

On the Minds of Investors

April 2019

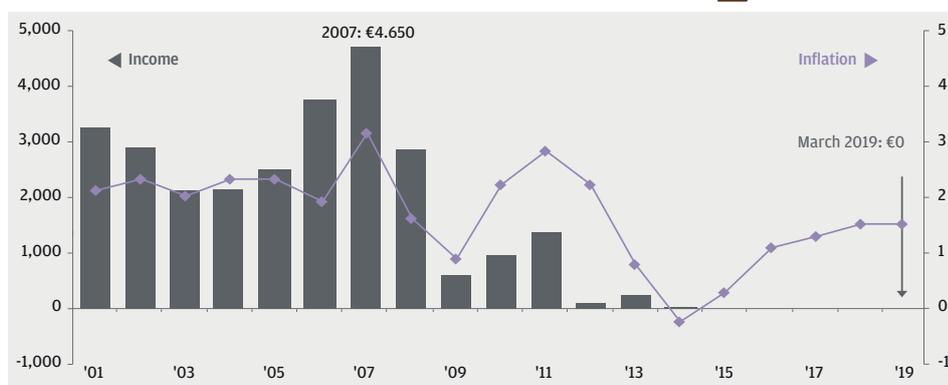
Finding income in a low yield world

Low interest rates and quantitative easing have reduced the income available to investors from cash and government bonds. The low level of rates is expected to continue given the recent dovish shift from the Federal Reserve and the European Central Bank, due to still subdued inflation and slowing growth. In the UK, even if Brexit-related uncertainty were to diminish, the Bank of England would be likely to only raise rates very gradually.

EXHIBIT 1: ANNUAL INCOME GENERATED BY €100.000 IN A THREE-MONTH BANK DEPOSIT

EUR (LHS); % change year on year (RHS)

GTM - Europe | 89



Source: Bloomberg, Eurostat, J.P. Morgan Asset Management. Inflation is the percentage change year on year for the eurozone harmonised index of consumer prices. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 31 March 2019.

AUTHORS



Michael Bell
Global Market Strategist



Maria Paola Toschi
Global Market Strategist

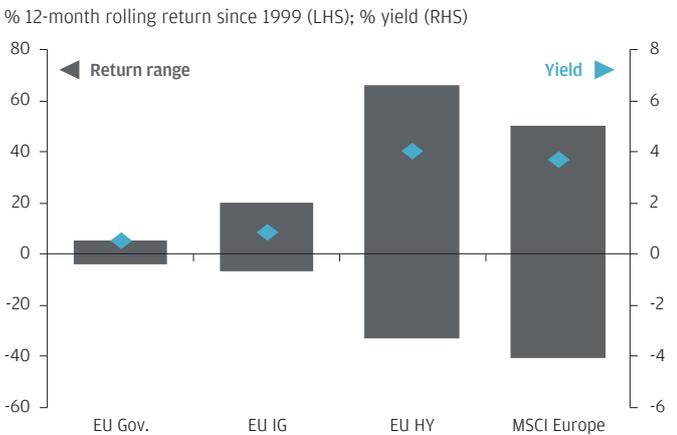
This low rate environment creates a now all too familiar dilemma for many investors who need an income from their savings. They either have to accept a much lower income than they were used to prior to the Global Financial Crisis, when interest rates were higher, or they have to take more risk to earn a higher income from their investments. This dilemma becomes even trickier the later we move into this economic cycle, as the rising risk of a recession increases the potential for declines in stock and corporate bond prices.

Unfortunately, the risk vs return trade-off isn't one that can be eliminated. So what can an investor who needs income do? While the risk associated with higher yielding investments can't be eliminated, it can be reduced in three ways.

1. Think in decades not days

The first way to reduce risk is to adopt a long time horizon for your investments. If you accept that it's hard to precisely time the peaks and troughs of the market cycle, but that over the long term the global economy and company earnings are likely to keep growing, then riskier investments can make sense as a long-term investment—even towards the end of an economic cycle. In short, if you can buy and hold on to your investments for the long term and ignore swings in their value as long as you continue to receive an income, then that enables you to take a bit more risk and earn a higher income.

EXHIBIT 2: INCOME YIELD AND RANGE OF ASSET CLASS RETURNS



Source: BAML, Bloomberg Barclays, MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. EU Gov.: Bloomberg Barclays Euro Agg. Government ; EU IG: Bloomberg Barclays Euro Agg. - Corporate ; EU HY: BofA/Merrill Lynch Euro Non-Financial High Yield Constrained. Fixed income yields are yield to maturity. Yield for MSCI Europe is dividend yield. Returns are based on total return in local currency. Past performance is not a reliable indicator of current and future results. Data as of 31 March 2019.

2. Be selective

If you can take a long-term approach to investing, the second consideration is to focus on the sustainability of the income produced. Some companies might pay a high dividend but have to cut their payout when profits fall during a downturn. Likewise, some companies might pay a high income in return for lending to them, but they may be unable to pay you back in full when profits fall. Some governments might even fall into this latter category, or at least they might struggle to pay you back in a currency that is worth as much in real terms.

