Finding opportunities as income investors

Multi-Asset Solutions

November 2020

IN BRIEF

- The events of 2020 have altered the economic, policy and investing landscape more profoundly than any other short period of modern history. We now see the economic recovery gaining pace and expect a robust expansion into 2021. This view is justified by the trajectory of macro data and our expectation that support from policymakers through both fiscal and monetary stimulus will remain in place. We're in the early days of a new economic cycle and this should be a positive environment for risk assets.
- The implications of this year's events on income investors can't be understated. While the income and safety attributes of traditional bonds have historically been attractive, a paradigm shift is needed when trying to seek income and capital appreciation today. We believe investors will be best served by employing a flexible, multi-asset approach.
- In the following pages we present our analysis, which draws on three key observations:
  - Traditional fixed income is challenged
  - Policymakers are supporting risk assets and guiding toward a prolonged period of low rates
  - Dividend-oriented equities offer compelling valuations

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TRADITIONAL FIXED INCOME IS CHALLENGED

Securing attractive income in traditional bonds was already a difficult endeavor before the COVID-19 crisis, but the pursuit of income from bonds has become even more challenging given the events of 2020. In fact, most people have only experienced declining yields in their investing lifetimes. The past 40 years have brought an extraordinary period in which rates grinded lower. That backdrop meant that traditional bonds not only provided a reliable shock absorber to a portfolio with equity and credit assets, but also added to gains.

The 10-year US Treasury yield stood just under 0.7% as the fourth quarter of 2020 got underway. At these levels, there is little in the way of income or potential price appreciation and even a small move higher in yields could lead to negative returns. As the compliance comment goes, "past performance is not a reliable indicator of current and future results" and traditional bonds should come with this disclaimer today. A bondholder's future return is going to link closely to prevailing yields.

The current unprecedentedly low yield levels dictate that return expectations come down. The past 40 years of US aggregate bond returns illustrates this point (see Exhibit 1). The portfolio hedging that bonds provide has also proved rather limited in this lower rate environment. Between September 2nd and September 21st 2020, as the S&P 500 declined 8.4%, the 10-year US Treasury yield was essentially unchanged at 66 basis points (bps).

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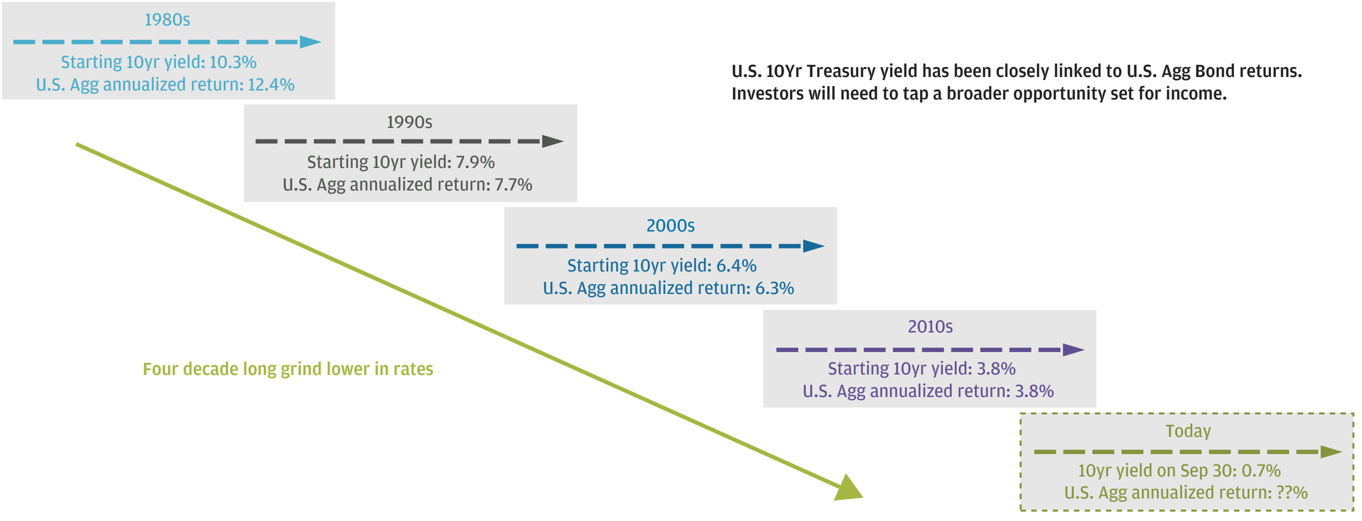
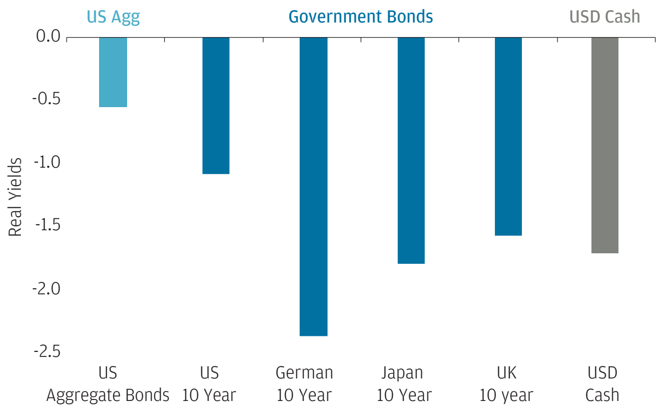
EXHIBIT 1: US AGGREGATE BOND INDEX RETURNS



