Insights
Fixed Income

March 2021

Shelter from the Storm
Where to Go Amid Rising Yields

Jason Simpson
Fixed Income ETF Strategist

- A substantial rise in US Treasury yields could have further to run given heightened inflation expectations and how low yields were post the COVID-19 crisis. This outlook suggests fixed income investors should retain a defensive/short duration stance.
- Looking at previous Treasury market sell-offs suggests favouring convertibles and high yield bonds, and also a preference for emerging market hard currency bonds to local currency.

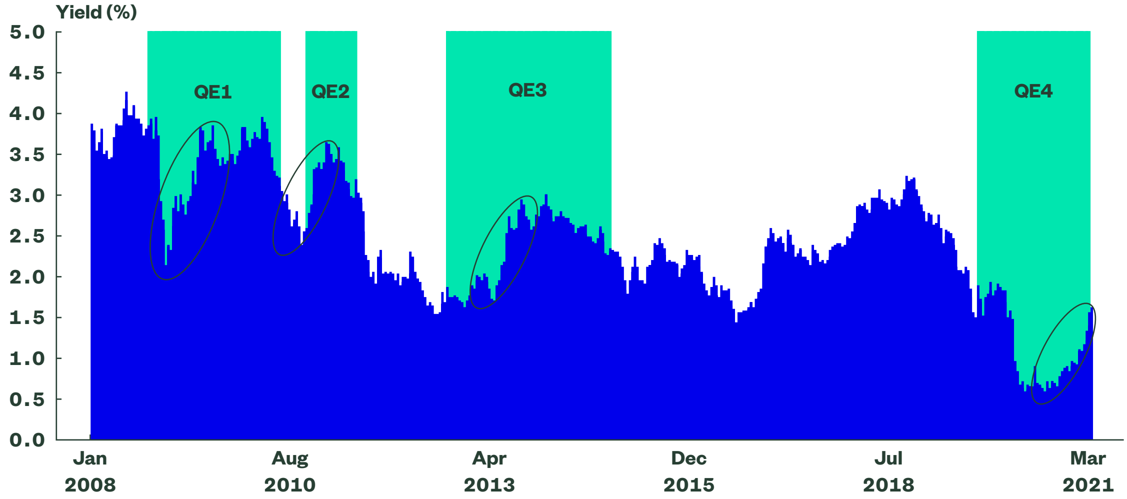
Yields Have Risen Rapidly

The sell-off in Treasuries has shocked fixed income investors, with yields on the 10-year more than 100bp higher than levels seen at the start of August 2020. There had been some hope that the substantial amount of securities purchases by central banks would at least slow the rise, but the move since the end of January 2021 has actually accelerated.

The backdrop for US Treasuries is certainly a challenging one. The US economy has not slowed at the start of 2021 but is instead showing strong growth. With the vaccination program proceeding more swiftly than expected, a resumption of something that resembles 'business as usual' should also be quicker than had been anticipated even a couple of months ago.

US inflation has also risen more sharply than expected, touching 1.7% in February 2021, and is likely to continue on its upward path into the middle part of the year on the back of base effects. The recently unveiled US government spending package of $1.9 trillion will only add fuel to this fire.

Figure 1
Yield Spikes in 10Y US Treasuries During QE



Source: Bloomberg Finance L.P., as of 12 March 2021.

