Bond Compass

Q4 2024

STATE STREET GLOBAL ADVISORS SPDR®

A Leader in Fixed Income Index Investing

$619

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 $619 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 September 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

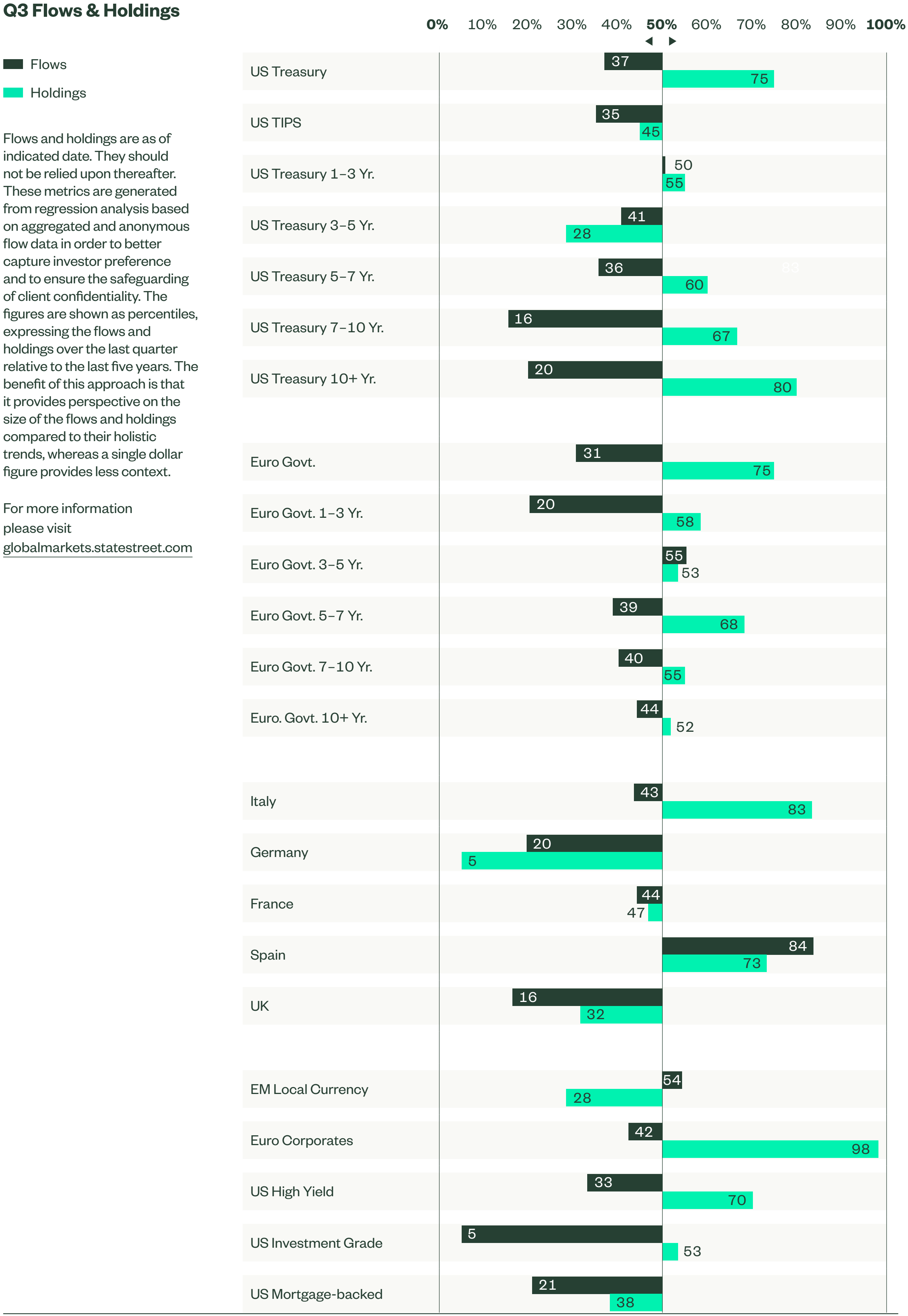
This data captures behavioural trends across tens of thousands of portfolios and is estimated to capture just over 10% of outstanding fixed income securities globally.

Emerging Markets Come Into View

The third quarter brought significant relief for fixed income market returns as economic data softened, inflation faded, and the Federal Reserve (Fed) finally began its easing cycle with a larger-than-expected 50 basis point (bp) rate cut. However, our investor sentiment metrics suggest we should be careful in extrapolating the impact of these moves into Q4.

