

Bond Compass

Q2
2020

The Path Forward from Pandemic

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A Leader in Fixed Income Index Investing

\$457

billion in indexed
fixed income assets

The Scale to Specialize

- 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 \$457 billion in indexed fixed income assets, managing 30+ currencies across 40 different countries*

24

years of
bond index
investing
experience

Proven Track Record

- 24 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

* State Street Global Markets, as of March 31, 2020.

** 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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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 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.

Fixed Income Flows and Holdings

State Street Global Markets builds indicators of aggregated long-term investor behavior in fixed income markets from a substantial subset of \$10 trillion worth of fixed income assets under custody and administration at State Street.¹

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

Analysis

The first quarter was one for the history books and we applaud you all for enduring what was one of the most intense periods of volatility in modern market history. Long forgotten is the strong investment tone that allowed US equities to hit a series of all-time highs and the apparent unquenchable appetite for corporate credit. Instead, we saw the fastest bear market in history, while the corporate bond markets emerged as a significant systemic risk. The monetary and then fiscal response has been unprecedented, and the impact will likely take years to fully understand, although for the moment it has provided comfort for frazzled markets.

The investor response to plunging yields has been to sell duration, with 20-day weighted sovereign flows at their lowest decile in both the developed and emerging markets. Credit had been stable during the earlier stages of last quarter's volatility, but gapping spreads and the shutdown of primary activity resulted in selling across both the investment grade and high yield markets, with flows to the latter also in the lowest decile.

Given how quickly markets have been moving, we are also looking at shorter-term moves that may provide an earlier indicator of changing risk tolerance. In this vein, five-day flows into emerging Latin America (LatAm) and Asia have bounced off their lows and currently show some buying — but of course, that could change.

¹ Source: State Street Global Markets, as of December 31, 2019.

