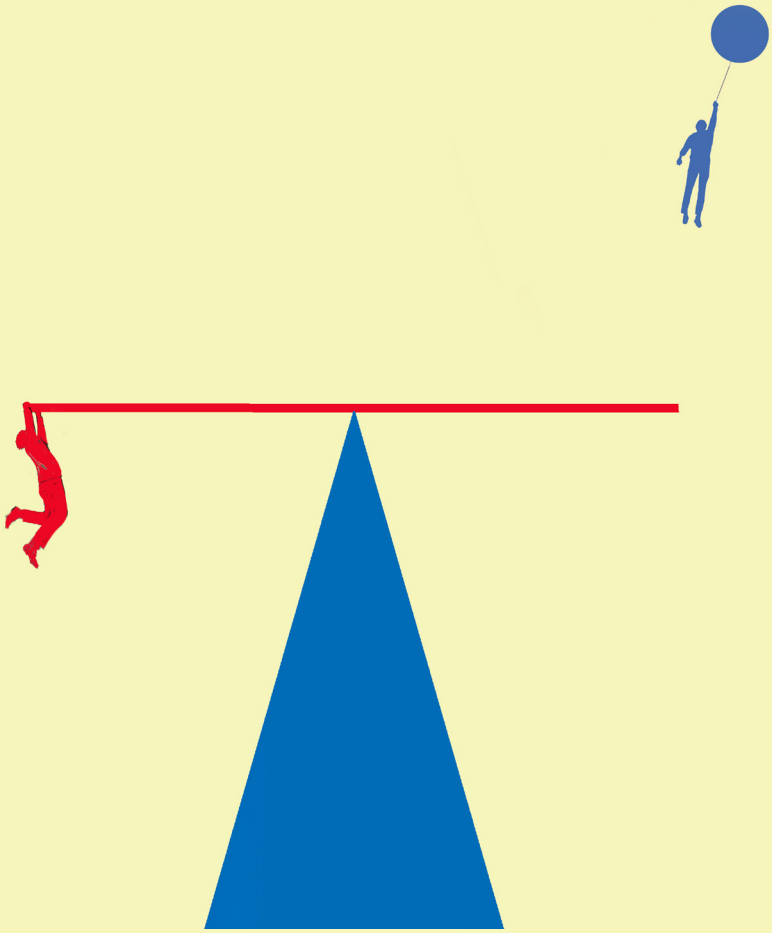
Bond Compass

Barbelling Credit and Defensives

Q4 2021



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billion in indexed fixed income assets

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- State Street Global Advisors' global scale enables our portfolio managers, traders and investment strategists to be sector specialists and based in their geographic markets
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years of bond index investing experience

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- Manage more than 100 fixed income index strategies, providing choice for investors
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100+

fixed income index strategies

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

** State Street Global Advisors, as of 30 September 2021.

Contents

Investor Sentiment — Flows and Holdings

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

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

Fixed Income Flows and Holdings

State Street Global Markets builds indicators of aggregated long-term investor behaviour in fixed income markets from a substantial subset of $10 trillion worth of fixed income assets under custody and administration at State Street.* This captures behavioural trends across tens of thousands of portfolios and is estimated to cover just over 10% of outstanding fixed income securities globally.

Not Yielding to Tiny Tantrums

Fixed income markets are currently weighing several potential peaks — peak growth, peak inflation (maybe) and peak policy support (likely). Having leapt higher throughout the year, US growth expectations are finally normalising following a quarter of largely disappointing activity data. While an expected growth rate of 5.9 percent (the current consensus) is still high historically, it is already much lower than the 7 percent that the US Federal Reserve (Fed) projected last quarter.

In contrast, adjustments to inflation forecasts have been less bond friendly. Peak inflation is now projected for the coming quarter, but the transitory inflation narrative cannot be taken for granted, a fact that policymakers are gradually adjusting to. While the Fed has hinted about when its asset purchases most likely will end, it has retained some flexibility about when it will begin tapering, and projections of actual interest rate hikes have been brought forward.

Together, this has created something of a mixed backdrop for fixed income markets. Long-term investor demand for US Treasuries across the curve has been below average across Q3, although we note it improved toward the end of the quarter. Interestingly, this stands in contrast to demand for European sovereign debt where, with the exception of Spanish bonos, demand has been in the top quartile of past flows. This is all the more notable given that Europe is experiencing a small inflation scare of its own and at least part of the European Central Bank's (ECB) support for fixed income markets, the Pandemic Emergency Purchase Programme (PEPP), is set to wind down in Q1 2022. Perhaps with their now symmetric but still singular inflation target, as well as a more tepid growth outlook, European markets are viewed as a potentially safer sovereign fixed income.

As clear as the preference for European over US sovereign debt has been in the past quarter, it is also impressive how strong demand for riskier areas of fixed income remains. For all the macro uncertainty about peak growth, inflation and policy, demand for US high yield was in the top quartile once again and inflows into European corporate debt were even stronger. Interestingly, this demand for what yield remains has not yet extended to emerging market (EM) sovereign debt due to regional and inflation nuances that we will discuss.

In summary, a quarter that could have been extremely uncomfortable for fixed income — with taper talk, inflation scares and potential credit risks in emerging markets, in particular — has ended with still relatively robust demand from institutional investors.

* State Street Form 10-K, as of 31 December 2020.

