

# Bond Compass

Higher for  
Longer  
Haunts  
Markets

# Q4 2023

04 **Investor Sentiment —  
Flows and Holdings**

10 **PriceStats® Analysis**

14 **Fixed Income Outlook**

22 **Finding Long-Term  
Fair Value in  
Short-Term Rates**



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# A Leader in Fixed Income Investing

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\$584\*

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

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26

years of bond  
investing  
experience

## Proven Track Record

- 26 years of bond investing — our first fixed income fund launched in 1996
- More than 100 fixed income professionals dedicated to conducting research, managing risks and costs, and supporting our clients

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100+

fixed income strategies

## Innovative Solutions for Bond Investors

- Comprehensive range of cost-effective\*\* ETFs
- Offering access to a range of options across the maturity and yield curve

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\* State Street Global Advisors, as of September 30, 2023.

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

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22	<b>Finding Long-Term Fair Value in Short-Term Rates</b>	William Ahmuty, Head of the SPDR Fixed Income Group, recently interviewed Senior Portfolio Manager James Palmieri on the current risks and opportunities in shorter-duration fixed income. Mr. Palmieri is the head of structured credit and co-portfolio manager of US Ultra-Short-Term, Short-Term, and Core Fixed Income Strategies at State Street Global Advisors.

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# Investor Sentiment — Flows and Holdings

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

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

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\* 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 anonymized 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.

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## Fixed Income Flows and Holdings

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The year 2023 was already a bad one for fixed income — then September happened.

US growth expectations had been drifting higher all year. But the continued run of surprisingly strong data across Q3 pushed expectations above 2% for the year, double what May's consensus forecast had been.

These higher growth expectations, combined with the Federal Reserve's consistent higher-for-longer mantra, created turbulence in global sovereign bond markets, especially in US Treasuries. Inflation expectations remained largely unchanged over the quarter and real long-term yields sharply rose, damaging returns.

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### Long-term Investor Demand Remains Resilient

So, the turbulence was real. But interestingly, State Street's Institutional Investor Indicators suggest it wasn't driven by selling from real money, or long-term investors.

In fact, long-term investor flows were not only robust in the face of such dire price action, in some cases, they were at or close to five-year highs (Figure 1). Nor was this some kind of dash for cash or safety at the front of the curve. Flows into long-dated bonds, and Treasuries in particular, were among the strongest flows in September.

The message from the Treasuries and European sovereign bond markets is simple: Long-term investors continue to see value in sovereign bonds at current yield levels.

There are nuances to this positive fixed income story across Italy, emerging markets, and credit. Holdings and the need to rebalance also likely played a role in the most recent flows. Nevertheless, the resilience of long-term investor demand is undoubtedly good news for Treasuries, given the supply that is coming.

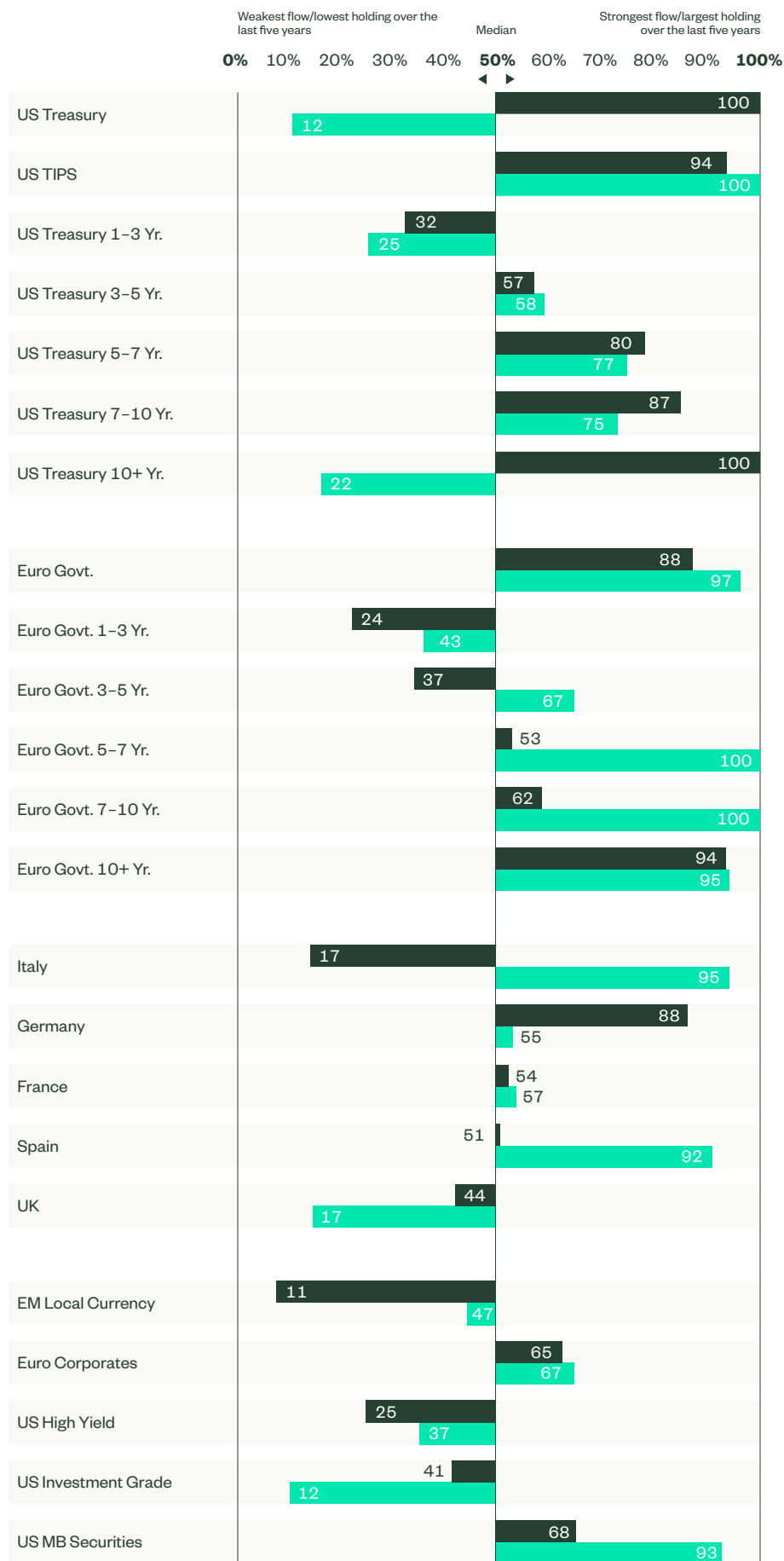
Figure 1  
Q4 2023

Flows & Holdings

90-Day 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](http://globalmarkets.statestreet.com)



Source: State Street Global Markets, as of September 30, 2023. Flows and holdings are as of date indicated. They should not be relied thereafter. \*As at quarter end.

