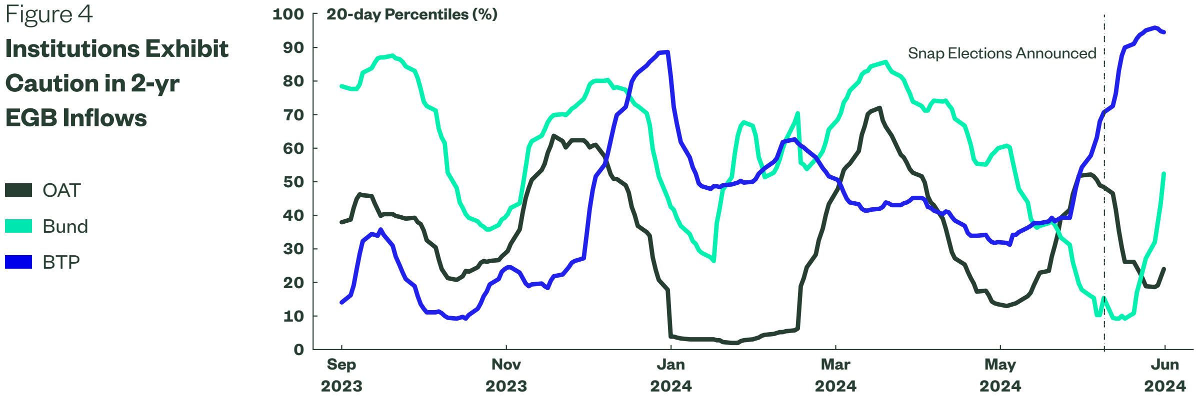
European Debt Appetite Amid Political Uncertainty

Elsewhere in the DM sovereign space, behavioural data revealed real money's reaction to the political drama in Europe throughout the quarter. The 10-yr French OAT-German bund spread recently widened by almost 30 basis points (bps) on the back of uncertainty prompted by French President Macron's call for snap parliamentary elections (Figure 4).

It appears, however, that a retreat in institutional demand for France's debt upon the election announcement has been confined to the shorter end of the curve. Investors certainly exhibited some caution in becoming more selective in where they increased their exposure to European debt, as a moderation in 2-yr OAT inflows to the 24th percentile from the 64th at the start of Q2 coincided with an acceleration in 2-yr bund and continued BTP buying. A steady increase in 10-yr OAT flows throughout the quarter, however, suggests there is little longer-term concern about France's fiscal risks currently being factored into real money decision-making. Inflows to 10-yr BTPs saw a similar pick-up over the past few months, while demand for 10-yr bunds dropped off notably.

Figure 4

Institutions Exhibit Caution in 2-yr EGB Inflows



Source: State Street Global Markets, as of 30 June 2024.

PriceStats®

Quarterly measure of inflation based on prices from millions of items sold by online retailers, helping investors anticipate and evaluate the impact of inflation.

PriceStats® provides high-frequency measures of inflation and real exchange rates drawn from prices on millions of items sold by online retailers. This real-time pulse of global economic trends helps investors anticipate and evaluate the impact of inflation, including the impact on monetary policy and the degree of exchange rate misalignments.

This information is available on a daily basis from State Street Global Markets: globalmarkets.statestreet.com.

