Bond Compass

Q1 2020

Hunting Yield, Wherever It May Be

04 **Investor Sentiment — Flows and Holdings**

10 **PriceStats®**

13 **Q1 Investment Outlook**

STATE STREET GLOBAL ADVISORS SPDR®

A Leader in Fixed Income Index Investing

$403

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 $403 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

* 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 Markets, as of 30 September 2019.

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

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

Analysis

The uncertainties that had dogged the outlook for much of 2019 came to a head in Q4, leaving an apparently cleaner slate for the 2020 outlook. A truce was tentatively agreed in the US-China trade war, Brexit cleared another hurdle with Boris Johnson's resounding election victory and recession risks in the US and elsewhere appeared to have declined.

The principle response across fixed income markets was a fall in precautionary demand for US Treasuries; inflows fell to a six-month low. Treasuries were not abandoned completely, however, with much of the selling concentrated at the long end of the curve. Investors appear to be anticipating a continued steepening in the curve in 2020. As additional proof that recession risks are dissipating, we saw recovery in demand for high-yielding corporate debt in spite of the rash of credit downgrades and lateness of the credit cycle.

It was not all good news though, as the elimination of the underweight holdings in Italian and emerging market sovereign bonds was interrupted in Q4. Local currency emerging market debt, in particular, may have been expected to be the destination of choice for more risk-seeking investors, but the nascent return of inflation and lower real yields are making investors pause for thought.

