

State Street Cash & Fixed Income

Banks Will Act More as a Cushion Than a Cause in the Next Cycle.

Only a decade removed from the Global Financial Crisis (GFC), it may seem a bit counterintuitive to label banks as more of a 'cushion' than a 'cause' of the next cycle. However, due to dramatic fundamental changes that have occurred post-GFC, we believe that banks today are much more defensive from a fixed income investor standpoint than they were during the depths of the crisis. Our view is underpinned by a two-pronged concept we call foundational oversight, which has benefitted creditor confidence.

Nevertheless, banks will not be immune to challenges that arise from the next downturn given their critical role in intermediating risk. In our view, as the implementation of resolution regimes across global banking jurisdictions continues, investors need to be increasingly cognizant of where their debt lies in a bank's capital structure. The next crisis, some senior bank creditors could be called upon to explicitly take losses. In this context, we favor the senior debt of the major Australian banks for capital preservation and liquidity.

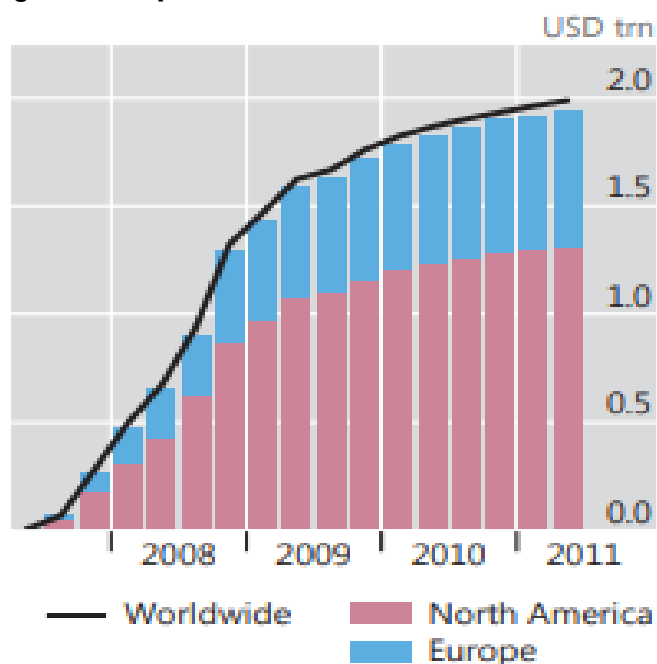
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Figure 1. **Rapid accumulation of crisis-related losses**

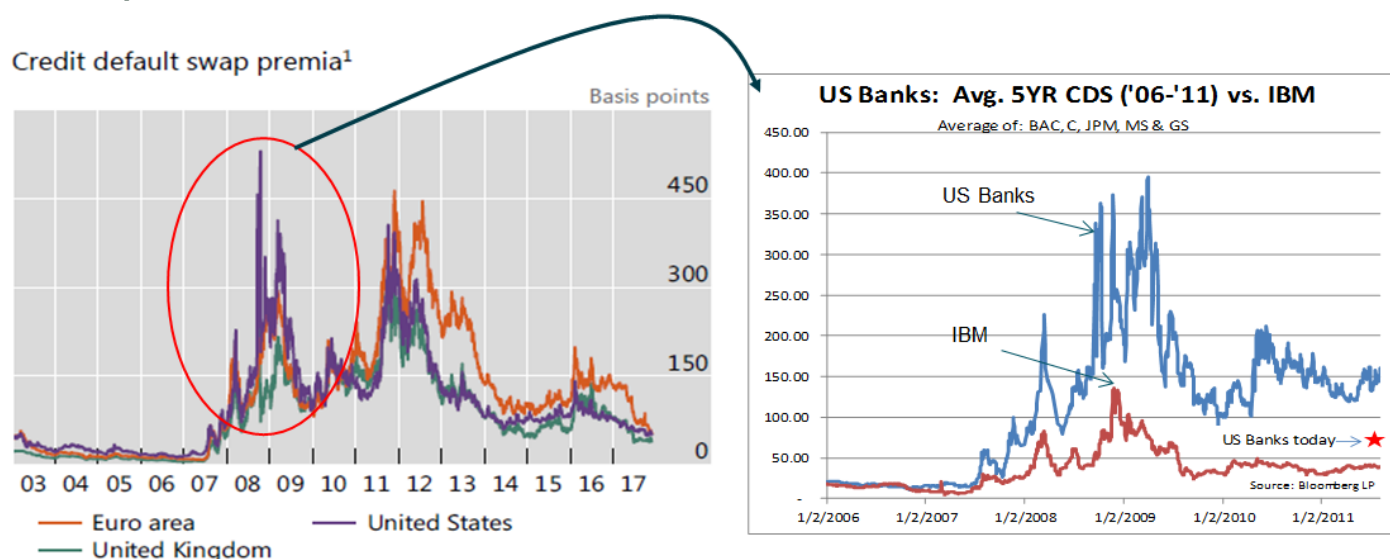


Source: BIS Annual Economic Report, Chapter III (June 2018). 1 Banks' cumulated losses and writedowns from Q2 2007 to Q2 2011.

The GFC offered many lessons for equity and creditor investors, not the least of which revolved around the interconnectedness of the global banking system and its impact on market liquidity. When the music stopped, global banks had accumulated losses of nearly USD \$2 trillion between the period 2007 and 2011¹.

While much has been written about the causes of the GFC, from a bank standpoint four important themes stand out. First, a focus on meeting near-term profitability and incentive compensation targets drove elevated risk appetite across the sector, leading to very poor underwriting practices and a severe deterioration in asset quality. Second, capital levels were too low relative to these growing risk exposures and provided limited margin for error. Third, a funding mismatch between long-term assets and short-term liabilities, most notably across large capital market intermediaries, exacerbated asset price declines as market participants' reduced leverage and sought to shed risk. Finally, global banking regulators were behind the curve and failed to act as proactively as was needed.