Long-term investor flows into sovereign fixed income were surprisingly tepid in the quarter, across countries and products (Figure 1). In many cases, quarterly flows were not significantly different from the average, but in the context of such robust market returns they are a cautionary tale. Meanwhile, demand for investment-grade (IG) corporate bonds, gilts and 10-year Treasuries were outright weak. We'll review what this caution may mean and explore some surprising pockets of strength in emerging markets and Europe.

Figure 1
Q3 Flows & Holdings



Flows and holdings are as of indicated date. They should not be relied upon thereafter. 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 the flows and holdings compared to their holistic 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 September 2024.

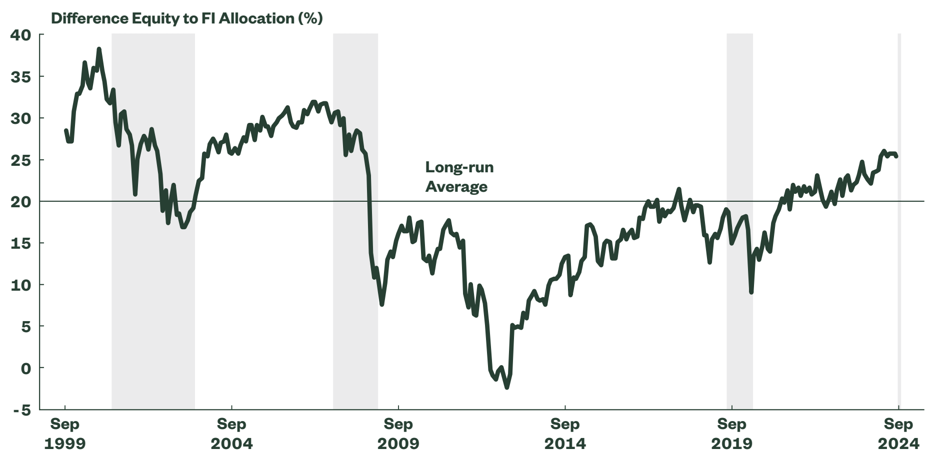
Bond Holdings Low Given Easing Cycle's Start

As gloomy as the short-term picture on bond market behaviour looks, taking a broader view across State Street's measures of long-term investor positioning highlights a more medium-term strategic balance of risks. Our monthly institutional investor indicators show that allocations to equities are still more than 25% of portfolio weight higher than allocations to fixed income assets (Figure 2). This is 5% higher than the 25-year average of 20%. While this allocation gap in favour of equities was higher in the late 1990s and again in the mid-2000s, it's notable that the gap has shrunk in favour of bonds during each of the three Fed easing cycles in the past quarter of a century.

This insight is reinforced by our work on long-term portfolio construction, which finds that the observed correlation between stocks and bonds since the 1970s is highly regime dependent. Specifically, higher inflation regimes are often associated with positive correlations between stocks and bonds, while low inflation regimes are not. With Fed easing cycles by definition occurring in the latter, we should expect the diversification properties of stocks and bonds to return. In other words, the "everything rally" we have enjoyed at various points this year may not last.

Figure 2
Difference Between Long-term Investors' Allocation to Equities and Fixed Income

Equity Minus Bond Allocation (%)
Fed Easing Cycle



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

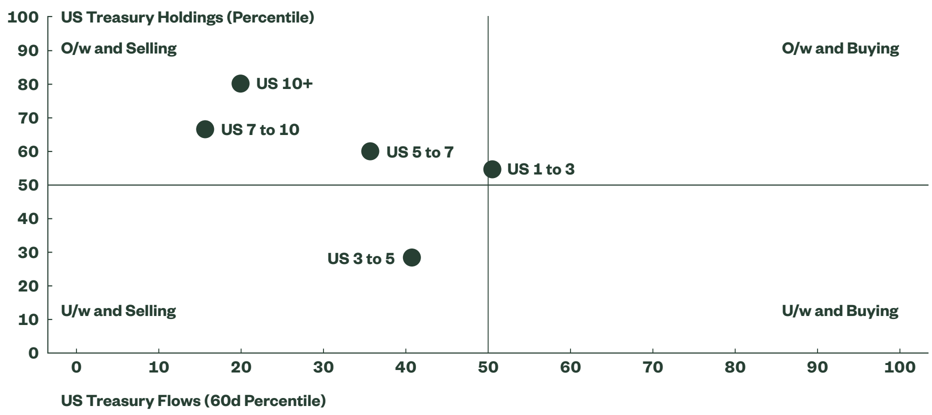
Curve Ball: Positioning Risks for Treasuries Dip

For the first time in 10 quarters, our flow metrics show long-term investor demand for emerging market (EM) sovereign debt was stronger, on a relative basis, than demand for Treasuries. This appears to imply both a stronger, broader risk appetite and a desire to de-risk on US assets ahead of the Presidential election.

