

# GLOBAL X ETF MODEL PORTFOLIOS

April 2023



## The Search for Yield - Equity Income Whitepaper

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### STABILITY OVER VOLATILITY

Investors should plan for a likely U.S. recession later this year. Historically, recessionary pressures weigh on earnings growth, with investors focusing on yield for a good portion of their total return. In 2022, higher-yielding areas of the market outperformed the S&P 500 as the Federal Reserve (Fed) aggressively raised interest rates, shifting investors' focus from future growth potential to current income.

Currently, markets expect the Fed's benchmark rate to peak around 5%, which may slow economic growth and ideally reduce inflation.<sup>1</sup> Still, rates could stay higher for longer, given the tight labor market, resilient consumer, and elevated inflation, which could create a favorable environment for income investors. This whitepaper outlines yield-focused solutions, especially applicable during times of economic uncertainty.

### KEY TAKEAWAYS

- Focus on quality dividends that can withstand economic shocks.
- Defensive sectors with high payout ratios typically outperform during late-cycle and recessionary environments.
- Equity income portfolios must be flexible enough to balance yield and total return throughout business cycles.

### VIABLE DIVIDENDS DURING MARKET DOWNTURNS

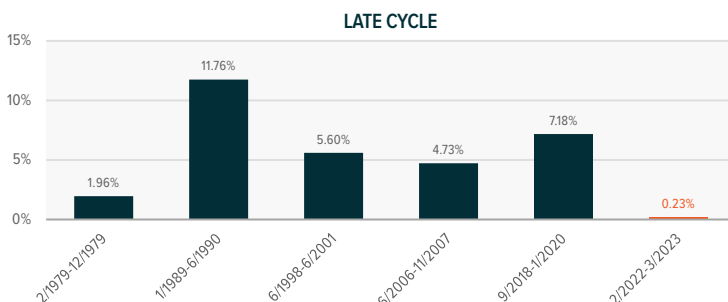
Dividend income can provide a margin of safety during times of market stress. But not all dividends are created equal. As the old saying goes, "cash is king," and some companies may cut payouts to retain cash through economic downturns. However, quality firms with strong balance sheets and free cash flow typically have more resilient payouts. The financial discipline of quality firms can enable reasonable payouts to shareholders while retaining enough earnings to fund growth.

We prefer yield stability, especially during recessionary environments. Quality stocks often have stable payout ratios and strong earnings, aiding performance versus non-dividend paying stocks during market downturns.<sup>2</sup> Notably, quality stocks outperformed the broader market in March 2023, reversing prior months of underperformance during this late-cycle environment that began in February 2022, as seen in the chart below.<sup>3</sup>

### EXCESS RETURNS

MSCI USA Quality Index vs. MSCI USA Index

Source: Bloomberg data as of March 31, 2023



There has been a notable delay in earnings downgrades over the past year despite weaker economic data, inflationary pressures, and a higher interest rate environment. The market sell-off in 2022 showed a wider dispersion between growth and value stock returns, and the premium attached to quality stocks, given their stronger fundamentals, possibly weighed on relative performance during the beginning of the current late-cycle stage. While substantial multiple compression makes value stocks appear attractive, varying fundamentals may create a "value trap" and could make some companies vulnerable during a recession. Therefore, the earlier mispricing of quality stocks during the challenging economic environment provided an opportunity for investors, especially those seeking stable dividend income. Quality could continue to benefit as the late-cycle stage advances.

