# Income perspectives

## Multi-Asset Solutions

**July 2020**

## IN BRIEF

- The first six months of 2020 have witnessed unprecedented market volatility, with the global coronavirus pandemic sparking one of the sharpest global downturns on record, before markets staged a significant recovery on the back of massive fiscal and monetary policy stimulus.
- Income portfolios have faced particular challenges in the review period. Many of the parts of the market that income investors typically focus on—including high dividend equities (such as financials and real estate investment trusts), credit markets and preferred equity—have underperformed year to date.
- Despite these challenges, investors are likely to continue to seek out alternative sources of income within their portfolios, given yields on cash and government bonds are now set to remain low for some time to come.
- The end of the previous market cycle and the start of a new cycle is also bringing new opportunities in risk assets, with corporate earnings expected to begin to recover in the second half of the year and with valuations in some areas now looking more attractive.
- In equities, for example, the relative valuations of dividend paying securities compared to the broad market look more attractive than at any point since the global financial crisis. Credit—both investment grade and high yield—continues to be supported by central bank purchases.
- Given uncertain backdrop and the dispersion in valuations, active asset allocation and underlying security selection will continue to be crucial for investors looking to generate attractive income while maintaining a balanced risk profile.

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## INCOME OVERVIEW

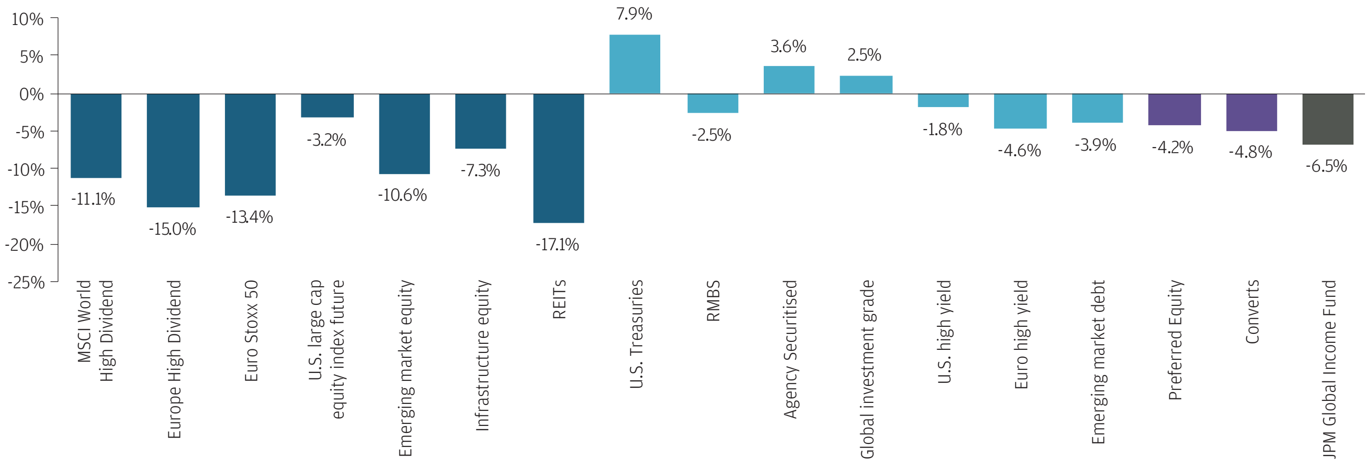
It's hard to believe that just a few months ago we entered 2020 with expectations for stronger growth, an upturn in earnings revisions, strongly supportive financial conditions and improvement in risk appetite. A phase one trade agreement between the US and China, insurance cuts from the Federal Reserve (the Fed) and a tentative upturn in macro data had spurred a year-end rally in risk assets and economic activity was expected to accelerate through the year ahead. But just as investors were focusing on the scope for economic momentum to rebound in 2020, the coronavirus was catching the attention of medics in China. Six months later, we find ourselves having been in the grip of a global pandemic and one of the sharpest global downturns on record, with a recovery that is looking almost as swift.

All data is sourced by J.P. Morgan Asset Management as of 30 June 2020 unless otherwise stated.

Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

**EXHIBIT 1: INCOME ASSETS HAVE LAGGED BROAD MARKETS**

Year to date performance




Source: Bloomberg, J.P. Morgan Asset Management, as of 19.06.2020. Indices: MSCI World High Dividend = MSCI World High Dividend Yield USD Index, Europe High Dividend = MSCI Europe High Dividend Yield Local EUR Index, Emerging market equity = MSCI Emerging market EUR Index, U.S. Treasuries = Bloomberg Barclays US treasury unhedged USD Index, Agency Securitised = Bloomberg Barclays U.S. Securitized: MBS/ABS/CMBS and Covered TR Index Value UnhTR USD Index, Global investment grade = Bloomberg Barclays Global Agg Corporate Index EUR Index, Global high yield = Bloomberg Barclays Global High Yield Total Return Index Value Hedged EUR, Emerging market debt = J.P. Morgan EMBI Global Core Hedged EUR Index, Preferred Equity = S&P Preferred Stock Total Return Index USD Index, Converts = Bloomberg Barclays Global Convertibles: Credit/Rate Sensitive TR Hedged EUR Index. TR=Total Return, JPM Global Income Fund = JPM Global Inome Fund A (div) - EUR.

Past performance is not a reliable indicator of current and future results.

Markets have been hit by unprecedented volatility. The MSCI World (net) index declined by 20.4% in EUR hedged terms over the first quarter of 2020. Crude oil prices plunged to levels last seen in 2002 as the Organization of the Petroleum Exporting Countries (OPEC) and Russia failed to reach an agreement on reducing oil supply in February, intensifying market volatility.

Credit markets came under severe selling pressure through February and March, with high yield spreads moving above 1,000 basis points (bps), as solvency concerns increased and investors rushed for liquidity. This liquidity crunch also affected some of the more traditionally defensive credit asset classes, such as non-agency mortgages, which for a time traded in line with high yield due to forced liquidations from leveraged investors in the space.

The dramatic surge for liquidity also affected duration assets and at times the traditional negative correlation between equities and government bonds broke down. At one point in March the 10-year US Treasury traded from a low of 0.3% to 1% within a week alongside a falling equity market.

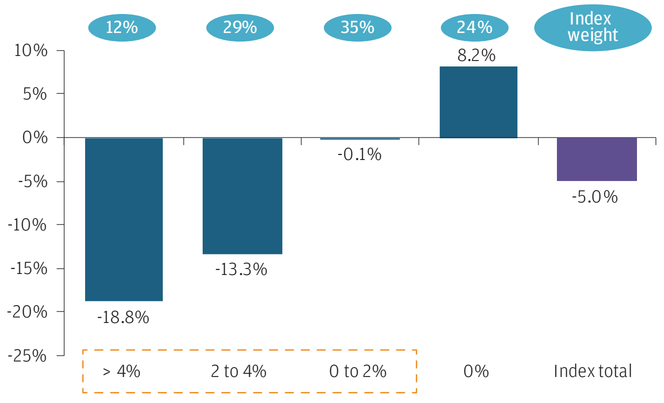
What turned out to be one of the deepest and fastest corrections since the great depression of the 1930s was quickly followed by a significant recovery as central banks and governments rushed to approve record fiscal and monetary policy stimulus. In the US, the Fed launched programmes to support market liquidity and to boost demand for fixed income assets, including corporate investment grade and high yield bonds. In Europe the European Central Bank (ECB) launched asset purchase programmes worth a record EUR 1.1 trillion to support the economy, while the Bank of England slashed interest rates and announced measures to stabilise markets.

Equity markets have recouped over 71% of their losses and recent central bank activity has provided a backstop for credit markets, which have seen high yield spreads tighten to 630bps.

Income investors have faced particular challenges during this period of volatility. Many of the parts of the market that income investors typically focus on—including high dividend equities (such as financials and real estate investment trusts), credit markets and preferred equity—have underperformed year to date (**EXHIBIT 1**).

Within higher dividend equities, this underperformance has been especially evident. Dividend names typically sit in the large cap value space as opposed to the growth areas of the market that have recovered from the sell-off more strongly. Growth-orientated names that pay little or no dividend have led the equity market rally over recent weeks (**EXHIBIT 2**) but do not sit in the opportunity set for a traditional income investor.