The third quarter was good for Treasury returns, but it was somewhat turbulent. At one point, recession concerns were sufficient to prompt market chatter about the possibility of an intermeeting ease. Even after all that, the 50 bps Fed cut, when it came, was still something of a surprise, especially to most economists. On top of that, while inflation data has been well-behaved (see more in PriceStats), labour market data has been both volatile and prone to revision. Against this backdrop — with added election risk through early November — long-term investors have opted to temper their demand for US duration. While flows were weak across the curve over the quarter, they were even weaker in buckets where long-term investor holdings are the highest (Figure 3). It's likely that this simply reflects a position adjustment in light of the curve steepening that accompanied the beginning of the easing cycle, as well as upcoming event and data risk.

That said, given the relative paucity of potential Treasury demand from other investor types, this will be a key behaviour to watch in 2025, when long-term asset manager demand for Treasuries will be an essential part of the greatly increased funding ask from the Treasury.

Figure 3
Treasury Risk Reduction



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

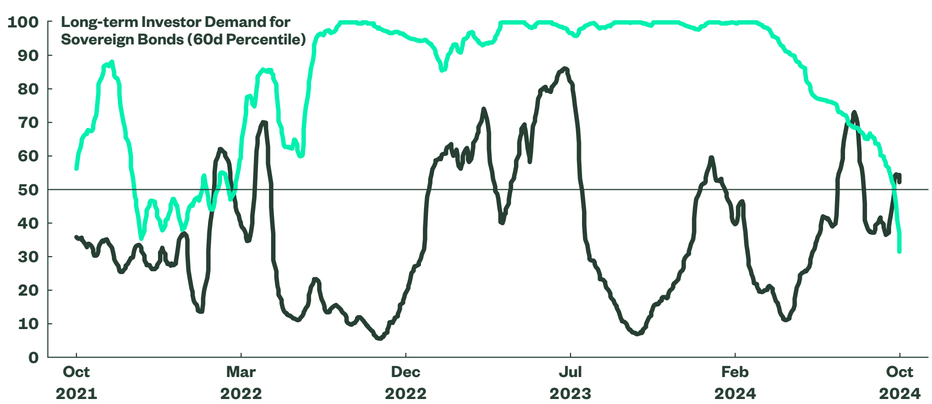
Emerging Risk Appetite

For the first time in 10 quarters, our flow metrics show long-term investor demand for EM sovereign debt was stronger on a relative basis than demand for Treasuries (Figure 4). This speaks to more than a reduction in positioning. Investors have been overweight long-dated Treasuries and underweight EM debt for some time. It could hint at a turn in risk appetite in fixed income more broadly.

The beginning of the Fed's easing cycle could support local currency EM bond markets, especially if it encourages a depreciation of the US dollar, leaving room for further easing from EM central banks. As we discuss in the PriceStats section, encouraging inflation news in emerging markets could boost central bank easing. Also, our metrics of investor behaviour show long-term investors are underweight emerging markets and reassessing that risk in light of potentially improving fundamentals. Third quarter inflows showed a relatively modest recovery, barely above the 50th percentile. But September saw a much stronger swing in sentiment. Inflows rose into the 80th percentile after Fed easing.

Finally, the additional stimulus from the Chinese authorities at the end of September has had an excellent reception in financial markets, which may limit the risk of a sharper downturn in global growth and could further improve the fundamental backdrop for a re-risking in EM bonds.

Figure 4
Sovereign Emerging Market Debt Demand Rising Sharply



Source: State Street Global Markets, as of 30 September 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®

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.

Global Inflation on the Run

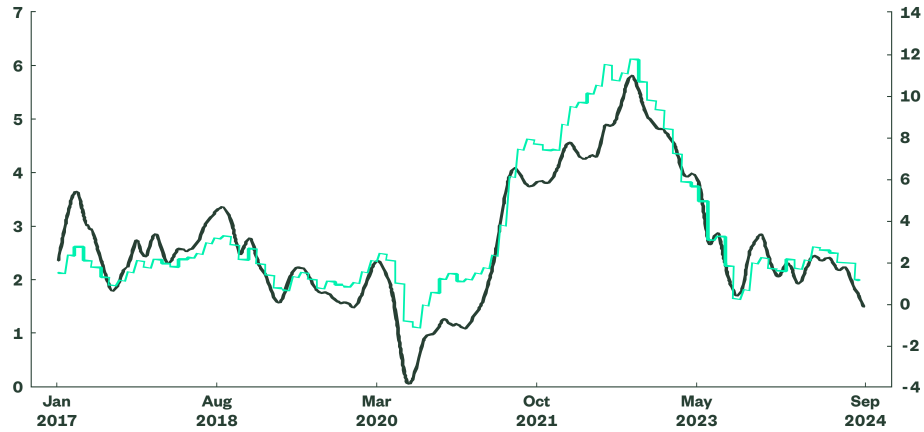
US Inflation Risks Recede Further

The beginning of the Fed's easing cycle has removed one uncertainty for rate markets, but the pace and end point of the cycle remain up for debate. This will be settled by the evolving balance of risks around incoming labour market and inflation data. On the latter, PriceStats provides a good deal of reassurance. PriceStats ended the third quarter benignly, with the US price level falling modestly in September. This was sufficient to bring the annual inflation rate according to PriceStats below 1.5%, its lowest reading in almost three years.