1 Source: State Street Global Markets, as of 30 September 2019.

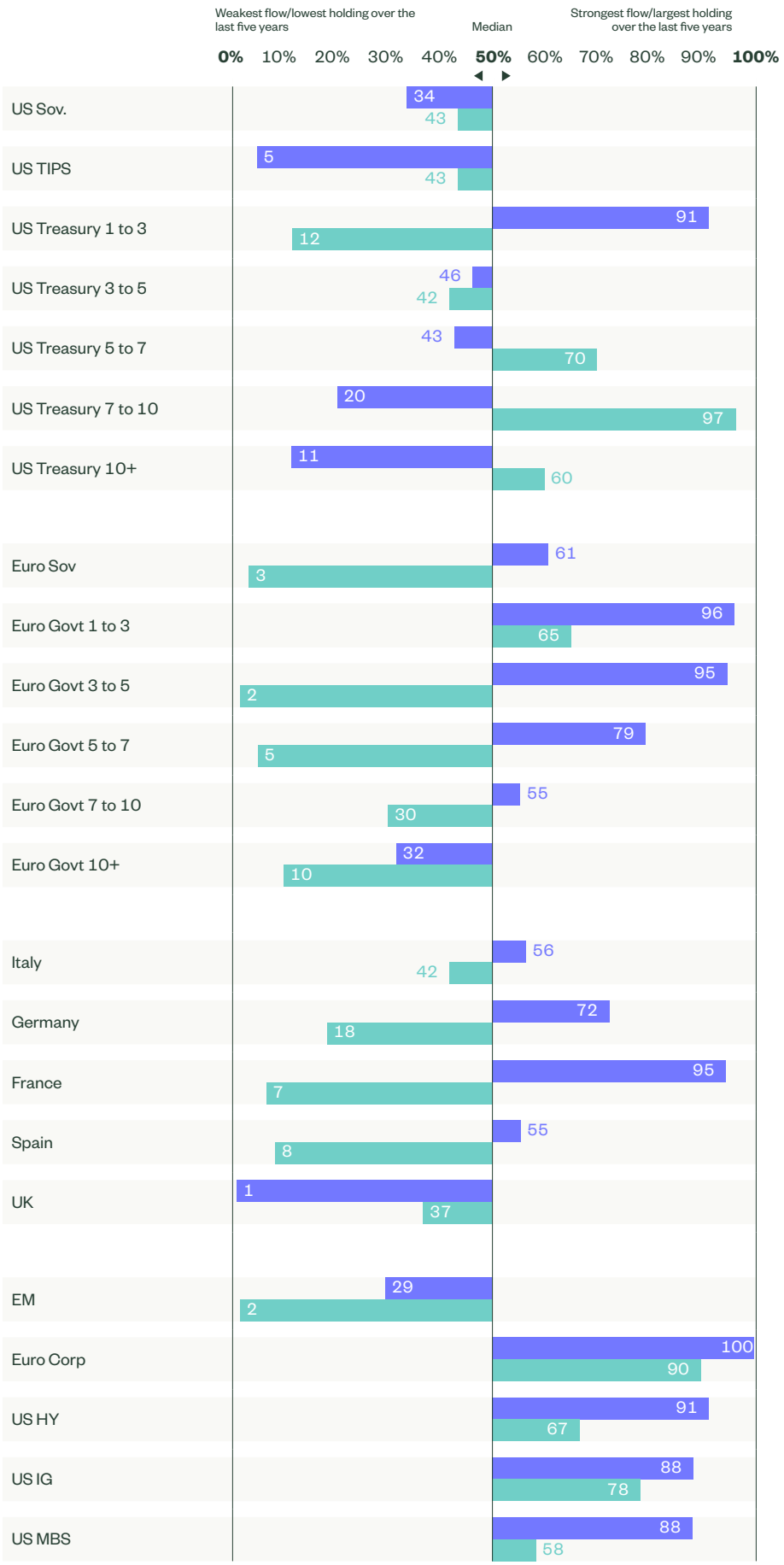
Q4 2019
Flows & Holdings

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



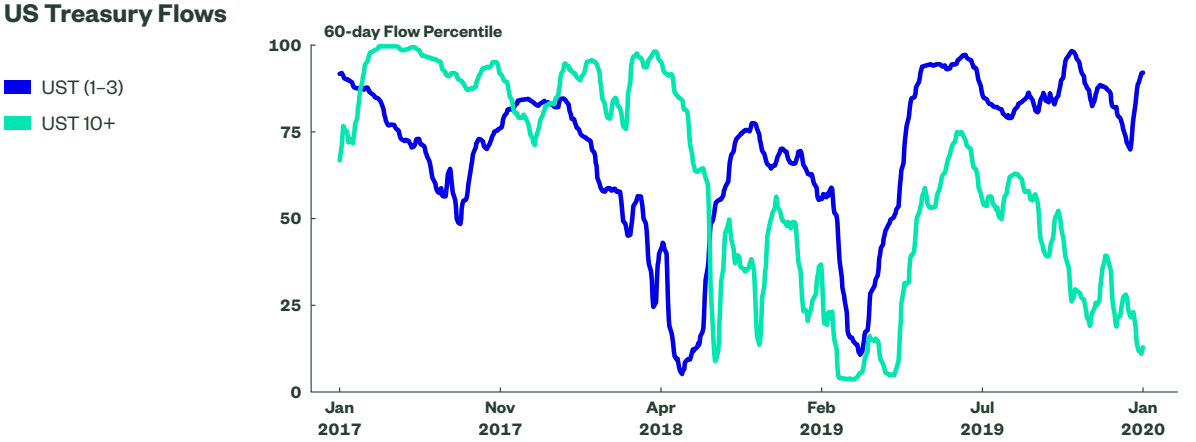
Source: State Street Global Markets, as of 31 December 2019. Flows and holdings are as of date indicated. They should not be relied thereafter. *As at quarter end.

The Long Drain on Treasuries

Given the broader backdrop of reduced tail risks, it was not surprising to see precautionary demand for Treasuries weakening during Q4. Long-term investor demand on a duration-weighted basis fell into the 33rd percentile across the quarter, the weakest reading in six months.

It would be wrong, however, to suggest investors have abandoned Treasuries altogether. Much of the weakness in demand was at the long end of the curve, with demand for Treasuries with a duration in excess of 10 years slipping into the 13th percentile. Demand for short-dated Treasuries was more or less unchanged and remains robust relative to history. The implication is that investors appear to be anticipating a further steepening in the US curve; this is consistent with steady if unspectacular growth and a lower risk of recession.