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## Allocation Trends: Bonds vs. Equities (and Cash)

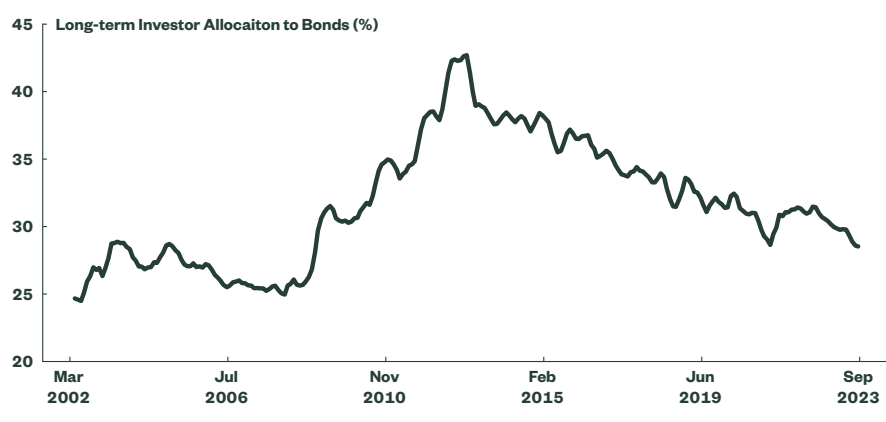
Bond Compass typically focuses on the behavior of long-term investors within the fixed income market. But in a regime where equity and fixed income markets are falling together, as they did once again in September, it's helpful to take a step back and consider the broader asset allocation trends.

State Street Institutional Investor Indicators allow us to compare aggregate long-term investor allocations to bonds, equities, and cash. Given the joint declines in equity and bond returns, it's no surprise cash holdings have risen sharply in recent months.

Allocations to cash now sit at just over 20%, more than a percentage point above their long-run average. Equity holdings are also still somewhat above their long-average. Together, this means that long-term investors are overweight cash and equities and underweight in their allocation to bonds.

The bond underweight is a few percentage points below its long-run average and at its lowest level in 15-years (Figure 2). Much of this underweight, of course, reflects the underperformance of fixed income.

Figure 2  
**Investors' Allocation to Bonds Is at a 15-Year Low**



Source: State Street Global Markets, as of September 30, 2023.

Flows into Treasuries and eurozone bonds, in particular, were strong over the past quarter. But, this rebalancing hasn't been enough to prevent the overall share of bonds in portfolios from falling. This is significant in two respects:

- 1 Long-term investor demand for bonds remains in spite of all the turbulence.
- 2 If investors decide to move holdings back toward benchmarks and long-term averages in Q4, fixed income should benefit at the expense of equities — and possibly even cash.

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## Treasuries Pressured but Real Money Investors Still Hungry for Long Bond

September's bond market dislocation was global in nature, but it dealt an especially hard blow to Treasuries — long-dated Treasuries at that.

In contrast to prior bond market wobbles, this one had little to do with how high the Fed would raise rates. Market expectations for peak rates have remained largely unmoved and are below the Fed's own projection for the year. It was the longer part of higher for longer that bore the brunt, as expectations for next year's rate cuts dramatically shrank and the curve rapidly dis-inverted in response.

Without looking at the flows, you might have assumed this price-action pattern caused investors to rush to safety at the relatively more stable front end of the curve. Yet, while some money did go to very short-dated Treasuries, demand for the very long end of the curve stayed unusually robust.

Some of this demand is likely rebalancing in the face such brutal price action. Notably, however, even though demand for the long end was strong all summer, our metrics suggest investors are now underweight long-dated Treasuries. In other words, investors have leaned against the price action in an attempt to maintain their Treasury holdings, but have so far been overwhelmed by price moves.

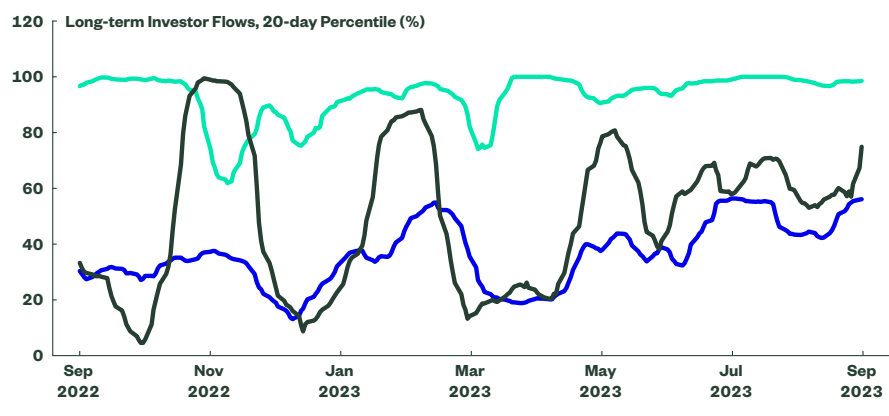
As with overall bond allocations, there are some encouraging take-aways. Long-term real money investors still have a significant appetite for the long bond. And, given relatively low holdings, that has the potential to continue.

This is good news given the extra Treasury supply that is coming. And, it's worth noting that long-term investors' appetite for demand at auction is close to a six-month high (Figure 3).

The bottom line: Treasuries are under significant pressure, but long-term investor demand remains solid for now, even if other market participants are in panic mode.

Figure 3  
**Treasuries Retain Investors' Full Faith**

■ Primary Demand — Treasuries  
■ 10yr + Treasuries  
■ >1yr + Treasuries



Source: State Street Global Markets, as of September 30, 2023.

## Where Did Long-term Investors Sell?

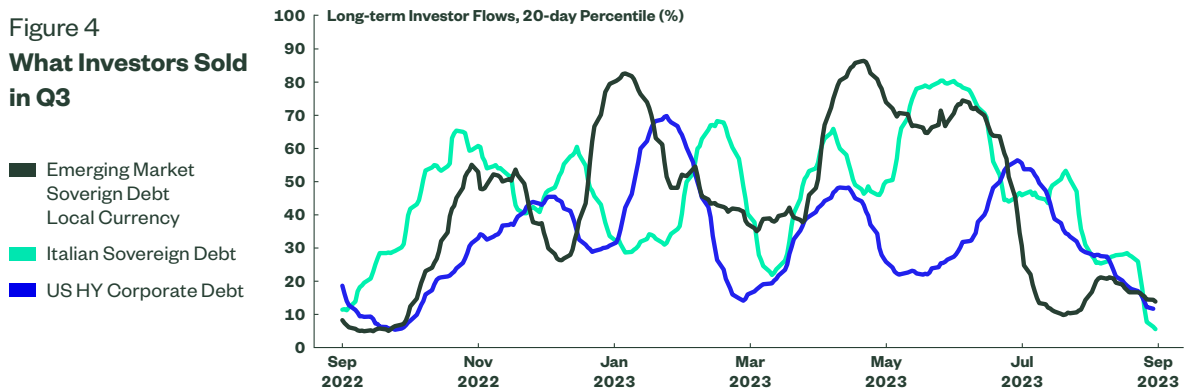
As good as aggregate investor behavior was during September's carnage, there were notable exceptions where long-term investors joined in the selling as opposed to leaning against the price action. Somewhat unsurprisingly, the selling in Q3 occurred in the perceived riskier ends of the sovereign and corporate bond markets.

Foreign long-term investor demand for Italian BTPs fell to its lowest level in more than a year (Figure 4). Downward revisions by the Italian government on growth and a deteriorating fiscal outlook make Italy especially vulnerable on top of its high debt level, even if the country's immediate refinancing needs are relatively modest.

With such high rates, Italy will need to run primary fiscal surpluses in excess of 1.5% GDP to meet the EU's 3% GDP deficit spending limits, which are set to resume again next year. And it remains unclear whether the Italian government has the political will to push through the necessary austerity.



Figure 4  
**What Investors Sold  
 in Q3**



Source: State Street Global Markets, as of September 30, 2023.

Demand for emerging market (EM) local currency debt also faltered. Although short-term interest rate cuts are forthcoming in a number of EM countries, inflation is reaccelerating. That, together with US dollar strength and much higher US yields, has made for a difficult macro environment for EM investing.

