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INVESTMENT TALKS

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A Multi-Asset Approach to the Income Challenge

Marco PIRONDINI
Head of Equities;
US Portfolio Manager

Howard WEISS
Director of Multi-Asset Solutions; US Portfolio Manager

Executive summary

- *Fourteen years of quantitative easing have created a massive spike in money supply and distortion in asset valuations.*
- *We believe a global multi-asset approach with the flexibility to deploy capital across all geographies and asset classes can better equip investors to generate income while balancing the risks of today's markets.*
- *The adoption of a more granular approach toward asset class definition offers the potential to identify attractive opportunities many investors are unable to recognize.*
- *Additionally, benchmark-oriented strategies are destined to produce benchmark-oriented returns. By instead placing focus on yielding a solution 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.*
- *A world with higher interest rates and persistently elevated rates of inflation motivates us to 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 more risky 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. 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 in all geographies, and in all asset classes. Importantly, 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 persistent inflation, rising interest rates, slowing growth, and a resulting disruption to global fixed income and equity markets. 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 quantitative tightening, and an overall trend of contraction.

After the extreme pace of rate increases these past 18 months, the US Federal Reserve paused its tightening program in September to allow time to observe how policy is influencing economic activity. While economies have historically required between 12 and 18 months to exhibit the impact of restrictive measures, it will likely take longer in the US this time around. This is because the majority of constituents are locked into 30-year mortgages that were either originated or refinanced at extremely low interest rates. Consequently, homeowners as a group will not feel the effect of higher rates for quite some time. Although investors believe the Fed will lower rates quickly in the wake of this tightening cycle, core inflation remains elevated because the effects on those with greater amounts of disposable/discretionary income have been muted. This phenomenon leaves little room for maneuvering, and is expected to require rates to remain higher for longer, until we achieve a meaningful slowdown in the service component of inflation.

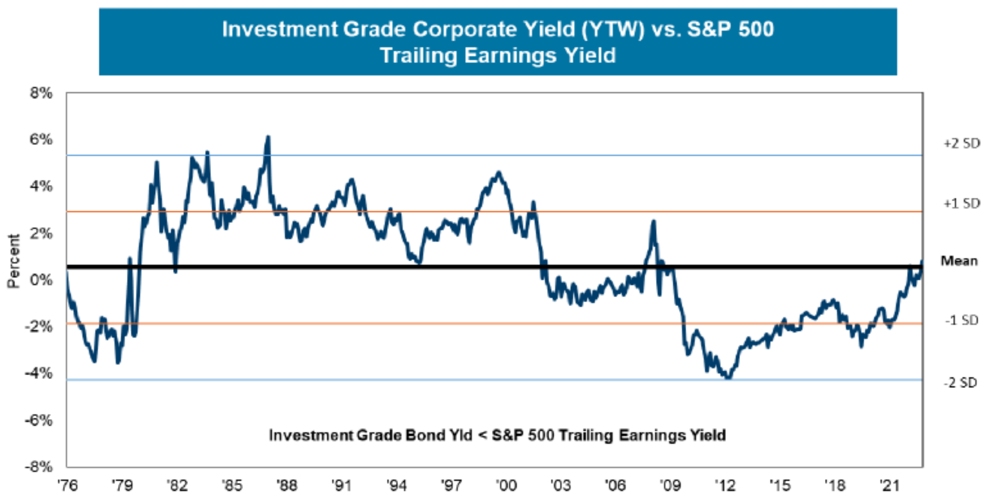
For the first time in more than a decade, we believe it makes sense to include a higher fixed income allocation in global balanced strategies that aim to generate income.

While capital markets valuations reflect general optimism that a recession can be avoided, we consider it likely that activity levels will deteriorate during the months ahead. A rise in the cost of money ultimately crowds out spending by both consumers and corporations alike. This presents as declining demand, and consequently motivates entities to reduce overall employment. We suggest investors keep this prospective outcome in mind as they evaluate potential investment strategies.

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

After the market correction of 2022 through the writing of this publication, the relative valuation of fixed income to equity investments has improved from incredibly stretched levels, leaving more space for debt in a global asset allocation strategy.

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



Source: Bloomberg, 8/31/2023. 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.

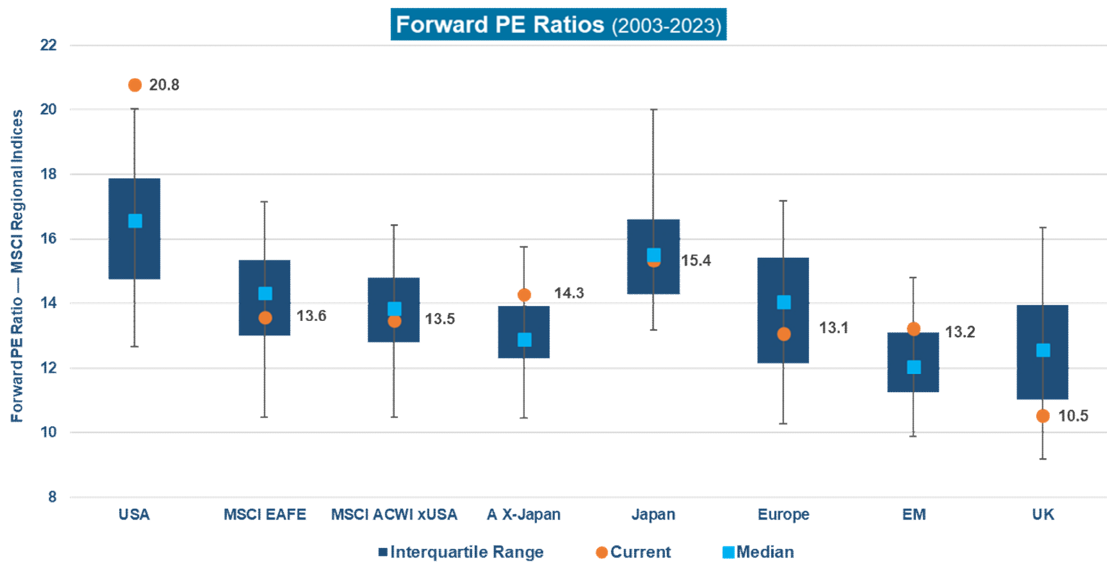
Using a disciplined valuation approach, investors can successfully identify both domestic and global securities possessing strong liquidity profiles and undemanding market prices

For most asset classes, interest rates have normalized quite a bit in the last year, 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 view 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. Data as of 31 August 2023.

For the first time in more than a decade, we believe sovereign debt can make sense for inclusion in global balanced strategies that seek to generate income.

Core to our present orientation is 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, 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 affords investors the opportunity to exercise patience.

Some examples of 'micro-asset classes' which 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 in 2023.

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 suggest investors select those banks with lower-than-average credit risk given the prospect of deteriorating macroeconomic trends.

A second sector of focus is energy, although the infrastructural sub-segment including pipelines and transport 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. In an environment where administrations are actively promoting policy to achieve an end of hydrocarbon dependency, little incentive exists for companies to commit major capital expenditure for new infrastructure, or development of new reserves. Excess returns are likely to be distributed to shareholders in the forms of elevated buybacks and dividends.

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:** An investment product that combines a fixed income investment with additional returns tied to the performance of equities.
- **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**.**