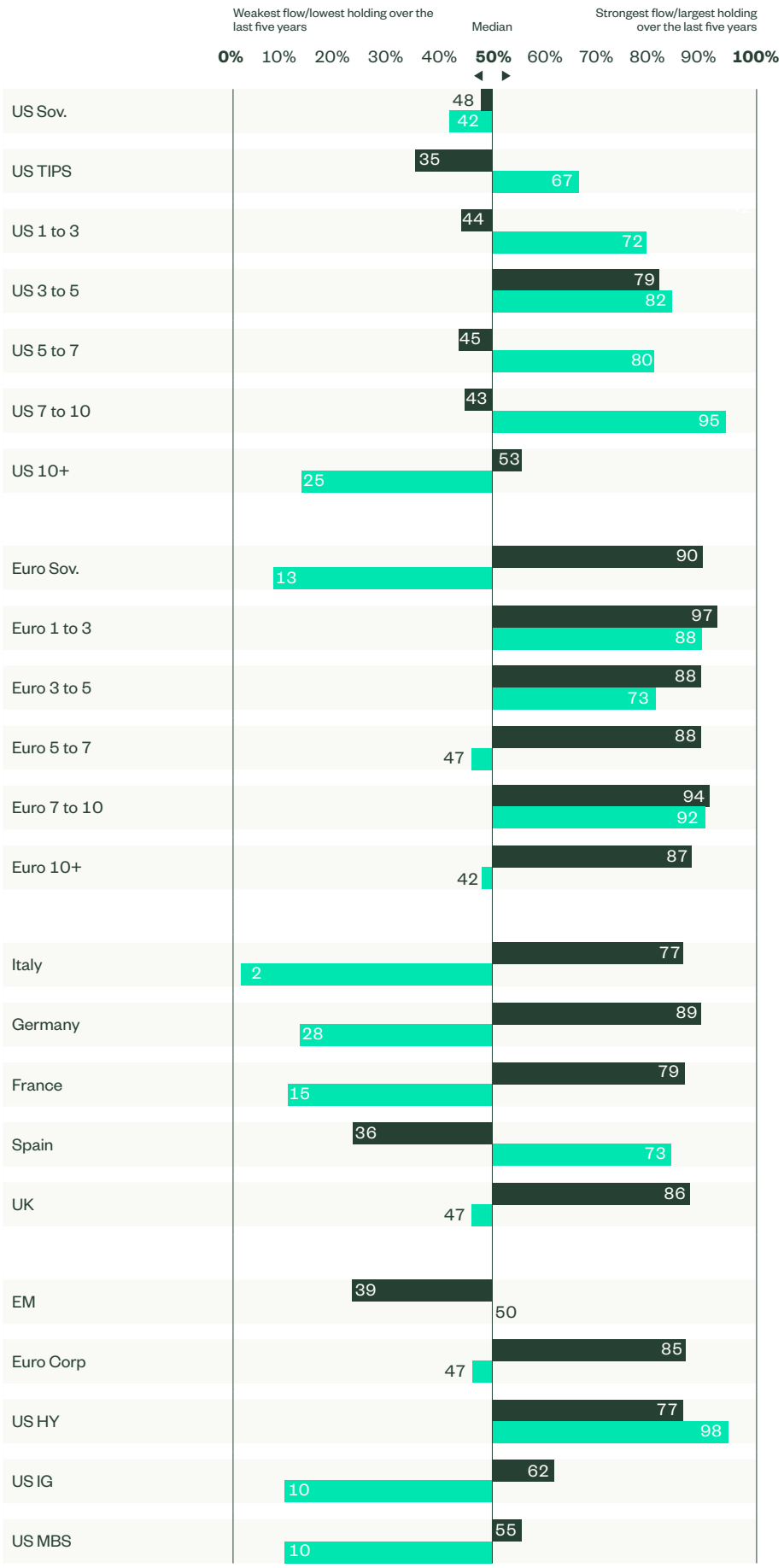
Q3 2021
Flows & Holdings

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

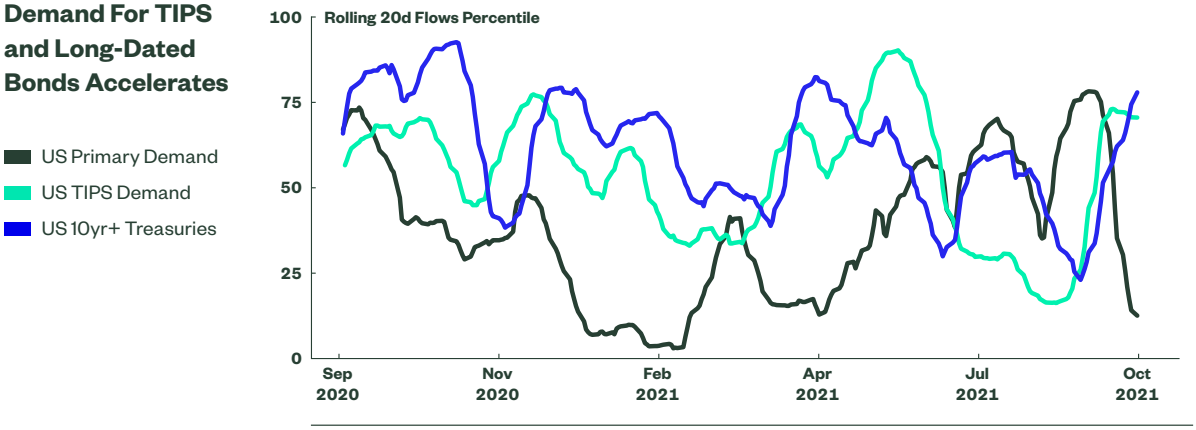


Source: State Street Global Markets, as of 30 September 2021. Flows and holdings are as of date indicated. They should not be relied thereafter. *As at quarter end.