Finally. We note that long-term investors also sold high yield corporate bonds across the quarter. This is interesting in light of both rising oil prices and the recent rise in US growth expectations. The implication is that long-term investors are not yet ready to give up on recession risk, even though the going today is good.

# PriceStats® Analysis

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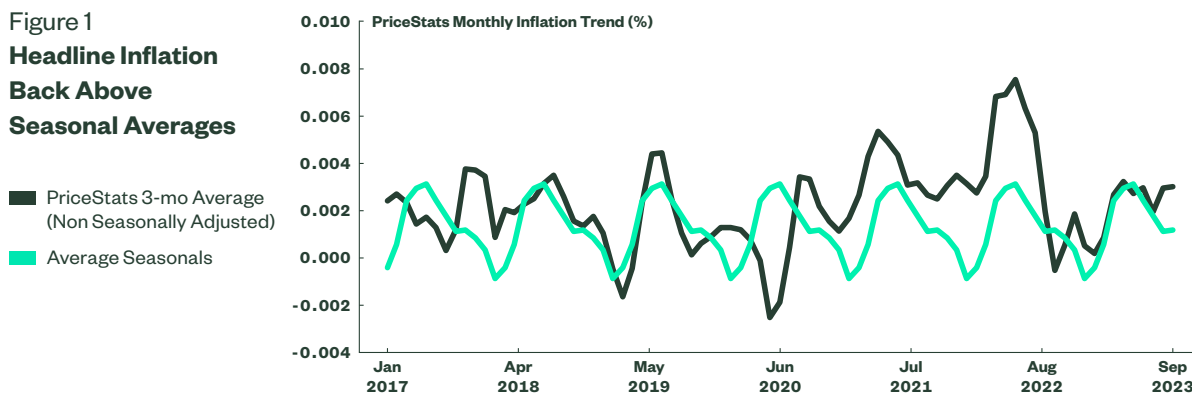
**A look at quarterly measures of inflation, based on prices of millions of items sold by online retailers, to help investors anticipate and evaluate the impact of inflation.**

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](https://globalmarkets.statestreet.com).

As brutal as the Q3 bond market sell-off was, it had little to do with the inflation trend.

Headline inflation has reaccelerated in the US and is again running at a quarterly rate above seasonal norms (Figure 1). This is almost entirely due to higher energy prices. So, while headline inflation may edge higher once again, readings on core inflation look to remain more benign.

Figure 1  
**Headline Inflation  
 Back Above  
 Seasonal Averages**



Source: State Street Global Markets, PriceStats, September 30, 2023.

### US Core Inflation Readings Contained for Now

The PriceStats sector series are especially encouraging in this regard. The prices of household equipment, furnishings, and operations — a useful proxy for goods price inflation and housing market trends — fell across Q3 for the first time in more than two years.

This signals that supply issues in the goods sector have fully normalized and the long-awaited slowdown in housing market inflation is finally coming. Of course, contagion from higher headline inflation could work back into core measures. We’ve seen that in recent years.

But, for now, the more favorable disinflationary trend in core inflation remains intact. And it’s equally encouraging that so far there’s been little impact from higher energy prices on market-based or consumer inflation expectations.

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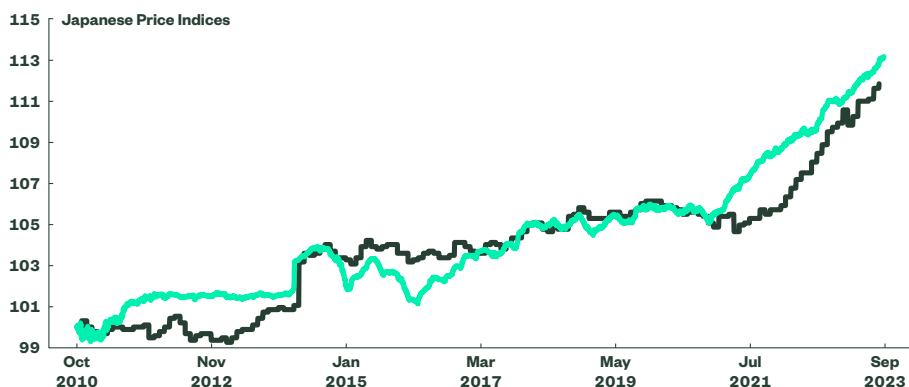
## Inflation is Back in Japan

Most countries have set policy over the past two years to squeeze unwelcome inflation out of the system. But in Japan, the aim has been to encourage inflation. And now, after two decades of failed attempts, inflation finally appears to be back.

Figure 2

### Japan's Price Level is Rising Again

■ Japan CPI index  
■ PriceStats Japan Index



Source: PriceStats, State Street Global Markets, September 30, 2023.

Perhaps the easiest way to demonstrate this is to plot an index of Japan's price level (Figure 2). Between 2010 and 2021 the price level was little changed. Inflation was close to or below zero, apart from the odd tax-inspired blips. But in the middle of 2021, online prices in Japan began to move differently, rising regularly in a similar way to most of the other countries where we collect data.

With official data now following, the trend in inflation shows no signs of changing: Inflation is back.

While this is a welcome development, it also suggests that the Bank of Japan (BoJ) will need to continue to roll back its ultra-accommodative monetary stance. Given outflows from Japanese investors have been a key source of demand for foreign bond markets, how the BoJ reacts to the prospect of higher yields in their local market will be watched closely indeed.

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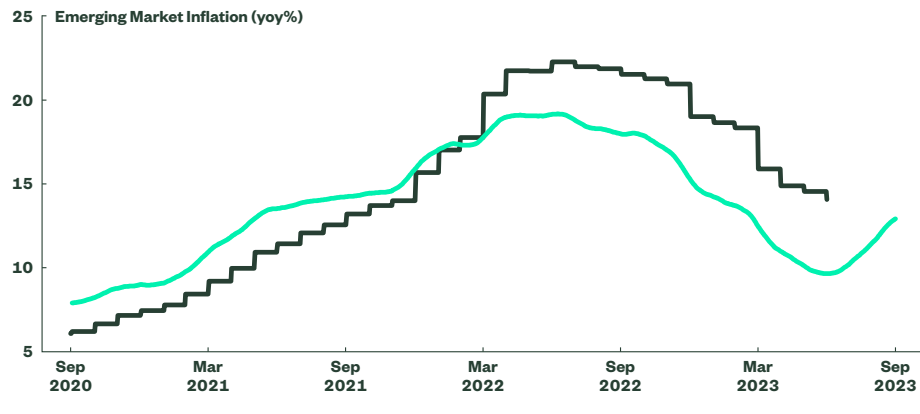
## Emerging Market Inflation Reaccelerates

The rebound in oil prices is proving potentially more problematic for emerging markets. Food and energy are bigger weights in emerging market (EM) inflation baskets, and this will be compounded in a number of cases by weakness in local currency markets.

Pass through typically happens faster in higher inflation EM economies, and that's proving true now. The month-on-month gain in the PriceStats EM aggregate in September was close to 2%, the biggest rise since Russia's invasion of Ukraine — and enough to prompt a sharp acceleration in the aggregate annual inflation rate (Figure 3).

Figure 3  
**Emerging Market  
Inflation Rises**

■ Official EM Inflation  
■ EM PriceStats



Source: PriceStats, State Street Global Markets, September 30, 2023.

In a similar vein to the US, much of this may be due to energy, but it creates extra complications for countries where easing cycles have already begun. This is another obstacle in an already difficult investing environment for EM local currency bonds.

Get more insight into today's higher-for-longer environment in our [Q4 Bond Compass](#).