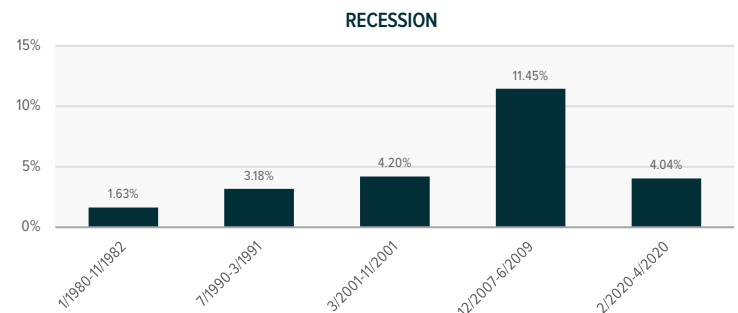
Market downturns enhance the attractiveness of quality's attributes, but the factor tends to underperform during early-cycle stages, highlighting the importance of understanding macroeconomic conditions.<sup>4</sup>

### POSITIONING WHEN POLICY RATES STABILIZE AND GROWTH SLOWS

U.S. markets could contend with delayed effects from policy tightening, evidenced by the significant fall in leading economic indicators. The Conference Board's Leading Economic Index for the U.S. is down 3.6% over the past six months through February, driven by manufacturing, credit, and consumer expectations, which more than offset strengths in labor markets and stock prices.<sup>5</sup> Meanwhile, the Goldman Sachs Financial Conditions Index (FCI) eased, reversing a portion of its rise from 2022 lows. A one-to-three quarter lag between a peak in the FCI and the resulting drag on U.S. real GDP growth is typical.<sup>6</sup>

The scenario table on the next page outlines the typical relationship between asset classes and economic variables. Recent liquidity concerns in the banking sector could encourage a slower trajectory of rate hikes. The "Yields Stable" section of the table highlights the most likely scenario during the first half of 2023, while the "Yields Declining" section could occur as recessionary pressures accelerate between 2H 2023 and 1H 2024. Here is a summary of positioning implications based on the current economic environment.

- Weak economic growth warrants defensive exposure with a greater focus on quality. Current profitability and consistent dividend distributions to shareholders are critical.
- Longer duration assets become attractive as yields decline from peak levels.
- The potential for higher volatility could warrant exposure to covered call strategies.





GDP & YIELD SCENARIO ANALYSIS

|                  | Real GDP Declining  | Real GDP Stable  | Real GDP Improving   |
|------------------|---|--|--|
| Yields Rising    | <p><b>Equities Weak</b></p> <ul style="list-style-type: none"> <li>• Recession scenario and risk of stagflation.</li> <li>• Defensive sectors including Utilities and Consumer Staples likely to outperform the broader market.</li> <li>• Focus on quality.</li> <li>• Current income important.</li> </ul>  | <p><b>Equities Mixed But Weak</b></p> <ul style="list-style-type: none"> <li>• Slowing economic growth and stagflation concerns.</li> <li>• Pressure on corporate earnings and valuation.</li> <li>• Favors market segments that can pass along higher prices and are generally positively correlated with inflation.</li> <li>• Real Estate and Energy have a positive relationship with inflation.</li> <li>• Current income important.</li> </ul> | <p><b>Equities Mixed</b></p> <ul style="list-style-type: none"> <li>• Cyclical market segments likely to benefit from strong underlying economic growth.</li> <li>• Strong consumer demand boosting consumption despite inflation.</li> <li>• Higher yields likely to keep valuations in focus.</li> </ul>                           |
|                  | <p><b>Fixed Income Mixed But Weak</b></p> <ul style="list-style-type: none"> <li>• Yield curve likely to invert.</li> <li>• Higher policy interest rates.</li> <li>• Middle of the curve likely to be weak.</li> <li>• Flight to safety could detract from corporates and high yield debt while benefiting long-term Treasuries.</li> </ul>   | <p><b>Fixed Income Mixed</b></p> <ul style="list-style-type: none"> <li>• Short duration likely performs better than long duration.</li> <li>• Corporate and high yield spreads may rise as earnings stagnate.</li> </ul>  | <p><b>Fixed Income Mixed</b></p> <ul style="list-style-type: none"> <li>• Improving economic environment likely to support corporates.</li> <li>• Long duration likely to remain weak due to higher yields and a steeper yield curve.</li> </ul>   |
| Yields Stable    | <p><b>Fixed Income Mixed</b></p> <ul style="list-style-type: none"> <li>• Recession likely.</li> <li>• Weakness expected in equities and corporates.</li> <li>• Treasuries should hold up reasonably well.</li> </ul>   | <p><b>Equities &amp; Fixed Income Mixed</b></p>  | <p><b>Equities Favorable</b></p> <ul style="list-style-type: none"> <li>• Risk-on environment, favoring equities and corporates.</li> <li>• Treasuries and long duration fixed income likely to be more muted.</li> </ul>  |
| Yields Declining | <p><b>Fixed Income Favorable</b></p> <ul style="list-style-type: none"> <li>• Recession likely.</li> <li>• Policy yields declining to support economic activity.</li> <li>• Equities likely mixed but weak, favoring defensive sectors and areas that are less dependent on economic growth.</li> <li>• Fixed income likely mixed but favorable with lower yields boosting long-term Treasuries.</li> <li>• Corporates may face headwinds.</li> </ul> | <p><b>Equities &amp; Fixed Income Mixed But Favorable</b></p>  | <p><b>Equities &amp; Fixed Income Favorable</b></p> <ul style="list-style-type: none"> <li>• Strong environment for equities and fixed income.</li> <li>• Growing economy translates to higher corporate profits, which is favorable for equities and corporates.</li> <li>• Lower yields support longer duration assets.</li> </ul> |