Inflation Trends Mixed

Trends Remain the Fed's Friend

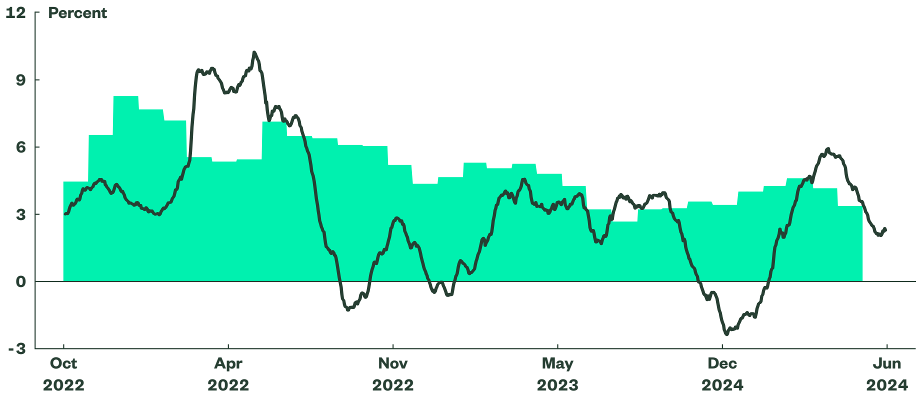
It appears more likely that the surge in Q1 inflation in the US was a temporary bump in the broader disinflationary trend. And while the Federal Reserve (Fed) and investors were caught off guard by the strength of resurging inflation, they are likely cheering the recent renormalisation of some of these trends.

June PriceStats data indicates that inflation's direction of travel remains friendly, settling in at only +3 basis points (bps) on the month, versus what would normally be a seasonal increase of +20 to +30 bps. Fuel costs are likely a large contributor to recent improvements, although most of the components that PriceStats tracks don't show any alarming trends. The annualised 3-month averages show that the recent disinflation patterns remain intact (Figure 5), although the lower realised inflation in mid-2023 is likely to make annual comparisons a bit more challenging in the coming months.

Figure 5
CPI Trends Remain Friendly

US PriceStats 90-day Annualised (%)

CPI Core 3-month Annualised (%)



Source: State Street Global Markets, PriceStats, Bloomberg Finance, L.P., as of 30 June 2024.

Eurozone: Inflation at Your Service

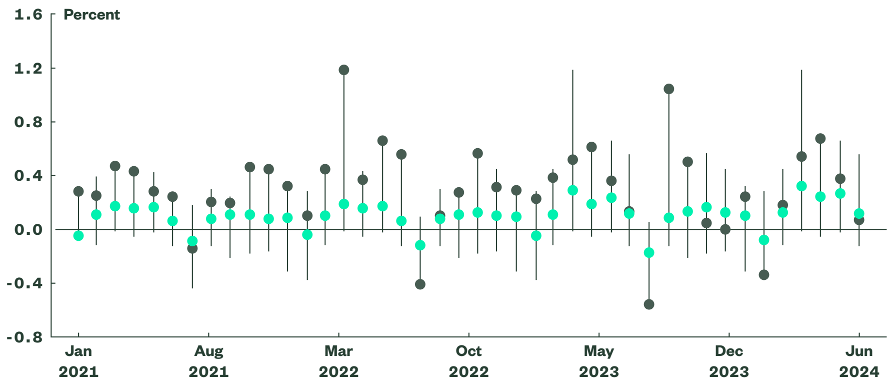
The European Central bank (ECB) finally started its normalisation process by cutting rates in June, but it did so with some trepidation. So, while growth concerns continue across the eurozone (EZ), inflation is proving a worthy adversary. In particular, services inflation was hotter and stickier than expected in May, which was reported just as the ECB started its cutting campaign.

The market subsequently adjusted its rate cut expectations for the EZ, as it appears the ECB is trying to execute a hawkish cut. For our part, PriceStats data indicates that overall disinflation trends remain intact with realised data for June tracking close to historical averages (Figure 6). Seasonal summer discounting may support the ECB's goal of additional rate cuts, although the fractured political process in France and across the European Union may prove complicating factors.

