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Pursuing Sustainable Income with a Multi-Asset Approach

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Executive summary

- *Fourteen years of quantitative easing created a massive spike in money supply and distorted asset valuations. The subsequent implementation of quantitative tapering, plus interest rate hikes designed to temper inflationary pressure, induced significant losses for fixed income investors and challenged traditional asset allocation structures.*
- *We believe a global, multi-asset approach with the flexibility to deploy capital across any geography and asset class can better equip investors to generate sustainable income while helping to balance the risks of today's markets.*
- *The adoption of a granular approach toward asset class definition offers the potential to identify attractive opportunities many investors are unable to recognize, or unable to capture.*
- *Additionally, benchmark-oriented strategies are destined to produce benchmark-oriented returns. By instead focusing on a strategy with less sensitivity to index composition, managers and investors are able to emphasize areas of markets with greater opportunity, while avoiding others where the risk and reward balance is unfavorable.*
- *We favor assets we believe possess deep valuation support and strong free cash flow generation.*

For a variety of reasons, investors today are challenged to balance the production of income against the need to preserve capital in an environment with potential for substantial volatility. Overall, we believe equity markets are riskier than they have been over the last 10 years. Valuations are stretched, monetary authorities are much less supportive, and governments have probably already reached the limits of the fiscal stimulus they can provide. While we do believe we are in the offing of a reduction in the Federal Reserve's target rate (as Chair Powell stated in his remarks in August 2024), room for maneuvering is much more confined. We do not believe rates at zero will be staging a return.

Given these challenges, we believe investors can potentially generate income and capital appreciation by employing a global multi-asset approach with the flexibility to invest across geographies and asset classes. Importantly, the adoption of a more nuanced definition set of asset classes, or micro-asset classes without constraint of benchmark orientation, affords investors the potential to identify attractive opportunities in the midst of broader categories where the top-level risk and reward characteristics may appear to be less favorable.

Challenges of the current environment

Today's economic backdrop is characterized by slowing growth, deteriorating labor market conditions, and ultimately a dislocation to global fixed income and equity markets realized through rising credit spreads. Most forecasters around the world project global growth to be around 2-3% for the next two years. This is close to a recessionary level, and indicates difficult economic conditions, with an overall slowdown to be expected. Fourteen years of quantitative easing have created a massive spike in money supply and distortion in asset valuations, including excess reserves in the banking system. In contrast, we believe the upcoming decade will likely be characterized by continuing quantitative tightening and an overall trend of contraction.

Although investors believe the Fed will soon lower interest rates in response to signs of slowing growth, core inflation remains elevated because of the muted effects of rate changes on those with greater amounts of disposable/discretionary income. As a result, the magnitude of cuts to be effected will likely prove disappointing.

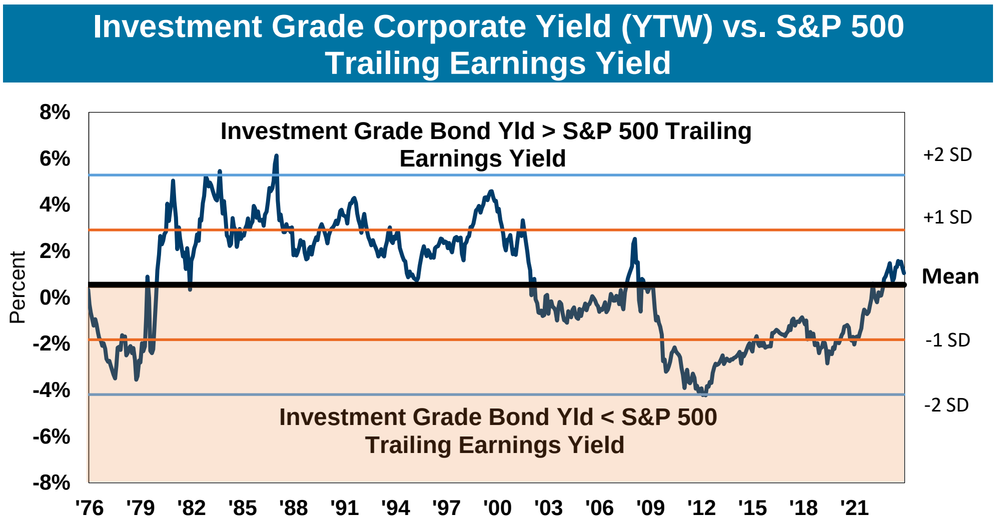
While capital markets valuations reflect general optimism that a recession can be avoided, we consider it likely that activity levels will continue to deteriorate during the months ahead. The rise in the cost of money we've experienced for the past two years has proven moderately effective at crowding out spending by both consumers and corporations alike. The resulting decline in demand motivates entities to reduce overall employment, which has been visible in data released by the Bureau of Labor Statistics (BLS). We suggest investors keep this prospective outcome in mind as they evaluate potential investment strategies.

