

# Race for income



### ***What is the theme?***

Investors are likely to become increasingly innovative when it comes to searching for yield. Therefore, we believe a diversified multi-asset income allocation is likely to perform well in the coming 12 months.

### ***Why now?***

A global commitment to keep monetary policies supportive of growth, even in the face of expansionary fiscal policies, is likely to keep interest rates and bond yields low, particularly in Developed Markets. The US Federal Reserve's shift to Average Inflation Targeting reinforces this outlook.

### ***Investment Implications***

Higher yielding assets, such as Emerging Market and high yield bonds, are likely to outperform. Global high dividend equities and non-traditional income assets, such as sub-financials, should be positioned to do well too. In all cases, we prefer to play this income theme through a diversified allocation tilted towards these asset classes. Additionally, investors can consider taking advantage of episodic spikes in equity market volatility to generate additional income by selling options via structured solutions.

### ***Risks***

(i) Sustained increases in bond yields could hurt interest rate-sensitive assets within an income allocation; (ii) Deterioration of global growth and earnings outlook could lead to pullbacks in high dividend equities and high yielding credit assets.

The 2021 investment landscape is likely to be shaped by the tug of war between short term uncertainty from rising new COVID-19 infection cases, and the medium-term outlook for recovery as we gain more clarity on vaccine deployment. This road to recovery is unlikely to be smooth. Here, we outline our guidance in navigating 2021 for income-oriented investors. Specifically, we attempted to answer the following questions: First, is the income investment theme still valid in 2021? Second, what can investors do to achieve the target yield of 4-5%? Lastly, is an income investing strategy relevant for total return investors in 2021?

# Income investment theme remains valid in 2021

In a world of  
**\$17**  
USD TRILLION  
in negative-yielding assets,  
the search for  
yield is likely to  
continue

Looking ahead to 2021, two basic assumptions that support the income theme – the ultra-easy monetary policy environment and low traditional bond yields – are likely to remain in place. In a world of USD 17 trillion in negative yielding debt, the search for yield continues.

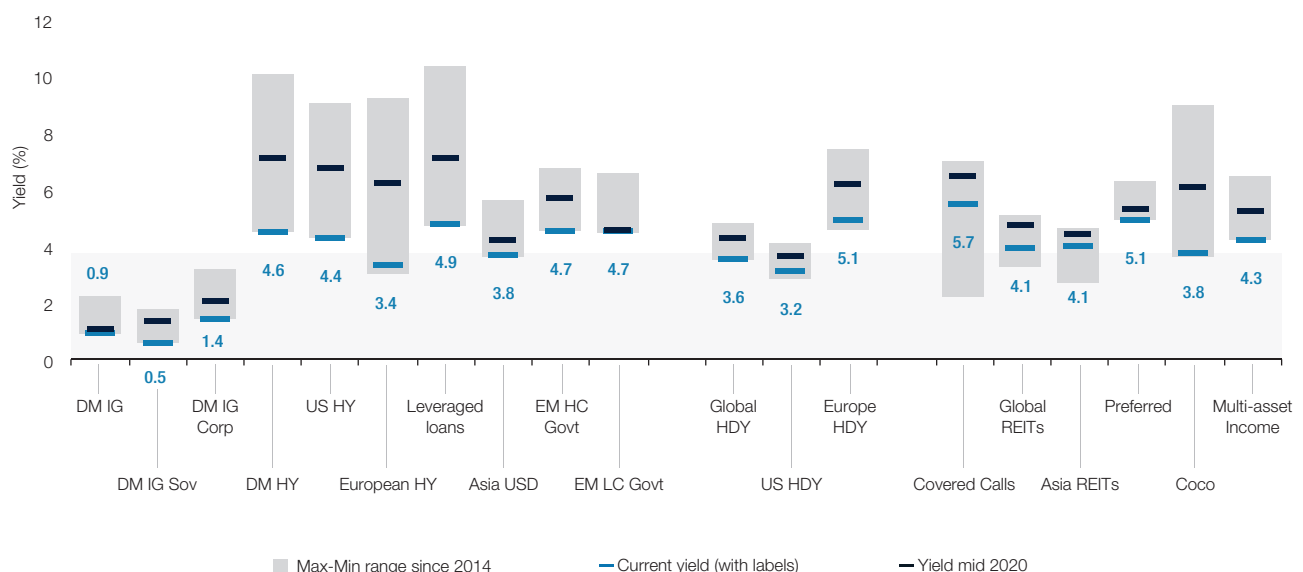
However, against the backdrop of a continued secular decline in bond yields, it is important for income seeking investors to adjust their expectations with regards to the income target that can be achieved without taking excessive risk.