Figure 6
EZ Inflation Looks Easy

Eurozone Headline MoM

10y Average MoM



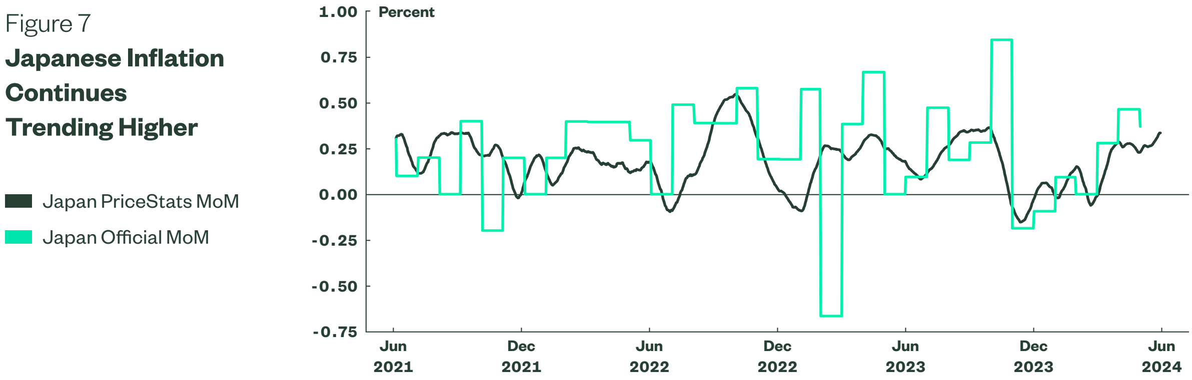
Source: State Street Global Markets, PriceStats, as of 30 June 2024.

Japan: No Time Like the Present for BoJ to Act

There's growing evidence that Japanese inflation has both reached its 2% target and is likely to stay at or above targeted levels. It has impressively risen toward the 2% goal with little intervention from the Bank of Japan (BoJ) from either a policy or currency perspective, as yen weakness remains a dominant market story.

Additionally, with PriceStats showing monthly data exceeding seasonal averages for the past quarter, it would seem an opportune time for the bank to take a step back from the extraordinary stimulus that has been in place for several decades. But it appears that the BoJ has little interest in hiking rates, even as the yen is again regularly trading above 160 versus the US dollar. Recent stress from underwater bond positions for some Japanese institutional investors dictates that the BoJ will need to tread carefully, although it's increasingly obvious that there's no time like the present for action (Figure 7).

Figure 7
Japanese Inflation Continues Trending Higher



Source: State Street Global Markets, PriceStats, as of 30 June 2024.

Q3 Investment Outlook

State Street Global Advisors has identified the key considerations for investors in the coming quarter, and how markets can be navigated using SPDR ETFs.

Investment Theme #1

High Yield and Convertibles: Sustained Momentum

- **The high yields on offer from the high yield asset class have provided investors with several successive quarters of positive returns and a soft economic landing suggests that the relatively benign backdrop is expected to continue. Convertible bonds offer a quality upgrade from high yield, while historically low deltas highlight considerable potential upside.**

High Yield Is Expected to Continue to Perform

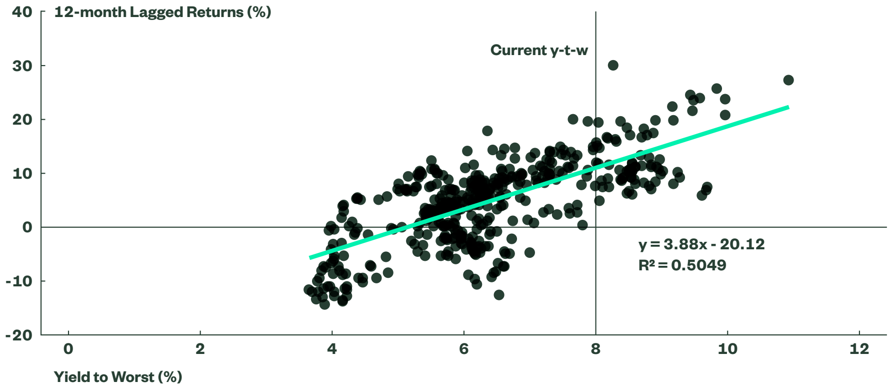
High yield has now delivered seven successive quarters of positive returns — quite a remarkable achievement given the broader backdrop of high levels of volatility. The short duration of high yield makes it less sensitive to big swings in yield while the high coupon provides holders with strong positive carry.