This is in keeping with the softer trend in official data, especially measures excluding shelter (Figure 5). Although shelter, which is not captured directly by PriceStats, remains a challenge, Fed Chair Powell recently reinforced the idea that as long as new rental inflation remained benign, the Fed could be relaxed about the stickiness of shelter prices. In short, if you dismiss shelter CPI as simply lagging, there's no need to worry about the US inflation trend for now. This will open the way for the pace of policy normalisation to be dictated by the rate of deterioration (or otherwise) in the labour market.

Figure 5
US Remains Sheltered From the Inflation Threat

PriceStats (YoY%)
US CPI (Ex-shelter) YoY%, RHS



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

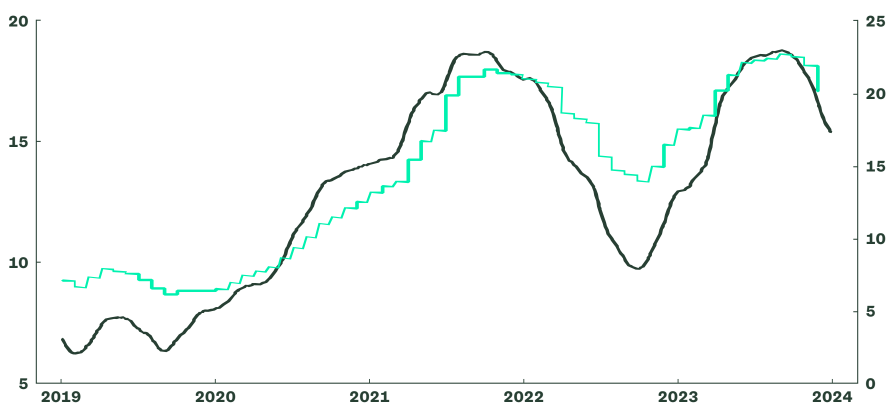
Emerging Market Inflation in Retreat

Part of the narrative of potentially improved fundamentals for EM sovereign debt is lower inflation. Both the interest rate and inflation cycles across emerging markets have in some cases been a number of months ahead of developed markets. To that end, it's important to track whether the good news on inflation will continue across emerging markets.

The good news from PriceStats is that annual food price inflation, which is a large part of many EM baskets, has fallen back to its lowest level this year (Figure 6). This could be an especially important factor in Mexico and South Africa. PriceStats captures their annual inflation rates are running below the official statistics, suggesting room for further policy easing.

Figure 6
Emerging Inflation Is Trending Downwards

PriceStats EM Inflation (YoY%)
Official Data (YoY%) RHS



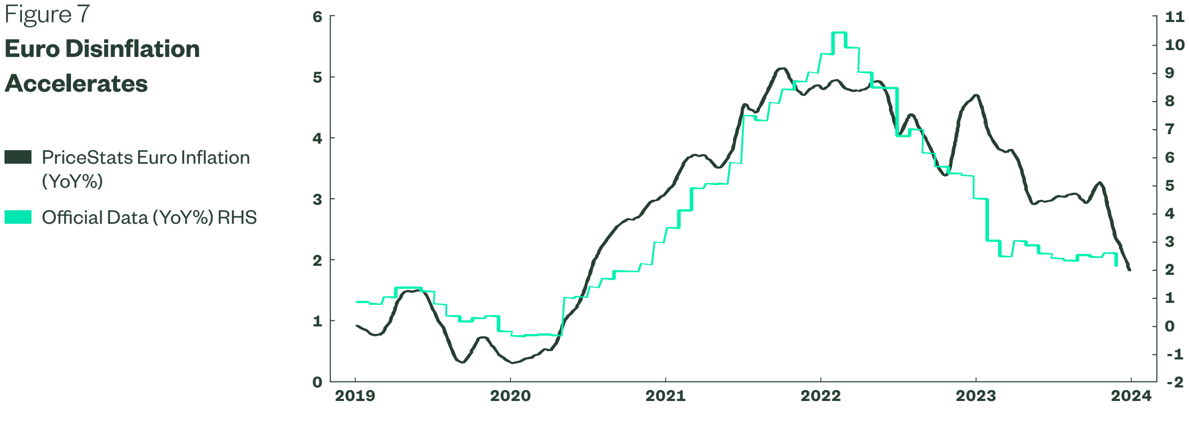
Source: State Street Global Markets, PriceStats, as of 30 September 2024.