US Treasury Flows



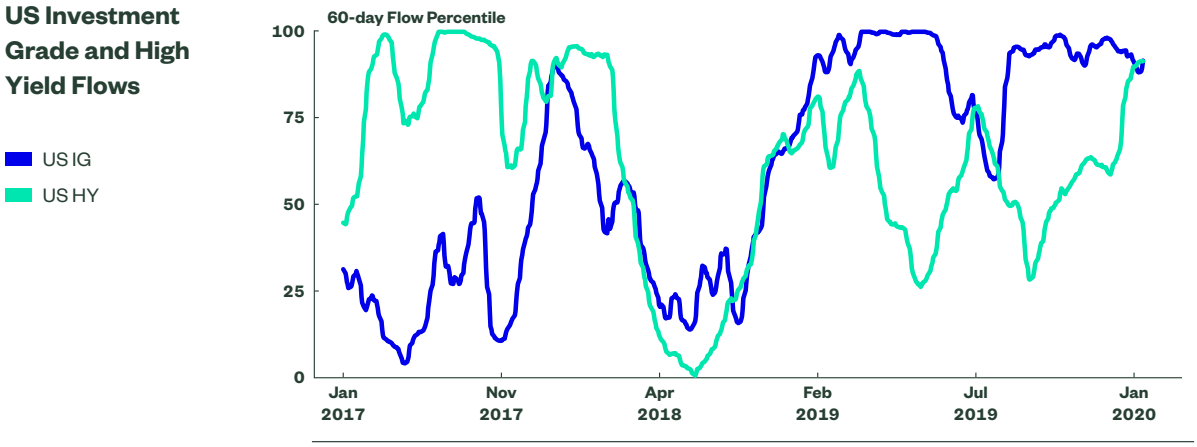
Source: State Street Global Markets, Bloomberg Finance L.P., as of 2 January 2020.
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

Credit Questions

Amidst the recession concerns that ebbed and flowed for much of 2019, the current cycle extended its record length and US high yield credit has attracted careful observation. It is perhaps telling then that demand for high-yielding corporate debt ended Q4 at a two-year high. Digging further into where net inflows occurred reveals solid demand all the way across the high-yielding rating spectrum, as well as an acceleration of inflows in December. This may be understandable given the reduction in aggregate recession risk, but the sheer strength and breadth of flows were surprising given the rash of high yield credit downgrades during the quarter; there where 1.86 downgrades for every upgrade, according to Moody's.

It is worth noting that such robust demand for credit was not seen only in the US. Demand for European corporate bonds rose to a five-year high in Q4. While this could simply be interpreted as an outright rush for yield, it does not quite fit with observed behaviour. As we discuss later, not all high-yielding sovereign bonds saw inflows during the quarter.

US Investment Grade and High Yield Flows



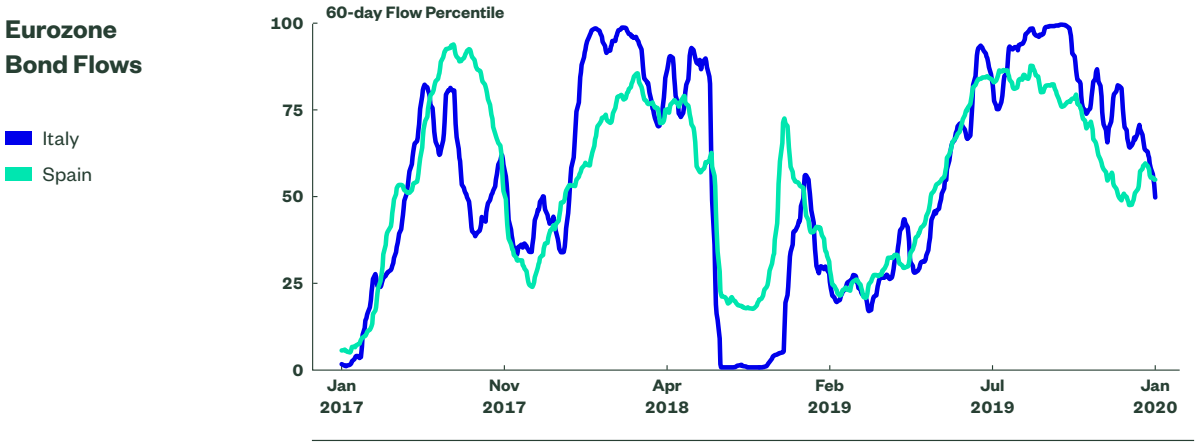
Source: State Street Global Markets, Bloomberg Finance L.P., as of 2 January 2020.
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

Eurozone Runs

A persistent theme in the Bond Compass publications during the past year has been the steady demand for Italian sovereign debt. For more than a year, investors have been unravelling their underweight positions in Italian bonds, even in the face of questionable fundamentals. The fiscal challenges presented by Italy's debt burden and barely growing economy have not changed significantly, but the lure of higher yields and promise of ECB buying proved too much. In Q4, however, Italian yields may have finally found their level.

