Authored by:
Rohan Reddy
Research Analyst

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Topic: Income

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Income Outlook: Q1 2021 – Resilient Portfolios For Reflation

The Global X Income Outlook for Q1 2021 can be **viewed here**. This report seeks to provide macro-level data and insights across several income-oriented asset classes and strategies.

Key Takeaways:

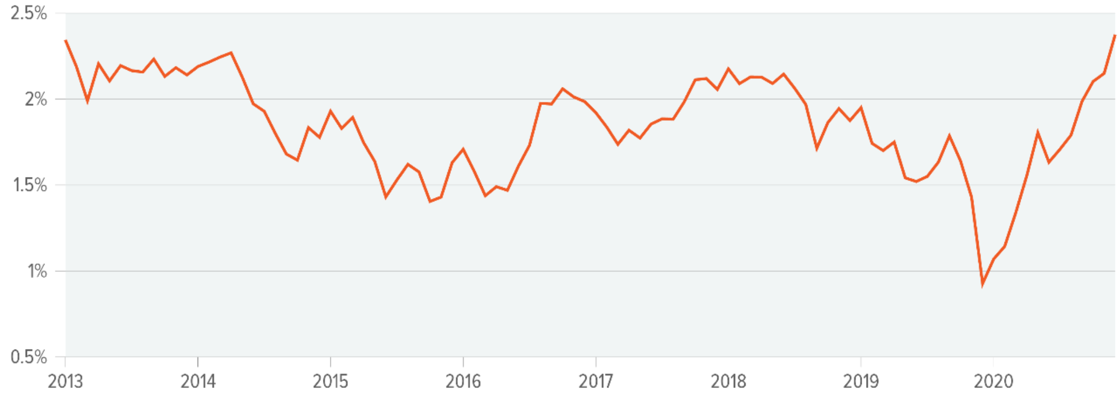
- Inflation expectations are rising alongside economic acceleration, resulting in selloffs in longer dated bonds. While inflation may continue to rise in the near term, it appears unlikely to reach unusually elevated levels. Energy, materials, and industrials typically perform well in this type of reflationary environment.
- Income-oriented investors may be wise to reduce the duration and instead focus on credit-like instruments like preferreds, or gaining exposure to high yielding Energy investments.
- The Nasdaq 100 faces a mixed return outlook in the midst of a rotation from growth to value, so a covered call strategy is a potential alternative for income and tech exposure.

Inflation Expectations Rising, But Likely to Peak in 2021

Inflation numbers in February came in at their highest levels since the pre-pandemic period, with the Consumer Price Index (CPI) reading 1.7% year-over-year. There are reasons to believe inflation could continue to rise from here. In fact, the market expects this. 10-year Treasury breakeven numbers were pricing in 2.37% inflation at the end of Q1, its highest level since April 2013.[1] The Fed's commitment to low rates amid elevated unemployment, increased consumer spending with the re-opening economy and fiscal stimulus, and a supply chain that can't keep up with accelerating demand could jolt inflation beyond the 2% marker in Q2. Biden's proposed $2.25 trillion infrastructure plan could further push inflation above 2% for an extended period if it is passed by Congress in 2021. For context, the US GDP is $21.5 trillion, so the infrastructure package is a meaningful source of stimulus.[2]

10-YEAR BREAKEVEN RATES (%)

Source: Bloomberg, Data from 3/31/13 to 3/31/21.