**EXHIBIT 2: YEAR TO DATE S&P500 PERFORMANCE BY DIVIDEND YIELD**



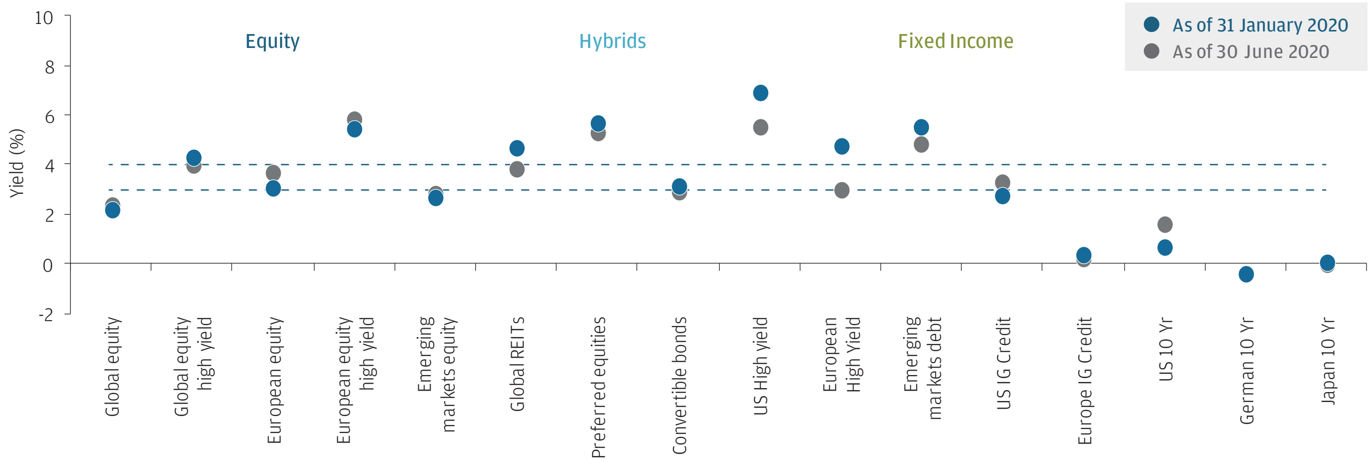

Source: Bloomberg, J.P. Morgan Asset Management, as of 31.05.2020.

As we look to the remainder of 2020 we consider the opportunity set for income investors from a multi-asset perspective. The late-cycle economy of the last three years is no more, and the longest US expansion on record is over. But with the 2020 recession we also see the beginnings of a new economic cycle. Leading economic data already point to a second-half rebound in activity and earnings, and the impact of stimulus is stoking pent-up demand, in turn pushing economic surprise indicators to new record highs. We expect improving macro data and earnings in the second half of 2020 to push up risk assets but for tail risks to remain meaningful in both directions, suggesting that there may also be lingering volatility to contend with.

Although the situation remains fluid and somewhat uncertain in the short term, one thing that is clear is that yields on cash and government bonds will remain low for some time to come. Investors will therefore continue to seek out alternative sources of income within their portfolios. Recent market moves have presented investors with a marked difference in the opportunity set (**EXHIBIT 3**). We believe that in this type of environment investors will be rewarded by utilising a flexible approach to investing for income, investing across asset classes, maintaining a focus on risk and not overstretching for yield. Active asset allocation and underlying security selection continue to be important tools for investors looking to generate attractive income while maintaining a balanced risk profile in this uncertain environment.

**EXHIBIT 3: WHERE CAN INVESTORS FIND YIELD TODAY**

Yield per asset class




Source: Bloomberg Barclays, J.P. Morgan Asset Management. Data as of 30.06.2020. Past performance is not a reliable indicator of current and future results. MSCI World Index (Net), MSCI World High Dividend Yield Net Total Return Index, MSCI Europe Index (Net), MSCI Europe High Dividend Net Return EUR Index, MSCI Emerging Markets Index (Net). FTSE EPRA/NAREIT Developed, iShares US Preferred Stock ETF, Bloomberg Barclays Global Convertibles, Bloomberg Barclays US Corporate High Yield 2% Constrained, BofA Merrill Lynch Euro Developed Markets Non-Financial High Yield Constrained Index, J.P. Morgan EMBI Global Diversified, Bloomberg Barclays US IG Credit Index, German 10 Yr Treasury Index, EURO Cash Index. Yield = book yield

