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GLOBAL X ETFs INVESTMENT STRATEGY

Investment Strategy Monthly Insights: Exploring Targeted Diversification via Covered Call Strategies, Uranium and Silver Miners

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In the first half of 2023, the Nasdaq 100 rallied 39%, its strongest first half year rally since 1983 when it rose 37%. Similarly, the S&P 500 index rose 16% in the first half—although the median stock only advanced 5%, as market breadth has been relatively narrow and driven predominantly by mega cap tech names. [1] The positive market sentiment was supported by generative AI, robotics, and themes related to the reshoring narrative, which significantly eclipsed risks such as recession fears, elevated levels of inflation, the prospect of more Fed hikes, geopolitical risks, the debt ceiling, and the collapse of certain regional banks in the U.S.[2] There are concerns about this weak market breadth, which has been limited so far. Encouragingly, there are initial signs of mid and small-cap stocks starting to participate in the rally, as indicated by the outperformance of the Russell 2000 Index since the beginning of June. Further, a resilient U.S. consumer and generally upbeat economic data have been supportive of risk assets, despite a tightening Fed.

As we enter the second half of the year and with the current Q2 earnings season in the spotlight, some major banks have already reported strong results. The overall outlook for S&P 500 companies, however, shows a projected 7.1% drop in second-quarter earnings, which would mark the third consecutive quarter of decline.[3] Investors are now focusing on forward-looking guidance and cost structures to assess the sustainability of the rally and the potential for avoiding an economic downturn.

Further concerns about the high yield credit and leveraged loan markets for the second half of the year are beginning to linger due to an increase in default rates.[4] Whilst some are arguing this is due to normalization of credit markets, more and more companies are due to refinance as their debt matures in an environment of high rates for longer. Despite the availability of high risk-free returns, many still find a balanced portfolio with equity exposure compelling due to reduced market volatility. As the year progresses, the markets might enter a range-bound phase, presenting opportunities for targeted portfolio diversification.

Investment strategies highlighted this month:

- **Enhancing Income Amidst Uncertain Growth –** In the face of uncertain global growth expectations for the latter half of 2023, investors can adopt a more cautious approach to equities by exploring covered call strategies.

- **Nuclear Energy and Uranium Continue to Play Vital Roles –** The supply/demand imbalance and declining uranium inventory further strengthen the case for uranium investment, as nuclear energy aims to fill a significant portion of the increasing global electricity demand.

- **Silver Mining Stocks –** Investors may want to consider capitalizing on a weaker U.S. dollar via a leveraged play on precious metals miners.

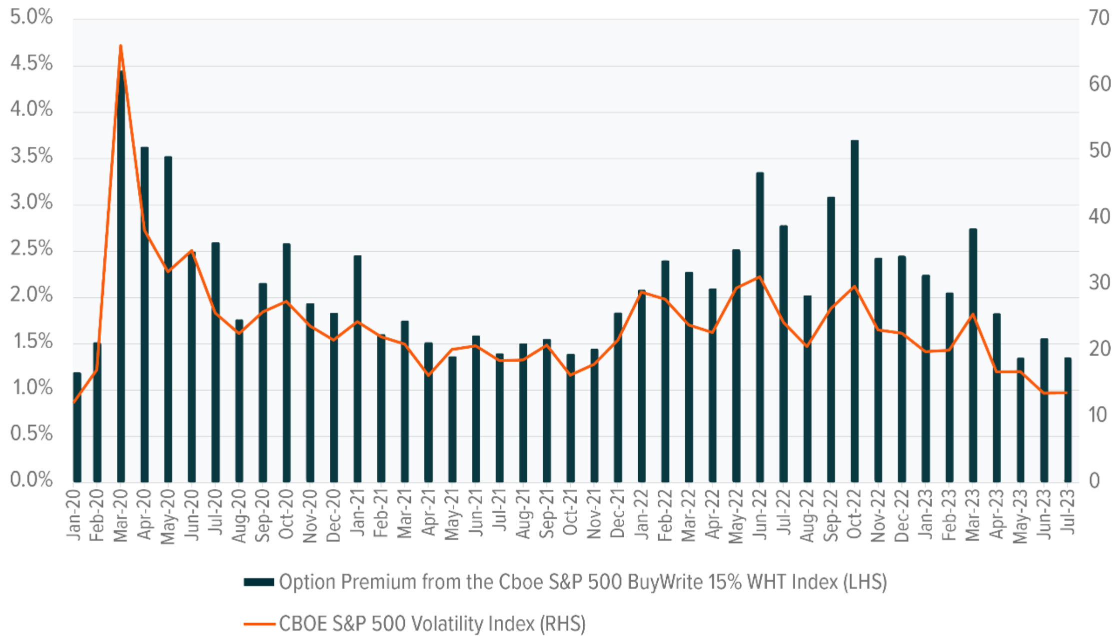
Enhancing Income Amidst Uncertain Growth