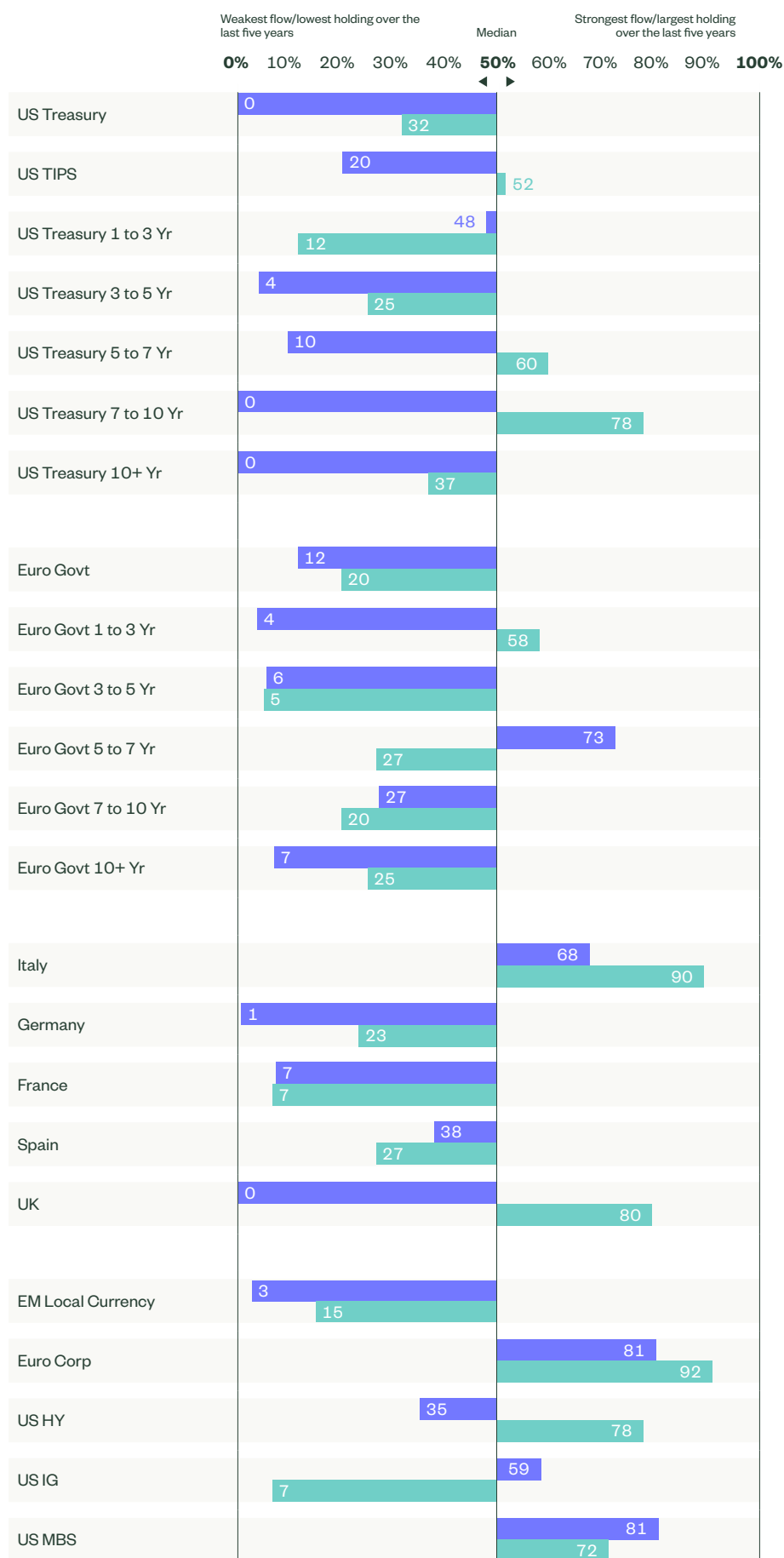
Q1 2020 Flows & Holdings

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 or email ir3@statestreet.com.



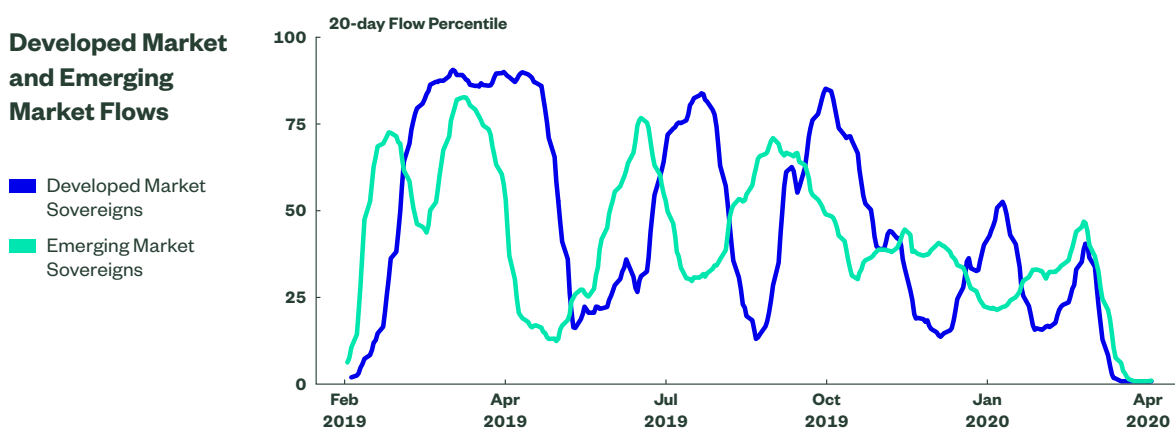
Source: State Street Global Markets, as of March 31, 2020. Flows and holdings are as of date indicated. They should not be relied thereafter. *As at quarter end.

Hard to Find Value

The world is in a very different place since we provided our 2019 year-end overview a few months ago. What was a low yield environment became even lower yielding, as essentially every central bank cut rates this past quarter. In the developed markets, which were never able to normalize post Global Financial Crisis, this has pushed policy rates back to the effective lower bound (ELB), only to be supplemented with aggressive asset purchases. Emerging markets also needed to cut rates, although their equilibrium has been challenged by weakening currencies, capital flight and, in some instances, inflationary concerns.

Given this backdrop, developed market rates have been one of the few shelters from the storm. However, instead of using sovereign bonds as a safe harbor asset, both developed and emerging market flows are at their lowest levels in five years. The generally flat yield curves that exist within the developed markets anchored at the ELB by policy rates offer no real return for investors. The need to rebalance portfolios following the volatile quarter also contributed to negative flows. These factors were less of an issue for emerging markets, which still offer real yields but are challenged by slumping global demand, capital repatriation and weak commodity prices.

Developed Market and Emerging Market Flows



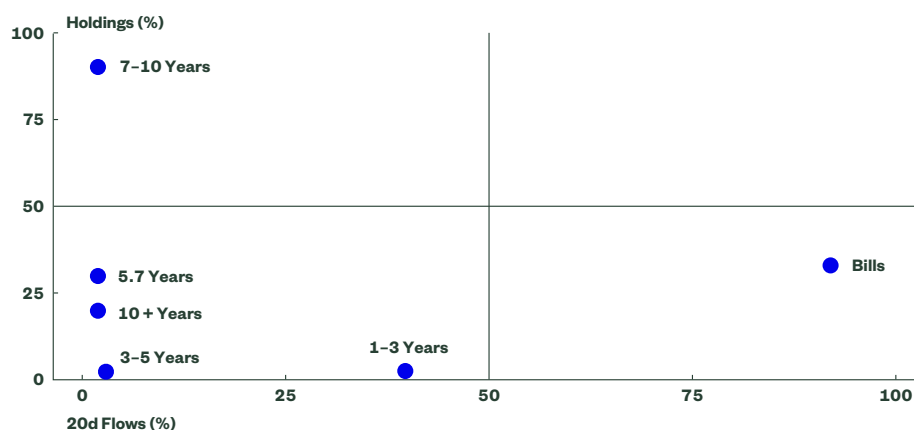
Source: State Street Global Markets, Bloomberg Finance L.P., as of March 31, 2020. Flows and holdings are as of the date indicated. They should not be relied on thereafter.