Source: Bloomberg; data as of September 30, 2020. Index used: Bloomberg Barclays US Aggregate Bond Index.

Inflation also needs to be considered. An investor's real yield equates to the nominal yield minus inflation. Despite generally low inflation in recent years, the environment of low - or in some cases negative - nominal yields has resulted in negative real yields for many bonds (see **Exhibit 2**). Quite simply, investors are seeing their purchasing power evaporate with a host of bond investments today.

EXHIBIT 2: FIXED INCOME REAL YIELDS



Bloomberg Barclays, J.P. Morgan Asset Management. Data as of September 30 2020. Past performance is not a reliable indicator of current and future results.

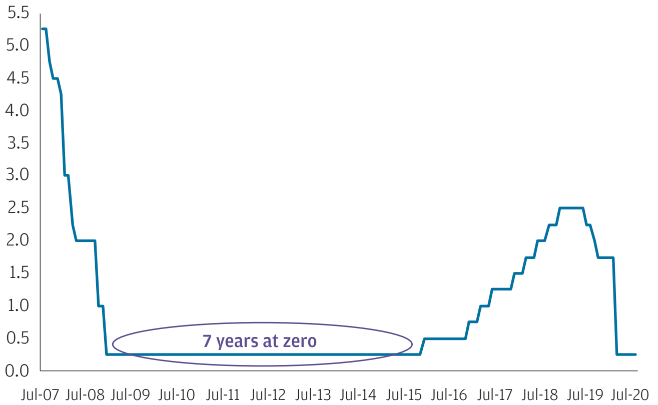
Bloomberg Barclays US Aggregate Index, US 10 Yr Treasury, German 10 Yr Treasury Index, UK 10 Yr Treasury, Japan 10 Yr Treasury, Average annual percentage rate (APR) on money market account (Bankrate.com). Yield = book yield; US Core CPI of 1.7%.

POLICYMAKERS ARE SUPPORTING RISK ASSETS AND GUIDING TOWARD A PROLONGED PERIOD OF LOW RATES

Immense policy assistance this year will likely continue to support risk assets and keep rates low for years to come. This backing is helping consumers and corporates avoid the worst case scenario and has far-ranging implications across markets. The drivers behind the Great Financial Crisis (GFC) were of course different compared to COVID-19 and the unprecedented sudden stop in business activity seen earlier this year. Many of the actions taken by policymakers during these two periods rhyme though. Back then, the Fed carried out a series of asset purchase programs (quantitative easing) and kept their benchmark rate at zero for seven years in an effort to ease financial conditions and promote economic growth (see **Exhibit 3**). These measures bolstered equity and fixed income markets by pushing people out the risk curve in pursuit of higher returns and more attractive income.