The best way to manage this risk versus income challenge is via a diversified income strategy, which should look beyond traditional fixed income assets to high dividend equity and hybrid assets for more sustainable yields going forward. The current yield spectrum on offer (table below) shows income opportunities to meet the target of 4-5% are available in traditional fixed income assets such as Emerging Market (EM) USD government bonds, Developed Market High Yield (DM HY) bonds and leveraged loans as well as non-traditional income assets, such as dividend yielding equity, sub-financials, a covered calls strategy and REITs.

As coronavirus risks remain a source of market uncertainty in 2021, investors could also consider taking advantage of potential bouts of volatility to generate additional income by selling equity put options. This strategy provides income streams from selling put options on stocks or indices. When market volatility becomes elevated, the option premium tends to increase, generating higher income. Of course, if the stock or index slumps, such a strategy can invoke significant marked-to-market losses.

**Fig. 1 The search for yield continues**

Yield to maturity/ dividend yield (%) across asset classes



Source: Bloomberg, Standard Chartered. Data as of 10 December 2020. For indices used, refer to end note at the conclusion of this section. Refer to Explanatory notes related to Contingent Convertibles at the end of this document.

# Improving growth and subdued inflation expectations in 2021 favour tilt toward non-traditional income assets

When planning for an uncertain 2021, we believe one useful input is a growth/inflation framework that examines how various income assets performed in similar economic scenarios historically. A few key conclusions that can be helpful to investors' asset allocation decision-making process emerge from this.

First, growth expectations matter. Regardless of inflation expectations, absolute returns across the income spectrum, especially riskier assets such as high dividend equities, covered calls strategy and REITs, tend to be substantially higher in scenarios with an improving growth outlook. Looking beyond near-term coronavirus risks, we believe the prospect of continued fiscal and monetary policy stimulus should be supportive for these income-generating assets over the medium term.

Second, income is a key driver of total returns when growth is expected to slow (not our baseline scenario). In these