Trouble for US Treasuries?

Despite the environment for a potentially more serious bond market dislocation, long-term investor demand for Treasuries across the quarter was not significantly below par. However, there was some variation. And in a perhaps more hopeful sign for Q4, demand for long-dated bonds accelerated sharply in September, suggesting the additional rate hikes appearing in the Fed's dot plot have not made investors too wary of duration risk. That doesn't mean the message from investor behaviour is all smooth sailing, though. Demand for inflation protection also ended the quarter strongly, which suggests the transitory inflation narrative cannot be taken for granted. And we also note a sharp drop in long-term investor participation in recent auctions — another trend that will need close watching with the debt ceiling and fiscal packages still up for debate.

Demand For TIPS and Long-Dated Bonds Accelerates

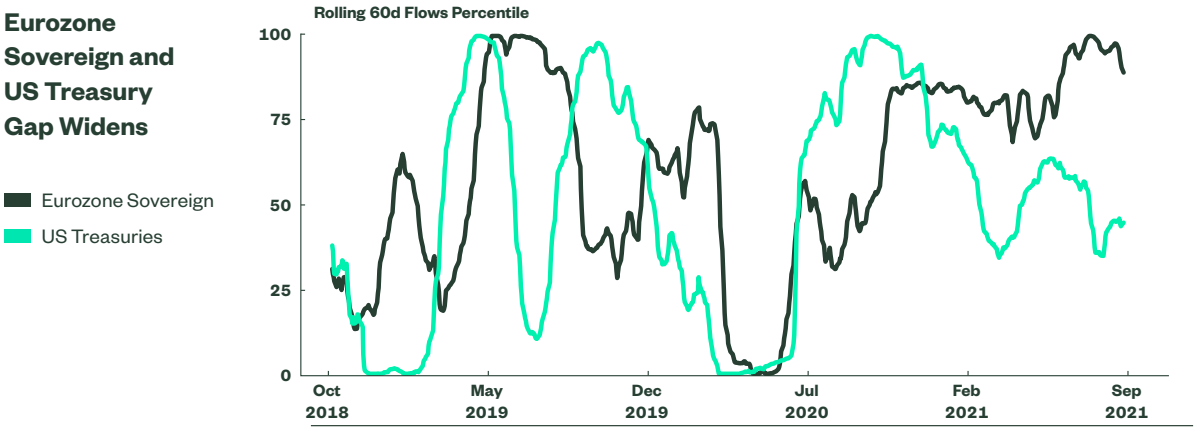


Source: State Street Global Markets, as of 30 September 2021.
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

European Demand Outpaces US

A key theme through much of 2021 has been more robust investor demand for eurozone sovereign debt — despite much lower yields and a potentially dangerous combination of relatively weak growth and high debt levels. This resilience will face further tests in the next six months now that we have a clear end date for the ECB's extra asset purchases through the PEPP and reemerging eurozone inflation. But for now, euro sovereigns remain the clear investor preference, perhaps because the starting levels for both growth and inflation expectations are so much lower in the area. The only caveat worth noting here is that while demand for Italian debt remains robust, we see weaker demand for both Spain and peripheral bonds, the latter worth watching for potential signs of stress once the PEPP buying ends.

Eurozone Sovereign and US Treasury Gap Widens



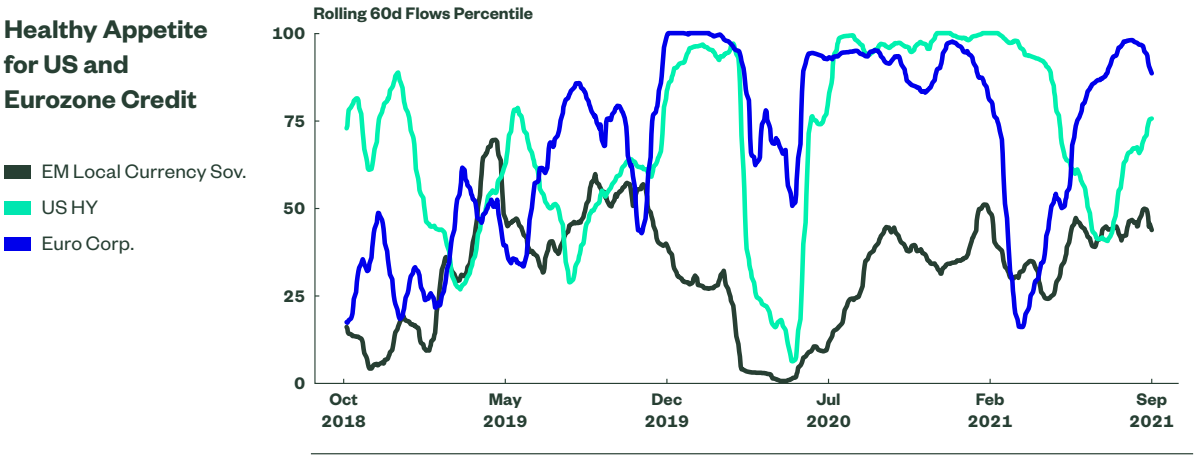
Source: State Street Global Markets, as of 30 September 2021.
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