Inflows into Italian government debt have begun to dry up and there were even pockets of selling in December, which suggests that one of the stronger fixed income trades of 2019 is unlikely to be as attractive in 2020. Meanwhile, demand for Spanish debt will warrant close watching as the new Socialist government, backed by the radical left-wing party Podemos, attempts to pass its first budget. Investors are already underweight Spanish debt and recent flows suggest no sign of panic yet.

Eurozone Bond Flows



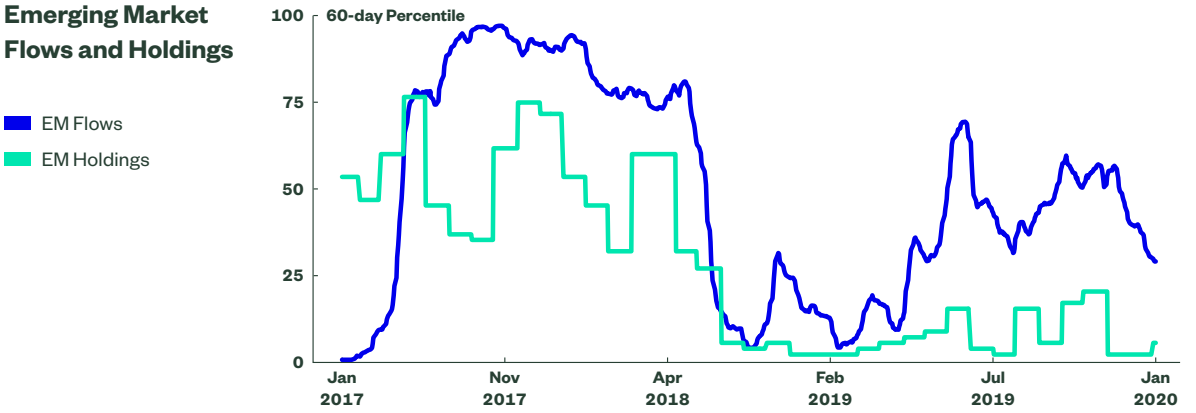
Source: State Street Global Markets, Bloomberg Finance L.P., as of 2 January 2020.
Flows and holdings are as of the date indicated. They should not be relied on thereafter.

An Emerging Surprise

As with Italy, long-term investors began 2019 with a significant underweight in emerging market debt. However, global trade war concerns alongside a range of country-specific risks have consistently restrained the return to emerging sovereign markets. Nevertheless, with the apparent reduction in tail risks over the past quarter, it was surprising to see long-term investor demand for emerging bonds actually fade into year-end.

It is possible that the US-China trade truce came too late in the quarter to rescue sentiment; we did not see any real improvement in demand in December. Further, it is notable that the weakness in demand was relatively broad-based; our regional flow aggregates showed soft demand across Latin America, EMEA and APAC. This does beg the question whether real yields remain attractive enough to entice investors back into local currency emerging market debt or whether emerging market equities are a better opportunity to play the potential trade truce. Finally, and as we note in the next section, emerging market inflation trends are beginning to look a little less friendly in certain places.

Emerging Market Flows and Holdings



Source: State Street Global Markets, Bloomberg Finance L.P., as of 2 January 2020.
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®

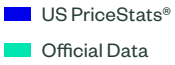
PriceStats® provides high-frequency measures of inflation and real exchange rates drawn from prices on millions of items sold by online retailers. This real-time pulse of global economic trends helps investors anticipate and evaluate the impact of inflation, including the impact on monetary policy and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

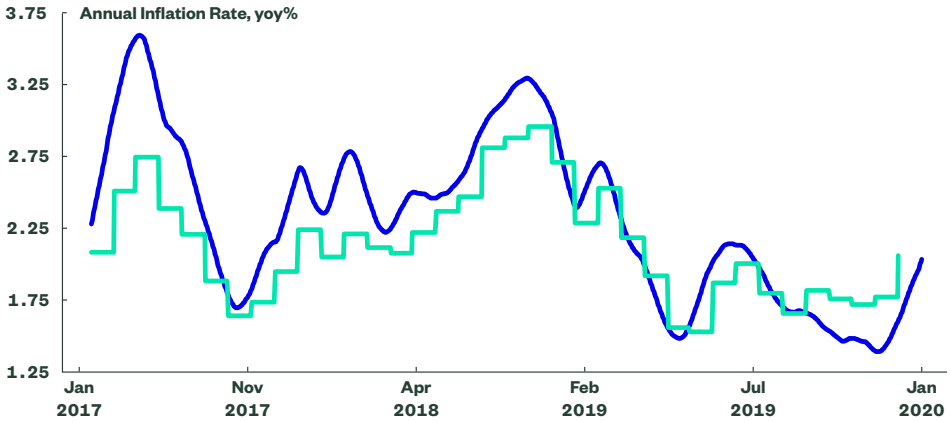
This information is available on a daily basis from State Street Global Markets: globalmarkets.statestreet.com.