Safety in the Short End

While we have witnessed broad outflows from all sovereign markets, including the US, it is notable that there continues to be strong interest in the T-bill space, offset by weakness out of the curve. This has been a trend since late last year, as investors lightened up on duration, expecting a steeper curve. The gap down in yields during the first quarter simply accelerated this trend, and outflows from US Treasuries have been the most aggressive in five years when measured from a duration-weighted perspective.

This overall negative picture obfuscates investor demand for T-bills, which currently stands at the 84th percentile. These flows have risen from neutral levels just before the spike in market volatility, which preceded the outflows from Treasury coupons. Since we view T-bills as a close substitute for cash, market volatility and dislocations placed a premium on assets that offered the strongest return of capital protection. Treasury issuance to fund the CARES Act will therefore be disproportionately weighted toward T-bill issuance given strong demand as affirmed by investor flows.

Treasury Holdings vs. Flows



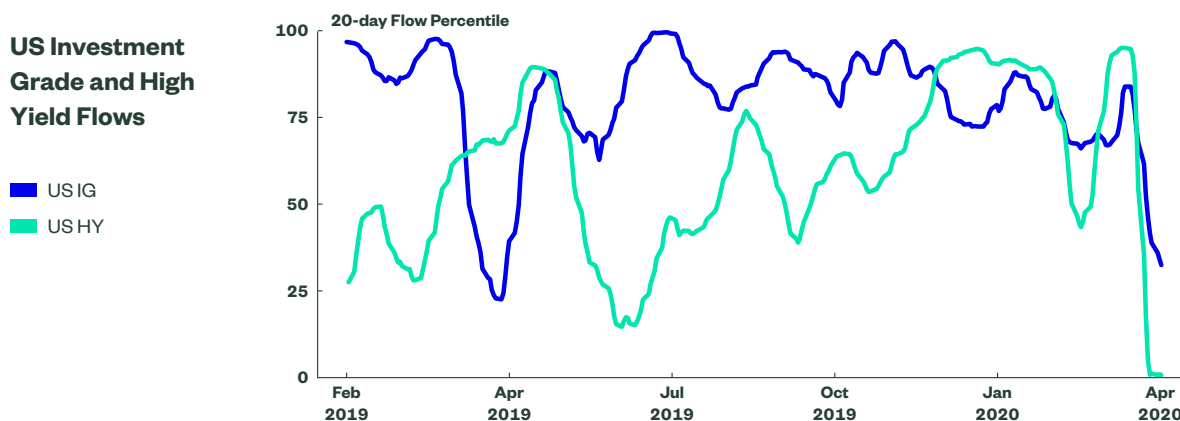
Source: State Street Global Markets, Bloomberg Finance L.P., as of March 31, 2020.
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

Credit Following the Fed

Of the many asset classes that were stressed in Q1, corporate bonds were one of the most problematic. Credit spreads in both the investment grade and high yield markets had initially remained relatively calm when compared with the volatility witnessed in other risk assets, particularly equities. As a result, overall US corporate bond flows remained mostly positive during Q1, led by strong buying of the high yield asset class until mid-March.

This idyllic construct started to fall from mid-March, however, as it became apparent that the virus could no longer be contained to just China and Italy, and widespread shutdowns would bring economic activity to a standstill across many economies. At the same time, companies began aggressively drawing down their credit lines in the face of limited access to the new issue and commercial paper markets. Spreads subsequently widened out by 180 bps for investment grade credits and over 500 bps in the high yield space during the final three weeks of the quarter. During that period, flows reversed from the 70th and 90th percentiles for investment grade and high yield respectively, to 30% and near 0 now. The Federal Reserve (Fed) subsequently announced several programs that will purchase investment grade bonds, which likely provided more support for this rating category versus high yield, which has not seen this level of outflows since 2016.