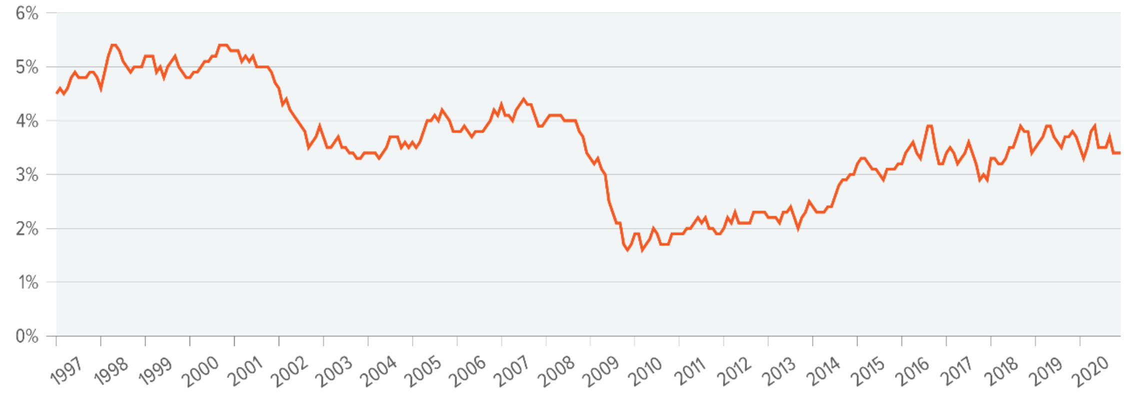
Breakeven rate is the difference between the nominal yields and the inflation protected bonds of the same maturity.

But while inflation may further increase from here, we believe it's unlikely we'll see prolonged periods of high inflation like the 70's and 80's. One reason is that labor markets tend to not move as fast in recoveries as they do during downturns. U-6 unemployment stands at 10.7% today, an improvement from the 22.9% peak figure in April 2020, but still well-above the February 2020 pre-pandemic number of 7.0%.[3] This means there is still substantial slack in the labor market, which is a headwind for inflation. In addition, the US government recently passed its third round of stimulus, but how consumers are using their stimulus checks should give inflation mega-bulls pause. 52% of those receiving stimulus checks from February 17th to March 1st used it mostly to pay down debt, and another 19% mostly saved it. Only 28% spent their stimulus checks, according to the US Census Bureau. Therefore, stimulus checks are not creating the surge in consumption that headline numbers suggested.

Wage growth even over longer periods hasn't changed much either, which might explain some of the consumer behavior explained previously. The Federal Reserve of Atlanta's wage growth tracker shows inflation has stayed fairly range-bound over the better part of the last five years. Wage growth rose since the financial crisis, but hasn't reached levels seen in prior cycles partly due to technological innovations. The Biden administration's proposal to raise the corporate tax rate from 21% to 28%, and closing corporate tax loopholes may add to these labor market pressures further. Considering consumption represents 68% of GDP, a much stronger labor market would be needed to push significant inflation into the system.[4]

FEDERAL RESERVE OF ATLANTA WAGE GROWTH TRACKER (%)

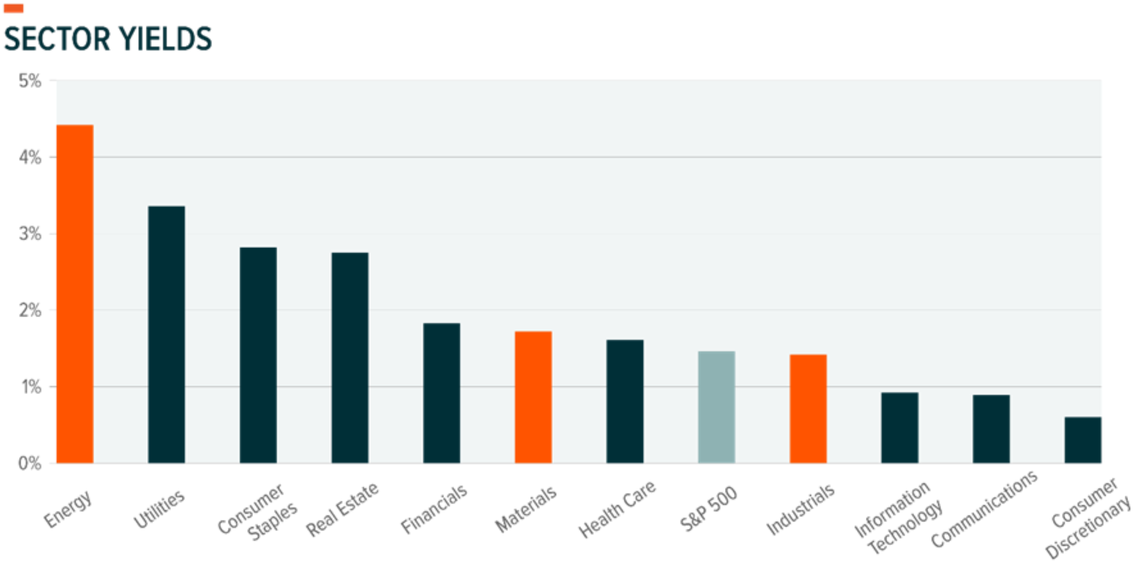
Source: Federal Reserve of Atlanta, Data from May 1997 to February 2021.