# Fixed Income Outlook

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

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# Q4 ETF Playbook for Bond Investors

**Matthew J Bartolini, CFA, CAIA**

Head of SPDR Americas Research

Although the Federal Reserve (Fed) didn't hike rates in September, its hauntingly hawkish tone has spooked markets, ushering in a higher-for-longer specter that poses challenges — and opportunities — for today's investors.

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## Bond Prices Tumble as Interest Rates Push Yields

Central bankers' higher-for-longer mantra has caused rates to rise across the curve over the past few weeks. The Bloomberg Aggregate Bond Index (Agg) has seen its yield rise over 60 basis points (bps) since the end of July. Higher yields are why the Agg is entering the fourth quarter down -1.2% for the year,<sup>1</sup> plummeting toward a record third annual loss.

It's unlikely credit will help the Agg recoup its losses. While the carry from the coupon has supported total returns, price returns over the past six months have been negative.<sup>2</sup> Spreads remain tight and ratings sentiment weak. Downgrades for high yield bonds have outpaced upgrades for five consecutive quarters.<sup>3</sup>

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## Opportunities for Income Now and Returns Going Forward

With rates moving higher, core bond yields are now more in line with their duration. The yield-per-unit of duration has moved from 0.65 to start the year to 0.90 — a level not seen since 2009.<sup>4</sup> That means opportunities in bonds have become more balanced when viewed over longer time horizons.

Higher for longer has kicked the reinvestment risk can further down the road as well. That means current elevated yields in below one year maturity bonds are likely to stick around, offering elevated income without outsized volatility.

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## Fixed Income Investing in a Higher-for-longer World

To respond to challenges and seize opportunities in a higher-for-longer world consider:

- **Active core strategies** to position portfolios for evolving macro risks, higher rates, and mixed fundamentals in credit markets.
- **Short-duration bonds** where elevated yields offer income while minimizing total risks — with potential for increased income if the Fed keeps rates high for a long time.<sup>5</sup>
- **Hybrid exposures** like convertibles and preferreds that add risk in a differentiated manner.

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1 Bloomberg Finance, L.P., as of September 29, 2023.

2 Bloomberg Finance, L.P., as of September 29, 2023, based on the ICE BoFA US Corp Master Index.

3 Bloomberg Finance, L.P., as of September 29, 2023, based on S&P ratings.

4 Bloomberg Finance, L.P., as of September 29, 2023.

5 Bostic Says Fed Should Hold Rates High 'For a Long Time', Bloomberg, October 3, 2023.

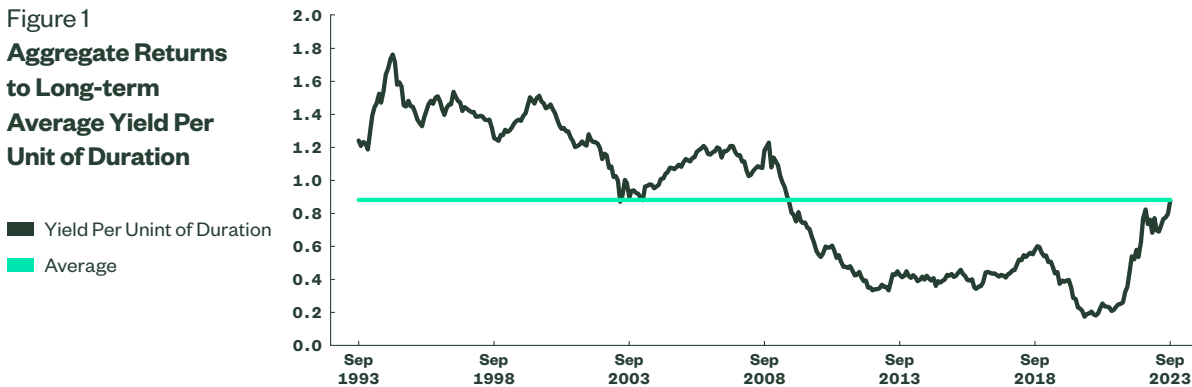
## Target Total Return Opportunities and Go Active in Core

Returns of broad core aggregate bonds have not benefited portfolios over the past few years. And the recent dual sell-off in stocks and bonds has sent their cross-asset correlations higher, negating any perceived long-term diversification benefits.

As of right now, core bonds' rolling 90-day correlation of daily returns sits in the 85th percentile over the past 35 years — having spiked sharply from the 13th percentile at the start of June.<sup>6</sup>

Yet, those higher rates have made the core aggregate bonds potentially more attractive going forward. After reaching the mid 5% range, core Agg bond yields are now closer to their duration (6.2 years), creating a balanced breakeven ratio not seen since 2009.<sup>7</sup> In fact, the Agg's yield per unit of duration is now back to its long-term average for the first time since 2009 (Figure 1).

Figure 1  
**Aggregate Returns to Long-term Average Yield Per Unit of Duration**

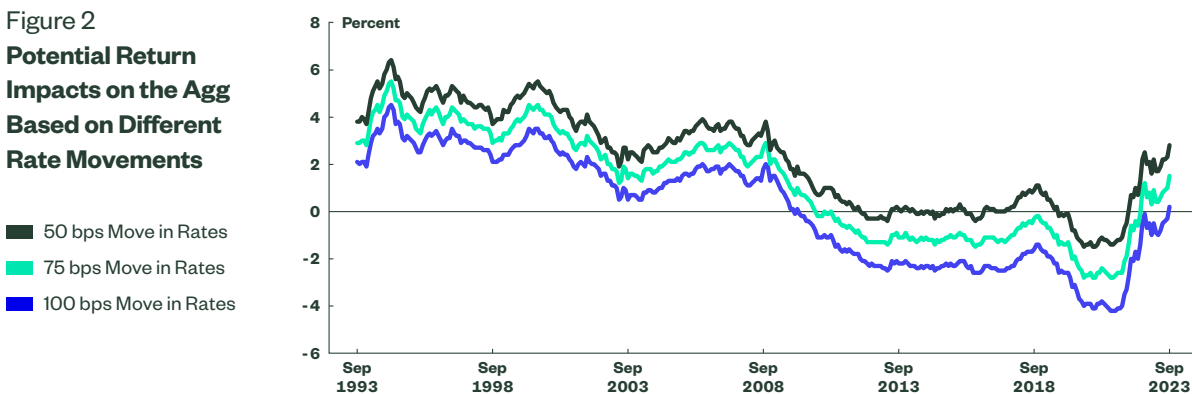


Source: Bloomberg Finance L.P., as of September 30, 2023. **Past performance is not a reliable indicator of future performance.**

This means that, for the first time since 2009, the Agg's subsequent one-year total return could be positive with even another 100 bps rise in rates. This calculation is based only on duration effects, while holding other factors equal, using the commonly accepted formula  $(-Rate\ Change * Duration) + Yield + Rate\ Change$ .

All this suggests that bonds may indeed be back — for income generation and total return.

Figure 2  
**Potential Return Impacts on the Agg Based on Different Rate Movements**



Source: Bloomberg Finance, L.P., as of September 29, 2023. **Past performance is not a reliable indicator of future performance.**

6 Bloomberg Finance L.P., as of September 29, 2023, based on the rolling 90-day correlation of daily returns between the S&P 500 Index and the Bloomberg US Aggregate Bond Index.