From a macro perspective, the backdrop continues to look supportive. In the Midyear Global Market Outlook, we outlined our expectations for a soft landing for the US economy coupled with a further easing in inflation pressures. This implies a gradual decline in interest rates as the Federal Reserve and other central banks ease policy. Lower-rated issuers could still be vulnerable but positive growth should support earnings. Declining rates should be more favourable considering the sizeable amount of debt that non-investment-grade issuers need to roll going into 2025. Ratings momentum looks consistent with the idea of a soft landing, as there has been a greater number of downgrades than upgrades, but the ratio is well above recent lows. There is also limited exposure to the worst rated paper.[1]

In the Q2 Bond Compass, we highlighted the high breakeven rates for high yield, i.e., the substantial degree to which the market would have to sell off for high yield strategies to lose money. The relative price insensitivity of high yield to moves in the underlying risk-free rate means that much of the return comes from coupons, which are currently high. This has been a key factor driving positive returns over recent quarters.

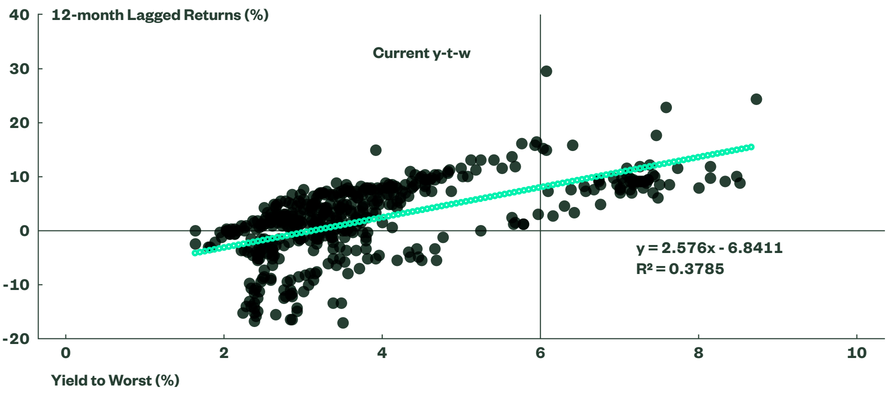
The following two figures show the dot plots of the US (Figure 8) and EUR (Figure 9) high yield index yield-to-worst plotted against the rolling 12-month returns from the indices lagged by 12 months. In other words, the 12-month total returns are shown relative to the yield at the time the investment would have been made. There is a correlation and, importantly, the 10-year history shown suggests that there have been no instances where investing at current yield levels would have resulted in a negative return.[2]

Figure 8
US HY Index Yield Versus 12-month Total Returns, Lagged by 12 Months



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 30 June 2024. Index: Bloomberg US Corporate High Yield Index.

Figure 9
Euro HY Index Yield versus 12-month Total Returns, Lagged by 12 Months



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 30 June 2024. Index: Bloomberg Liquidity Screened Euro High Yield Index.

French Politics

Investors may have some concerns over the most recent political issues in France. French issuers account for around 22% of the Bloomberg Liquidity Screened Euro High Yield Bond Index, meaning this has been one factor behind the widening of euro credit spreads from their tightest levels on 7 June. Looking at the index constituents in more detail shows that French names have widened by an average of 66 basis points (bps) between the end of May and 21 June, a week after the election had been called. This is a 23% widening of spreads at the end of May, compared to a 26 bps widening for non-French bonds, the equivalent of a 10% widening. This suggests there has already been quite a material repricing of French bonds within the index.