Improving Inflation News for Europe

In contrast with the Fed, the European Central Bank's easing cycle had been well telegraphed since almost the start of this year, to begin in June and progress at a pace of 25 bps a quarter thereafter. But the lurch lower in leading indicators and recent acceleration in the pace of disinflation are prompting markets to consider something quicker (Figure 7).

The softer trend in inflation is borne out by our PriceStats data, which shows the eurozone's annual inflation rate fell by more than 1.4 percentage points in the third quarter alone. While part of this was due to favourable base and energy effects, there is still a clear softening in the underlying inflation trend, which suggests weaker economic activity is finally impacting companies' pricing power. Interestingly, this rapid change in the inflation trend and potential for further easing have yet to dramatically alter investor behaviour toward European sovereign debt, especially Bunds, where long-term investor demand remains unusually weak. This will be something to watch for in Q4.

Figure 7
Euro Disinflation Accelerates



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

Q4 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

Convertible Bonds Enjoying a Sweet Spot

- **The bonds and stocks rallies in Q3 have created a sweet spot for convertible performance. A soft landing may continue to support performance — and the different composition of convertible bonds to either high yield or small-cap equities can help diversify risk. They can also be a defensive play if equity volatility picks up.**

Bonds and Stocks Align

The negative drag from the bond market during H1 weighed on convertibles — but this weakness has morphed into a strength during Q3. The Fed rate cut has supported Treasuries which, coupled with a still favourable risk backdrop, has seen convertible bonds post returns for the quarter that have been higher than for the S&P 500 Index.[1]

Convertibles should remain in their sweet spot if risk assets continue to do well at the same time that the Fed eases policy. The Fed's validation of the cuts that are priced by the market should provide a solid basis for small- and mid-cap equity performance, which correlates well with convertibles.[2] The risks come from an increase in fears over a hard landing, which would certainly damage risk sentiment. A hard landing is not the central view of State Street Global Advisors, but some further deceleration of the US economy does still seem likely. For this reason there may be some caution from investors about taking on too much credit risk. However, the ratings profile for convertibles is a crossover one with 57.5% rated as investment grade,[3] which implies it should be less exposed to a meaningful slowdown in growth than high yield strategies.

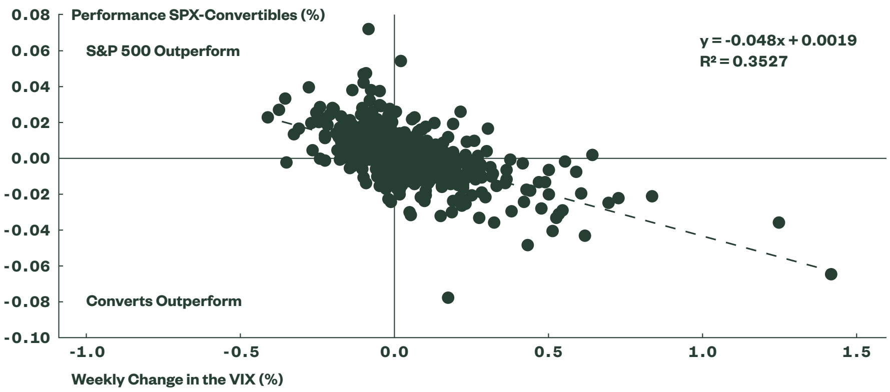
A Different Asset Mix Helps Diversification

As well as offering a different credit mix to high yield bonds, convertibles also provide some sector diversification, with a far lower allocation to financials than the Bloomberg Global High Yield Index, which is around 35% financials. The Refinitiv Qualified Global Convertible Index is more concentrated in Tech, which accounts for close to 27% of the index. However, these stocks are predominantly those of small- and mid-cap companies which have not had the huge run-up in prices that the Big Tech, Magnificent 7 type of stocks have.

August was a typical example of how convertible bonds can help portfolio stability in markets struck by sudden volatility. It was a month of large asset price swings, particularly among small caps, in reaction to economic data and central bank commentary, so performance was mixed versus longer-duration fixed income indices given the drop in yields. However, convertibles largely outperformed their own underlying stocks and also demonstrated favourable convexity, a feature that makes convertibles an interesting tool in a portfolio.