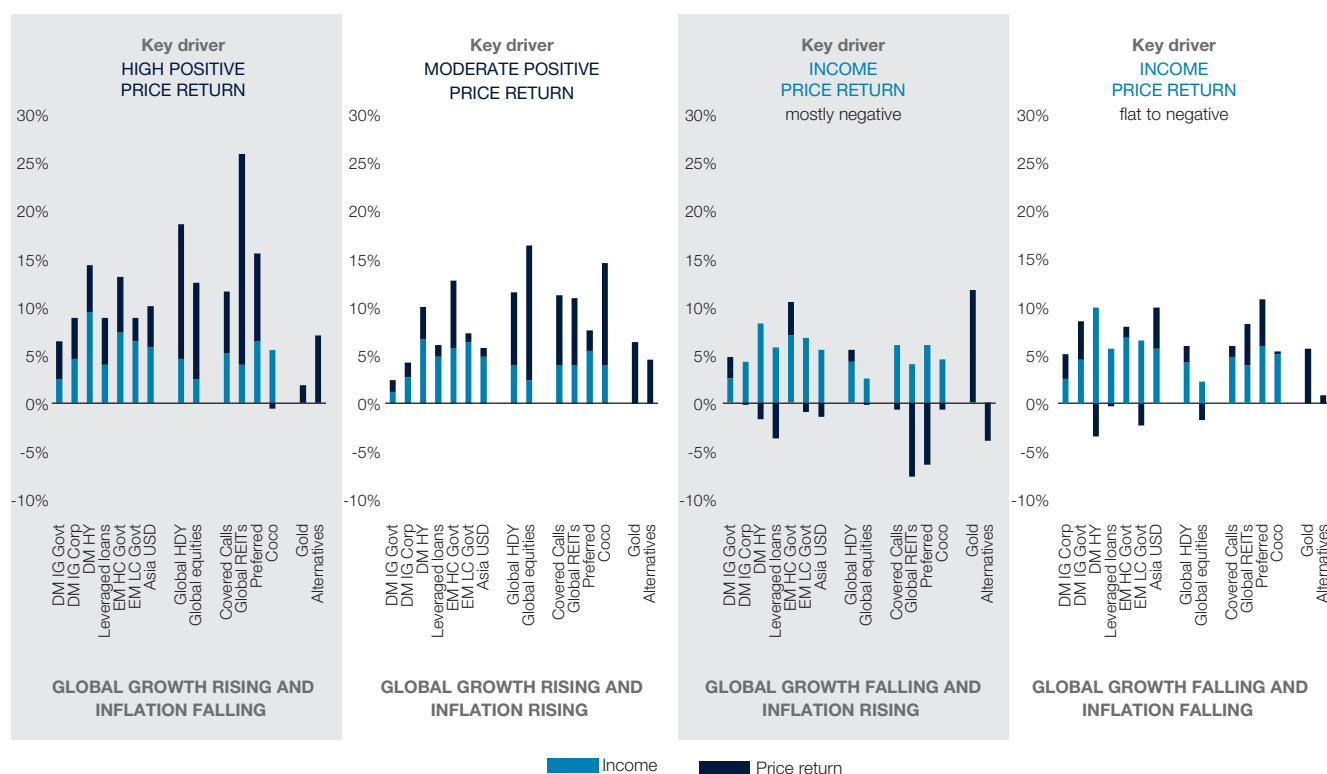
instances, traditional credit assets such as DM HY, EM and Asia USD bonds were the top performers; high dividend equities delivered significantly lower return, but outperformed traditional equities thanks to the higher dividend.

Third, risk asset returns are sensitive to changing inflation regimes. Rising inflation expectations will likely be high on investor's list of concerns in 2021. History shows rising inflation expectations can weigh on asset valuations, leading to lower capital appreciation, all else being equal.

Lastly, if our baseline scenario of improving growth and subdued inflation pans out, historically, risk assets including global high dividend equity, credit and non-traditional assets have done well. A multi-asset income strategy has also fared well as a high income core is balanced by exposure to defensive and growth-oriented assets.

**Fig. 2 Asset class performances in different economic scenarios**

Average 12-month return and volatility of various asset classes in different economic scenarios (2005–2020)



Source: Bloomberg, Standard Chartered. For indices used, refer to end note at the conclusion of this section. Economic scenarios are identified by BCA research data of global growth/inflation quadrants across business cycles. Refer to Explanatory notes related to Contingent Convertibles at the end of this document.





# Our preferences in 2021

One of many lessons that 2020 has taught us is the importance of diversification. While an inflation/growth framework can be useful in making asset allocation decisions over the medium term, we believe that diversifying the income sources across asset types, by regions, and by credit quality is an additional step investors can do to not only enhance income potential, but also increase the portfolios' resilience against short term market fluctuations.