Upgrading Quality Through Convertible Bonds

If heavily allocating to non-investment-grade issuers at what feels like quite a late point in the economic cycle does not sit comfortably, convertible bonds have shown similarly robust performance year to date, but typically have a higher quality profile. The Refinitiv Qualified Global Convertible Index consists of about 55% investment-grade paper, meaning it is more reflective of a crossover exposure.[3] Being a global exposure, it is largely US-denominated paper (57.8%) and, therefore, also has more limited exposure to France (7.4%).

It has around 27.3% exposure to IT services, which may help it benefit from the 'halo effect' of being associated with Tech companies. They are typically smaller issuers, so could benefit in the event that market gains start to broaden out. The Refinitiv Qualified Global Convertible Index is strongly correlated to returns in both small and mid caps.

From a valuations standpoint, convertible bonds do not look stretched. The delta on the Refinitiv Qualified Global Convertible Index has dipped back to 41, having reached highs of over 45 earlier in the year.[4] This is below the long-term average for the index and implies that convertible bonds within the index have more 'bond-like' characteristics than 'equity-like'. This signals opportunity for price gains to accelerate as the underlying stocks move above their conversion prices.

1 The indices tracked by SPDR ETFs have little exposure to the worst rated paper. The Bloomberg Liquidity Screened Euro High Yield Bond Index has a CCC cut-off, while the Bloomberg SASB US Corp HY ESG Ex-Controversies Select Index has just 1.31% in CC or lower rated paper as of 30 June 2024.

2 See the recent Weekly ETF Brief, High Yield Still on the Up.

3 State Street Global Advisors, Refinitiv Indices, as of 30 June 2024.

4 Refinitiv Indices, as of 30 June 2024.

Investment Theme #2

Positioning for Easier Policy and Politics

- **Barbelling risk in European markets continues to appeal. It can provide a higher yield than just a straight government exposure for the same duration risk. There is also additional convexity, which can aid performance in the event that growth decelerates quickly.**

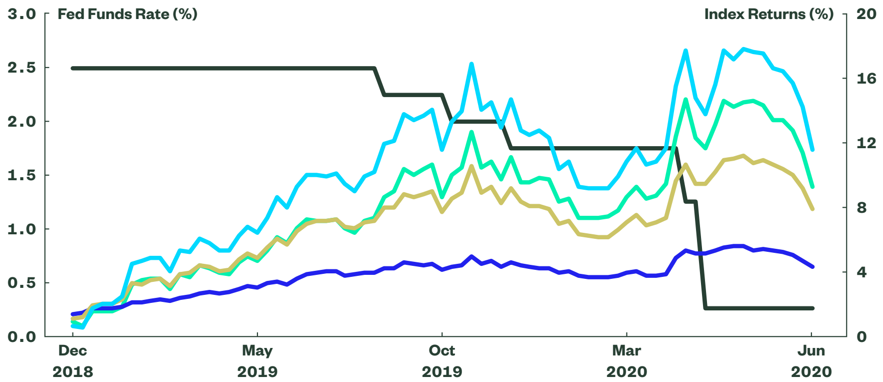
The market has, at times, clearly looked overly aggressively priced for Federal Reserve (Fed) cuts in light of the persistent strength of the US economy and stickiness of inflation. In addition, the inverted term structure of rates means that, as an investor, you are not compensated for extending out along the curve. As a result, we have preferred to focus on short-maturity strategies. On the data front, there are finally hints that the economic winds are changing. The Bloomberg US Economic Sentiment Index has been in negative territory for all but one of the past 13 weeks and is close to its February 2019 lows. In addition, as outlined in the 2024 Midyear Global Market Outlook, expectations are for inflation to ease further.

Cautiously Moving Towards Longer Duration

Figure 10 illustrates the value of being longer duration as the rate cutting cycle gets underway, with the 7-10Y maturity bucket outperforming shorter exposures and even the all-maturities index (which also has a slightly shorter duration). Being long duration produces higher returns if a cut is delivered, but can be costly if it does not materialise.

