Insights
Fixed Income

September 2020

Living with Lower for Longer:
The Case for Global Aggregate

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With rates forecast to remain low for an extended period of time, investors will need to look at strategies for enhancing yield returns. For those wanting to limit risk exposure, global aggregate funds combine relatively safe but low-yielding government bonds with those that offer higher returns.

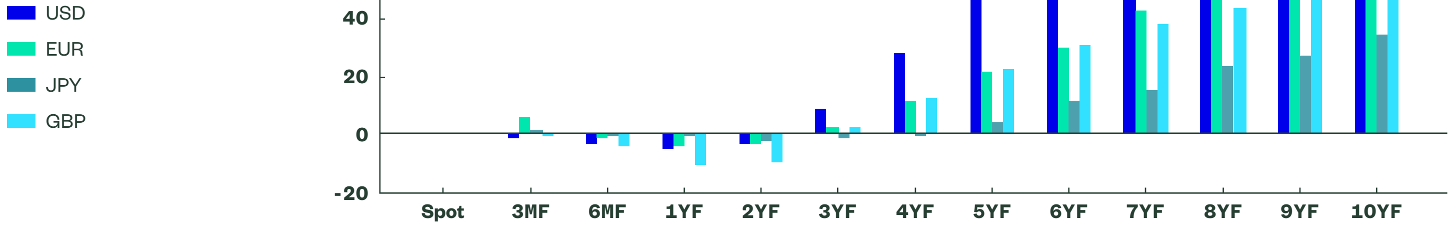
The medium-term growth outlook remains uncertain but there are clear signs that the economy is bouncing quite nicely as it comes out of lockdown. This should underpin the rebound during H2 2020 and for 2021 still extremely accommodative central bank policy and fiscal loosening should see the recovery sustained. The IMF predicts close to a 5% contraction in global GDP in 2020 but growth rebounding to 5.4% in 2021 (advanced economies +4.8% and EM 5.9%).[1]

However, the pandemic will have left some deep economic scars with materially higher unemployment and a wider output gap. These effects should bear down on inflation and are likely to result in central banks keeping policy accommodative for an extended period of time. The experience of the Great Financial Crisis should ensure that even a more robust than predicted bounce in growth during the 2021–2022 period is unlikely to shake conviction that rates need to stay low in order to close the output gap. The ECB's 2011 rate rise proved to be a costly policy error and one that suggests no central bank will be in a rush to tighten policy.

The market has already factored in expectations that policy rates will remain low. Figure 1 shows the changes in 1-month Overnight Index Swap (OIS) rates at (largely) 1-year forward starting dates for USD, EUR, JPY and GBP. The overnight rate typically stays close to the official central bank rate making the forwards an effective way to judge the market pricing of how central bank policy rates could evolve.

For most central banks, the market is pricing up to around 10bp of cuts over the coming two years, with a bias to ease stretching out to three years. After that, the US Federal Reserve is priced to start tightening policy but the pace of hikes is slow at around 25bp per year. The ECB is only really priced to commence its tightening cycle beyond the 5-year mark while the Bank of Japan and Bank of England have a shallow profile for rates, with only around 25–50bp of tightening factored in over the entire 10-year period. For the Bank of England, this relates to Brexit and concerns over reaching the end of the transition period without a deal and to the general impact on life outside of the EU trading block.

Figure 1
Changes in Central Bank Policy Rates Priced by Overnight Index Swaps



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 31 August 2020.