7 Bloomberg Finance L.P., as of September 29, 2023, based on the Bloomberg US Aggregate Bond Index.



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Of course, credit risks challenge the above duration-only impact analysis. Both investment-grade and high yield credit spreads have narrowed this year, and high yield spreads sit 20% below their historical average.<sup>8</sup> And both bond sectors are down on a price basis over the past few months, with investment-grade down 4% over the past three.<sup>9</sup>

A tight credit spread environment indicates that valuations for taking on credit risk alone aren't overly conducive on a forward-looking return basis. For example, high yield bonds' effective convexity, which has fallen all year and is now nearly negative, further supports the view that there is less upside relative to downside.<sup>10</sup> And investment-grade corporates' effective convexity is at a 10-year low.<sup>11</sup>

But by combining traditional and non-traditional fixed income asset classes to maximize total return over a full market cycle, active sector allocation and security selection can help investors take advantage of income and total return opportunities, while seeking to mitigate the credit and rate risks facing core markets.

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### **Why SPDR® DoubleLine® Total Return Tactical ETF (TOTL)**

The actively managed SPDR® DoubleLine® Total Return Tactical ETF (TOTL) (combines the Agg's traditional bond sectors with credit-sensitive sectors such as high yield corporates and bank loans. And the fund's embedded mortgage bias enhances its credit quality, as these securities are backed by the federal government.

With 74% exposure to investment-grade rated debt, 58% of TOTL is AAA rated.<sup>12</sup> As a result, it's been able to mitigate volatility while remaining a source of returns and income.

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Having outperformed the Agg by 73 bps this year,<sup>13</sup> TOTL also exhibits:

- 30-Day SEC Yield (5.8% versus 5.39%)<sup>14</sup>
- More even-balanced yield-per-unit-of-duration (0.94 versus 0.88)<sup>15</sup>
- Higher yield-per-unit-of-volatility (0.91 versus 0.74)<sup>16</sup>

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8 Bloomberg Finance, L.P., as of September 29, 2023, based on the ICE BoFA US High Yield Index.

9 Bloomberg Finance, L.P., as of September 29, 2023, based on the ICE BoFA US High Yield Index and the ICE BoFA US Corp Master Index.

10 Bloomberg Finance, L.P., as of September 29, 2023, based on the ICE BoFA US High Yield Index.

11 Bloomberg Finance, L.P., as of September 29, 2023, based on the ICE BoFA US Corp Master Index.

12 ssga.com, as of September 29, 2023.

13 Bloomberg Finance, L.P., as of September 29, 2023.

14 Bloomberg Finance, L.P., as of September 29, 2023, based on the 30-day SEC yield and the yield-to-worst.

15 ssga.com, Bloomberg Finance L.P., based on the 30-Day SEC Yield TOTL, the yield-to-worst on the Bloomberg US Aggregate Bond Index and the duration of TOTL and the Bloomberg US Aggregate Bond Index as of September 29, 2023.

16 ssga.com, Bloomberg Finance, L.P., based on the 30-Day SEC Yield TOTL, the yield-to-worst on the Bloomberg US Aggregate Bond Index and the one-year standard deviation of returns for TOTL and the Bloomberg US Aggregate Bond Index as of September 29, 2023.

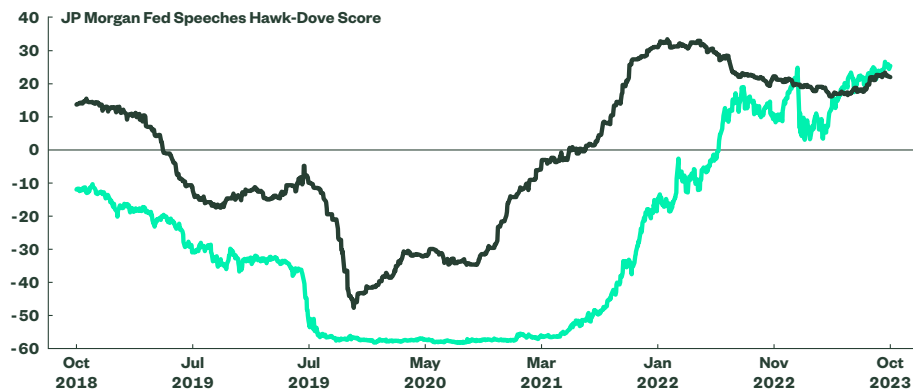
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## Look to Shorter Duration Bonds for Stability and Income

Yields began increasing when Fed rhetoric began to lean more hawkish (Figure 3). If this relationship holds, shorter duration bonds could see their income potential rise further. Or at the very least stay where it is given how recently Cleveland Fed President Loretta Mester reaffirmed the central banks higher-for-longer stance, saying they “will likely need to raise rates once more this year and then hold them at higher levels for some time to get inflation back to its 2% target”.<sup>17</sup>

Figure 3  
**The Fed has Become More Hawkish and Rates have Risen**

■ JP Morgan Fed Speeches Hawk-Dove Score  
■ US 2-Year Yield (%)



Source: Bloomberg Finance, L.P., as of September 29, 2023. **Past performance is not a reliable indicator of future performance.**

So, don't fight the Fed. For both income potential and capital preservation, the shorter duration corner of the bond market offers more stability and lower volatility than segments further out on the curve.

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## Why SPDR® DoubleLine® Short Duration Total Return Tactical ETF (STOT)

To trim duration in the core while retaining broad sector exposure and the potential for alpha generation, consider the short-term version of TOTL: SPDR® DoubleLine® Short Duration Total Return Tactical ETF (STOT).

STOT employs a similar approach to TOTL, but seeks to maintain a dollar-weighted average effective duration between one and three years. Outperforming its benchmark and the Agg by 227 and 443 bps over the past year,<sup>18</sup> STOT now has a:

- 30-day SEC yield of 5.57%
- Yield-per-unit-of-duration of 4.4
- Yield-per-unit-of-volatility of 2.2<sup>19</sup>

17 “Fed’s Mester Back November Rate Hike If Economy Holds Steady,” October 3, 2023.

18 Bloomberg Finance, L.P., based on the return on the Bloomberg US Aggregate 1-3 Years Index and the Bloomberg US Aggregate Bond Index.

19 ssga.com, Bloomberg Finance, L.P., based on the 30-day SEC yield for STOT, the yield-to-worst on the Bloomberg US Aggregate Bond Index and the duration, and the one-year standard deviation of returns for STOT and the Bloomberg US Aggregate Bond Index as of September 29, 2023.

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## Why SPDR® SSGA Ultra Short Term Bond ETF (ULST)

Along the same lines, an active *ultra*-short strategy can structure attractive shorter-term bond segments such as securitized credits, asset-backed securities, mortgage-backed securities, and commercial mortgage-backed securities alongside the over 5% yielding T-Bill market.<sup>20</sup>

The actively managed ETF ULST invests at least 80% of its net assets in a diversified portfolio of US dollar-denominated investment-grade fixed income securities, including up to 10% in high yield. The ETF targets a duration of 1 year or less and a weighted average maturity of 2.5 years or less.

Given its credit selection and risk management tactics, ULST currently offers a yield equivalent to the broader Agg (30-day SEC yield of 5.34% versus Agg's yield-to-worst of 5.39%),<sup>21</sup> but with 92% less volatility.<sup>22</sup>

And ULST's lower volatility doesn't mean lower returns. The ETF is outperforming the Agg this year (+3.59% versus -1.21%) and over the past 12 months (+4.78% versus 0.64%).<sup>23</sup>

Due to their maturity focus, income potential, and volatility profile relative to the broader market, STOT and ULST are attracting bond investors who seek more income than what's offered by T-Bills. And these higher income levels could be around for longer, with more stability and less volatility than core Agg bonds.

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## Add Hybrids to Seek Upside in a More Balanced Way

Amid evolving macro risks and cautiously optimistic fundamental trends, investors often look to reduce portfolio volatility while still maintaining exposure to stocks and bonds for their total return and income potential.