US: Inflation Inflection Points

PriceStats® suggests that US inflation was unseasonably robust across the fourth quarter. Added to 2018's collapse in energy prices dropping out of the inflation calculation, this has prompted an abrupt turnaround in the annual inflation rate. Headline and core inflation rates will now converge above 2%, begging the question for the first half of 2020 of whether they will remain below 2.5%.

PriceStats® Daily Country Inflation Index



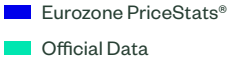


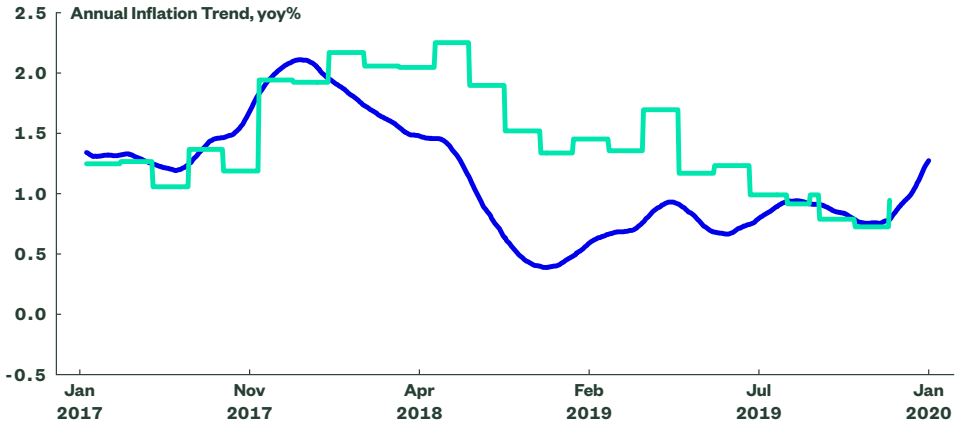
Source: State Street Global Markets, as of 31 December 2019.

Eurozone: Disinflation Now Over

The starting point for eurozone inflation is much lower, but the trend acceleration is similar. This is partly but not entirely due to base effects. Having run below the official series for more than a year, PriceStats® now suggests that eurozone disinflation is over.

PriceStats® Daily Eurozone Inflation Index



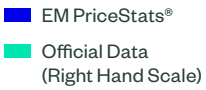


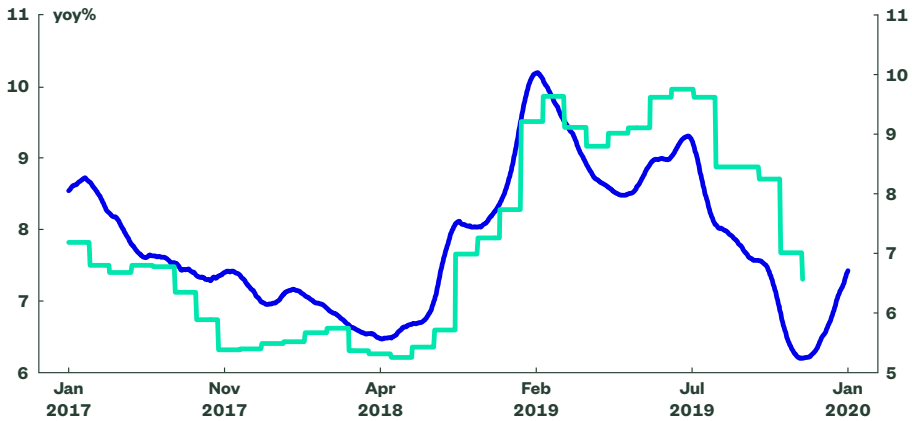
Source: State Street Global Markets, as of 3 January 2020.

Emerging Markets: Low Inflation Unlikely to Last

Declining official inflation, and at times currency stability and even appreciation, have provided the cover for some significant interest rate reductions in emerging markets in the past year. PriceStats®, however, suggests the run of lower inflation readings is unlikely to last into 2020.