Sovereign versus Credit Concerns

We would caution not to interpret robust investor demand for euro sovereign debt as indicating a lack of appetite for yield. Even though demand for Treasuries was tepid in Q3, the same cannot be said of US high yield debt and, to a lesser extent, investment-grade credit. This trend was mirrored in Europe, where demand for corporate debt was also robust. Although growth expectations may have peaked, we note that earnings news in general has been solid, suggesting corporates remain in better-than-average health. That isn't the case everywhere, of course, but it is interesting to note that contagion from potentially lower growth expectations, more generally, and from the news of Chinese property giant Evergrande's debt crisis, more specifically, has been limited so far.

Curiously though, it is telling that robust demand for credit does not extend to higher yielding local currency like EM sovereign debt, where flows have recovered only to near average levels. As we will explore later, this may reflect more troubling inflation trends in a range of EM markets and, in many places, the beginning of interest rate tightening cycles in response.

Healthy Appetite for US and Eurozone Credit



Source: State Street Global Markets, as of 30 September 2021.
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

PriceStats®

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

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

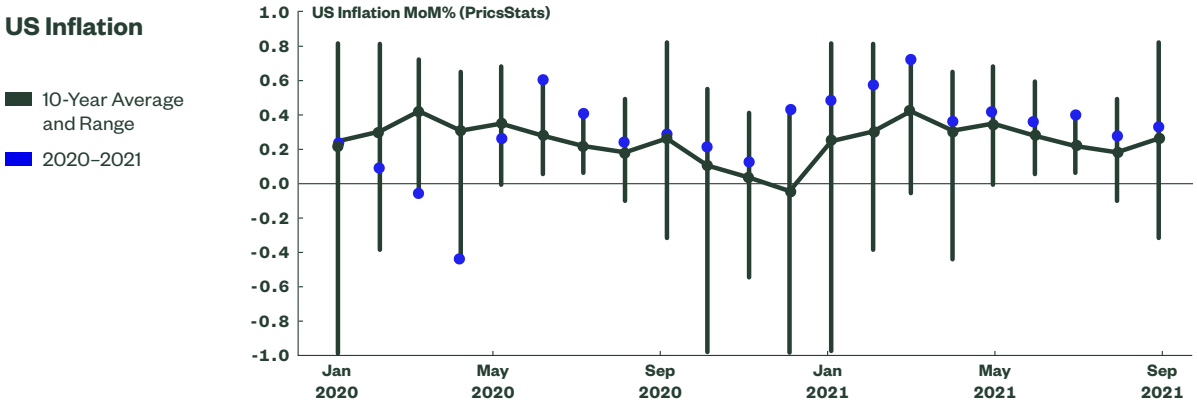
This information is available on a daily basis from State Street Global Markets: globalmarkets.statestreet.com.

Anything but Average

The hope that inflation would be transitory has and continues to be a key theme supporting both fixed income and equity markets. Unfortunately, while elements of the current inflation are beginning to reverse, other factors are emerging to take their place. This could potentially test both the markets' and policymakers' patience if underlying inflation does not start to ease soon.

PriceStats® allows us to track this in near-real time, with the additional *advantage* of not directly collecting some sectors distorted by the re-opening so as to capture underlying inflation. If we assume PriceStats® returns to its normal seasonal run rate, the annual rate of inflation will be back below 3 percent by the last week in December and back to 2.3 percent by the end of March — a clear and transitory supporting trend. The challenge, however, is that PriceStats® has returned at or *above* average monthly inflation readings for 17 consecutive months, September included. While recent monthly gains have been closer to their historic averages, the longer this run of above average monthly readings continues, the less credible the transitory narrative becomes. This would be true even if the annual inflation rate begins to fall, which it almost inevitably will in the next six months.

US Inflation



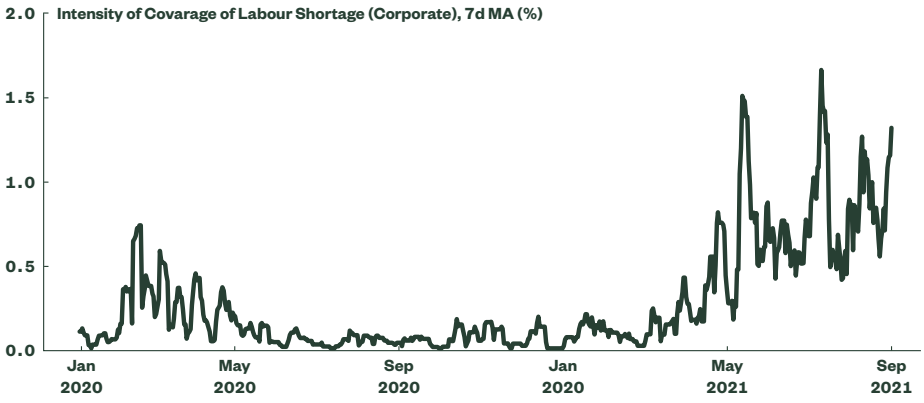
Source: State Street Global Markets, as of 30 September 2021.