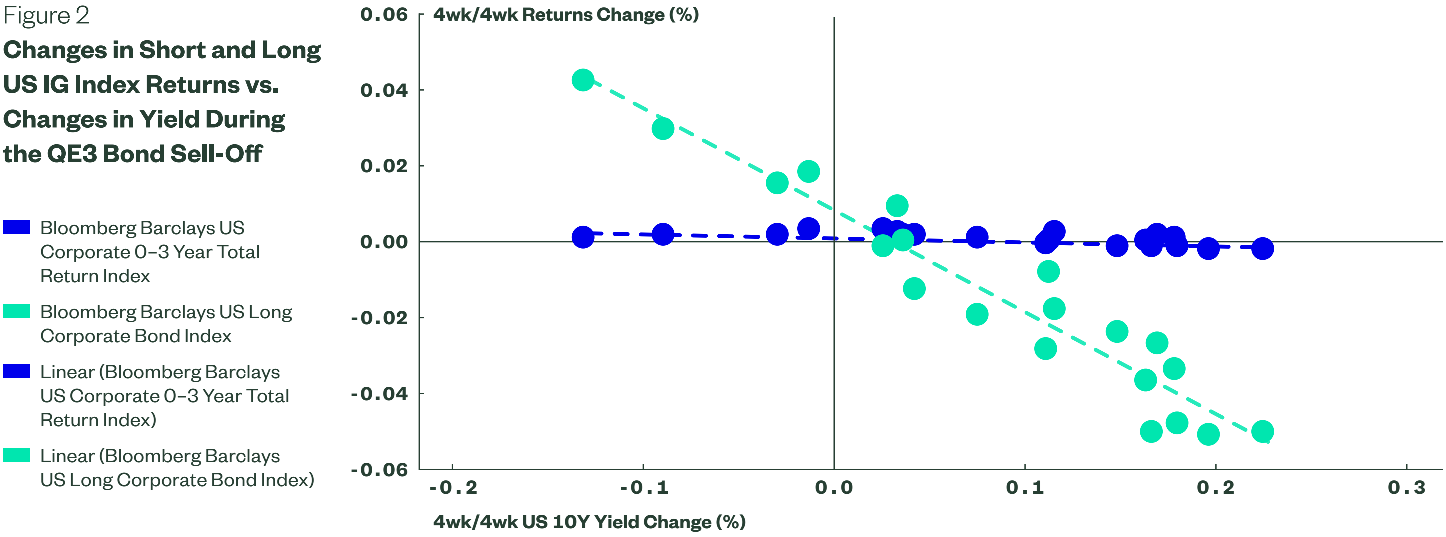
Staying Safe in a Sell-Off: Shorten Duration

The current backdrop poses the question, what are the best defensive strategies for a fixed income investor to pursue in a reflationary environment? As Figure 1 shows, a meaningful bond sell-off during a phase of quantitative easing (QE) is not unusual, largely because QE is designed to reflate the economy. It is a sign that the Federal Reserve's (Fed) medicine is working. There have been periods of aggressive yield rises in all three of the Fed's phases of QE. On average these periods lasted 21 weeks and saw a rise in the 10Y Treasury yield of 140bp.[1] While the duration of the most recent sell-off has been longer than average, at 33 weeks, much of the rise has been driven by higher breakevens, which was not the case during QE2 or QE3, but was for QE1, which was the largest of the three sell-offs. Yields have also come from record lows, hinting there may be further to run in the latest sell-off.

These previous sell-offs during periods of very easy monetary policy offer some clues as to the best way of providing a degree of protection to portfolios. The most obvious strategy is to shorten the duration of holdings (see our **Strategy Espresso on the topic**), which will reduce the price sensitivity of the portfolio to the ongoing rise in yields. The advantages of duration reduction can be clearly demonstrated by looking at index returns from different maturity buckets.

Figure 2 shows the 4-week/4-week returns of both the Bloomberg Barclays US Corporate 0–3 Year Index and the Bloomberg Barclays US Long Corporate Bond Index during the period of sharply rising yields that occurred while the Fed was conducting QE3. The explanatory variable used for changes in returns is the 4-week/4-week change in the 10Y US Treasury yield. The rise in yields had very little impact on returns from the 0–3 Year Index but dragged returns from the long index (+10 Year) sharply lower.

Figure 2
Changes in Short and Long US IG Index Returns vs. Changes in Yield During the QE3 Bond Sell-Off



Source: Bloomberg Finance L.P., as of 12 March 2021. Period reviewed spans 26 April 2013–6 September 2013.

This is not dissimilar from the return profiles seen during the sell-offs in QE1 and QE2. While it may not be practical, or desirable, to completely switch holdings into the very short end of the curve, these observations do underline the potential benefit of shortening duration exposure.

In addition, market pricing of central bank tightening looks fairly aggressive. The overnight index swap forwards price more than 50bp of hikes from the Fed over the coming 2 years and more than 110bp over 3 years. As long as inflation stays reasonably well contained and does not force the Fed's hand, it seems unlikely that the FOMC will rush to tighten policy. After all, it took nearly 7 years to raise interest rates following the Global Financial Crisis. This should ensure that shorter-dated bonds are relatively well insulated.