With both stock- and bond-like characteristics, hybrids can help investors express risk in a more balanced manner than with straight equity or credit exposures. Convertible securities are corporate bonds with an embedded option that allows investors to convert bonds into the common stock of the issuing company.

As a result, convertibles combine the upside potential of equities with a coupon payment and bond-like floor to help mitigate downside risk. Convertibles' correlation to stocks and bonds is 0.88 and 0.31, respectively.<sup>24</sup>

Convertible issuers tend to be more common in high-growth sectors; more than 50% of the convertibles market is allocated to the Consumer Discretionary, Communication Services, and Information Technology sectors — the three sectors powering equity returns this year. This structure has led convertibles to post stronger returns than bonds this year (6.7% versus -1.21%),<sup>25</sup> with 30% less volatility in returns than stocks.<sup>26</sup>

Despite the return trends, convertibles' valuations indicate they're now trading more like bonds than stocks. Convertibles' low sensitivity to the underlying stocks is also met with a higher-than-average premium to parity, which is the difference between the price of convertibles and the value of the underlying equity if converted (Figure 4).

20 Bloomberg Finance, L.P., as of September 29, 2023, based on the US 3-month T-Bill yield.

21 ssga.com as of September 29, 2023, and Bloomberg Finance, L.P., as of September 29, 2023.

22 Bloomberg Finance, L.P., based on 1-year standard deviation of returns for ULST and the Bloomberg US Aggregate Bond Index as of September 29, 2023.

23 Bloomberg Finance, L.P., as of September 29, 2023, based on the return for ULST and the Bloomberg US Aggregate Bond Index.

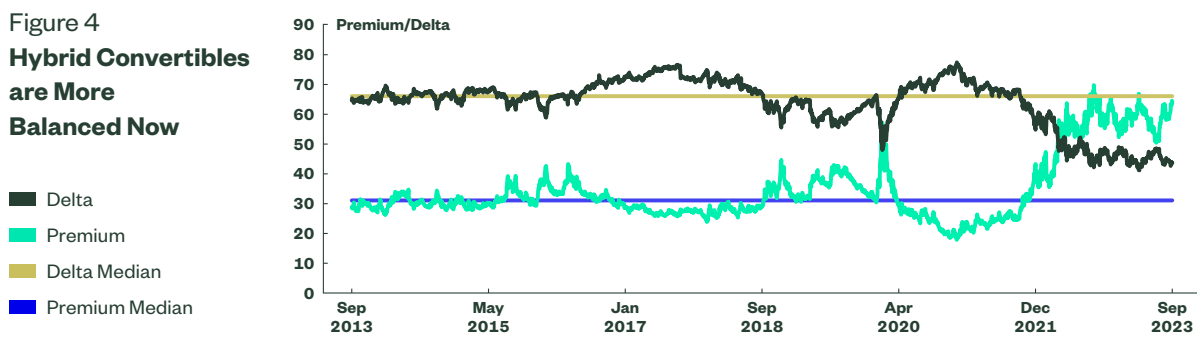
24 Bloomberg Finance, L.P., as of September 29, 2023, based on the 10-year monthly correlation of the Bloomberg US Convertibles Liquid Bond Index and the MSCI ACWI IMI Index and the Bloomberg US Aggregate Bond Index.

25 Bloomberg Finance, L.P., as of September 29, 2023, based on the Bloomberg US Convertibles Liquid Bond Index and the Bloomberg US Aggregate Bond Index.

26 Bloomberg Finance, L.P., as of September 29, 2023, based on the 1-year standard deviation of daily returns for the Bloomberg US Convertibles Liquid Bond Index and the S&P 500 Index.

As a result, while equity valuations are stretched (the S&P 500 price-to-earnings ratio is above average) and credit spreads are 20% below averages,<sup>27</sup> convertibles trade in a more balanced bond-like profile. That's underscored by convertibles' delta to the underlying equities being 34% below its historical median.

Figure 4  
**Hybrid Convertibles  
are More  
Balanced Now**



Source: Bloomberg Finance, L.P., as of September 29, 2023. **Past performance is not a reliable indicator of future performance.**

Overall, convertible securities may offer risk-controlled equity exposure with the potential for upside growth — but with less volatility than straight equities.

### Why Allocation to a Blend of Convertibles and Preferreds

Combining an allocation to convertibles with preferred securities, another hybrid investment, introduces an income overlay with sector diversification, but with equally balanced correlation profiles (0.55 to stocks and 0.60 to bonds).<sup>28</sup>

While convertibles yield roughly 5.0%, preferreds yield 6.83%.<sup>29</sup> A 50/50 blend of the two would produce a yield of near 5.9% — that's 56 bps greater than the yield on the Agg, 370 bps more than global stocks, and 238 bps more than the standard globally diversified 60/40 portfolio.<sup>30</sup>

This hybrid blend's yield potential coincides with a historical volatility profile below that of stocks (9.5% versus 14.5%) and on par with the standard 60/40 portfolio (9.5% versus 9.3%) over the last decade.<sup>31</sup> And, additional volatility/correlation data illustrate the historically differentiated nature of this blend, as it has an 80% correlation stocks and a 50% correlation to bonds.<sup>32</sup>

Broad core stocks and bond markets are now being met with some near-term risks. Consequently, a blend of convertibles and preferreds may be a useful low volatility strategy to efficiently allocate capital on both sides of a balanced portfolio, while also enhancing yield relative to core stocks and bonds.

To access the convertibles market, consider the SPDR® Bloomberg Convertible Securities ETF (CWB).

To access the preferreds market, consider the SPDR® ICE Preferred Securities ETF (PSK).

27 Bloomberg Finance, L.P., as of September 29, 2023, based on the price-to-earnings ratio for the S&P 500 Index and the Option Adjusted Spread for the ICE BoFA US High Yield Index.

28 Bloomberg Finance, L.P., as of September 29, 2023, based on the 10-year monthly correlation of the ICE Exchange-Listed Fixed & Adjustable Rate Preferred Securities Index and the MSCI ACWI IMI Index and the Bloomberg US Aggregate Bond Index.

29 Bloomberg Finance, L.P., as of September 29, 2023, based on the yield-to-worst of the ICE Exchange-Listed Fixed & Adjustable Rate Preferred Securities Index and convertible yield of the Bloomberg US Convertibles Liquid Bond Index.

30 Bloomberg Finance, L.P., as of September 29, 2023, based on the yield-to-worst of the ICE Exchange-Listed Fixed & Adjustable Rate Preferred Securities Index and convertible yield of the Bloomberg US Convertibles Liquid Bond Index, the yield-to-worst on the Bloomberg US Aggregate Bond Index and the trailing 12-month dividend yield for the MSCI ACWI Index.

31 Bloomberg Finance, L.P. as of September 29, 2023, based on the 10-year return streams of the ICE Exchange-Listed Fixed & Adjustable Rate Preferred Securities Index and the MSCI ACWI IMI Index and the Bloomberg US Aggregate Bond Index.

32 Bloomberg Finance, L.P. as of September 29, 2023, based on the 10-year return streams of the ICE Exchange-Listed Fixed & Adjustable Rate Preferred Securities Index and the MSCI ACWI IMI Index and the Bloomberg US Aggregate Bond Index.