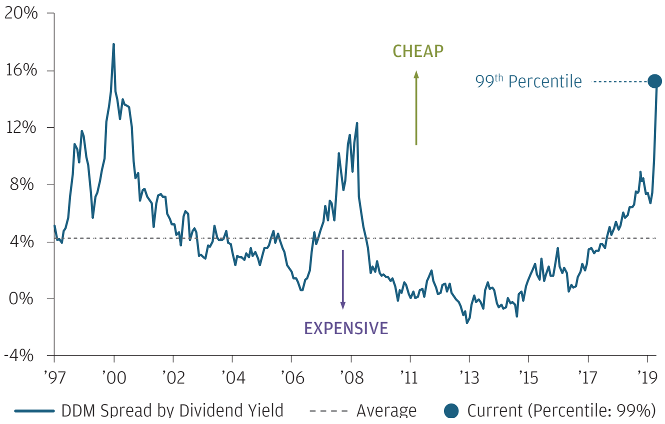
Yield is not guaranteed and might change over time.

## EQUITIES

As the global economy now appears to be moving through a new early cycle phase we expect the environment to be more supportive for risk assets. For income investors the relative valuations of dividend paying securities compared to the broad market look more attractive than at any point since the global financial crisis (**EXHIBIT 4**).

**EXHIBIT 4: DIVIDEND STOCKS AT HISTORICALLY CHEAP LEVELS**

Dividend Yield - Valuation versus broader equity market




Source: Bloomberg, J.P. Morgan Asset Management, as of 31.05.2020.

**Yield is not guaranteed and might change over time.**

With companies suddenly preparing themselves for a global recession of unknown depth and duration we have seen many pull guidance, draw down credit lines and, in some cases, delay or suspend dividends. In Europe in particular dividend cuts have been driven by ECB guidance for banks not to pay 2019 dividends (if they haven't already done so) and not to accrue 2020 dividends until October at the earliest. This has been combined with guidance in Germany that firms who seek financial assistance from the state cannot distribute dividends to shareholder.

In this environment it is important to differentiate between those names that are suspending dividends as a consequence of challenged business models or fundamentals and those names where the cuts come as a consequence of external pressure.

As companies continue to digest the impact of Covid-19 and the subsequent collapse in activity corporate earnings will see significant headwinds. However, the second quarter should prove to be the low point, and with activity now improving, consensus earnings growth expectations are positive for 2021.

Within equities, a broad exposure across regions is warranted as we move through the early stages of a new cycle. The US has continued to lead in the rebound year to date, as it did in the last cycle, and we do retain our bias for its more defensive qualities. However, our focus is starting to move towards more cyclical markets, such as Europe and emerging markets, which can offer attractive dividends and can outperform in early cycle. Recent policy announcements have improved the European outlook, with commitments to shared fiscal stimulus directly countering some of the breakup fears that sometimes surface for the single-currency zone during periods of economic turmoil. Meanwhile, emerging market equities offer an element of cyclical gearing and remain relatively inexpensive.

Within global developed market equities our focus is on compounders and companies with dividend sustainability, which we think is superior compared to the broad high dividend index. Within our income portfolios we have already taken action to remove the most challenged names from the perspective of leverage and liquidity, and hence we hope to avoid significant exposure to dividend cuts that come as a consequence of challenged business models and fundamentals.

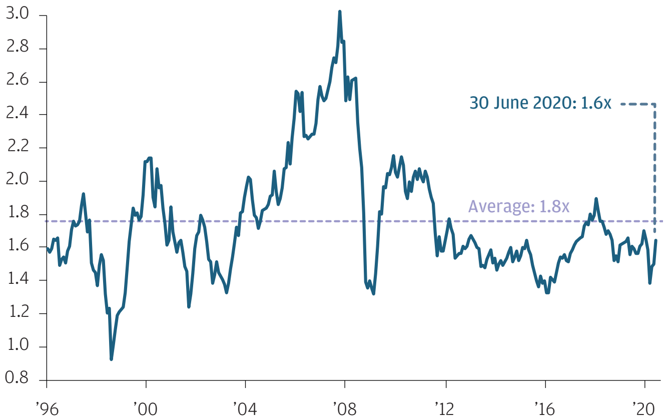
Our global equity allocation continues to generate an attractive yield of 3.9% relative to the index of 2.3% (MSCI World leading dividend yield) with dividend growth of 10.1%. On a sector basis, we have been avoiding sectors where we believe that companies will continue to struggle, specifically consumer staples, while focusing exposure on sectors less affected by the shutdown, such as technology.