Fed Chair, Jerome Powell, believes inflation could be higher, but not uncontrolled, as well. In March, Powell stated the Fed expects inflation to hit 2.4% in 2021, but for the move to be "transient". Hence why the Fed is in no rush to raise interest rates through 2023. Their 2021 GDP growth expectations rose from 4.2% in December to 6.5% in March, but growth globally is still playing catch up. China has set its 2021 GDP growth target at 6%, at the low end of its 6-6.5% target from previous years. Europe stands in stark contrast to the rest of the world in its COVID-19 progress. France just entered its third national lockdown, and most of Western Europe is either in lockdown or restrictive activity mode. This implies that inflation should remain muted as consumer spending remains reigned amid continued lockdown measures.

Overall, we believe inflation is likely to rise above recent norms, but not enough to cause a hyperinflationary environment. Investors should prepare themselves instead for a reflationary period where elevated inflation is coupled with strong economic growth.

90% of Americans will be eligible for vaccines by mid-April according to President Biden, a landmark announcement. Current projections show all adults in the US will be vaccinated by July 4th. With widespread vaccinations, offices, businesses and schools can fully re-open, and consumers can resume in-person activities like dining out, travel, and attending events. Cyclical sectors like Energy, Materials, and Industrials are among the best positioned for this development. Energy prices are already rising as the re-opening economy takes effect and demand for oil increases. Materials stocks should get a boost from rising input costs, increased industrial activity, and more importantly Biden's potential $2.25 trillion infrastructure bill. Materials and Industrials companies, like construction and engineering firms, would be direct beneficiaries of this proposed package. These companies typically don't offer high yields like the Energy sector, but offer investors a total return strategy with market-level yield potential.



Source: Bloomberg. Represented by GICS sectors. Data as of 3/31/21.
Asset class representations are as follows, Information Technology, S&P 500 Information Technology Sector GICS Level 1 Index; Consumer Discretionary, S&P 500 Consumer Discretionary Sector GICS Level 1 Index; Real Estate, S&P 500 Real Estate Sector GICS Level 1 Index; Communications, S&P 500 Communication Services Sector GICS Level 1 Index; Utilities, S&P 500 Utilities Sector GICS Level 1 Index; Consumer Staples, S&P 500 Consumer Staples Sector GICS Level 1 Index; Health Care, S&P 500 Health Care Sector GICS Level 1 Index; Materials, S&P 500 Materials Sector GICS Level 1 Index; Industrials, S&P 500 Industrials Sector GICS Level 1 Index; Energy, S&P 500 Energy Sector GICS Level 1 Index; Financials, S&P 500 Financials Sector GICS Level 1 Index. S&P 500 represented by 12-month dividend yield.