For shares, it's important to consider dividend coverage ratios and the sustainability and cyclical-ity of the company's profits, as well as the yield. Dividend coverage ratios are a measure of company profits divided by the dividend payment, so a company with a high dividend coverage ratio is less likely to have to cut its dividend if profits fall. Companies are generally reluctant to cut dividends where possible but companies with low payout ratios (the inverse of the dividend coverage ratio) can increase the proportion of their earnings that they spend on paying their dividend to avoid having to cut it, whereas those with higher payout ratios have less flexibility.

EXHIBIT 3: MSCI EUROPE EARNINGS AND DIVIDENDS PER SHARE



Source: Bloomberg, MSCI, Refinitiv Datastream J.P. Morgan Asset Management. Earnings and dividends per share is based on trailing twelve months. Past performance is not a reliable indicator of current and future results. Data as of 31 March 2019.

It's also important to consider the sustainability and cyclical-ity of corporate earnings, as a company with a higher dividend coverage ratio could still be more likely to cut its dividend if its profits fell by much more than the company with a lower dividend coverage ratio. For example, a water company is unlikely to see a sharp fall in its earnings during a recession whereas a restaurant chain might. Likewise a DVD rental company might once have been viewed as likely to benefit from people eating out less and staying in to watch films more during a recession, but its earnings were unsustainable in the long term given the shift to online video streaming.

The same principle applies when lending money to companies by investing in corporate debt. This time investors need to consider interest coverage ratios, which are a measure of profits divided by interest payments rather than dividend payments. Again, the sustainability and cyclical nature of earnings are also key when considering whether the company will still be able to pay you during a recession. As interest payments have to be made before a company can pay a dividend and debt holders generally have a claim on the company's remaining assets in the event of a bankruptcy, a company's debt is less risky than the same company's equity. However, lending to a highly indebted company with cyclical earnings is not necessarily less risky than investing in the equity of a company with low debt and stable earnings.

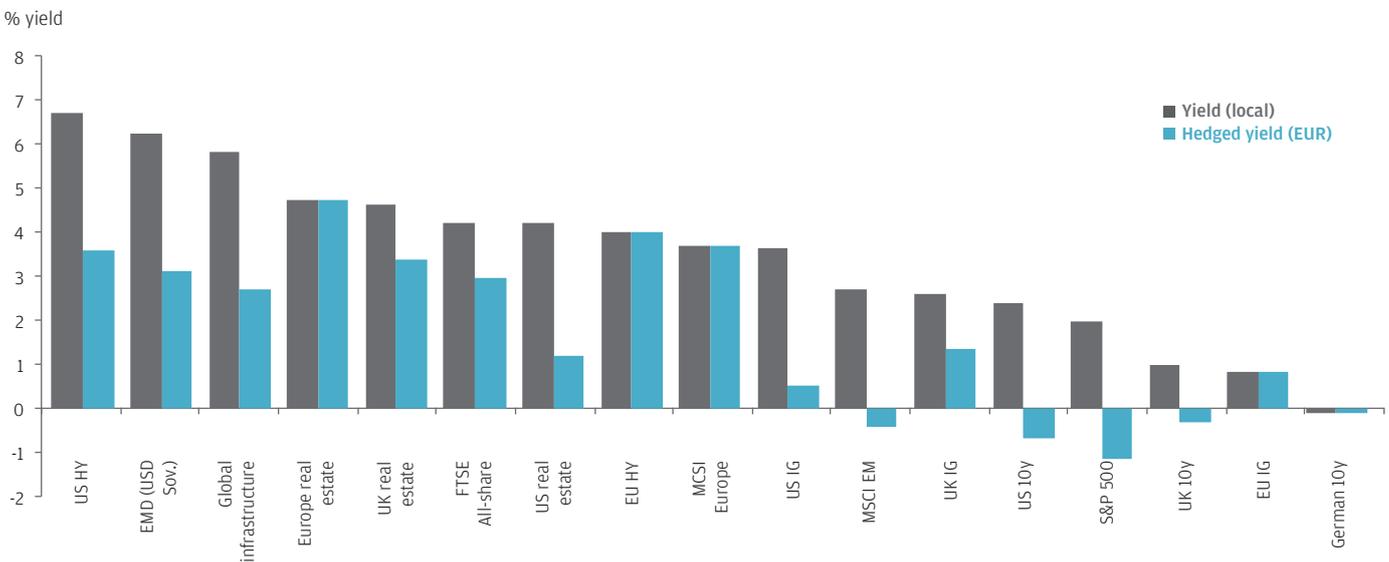
So the key for investors who need an income from their savings and can take a long-term investment approach, resisting the temptation to sell during a downturn, is to buy the debt and shares of companies that are able to keep paying you dividends and interest payments, even during a recession. Importantly, it's not just a matter of picking the debt and equity of the highest yielding companies but carefully selecting the highest yielding companies that can keep paying you that yield.