Although there have been concerns about dividend cuts in Europe, income levels remain attractive relative to other regions. Our exposure to European equities has been at the lower end of historical ranges for some time now; however, we have become more constructive and have increased our allocation recently. The cyclical nature of the region and the progress being made politically in terms of a coordinated response to the crisis makes the region look more favourable. Within our European equity allocation we have taken steps to reduce exposure to leverage and weak liquidity in favour of more defensive dividends, reducing exposure to banking names, where we had concerns about loan books or the size of capital buffers. The allocation is currently generating an attractive yield of 5.1% relative to the index of 3.5% (MSCI Europe leading dividend yield) with dividend growth of 13.3%.

We would expect emerging markets to be leveraged to any recovery in economic activity, while dividends in the region remain reasonable. Even after the recent recovery, the emerging market equity price-to-book ratio, at 1.6x, remains below the long-term average (**EXHIBIT 5**). There are still many unknowns on the future path of markets, but we do know that historically these have been attractive valuation levels for the long-term investor.

**EXHIBIT 5: MSCI EMERGING MARKETS PRICE-TO-BOOK RATIO**

x, multiple




Source: (All charts) MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. *Dots represent monthly data points since 1996, which is earliest available. MSCI EM Index returns are in USD. *Guide to the Markets - Europe*. Data as of 30.06.2020.

**Past performance is not a reliable indicator of current and future results. Yield is not guaranteed and might change over time.**

Within our emerging market equity allocation we are focusing on companies with stronger balance sheets relative to their sectors as a whole. As an example, close to half of our non-financials have net cash on their balance sheets. Our financials look healthy from a capital ratio perspective, although we are watching closely to see how the operating and regulatory environment is changing.

Our analysis shows that yields are higher for our emerging market allocation at 4.7% versus the broad index (MSCI EM leading dividend yield) at 3%, and this spread should be maintained even if dividends are cut. It remains clear that 2020 will be challenging for dividends in emerging markets; however, to date our allocation has been resilient. To the end of May, the majority of dividend announcements have been in line with expected dividend policy but we have seen a small number of omissions or pauses, mainly in the banking sector.

While mindful of the challenges associated with the current virus issues, we have avoided making decisions on a short-term, tactical basis within our emerging market equity allocation. We remain focused on our long-term aim of investing in sound businesses, selecting stocks on their fundamental qualities - returns on capital, free cash flow and dividend policies.

Global real estate has faced headwinds year to date as fundamentals have been correlated to the effects of the pandemic. Hotel operators and retail have suffered and are in cash conservation/cost-cutting mode. Healthcare has faced similar challenges, with occupancy in senior housing taking a hit, and expenses increasing on the back of necessary expenditure on safety measures. In these challenged sectors, dividend cuts and suspensions have been commonplace. Conversely, offices have been fairly robust, although the debate rages on whether the working from home phenomenon will result in a permanent reduction in office space requirements. Consensus seems to be coalescing around a 15%-20% reduction in space needed—although space per employee may increase as a result of social distancing requirements.

Industrial/logistics has held up very well, with few tenant issues and an increase in demand from e-commerce tenants as well as from other users stockpiling inventory due to closed stores or supply chain challenges. Similarly, data centres and towers have been largely unaffected by the pandemic, with the lockdown and increase in work-from-home activity leading to significantly more demand for data traffic, and corporations accelerating plans for cloud deployment and remote working solutions. In our allocation we maintain a positive tilt towards sectors exhibiting above-average growth, such as data centres, industrial as well as residential. However, as companies have taken action to bolster their balance sheets and it has become apparent that they would survive the current downturn, we have increased positions at the value end of the spectrum, including some positions in healthcare and hotels.

