Insights
Fixed Income

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How Fixed Income Can (Still) Provide an Anchor to Windward

Jake Brown, CFA®
Head of US Fixed Income Client Portfolio Management

A variety of strategies and tactics can help enhance diversification and return in fixed income portfolios.

The financial markets' turbulence since mid-February has been well chronicled. (See the State Street Global Advisors Insights page for our thoughts on the matter.) In addition to concerns about ongoing changes in trade policy, immigration rules, and government spending, investors and business leaders are worried about the overall lack of clarity and stability in policy — including difficulty discerning which pronouncements represent genuine intentions versus negotiating tactics.

Both equity and bond markets have been exceptionally volatile:

- The S&P 500 nearly entered bear market territory, dropping 19% between February 19 and April 8, as the VIX spiked to levels last seen in the early days of the COVID-19 pandemic. The benchmark equity index subsequently recovered, and as of early July it had reached a new all-time high.
- The yield on the 10-year US Treasury note swung from a closing high of 4.62% on February 12 to a low of 3.99% on April 4, then rose back to 4.60% in late May before once again retreating.

US Treasuries historically have helped stabilize portfolios during periods with turbulent equity markets. Many of our clients are trying to determine how they can use fixed income to play this role today, when sources of volatility seem to shift daily. We have several ideas for fixed income strategies and tactics that may help manage risks by improving diversification and have the potential to generate additional return as well.

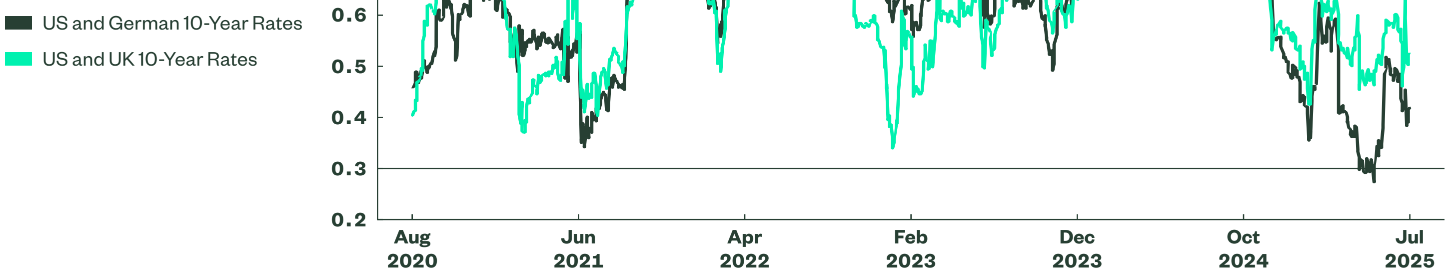
International Opportunities

The United States is the epicenter of today's turbulence, and shock waves are emanating outward from US markets. The diversification provided by exposure to other bond markets could help mute their impact.

The current trade war represents an escalation of a trend toward deglobalization that picked up steam amid COVID-related supply chain disruptions. Deglobalization has a silver lining for fixed income investors: As countries pull back on foreign relationships to varying degrees, we expect economies to experience divergent growth, inflation, and policy trends. Those differences will affect bond markets, likely leading to a wider range of opportunities for return and diversification. For example, US 10-year Treasury rates' correlations with UK and German sovereign rates fell immediately following the US presidential election, partially recovered, then plunged again following the announcement of tariff policies in April 2025 (Figure 1).

Figure 1

Correlations Between US Treasury Rates and Other Sovereign Bond Rates Have Fallen



Rolling 60 day correlation between US, German, and UK 10 year interest rates. Source: Bloomberg. As of July 9, 2025.

We currently see opportunities in several markets:

- In Europe, the central bank is cutting more aggressively than the US Federal Reserve.
- In Germany, high issuance and potential budget changes may lead to a steepening yield curve. German bund yields' remarkable stability as Treasury yields jumped between April 8 and April 11 illustrates their diversification potential.
- In the UK, real yields on long-duration bonds have risen faster than expectations for growth and inflation.

Systematic Active Fixed Income

Active management can help enhance a fixed income allocation's returns without sacrificing the qualities that help it stabilize a broadly diversified portfolio — namely regular income payments and low correlations to other asset classes.

Systematic active fixed income (SAFI) strategies use a quantitative approach that emphasizes specific investment factors. SAFI strategies seek to add a level of excess return similar to that of traditional, fundamental active strategies. Because systematic and fundamental strategies derive alpha from different sources, the two approaches' excess returns can have low correlations to each other, providing the potential to enhance diversification in the overall fixed income allocation (Figure 2).