US Investment Grade and High Yield Flows



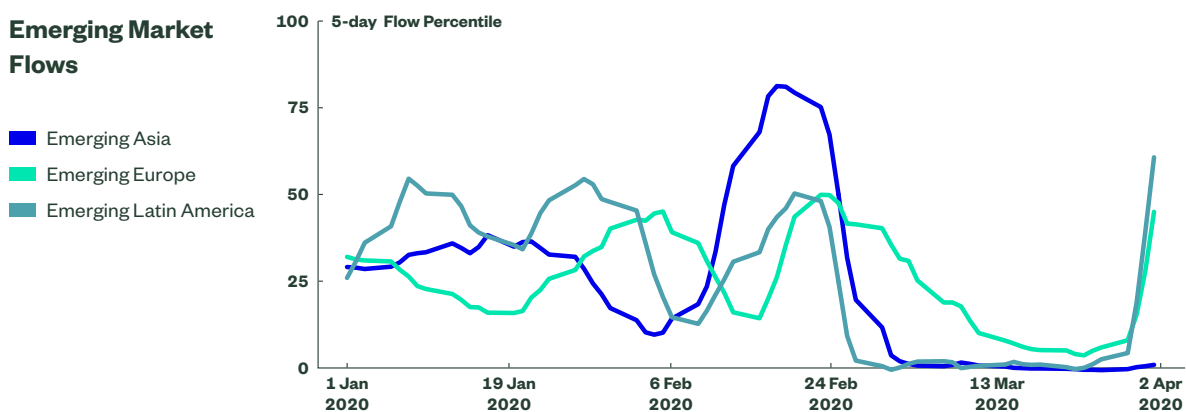
Source: State Street Global Markets, Bloomberg Finance L.P., as of March 31, 2020.
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

Nascent Signs of Risk-taking Emerges

Given how quickly markets have moved, it is useful to consider investor flows from various time perspectives. As the other charts in this quarterly update indicate, most fixed income indicators showed strong outflows, which is no different for the emerging markets (EM). This negative bias reflects the challenges for emerging economies in the face of slowing global growth, along with a home bias for investors during times of market volatility. However, when we compress the timeframe of these flows to just a five-day moving average (versus our typical 20- or 60-day analysis) we can see some nascent buying of EM fixed income again. Just as one data point does not make a trend, the continuation of this trend very much depends on the evolution of the virus and how it affects market volatility.

Having said that, this EM buying has initially focused on Latin American and Eastern European sovereigns, while Asia EM flows remain near the lower bounds. The stronger flows into LatAm reflect a reach for yield as the region remains a high yielder despite rate cuts from numerous regional central banks. Sovereign yields from Asia have generally been compressed even before recent rate cuts and concerns over the extent of China's stimulus emerged. While real yields have fallen globally, they are negative in most of the developed markets, giving EM the advantage of positive income, albeit with the caveat that global growth concerns can disproportionately impact emerging economies.

Emerging Market Flows



Source: State Street Global Markets, Bloomberg Finance L.P., as of March 31, 2020.
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

PriceStats® Analysis

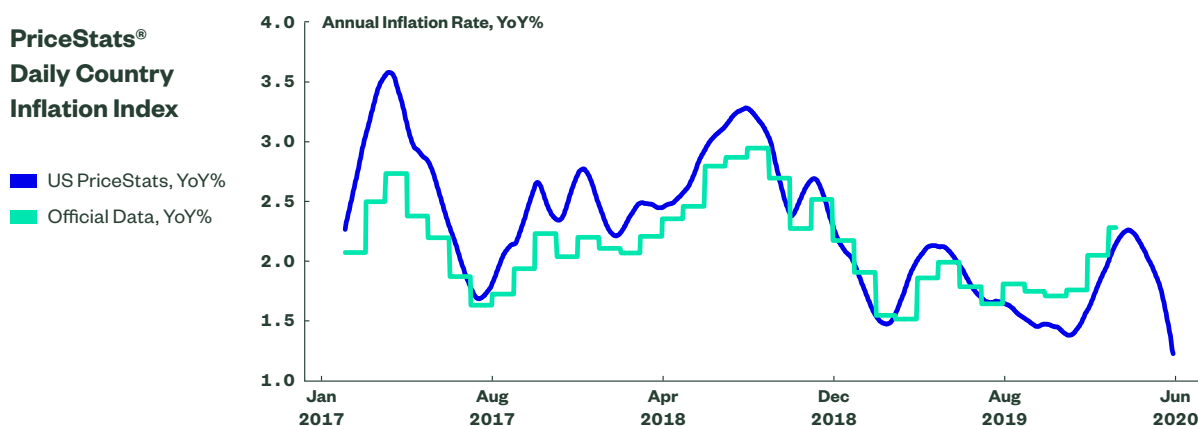
A look at quarterly measures of inflation based on prices from millions of items sold by online retailers to help investors anticipate and evaluate the impact of inflation.

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.

US: Deflation Watch

Our US PriceStats® metrics only capture the prices of goods, not actual purchases. The pricing behavior of retailers can still, however, be informative about demand conditions. This was certainly the case in the aftermath of the Lehman bankruptcy in September 2008; PriceStats® recorded an almost immediate collapse in retailer price power. Such a sharp collapse in prices has not occurred in 2020. Nevertheless, the modest fall in online prices in March was still the weakest in the past decade and will lead to a sharp decline in the annual inflation rate.