Looking at a 10-year history of the relative performance of convertibles versus the S&P 500 suggests that as equity volatility — as represented by the VIX — rises, the relative trade-off of returns swings away from the S&P 500 and becomes more in favour of convertibles. There is an element of multicollinearity in that the VIX is the expected volatility of the S&P 500 but, as can be seen in Figure 8, the more extreme rises in the VIX have historically been associated with a relatively stronger performance from convertibles than straight equity — the lower right-hand quadrant.

Figure 8
Relative Performance of the S&P 500 vs Convertibles in Times of Volatility



Source: State Street Global Advisors, Bloomberg Finance, L.P., as at 30 September 2024. Performance is weekly change in the S&P 500 — weekly change in the Refinitiv Qualified Global Convertibles Index.

If the soft-landing narrative holds while inflation continues to slow, then convertible bond performance over the next few quarters will remain dictated by a potential broadening of equity market performance. Fears of a recession could dent the positivity- but valuations remain balanced. The Refinitiv Qualified Global Convertible Bond Index delta stands at circa 44 as of the end of September, which is below its long-term average and this has historically been associated with gains of between 8 and 9% over the succeeding 12 months.

1 S&P 500 Index total return from 28 June 2024 to 30 September 2024 of 5.89% versus 6.30% for the Refinitiv Qualified Global Convertible Index.

2 The Refinitiv Qualified Global Convertibles Index has a correlation of 86.6% to the MSCI World Small Cap Index based off five years of weekly observations. State Street Global Advisors, Bloomberg Finance, L.P., as at 30 September 2024.

3 Constituents of the Refinitiv Qualified Global Convertibles Index as rated by FinAPU, as at 31 August 2024.

Investment Theme #2

Fed Easing See-saws EM Debt Performance Toward Local Currency

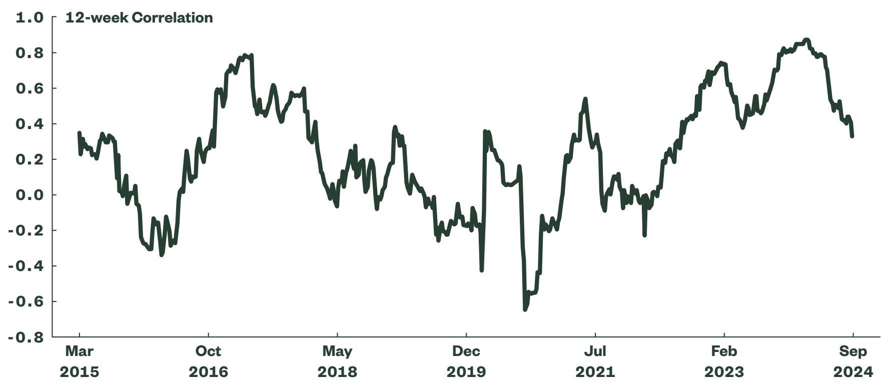
- **The start of the Federal Reserve's easing cycle should be supportive of EM debt, both because it opens the door for local central banks to cut rates and undermines support for the USD. High yields on EM bonds are also appealing. There are risks, most notably from the US election, but strong year-end seasonals could help performance once the election fog clears.**

Federal Reserve Swings the Pendulum

Over the past couple of quarters our preference has been for EM hard currency exposures. With hard currency debt being a 'spread product' to US rates, hard currency provided a consistent return while Fed rates remained high. Yields are still high (yields on the JP Morgan EMBI Global Diversified Index is at 7.5%),[4] but with the US rates market pricing in significant policy easing and spreads to Treasuries historically quite tight, there is less scope for EM hard currency debt to post meaningful returns above Treasuries.

Yields on local currency exposures are lower (the yield-to-worst on the Bloomberg EM LC Liquid Index is 6.05%)[5] but correlations to US Treasuries have declined significantly since early 2024 (Figure 9). Looking at the 12-week rolling average of the returns from Treasuries and EM local currency debt, they have dipped below 35%. Given the amount of easing already priced into the US curve, this may provide some diversification for portfolio returns.

Figure 9
EM Local Currency Debt Correlations to Treasury Returns Are Falling



Source: State Street Global Advisors, Bloomberg Finance, L.P., as at 30 September 2024. Shown above, the 12-week rolling correlation of returns for the Bloomberg EM Local Currency Liquid Government Index versus the Bloomberg US Treasury Total Return Index.

More importantly, the move by the Fed to cut rates swings the pendulum in favour of local currency exposure for two key reasons:

- Given the proportion of EM returns that are typically determined by moves in forex, we have long pointed to the 'overvaluation' of the USD versus EM currencies as a reason to be constructive on EM assets. However, the USD has been a consistent thorn in the side of investors in local currency exposures, with the most recent bounce-back in the USD in H1 2024 undermining returns. However, since the Fed signalled that it was heading towards cuts, the USD has struggled. Even early August volatility failed to spur a flight to the safety of the dollar. As the prop of higher US rates is removed, the USD could continue to depreciate.