Figure 2
SAFI Has Produced Low Correlations to Fundamental Active Strategies

	Bloomberg US IG Corp Index	SAFI US IG Corp Backtest	Western US IG Credit Plus	Loomis IG Corp Credit	Western US IG Credit	Invesco US Corp Credit	GSAM US IG Credit	PIMCO IG Corp	Voya IG Credit
Bloomberg US IG Corp Index	1.00								
SAFI US IG Corp Backtest	0.53	1.00							
Western US IG Credit Plus	0.84	0.56	1.00						
Loomis IG Corp Credit	0.85	0.52	0.84	1.00					
Western US IG Credit	0.82	0.55	0.83	0.82	1.00				
Invesco US Corp Credit	0.70	0.59	0.72	0.69	0.53	1.00			
GSAM US IG Credit	0.77	0.51	0.66	0.79	0.77	0.56	1.00		
PIMCO IG Corp	0.44	0.50	0.61	0.47	0.45	0.64	0.44	1.00	
Voya IG Credit	0.50	0.31	0.65	0.59	0.43	0.49	0.31	0.46	1.00
Mean	0.68	0.51	0.70	0.67	0.63	0.60	0.58	0.51	0.46

Fundamental Active US Credit Managers with AUM > $20B Sources: State Street Global Advisors, eVestment, Bloomberg Finance, L.P. As of December 31, 2024. Analysis is conducted on the largest fundamental active credit managers by AUM as of 6/30/2024 using monthly excess returns vs. manager preferred benchmarks from December 2010 to December 2024. Credit index excess returns are defined as excess returns over like-duration Treasuries for the Bloomberg US Investment Grade Corporate Bond Index. Manager returns are gross of fee. Performance is calculated based on monthly total returns for the back-tested model portfolio with assumed transaction costs based on Barclays Liquidity Cost Score (LCS) measure, which is a widely used liquidity model in the investment industry. LCS represents a bond-level transaction cost expressed as a percent of a bond's price, and measures the cost of an immediate, institutional-size, round-trip transaction. Total returns for the Bloomberg US Investment Grade Corporate Index do not take into account transaction costs. Back-tested performance is the result of applying an SSGA model to market data that predates the model, in order to yield results that predate the model's inception (i.e. all data is back tested) OR the results of an SSGA model, some of which predates model inception, and some of which was generated after model inception. Analysis is done on back-tested performance based on SSGA's Model Portfolio Optimization process, taking factor inputs from QPS Indices. The back-tested performance presented herein reflects the output of the SSGA Model Portfolio Optimization process portion of the Systematic US Investment Grade Corporate strategy only and does not reflect or incorporate any potential deviations from the model portfolio at the time of implementation. The data displayed is a hypothetical example of back-tested performance, is for illustrative purposes only, and is not indicative of the past or future performance of any SSGA product. Back-Tested Performance does not represent the results of actual trading but is achieved by means of the retroactive application of a model designed with the benefit of hindsight. Actual performance results could differ substantially, and there is the potential for loss as well as profit. The Back-Tested Performance may not take into account material economic and market factors that would impact the adviser's actual decision-making. The performance reflects transaction costs but does not reflect management fees and other fees and expenses a client would have to pay, which reduce returns. SSGA does not yet manage actual assets to this strategy. A complete list of the firm's composites and their descriptions is available upon request.

Adding a systematic approach to an allocation otherwise composed of fundamental strategies can help enhance diversification while maintaining the incremental return offered by active management. What's more, fees often are lower for systematic active strategies than for fundamental active strategies, helping to reduce cost drag on investors' portfolios.

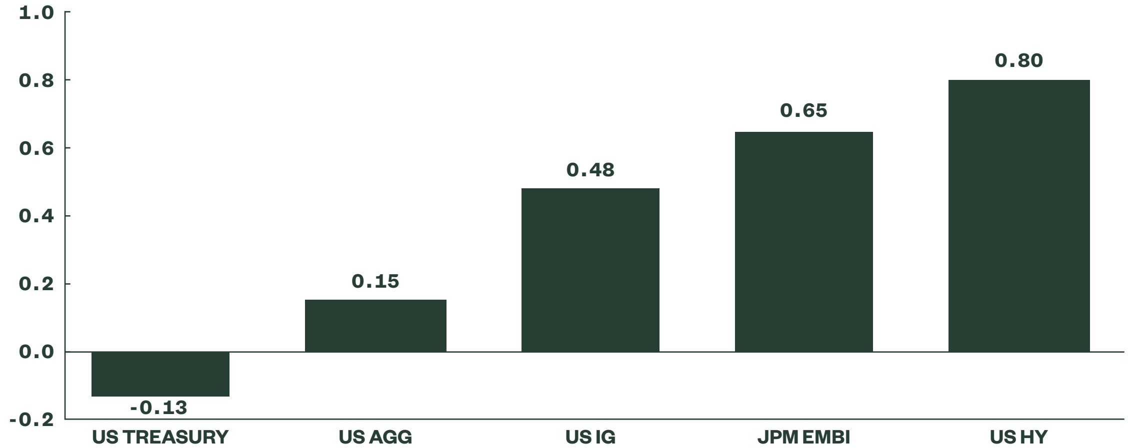
Indexed Leveraged Loan Exposure

Investors can add another dimension of diversification by allocating to assets with lower interest rate risk than the broad fixed income universe. Leveraged loans — also known as senior loans or bank loans — can play this role.