Source: State Street Global Markets, as of March 31, 2020.

Eurozone: Little Room for Prices to Fall Further (Outside of Energy)

Euro inflation had been staging a modest recovery up until the virus hit, but that will now change quickly. Euro fuel prices are already close to 10% lower YoY. Headline inflation will correct sharply lower as result, falling back below 1% once more. And given core Euro inflation was only 1.2% before this began, there's little room for prices outside of energy to fall either. The European Central Bank (ECB) will be watchful of deflation expectations building once more.

PriceStats® Daily Eurozone Inflation Index

■ Eurozone PriceStats®
■ Official Data



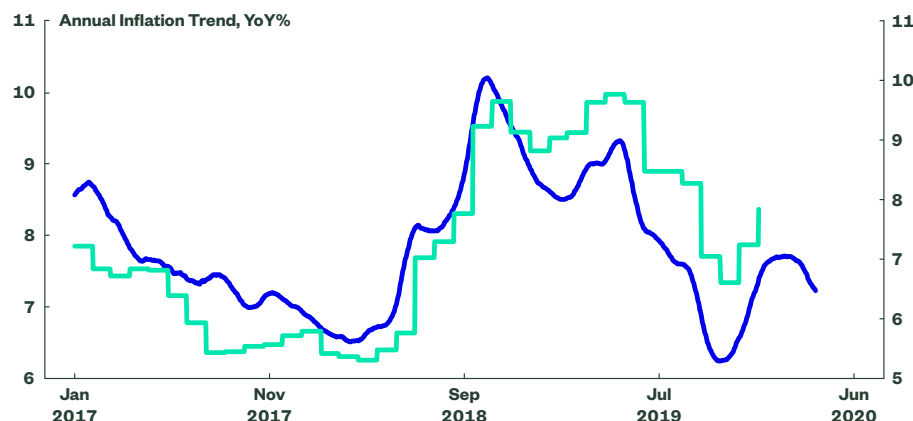
Source: State Street Global Markets, as of March 31, 2020.

Emerging Markets: Headline Inflation Headed Lower

A number of emerging market currencies have weakened significantly in the past month; however, the impact on inflation has been offset by an even larger fall in energy prices. The combination thus far means that headline emerging market inflation is still headed lower. This will be helpful for emerging market central banks and, indeed, bond investors as the last challenge emerging market economies need to face now is a bad case of stagflation.

PriceStats® Daily EM Inflation Index

■ EM PriceStats®
■ Official Data
(Right Hand Scale)



Source: State Street Global Markets, as of March 31, 2020.

Interview with a Portfolio Manager

Jeffrey Sherman, CFA , is DoubleLine's Deputy Chief Investment Officer. Here, Jeff discusses how fixed income markets have behaved and where he thinks opportunities and pitfalls lie in the months ahead.



Jeffrey Sherman, CFA

DoubleLine's Deputy
Chief Investment
Officer

Interview with Jeff Sherman

As DoubleLine's Deputy Chief Investment Officer, Jeff Sherman oversees and administers DoubleLine's Investment Management sub-committee coordinating and implementing policies and processes across the investment teams. He also serves as lead portfolio manager for multi-sector and derivative-based strategies. He is a member of DoubleLine's Executive Management and Fixed Income Asset Allocation Committees.

Most investors typically think of investment-grade credit as a diversifier to equity volatility, but that hasn't been the case recently. Is this because of underlying deteriorating fundamentals in the investment-grade corporate market?

There's deterioration because we have a shutdown in America. And it's difficult to forecast when corporate America will snap back from this. I think the Fed stepping in and providing liquidity has been helpful, but it doesn't solve the fact that we don't know how long we're all going to be quarantined or what the impact of that will be.

Another contributing factor is pain in the commercial mortgage-backed securities market. With the Trump administration messaging holds on mortgage payments, we're not sure how long cash flows will be shut off in this area. And with this uncertainty, people just don't want to own a lot of risk assets.

In comparison, the equity market has done pretty well, but you're not seeing that translate into all these credit areas. I think this is because credit is trying to understand where defaults and downgrades may be.

So right now, we're raising cash for our clients and making sure that we're keeping the portfolios adequately balanced in terms of those risks.

Interview
with
a Portfolio
Manager

Is this also the case for the municipal market?

Again, you have to do a lot of scenario analysis. In this market, I think that you have a government backstop, with the Fed talking about helping to provide some liquidity here, purchasing some of this local debt.

At the yield levels you have now, in a high-tax state, I think it makes sense to own municipals. Keep in mind though, what's typically a much more stable, more orderly market, has become just the opposite as of late.

Similar to the credit market, there is a lot of uncertainty here. What's going to happen when all the states shut down? Will they be able to generate revenue?