Investors who remain uncertain about slower global growth expectations for the second half of 2023, could consider a more cautious approach towards equities. A covered call strategy is a popular method for generating income while potentially improving risk-adjusted returns. An example of a covered call strategy involves purchasing the S&P 500 Index and selling call options on that index with the aim of earning the premium from selling these options at the expiry date. A strategy of selling at-the-money calls is often used to maximize volatility premiums that are collected as a form of income. During periods of higher implied volatility, option premiums tend to increase, offering a potential risk management element by reducing portfolio volatility and offering monthly income distributions in exchange for capped upside potential.[5]

Covered calls provide an alternative income solution and benefit most during slowly rising or rangebound markets. This unique approach holds appeal for income investors who already have allocations to defensive and cyclical equities with high dividend payouts in their portfolios. Furthermore, covered call strategies exhibit low correlations to traditional fixed income investments, and the potential income collected from covered call writing could be particularly attractive to add on dividend yields amid higher interest rates. It is important to note that a covered call strategy does not provide additional downside protection beyond the premium income received. Moreover, the potential upside is capped by the strike price of the call option sold, which limits gains during a strong bull market environment in the underlying index.

IMPLIED VOLATILITY OF S&P 500 INDEX VS OPTION PREMIUMS

Source: Global X ETFs, Bloomberg as of 24 of July 2023.



Note: Option Premiums vs. Implied Volatility graphs include implied volatility for the S&P 500 Index. The Option Premium from the Cboe S&P 500 BuyWrite 15% WHT Index (BXMU) measures the total rate of return of a S&P 500 covered call strategy.

Covered calls provide an alternative income solution while potentially avoiding risks commonly associated with traditional income-oriented investments like fixed income and dividend stocks.[6] S&P 500 exposure in an income portfolio diversifies sources of risk, as the index offers broad diversification compared to most dividend strategies that favor value-oriented sectors like Energy, Financials, and Utilities. By implementing a covered call overlay, investors can experience a different risk/return profile relative to the reference index itself.

Nuclear Energy and Uranium Continue to Play Vital Roles in Global Energy Demand

Uranium continues to perform well, with spot prices rising by 15% YTD through to 17 July 2023 and approaching the $60-per-pound mark.[7] Supply concerns related to Kazakhstan, the world's largest producer, and its growing relationship with China and Russia remain elevated after the sale of a stake in Kazatomproms Budenovskoye mine to Russian energy company, Rosatom in late 2022 , which helped Russia secure supply over the next three years.[8]

Sentiment towards uranium is improving as more and more countries are coming to the conclusion that nuclear power is a safe and reliable means of adjusting their energy mix. Developing economies like China and India have ambitious plans to expand their nuclear power capacities, while established markets such as the U.S. and Europe are reevaluating nuclear energy's role.

The U.S. and Europe are prudently trying to line up future supply from outside of Russia. Urenco, an enrichment services company, recently announced plans to increase capacity at its Eunice plant in New Mexico by 15%, supported by new commitments from U.S. customers for non-Russian fuel. This expansion is envisaged to strengthen the nuclear fuel supply chain in the U.S. and globally, adding around 700 tons of separative work units (SWU) per year and potentially increasing Urenco USA's total enrichment production capacity to 10 million SWU.[9] California last year decided to keep its Diablo Canyon nuclear power plant operating another five years, to 2030. The plant supplies roughly 8% of power produced in the state. The U.S. Inflation Reduction Act introduced a tax credit to incentivize the continued operation of existing nuclear power plants, while countries such as Belgium, Japan, and Finland have also made the decision to extend the lifespan of certain nuclear power plants. Moreover, the European Union has supported a declaration that grants nuclear energy equal recognition with renewables in their endeavors to decarbonize.[10] Demand for uranium to fuel the world's nuclear reactors is anticipated to rise to 79,400 metric tons of elemental uranium (MTU) by 2030, up from 62,500 MTU in 2021, with that number expected to climb to 112,300 MTU in 2040, according to a report by the World Nuclear Association.[11]

Following the 2011 Fukushima disaster, there was a supply deficit in the uranium market due to reduced exploration and production activities. The uranium market currently faces a supply/demand imbalance, which is exemplified by the declining uranium inventory held by U.S. nuclear power plants. According to the U.S. Energy Information Administration's uranium report, uranium inventories held by U.S. nuclear power plants experienced a decrease of 4.4% last year.[12] Additionally, in 2021, the United States sourced approximately 14% of its uranium supply from Russia, as reported by the International Energy Agency.[13] Furthermore, European Union utilities relied on Russia for a significant portion of their uranium supplies, accounting for a fifth of their total uranium supply in 2021. These figures highlight the dependence on Russia and the need for utilities to explore alternative supply sources to ensure a stable uranium market.[14]

According to research from McKinsey, global electricity demand is projected to triple by 2050, and nuclear energy will need to fill part of that gap by supplying 10% to 20% of this demand—suggesting a doubling or tripling in nuclear capacity.[15] With growing global electricity demand and the limitations of renewable energy, nuclear power is projected to play a vital role, offering reliable and low-carbon electricity.