FAVORING CREDIT OVER DURATION AMID REFLATION

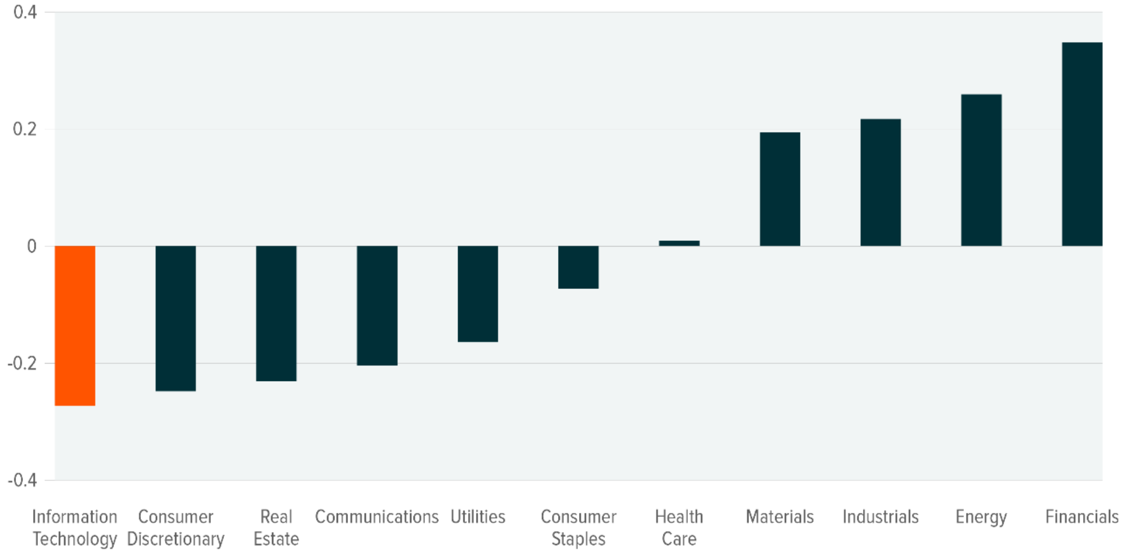
Longer-dated bond yields rose materially in Q1 with 10-year treasury yields rising 83 basis points, and we expect choppiness in the yield curve to continue this year. For investors, the risk of rising inflation makes duration-sensitive assets like long term bonds a difficult proposition. Instead, we favor overweighting credit risk versus duration in this type of reflationary environment. Credit spreads are likely to remain tight with supportive Fed policy and an expanding economy.

Preferred stock is one way to implement this tilt. Preferreds offer a duration of 4.6 years and the average credit rating of the ICE BofA Diversified Core U.S. Preferred Securities Index is BBB-, putting them just inside the investment grade realm.[5] Preferred issuers are also 61% weighted towards financial institutions, which should benefit from rising rate environments.[6] This could potentially offset some of the duration sensitivity in the actual preferreds themselves. Preferreds were only down -0.27% in Q1 compared to -3.37% for the broader bond market, and -4.65% for investment grade corporate bonds.[7] Variable rate preferreds are another option to gain exposure to credit but potentially reduce duration further. Variable rate preferreds offer a duration of 2.5 compared to 4.6 at the broader preferred level.[8]

Technology Sector Positioning

2021 is proving to be more challenging for the Information Technology sector than in the recent past. The sector's returns flirted between negative and flat for most of Q1. Profit-taking, the re-opening economy, and rising bond yields are all presenting headwinds for the sector following a phenomenal 2020. The IT sector this year has displayed an acutely negative correlation to bond yield moves. IT's correlation to daily 10-year bond yield moves in Q1 was -0.27.[9]