In particular, I'm watching the higher-quality segments of each of these markets — the higher-quality AA type of investment grades or BB and BB+ in the high yield market — I want to see some stability there. And so, I think that can be applied to municipals, as well.

DoubleLine has mentioned that Treasury yields today are not the hedge they might have been in the past. Can you detail the thinking?

Between running a deficit — let's estimate it at 15% of GDP and the \$2 trillion package — it's easy to see an unfathomable \$3.5 trillion deficit this year.

The US Treasury Market — traditionally a very liquid, very deep market — is not providing that balance today. The Fed is buying Treasuries and mortgages, and Treasuries are still being offered out. It's been a panicked market.

Liquidity is better in Treasuries today, but when the dust settles, you might not want to own Treasuries. I think in the post-COVID-19 world, we'll have higher yields and a more discerning kind of risk premium in the marketplace. When you start to flood the market with these types of securities, it's hard to see yields staying at these levels for a prolonged period of time.

**Interview
with
a Portfolio
Manager**

What's the biggest risk in credit in the coming year?

Auto loans, credit cards, student loans — consumer-related debt, essentially.

The one thing about the mortgage industry is that, unlike these other markets, it's been through forbearance and letting things subside for a while. Consumer-related debt will likely be challenged for the remainder of the year.

Do you believe the issues in the repo market back in the fall of last year was a signal to the market that we should be cautious?

Yes, it was. Liquidity was a problem, and that's why the Fed stepped in and increased the balance sheet.

It's hard to say that no one could have predicted the COVID-19 crisis, because we obviously had the indicators of the threat of a global pandemic. However, the US ignored it longer than the rest of the world did, and that has impacted asset price performance.

To say that the repo market forecasted the current volatility is a stretch. What we've seen here is an exogenous shock. COVID-19 hit the markets along with the oil shock caused by the failed OPEC agreement. That one-two punch is challenging for the economy.

We've never seen a contraction of global economic activity in the post-World War II era like we're seeing. And so, it's nice to look back in history and say, well, you should have noticed this flare-up. That flare-up was a cause of stress in the market, and the Fed was addressing that. It was working, but now, all bets are off since this new exogenous risk hit.

**Interview
with
a Portfolio
Manager**

Q2 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.

Three Ideas for More Resilient Fixed Income Portfolios

Seek Relative Value in Rates

Central banks have returned to Great Financial Crisis (GFC)-era monetary stimulus tools to reassure the market and inject much-needed liquidity. While the COVID-19 global pandemic is unprecedented, the policy responses are similar, and insights can be gleaned from the past. Following the GFC, inflation began increasing as a result of the stimulus measures — averaging 2.4% from 2009 until 2012 — after a demand-driven deflation shock began in 2008. One could reasonably expect the same trend today — given the potential for the price tag of the monetary and fiscal stimulus plans (approximately \$6 trillion)¹ to fuel an economic rebound² later in the year, once the COVID-19 curve has flattened. Therefore, investors may consider potential relative value opportunities in the rates markets, swapping nominal US Treasuries for inflation-protected Treasuries — legging into the trade over the next quarter, as data have yet to reflect the demand-driven deflation shock.

CPI and TIPS Versus Nominals Post GFC



Source: Bloomberg Finance L.P., as of March 31, 2020. **Past performance is not a guarantee of future results.** Figures shown are total returns based on index returns and do not assume any fees. TIPS as measured by the Bloomberg US Inflation Protected Notes Index, Nominals as measured by the Bloomberg Barclays US Treasury Index.

**Q2
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Outlook**

How to Implement

As shown above, as inflation rose post the GFC crisis, Treasury Inflation-Protected Securities (TIPS) began to outpace nominal US Treasuries. From mid-2009 through 2012, TIPS outperformed nominals in 60% of the months, by an average of 30 basis points.³ Outside of any ability to go long/short, swapping nominal exposure for TIPS may be the most efficient way to capture this premium — either completely or through a blend (i.e., 50%/50%). Adding TIPS without reducing nominal exposure may unintentionally extend a portfolio's duration profile and dilute the potential relative value opportunity, as duration effects will be the predominant driver of risk and return of this trade. After all, TIPS are still bonds.