Real estate investment trusts (REITs) have underperformed the broader equity market during this market drawdown and subsequent recovery, but in general they have typically outperformed in the exit from recession. Given the short-term hit to incomes and potential slowdown in investment activity, valuations will suffer. However, for many real estate subsectors earnings should be relatively resilient, and we expect the yield characteristics of property and REITs to continue to be in demand. The yield on our allocation remains attractive at 4.1% (June 2020) with dividend growth of 6.6%.

## FIXED INCOME

Credit, with its attractive yields, will typically be a core allocation within an income portfolio. As we entered 2020, considering that we were in the latter part of the cycle, we had maintained a lower allocation to high yield credit versus history with an up in quality tilt and balanced with allocations to higher quality and liquid areas of the credit market. As the cycle came to a swift end in the first quarter this positioning helped mitigate some of the more extreme moves seen in credit.

Corporates continue to face significant challenges as economies begin to reopen following enforced lockdowns. The economic impact will be most lasting in travel, leisure, restaurants, retail, casinos, and energy. Governments and central banks have responded with unprecedented fiscal and monetary policy actions to counter the economic impact of the virus. The Fed, through its Primary and Secondary Market Corporate Credit Facilities, announced it would directly intervene in the credit markets for the first time in its history, and this is clearly being reflected in credit markets today.

Within US high yield the trailing 12-month default rate is currently 6.19% (**EXHIBIT 6**), and we expect this to increase to 7%-10% over the remainder of 2020, driven by energy and the weakest issuers in the most affected sectors, such as travel and casinos. However, we expect defaults to decline again in 2021 given the improvement in financial market access. Markets have already begun pricing a substantial improvement in fundamentals and a decline in defaults, with spreads tightening significantly to 630bps by the end of June.

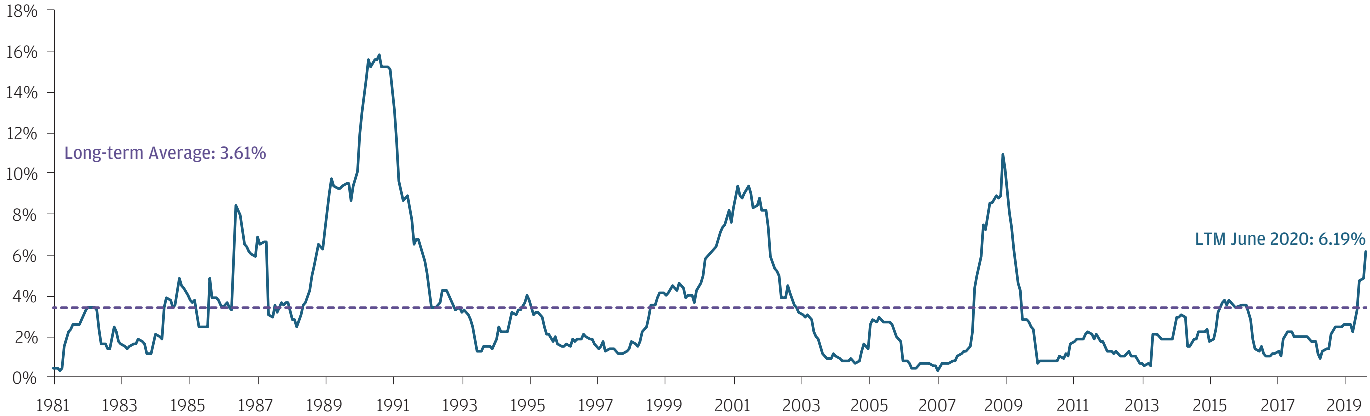
Active management and security selection will be critical as we move through this uncertain environment. We maintain conviction in the more defensive areas of the market, such as healthcare, consumer products and telecoms, while remaining cautious on the more speculative credits linked to resources and energy sectors, given their sensitivity to recent weakness in oil prices.

The recent technical driven rally that has supported fallen angels and energy names is, in our opinion, trading ahead of fundamentals and so we maintain a quality tilt in our allocations, which we believe will provide more attractive risk-adjusted returns and income for portfolios over coming quarters.