For the first time in more than a decade, we believe it makes sense to include a higher fixed income allocation in global balanced strategies that aim to generate income.

Are bonds really back? Fixed income plays an important role, but risks must be understood

After the market correction of 2022, the relative valuation of fixed income to equity investments left more space for debt in a global asset allocation strategy. With that said, recent investor enthusiasm for prospective interest rate cuts has reversed a portion of this improvement, with corporate credit particularly vulnerable to correction, in our opinion.

Exhibit 1: Earnings yield of equity market is aligned to the long-term average yield of the investment-grade bond market



Source: Bloomberg, August 30 2024. S&P 500 Earnings Yield Index. When yield is shown to be below 0%, equity yields are more attractive; when above 0%, fixed income yields are more attractive. Currently, the yield has reverted to the long-term mean, which could indicate a potential opportunity for investment grade fixed income investments.

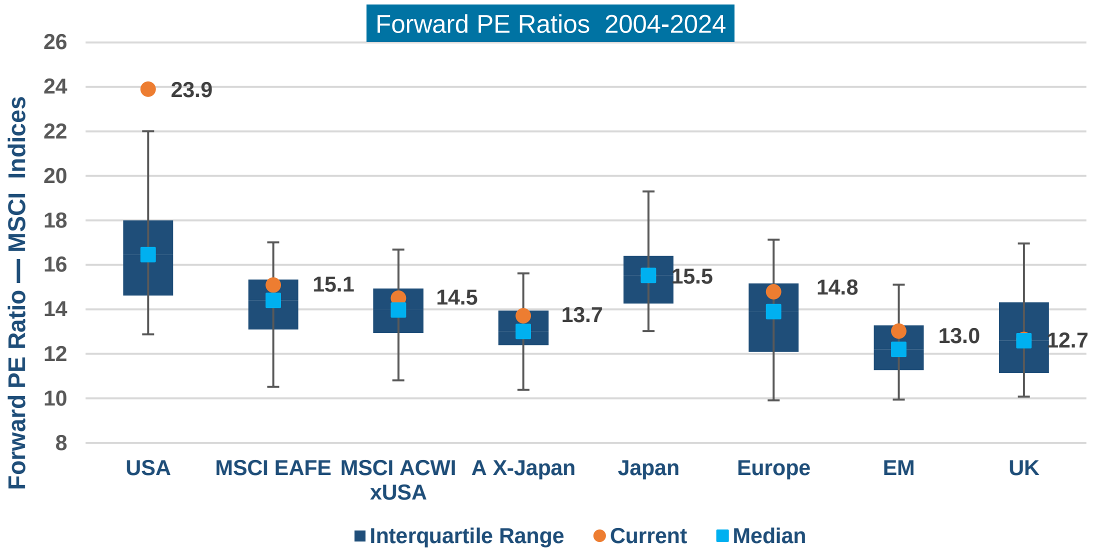
Using a disciplined valuation approach, investors can successfully identify both domestic and global securities possessing strong liquidity profiles and undemanding market prices

For most asset classes, interest rates normalized quite a bit during 2022 and 2023, moving back to where they were prior to the Global Financial Crisis of 2008. With that said, nominal yields only tell part of the story. Inflation remains elevated versus historical metrics, while credit spreads have actually narrowed. In this environment, investors receive lower aggregate compensation for underwriting credit risk at the point in this cycle where it potentially becomes dangerous for them to do so should activity weaken. Following years of exclusion, sovereign bonds appear more interesting, although the inversion of the yield curve, coupled with concerns about new issuance supply overwhelming demand, has concentrated value in shorter dated maturities. It is our belief that investors should consider lengthening duration gradually as these conditions become better understood.