PriceStats® Daily EM Inflation Index





Source: State Street Global Markets, as of 3 January 2020.

Q1 Investment Outlook

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

Investment Theme #1

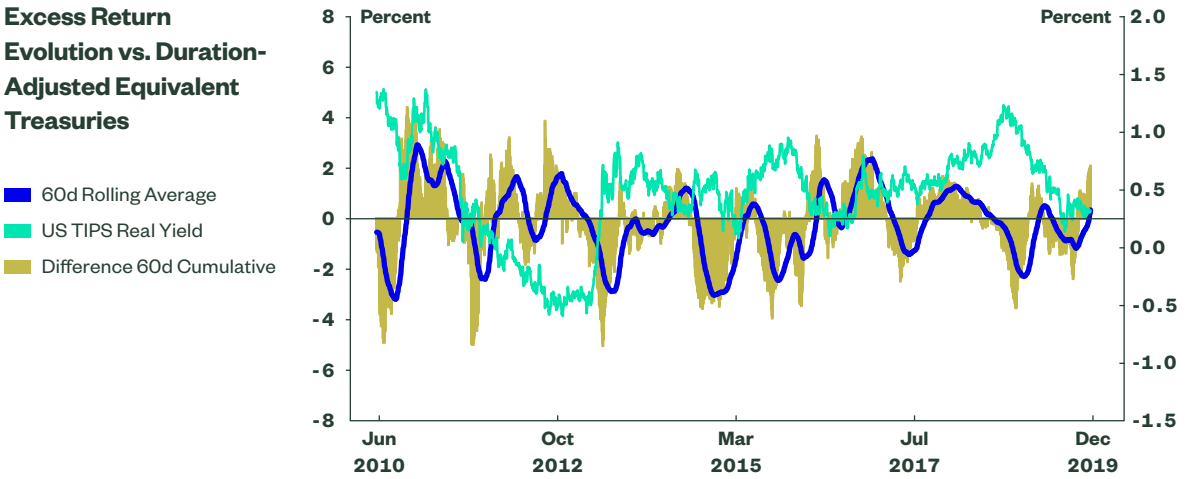
Get Real! Go Tactically Long TIPS vs. Nominals

Inflation has trended down in recent years, but there is movement towards a rebound in Q1 2020. Meanwhile, institutional investors have not necessarily favoured US TIPS lately, possibly underestimating the risk of this potential grey swan in 2020 investment outlooks. The PriceStats® measure of US inflation has indeed showed an inflection that may sow the case for more surprises in early 2020.

Some factors to watch in Q1 2020 include: oil prices holding up, leading to a continuation of the base effect in energy; wage inflation and average hourly earnings remaining above 3% against a 50-year low in the unemployment rate; continued US consumer spending; a weaker dollar; and technical support (particularly in the 5 and 30-year range) due to low expected issuance.

The progress on the phase one deal has partially lifted US-China trade war risk, but it remains a potential hazard to the more positive overall picture. We should also highlight the more tactical nature of this positive inflation story as anticipations for headline CPI beyond Q1 2020 are less optimistic.

Excess Return Evolution vs. Duration-Adjusted Equivalent Treasuries



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 31 December 2019.
Past performance is not a reliable indicator of future performance.

Investment Theme #2

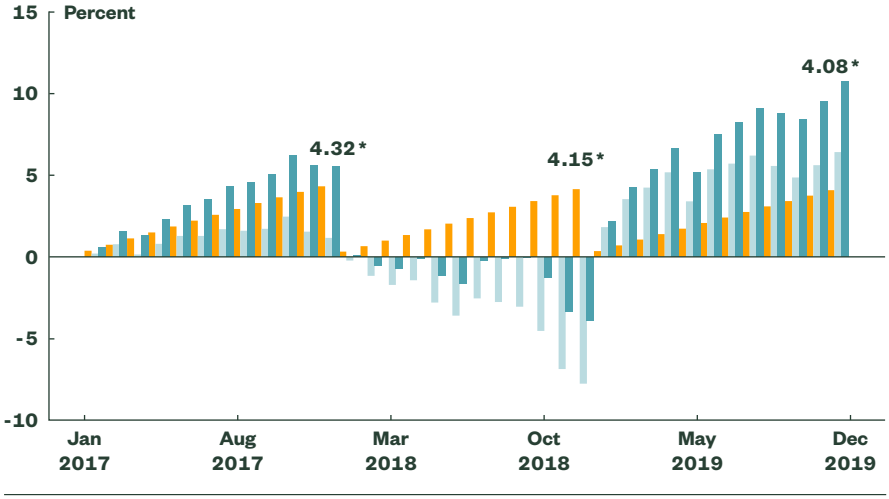
Coupon and Risk-On: High Yield and Convertible Bonds