Focus on Reflation Strategies

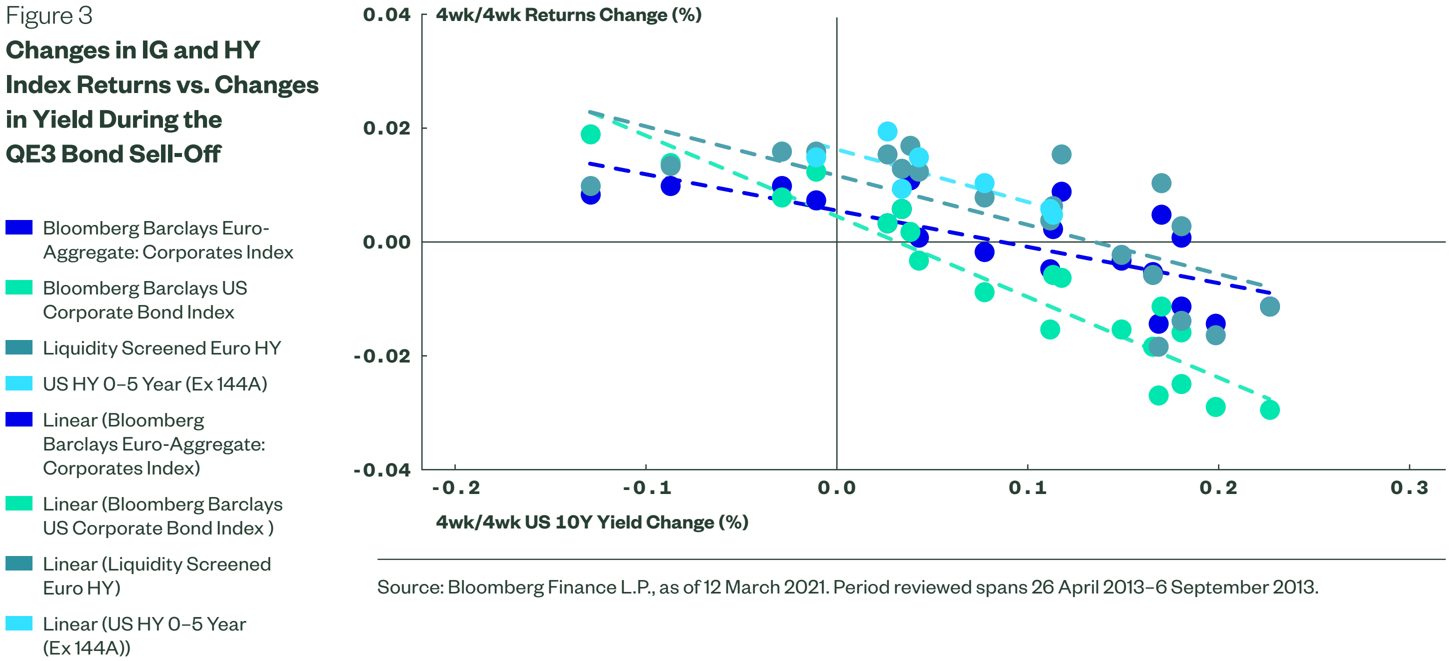
The themes in the Q1 2021 Bond Compass focused on strategies that should perform well during a reflationary, risk-on environment. Government bond strategies were avoided given the asymmetrical risk-reward pay-off. That said, a bond sell-off of the magnitude seen so far in 2021 was not anticipated and has, in some instances, proved de-stabilising. The following charts illustrate the strategies that typically perform well, and those that do not, during a substantial rise in yields.

High Yield and Investment Grade

As seen in Figure 3, high yield (HY) demonstrates a relative outperformance with the line of best fit at a higher level than for investment grade (IG) credit, suggesting higher returns. This is most likely the cushion effect of the high coupon on offer as well as the fact that HY indices typically have a shorter duration profile than IG indices. The returns on the Bloomberg Barclays US High Yield 0–5 Year (Ex 144A) Index appear more robust than for the Bloomberg Barclays Liquidity Screened EUR HY index, although this is based off only partial data.[2]

IG paper does not perform well. With IG spreads to the underlying government curve so tight, IG has a limited ability to absorb higher government yields. The US index lags the performance of the European, which should be expected given the movements in the US Treasury market are presumably driven by stronger domestic data. The Euro area economic cycle is likely to be slightly different.