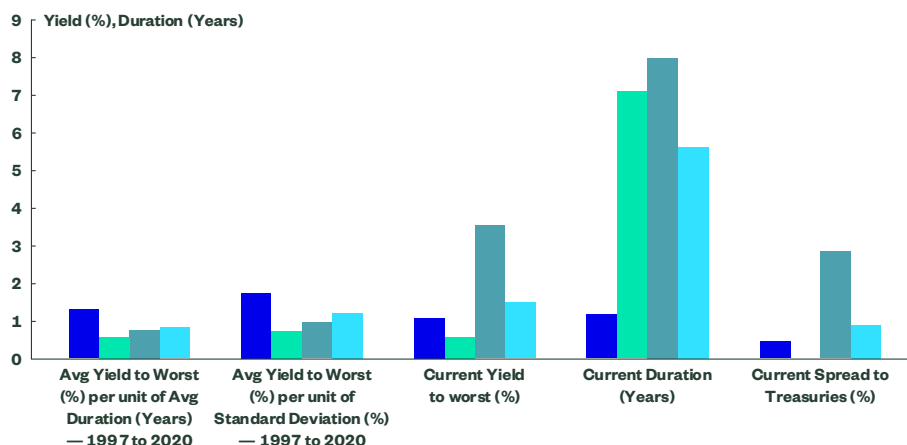
For TIPS exposure, investors may consider the SPDR Portfolio TIPS ETF **[SPIP]**.

Don't Fight the Fed — Part 1: Adopt a Mortgage Bias

The Wall Street mantra “Don’t fight the Fed” refers to the notion that investors can do well by investing in a way that aligns with current monetary policies of the Federal Reserve (Fed).⁴ To counter the current crisis, the Fed will be purchasing agency mortgage-backed securities (MBS) as stimulus tools, similar to what it did in the GFC. While the initial purchase amount was set at least \$200 billion, a March 23 release indicated that the Fed would buy what is needed to support the economy. In other words, the Fed will conduct unlimited quantitative easing (QE).⁵ Beyond having a large, constant buyer that will likely support a steady “bid” on the asset class, MBS have a structurally unique yield per unit of risk exposure, as shown below, that may prove beneficial in today’s uncertain environment.

Yield Per Unit of Risk Measures and Current Profile

■ MBS
■ US Treasuries
■ IG Corp
■ Agg



Source: Bloomberg Finance L.P., as of March 31, 2020. **Past performance is not a guarantee of future results.** Figures shown are based on index data and do not assume any fees. Treasuries: Bloomberg Barclays US Treasury Index, MBS: Bloomberg Barclays US Securitized Index, Agg: Bloomberg Barclays US Aggregate Bond Index, IG Corp: Bloomberg Barclays US Corporate Bond Index.

How to Implement

Although the GFC was a housing-related crisis, agency MBS (+20.3%) actually outperformed US Treasuries (+19.6%), the Agg (+19.3%), and IG Corporates (+18.0%) with less drawdown risk,⁶ as default risks were, and still are, negligible.⁷ The GFC returns shown above should diminish any concern over how a downturn in the housing market could impact the agency MBS market during the current crisis. Moreover, since volatility spiked, agency MBS (+2.2%) have outperformed the Agg (+0.8%) and IG Corporates (-7.1%).⁸ As we venture further into an uncertain 2020, follow the Fed’s plan on asset purchases; an overweight to MBS in broad portfolios may help to balance risk (rate and credit) in the hunt for yield.

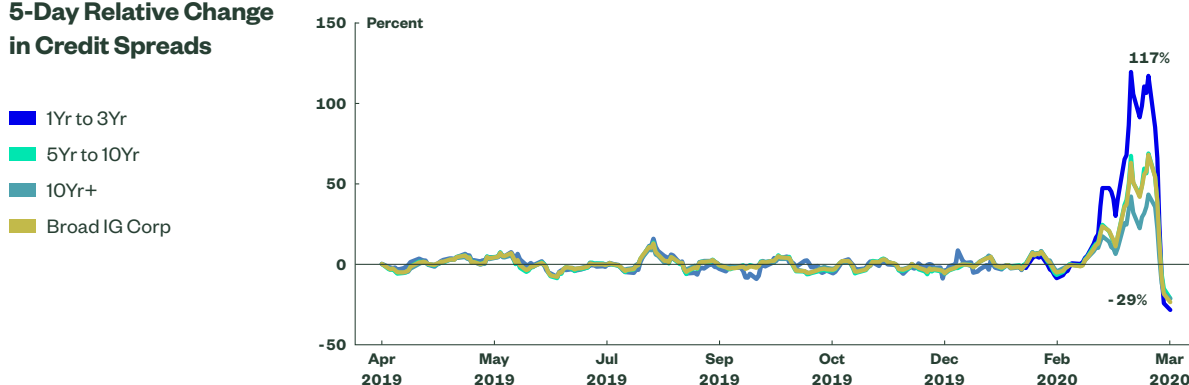
For agency MBS exposure, investors may consider the SPDR Portfolio Mortgage Backed Bond ETF [SPMB].