- Fed easing should also give EM central banks confidence that they can also cut rates. Many have started their easing cycle but may have been reluctant to go too far in case the move in interest rate differentials undermined their currencies. Real interest rates remain at higher levels for EM central banks (3.2%) than for either the Fed (2.5%) or the ECB (1.45% using Euro HICP) suggesting there remains more room for EM central banks to ease policy.[6]

These have combined to support returns over the past quarter, which for the Bloomberg EM Local Currency Liquid Govt Index were 4.2% in Q3 for currency returns and 2.8% for bond price returns. The final element to add in is the strong coupon flow of 1.2% for the quarter to bring total returns for Q3 to 8.3%.[7]

Hurdles Ahead

Interest rates in EM are high but not all central banks are at the same stage of the policy cycle. Brazil put interest rates up on the same day that the Fed eased policy. However, given high real yields and still easing inflation pressures, the trend should be for central banks to cut rates over the coming few quarters.

Another potential hurdle is the US election. The imposition of a new round of tariffs under a Trump administration could hurt economic growth in some EM nations. This would be more of a consideration for equity investors but could still impact EM debt if the USD strengthens or it causes investors to reduce their risk appetite. China is seen as particularly vulnerable, but the recent round of stimulus should, to a degree, help to rebalance the economy towards domestically generated growth. Looking at the 2016 election, EM debt slid sharply on the result, but then rallied from December 2016 onwards as the risk-on mood started to build, largely driven by the surge in equities.

For 2024, election timing may also tie in with the market's seasonal factors, as the final quarter of the year has typically proved quite positive for EM debt. Over the past 10 years, returns for the quarter have only been negative in three years (2014, 2016, and 2021), with returns in November and December especially strong (average returns of 2.1%).

4 Bloomberg Finance, L.P., as at 30 September 2024.

5 Bloomberg Finance, L.P., as at 30 September 2024.

6 State Street Global Advisors, as at 30 September 2024. Real rates are the central bank rate less year-on-year headline CPI. The EM central banks real rate is weighted in line with the central banks in the Bloomberg EM Local Currency Liquid Index.

7 Bloomberg Finance, L.P., as at 30 September 2024.

Investment Theme #3

Is It Time to Reduce Credit Risk?

- **The backdrop for risk assets is gradually deteriorating, prompting questions over whether it is time to rotate into lower-risk credit. For the Euro area this looks like a reasonable strategy, but less so for US fixed income.**

A Higher Yielding World

The third quarter of 2024 capped a remarkable run for high yield strategies, marking an 8^{th} successive quarter of positive returns. The argument advanced in the Q3 Bond Compass, that the yield that the strategy was initially invested in is a strong determinant of 12-month total returns, still holds. With US high yield offering around 7% and Euro around 5.80%, based on the historical relationship of yields to returns over the following 12-months, it would be unusual for investors to suffer losses. That said, spreads remain relatively tight from a historical perspective and there are signs of stress emerging for non-IG issuers. The upgrades/downgrades ratio has been below one for the past nine quarters in the US for both Moody's and S&P agencies. Europe has been more mixed but also hints at a gradual deterioration in credit quality.

In addition, there will be around USD100B in redemptions for the US market and EUR52B for Euro high-yield issuers in 2025. To date, issuance has been subdued, with issuers reluctant to pay such high outright rates. However, with rates coming down, there are risks of a resurgence of issuance in 2025.

Is It Time to Reduce Risk?

Risk assets have had a strong run but the fundamentals no longer look as supportive. An obvious risk mitigation strategy is to improve the credit quality of investments. There are several factors that need to be assessed:

- **Yield give-up** Yields on IG exposures are not as appealing as high yield, at 4.7% for US IG and 3.25% for Euro. However, this is only one source of returns and, in total return terms, IG did outperform high yield over Q3.[8]

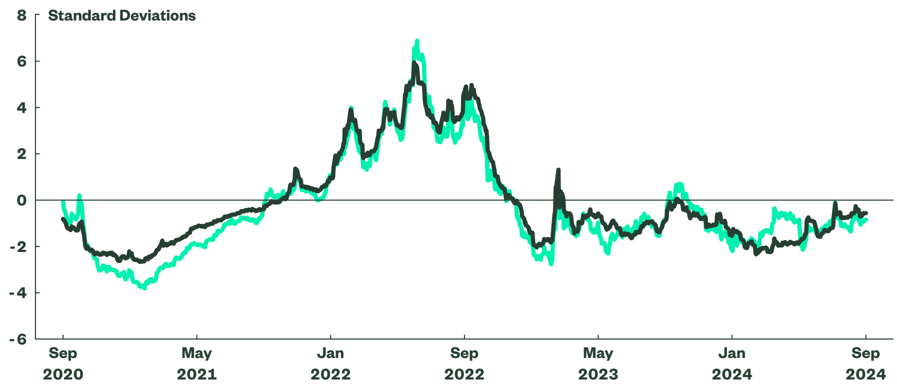
- **Balance sheet risks** Balance sheet stresses are less evident in IG, which should ease concerns over economic weakness. The upgrades/downgrades ratio for US IG was above 2.5 in Q3 for both S&P and Moody's, although there were five fallen angels during the quarter. In Europe the ratio was above three for both S&P and Moody's, and there were 10 fallen angel issuers, although several had the same parent company.