Potential opportunities in global investments

We believe today's market is overpriced for growth factor investments given their associated long durations, but opportunities abound for investors who broaden their investment universe. While US indexes appear expensive to their historical means, as well as other global equity markets, concentration issues of the top eight constituents are masking behavior and investment potential of the larger marketplace. Using a disciplined valuation approach, investors can successfully identify both domestic and global securities possessing strong liquidity profiles and undemanding market prices, which have potential for generating attractive income and capital appreciation in what is otherwise a hostile environment.

Exhibit 2: Forward price-earnings ratios of MSCI regional indices

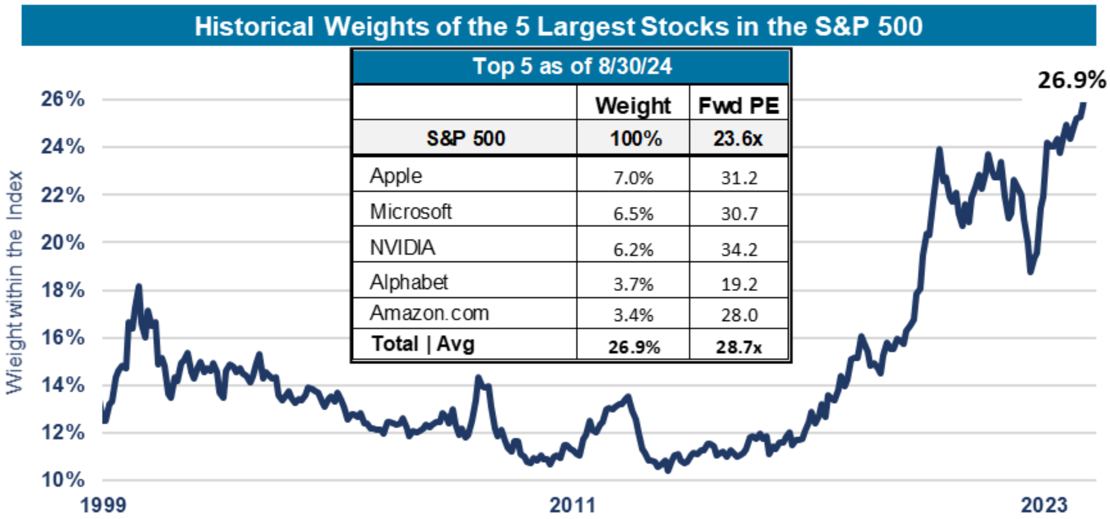


Source: Bloomberg and Amundi US. Based on consensus analyst forecasts from Bloomberg. Data as of August 30, 2024.

We believe sovereign debt can make sense for inclusion in global balanced strategies that seek to generate income.

Core to our present orientation is the belief that risks are currently outsized to the downside, and should not be increased in favor of producing potentially greater returns. While investors thirst for income and have reoriented themselves to an environment offering higher yields, we recommend they also maintain some capital to deploy when unexpected opportunities present themselves, which often happens as conditions first reveal signs of deterioration. Elevated short rates afford investors the opportunity to exercise patience.

Exhibit 3: S&P 500 concentration at record levels



Source: Bloomberg and Amundi Research. Data as of August 30, 2024. Forward price-earnings ratio (fwd PE) is the current price of a stock divided by the consensus analyst estimates of one-year projections of its earnings per share. For illustrative purposes only and not a recommendation to buy or sell stocks. For educational purposes only. The material should not be construed as a recommendation to buy or sell any of the securities discussed. Data is based on past performance, which is no guarantee of future returns.