US Inflation: No Shortage of Concern

As troubling as the incoming inflation prints are, the market will continue to take some comfort from more limited evidence that inflation is becoming embedded in expectations. While long-term inflation expectations from financial markets, consumer sentiment and economist surveys have all risen, they remain contained and are notably below shorter-horizon expectations. This reflects a continued belief in the transitory inflation narrative. Arguably the biggest threat to this, over and above the current inflation trend itself, is evidence of more robust wage growth.

In a similar vein to these expectations themselves, wage growth (adjusted for the changing composition of the workforce) has accelerated, but not yet to levels that would be deemed troubling. Further, with employment levels still substantially below pre-pandemic levels, one might assume that wage growth should not become a serious threat with a plentiful supply of available labour to constrain it. However, the unevenness of the COVID-19 pandemic recovery means that this cannot be taken for granted, and the intensity of mentions of labour shortages in corporate communications is rising once more. With the potential to either restrain output growth or to generate wage growth strong enough to cast doubt on the transitory inflation narrative, the resolution of these pockets of labour market shortages seems likely to be a key tipping point for fixed income markets in the next six months.

Intensity of Coverage of Labour Shortage



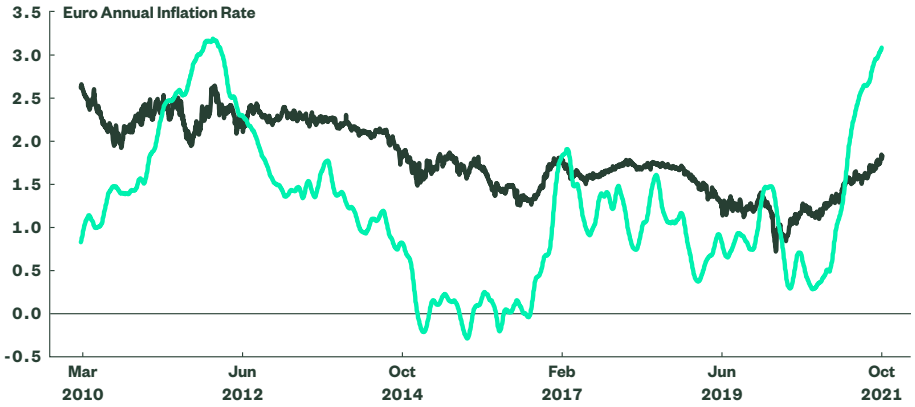
Source: State Street Global Markets, as of 30 September 2021.

Eurozone Inflates

The recovery in eurozone output has not been as spectacular as that in the US. Despite an initially hesitant vaccine rollout and disrupted reopening in H1, and more modest direct fiscal stimuli, growth forecasts in the eurozone did not rise earlier in the year as they did in the US. They are, however, beginning to surge higher as the reopening gets underway and retailers appear to have some pricing power.

Like other areas, Europe has had to contend with a less friendly global inflationary environment, but has had its own specific, largely political issues with the constrained supply of natural gas. This has taken headline inflation above 3 percent for the first time, a trend that PriceStats® had been warning about for a few months prior. But it is notable now that medium-term inflation expectations are beginning to rise in response. In fact, for all the focus on the uptick in inflation in the US, European inflation expectations rose the most in the last quarter. Similar to the US, Europe's current wage growth is not yet suggestive of potential second-round effects, but this pressure will build the longer inflation remains high.

Europe Inflation



Source: State Street Global Markets, as of 30 September 2021.

Emerging Inflation Plateau?

Inflation trends in emerging markets (EMs) have been a challenge for both investors and policymakers for much of this year and will remain so in Q4. PriceStats® was quick to capture the rapid acceleration in EM inflation in the middle of 2020 and the rate of acceleration has only begun to moderate in the last quarter. The good news is that in contrast to developed markets, most EM central banks are showing no signs of accommodating this rise in inflation and tightening cycles are already underway, even with a more uncertain growth outlook. Combined with favourable base effects and currency stability, this means that inflation should start to peak in the coming six months. As we noted earlier, this could prove a key catalyst for the return of long-term investors into EM local currency sovereign markets, if and when the inflation trend finally turns.

Emerging Market Inflation

Source: State Street Global Markets, as of 30 September 2021.

Q4 Investment Outlook

State Street Global Advisors has identified key considerations for investors in the coming quarter.

Investment Theme #1

High Yield: Keep Calm and Keep the Carry

- **High yield has been a cornerstone of returns for fixed income investors in 2021 year to date. Returns were even positive in Q1, when US Treasury yields shot higher. The powerful stabilising supports of spread compression and generous coupon payments are reasons why high yield has been an investment theme in each Bond Compass for 2021.**