- **What is priced in spreads** Spreads are fairly tight from a historical perspective, but off their tightest levels seen in late May (Figure 10). Looking at the index option-adjusted spreads suggests little difference in the tightness of US corporate spreads between IG and non-IG indices, with both around -0.75 standard deviations to their 12-month average. For Euro-denominated paper, IG looks less rich (-0.6 standard deviations) than high yield (-0.9 standard deviations) to their 12-month average spread.[9]

Figure 10
Euro IG Spreads Look Less Rich Than High Yield

Bloomberg Euro Aggregate Corporate

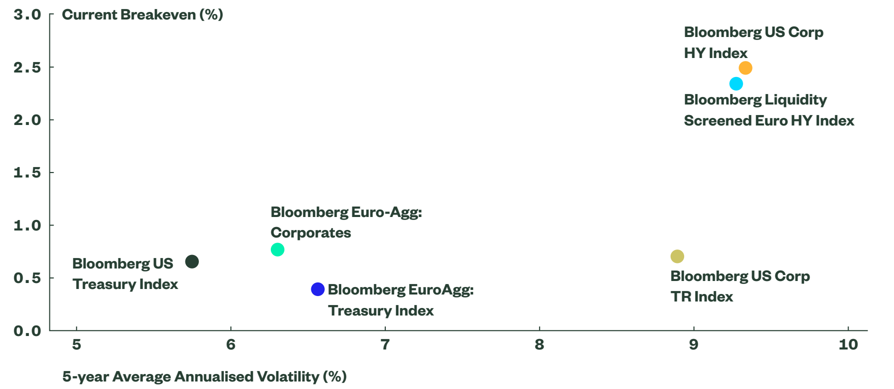
Bloomberg Liquidity Screened Euro HY Index



Source: State Street Global Advisors, as at 30 September 2024.

- **Breaking even** A key reassurance for high yield investors has been the high breakevens, or the degree that yields have to rise to offset the yield gained from holding the strategy for a year.[10] These remain high, well above two, in the sub-IG world but, given lower yields and longer durations, substantially lower in IG strategies. Surprisingly, as illustrated in Figure 11, US IG corporates have a similar breakeven to Treasuries but a higher level of volatility. Conversely, in Euro, IG corporates offer higher returns and slightly less volatility.

Figure 11
Breakevens Versus Volatility



Source: State Street Global Advisors, as at 30 September 2024. Breakeven rate: yield-to-worst\ option-adjusted duration of the index. 5-year average annualised volatility of the index.

To Rotate or Not?

Pulling the above factors together suggests some merits to reducing risk in Euro credit strategies. Given the weakness of the Euro area economy, there may be some advantages to the longer duration and greater convexity of IG. The balance sheet of IG issuers looks more robust while spreads seem slightly more stretched for high yield than IG. Lastly, IG offers a better risk-reward trade-off than government bonds with a higher breakeven and lower levels of volatility.

For the US it is less clear. High yield spreads to Treasuries may be tight, but no more so than IG, and they seem more justified by the stronger US growth dynamic. Switching out of high yield into IG implies a significant drop in yield and extension in duration, reducing the breakeven but not necessarily the volatility.

8 Non-annualised returns in base currency from 30 June 2024 to 30 September 2024 were 2.88% for the Bloomberg Liquidity Screened Euro HY Index vs 3.27% for the Bloomberg Euro-Agg Corporate Index and 5.8% for the Bloomberg US Corporate High Yield Index vs 5.84% for the Bloomberg US Corporate Index.

9 State Street Global Advisors, as at 30 September 2024. Based off Bloomberg Liquidity Screened Euro HY Index, Bloomberg Euro-Agg Corporate Index, Bloomberg US Corporate High Yield Index, and Bloomberg US Corporate Index.

10 State Street Global Advisors, as at 30 September 2024. Breakeven rate calculated as yield-to-worst divided by the option-adjusted duration of the index.

Important Information

Marketing Communication.
Information Classification:
General Access.

State Street Global Advisors

Worldwide Entities

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