INTERNATIONAL MARKETS REBOUND, RISKS LOOM

Investor sentiment is improving outside of the U.S. after nearly a decade of underperformance. During that stretch, U.S. stocks traded at a significant valuation premium relative to international developed and emerging markets compared with historic trends. In Europe, the sharp decline in energy prices and improving economic data could lead to positive earnings surprises. China's easing COVID restrictions and policy stimulus could strengthen economic growth, supporting additional upside in emerging market (EM) equities relative to U.S. equities.

Despite potential value opportunities abroad, economic conditions remain fragile. Uncertainties surrounding the Russia/Ukraine war and China's property market woes could prevent a meaningful economic recovery, and if these and other international headwinds materialize, investors could face an unstable dividend environment. The S&P 500's dividend payout ratio is 36%, while the Stoxx Europe 600's dividend payout ratio is 49%. The Dow Jones Industrial Average's payout ratio is 53%, which is higher than the S&P 500, possibly reflecting its lower exposure to Information Technology, like Europe.<sup>7</sup> However, while European stocks offer attractive dividend yields versus U.S. stocks, they tend to cut dividends faster during economic slowdowns.<sup>8</sup>

EQUITY INCOME OPPORTUNITIES

Equity income offers many solutions that can generate yield in the current environment. Solutions include quality stocks that provide stable dividends, fit to withstand economic shocks. Investors can also consider lower beta

ANNUAL GDP GROWTH

Source: WSJ; Eurostat (Eurozone); National Bureau of Statistics (China); Commerce Department (U.S.); IMF (2023-2024 projections, as of January 31, 2023)

|       | U.S.  | EUROZONE | CHINA |
|-------|-------|----------|-------|
| 2018  | 2.9%  | 1.8%     | 6.7%  |
| 2019  | 2.3%  | 1.6%     | 6.0%  |
| 2020  | -2.8% | -6.1%    | 2.2%  |
| 2021  | 5.9%  | 5.3%     | 8.1%  |
| 2022  | 2.1%  | 3.5%     | 3.0%  |
| 2023* | 1.4%  | 0.7%     | 5.2%  |
| 2024* | 1.0%  | 1.6%     | 4.5%  |

\*Projected data

solutions such as preferred stocks and covered call strategies that benefit from rangebound markets. Yield can also be achieved through targeted common equity exposure.