## PREFERENCES BY ASSETS

Traditional fixed income remains a core holding but we advocate increasing allocation towards global high dividend equity and hybrid assets to boost income and build resilience of the overall allocation

## PREFERENCES BY CREDIT QUALITY

Being selective is key as one moves down the credit quality spectrum in search of yield



## PREFERENCES BY REGIONS

Diversifying a global multi-asset income allocation into EM assets for their attractive yield on offer and regional diversification benefits

## RISK MANAGEMENT A PRIORITY

We retain conviction in credit assets as they provide medium/high income with potential moderate downside risk



Source: Standard Chartered Global Investment Committee



## PREFERENCES BY ASSET CLASSES

Bonds have always been a mainstay for any multi-asset income allocation. The low-to-negative interest rate regime suggests investors broaden their scope in the search for yields. A look at the current yield spectrum (figure 1 on page 3) suggests increasing allocation to non-traditional income assets such as dividend equity and hybrid asset.

Fundamentally, we are constructive toward global high dividend equities over the next 12 months. Catalysts behind this preference are three-fold: (1) Valuations remain attractive, with yields comparable to many fixed income counterparts; (2) Dividend cut concerns have eased; (3) High dividend equities should benefit if we see a more decisive rotation from growth to value equities.

For similar equity-like exposure, a reasonable exposure to a covered call strategy and Real Estate Investment Trusts (REITs) should help boost the long-term income potential of the overall allocation. Historically, these hybrid assets tend to have lower correlation with bonds and equities, providing excellent diversification benefits and more “staying power” in risk-off scenarios. REITs, in addition, can offer protection against a tick up in inflation expectations.

We also like Contingent convertible bonds (CoCos)<sup>1</sup> and preferred securities for their valuable income. We are constructive on these assets given the availability of various credit facilities and buying programmes by central banks. Both Cocos and preferred securities carry a large tilt toward global financials and should benefit when bank lending activities improve from global economy normalisation.



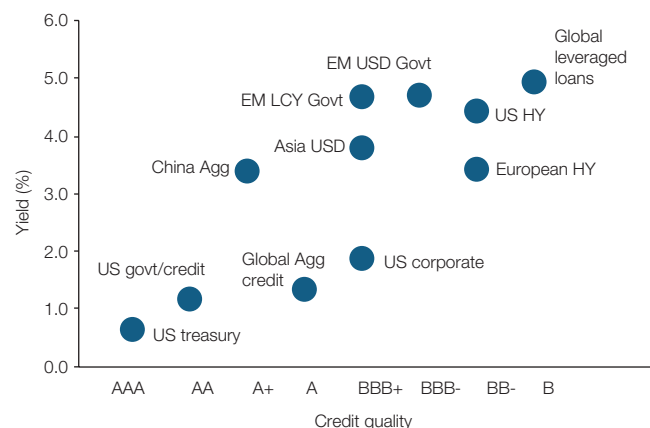
## PREFERENCES BY CREDIT QUALITY

The chart below showcases the lack of yield from high quality bonds globally. Despite their depressed level of yields, we maintain a small exposure to high quality bonds such as DM IG government and DM IG corporate bonds as a volatility dampener. However, credit – USD bonds with a yield premium above US government bonds – remains the most preferred area within our bond allocation. We believe that better yields on offer and a tailwind from the global economic recovery mean credit offers more attractive risk/reward trade-offs. We have opportunistically increased allocation to high yielders such as DM HY and EM USD govt bonds.

Looking ahead into 2021, as we transit into the early stage of a new cycle with potentially higher defaults and valuation risks, being selective is key as one moves down the credit quality spectrum to search for yield. Specifically, we prefer DM HY bonds over global leveraged loans as they offer higher credit quality for the similar level of income potential.

**Fig. 3 Be selective as one moves down the credit quality spectrum**

Yield to maturity/ dividend yield (%) across different credit quality buckets



Bloomberg, Standard Chartered. Data as of 10 December 2020. For indices used, refer to end note at the conclusion of this section.

<sup>1</sup> Refer to Explanatory notes related to Contingent Convertibles at the end of this document.



## PREFERENCES BY REGIONS

While the universe for DM focused income assets is wider, EM- and Asia-focused income assets play an important role in any global income allocation. We retain a sizable allocation to EM debt and Asia USD bonds and small exposure to Asia REITs in our income allocation. Fundamentally, we are positive on EM and Asia assets because (1) the yield on offer remains attractive; (2) our expectations for improving global growth and a weaker USD imply positive price returns for EM assets; (3) as US-China relations continue to fluctuate, we could see more differentiated or less correlated return profiles between DM and EM assets.