Figure 2. Default risk spiked quickly but without government support, the impact would have been catastrophic



Source: Structural Changes in Banking After the Crisis (BIS January 2018) . 1 Asset-weighted average 5 year premia

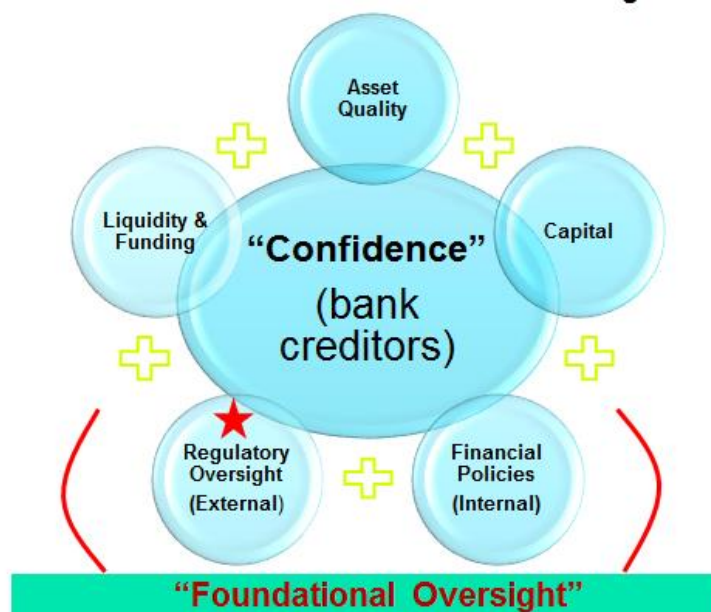
While systemically-important banks were at the center of the downturn in 2008/2009, pricing in a very high likelihood of default in the credit default swap (CDS) market (see figure 2), the contagion effects reverberated well-beyond just the financial sector². This included a non-financial corporate such as International Business Machines Corp, or IBM, which saw its 5 year default risk soar to unprecedented levels despite its nonexistent role in the underlying crisis.³ Though governments around the globe eventually responded by providing extraordinary support to financial markets and to banks, the situation would have been far more disastrous had they not (see Figure 2).

¹ Source: BIS Annual Economic Report 2018 <https://www.bis.org/publ/arpdf/ar2018e3.pdf>

² Source: Committee on the Global Financial System: Structural changes in banking after the crisis <https://www.bis.org/publ/cgfs60.pdf>

³ Source: Bloomberg Finance L.P.

Figure 3. **When the ‘Heat is On’ Confidence is Critical. What is the most important variable for a bank?** Changes since the GFC have benefitted “confidence” which is critical for banks.



Source: SSGA, January 2019. For illustrative purposes only.

We believe that the concept of creditor “confidence” across the global banking system was severely underappreciated pre-GFC. As Warren Buffet has stated, *“Credit is like oxygen. When either is abundant its presence goes unnoticed. When either is missing, that’s all that is noticed. Even a short absence of credit can bring a company to its knees”*.⁴ While a nonfinancial corporate generally has time to work its issues (absent idiosyncratic risks such as fraud), a bank has no such luxury and is vulnerable to the loss of creditor/depositor confidence. It is for this reason that the RBA instituted a deposit insurance scheme in 2008 and also guaranteed wholesale funding of the largest banks.⁵⁶ Confidence is absolutely critical for a bank.

So what has instilled this confidence in the banking sector over the past decade? We call it *foundational oversight* and believe that it consists of two important components. The first component is financial policies established by bank management teams which have become much more conservative post-GFC. In a way, this can be viewed as an internal, self-correcting mechanism as the banks have learnt from their past mistakes and evolved. The second component is more of an external mechanism, regulatory oversight, which we believe has greater durability over the long run. Ultimately, changes to financial policies and regulatory oversight have been critical drivers of improvements to bank fundamentals post-GFC have been built (Figure 3).

⁴ <http://www.berkshirehathaway.com/2010ar/2010ar.pdf>

⁵ <https://www.rba.gov.au/publications/bulletin/2016/mar/5.html>

⁶ <https://www.imf.org/external/pubs/ft/scr/2012/cr12310.pdf>

Figure 4. **Regulatory Oversight: A Game Changer**

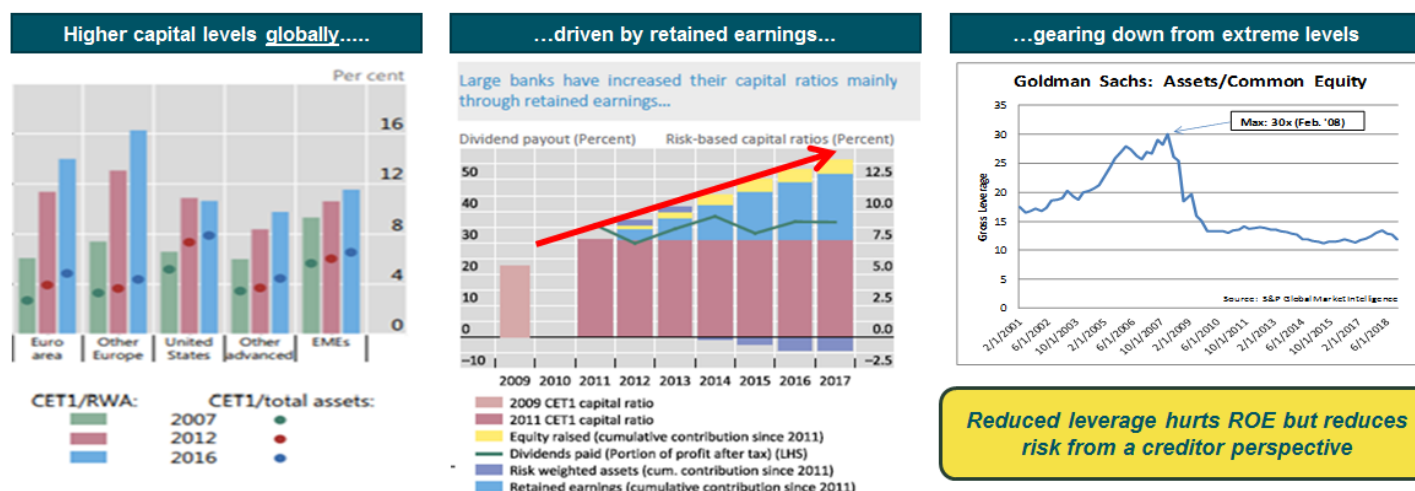


For more information, please see our 6-Part Series "Yielding to a New Regulatory Reality"
<http://ssgacash.com/1047/files/yielding-to-a-new-regulatory-reality-a-six-part-series.pdf>

Source: SSGA, January 2019. For illustrative purposes only.

Still, regulatory oversight has been a particular game changer in underpinning a much more resilient banking system today than a decade ago. Post crisis, we point to four key pillars of bank regulation and will touch upon some of these in the following sections (Figure 4).