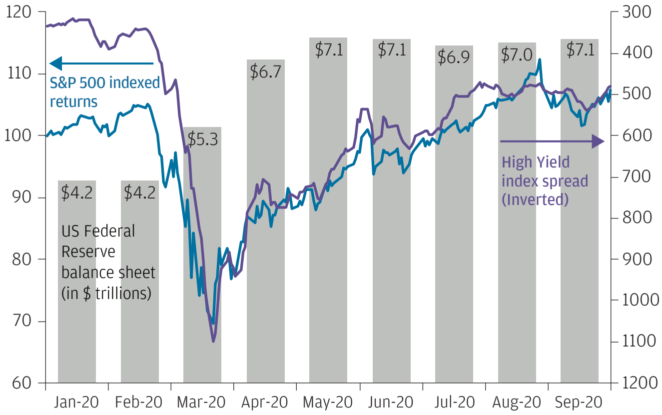
In 2020, the level of monetary and fiscal stimulus is unprecedented. On the fiscal side, we're getting much more than we would have in a recession that didn't involve a pandemic. The combined effect of central bank actions and the 13.1% of GDP committed by G20 nations to fiscal stimulus this year continues to fuel a powerful economic recovery and support risk assets.

EXHIBIT 3: FEDERAL FUNDS TARGET RATE (%)



Source: Bloomberg; Federal Funds Target Rate - Upper Bound (FDTR Index): The federal funds rate is the short-term interest rate targeted by the Federal Reserve's Federal Open Market Committee (FOMC) as part of its monetary policy. In December 2008, the target "fed funds" level was replaced by a target range - this data stream represents the upper bound of that range.

EXHIBIT 4: S&P 500 AND HIGH YIELD, JAN-SEPT 2020



Source: Bloomberg; US Condition of All Federal Reserve Banks Total Assets (FARBAST Index) - tracks the aggregate assets and liabilities of banks within an economy. Daily data as of September 30, 2020 used for S&P 500 returns and Barclays HY 2% IC spreads.

We would not have entered a recession in Q1 2020 if it wasn't for COVID-19. The government-enforced nature of lockdowns across much of the globe gave policymakers air cover to deliver considerable support. These actions started with the Federal Reserve (Fed) cutting its benchmark rate to zero in March, announcing that they'd buy Treasury and agency mortgage-backed securities to pump trillions into the economy and taking the unprecedented step of backstopping corporate credit markets. Other central banks also took action - in Europe for instance, we have seen monetary stimulus from the European Central Bank and positive news flow on the European Recovery Fund.

With all the monetary policy goodwill created by central banks to address capital markets, it would not have been nearly as effective without fiscal support out of Washington and elsewhere. Furlough programs provided support in many European countries and in the US, Congress delivered a bi-partisan $1.8 trillion economic stimulus bill (CARES Act) that dwarfed the $831 billion stimulus effort from 2009.

These policy actions were key in stocks turning upward, bond markets stabilizing and volatility beginning to ease. Combined with an inflection in economic data, the S&P 500 surpassed its February high by mid-August. This was the quickest snapback ever witnessed in equity markets and credit spreads came down across the board. The Fed expanded their balance sheet by an amazing 70% between March and September, as the S&P 500 gained more than 50% from the low on March 23rd and spreads on the high yield index ended the third quarter near 500 bps (see **Exhibit 4**).