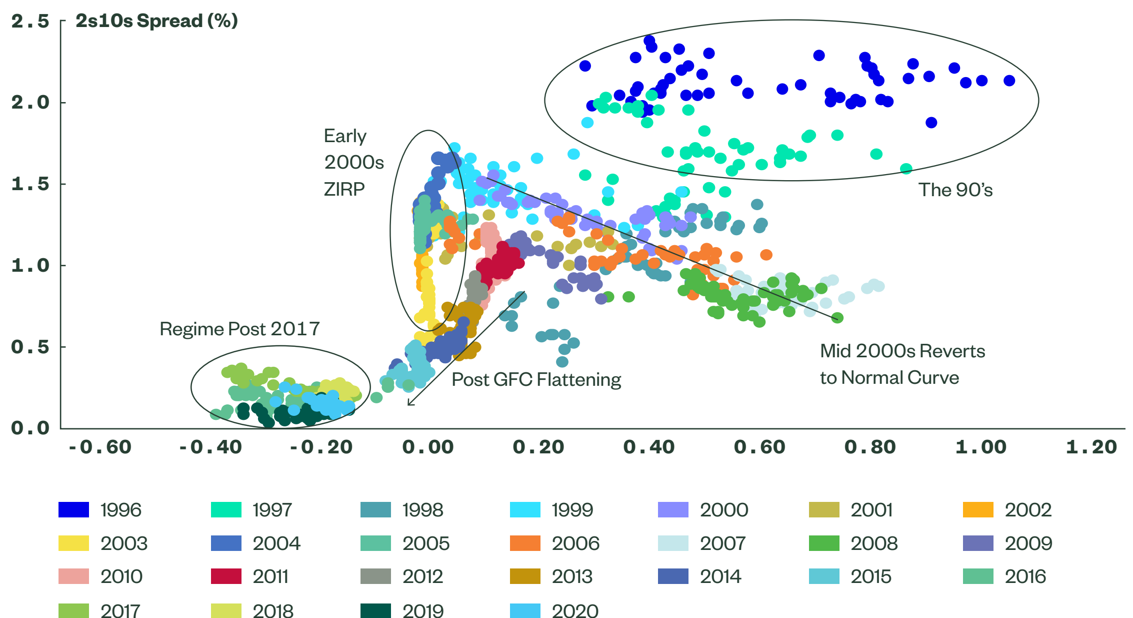
The Future of Fixed Income in a Lower-for-Longer Regime

As market pricing indicates, there are near-term risks that central banks could cut rates further, which would support fixed income. However, the 'experiment' of deeply negative rates has yielded disappointing results. Beyond weakening the currency, it is unclear that it has provided the incentive to spend or invest rather than save, as was anticipated. On the contrary, the policy has been criticised for impairing the profitability of the banks, inhibiting that sector's ability to lend. There are clearly no simple solutions to a broken or heavily impaired monetary transmission mechanism and the result is that central banks' appetite to take rates into, or further into, negative territory should be limited.

Conversely, for the reasons outlined above, there seems little prospect of tighter policy any time soon. This suggests short-maturity government bonds will remain in a narrow 'yield corridor' for the foreseeable future. The risk is that if 2021 growth expectations get gradually downgraded, history suggests that yields further out along the curve could also decline.

The Japanese curve is a prime example. Figure 2 shows the 2–10Y spread in JGBs plotted against the 1Y rate since 1996. The 1990s saw the 1Y rate between 30–100bp with a 2–10Y spread of 150–250bp. As rates were cut to zero in the BoJ's first phase of Zero Interest Rate Policy (ZIRP), curve spreads remained in the 50–175bp range. There was some normalisation of the curve dynamic (flattening as front end rates rose/steepening as it fell) as policy was tightened ahead of the Global Financial Crisis. Post the GFC, curves globally have flattened with the 2–10Y JGB spread now ranging between 0 and 50bp despite negative front-end yields.

Figure 2
The Gradual Compression of Japanese Curve Spreads



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 7 August 2020.

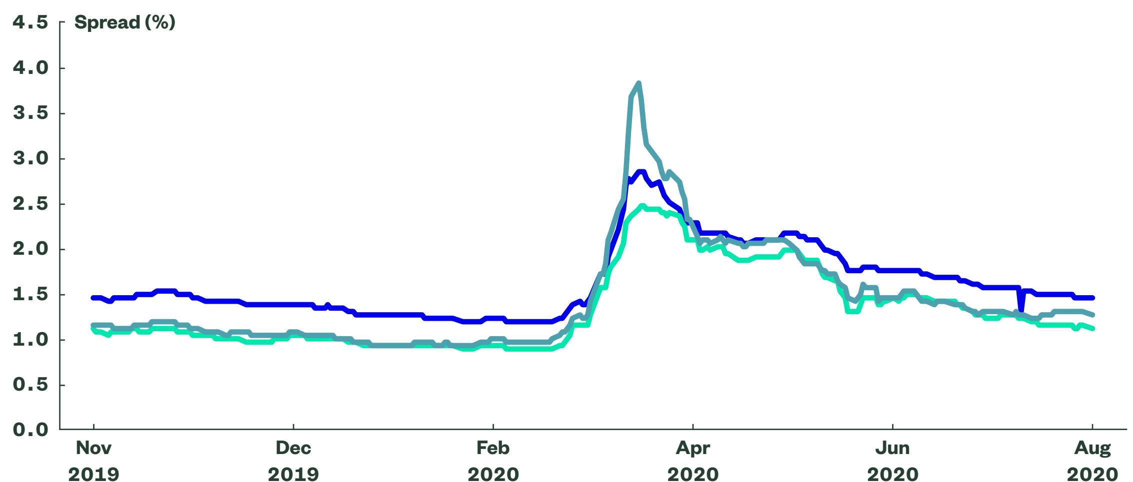
Aside from the obvious implications for curve trades, this powerful compression of spreads towards short-dated levels suggests a bias towards higher-yielding government debt, such as US Treasuries, or the periphery nations of the euro area as one strategy to enhance returns. Likewise, locking in the higher rates of carry provided by investment grade corporates, which offer a meaningful pick-up to government bonds (Figure 3), is likely to prove important for returns in this 'lower-for-longer' interest rate environment.