**Fig. 4 Yield spectrum of income assets broken down by region**

Yield to maturity/dividend yield (%)

	US	Europe ex UK	Asia ex Japan	EM
Covered calls	5.7			
Leveraged loans	4.9			
Preferred	5.1			
DM HY	4.6			
EM HC Govt				4.7
EM LC Govt				4.7
Asia REITs			4.1	
Global REITs	4.1			
Coco	3.8			
Global HDY	3.6			
Asia USD			3.8	
DM IG	0.9			
Multi-asset income	4.3			

Bloomberg, Standard Chartered. Data as of 10 December 2020. For indices used, refer to end note at the conclusion of this section.



## MANAGING RISK

While finding diversified sources of yield for our multi-asset income allocation continues to be a key focus, we believe managing downside risks (as proxied by maximum drawdown) remains a priority in 2021. Income assets can be broadly categorised into three drawdown buckets.

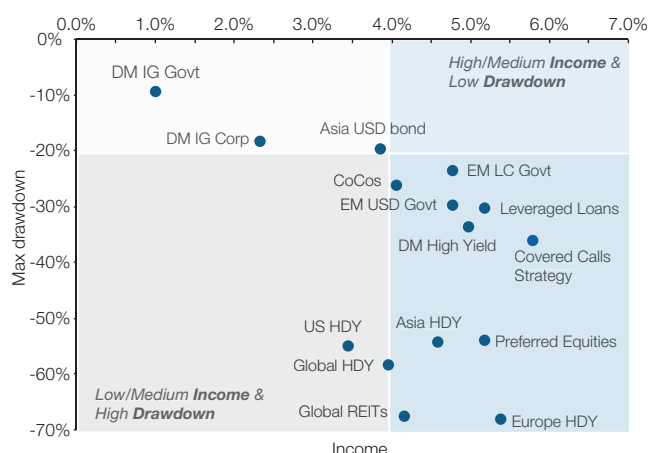
- High drawdown – dividend equity, preferred equities, REITs
- Medium drawdown – DM HY bonds, leveraged loans, EM bonds, Covered call strategy, CoCos
- Low drawdown – DM IG govt, DM IG corporate, Asia USD bonds

This simple generalised framework provides investors with insights of potential risk/reward trade-offs in supporting their asset allocation decisions.

Under this framework, we can justify having a large allocation into credit as it falls into the bucket of high/medium income with medium downside risk. With the central banks' commitment to keep interest rates and yields low for longer, risks of a significant pullback of these assets should be limited thanks to ample market liquidity. For the same reason, we are also comfortable with having some exposure to higher drawdown assets such as high dividend equities, preferred securities and REITs. These asset allocation decisions are consistent with fundamental drivers discussed in previous sections (page 4 and 6).

**Fig. 5 Downside risk/income potential framework supports our preference for credit**

Historical average max drawdown (2005 - 2020) and current yield of various income assets



Source: Bloomberg, Standard Chartered. For indices used, refer to end note at the conclusion of this section.

# There is a case for an income investing strategy for both income-focused and total return investors

Usually, multi-asset investors seeking a sustainable cash flow would prefer an income-focused allocation, while total return investors would prefer a growth-tilted allocation for price return potential. However, central bank policy over the past decade has meant both types of investors have increasingly favoured income strategies.