Actively selecting the highest yielding companies that will still be able to pay you an income in a recession is a job for professionals who have the time and skill to analyse financial statements, meet company management and assess the risk to profits in the near and long term. Even professionals might mistakenly pick a company that has to cut its dividend or that can't make its interest payments, but by diversifying across many of their carefully chosen favourite stocks and bonds, they should be able to reduce the risk that the occasional mistake has much of an impact on the overall portfolio.

3. Expand your horizons

Investors looking to maximise both yield and diversification, while also being selective and only picking securities from issuers that can reliably pay them an income, should also seek the widest opportunity set possible. A global approach allows the portfolio manager to select the most reliable income payers from across the whole world. A cross-asset approach also helps to expand the opportunity set to a larger amount of income-producing investments. Investors should consider the yield available on a wide variety of assets from all over the world, taking into account hedging costs to reduce currency risk where appropriate.

EXHIBIT 4: ASSET CLASS YIELDS



Source: Bloomberg Barclays, BAML, FTSE, MSCI, ODCE, Refinitiv Datasream, Standard & Poor's, J.P. Morgan Asset Management. US HY: BofA/Merrill Lynch US High Yield Constrained ;EMD (USD Sov.): J.P. Morgan EMBI Global; Global infrastructure: MSCI Global Infrastructure Asset Index-Low risk; Europe real estate: IPD Global Property Fund Index - Continental Europe; UK real estate: IPD Global Property Fund Index - UK; US real estate: NCREIF-ODCE Index; EU HY: BofA/Merrill Lynch Euro Non-Financial High Yield Constrained; US IG: BofA/Merrill Lynch US High Yield Constrained; UK IG: Bloomberg Barclays Sterling Agg. - Corporate ; EU IG: Bloomberg Barclays Euro Agg. - Corporate. 10-year yields are government bond yields. Equity index yields are dividend yields. Grey bars show yields based on local currencies. Blue bars show yields based on local currency plus the benefit or cost of hedging the local currency risk back to EUR. Hedging cost is annualised and based on three-month currency forwards. Hedging cost for Global infrastructure and MSCI EM based on assumed local currency of USD. Data is latest available as of 31 March 2019.

Default rates are currently low among high yielding corporate bonds and there are opportunities to be had for selective long-term investors in this asset class. In emerging market debt, there are also various different investment opportunities with differing risk/reward profiles. Local currency sovereign bonds in some emerging markets, for example, offer high real yields relative to developed market government bonds, where in some countries real yields are negative. Furthermore, the dovish shift from the Federal Reserve could allow emerging market central banks to adopt a more accommodative stance. As well as providing opportunities in debt, emerging market equities can be a fertile hunting ground for income. Many emerging market companies are now more focused on corporate governance and distributing cash to shareholders compared to in the past. Away from high yield bonds, emerging market debt and equity markets, investors should also consider the steady and relatively defensive income streams available from real estate and infrastructure investments.

Conclusion

In summary, you can't get away from having to take a bit more risk to earn a higher income than is available on cash and government bonds. But by extending your time horizon, going global, actively selecting the reliable income payers and diversifying across different companies and asset classes you can reduce the risks involved and increase the income from your savings.

The Market Insights program provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the program explores the implications of current economic data and changing market conditions. For the purposes of MiFID II, the JPM Market Insights and Portfolio Insights programs are marketing communications and are not in scope for any MiFID II / MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programs, as non-independent research, have not been prepared in accordance with legal requirements designed to promote the independence of investment research, nor are they subject to any prohibition on dealing ahead of the dissemination of investment research.

This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be taken as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit, and accounting implications and determine, together with their own professional advisers, if any investment mentioned herein is believed to be suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yields are not a reliable indicator of current and future results. J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide. To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our Company's Privacy Policy (<https://www.jpmorgan.com/global/privacy>). For further information regarding our local privacy policies, please follow the respective links: Australia (<https://www.jpmorganam.com.au/wps/portal/auec/PrivacyPolicy>), EMEA (www.jpmorgan.com/emea-privacy-policy), Hong Kong (<https://www.jpmorganam.com.hk/jpm/am/en/privacy-statement>), Japan (<https://www.jpmorganasset.co.jp/wps/portal/Policy/Privacy>), Singapore (<http://www.jpmorganam.com.sg/privacy>) and Taiwan (<https://www.jpmorgan.com/country/GB/en/privacy/taiwan>).

This communication is issued by the following entities: in the United Kingdom by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions by JPMorgan Asset Management (Europe) S.à r.l.; in Hong Kong by JF Asset Management Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited; in Singapore by JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601586K), or JPMorgan Asset Management Real Assets (Singapore) Pte Ltd (Co. Reg. No. 201120355E); in Taiwan by JPMorgan Asset Management (Taiwan) Limited; in Japan by JPMorgan Asset Management (Japan) Limited which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Australia to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Cth) by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919); in Brazil by Banco J.P. Morgan S.A.; in Canada for institutional clients' use only by JPMorgan Asset Management.

LV-JPM52051 | 04/19 | 0903c02a82589e1e