**COMMON EQUITY YIELD STRATEGIES**

It's important to focus on quality companies, especially during market downturns. These companies consistently grow their dividends over an extended period and are less sensitive to economic changes. Exposure to MLPs (Master Limited Partnerships) and REITs (Real Estate Investment Trusts) can also provide higher yields relative to the S&P 500 and the 10-year Treasury yield.

**HIGH DIVIDEND YIELD, MLPs AND REITS**

Energy stocks continued to rise in 2022. Oil prices rallied during 1H 2022, although prices retreated during the second half as recession concerns surfaced. However, energy stocks held up, diverging from the underlying WTI Crude Oil spot price. Markets rewarded energy companies because of positive earnings surprises and capital discipline. Commodities tend to weaken during recessionary phases, which could narrow the performance gap between energy stocks and oil futures. While the Russia/Ukraine war has the potential to maintain a premium on energy prices, we expect fundamental risks to cap additional upside. Conditions for MLPs and the energy sector may be difficult with less tightness in the oil market and slower U.S. drilling activity.

MLPs which cover exploration, storage, and distribution of crude oil and natural gas, are compensated on volume growth, so profits tend to rise alongside higher demand. Strong volume growth is typically associated with higher energy prices. MLPs tend to have higher yields because of their structure from a taxation perspective. MLPs must distribute 90% of their income in the form of dividends to maintain their preferred tax treatment, which includes no federal or state taxes.

REITs are companies that own or finance real estate across different property sectors. Like MLPs, REITs must distribute about 90% of their income in the form of dividends to keep their preferred tax status. Therefore, REITs tend to pay a higher-than-average yield. REITs cover a wide scope of property types, which could help investors maintain their real estate exposure through different phases of the business cycle. For example, office REITs tend to benefit when employment rises. Residential REITs benefit in areas and times of population growth and strong housing fundamentals. Healthcare REITs benefit from an aging population. Mortgage REITs hold mortgages and mortgage-backed securities (MBS) on their balance sheets, profiting from the spread between income earned and the interest paid on assets.

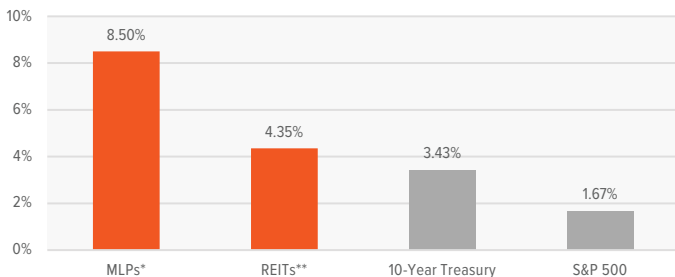
Generally, late-cycle dynamics such as higher interest rates can increase a REIT's cost of debt and weigh on valuations. However, rent growth and high dividend payouts can provide a hedge against inflation. During the early cycle and expansion phase, declining interest rates and favorable growth dynamics can benefit REITs. A consideration is that recessionary conditions can negatively impact rent and property values, particularly in the office sector. The U.S. office vacancy rate has risen 3% points since 2019, burdened by layoffs and the shift to remote/hybrid work.<sup>9</sup>

Investors can also find higher-than-average dividend yield opportunities within the telecommunications industry of the Communication Services sector. Companies in this space are older, well-established, and have a history of paying above-average dividends.

The chart below shows MLP and REIT yields versus 10-year Treasury and S&P 500 yields.

**HIGHER RELATIVE YIELD IN MLPs AND REITS**

Source: Bloomberg data as of March 31, 2023



Asset class representations: \*S&P MLP Index, \*\*FTSE NAREIT All Equity REITs Index