Figure 10
12-month Total Returns from Treasury Indices During the Fed's 2019 Rate Cut Cycle

- Fed Funds Target Rate
- UST All Maturities
- 1 to 3Y Maturities
- 3 to 7Y Maturities
- 7 to 10Y Maturities



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 30 June 2024.

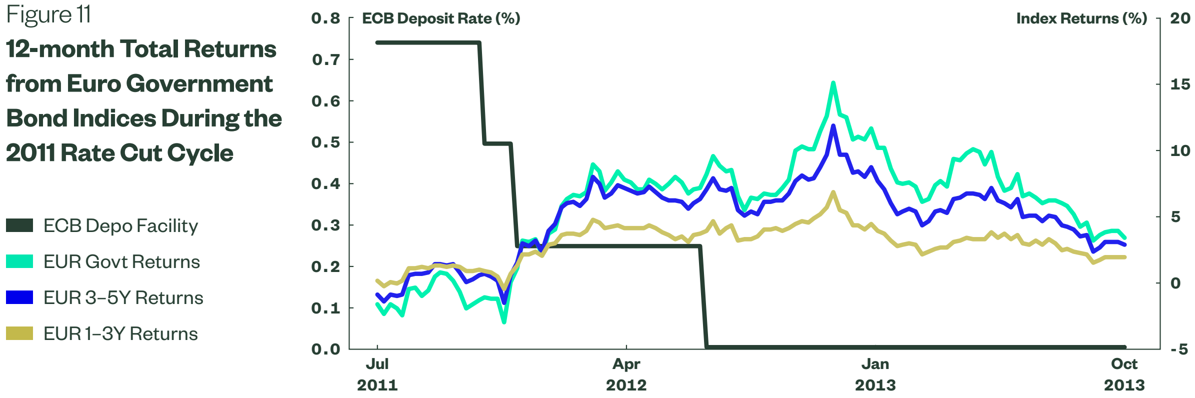
Pushing the first rate cut in the cycle further into the future has been a common theme this year. Even as we enter the second half of the year, the market does not have the confidence to price two full 25 basis point rate cuts from the Federal Reserve. This underlines both a lack of conviction that the economic data falls into line and complications around the US election.

The significantly lower returns for the short-maturity bucket (seen in Figure 10) suggest it is worth moving closer to neutral market duration. The 3–7Y part of the curve looks well positioned; its performance was in line with the all-maturity exposure in the run-up to the first Fed easing in 2019. However, for 2024 year to date, it has proved more defensive, with the most extreme losses in April being -2.5% against -3.4% for the all-maturities index.

The ECB Gets the Ball Rolling

For Europe, rate cuts are already in play. The ECB took their deposit rate down from 4.0% to 3.75% at the start of June. As suggested by Figure 11, which shows the mini easing cycle undertaken by the ECB in 2011, it makes sense to extend duration as the cuts get underway. For several quarters we have been advocating neutral duration positions but through a barbell structure: short-dated investment-grade credit for yield coupled with long-maturity government exposure to add duration and convexity. This has worked well, returning 24 bps more than the all-maturity government bond index over the quarter.[5]

Figure 11
12-month Total Returns from Euro Government Bond Indices During the 2011 Rate Cut Cycle



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 30 June 2024.

However, returns were still negative, as market pricing had been contaminated both by volatility in US markets and political issues in Europe. Only investors in the short part of the curve would have seen positive returns. Therefore, it may make sense to focus on the shorter part of the curve. As can be seen in Figure 11, the returns from the 3-5Y part of the curve kept pace with the all-maturities index during the early part of the 2011 easing cycle. It has also proved more defensive during the first half of 2024.