Leveraged loans have floating rates, resulting in effective durations close to zero and helping provide a degree of diversification in a rising rate environment. In addition, leveraged loans have a historical correlation of just 0.15 to the Bloomberg US Aggregate Bond Index (Figure 3). And loans often are both callable (a feature that caps their upside) and secured (which can reduce losses), contributing to a relatively stable return profile over time.

The loans market has expanded and evolved considerably in recent years. It is now possible to index exposure to leveraged loans, which can help improve the efficiency and liquidity of allocations to this unique asset class.

Figure 3
Leveraged Loans Have Low Correlations to Other Fixed Income Sectors



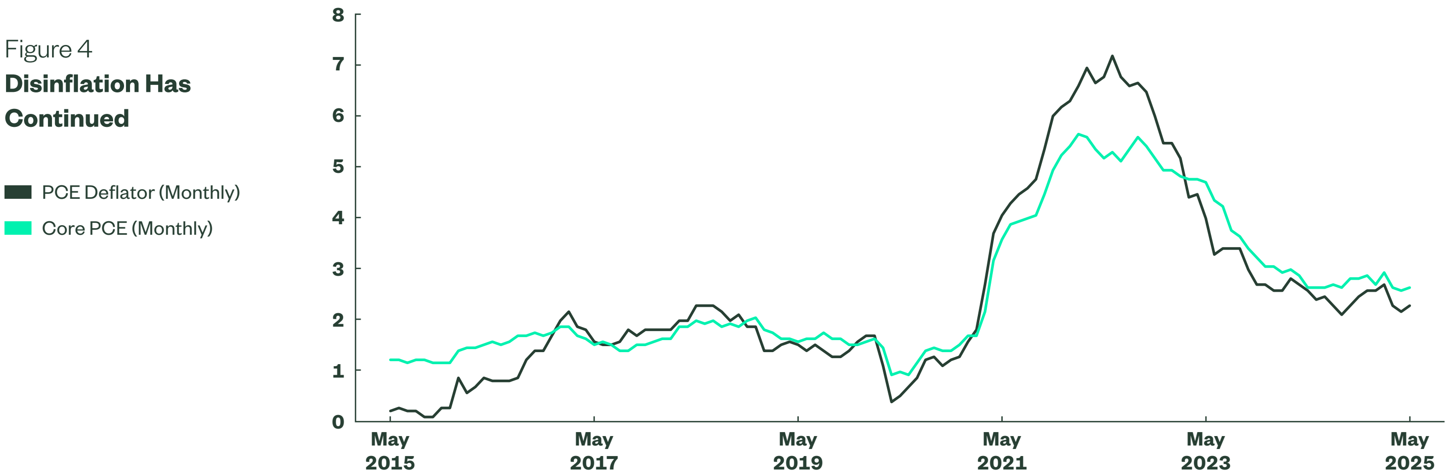
Source: Morningstar, Bloomberg, as of March 31, 2025. Correlations represented are for the 10 years through March 31, 2025. Leveraged loans represented by Morningstar LSTA Leveraged Loan Index; US Agg represented by Bloomberg Barclays Aggregate; US IG represented by Bloomberg US Corporate Index; US Treasury represented by Bloomberg US Treasury Index; US HY represented by Bloomberg US High Yield Index; JPM EMBI is the JP Morgan Emerging Market Bond Index.

Thoughtful Duration Extension

For some time, we have favored pursuing additional yield through duration rather than credit. Absolute yields have been relatively attractive in recent years, and credit is not cheap by most measures after spreads tightened between early April and the end of June. Softening economic data and tariffs' potential impacts on growth have increased our conviction in duration over credit.

Meanwhile, disinflation persists. The PCE (personal consumption expenditures) deflator, the Fed's preferred inflation gauge, continues to trend lower: Year-over-year headline inflation based on the PCE stood at 2.3% as of May, with core inflation at 2.7% (Figure 4). Under normal circumstances, the Fed would likely consider these results consistent with continued disinflation.

Figure 4
Disinflation Has Continued



Source: Bloomberg, as of July 9, 2025.

Tariffs add uncertainty to the inflation outlook and potential Fed decisions. We expect these dynamics, along with elevated fiscal and geopolitical uncertainty, to drive higher-than-normal volatility, potentially presenting opportunities to purchase longer-term bonds when yields are relatively high.

The fixed income markets' breadth and depth provide a wide range of options. Investors can capitalize on this diversity to help navigate rough seas. For additional information about how to make the most of your fixed income allocation, please contact us.

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*This figure is presented as of June 30, 2025 and includes ETF AUM of $1,689.83 billion USD of which approximately $116.05 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Investment Management are affiliated. Please note all AUM is unaudited.

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