In Europe, the high yield market continues to offer up opportunities for income investors. Despite volatility in February and March, European high yield was one of the better performing credit markets over the second quarter and provides some diversification, with a higher average quality, alongside US credit exposure. Within European high yield we have been more conservatively positioned with less exposure to cyclical areas and a preference for more defensive sectors, such as telecoms and healthcare. We continue to seek issuers that are likely to experience the most rapid recovery from any abatement in Covid-19 headwinds. Once again, in this environment we see active management and fundamental analysis of names as critical to manage risks and seek out attractive income and returns.

**EXHIBIT 6: US HIGH YIELD DEFAULT RATES**

Yield per asset class




Source: JPMorgan Chase & Co and Moody's Investor Services. Default rates are par-weight. Recoveries are issuer-weighted and in 2009 were 22.4 based on prices 30-days post default and were 35.7 based on year-end prices. The above information is shown for illustrative purposes only.

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Within investment grade, high quality credit provides a reasonable carry pickup compared with sovereign bonds. With central banks effectively providing a backstop, high quality credit also acts as an attractive source of diversification in fixed income. We expect demand for investment grade corporate bonds, which has rebounded over recent weeks, to remain strong as investors increasingly look for a combination of high quality and positive yielding assets in the current low rate environment.

We believe that it made sense to rotate away from more cyclical and lower quality BBB names earlier this year, where we saw risks of downgrades to high yield. Having been focused further up in quality, we are now seeing some opportunities across the quality spectrum. A fundamental approach, identifying companies with more sustainable revenue through the recession and subsequent recovery should be rewarded. Our focus is in sectors such as consumer non-cyclical, communications and financials. Through the recent volatility spread curves flattened dramatically; however, as the economy moves into the early cycle phase curves have steepened, creating opportunities to pick up more attractive yields in longer-dated credits.

Elsewhere in credit markets, preferred equity has faced headwinds through the first half of the year as financials broadly underperformed. Spreads have since narrowed, yet relative to history, common equity and senior spreads do look attractive. Preferred equity is one of the higher yielding asset classes, with our allocation generating a 5.9% yield as at the end of June. As banks came into this recession with tier 1 capital ratios at strong levels we believe that the majority of issuers will remain fundamentally sound through the downturn. We should not expect defaults, conversions, or coupon deferrals at this time; however, a fundamental approach to security selection will be key.

## SECURITISED

We continue to believe that securitised credit has a place in a diversified multi-asset income portfolio. The non-agency mortgage market has continued to recover over recent weeks following the most volatile quarter in the history of the asset class. Fundamental performance of the US housing sector has remained surprisingly resilient despite the full economic shutdown experienced over the first half of the year. The drivers have been record low interest rates, historically low levels of housing inventory and the new-found premium that is placed on maintaining a fully functional work space. As a result, house price appreciation remains positive over the past 12 months, with the S&P CoreLogic Case-Shiller Index showing a 4.73% increase in home prices nationwide.

On the other hand, roughly 9% of all US mortgages have entered a forbearance plan, which allows for mortgage payment relief. As government programmes designed to backstop the economy come to an end it remains unclear whether a second wave of virus outbreaks will wreak further economic damage. We are therefore cautious in our housing market outlook and consequently believe that it's prudent to remain defensive in our mortgage credit positioning, staying up the capital structure and adding bonds where principal recovery appears highly probable in all but the most pessimistic stress scenarios.

Within agency mortgages, record low interest rates and the ability of borrowers to refinance is providing headwinds. Despite initial expectations that refinancing activity would be slowed by the Covid-19 outbreak, refinancing actually remained strong due to technological advancements made to the mortgage system. The asset class has been a useful source of diversification year to date, but looks less attractive today.

## LIQUIDITY

As we have progressed rapidly through a sharp recession and recovery over recent months any liquidity in portfolios has proved to be a useful tool. At times of stress, maintaining adequate liquidity provides portfolio ballast, helping to dampen the effects of market volatility. As the global economy begins to recover, cash holdings also provide a source of capital that can be deployed to take advantage of attractive valuations and yield opportunities.

Yield is not guaranteed and might change over time.

## NEXT STEPS

For more information, contact your J.P. Morgan Asset Management representative.



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