Bank of England Ready for Take-off

With the UK election now out of the way, the political backdrop looks more settled. Growth has rebounded after a weak end to 2023 and CPI has returned to its 2% target. The Bank of England (BoE) has the cover it needs to cut rates and two of the nine MPC members already voted to ease policy at the June meeting. That said, it is unlikely to adopt an aggressive stance given fears that CPI may creep higher into the end of the year. There is also uncertainty over growth. The new Labour government has plenty of ambition to kick-start the economy, meaning the BoE may be wary of expansionary fiscal policies. An increase in gilt supply may steepen the curve. While there are signs that the curve out to 10 years is reverting back to a steepness that is more consistent with the levels seen prior to the financial crisis, there is still some term premium rebuild that needs to occur to get there. In our opinion, given these uncertainties, it would make more sense to focus on the front end of the curve where the higher yield and shorter duration provides more protection.

5 Returns on the Bloomberg EuroAgg Treasury Total Return Index in Q2 2024 were -1.33% against a return of -1.09% from a barbell made up of 56% Bloomberg EUR 0-3 Year Corporate Bond Index and 44% Bloomberg EuroAgg Treasury 10+ Year TR Index.

Investment Theme #3

Emerging Markets Debt

- **Volatility in the US dollar continues to support the case for emerging markets hard currency exposure — for now. However, once US political uncertainty is out of the way and the Federal Reserve (Fed) embarks on a policy easing path, the outlook for local currency exposure should greatly improve.**

Hard-to-predict US Dollar Points to Hard Currency

Theme 3 of the Q2 Bond Compass revolved around emerging market hard currency debt. With US Treasury yields still high, the short-maturity ICE BofA 0-5 Year EM USD Government Bond Index returned close to 1% over the quarter. The short duration of the exposure (2.36 years) means the strategy has been fairly insensitive to the movements in US Treasuries while the coupon has provided the returns.

There is a risk that little changes over the coming quarter. Political uncertainty is likely to continue to underpin USD volatility. US growth appears to be slowing and inflation easing, but the political calendar has made the market reluctant to price in an early cut from the Fed, preferring to focus on the post-election meeting in November.

The key pushback to hard currency is that spreads to Treasuries are historically tight. While there are always idiosyncratic risks in emerging market countries, the average rating on the index is BBB, with only around 2.5% either rated below B- or not rated.[6] This may not eliminate the risks of spread widening but should limit the risks of issuer defaults in the event of a broader growth slowdown.

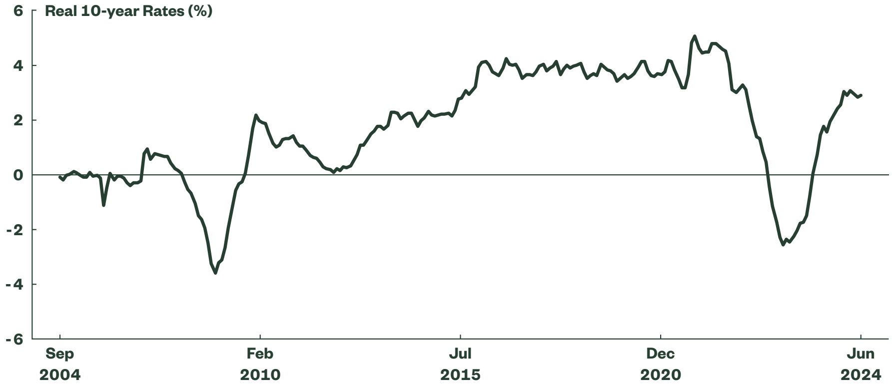
The draw of the strategy remains the breakeven rate of over 250 basis points (bps).[7] This is high from a historical perspective and implies that yields need to rise by around 250 bps before the price losses from the index offset the annual yield. This relatively large cushion is, perhaps, a reason why investors seem willing to tolerate such tight spreads to Treasuries.