Figure 5. **Capital Levels Have Risen Materially. Banks today are better equipped to handle unforeseen losses...**



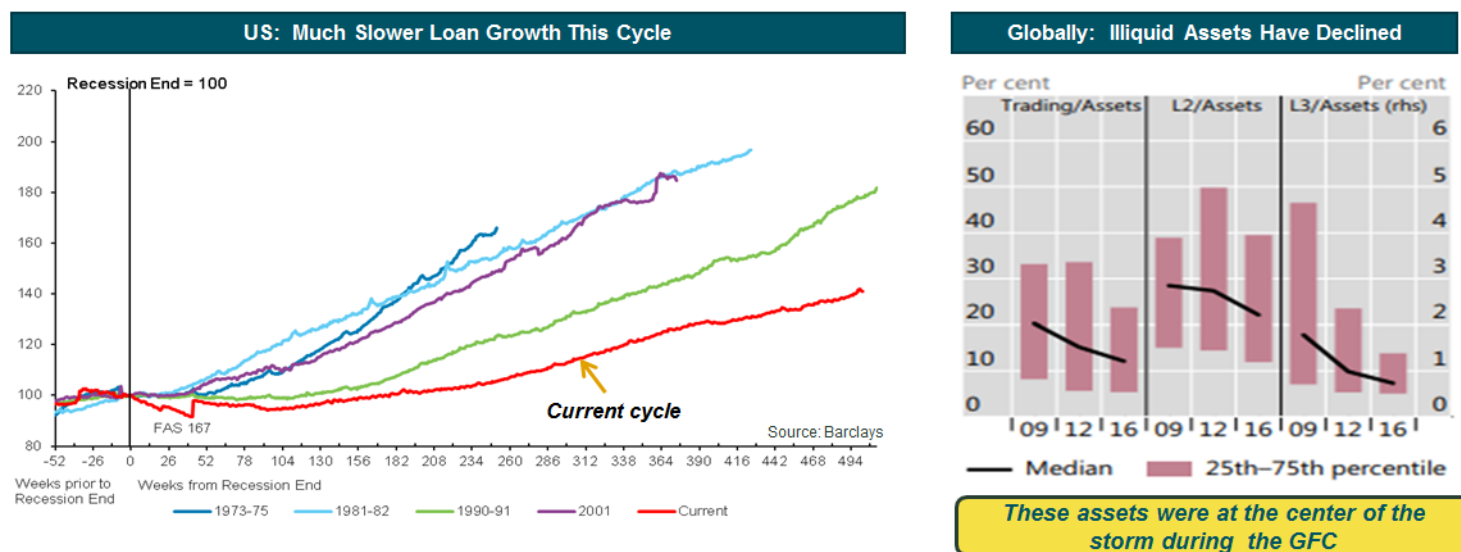
Source: BIS (January 2018) and FSB (November 2018)

One of the key improvements has been to bank capital levels. Capital is the foundation upon which a bank is built and represents equity and loss absorbency, truly the last line of defense for a bank. It is the ultimate rainy day fund and provides creditors and depositors protection against unforeseen losses or shocks in the operating environment. Referring to the far left chart in Figure 5, bank capital levels are up on a global basis across both

Information Classification: General

developed markets, such as Australia, as well as emerging markets⁷. The middle chart indicates that this growth has been predominantly due to banks retaining their own earnings⁸. And to the far right, a real life example shows just how these changes have impacted an individual firm: Goldman Sachs, one of Lehman Brothers primary competitors back in 2008, has seen its assets-to-equity ratio decline to nearly 12 times from a peak of 30 times back in 2008⁹. Of note, we believe Goldman's assets-to-equity ratio was likely even higher than this 30x figure on an intra-period basis. While lower levels of leverage is a headwind to return on equity from a shareholder perspective, from a creditor standpoint it drives increased confidence in the broader banking system's ability to withstand a severely-adverse stress scenario.

Figure 6. **Reduced Risk Appetite Benefits Asset Quality.**



Source: Barclays Research and Federal Reserve (January 2019), BIS (January 2018)

There have also been significant changes to risk appetite to the benefit of asset quality. For example in the left hand chart of Figure 6, loan growth in the United States post-GFC has been the slowest in the current cycle of any post-recessionary period since 1973.¹⁰ While this in part reflects both a proliferation of non-bank lending growth and more conservative borrower behavior in the wake of the crisis, we ultimately believe it points back to the concept of foundational oversight we discussed earlier.

Bank of America provides a good example as to changes in financial policies. The bank received USD \$45B in capital from the US government during the GFC and was beleaguered as a result of its acquisition of Countrywide Financial Corporation.¹¹ Today, the bank lives by the mantra of *Responsible Growth* and has been effective in rebuilding both its image and its financial position in the wake of the crisis, as evidenced in its credit spreads. The takeaway here is that large banks were burned very badly a decade ago and have since adjusted their operating models and underwriting practices to prioritize more responsible, conservative business practices, a positive for creditors.

⁷ Source: Committee on the Global Financial System: Structural changes in banking after the crisis <https://www.bis.org/publ/cgfs60.pdf>

⁸ Source: Implementation and Effects of the G20 Financial Regulatory Reforms <http://www.fsb.org/wp-content/uploads/P281118-1.pdf>

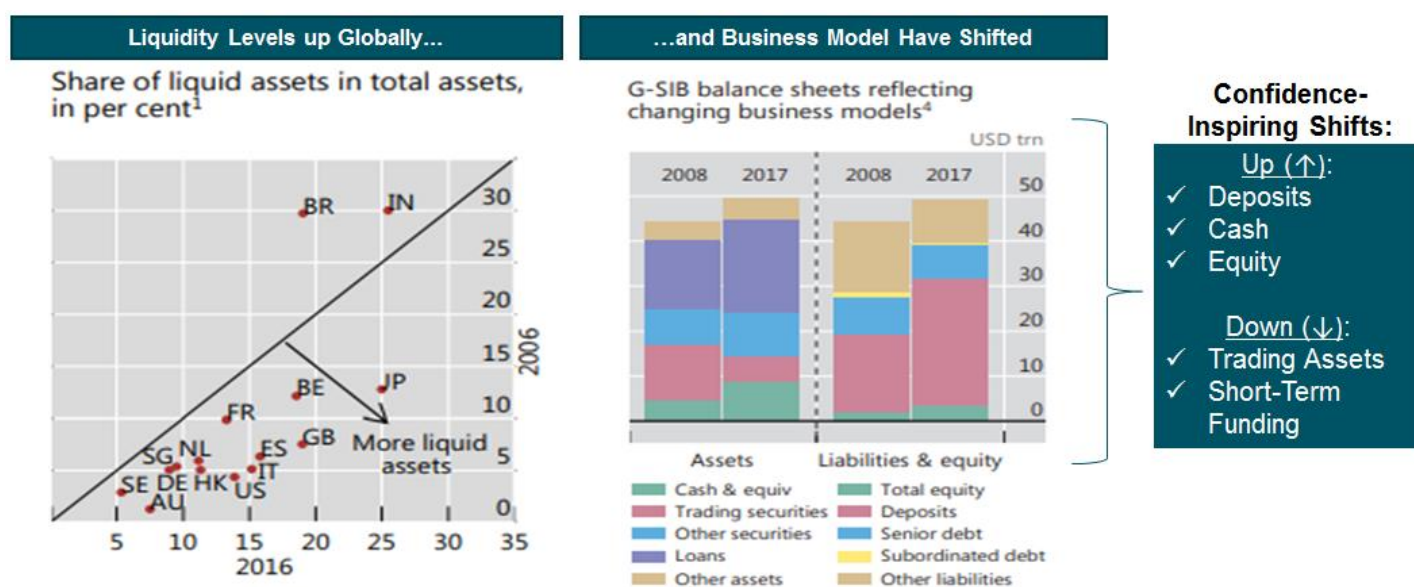
⁹ Source: Bloomberg Finance LP, Company Reports