**Fund Performance as of September 30, 2023**

Ticker	Name	QTD (%)	YTD (%)	Annualized					Inception Date	Gross Expense Ratio (%)
				1 Year (%)	3 Years (%)	5 Years (%)	10 Years (%)	Since Inception (%)		
TOTL	SPDR® DoubleLine® Total Return Tactical ETF (NAV)	-3.51	-0.47	0.74	-4.32	-0.47	—	0.35	February 23, 2015	0.55
TOTL	SPDR® DoubleLine® Total Return Tactical ETF (MKT)	-3.54	-0.39	1.07	-4.20	-0.40	—	0.38	February 23, 2015	0.55
STOT	SPDR® DoubleLine® Short Duration Total Return Tactical ETF (NAV)	1.25	3.96	5.07	0.23	1.54	—	1.43	April 13, 2016	0.45
STOT	SPDR® DoubleLine® Short Duration Total Return Tactical ETF (MKT)	1.08	3.68	5.11	0.20	1.50	—	1.41	April 13, 2016	0.45
ULST	SPDR® SSGA Ultra Short Term Bond ETF (NAV)	1.18	3.59	4.78	1.65	1.93	—	1.48	October 9, 2013	0.20
ULST	SPDR® SSGA Ultra Short Term Bond ETF (MKT)	1.21	3.59	4.83	1.66	1.94		1.48	October 9, 2013	0.20
PSK	SPDR® ICE Preferred Securities ETF (NAV)	-1.44	3.49	-0.47	-3.81	0.28	3.43	4.47	September 16, 2009	0.45
PSK	SPDR® ICE Preferred Securities ETF (MKT)	-1.30	3.22	-0.69	-3.95	0.24	3.44	4.46	September 16, 2009	0.45
CWB	SPDR® Bloomberg Convertible Securities ETF (NAV)	-2.50	6.71	9.05	1.76	8.01	8.68	10.44	April 14, 2009	0.40
CWB	SPDR® Bloomberg Convertible Securities ETF (MKT)	-2.88	6.58	9.55	1.70	7.95	8.58	10.42	April 14, 2009	0.40

Source: **Past performance is not a reliable indicator of future performance. Investment return and principal value will fluctuate, so you may have a gain or loss when shares are sold. Current performance may be higher or lower than that quoted. All results are historical and assume the reinvestment of dividends and capital gains. Visit [ssga.com](http://ssga.com) for most recent month-end performance.**

Performance returns for periods of less than one year are not annualized. The gross expense ratio is the fund's total annual operating expenses ratio. It is gross of any fee waivers or expense reimbursements. It can be found in the fund's most recent prospectus.

# Finding Long-term Fair Value in Short-Term Rates

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## Finding Long-Term Fair Value in Short-Term Rates

### William Ahmuty

Head of SPDR ETF Fixed Income

### James F Palmieri, CFA

Senior Portfolio Manager

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William Ahmuty, Head of the SPDR Fixed Income Group, recently interviewed Senior Portfolio Manager James Palmieri on the current risks and opportunities in shorter-duration fixed income. Mr. Palmieri is the head of structured credit and co-portfolio manager of US Ultra-Short-Term, Short-Term, and Core Fixed Income Strategies at State Street Global Advisors.

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### **How would you describe bond markets, especially in the short end of the curve, during the first nine months of the year? Any surprises?**

Let's start with the surprises.

In March, against the backdrop of tight monetary policy, we saw a few regional bank failures. In response, 2-year Treasury notes went from a yield of 5.07% to 3.98% in just a few trading days and credit spreads sharply widened.

The bigger surprise was how little these regional bank failures impacted the broader economy. Job creation and Fed rate hikes continued in the second and third quarters. This led to a recovery in the market to levels not seen since the first week of March. For example, the 2-year Treasury note is back just above 5% and credit spreads tightened significantly.

Overall, what we're seeing is a marketplace where, through our long-term fair value lens, rates are at the cheap side of long-term fair value and credit spreads are pricing tight, or on the rich side of long term fair value. I've described this divergence in pricing between rates and credit spreads as a rubber band being stretched thin. And typically this divergence is unsustainable.

In short, I think the market is no longer really pricing in a hard landing, which makes it vulnerable.

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## What are the biggest risks and opportunities from now to the end of the year and heading into 2024?

When we think about the direction of travel for the economy, with respect to lower growth and lower inflation against the backdrop of restrictive monetary policy, the primary risk to the market from a pricing perspective is clearly a hard landing. And the market that would be most exposed to that would be the credit sector.

I look at March of this year as a great example of what would happen if we had a growth scare. We'd expect to see rates at current levels rally sharply and likely see credit spreads widen sharply in response.

In terms of opportunity, given our outlook and given the risks in the market, the primary opportunity is in the form of rates — in particular on the short end and, to a lesser extent, the middle part of the Treasury curve.

In terms of spreads, there's really only one market that has pockets of it pricing in an economic hard landing, and that's the CMBS market. And with commercial real estate consistently in the headlines, it's no surprise that there's some softness in that market.

And as we go into 2024, we're preparing a "shopping list" should pricing in the CMBS market overshoot further to the cheap side of long-term value.

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## What about funding the US government's fiscal deficit? Does that raise concerns about Treasury issuance?

I don't think it's going to be a surprise to anyone that in 2024 we're going to see more Treasury issuance than we saw in 2023. And with respect to T-bills or the proportion of issuance in T-bills, we expect it to remain at the high end of what's called the optimal Treasury debt structure, which is 15 to 20%.

In fact, it's anticipated that the issuance of T-Bills may slightly exceed 20%. You know, when we think about that much issuance, it helps to have a framework or an outlook.

When I look at the market, it's pricing in what I would call higher for longer.

In that environment, we feel like there'll be plenty of demand for money market funds, which will generate plenty of demand for T-bills. Given some of the challenges with bank balance sheets, they're unlikely to be able to compete with money market rates anytime soon. So, it's possible that this increase in issuance and T-bills could get absorbed if the markets are right about higher for longer.

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## How are you positioning ULST given your views?

Given our outlook for lower growth and lower inflation against a backdrop of restrictive monetary policy and relative value, cheapness in rates versus credit, I would describe our positioning as favoring duration, quality, and liquidity.

And that translates into a higher allocation to duration, a higher allocation to governments, and a lower allocation to credit at this stage. This leaves the fund well positioned for opportunities to deploy its liquidity at more favorable spread levels should credit reprice over the coming quarter and into 2024.

I think it's important to note that, as compared to last year, short-end-of-the-space-products like [Ultra Short Term Bond ETF \(ULST\)](#), as well as [Bloomberg 1–3 Month T-Bill ETF \(BIL\)](#) and [Bloomberg 3–12 Month T-Bill ETF \(BILS\)](#), are sitting on a lot more income cushion to weather the storm. So, I think that all the rate hikes over the past 18 months have generated an income cushion that is quite compelling as compared to the last couple of years.



## What are the risks in allocating to the very short end of the curve?

Well, I think much of the risk that existed for the short duration space has come to pass. Usually what disrupts that market is a surprise inflation print, followed by aggressive Fed tightening — and we've already gone through that storm, so to speak, in the short duration space.

I think most market participants would say that the Fed is very near done, if not already done, raising rates and it's all about how long they'll hold rates.

So, I think the risk to the short end has been mitigated by this Fed moving very fast from accommodative to restrictive monetary policy. I think within this short duration space, you aren't getting paid a lot to take on credit risk. So, that's the primary risk against this restrictive Fed backdrop. And it's why we're holding a lower-than-strategic allocation to credit at this juncture.

Get more insight into today's higher-for-longer environment in our [Q4 Bond Compass](#).