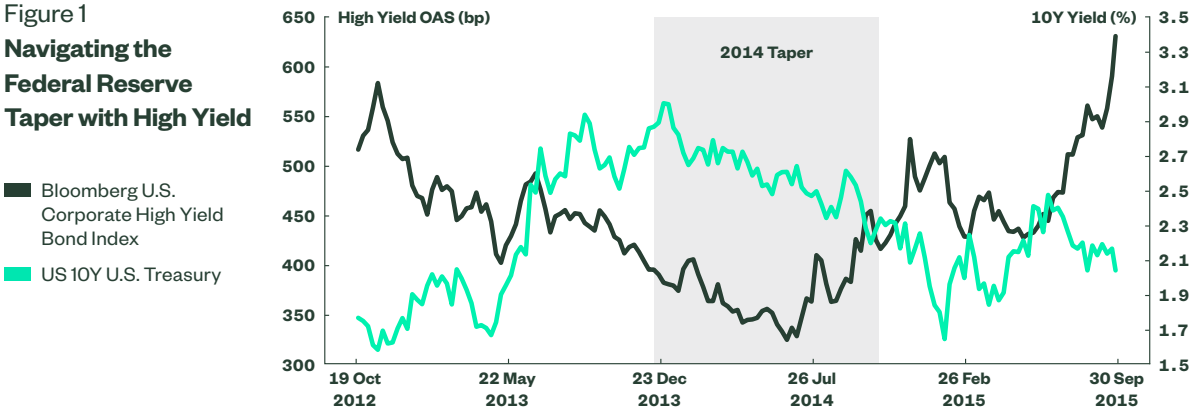
The recent wobble in equities has seen high yield spreads widen. However, risks of a material widening look limited by the still strong growth dynamic. While the pace of growth is starting to slow, it is expected to remain firmly in positive territory into 2022, which should also see earnings well supported. Additionally, supply bottlenecks should eventually ease and labour may become more plentiful as government support schemes end. It should be no surprise that recent ratings upgrades have been skewed towards positive outcomes, with US high yield companies seeing an upgrades/downgrades ratio of above 2.5 over the last 2 quarters for both the Moody's and S&P[1] ratings agencies.

Learning to Live Without the Fed

The other uncertainty is the effect that the reduced level of bond purchases by central banks will have on high yield bonds. Neither the Federal Reserve (Fed) nor the European Central Bank (ECB) buy high yield bonds but, if underlying yields are forced higher, then returns will still suffer. However, the impact of slowed central bank buying on fixed income returns is by no means mechanical even for government bonds.

The 2014 tapering of purchases by the Fed and the impact that had on the 10-year U.S. Treasury yield and the option-adjusted spread of the Bloomberg U.S. Corporate High Yield Bond Index is shown in Figure 1. Treasury yields actually rose in advance of the taper, peaking just shortly after its start. They then declined over the rest of the period when bond purchases were phased out. In high yield, there was actually a tightening in the spread to Treasuries over the first 6 months of the tapering, largely because economic growth momentum remained strong. Notably, monthly returns from US high yield indices were positive between September 2013 (i.e. once the mid 2013 taper tantrum had subsided) until July 2014 (asset purchases ended in October 2014).

Figure 1
Navigating the Federal Reserve Taper with High Yield



Source: Bloomberg Finance L.P., as of 30 September 2021.

While any historical comparison comes with a warning that things are different this time, the preceding example does highlight the resilience of high yield returns due to their high coupon payments and short duration. Despite spreads having widened, their ability to absorb any rise in underlying Treasury yields may be more limited this time around but there could still be scope for this as long as growth remains firm.

European high yield bonds should be less affected by central bank actions than the US. The ECB has noted that it will purchase fewer bonds in Q4 but, unlike the Fed, it has announced no estimated target date for the cessation of purchases altogether. This should ensure a more stable performance from government bonds. In addition, spreads on European high yield are not as tight from a historical perspective as those in the US. For instance, the option-adjusted spread on the Bloomberg Liquidity Screened Euro High Yield Bond Index remains more than 120bp wider than the tights reached in 2017, while the US high yield spreads remain closer to their lowest levels since 2003.[2]

Both US and European high yield still offer appealing levels of yield and relatively short durations. While we expect that the Fed's Taper will not cause a major spike in Treasury yields, defensive duration positions mean a limited impact on performance if yields do push higher.

1 Source: Bloomberg Finance L.P., as of 30 September 2021.

2 The Bloomberg U.S. High Yield Index has an Option Adjusted Spread to Treasuries of 287bp versus lows of 235bp in May 2007 based on monthly data. Source: Bloomberg Finance L.P., as of 30 September 2021.

Investment Theme #2

Emerging Market Debt Left Out in the Cold

- **Emerging market debt had a volatile first three quarters of 2021. Returns have been weighed on by concerns around COVID, high inflation forcing central banks to tighten policy, and a resurgent USD. Fears over the upcoming Federal Reserve taper have done their bit to keep investors on the sidelines.**

The first half of 2021 saw certain pitfalls for investors in emerging market (EM) debt. The first three months of the year delivered negative returns as the snap higher in US Treasury yields and the USD, coupled with rising COVID infection rates in EM, saw investors turn cautious on EM assets.