¹⁰ Source: Barclays Capital Inc.

¹¹ <http://investor.bankofamerica.com/phoenix.zhtml?c=71595&p=irol-newsArticle&ID=1361144#fbid=Zk16rJDdAE3>

The second half of foundational oversight, regulatory oversight, has also played a major role in influencing risk appetite across the banking sector. This is evidenced in the right hand chart of Figure 6 which shows banks have dramatically reduced their holdings of some of the most toxic assets at the epicenter of GFC¹². These include, for example, illiquid assets which are measured with unobservable inputs or valued with assumptions (i.e. Level 3 assets) as well as trading assets. As new regulations now require higher risk-weightings be applied to these assets, they have become less economical to hold and have declined. Another important change has been to stress testing which in the US, for example, is a tool regulators have used to control risk-taking in a fairly dynamic fashion. Since failing the stress test is a very negative development, banks will naturally be very cautious in growing the types of loans and other assets with higher loss rate assumptions assumed by regulators under a given stress scenario, which can be tailored. This naturally promotes a more conservative posture from banks.

Figure 7. **Liquidity Stronger, Funding More Durable**



Source: BIS (January 2018 and June 2018). 1 Liquid assets include cash and balances with central banks and government securities as a share of total assets. 4 Total values based on a balanced sample of 28 Global Systemically-Important Banks (G-SIBs)

Another important change has been to bank liquidity and funding. If capital is the foundation of a bank, liquidity and funding would represent its lifeblood. Since the financial crisis, there have been major improvements made to liquidity and funding primarily as a result of the implementation of the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), both key pillars of Basel III.

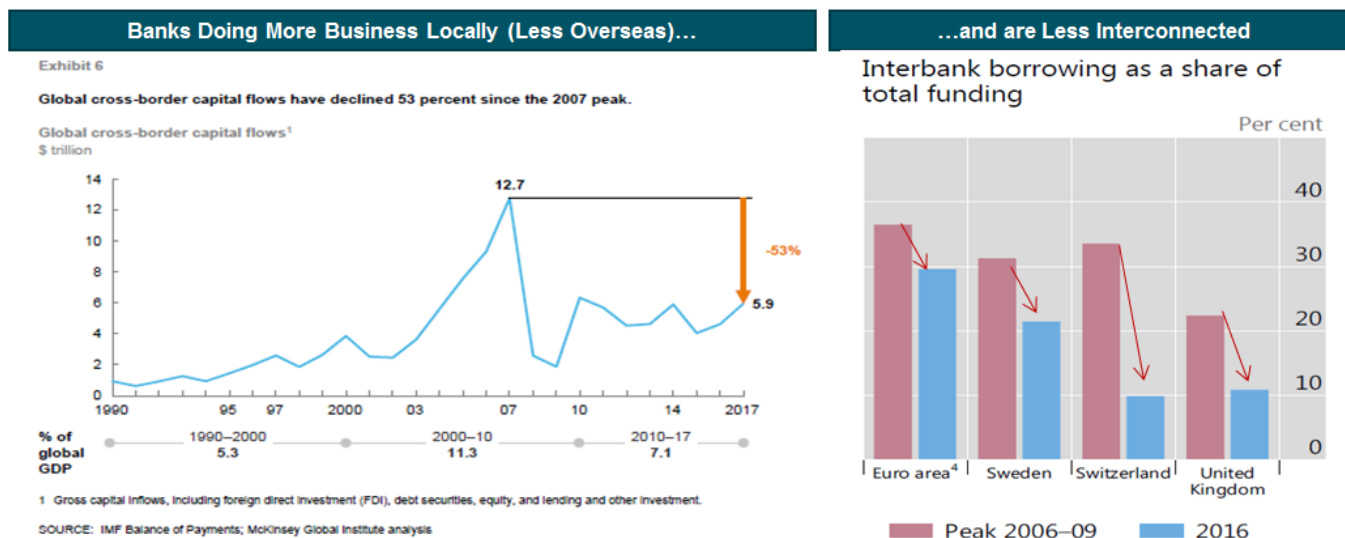
A key consequence of these regulations has been for banks to hold a greater amount of liquid assets to total assets, as shown in the left hand chart in Figure 7. This scatter plot depicts global banking jurisdictions in which any observation to right of the diagonal line represents a banking system with a greater proportion of its balance sheet in liquid assets relative to 10 years prior¹³. The trend is fairly universal and evidences a much more liquid banking sector than what existed in the years leading up to the GFC, a clear positive for bank creditors.

¹² Source: Committee on the Global Financial System: Structural changes in banking after the crisis <https://www.bis.org/publ/cgfs60.pdf>

¹³ Source: Committee on the Global Financial System: Structural changes in banking after the crisis <https://www.bis.org/publ/cgfs60.pdf>
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New regulations have prompted banks to modify their operating models in a more creditor-friendly manner. The chart to the right of Figure 7 shows changes to the aggregate composition of global systemically-important bank balance sheets over the past decade¹⁴. These changes include higher proportional balances of deposits, cash and equity as well as declines in trading assets and short-term funding (within 'other liabilities'). These shifts remain ongoing even today as many banks, and particularly those with a capital markets tilt, focus on producing more stable earnings. Ultimately, the changes that have taken place inspire confidence from a credit standpoint.