The Fed recently announced a major policy shift that pulls back from pre-emptively raising rates to head off inflation. This announcement indicates the Fed prioritizing a further jobs recovery over inflation. A second key implication is that the Fed will be slower to raise interest rates - indeed, the Fed signaled in September that it expects to keep its benchmark rate at zero through at least the end of 2023. And for the foreseeable future, it expects to continue to purchase roughly $120 billion per month of Treasury and agency mortgage-backed securities. Given the Fed's policy change on inflation and its desire to run the economy hot, these stances seem unlikely to shift in a hawkish direction over the next year.

Below are three opportunities given this supportive policy backdrop:

1. **Credit:** The Fed's corporate bond-buying program offers an effective backstop to investment grade corporates. While companies have added leverage in recent years, this is being mitigated to a large extent by appealing interest coverage ratios. We also find high yield attractive, with the asset class operating as a low beta alternative to additional equity exposure. The Fed's willingness to support fallen angels in high yield is helpful and default expectations have been trending lower. We would also note that large corporate issuance over recent months has primarily been used to refinance existing debt and build cash positions.

2. **Preferred stock:** The asset class provides characteristics of both bonds and common stock, resulting in one of the most attractive absolute and risk-adjusted yield opportunities across our opportunity set. Preferred dividends have been well-maintained amidst an environment that saw many companies cut or suspend their common equity dividends earlier in 2020. Banks comprise the majority of the preferreds market and we believe they have the balance sheets to remain fundamentally sound through this environment.
3. **Covered calls:** Constructed by holding a long position in a stock or equity index and then selling (writing) a call option on that same asset, covered calls provide compelling income and potential capital appreciation. Equity volatility levels in March exceeded levels seen during the GFC and this environment has led to better terms (higher income levels and more potential equity upside) for those that employ a covered call strategy. US small cap equities have been our preferred market to express this view more recently. An environment of improving growth should benefit the cyclical exposure from small caps and higher volatility levels (compared to their large cap counterparts) allow us to capture more income in writing the call position.

DIVIDEND PAYING EQUITIES OFFER COMPELLING VALUATIONS

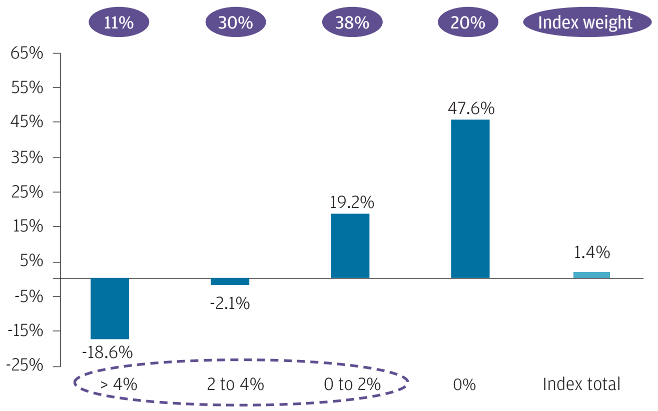
Income investors have been particularly challenged this year. Headlines in 2020 have been full of stories relating to dividend cuts or suspensions as companies have had to deal with the fallout from the global pandemic and at times regional government measures. This may have provided a headwind for dividend stocks in 2020 however, as is often the case, the reality isn't as bad as the headlines would have you believe. There have certainly been challenges in certain regions or sectors, such as some of the UK energy names for example, but this is where a truly global approach to investing literally pays dividends.

For example, in the US equity market this year 359 companies in the S&P500 either maintained or increased their dividend during the COVID crisis while only 38 suspended dividends and 85 didn't pay[1]. This is a staggering achievement in such a tumultuous environment yet it reflects the capital discipline and robust cost management of companies that can be identified through bottom up research.

Active management is critical in this type of environment as you want to be able to distinguish between those companies that are paying sustainable dividends, those that are suspending dividends through caution in the short term and those that are suspending them through necessity and challenging fundamentals.