Looking ahead, we believe this dynamic should remain largely unchanged, implying that an income strategy remains appropriate for total return investors. This can be attributed to the following reasons:

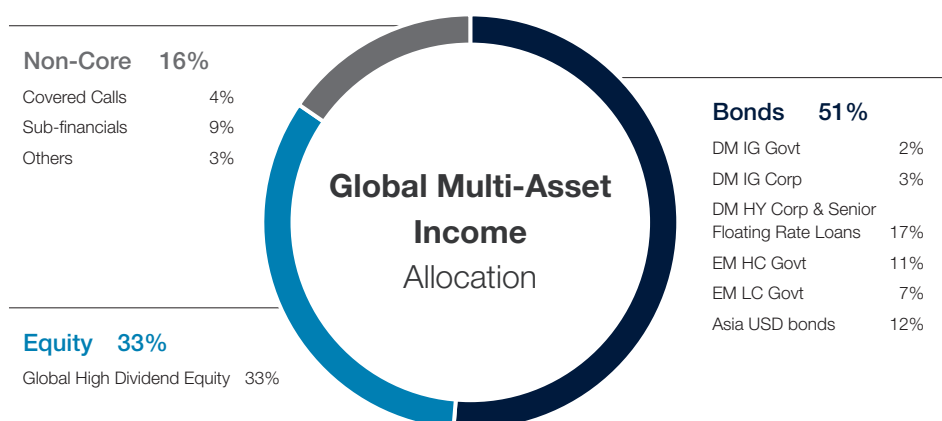
First, central bank policy settings are likely to remain accommodative for the foreseeable future. The continued search for yield should support demand for income assets.

Second, the greater focus on fiscal policy to revive the global economy should be supportive for capital appreciation of income assets. This can be validated by results from our inflation/growth framework (figure 2). Historical studies show that when global growth expectations picked up, most income assets reported high positive total return with price return as the key contributor.

Lastly, a more decisive value/growth style rotation should benefit a diversified income allocation given its exposure to high dividend equities.

As for yield-seeking investors, in 2021, the income goal of 4-5% will require investors to not only broaden their scope, but also think differently about portfolio diversification for protection from market fluctuations. While a tilt towards credit remains attractive, in our view, income assets such as high dividend yield equities, a covered call strategy, sub-financials and REITs seem positioned to do well in a low yielding world supported by strong policy stimulus.

**Fig. 6 Our proposed multi-asset income allocation for 2021**



Source: Standard Chartered Global Investment Committee. Allocation figures may not sum up to 100% due to rounding effects.

## End note:

Indices are J.P. Morgan EMBI Global Diversified TR, Barclays Global High Yield TR, J.P. Morgan JACI Composite TR, S&P Leveraged Loan TR, SPDR Wells Fargo Preferred Stock ETF, FTSE EPRA/NAREIT Asia REITs TR, FTSE EPRA/NAREIT Global REITs TR, Chicago Board Options Exchange S&P 500 BuyWrite, Citi Non-MBS WorldBIG Govt, Citi WorldBIG Corporate, BC US Conv 500MM Face Liquidity Constraint TR, MSCI ACWI High Dividend Yield Net TR, MSCI Daily TR Net USA, MSCI Europe ex UK Daily Net TR, MSCI AC Daily TR Net Asia Ex Japan, MSCI AC World Daily TR Net, MSCI EM ex Asia Daily Net TR, Barclays Global Contingent Capital TR Index Value Unhedged USD, J.P. Morgan Cash Index USD 3m. Bloomberg Gold TR, J.P. Morgan GBI-EM Broad Diversified, Barclays Global Aggregate TR, HFRX Global Hedge Fund Index, MSCI Asia High Dividend Yield Net TR, MSCI US High Dividend Yield Net TR, J.P. Morgan JACI Investment Grade TR, J.P. Morgan JACI Non-Investment Grade TR, MSCI UK Daily TR Net, MSCI Japan Daily TR Net



# Explanatory notes

1. Figure 6 (page 8) shows multi-asset income allocation for a moderate risk profile only – different risk profiles may produce significantly different asset allocation results. Page 8 is only an example, provided for general information only and they do not constitute investment advice, an offer, recommendation or solicitation. They do not take into account the specific investment objectives, needs or risk tolerances of a particular person or class of persons and they have not been prepared for any particular person or class of persons.

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