Figure 8. **Still Complex, but Much Less So Today.**



Source: McKinsey: 10yrs Later (September 2018), BIS (January 2018)

Finally, banks are much less complex and interconnected than they were during the GFC and are doing more business locally and less overseas. Referring to the left chart of Figure 8, by virtue of these trends, global cross border capital flows have declined by over 50% to nearly USD\$6 trillion over the course of the past decade¹⁵. In addition, banks are lending less to one another as seen in interbank borrowing statistics, as shown in the chart to the right¹⁶. A key driver here is lower capital surcharges for systemically important banks to the extent that they are less complex and less interconnected, encouraging a more focused geographic footprint.

¹⁴ Source: BIS Annual Economic Report 2018 <https://www.bis.org/publ/arpdf/ar2018e3.pdf>

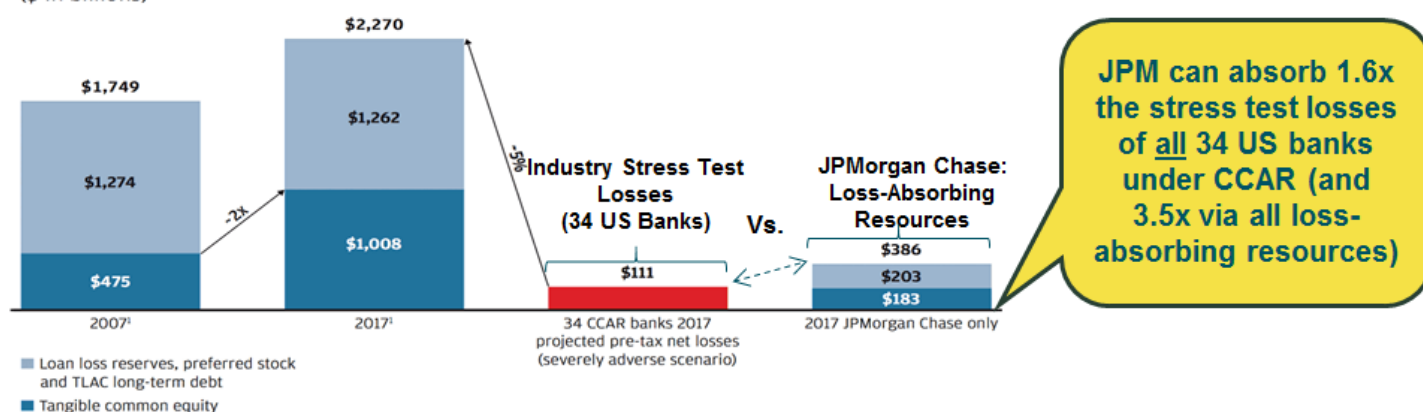
¹⁵ Source: A Decade After The Global Financial Crisis: What has (and Hasn't) Changed?
<https://www.mckinsey.com/~/media/McKinsey/Industries/Financial%20Services/Our%20Insights/A%20decade%20after%20the%20global%20financial%20crisis%20What%20has%20and%20hasnt%20changed/MGI-Briefing-A-decade-after-the-global-financial-crisis-What-has-and-hasnt-changed.ashx>

¹⁶ Source: Committee on the Global Financial System: Structural changes in banking after the crisis <https://www.bis.org/publ/cgfs60.pdf>

Figure 9. How Will Banks Weather the Next Storm?

Loss Absorbing Resources of U.S. SIFI Banks Combined

(\$ in billions)



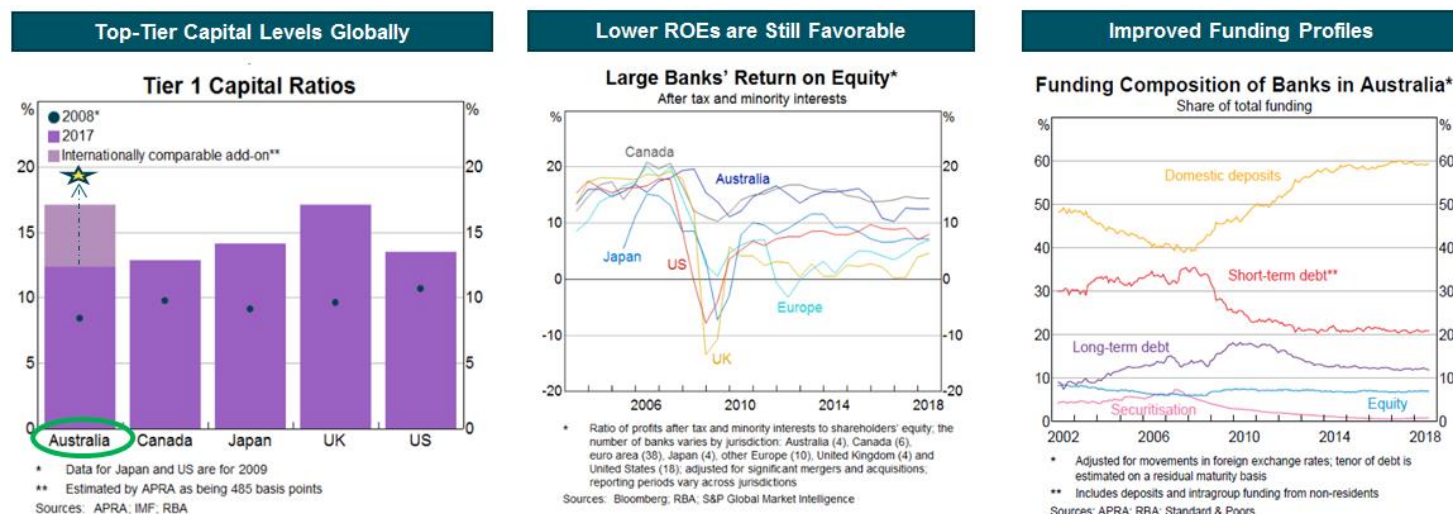
¹ Includes only the 18 banks participating in CCAR in 2013, as well as Bear Stearns, Countrywide, Merrill Lynch, National City, Wachovia and Washington Mutual
 Source: SNL Financial; Federal Reserve Bank, February 2018
 SIFI = Systemically important financial institution
 CCAR = Comprehensive Capital Analysis and Review
 TLAC = Total loss absorbing capacity

Source: JPMorgan Chase (April 2018)

All these improvements to bank fundamentals render the question: how will banks weather the next storm? In a recent version of its industry-wide stress test, the Federal Reserve examined losses of the 34 largest US banks under a severely adverse scenario (Figure 9). After taking into account stressed pre-provision net revenue trends and draconian loss rates by asset class, the Fed estimated USD \$111B of losses over their stress time horizon¹⁷. JPMorgan Chase, in quantifying the amount of capital that it holds as a result of new regulations, indicates that it would not only be able to absorb its own losses under such a severely-adverse stress scenario but also the aggregate losses of the entire US banking system. In fact, it could do so at a ratio of 1.6x with just its equity capital base and 3.5x if including all of its loss-absorbing resources (including long-term debt subject to bail-in). While just an exercise, these statistics tell a story around the capital strength of the industry at large.