CORRELATION TO 10-YEAR TREASURY YIELD MOVES IN Q1

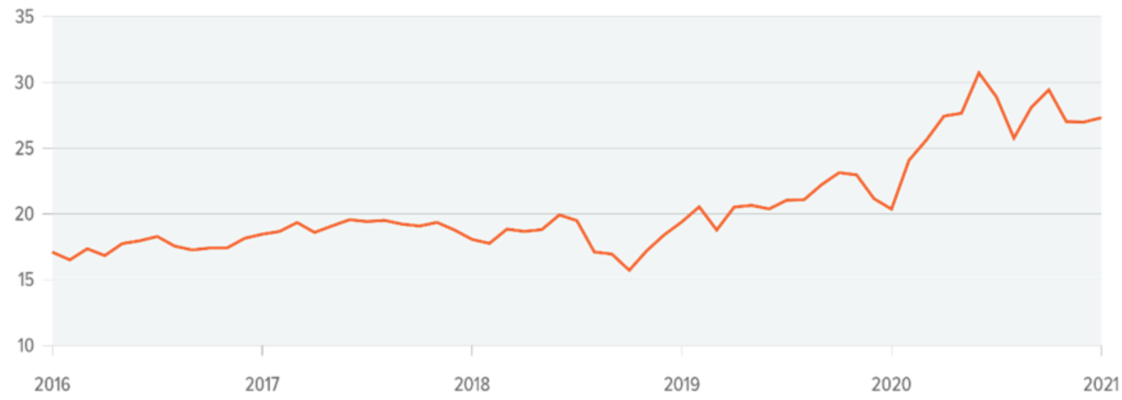


Source: Bloomberg. Represented by GICS sector indexes. Data from 12/31/20 to 3/31/21.
Asset class representations are as follows, Information Technology, S&P 500 Information Technology Sector GICS Level 1 Index; Consumer Discretionary, S&P 500 Consumer Discretionary Sector GICS Level 1 Index; Real Estate, S&P 500 Real Estate Sector GICS Level 1 Index; Communications, S&P 500 Communication Services Sector GICS Level 1 Index; Utilities, S&P 500 Utilities Sector GICS Level 1 Index; Consumer Staples, S&P 500 Consumer Staples Sector GICS Level 1 Index; Health Care, S&P 500 Health Care Sector GICS Level 1 Index; Materials, S&P 500 Materials Sector GICS Level 1 Index; Industrials, S&P 500 Industrials Sector GICS Level 1 Index; Energy, S&P 500 Energy Sector GICS Level 1 Index; Financials, S&P 500 Financials Sector GICS Level 1 Index.

Recent weak IT performance is in spite of the fact that valuations are comparable to the second half of 2020, if not cheaper, indicating profit-taking and/or rotation trades.

INFORMATION TECHNOLOGY SECTOR FORWARD PRICE-EARNINGS RATIO

Source: Bloomberg. S&P 500 Information Technology Sector GICS Level 1 Index. Data from 3/31/16 to 3/31/21.



Should the shift from growth to value continue and Tech names remain choppy, selling call options on the Nasdaq 100 could help monetize the sector's sideways returns. Covered call strategies on the Nasdaq also add another source of potential returns to income portfolios, which traditionally are underweight the Information Technology sector.

CONCLUSION

The global economy is on a stronger footing, and the effects of the pandemic are beginning to subside, but income investors need to be careful with their exposures. Inflation is rising moderately and that is having a substantial impact on longer dated bonds. Cyclicals and small caps are faring well, but fixed income and Tech may need more nuanced approaches. Hybrid securities like preferreds, options strategies like covered calls, and inflation-insulated sectors like Energy should all be considered for income portfolios today.

DEFINITIONS

Duration: Measure of bond's price sensitivity to changes in interest rates.

Forward price-to-earnings (forward P/E) Ratio: The ratio provides an indication of the valuation of a stock by looking at its share price relative to its forecasted earnings.

S&P 500 Index: S&P 500 Index tracks the performance of 500 leading U.S. stocks and captures approximately 80% coverage of available U.S. market capitalization. It is widely regarded as the best single gauge of large-cap U.S. equities

S&P 500 Information Technology Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Information Technology sector. These companies include software & services, technology hardware & equipment, and industry group that make up the Information Technology sector.

S&P 500 Consumer Discretionary Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Consumer Discretionary sector. These companies include automobile & components, consumer durables & apparel, consumer services and retailing.