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Don't Fight the Fed — Part 2: Shorten Credit Curve Exposure

Part of the Fed's stimulus arsenal to combat the current crisis is to extend liquidity and capital to corporate borrowers by purchasing individual bonds of US investment-grade-rated firms with a maturity of five years or less as well as broad corporate bond ETFs. Back-of-the-envelope math using the Fed's outlined constraint of being able to purchase only 20% of an ETF's assets indicates that roughly \$30 billion of corporate bond fixed income ETFs could be purchased⁹ — meaning that \$220 billion of short-term corporate bonds could be bought.¹⁰ Similar to agency MBS, short-term corporate bonds will have the Fed supplying a supportive bid. As shown below, relative to other parts of the credit curve, the short-term segment witnessed a larger relative increase in spreads during recent volatility — but also snapped back faster following the Fed's asset purchase announcement.

5-Day Relative Change in Credit Spreads



Source: Bloomberg Finance L.P. as of March 31, 2020. **Past performance is not a guarantee of future results.** Figures shown are based on index data and do not assume any fees. IG Corp: Bloomberg Barclays US Corporate Bond Index, 1 to 3 yr: Bloomberg Barclays US Corporate 1-3 Yr Index, 5yr to 10 yr: Bloomberg Barclays US Credit Corp 5-10Y Index, 10+: Bloomberg Barclays Long U.S. Corporate Index.

How to Implement

Broad investment-grade corporate bonds posted their worst quarterly loss since 2008. And looking ahead to the next two quarters, risks are skewed to the downside — even with the supportive stimulus actions — given that we are likely to see an uptick in rating downgrades, depressed earnings, and weak economic data. While ETF purchases are likely to support broader tenors, the more sizable and targeted stimulus actions will have a greater impact on the short end. As a result, allocating alongside the Fed and overweighting the short-term segment may help to balance yield and credit risks within a portfolio's corporate exposure, particularly if future stresses emerge and the size of the program increases.

For short-term IG corporate credit exposure, investors may consider the SPDR Portfolio Short Term Corporate Bond ETF [SPSB].

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Endnotes

- 1 "Kudlow Projects Coronavirus Aid Package to Reach 'Roughly' \$6 Trillion", National Review 3/24/2020.
- 2 Economic forecasts indicate negative growth in Q1 and Q2 and a rebound in Q3, based on consensus economic estimates, Bloomberg Finance L.P. as of 03/31/2020.
- 3 Bloomberg Finance L.P. as of 03/31/2020, calculations by SPDR Americas Research.
- 4 What is the Meaning of 'Don't Fight the Fed'? thebalance.com.
- 5 "Fed Unveils Unlimited QE and Aid for Businesses, States", Bloomberg 3/23/2020.
- 6 Bloomberg Finance L.P. Performance from 12/31/2007 to 12/31/2009 as measured by the performance of the Bloomberg Barclays US Securitized Index (MBS), Bloomberg Barclays US Treasury Index (US Treasuries), Bloomberg Barclays US Aggregate Bond Index (the Agg), and the Bloomberg Barclays US Corporate Bond Index (IG Corporates). Drawdowns during the period were (-4.2%, -7.2%, -5.1%, and -16.0% respectively).
- 7 Agency MBS either have the explicit backing of the federal government (Ginnie Maes) or the implicit backing from the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac.
- 8 MBS +2.2%, Agg +0.8%, IG Corporates -7.1% per Bloomberg Finance L.P. as of 03/31/2020 from 2/21/2020 to 3/31/2020.
- 9 Calculations based on removing any active, non-US focused corporate bond ETFs then applying a 20% constraint to the current asset levels.
- 10 The program is the Federal Reserve Secondary Market Corporate Credit Facility (SMCCF), and has \$25 billion of capital allocated by the US Treasury. The Fed can, however, lend roughly ten times what it holds in collateral for non-government securities, meaning the size of the program could be as large as \$250 billion.

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Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

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Non-diversified funds that focus on a relatively small number of securities tend to be more volatile than diversified funds and the market as a whole.

Increase in real interest rates can cause the price of inflation-protected debt securities to decrease. Interest payments on inflation-protected debt securities can be unpredictable.

Investments in asset backed and mortgage backed securities are subject to prepayment risk which can limit the potential for gain during a declining interest rate environment and increases the potential for loss in a rising interest rate environment.

Diversification does not ensure a profit or guarantee against loss.

The units of the Sovereign Bond Flow Indicators are standardized by debt outstanding at each point in the curve and then for the aggregates are duration weighted. State Street Global Markets then aggregates the indicators into percentiles to gauge the significance of a flow or positioning metric over a variety of time periods and countries. State Street Global Markets' use is aimed at being a simple way of ranking flow and positioning indicators relative to their own history. For all of the flow indicators within the Bond Compass, State Street Global Markets calculates the percentiles based on the distribution of flows over the last five years using the daily aggregate time periods shown in the charts. As a guide a 100th percentile reading represents the strongest buying in five years; and a zero percentile equals the strongest selling. A reading in the 50th percentile would signal that net flows in the asset over the period are at their average level, typically close to zero.

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Investing involves risk including the risk of loss of principal.

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