¹⁷ Source: JPMorgan 2017 Annual Report: Chairman & CEO Letter to Shareholders <https://reports.jpmorganchase.com/investor-relations/2017/ar-ceo-letters.htm?1>

Figure 10. **Where do the Australian Banks Stand?** A more challenging environment but credit fundamentals remain sound.



Source: RBA (October 2018)

As one of the largest global institutional cash managers, Australian banks are a key constituent of our holdings and we continuously contemplate their fundamental profiles. Overall, while we believe that fundamentals have improved over the past decade and remain sound, the banks today are operating in a very challenging operating environment which is pressuring profitability. The good news, however, is that strong, proactive regulatory oversight continues to be beneficial to creditors.

As shown to the far left of Figure 10, Australian banks hold capital levels which compare very favorably to a basket of global peers and have risen over 50% in the past decade¹⁸¹⁹. The largest banks are mandated by APRA to maintain 'unquestionably strong' capital levels which should continue to support creditors over time.²⁰ Naturally, as shown in the center chart, higher capital levels and a more challenging operating environment has coincided with lower return on equity (ROE), though this measure still remains enviable on an international basis²¹. Finally, while Australian banks have improved their funding profiles significantly post-GFC including growth in deposits and declines in short-term wholesale funding, as shown in the far right chart, this continues to be a relative vulnerability compared with many global peers²².

¹⁸ Source: Financial Stability Review <https://www.rba.gov.au/publications/fsr/2018/oct/pdf/financial-stability-review-2018-10.pdf>

¹⁹ Source: <https://www.rba.gov.au/speeches/2018/sp-ag-2018-10-30.html>

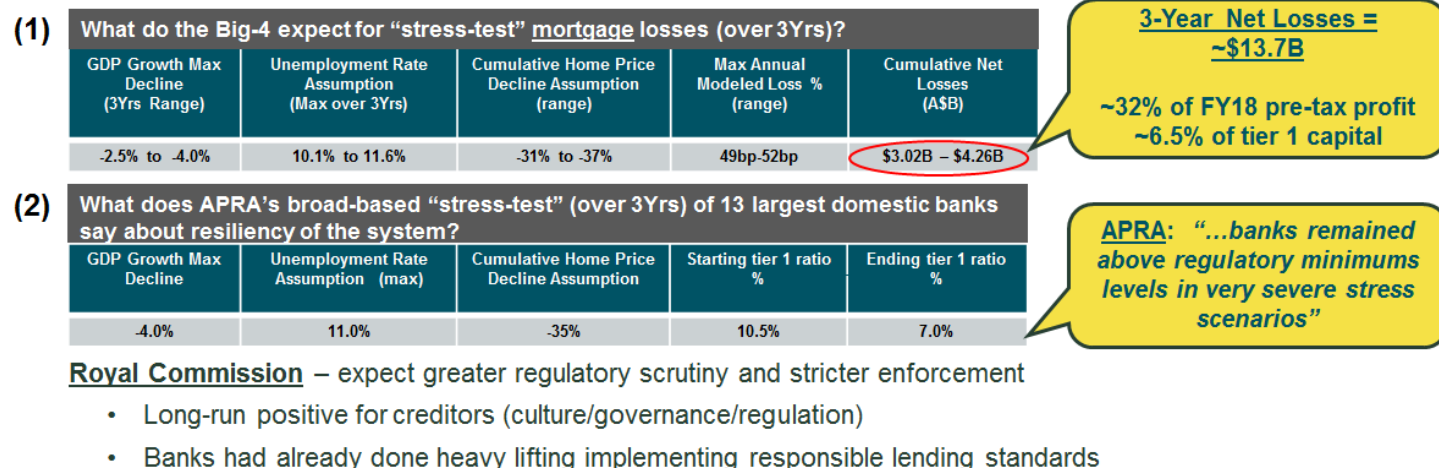
²⁰ <https://www.apra.gov.au/media-centre/media-releases/apra-announces-unquestionably-strong-capital-benchmarks>

²¹ Source: <https://www.rba.gov.au/speeches/2018/sp-ag-2018-10-30.html>

²² Source: How have the Australian Banks responded to tighter capital and liquidity requirements?

<https://www.rba.gov.au/publications/bulletin/2017/jun/pdf/bu-0617-5-how-have-australian-banks-responded-to-tighter-capital-and-liquidity-requirements.pdf>

Figure 11. **Australian Banks: Hot Topics.** Housing/Household Debt – risk more macro than direct for the banks . Well-secured, strong oversight, full-recourse, originate-to-hold, small % high-LTV.



Source: Company reports for fiscal year-end 2018, Bloomberg Finance LP, SSGA, (January 2019)

Hot topics across the Australian banking sector frequently revolve around the housing market and the rise of household indebtedness. With respect to the housing market, we generally believe that the risks to the major Australian banks are more macro as opposed to direct. That is, understanding the economic implications from falling home price and how it filters through into consumer spending, economic growth and the labor market is especially important for the banks. On a direct basis, there are considerable mitigating factors in the domestic mortgage market that make exposures manageable, albeit very large, with a recent “real-life” stress tests across Western Australia showing just that.

For example, the mortgage market in Australia is vastly different than that of the United States. First, there is a very strong payment culture in Australia including full-recourse to the borrower. Together with a lack of mortgage interest deductibility for owner-occupiers, the majority of borrowers have a strong incentive to pay-down debt. Second, portfolios across the largest banks are very well-secured on average as measured by LTVs with “tails” relatively limited and manageable, in our view. Third, bank business models are originate-to-hold as opposed to originate-to-sell, so banks hold the mortgages they originate and are incentivized to make good loans. Finally, we believe regulatory oversight is generally very strong and proactive in Australia which benefits underwriting standards.