Local Currency Outlook Still Hangs on the Fate of the USD

Returns for local currency exposures were around -2% in Q2. The strength of the USD proved a major drag on performance but there were also several markets, notably Brazil and Mexico, where FX weakness combined with negative bond price returns to hit performance. There were some positives such as South Africa and Turkey but these were unable to offset the wider negative returns.[8]

The story remains frustratingly similar: The USD looks over-valued by around 14% versus the currencies that comprise the Bloomberg EM Local Currency Liquid Govt Index.[9] Real rates are firmly in positive territory (Figure 12) meaning returns are positive once adjusted for inflation, and coupon returns remain strong at over 1% per quarter.

Figure 12
Emerging Market Real Rates Are Well into Positive Territory



Source: State Street Global Advisors, as of 30 June 2024. Real rates are the 10Y nominal bond yield minus the annual rate of CPI for the countries included in the Bloomberg EM Local Currency Liquid Govt Index, weighted according to the index weights.

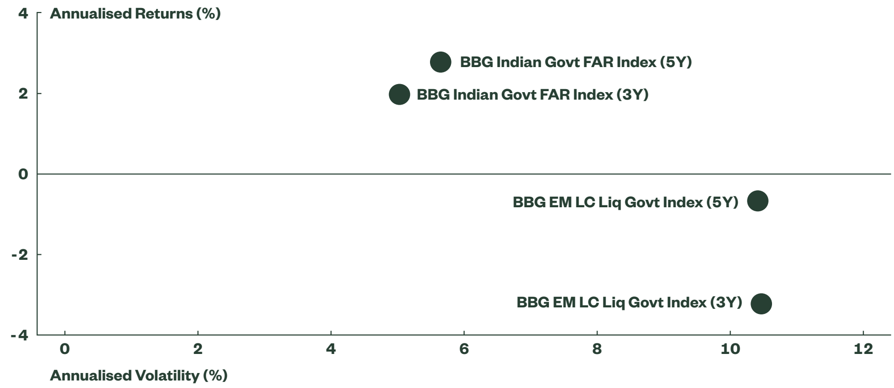
The factors spoiling the party are clearly USD strength and correlations to US Treasuries. There is some positive news on the latter factor, as EM debt returns do appear to be de-coupling with the 12-week correlation of returns dropping to 51% by the end of June against highs of over 87% in early March. However, the USD is likely to remain volatile ahead of the US election and the uncertainties around the timing of the first rate cut from the Fed.

India Joins the Club

Indian Fully Accessible Route (FAR) bonds are starting to be included in emerging market local currency indices. JP Morgan announced its inclusion in their EM indices from end June 2024 and Bloomberg will start including them from January 2025. The size of the market means that India FAR bonds will ultimately hit the 10% cap applied to many indices. When fully incorporated, the net effect for the Bloomberg Local Government Index 10% Capped Index should be a slight increase in yield (+3 bps) and a lengthening in duration (+0.1 years).[10]

So the impact on index risk characteristics looks limited but there should be benefits from an improvement in returns and a reduction in volatility. Figure 13 illustrates this by showing the higher 3- and 5-year annualised returns and lower volatility of the Indian Government FAR Bond Index versus the Bloomberg EM Local Currency Liquid Govt Index.

Figure 13
Higher Returns and Lower Volatility from the Indian Government FAR Bond Index than for the Broader EM Index



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 30 June 2024.

6 Bloomberg Finance, L.P., as of 30 June 2024. Ratings are generic quality rating from Bloomberg, based on the conservative average of Moody's, S&P and Fitch.

7 State Street Global Advisors, as of 30 June 2024. The ICE BofA 0-5 Year EM USD Government Bond Index has a yield to worst of 5.93% and a duration of 2.36. The breakeven rate is the YTW/Duration = 2.51%.

8 Bloomberg EM Local Currency Liquid Govt Index returns were -2.0% for Q2 2024, with currency returns accounting for -2.72%, price returns -0.51%, and coupon +1.27%.

9 Overvaluation based on SSGA model of currency values, as of 30 June 2024.

10 Estimates provided by Bloomberg.

Important Information

Marketing Communication.
Information Classification:
General Access.

State Street Global Advisors

Worldwide Entities

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