**QUALITY DIVIDENDS**

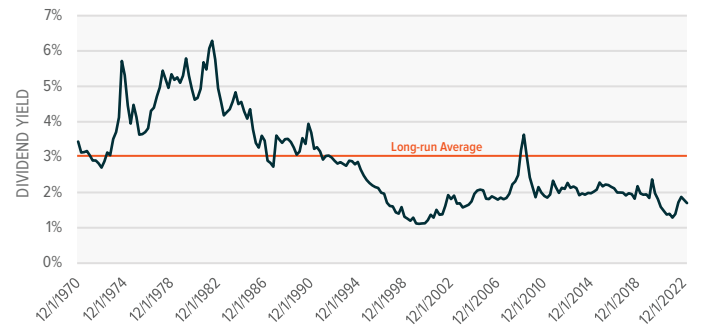
We view the quality dividends segment as a core strategic holding because of its focus on profitable growth and quality value. Historically, companies with strong free cash flow and healthy balance sheets fare best among value factors during market downturns. BofA Securities research shows the risk of deep value strategies becomes increasingly pronounced during late-cycle and recession periods, while the quality factor can provide a timely hedge. Quality stocks typically provide a lower payout ratio relative to high yielding equities, but they focus on consistent dividends and dividend growth despite the economic environment. Therefore, quality stocks' lower yield is less sensitive to economic changes.<sup>10</sup>

**SECTORS WITH GOOD YIELDS**

Dividend yields have remained below the long-term average of 3% for the past 30 years. The S&P 500's dividend yield rose to 1.67% over the past year from a low of 1.20% in December 2021, though it remains below average levels, according to Bloomberg data. The index's dividend yield rose as equity prices fell. Despite historically low dividend yields, investors can still achieve yield by positioning within sectors that have relatively high payout ratios.

**S&P 500 DIVIDEND YIELD OVER TIME**

Source: Bloomberg data as of March 31, 2023



When searching for equity income across sectors, we prefer established companies that generate a steady stream of cash flow. These firms can reinvest capital to cover growth while paying out a reasonable amount of earnings to shareholders.

Energy offers a relatively high dividend yield of 3.93%. Despite the potential for lower oil prices during a recession, capital discipline and improved cash flows relative to previous cycles could help sustain dividends during a downturn. Utilities offer recession-proof characteristics and a 3.15% dividend yield, though, high Treasury yields can negatively impact this sector. We prefer the defensive nature of Consumer Staples, which offers a 2.50% dividend yield. The table below lists current dividend yields by S&P 500 sectors.

**S&P 500 SECTORS AND YIELDS**

Source: Bloomberg Trailing 12-month Dividend Yields data as of March 31, 2023

| Sector                 | Yield |
|------------------------|-------|
| Energy                 | 3.93% |
| Real Estate            | 3.90% |
| Utilities              | 3.15% |
| Consumer Staples       | 2.50% |
| Materials              | 2.18% |
| Financials             | 1.92% |
| Industrials            | 1.74% |
| S&P 500                | 1.67% |
| Health Care            | 1.66% |
| Consumer Discretionary | 0.98% |
| Information Technology | 0.96% |
| Communication Services | 0.92% |



**PREFERRED EQUITY OFFERS RISK MITIGATION WITH HIGH YIELD**

In the capital structure, preferred stockholders are above common stockholders and below bondholders. Preferred equity investors receive dividend income before common equity investors. Preferreds offer a fixed or variable yield, and they are usually issued by financial corporations. Yield from preferred stocks can be treated as qualified dividend income instead of ordinary income, resulting in favorable tax treatment.

We favor preferred equities due to their position in the capital structure and low beta. Their lower sensitivity to equity market price movements aids in reducing volatility relative to common equities. The dividends on variable rate preferreds float relative to a reference rate, which can be beneficial in a rising rate environment. It is important to remember that variable and fixed-rate preferreds have duration risk due to their perpetual nature.