Figure 3
Changes in IG and HY Index Returns vs. Changes in Yield During the QE3 Bond Sell-Off



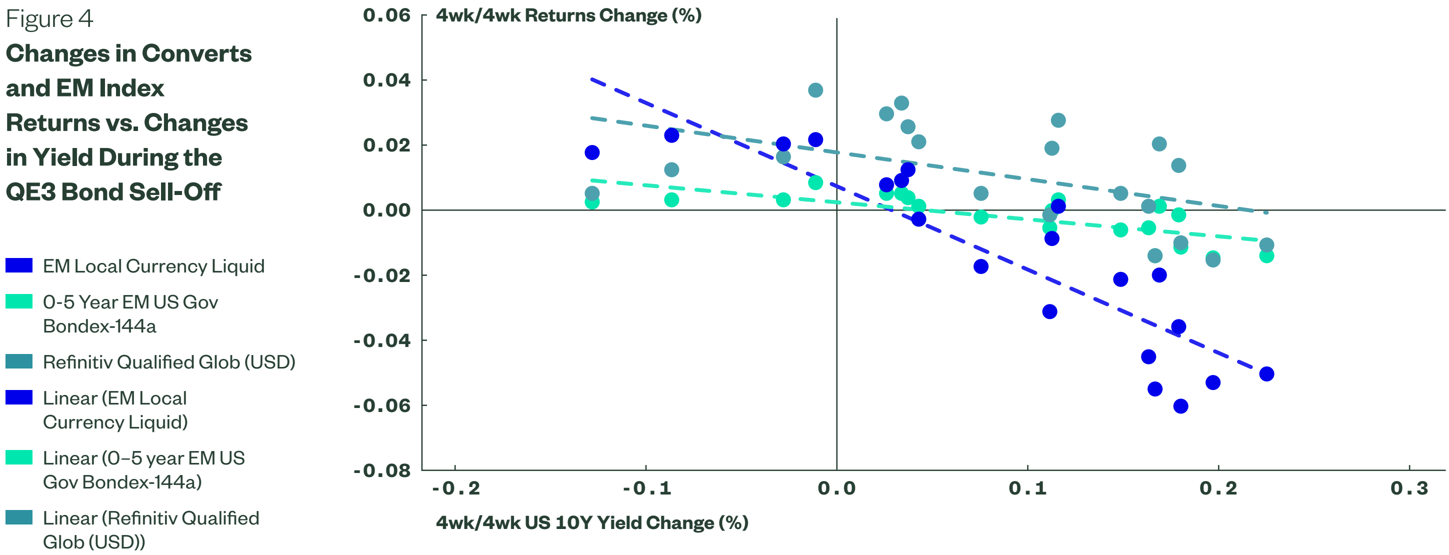
Source: Bloomberg Finance L.P., as of 12 March 2021. Period reviewed spans 26 April 2013–6 September 2013.

Convertible Bonds and Emerging Market Debt

Equity-like products, most notably convertible bonds (Figure 4), have posted the strongest returns. This is consistent with the idea that reflation should support risk assets. While the regression line for convertibles does have a negative slope, implying that strongly rising yields are ultimately detrimental to returns, there are actually relatively few negative return readings.[3] This may indicate an environment where surging yields start to become a negative factor for equity markets. Average returns over the sell-offs in QE1, QE2 and QE3 were 8.6%.

Emerging market debt is susceptible to rising US yields. Local currency appears more heavily impacted than hard currency. This is potentially because rising US Treasury yields support the USD against emerging market currencies, a key component of local currency returns.

Figure 4
Changes in Converts and EM Index Returns vs. Changes in Yield During the QE3 Bond Sell-Off



Source: Bloomberg Finance L.P., as of 12 March 2021. Period reviewed 26 April 2013–6 September 2013.

Lessons from the Latest Rout

Fixed income assets showed relatively consistent behaviour during the US Treasury market sell-offs in QE1, QE2 (not shown) and QE3. The exception is the positive slope to the regression line for European HY during QE1, suggesting HY rallied regardless of what the government curve was doing. However, this was largely because the yields on non-IG paper had soared to 20% by the end of 2008, after which there was a substantial rally.

During the current sell-off, market dynamics appear similar to those described in previous episodes of QE. US IG credit and emerging market local currency debt markets have performed poorly while HY has continued to post positive returns. Returns for convertibles have been higher than in previous market sell-offs. Returns of close to 24%[4] have been made since US Treasury yields started to trend higher against an average of 8.6% for the previous sell-offs.

So the message from history is to: 1) keep duration as short as is practically possible; 2) focus on equity-like products such as HY and convertibles; and 3) favour emerging market hard currency over local currency.

Endnotes

1 Sell-off periods averaged: During QE1: 19 December 2008–5 June 2009; QE2: 8 October 2010–4 February 2011; QE3: 26 April 2013–6 September 2013.