The end result is that, currently in the broader market where credit spreads have compressed, yields on EM debt are at relatively normal levels from a historical perspective. The yield to worst on the Bloomberg Emerging Markets Local Currency Liquid Index is 4.90%, in line with the 5-year average. The obvious comparison is with developed market high yield strategies and, for the Bloomberg US Corporate High Yield Bond Index, the current yield of 4.20% is well below the 5.80% 5-year average. Indeed, the spread between these two indices is 70bp, against a 5-year average of -85bp.[1]

Aside from the appeal of a higher yield, there are reasons to expect long-term returns from EM debt:

- Signs that inflation may be starting to top out (or at least moderate over the coming six months as suggested by PriceStats®) should relieve some pressure on EM central banks to raise rates. Indeed, there are already signals that momentum in central bank policy tightening may be starting to turn. Figure 1 shows the balance of central banks raising rates versus cutting them for the 19 central banks in the Bloomberg Emerging Markets Local Currency Liquid Index. While the 12-week average is now in positive territory, it has started to decline. With a significant amount of policy tightening already priced into the curve,[2] signs that inflation pressures are easing could result in a flatter profile for future interest rate rises, which in turn would support bonds.

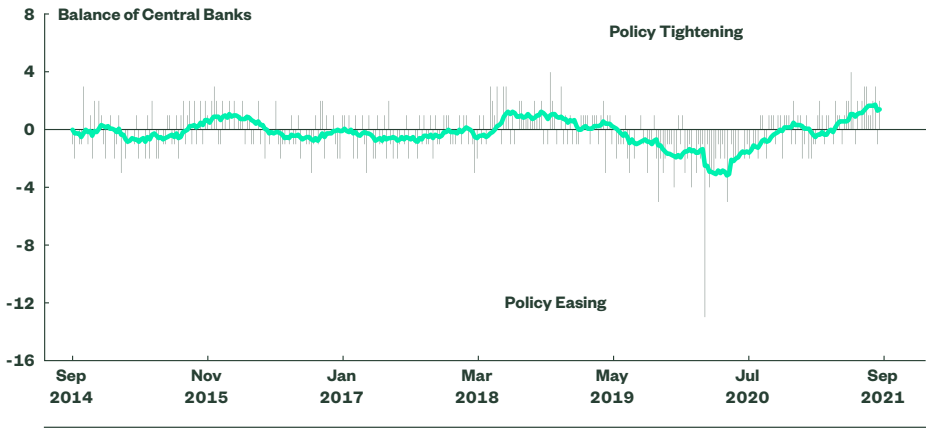
- As at the end of September 2021, the USD was expensive versus EM FX. The model of the long-term value of currencies, as run by State Street Global Advisors, calculates that the USD was 7.6% expensive to the basket of currencies that makes up the Bloomberg Emerging Markets Local Currency Liquid Index. This is its richest level in a year.

The above factors support EM debt. There are no guarantees that this scenario will play out during the coming quarter but there could be some potential triggers for better performance. EM debt investors have been nervous of Fed actions since the 2013 Taper Tantrum hit returns, so weaker economic numbers, pushing out the date of the taper, may support risk appetite. Alternatively, if the Fed starts to cut its bond purchases and the markets react favourably, fears of an aggressive back-up in Treasury yields and spike in the USD would diminish. Damping concerns over USD strength, in particular, should bolster investor confidence in EM debt returns.

1 Source: Bloomberg Finance L.P. All yield levels and spreads are as at 30 September 2021.

2 The EM Local Currency 0–2 year bond curve slope remains around its steepest since September 2018 if local market curves are weighted according to their exposure in the Bloomberg Emerging Markets Local Currency Liquid Index.

Figure 1
EM Central Bank Hike/Cut Momentum is Starting to Turn



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 30 September 2021.

The China Factor

A key support for EM debt should continue to come from China. Making up around 10% of the Bloomberg Emerging Markets Local Currency Liquid Index, Chinese bonds have turned in the strongest performance of any country bonds year to date, returning 5.8%.[3] Chinese bonds are a useful risk diversifier, often not behaving like the majority of EM bonds. This was evident during the peak of the COVID crisis and has continued to be the case, with local Chinese bonds actually rallying in Q3 on the back of the deteriorating growth outlook as the September manufacturing PMI dropped below 50. There is a feeling that the People's Bank of China will continue to focus on adding liquidity rather than cutting rates at this juncture. However, wider contagion from the problems at Evergrande, coupled with persistent weakness in economic indicators, may cause the market to speculate on the possibility of a rate cut.

The CNY has also contributed to positive returns year to date, which is unusual in the context of the USD rally seen in 2021. Some support for the currency would have come from the favourable flow story of Chinese bonds. Data from the Institute of International Finance suggests that just over 50% of the $200 billion of foreign investment flows into EM debt seen so far in 2021 have moved into Chinese bonds.[4] Overseas investment is expected to continue with the expansion of the FTSE World Government Bond Index (WGBI), which is set to include China from October 2021.

Past performance is not a reliable indicator of future performance.

3 Source: Bloomberg Finance L.P., as of 30 September 2021.

4 Source: Institute of International Finance for year-to-date end August 2021

Investment Theme #3

US Investment Grade Credit: Barbelling Risk to Add Durability

The first two investment themes revolve around staying invested in high yield and EM debt. Both strategies offer yields well in excess of those from government bonds, which provides investors with some protection. However, both could be vulnerable if the broader market goes risk-off, pushing equities lower. This is not a central view: State Street Global Advisors expects firm economic growth into 2022 to support risk appetite. Nonetheless, there are several reasons for fixed income investors to be cautious:

- **Year-end market issues** Challenging market liquidity conditions sometimes occur as year-end approaches. These conditions could be exacerbated if central banks ease back on policy support measures.