The preferred equity market may face periods of heightened volatility during episodes of banking stress. As securities that are included in regulatory capital, banks are one of the largest issuers of preferreds. During normal market conditions, this is a boost for preferred credit quality. However, it also means that preferreds are impacted by the overall health of the financial system. The recent regional banking crisis negatively impacted preferreds, although the greater issuance by large banks since the 2008 financial crisis can offer some resilience.<sup>11</sup>

**COVERED CALLS OFFER DIFFERENTIATED YIELD**

Covered calls perform best when markets are rangebound. The income generated from selling call options on the S&P 500, Nasdaq 100, or Russell 2000 is paid out to investors in the form of yield. Investors have full exposure to the downside, as calls expire worthless in a declining market. Exposure is capped on the upside, as the underlying security can be called away. When volatility rises, the premium received increases to compensate for market instability.

In a reasonably tight range, covered calls benefit from receiving premium income and potentially small improvements in the underlying equities while not having the underlying called. In a rising market, covered calls typically underperform the overall market because the underlying security is called away, affecting the capital gain return, not the income return. In a declining market, covered calls provide a small buffer of protection because of their premium income.

For investors seeking downside protection in a declining market, a collar strategy can be appropriate. Like a covered call strategy, calls are sold on an index such as the S&P 500 or Nasdaq 100, but with a collar, puts are also purchased on the index. The risk/reward tradeoff is a lower yield relative to the covered call on its own. The potential for higher volatility during the transition from late cycle to recession could make covered calls attractive.

**HOLISTIC APPROACH FOR HIGHER YIELDS & TOTAL RETURN**

Finding yield through equity income is important, but selectivity is vital given current economic uncertainties. Exposure to quality stocks can provide resilient yield. Covered calls can offer a relatively high premium during volatile and rangebound market environments. And preferred stocks can provide a reasonable income and lower beta.

Each of these areas generally focus on either yield or return potential. Combining equity income solutions can improve a portfolio's exposure diversification while also diversifying its sources of yield. This can create a portfolio that provides a solid yield while also focusing on total returns. Although the economic outlook includes some dark clouds, opportunities can emerge during recessionary periods. Equity income portfolios must be flexible enough to capture upside while maintaining a decent yield throughout the business cycle.

**FOOTNOTES**

- <sup>1</sup> CME Group Fed Watch Tool, data as of April 3, 2023
- <sup>2</sup> Morgan Stanley, Can Dividend Stocks Help Protect Your Portfolio, November 9, 2022
- <sup>3</sup> Based on National Bureau of Economic Research's (NBER) U.S. late cycle and recession dates
- <sup>4</sup> Polen Capital, Quality's Performance Across The Business Cycle, November 3, 2022
- <sup>5</sup> The Conference Board, LEI for the U.S. Declined Again in January, February 17, 2023
- <sup>6</sup> Goldman Sachs Research, The Bigger Worry: Growth or Inflation?, January 27, 2023
- <sup>7</sup> Payout ratios based on Bloomberg data, as of April 3, 2023
- <sup>8</sup> Barron's, European Dividends Are on the Mend After a Pandemic Slashing, July 6, 2021
- <sup>9</sup> National Association of Realtors, Office Vacancy Rates, February 21, 2023
- <sup>10</sup> BofA Global Research, Year Ahead 2023: Sprint Lower, Marathon Higher, November 22, 2022
- <sup>11</sup> Bloomberg data as of March 14, 2023

**DEFINITIONS**

|  |   |
|--|---|
| Conference Board Leading Economic Index        | An American economic leading indicator intended to forecast future economic growth.   |
| Dow Jones Industrial Average                   | The index includes 30 prominent companies listed on the U.S. stock exchange and is one of the oldest and most commonly followed equity indexes. |
| Goldman Sachs Financial Conditions Index (FCI) | The index represents the weighted average of riskless interest rates, exchange rates, equity moves, and shows how each directly impacts GDP.    |
| NASDAQ 100                                     | The NASDAQ 100 index includes 100 of the largest non-financial companies listed on its stock market.  |
| Russell 2000 Index                             | The small-cap market index consists of the smallest 2,000 markets in the Russell 3000 Index.  |
| S&P 500 Total Return Index                     | The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.                       |

Index returns are for illustrative purposes only and do not represent actual fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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