The major central banks are also purchasing investment grade bonds, which should ensure orderly markets and avoid a return to the volatility we saw in March 2020. It is also important to note that many of the policies put in place by central banks and governments, such as paying for staff to be furloughed, deferred tax payments and loans, have been designed to improve the survival rate of corporates. Especially high levels of corporate issuance since March 2020 are a sure sign that companies are making use of benign financing conditions to repair their balance sheets.

The dark side to these policies is that higher leverage, deferred payments and potentially higher taxes all raise risks for longer-term company profitability and therefore the dividend stream. It would seem that these measures prioritise debt over equity, which should favour credit.

Figure 3
Option-Adjusted Spreads for Corporates — Ongoing Compression

- Bloomberg Barclays Sterling Corporate Index
- Bloomberg Barclays Euro Aggregate Index
- Bloomberg Barclays U.S. Corporate Index



Source: Bloomberg Finance L.P., as of 31 August 2020.

Diversifying Away the Risks

There remain high levels of uncertainty over what may materialise during the coming one to two years. Risks of a second major wave of the pandemic. Risks that the rebound proves tepid and that weak growth is long-lasting, as warned about by Fed Chairman Powell. Risks of rising company downgrades and defaults.

The reality is that even within the ecosystem of government bonds an increase in returns can only be achieved through taking on additional duration or credit risk. If credit risk is taken, for instance through overweight positions in euro area periphery government bonds, then assets do not behave in the same way as higher-rated government bonds, and typically perform well only in risk-on environments. It is the same for investment grade credit.

With the market likely to undergo many more swings in risk appetite, there is a strong case for long-term investors to combine relatively safe but low-yielding government bonds with higher-yielding bonds for the carry. The Bloomberg Barclays Global-Aggregate Total Return Index does just that.

- The index consists of 56% government bonds with another 6.5% in quasi-government bonds such as Supranationals, Sovereigns and Local Authorities. Agency debt, which is often government guaranteed in some way, accounts for 7.7% of the index. So it is largely rooted in government debt with less than 20% accounted for by corporate bonds.
- Close to 27% of the government bond portfolio is in US Treasuries, which supports overall returns given US yields are typically higher than those of core European or Japanese bonds.
- Additional yield comes from spread product. For instance, the option-adjusted spread on the corporate bond portfolio is around 125bp.
- Likewise ABS, MBS and CMBS provide a pick-up of between 55bp and 110bp to Treasuries.[2] Other, predominantly European, securitised assets such as covered bonds also provide a pick-up but are heavily weighted to AAA paper.
- The overall yield-to-maturity is just above 90bp, which is comfortably above yields on government only portfolios. For instance, the yield on the Bloomberg Barclays US Treasury index is 50bp.
- The index is geographically well diversified with its greatest exposure to the US (37%), the euro area (22%) and Japan (15%).
- It is an investment grade index and within that 39% is AAA rated and 15% AA.[3]

How to Play this Theme and Options to Hedge

The Bloomberg Barclays Global-Aggregate Index is tracked by the SPDR Bloomberg Barclays Global Aggregate Bond UCITS ETF (USD unhedged, distributing share class). Given the substantial number of bonds contained in the index (c. 25,700), the ETF samples it in order to replicate various index characteristics such as currency, duration, credit rating and bond type but using fewer bonds (3,767).