To gauge their resiliency to a downturn, the four major banks disclose stress tests on their residential mortgage portfolios over a three-year time horizon, as shown in table 1 of Figure 11. Under a set of severe assumptions that varies by bank, cumulative losses totaled just shy of AUD \$14B. While this is a large figure in isolation, it is more than manageable at less than a third of one year’s worth of cumulative pre-tax earnings.^{23 24} On a more standardised basis, APRA conducts a similar stress test of the 13 largest lenders but also incorporates non-housing loans into their analysis, a category which has tended to have significantly higher loss rates in past downturns.²⁵ APRA’s

²³ Source: Company reports (Investor Discussion Packs for Fiscal year-end 2018)

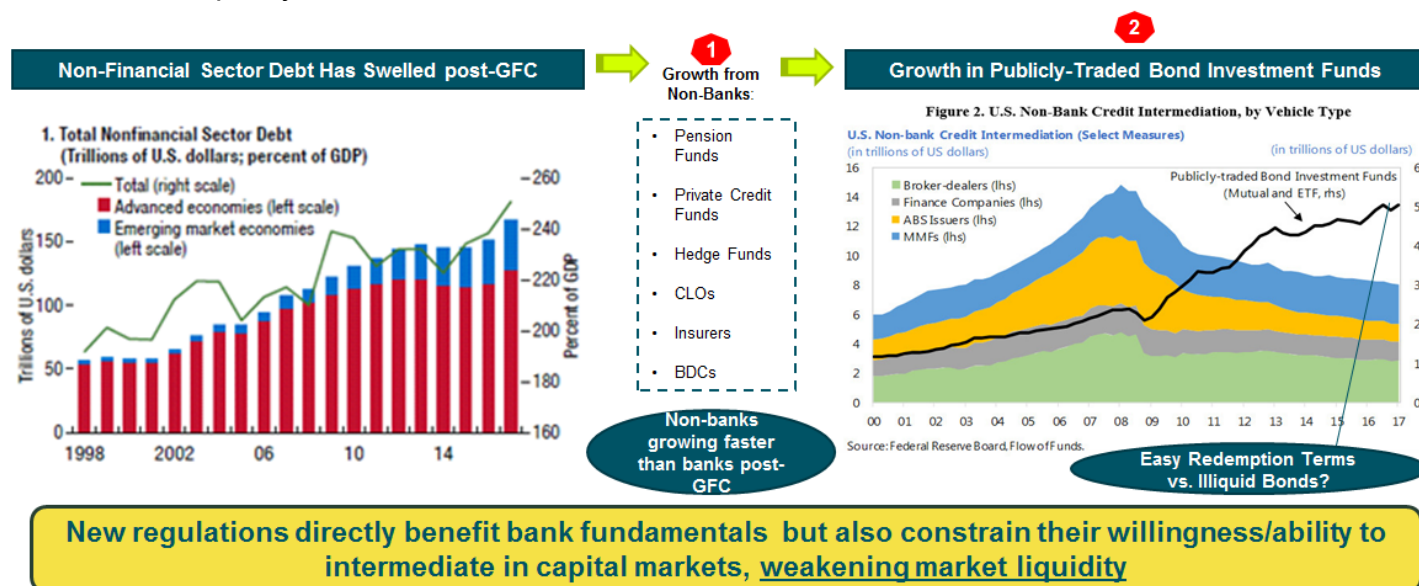
²⁴ Source: Bloomberg Finance LP (Reflects FY18 data for ANZ, CBA, NAB and WBC)

²⁵ Source: <https://www.apra.gov.au/media-centre/speeches/preparing-rainy-day>

scenario is shown in table 2 of Figure 11. Under this stress test, bank capital levels remained above regulatory minimums.

A second hot topic of late relates to the Royal Commission. Without being too specific, we believe the Royal Commission presents additional challenges to the operating environment and to bank profitability via one-time costs for compliance and remediation, but that this short-term earnings headwind could be offset over time by improvements in culture, governance and regulation. Still, a more interventionist approach from regulators could add to volatility over time.

Figure 12. Current Sources of Global Risk/Vulnerability. Corporate Debt, Non-Bank Intermediation and Market Liquidity.



Source: IMF (October 2018) and (September 2017)

There of course remain risks in the system and banks, by their nature, intermediate risk and will not be unexposed. One such risk that has increased materially in the wake of the financial crisis has been across global nonfinancial sector debt which has swelled to over 250% of aggregate GDP compared to 210% back in 2008, as shown far left chart in Figure 12²⁶. Interestingly, however, there is evidence that an increasing proportion of this growth has taken place away from the banking system. To make an analogy, growth in risk-taking post-GFC has been akin to pushing down on a water bed: the risk has shifted elsewhere, though it has not disappeared.

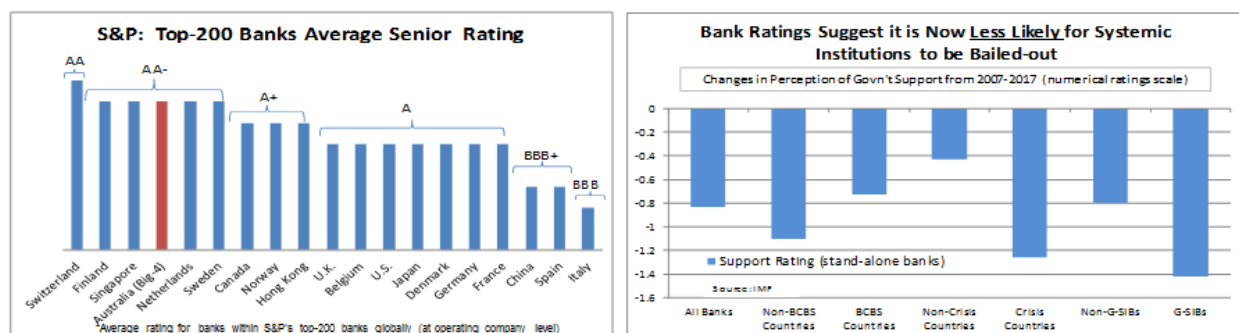
We believe there have been two primary areas where risk has shifted away from banks. The first is into non-banks, a subset of which is listed in the middle of Figure 12. According to Bank of America Merrill Lynch, non-bank commercial lending has grown at 1.3x the pace of bank commercial lending since 2009 and, if you look back 20 years, has risen from 1% of GDP to 8% of GDP versus a range of 8%-10% of GDP for traditional banks.²⁷ Though some of these non-banks may not be forced sellers in the next downturn benefit from committed long-term funding, monitoring these risks will be important.