Some examples of "micro-asset classes" that appear attractive in a challenging environment

While spread levels in corporate debt remain compressed, equity-linked notes have presented an attractive alternative for generating higher income through their conversion of volatility into a payable coupon stream. These investments incorporate an underlying equity component that can be of better fundamental quality (balance sheet, liquidity, etc.) than a corporate bond in the investment grade or high yield spaces with a commensurate yield profile. Investors should always evaluate whether the available compensation structure is appropriate in light of the accompanying risks. Our belief is that this asset class strikes a superior balance at this point in time, although a widening of credit spreads would likely accompany some element of reallocation.

Event-linked bonds such as catastrophe bonds, which are tied to weather events instead of traditional markets, can also offer investors the potential for generating uncorrelated return. A larger-than-average number of catastrophes in 2022, combined with deteriorating market conditions and higher interest rates reduced the aggregate amount of capital flowing in to this area, which created a better pricing environment for investors for 2023, and again in 2024.

Housing has been an additional source of opportunity, if one is able to break apart the larger securitized market to identify smaller sectors possessing attractive fundamentals. Non-agency mortgage receivables experienced severe volatility in late 2022 and early 2023 as rates pushed higher and prepayment activity declined to historic lows, but the underlying collateral value on seasoned loans is higher than it has ever been. Pools with loan-to-value ratios lower than 60%, and average borrower FICO scores in excess of 740 traded down to extremely discounted levels.

On the equity front, we favor companies possessing excess liquidity and significant valuation support. One sector that fits this profile is financials, particularly traditional banks outside the US, which are typically offering dividends of seven or eight percent. As we would expect, the earnings for these banks are rising as interest rates go up. And because the banks, unlike their US counterparts, haven't bought large amounts of long duration bonds and are suffering less severe deposit outflows, there is potential for opportunistic expansion, or the return of capital to shareholders via dividends and buybacks. For the first time in 20 years, we estimate that the banking sector is in better shape outside the US than inside. We prefer banks with lower-than-average credit risk, given the prospect of deteriorating macroeconomic trends. Another area of focus is the energy infrastructure subsector, including pipelines and transports, which has seen dramatic balance sheet and earnings improvement over the last eight years. On the whole, these companies have reduced their leverage, limited sensitivity to rate changes, and are now producing attractive income regardless of the price of the underlying commodity. We do expect that a portion of the outsized performance and capital returns experienced in this market segment for the last few years may slowly erode in the face of a) larger E&P capex initiatives; b) developed market economic weakness, and c) more pronounced economic deterioration in China. Accordingly, some of our elevated exposure has been harvested, but several of these companies still trade at meaningful discounts to book value with exceptional free cash flow generation.

As investors seek effective strategies to enhance income, it is important to diversify portfolios, consider risk management, and, most importantly, avoid crowded sectors and overvalued securities.

Conclusion

In today's economic environment, investors are continuing to look for potential income-producing solutions amid market challenges that are likely to intensify in the future. As investors seek effective strategies to enhance income, it is important to diversify portfolios, consider risk management, and, most importantly, avoid crowded sectors and overvalued securities. We believe a flexible, global multi-asset approach can help investors achieve their capital preservation and income generation goals. Importantly, it is our strong belief that adoption of a more nuanced definition set of asset classes, or micro-asset classes without constraint of benchmark orientation, affords investors the potential for identifying value in areas that may otherwise appear unattractive.

Index and Term Definitions

- Equity-linked note: A type of debt instrument structured to pay out based on the performance of an underlying equity investment. ELNs are different from traditional bonds because they do not offer a fixed interest rate; instead, the returns are tied to the performance of the underlying equity, which can be a single stock, a collection of stocks, or an equity index.
- Global Financial Crisis: The period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.
- Gross domestic product: The standard measure of the value added created through the production of goods and services in a country during a certain period.
- Inflation: A general increase in prices and fall in the purchasing value of money.
- S&P 500 Index: A stock market index that tracks 500 publicly traded domestic companies and serves as the foundation for a wide range of investment products.
- Sustainable income: Investment income made steadily and consistently over a period of time.

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