Given bond portfolio expected returns in this still relatively low yield environment, the coupon returns in the Bloomberg Barclays Global Aggregate Index provide limited protection against large percentage currency moves. The trade-weighted USD (DXY) fell by more than 4% in July 2020 and has remained weak. There remain several risks to the USD, including a prolonged reversal of the flight-to-the-USD generated by the pandemic, the high COVID-19 infection rate in the US and the US presidential election. This can be addressed by a currency-hedged version of the SPDR Bloomberg Barclays Global Aggregate Bond UCITS ETF.

Multiple currency-hedged share classes are available. For example, the EUR-hedged share class aims to track the performance of global investment grade bond markets by tracking the performance of the Bloomberg Barclays Global Aggregate Euro-Hedged Index. This index incorporates monthly forwards within the Index methodology.

Bloomberg Barclays Currency Hedged Index Methodology

The methodology for currency-hedged variants of the Bloomberg Barclays Global Aggregate Bond Index (the 'parent index') employs rolling one-month FX forward contracts, which aim to hedge each security denominated in non-reporting currency, into the relevant reporting currency of the currency hedged index (sometimes referred to as 'portfolio hedging').

Correspondingly, hedged share classes of the SPDR Bloomberg Barclays Global Aggregate Bond UCITS ETF, aim to track a separate currency-hedged index with a reporting currency denominated in the currency of the hedged share class, as outlined in the supplement to the fund prospectus.

Key Features of the Methodology

Currencies hedged All currency exposures of the parent index are hedged to derive a currency-hedged index.

Implementation FX forward contracts for all non-reporting currencies in the parent index are sold in exchange for receipt of the reporting currency of the currency-hedged index at one-month forward rates.

Calculation of exposures to be hedged Determined each month-end, as the projected month-end value for the forthcoming month (M1) taking into account new constituents of the parent index at month-end, and upcoming yield during the forthcoming month: size of hedged amount in local currency = [(1+*yield*/2)]^[(1/6)].

Reset frequency Hedge amounts are reset monthly, on the last day of each month (M0) — at the same time as the rebalancing of the parent index.

Intra-month reset There is no intra-month reset for the currency-hedged index; the hedged amount remains constant over the month until the following month-end (sometimes referred to as a 'static hedge').

FX forward rates Determined by the 4pm WM/Reuters rate.

Focusing on the UCITS Hedge Ratio

- **Limitation** As of June 2017, ESMA require currency hedges for hedged classes that do not result in a hedge ratio > 105%, or < 95% of the class NAV. Upon a breach outside these bounds, the manager must adjust hedges to bring the ratio inside. **This adjustment is not built into currency-hedged benchmarks, and so will result in tracking error.**

- **The State Street Global Advisors approach** The FX portfolio managers bring the hedge ratio back to 103%/97% upon a breach, rather than a full reset to 100%, so as to minimise tracking error while complying with the rules.

Endnotes

1 Source: IMF World Economic Outlook Update, June 2020.

2 Source: Bloomberg PORT, as of 31 August 2020.

3 Ratings are based on the Bloomberg Composite rating methodology.

Figure 4
**Performance
(USD Unhedged, %)**

	1 Month (%)	3 Month (%)	YTD (%)	1 Year (%)	3 Year (%)	5 Year (%)	Since Inception (%) 26-Jan-18
SPDR® Bloomberg Barclays Global Aggregate Bond UCITS ETF (Dist)	-0.20	3.87	5.90	5.31	—	—	9.95
Bloomberg Barclays Global Aggregate Bond Index	-0.15	3.95	6.11	5.54	12.19	22.28	10.48
Difference	**-0.05**	**-0.08**	**-0.20**	**-0.23**	—	—	**-0.54**

Source: State Street Global Advisors, as of 31 August 2020. Performance is net of fees. **Performance quoted represents past performance, which is no guarantee of future results. 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. The performance data do not take account of the commissions and costs incurred on the issue and redemption, or purchases and sale, of units. Visit ssga.com/etfs for most recent month-end performance.** Performance returns for periods of less than one year are not annualised. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

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ID286804-3233520.1.1.EMEA.INST 0920
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