²⁶ Source: IMF Global Financial Stability Report October 2018: A Decade after the Global Financial Crisis: Are We Safer?
<https://www.imf.org/en/Publications/GFSR/Issues/2018/09/25/Global-Financial-Stability-Report-October-2018>

²⁷ Source: Cross Asset Strategy: Non-Bank vs. Bank Commercial Lending: Structural Shift, but Watch the Cycle", Bank of America Merrill Lynch October 2018

A second area of risk accumulation, as shown in the chart to the far right of Figure 12, is across publicly traded bond investment funds, namely ETFs and mutual funds²⁸. In our view, a critical and perhaps underestimated risk is that these vehicles are providing easy redemption terms to investors relative to underlying bonds that could ultimately prove to be illiquid. Indeed, while new regulations have directly benefited bank fundamentals and improved their ability to sustain losses, they also constrain their willingness and ability to intermediate in capital markets as they did prior to the GFC. Ultimately, this could hamper market liquidity during the next downturn and speaks to a need for investors to be increasingly cognizant of liquidity risk.

Figure 13. Where in the (Bail-In) World is Your Debt? “Bail-In” is loss-sharing across debt classes in lieu of government support (“bail-out”). Debt may be “senior” but in many cases will be subject to losses under new “bail-in” rules.



Jurisdiction	Commentary on "Bail-In" (<i>implementation is ongoing and varies by jurisdiction</i>)
United States	Bail-out is prohibited by law; senior holding company creditors slated to bear losses (<u>issuing TLAC senior debt</u>)
Europe	Burden-sharing amongst creditors must take place first, then government can provide support (<u>issuing TLAC senior debt</u>)
Canada	Debt subject to bail-in (the preferred option of regulators) but flexibility remains to bail-out banks (<u>issuing TLAC senior debt</u>)
Japan	Government has been explicit that it will bail-out if needed, protecting senior debt (but still <u>issuing TLAC senior debt</u>)
Australia	APRA comment letter: (Nov '18) "bail-in" debt would consist of <u>subordinated</u> debt, leaving senior debt untouched in a "bail-in" scenario (even if proposal changes, we expect senior debt to be supported)

Source: Standard & Poor's (December 2018) and IMF (October 2018)

One final risk for bank creditors to contemplate is that of bail-in or resolution regimes. The concept of “bail-in” relates to loss-sharing across the debt capital stack in lieu of government support or a bail-out, which took place at times during the GFC. Although many global banking jurisdictions today maintain high average credit ratings in part due to improved fundamentals, as shown in the top left chart of Figure 13, the perception of government support as embedded in these ratings has declined, as shown in the top right chart^{29, 30}. This reflects the implementation of bail-in regimes globally, which remains ongoing today.

²⁸ Source: IMF: Shadow Banking and Market Based Finance <https://www.imf.org/en/News/Articles/2017/09/13/sp091417-shadow-banking-and-market-based-finance>

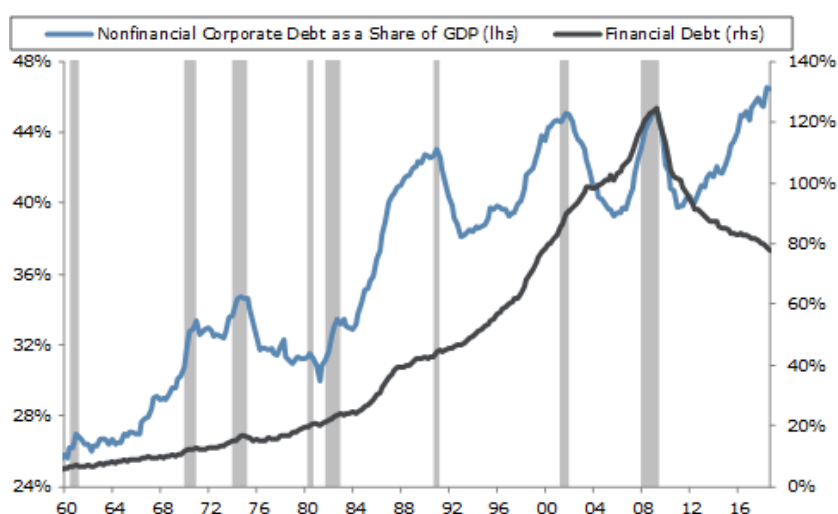
²⁹ Source: Standard & Poor's, "Ratings Component Scores For the Top 200 Banks Globally", December 2018

³⁰ Source: IMF Global Financial Stability Report October 2018: A Decade after the Global Financial Crisis: Are We Safer? <https://www.imf.org/en/Publications/GFSR/Issues/2018/09/25/Global-Financial-Stability-Report-October-2018>

Given that the timeline for implementing resolution regimes varies by country, understanding where your debt is domiciled will be a critical factor for capital preservation if we experienced another GFC. For example, the US, Europe, UK, Japan, and Canada are today issuing senior debt that is subject to bail-in, meaning these creditors could be called upon to take explicit losses. At this point, Australia's senior debt would exempt from bail-in under a comment letter issued by APRA in late 2018³¹. Rather, bail-in debt would be filled using additional issuance of subordinated debt instruments, which if enacted would be a positive development for senior creditors.

In our opinion, even if APRA's initial proposal is modified, systemically-important Australian banks should maintain some level of implicit government support in order to ensure confidence from offshore wholesale funding providers. We believe this is very important given the country's large net external borrowing needs, which are funded through the banking system. Indeed, APRA's listing of "public funds" as one of three financial resources available to facilitate orderly resolution adds some assurance to this view. Nevertheless, it is clear that across the world "senior" bank debt is not created equal in a tail-risk scenario and we believe Australia stands out positively in this regard.

Figure 14. **Bank Credit Outlook**



Source: Wells Fargo Securities, Federal Reserve. As at 30-Sept-18.

In summary, we believe that bank fundamentals both globally and domestically have improved materially following the GFC (Figure 14). While new and enhanced regulation has supported these fundamental improvements, there are unintended consequences of a more regulated banking sector including weaker market liquidity and the growth /buildup of asset risk away from the banking system. Still, we believe that systemically important banks will prove to be much more resilient than they were in the most recent cycle and are in a much stronger position to withstand a severely-adverse stress environment while supporting their respective domestic economies. For this

reason we believe that banks are likely to be a cushion as opposed to a cause the next time – or a “buffer”, as noted by Barclays CEO Jess Staley³².

³¹ Source: https://www.apra.gov.au/sites/default/files/increasing_the_loss-absorbing_capacity_of_adis_to_support_orderly_resolution.pdf

³² Source: <https://www.bloomberg.com/news/articles/2019-01-24/barclays-chief-says-a-crisis-is-likely-potentially-in-credit>

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Expiry Date: 31 May 2020 | 2523637.2.1.ANZ.RTL

Information Classification: General