After a strong year for long-duration high quality assets, return forecasts are dimmer for 2020. While high grade bonds have not been rated as well in the portfolio, a number of fund managers continue to prefer overweighting credit and looking for carry. "Lower for longer" has not gone away, but Treasury yields are not expected to fall any further, with average expectations across US and German 10-year yields of a c. 0.2% increase by 2020 year-end.

Modestly favourable conditions for credit assets seem to be present, at least in the first quarter. Inflation expectations have picked up and central bank liquidity injections have provided a positive backdrop for financial conditions. Spread contraction may be shallower after a strong 2019 but some analysts forecast up to 45bps of spread tightening in euro high yield. Meanwhile, the carry component of high yield exposures could help them outperform high grade rates in Q1.

The risk to this outlook remains a potential resurgence of trade tensions as well the extended positioning of investors. Issuance could also weigh on spreads if new issue appetite becomes fickle. Last, central bank policy may be more challenging to forecast as economic data is better behaved and inflation surprises to the upside.

High Yield Performance Decomposition
Bloomberg Barclays Liq. Screened Euro HY Index



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 31 December 2019.
Past performance is not a reliable indicator of future performance. *Cumulative coupon performance.

Investment Theme #3

Capture Continuing Tailwinds for Emerging Market Debt

Low yields in DM bonds remain a key issue for investors in Europe. In this environment, we see the potential for stronger relative returns in EM debt, particularly local currency bonds. Heading into 2020, as a US-China phase one trade deal inches closer, a mix of factors could drive EM debt, including:

- Economic growth differentials as EM countries are expected to rebound at 4.6% growth in 2020 versus 1.7% for developed economies.
- Accommodative global central bank policies propping up liquidity.
- Real yield differential continues to support investor flows.
- A weaker USD helping EM currencies to strengthen (currently USD is c. 5.6% undervalued for the Bloomberg Barclays EM Local Currency Liquid Govt index) and the seasonality of the EM FX basket in Q1 if the environment remains constructive.

EM FX Seasonality — Deutsche Bank Emerging Market Currencies Basket Index

	Q1 (%)	Q2 (%)	Q3 (%)	Q4 (%)
2019	0.05	1.46	-3.21	3.78
2018	2.13	-8.00	-2.12	0.81
2017	4.76	2.40	1.62	1.56
2016	6.35	0.11	1.50	-4.35
2015	-3.30	1.22	-7.79	-0.92
2014	-0.29	2.07	-4.81	-6.22
2013	-1.55	-2.64	1.47	-0.34
2012	5.89	-3.24	2.96	1.36
2011	3.01	1.98	-10.57	-0.26
Average Since 2011	1.89	-0.51	-2.33	-0.51

Source: State Street Global Advisors, Bloomberg Finance L.P., as of 31 December 2019.

Important Information

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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 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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Exp. Date 30/04/2020

Calendar of Events

Q1 2020

January

3	Fri	US	FOMC Meeting Minutes
10	Fri	US	Change in Nonfarm Payrolls
14	Tue	US	CPI YoY
15	Wed	UK	CPI YoY
17	Fri	EC	CPI YoY
21	Tue	JN	BOJ Policy Balance Rate
22	Wed	CA	Bank of Canada Rate Decision
23	Thu	EC	ECB Main Refinancing Rate
29	Wed	US	FOMC Rate Decision
30	Thu	UK	Bank of England Bank Rate

February

7	Fri	US	Change in Nonfarm Payrolls
13	Thu	US	CPI YoY
19	Wed	UK	CPI YoY
19	Wed	US	FOMC Meeting Minutes
21	Fri	EC	CPI YoY

March

4	Wed	CA	Bank of Canada Rate Decision
6	Fri	US	Change in Nonfarm Payrolls
11	Wed	US	CPI YoY
12	Thu	EC	ECB Main Refinancing Rate
18	Wed	EC	CPI YoY
18	Wed	US	FOMC Rate Decision
19	Thu	JN	BOJ Policy Balance Rate
25	Wed	UK	CPI YoY
26	Thu	UK	Bank of England Bank Rate