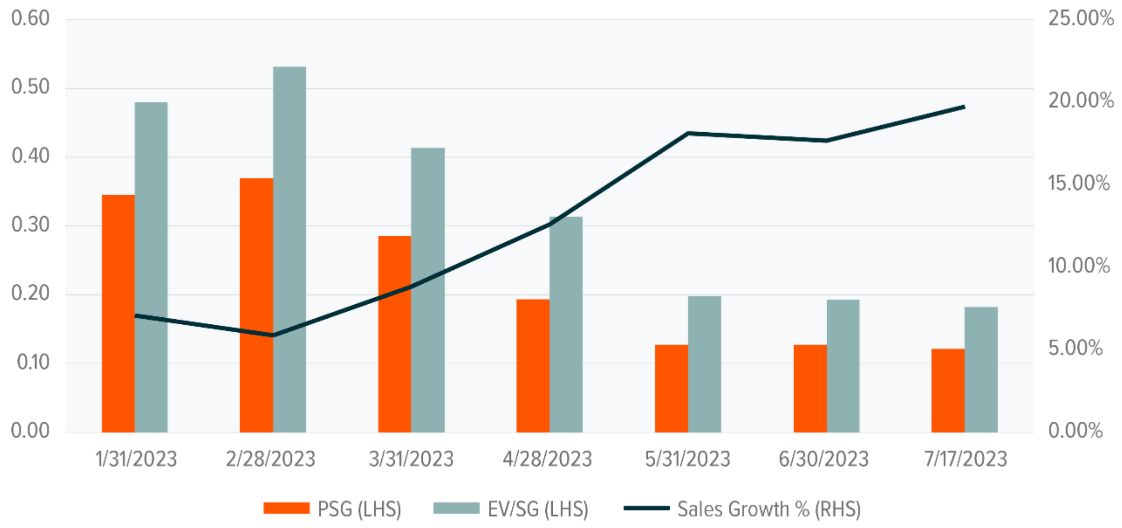
Silver Mining Stocks – Capitalizing on a Weaker U.S. Dollar via a Leveraged Play on Precious Metals Miners

Amid a declining U.S. Dollar Index (DXY), commodities, particularly precious metals, could appear attractive in this environment, as investors look to hedge dollar risk in their portfolios. The current decline in the U.S. dollar is driven by rate differentials versus Europe, the U.K., and Japan, given that the central banks of the latter economies are behind the U.S. Fed and are due to follow with more rate hikes in the near term. A further potential global macroeconomic slowdown could lead to precious metals outperforming other major assets in the near term. Over the past five years, silver has exhibited a negative correlation of 0.54x with the U.S. dollar, and over the last 12 months, it has shown a negative correlation of 0.62.[16]

Silver mining stocks could provide a leveraged play via equities based on the performance of the metal itself. Typically, these stocks perform better when silver prices are on the rise, but they tend to struggle when prices decline. A significant catalyst for a substantial increase in value could be a noticeable economic slowdown. Furthermore, silver miners exhibit similar characteristics, with a 0.82 correlation to silver and a negative 0.64 correlation with the U.S. Dollar Index (DXY).[17] While silver prices of $24.84 an ounce are now above their five-year average of $20.61, silver mining stock prices look undervalued. A basket of silver mining stocks represented by the Solactive Global Silver Miners Total Return v2 Index is currently trading at a PSG of 0.12x and enterprise value to sales growth of 0.18. This is relatively cheap compared to six months ago, as those figures stood at 0.35x and 0.48x, respectively, at the end of January 2023. This was driven by an increase in sales growth expectations for silver miners, which currently shows a 19.70% forward consensus sales growth rate compared to 7.10% back in January.[18]

SILVER MINERS SALES GROWTH AND VALUATION

Source: Bloomberg as of 17 of July 2023.



Note: Source: Bloomberg as of 17 July 2023 Data for the Solactive Global Silver Miners Total Return v2 Index.
*Sales Growth % represented on the right hand axis.PSG is a sales-based valuation metric. It is the ratio of Price-to-Sales (P/S) divided by 12 month forward expected sales growth. EV/SG is a sales-based valuation metric. It is the ratio of Enterprise Value to Trailing 12m Sales divided by 12-month forward expected sales growth.

Furthermore, the gold/silver ratio is currently at 79, which means it takes 79 ounces of silver to buy one ounce of gold, well above its long-term average of 69. This ratio could decline significantly if precious metals enter an enduring bull market, potentially causing silver to outperform gold, given its five-year beta to gold of 1.68.[19]

Silver has greater industrial exposure than gold, though the U.S. dollar and real interest rates drive performance for both metals. In addition, silver is a key input in photovoltaic (PV) cells and could benefit from structural tailwinds, as solar plays major roles in Europe's clean energy transition and in the Inflation Reduction Act. These factors could at least partly offset any potential upcoming slowdown in industrial production.

Footnotes

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