S&P 500 Consumer Staples Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Consumer Staple sector. These companies include food & staples retailing, food, beverage & tobacco, household & personal products

S&P 500 Real Estate Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Real Estate sector. These companies include equity real estate investment trusts and real estate management & development.

S&P 500 Communication Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Communication sector. These companies include telecommunication services and media & entertainment.

S&P 500 Utilities Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Utilities sector. These companies include electric utilities, gas utilities, water utilities, independent power and renewable electricity producer.

S&P 500 Health Care Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Health care sector. These companies include health care equipment & services, pharmaceuticals, biotechnology and life sciences.

S&P 500 Materials Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Materials sector. These companies include chemicals, construction materials, containers & packaging, metals &mining, and paper & forest products companies.

S&P 500 Industrials Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Industrials sector. These companies include capital goods, commercial & professional services and transportation.

S&P 500 Energy Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Energy sector. These companies include energy equipment & services, oil, gas, & consumable fuels.

S&P 500 Financials Sector GICS Level 1 Index: The Index comprises those companies included in the S&P500 that are members of the Global Industry Classification Standard (GICS) Financials sector. These companies include banks, diversified financials, and insurance.

Endnotes:

1. Bloomberg. Data from 3/31/21.
2. Federal Reserve of St. Louis. GDP data for Q4 2020.
3. Bloomberg, Bureau of Labor Statistics. Most recent data as of March 2021. U-6 Unemployment rate measures worker no longer looking for jobs and part time worker seeking full time employment.
4. Federal Reserve of St. Louis. GDP data for Q4 2020.
5. Bloomberg. ICE BofA Diversified Core U.S. Preferred Securities Index. Data as of 3/31/21. Credit quality methodology: credit ratings are an average of Moody's, S&P, Fitch, & DBRS. If a security is rated by more than one of these organizations, the lowest rating assigned is considered for this analysis. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).
6. Bloomberg. ICE BofA Diversified Core U.S. Preferred Securities Index. Data as of 3/31/21.
7. Bloomberg. Preferreds represented by ICE BofA Diversified Core U.S. Preferred Securities Index, broader bonds represented by Bloomberg Barclays US Aggregate Total Return Index, and corporate bonds represented by Bloomberg Barclays US Corporate Total Return Index. Performance from 12/31/20 to 3/31/21.
8. Bloomberg. Data as of 3/31/21. Broad Preferreds represented by ICE BofA Diversified Core U.S. Preferred Securities Index. Variable rate preferreds represented by ICE U.S. Variable Rate Preferred Securities Index.
9. Bloomberg. GICS Information Technology Index against 10-year bond yield moves on a daily basis. Data from 12/31/20 to 3/31/21.

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Investing involves risk, including possible loss of principal. Technology-themed investments may be subject to rapid changes in technology, intense competition, rapid obsolescence of products and services, loss of intellectual property protections, evolving industry standards and frequent new product productions, and changes in business cycles and government regulation.

Bonds will decrease in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments.

Preferred stock is subject to many of the risks associated with debt securities, including interest rate risk. In addition, preferred stock may not pay a dividend, an issuer may suspend payment of dividends on preferred stock at any time, and in certain situations an issuer may call or redeem its preferred stock or convert it to common stock. High yielding stocks are often speculative, high-risk investments. These companies can be paying out more than they can support and may reduce their dividends or stop paying dividends at any time, which could have a material adverse effect on the stock price of these companies.

An option is a contract sold by one party to another that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a stock at an agreed upon price within a certain period or on a specific date. A covered call option involves holding a long position in a particular asset and writing a call option on that same asset with the goal of realizing additional income from the option premium. By selling covered call options, the investor limits their opportunity to profit from an increase in the price of the underlying asset above the exercise price, but continue to bear the

risk of a decline in the underlying asset. While the seller receives a premium for writing the call options, the price it realizes from the exercise of the option could be substantially below the investment's current market price. These strategies may not be appropriate for all investors.

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