### ULST Standard Performance as of September 30, 2023

	QTD (%)	YTD (%)	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)	Since Inception Oct 9, 2013 (%)
NAV	1.18	3.59	4.78	1.65	1.93	—	1.48
Market Value	1.21	3.59	4.83	1.66	1.94	—	1.48
Bloomberg US Treasury Bellwether 3 Month Index	1.33	3.72	4.65	1.76	1.76	1.14	1.15

Source: ssga.com, as of September 30, 2023. Inception date: October 9, 2013. Gross expense ratio: 0.20%. **Past performance is not a reliable indicator of future performance. Investment return and principal value will fluctuate, so you may have a gain or loss when shares are sold. Current performance may be higher or lower than that quotes. All results are historical and assume the reinvestment of dividends and capital gains. Visit ssga.com for most recent month-end performance. Performance of an index is not illustrative of any particular investment. All results are historical and assume the reinvestment of dividends and capital gains.**

**It is not possible to invest directly in an index. Performance returns for periods of less than one year are not annualized. Performance is shown net of fees.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. The market price used to calculate the Market Value return is the midpoint between the highest bid and the lowest offer on the exchange on which the shares of the Fund are listed for trading, as of the time that the Fund's NAV is calculated. If you trade your shares at another time, your return may differ.

The gross expense ratio is the fund's total annual operating expenses ratio. It is gross of any fee waivers or expense reimbursements. It can be found in the fund's most recent prospectus.

### BIL Standard Performance as of September 30, 2023

	QTD (%)	YTD (%)	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)	Since Inception May 25, 2007 (%)
NAV	1.30	3.57	4.44	1.60	1.55	0.95	0.84
Market Value	1.29	3.57	4.45	1.60	1.56	0.95	0.84
Bloomberg 1-3 Month U.S. Treasury Bill Index	1.34	3.71	4.63	1.75	1.71	1.09	0.97

Source: ssga.com, as of September 30, 2023. Inception date May 25, 2007. Gross expense ratio: 0.1354%. **Past performance is not a reliable indicator of future performance. Investment return and principal value will fluctuate, so you may have a gain or loss when shares are sold. Current performance may be higher or lower than that quotes. All results are historical and assume the reinvestment of dividends and capital gains. Visit ssga.com for most recent month-end performance. Performance of an index is not illustrative of any particular investment. All results are historical and assume the reinvestment of dividends and capital gains. It is not possible to invest directly in an index. Performance returns for periods of less than one year are not annualized. Performance is shown net of fees.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. The market price used to calculate the Market Value return is the midpoint between the highest bid and the lowest offer on the exchange on which the shares of the Fund are listed for trading, as of the time that the Fund's NAV is calculated. If you trade your shares at another time, your return may differ.

The gross expense ratio is the fund's total annual operating expenses ratio. It is gross of any fee waivers or expense reimbursements. It can be found in the fund's most recent prospectus.

## BILS Standard Performance as of September 30, 2023

	QTD (%)	YTD (%)	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)	Since Inception Sep 23, 2020 (%)
NAV	1.28	3.46	4.26	1.40	—	—	1.39
Market Value	1.26	3.43	4.26	1.40	—	—	1.40
Bloomberg 3-12 Month U.S. Treasury Bill Index	1.33	3.57	4.43	1.54	—	—	1.53

Source: ssga.com, as of September 30, 2023. Inception date September 23, 2020. Gross expense ratio: 0.135%. **Past performance is not a reliable indicator of future performance. Investment return and principal value will fluctuate, so you may have a gain or loss when shares are sold. Current performance may be higher or lower than that quotes. All results are historical and assume the reinvestment of dividends and capital gains. Visit ssga.com for most recent month-end performance. Performance of an index is not illustrative of any particular investment. All results are historical and assume the reinvestment of dividends and capital gains. It is not possible to invest directly in an index. Performance returns for periods of less than one year are not annualized. Performance is shown net of fees.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. The market price used to calculate the Market Value return is the midpoint between the highest bid and the lowest offer on the exchange on which the shares of the Fund are listed for trading, as of the time that the Fund's NAV is calculated. If you trade your shares at another time, your return may differ. The gross expense ratio is the fund's total annual operating expenses ratio. It is gross of any fee waivers or expense reimbursements. It can be found in the fund's most recent prospectus.

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## Important Information

### Information Classification: General Access.

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### Glossary

#### Bloomberg Aggregate Bond Index

A benchmark that provides a measure of the performance of the US dollar-denominated investment-grade bond market. The "Agg" 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.

**Emerging Markets** Developing countries where the characteristics of mature economies – political stability, market liquidity and accounting transparency – are beginning to manifest. Emerging market investments are generally expected to achieve higher returns than those of developed markets but are also accompanied by greater risk, decreasing their correlation to investments in developed markets.

**Inflation** Inflation is an overall increase in the prices of an economy's goods and services during a given period, translating to a loss in purchasing power per unit of currency. Inflation generally occurs when growth of the money supply outpaces growth of the economy. Central banks attempt to limit inflation, and avoid deflation, in order to keep the economy running smoothly.

**30-day SEC Yield** (Also known as Standardized Yield) An annualized yield that is calculated by dividing the net investment income earned by the fund over the most recent 30-day period by the current maximum offering price.

**Alpha** The excess return of an investment relative to the return of a benchmark index.

**Correlation** A statistic that measures the degree to which two securities move in relation to each other.

**Credit Spread** The spread between the yield on a bond and the yield on the equivalent duration matched government bond. Dispersion The difference in returns between one asset class or market exposure to another.

**Duration** A measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates.

**Yield-to-worst** A financial metric that helps investors assess the minimum yield they can expect from a bond under various scenarios. It accounts for the bond's yield in the worst-case scenario, considering factors like call provisions,

prepayments, and other features that may affect the bond's cash flows.

**Standard Deviation** The statistical measure of market volatility, measuring how widely prices are dispersed from the average price.

**High Yield** A company or bond that is rated "BB" or lower is known as junk-grade or high yield, in which case the probability that the company will repay its issued debt is deemed to be speculative.

**Volatility** The tendency of a market index or security to jump around in price. Volatility is typically expressed as the annualized standard deviation of returns. In modern portfolio theory, securities with higher volatility are generally seen as riskier due to higher potential losses.

**Yield** The income produced by an investment, typically calculated as the interest received annually divided by the price of the investment. Yield comes from interest-bearing securities, such as bonds and dividend-paying stocks.

The views expressed in this material are the views of Matthew Bartolini through the period ended October 3, 2023 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

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Actively managed funds do not seek to replicate the performance of a specified index. An actively managed fund may underperform its benchmark. An investment in the fund is not appropriate for all investors and is not intended to be a complete investment program. Investing in the fund involves risks, including the risk that investors may receive little or no return on the investment or that investors may lose part or even all of the investment.

TOTL and STOT are actively managed. The sub-adviser's judgments about the attractiveness, relative value, or potential appreciation of a particular sector, security, commodity or investment strategy may prove to be incorrect, and may cause

the fund to incur losses. There can be no assurance that the sub-adviser's investment techniques and decisions will produce the desired results.

The fund (ULST) is actively managed. The adviser's judgments about the attractiveness, relative value, or potential appreciation of a particular sector, security, commodity or investment strategy may prove to be incorrect, and may cause the fund to incur losses. There can be no assurance that the adviser's investment techniques and decisions will produce the desired results.

Passively managed funds invest by sampling the index, holding 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.

U.S. Treasury obligations may differ from other fixed income securities in their interest rates, maturities, times of issuance and other characteristics. Similar to other issuers, changes to the financial condition or credit rating of the U.S. government may cause the value of the Fund's U.S. Treasury obligations to decline.

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International Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

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

The Fund/share class may use financial derivatives instruments for currency

hedging and to manage the portfolio efficiently. The Fund may purchase securities that are not denominated in the share class currency. Hedging should mitigate the impact of exchange rate fluctuations however hedges are sometimes subject to imperfect matching which could generate losses.

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