Some of these concerns have been a headwind for income investors as dividend paying stocks have underperformed in the equity rally that began in the second quarter. 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. These more growth-orientated names, which pay little or no dividend, have led the equity market rally over recent months but do not sit in the opportunity set for a traditional income investor. This is especially evident when you consider the performance of global stocks split out by their dividend yield – anything with a yield in excess of 2% is still negative in terms of YTD performance while the zero dividend names have generated the majority of YTD returns (See **Exhibit 5**).

EXHIBIT 5 - YEAR TO DATE MSCI WORLD PERFORMANCE BY DIVIDEND YIELD



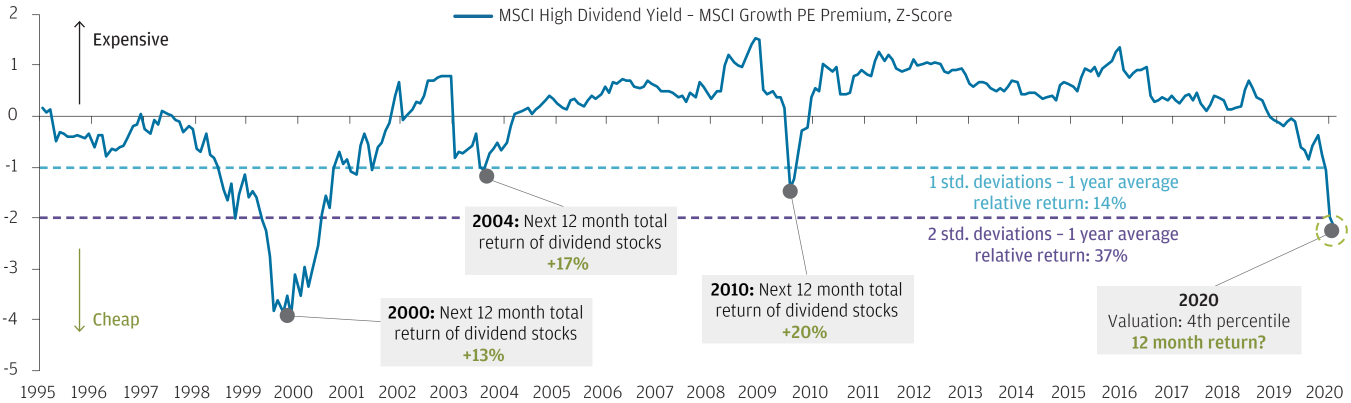
Source: Bloomberg, J.P. Morgan Asset Management, as of September 30, 2020.

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

This market dynamic has led to some compelling valuation opportunities that income investors can capitalize on. If we look at the relative valuations of dividend paying securities (MSCI World High Dividend Index) versus the growth part of the market, then dividend stocks are cheaper than they have been at any point in the last 20 years – at more attractive levels even than in the depths of the Global Financial Crisis.

[1] Data as of September 2020.

EXHIBIT 6 - ATTRACTIVE VALUATIONS ON DIVIDEND STOCKS



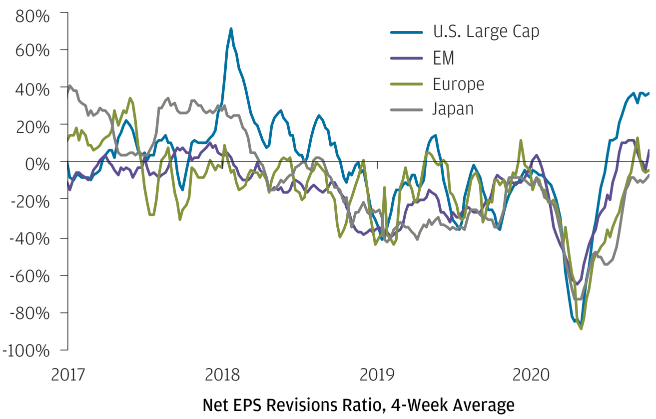
Source: Bloomberg, J.P. Morgan Asset Management, as of 08.31.2020. MSCI World Growth Index, MSCI World High Dividend Index. P/E = 12 month trailing price earnings ratio.