- **Growth slowdown** Some recent data has hinted that growth momentum is starting to fade. The PMIs in most of the key economies have come off their highs and logistical issues continue to hamper the reopening of the economy. There are particular issues in China, where a more meaningful slowing could heighten fears that global growth in 2022 will not be as robust as is currently expected.

- **Short squeeze** Lower-than-benchmark duration exposure is a natural position to take if expectations are that bond yields will go up. The post-September FOMC rise in Treasury yields is likely to reinforce underweight market positioning. However, with yields a little higher, and if growth momentum does start to slow, there is the risk of a scramble to push durations back to more neutral levels.

As a consequence, we like to balance these higher risk strategies with US investment grade (IG) exposure. IG spreads to government bonds are historically tight at around 80bp.[1] Even though spreads can be expected to widen if economic indicators start to slow in a more meaningful way, the additional duration of the IG exposure should ensure positive returns as underlying bond yields decline.

Taper Ahead

The risk is clearly that high inflation prompts central banks to exit policy stimulus more rapidly. However, using the example of the Fed's actions in 2014 (the only real example of a taper that we have), it is clear that investors would have received higher returns from being invested in IG credit than in Treasuries.

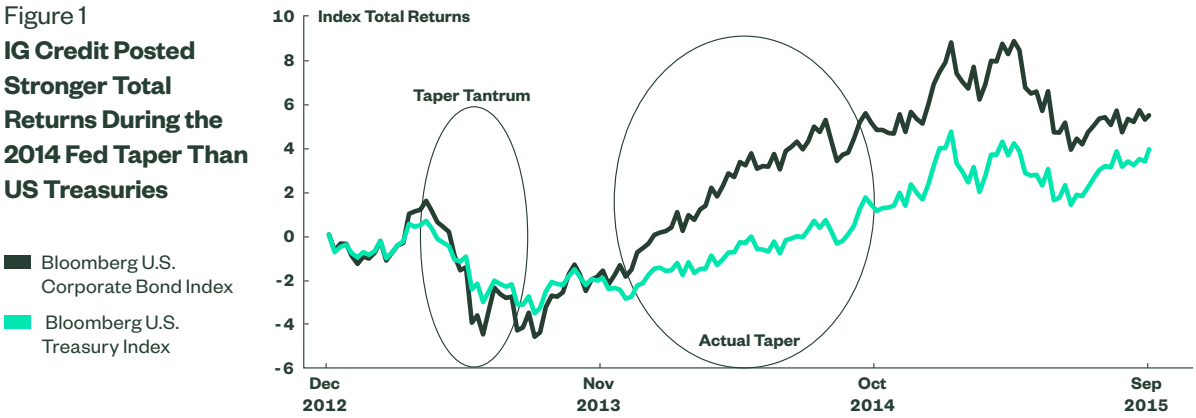
Figure 1 shows total returns from the Bloomberg US Corporate Bond Index and the Bloomberg US Treasury Index during and around the 2014 taper. While there was a little more volatility from the IG credit index in the run-up to the Fed taper, once the process got underway, returns from IG were considerably higher than for Treasuries.[2] Some of this performance was the result of the longer duration of IG credit but this was limited given the yield to worst on the Treasury index fell by less than 10bp during the taper. The stronger performance of IG credit was more about spread compression coupled with the higher coupon on credit versus government bonds than moves in rates.

1 Source: Bloomberg Finance L.P. The option-adjusted spread on the Bloomberg SASB US Corporate ESG Ex-Controversies Select Index was 80bp as at 30 September 2021.

2 Returns taken between the Fed's taper announcement in December 2013 and the end of asset purchases on 31 October 2021 were 6.2% for the Bloomberg US Corporate Bond Index and 3.7% for the Bloomberg US Treasury Index.

Figure 1

IG Credit Posted Stronger Total Returns During the 2014 Fed Taper Than US Treasuries



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 30 September 2021. 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.

Additional protections

An additional layer of defence can come from incorporating ESG into your portfolio. This is becoming an increasingly popular approach with investors. One key reason is the potentially higher degree of stability provided by ESG strategies. For example, the Bloomberg SASB ESG US Corporate Ex Controversies Select Index performed better during the peak of the COVID Crisis than the standard Bloomberg US Corporate Index. Our analysis highlighted the benefits of ESG screening for index stability and longer-term index performance versus the traditional market weighted index. So there are grounds to believe that ESG integration could help dampen volatility around the start of the Fed's taper.

We have focused on US IG strategies given the yield that they provide, with a pick-up of over 180bp versus a similar European IG corporate strategy.[3] While the carry will be appealing, currency risks cannot be ignored, not least given the recent appreciation of the USD. As such, for euro-based investors, it may be worth considering a EUR-hedged strategy to remove the drag on performance if the USD does start to weaken.

3 Source: Bloomberg Finance L.P. The spread between the Bloomberg SASB US Corporate ESG Ex Controversies Select Index and the Bloomberg SASB EUR Corporate ESG Ex Controversies Select Index was 183bp at September 2021 month-end.

Important Information

Information Classification:
General Access.

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State Street Global Advisors Worldwide Entities

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The units of the Sovereign Bond Flow Indicators are standardised by debt outstanding at each point in the curve and then for the aggregates are duration weighted. State Street Global Markets ('SSGM') then aggregate the indictors into percentiles to gauge the significance of a flow or positioning metric over a variety of time periods and countries. SSGM's 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 State Street 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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