2 There is no index data prior to June 2013.

3 For the Refinitiv Global Converts index, an average of 22% of the weekly readings over QE1, QE2 and QE3 are negative compared to over 47% of readings for the Bloomberg Barclays US Corporate Bond Index.

4 Returns between 31 July 2020 and 12 March 2021.

ssga.com/etfs

Marketing communication.
For professional investor use only.

Information Classification: General Access

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, ADGM Branch, Al Khatem Tower, Suite 42801, Level 28, ADGM Square, Al Maryah Island, P.O. Box 764604, Abu Dhabi (United Arab Emirates) Regulated by ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. F: +971 (0)4-4372818. **Australia:** State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia T: +612 9240-7600. F: +612 9240-7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 185, 1170 Watermael Boitsfort Belgium. T: +32 2 663 2036, F: +32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Ireland Limited. State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Quebec, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900. **France:** State Street Global Advisors Ireland Limited, Paris Branch ("State Street Global Advisors Paris Branch") is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Paris Branch is registered in France with company number RCS Nanterre 832 734 602, and its office is located at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92. **Germany:** State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Israel:** No action has been taken or will be taken in Israel that would permit a public offering of the Securities or distribution of this sales brochure to the public in Israel. This sales brochure has not been approved by the Israel Securities Authority (the 'ISA'). Accordingly, the Securities shall only be sold in Israel to an investor of the type listed in the First Schedule to the Israeli Securities Law, 1978, which has confirmed in writing that it falls within one of the categories listed therein (accompanied by external confirmation where this is required under ISA guidelines), that it is aware of the implications of being considered such an investor and consents thereto, and further that the Securities are being purchased for its own account and not for the purpose of re-sale or distribution. This sales brochure may not be reproduced or used for any other purpose, nor be furnished to any other person other than those to whom copies have been sent. Nothing in this sales brochure should be considered investment advice or investment marketing as defined in the Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 1995 ("the Investment Advice Law"). Investors are encouraged to seek competent investment advice from a locally licenced investment advisor prior to making any investment. State Street is not licenced under the Investment Advice Law, nor does it carry the insurance as required of a licencee thereunder. This sales brochure does not constitute an offer to sell or solicitation of an offer to buy any securities other than the Securities offered hereby, nor does it constitute an offer to sell to or solicitation of an offer to buy from any person or persons in any state or other jurisdiction in which such offer or solicitation would be unlawful, or in which the person making such offer or solicitation is not qualified to do so, or to a person or persons to whom it is unlawful to make such offer or solicitation. **Ireland:** State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Ireland Limited Milan Branch (Sede Secondaria di Milano) ("State Street Global Advisors Milan Branch") is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Milan Branch is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960, and its office is located at Via Ferrante Aporti, 10 - 20125 Milano, Italy. T: (+39) 02 32066 100. F: (+39) 02 32066 155. **Japan:** State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. Telephone: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. Switzerland: State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States:** State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641.

The views expressed in this material are the views of the SPDR Capital Markets as of 18 March 2021 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. There is no representation nor warranty that such statements are guarantees of any future performance. Actual results or developments may differ materially from the views expressed.

All information is from SSGA unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

The trademarks and service marks referenced herein are the property of their respective owners.

Standard & Poor's, S&P and SPDR are registered trademarks of Standard & Poor's Financial Services LLC (S&P); Dow Jones is a registered trademark of Dow Jones Trademark Holdings LLC (Dow Jones); and these trademarks have been licenced for use by S&P Dow Jones Indices LLC (SPDJI) and sublicenced for certain purposes by State Street Corporation. State Street Corporation's financial products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates and third party licensors and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability in relation thereto, including for any errors, omissions, or interruptions of any index.

Investing involves risk including the risk of loss of principal.

ETFs trade like stocks, are subject to investment risk and will fluctuate in market value. The investment return and principal value of an investment will fluctuate in value, so that when shares are sold or redeemed, they may be worth more or less than when they were purchased. Although shares may be bought or sold on an exchange through any brokerage account, shares are not individually redeemable from the fund. Investors may acquire shares and tender them for redemption through the fund in large aggregations known as "creation units." Please see the fund's prospectus for more details.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, 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.

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.

Investing in foreign domiciled securities may involve risk of capital loss from unfavourable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations. Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

ID435000-3514475.1.1.GBL.INST 0321
Exp. Date: 31/03/2022