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

High dividend stocks are today trading at a two standard deviation discount to growth stocks. Historically, this level of discount has led to attractive returns over subsequent periods. In fact, the absolute return of dividend stocks from these levels has been between 13% and 20% over a 12 month period when we have seen similar valuations over the previous 25 years (See **Exhibit 6**).

When we consider equities today we shouldn't forget why we really own stocks, and that is for the receipt of future cash flows. Valuations today reflect the discounted value of those future cash flows and dividends. Currently markets are pricing future dividends as if some parts of the economy, and some companies, may never again recover from the COVID crisis. In fact, after bottoming out in the second quarter earnings (and dividends per share) are actually improving again (see **Exhibit 7**). The US and Emerging Markets are already seeing positive earnings revisions with Europe not far behind.

EXHIBIT 7 – EARNINGS RECOVERY



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of September 2020

This recovery in earnings, combined with significant global demand for income, should provide support to dividend paying stocks and help close this valuation gap over coming quarters.

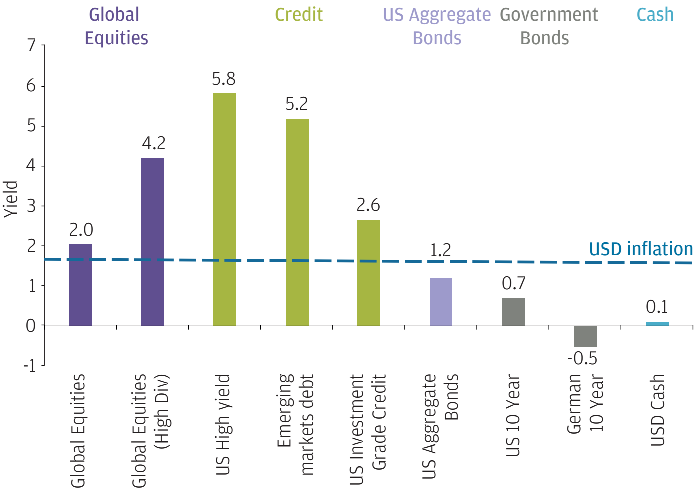
Equities continue to offer attractive dividends with the potential for capital appreciation based on today's valuations. In the current environment we would consider a diversified approach, complementing defensive allocations with cyclicality and seeking out attractive companies through a fundamental bottom up approach.

WHY MULTI-ASSET FOR INCOME NOW?

With traditional income sources such as deposits and government bonds remaining challenged clients will need to consider a broader opportunity set in order to achieve their income goals.

A multi-asset approach opens up a wide array of income opportunities with the benefit of diversification for risk management purposes (See **Exhibit 8**). Equity valuations are attractive today and, along with credit, are seeing support from policy action. But with the ability to look further afield, a multi-asset investor can source income from areas such as preferred equity or covered calls, which allow you to generate income from the higher levels of equity volatility we have seen recently.

EXHIBIT 8: NOMINAL YIELDS FOR ASSET CLASSES



Source: Bloomberg Barclays, J.P. Morgan Asset Management. Data as of of September 30 2020. Past performance is not a reliable indicator of current and future results.

MSCI World Index, MSCI World High Dividend Index, Bloomberg Barclays US Corporate High Yield 2% Constrained, J.P. Morgan EMBI Global Diversified, Bloomberg Barclays US IG Credit Index, Bloomberg Barclays US Aggregate Index, US 10 Yr Treasury, German 10 Yr Treasury Index, Average annual percentage rate (APR) on money market account (Bankrate.com). Yield = book yield

In the hunt for income investors will benefit from a flexible multi asset approach such as this, capitalizing on a wider range of opportunities:

- Investing across asset classes, regions and the full capital structure
- Maintaining a focus on risk, not overstretching for yield
- Combining flexible asset allocation with active security selection

NEXT STEPS

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

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