GLOBAL X INSIGHTS

Quarterly Income Commentary: Enhancing Yields Through Preferred Stocks and Fixed Income

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The Global X Income Outlook for Q1 2024 can be viewed here. This report seeks to provide macro-level data and insights across several income-oriented asset classes and strategies.

The potential for the Federal Reserve (Fed) to cut interest rates makes 2024 something of a transitional year. Economic conditions remain robust, as reflected by recent labor and GDP reports, but we think that it's important for investors to not become complacent. The elevated cost of credit remains a double-edged sword, offering the most attractive yields in decades, but also encumbering business investment and household spending. Nevertheless, with bond yields at their highest levels in 15-years, we believe that this environment presents a good opportunity to increase exposure to fixed income, potentially enhancing yields while benefiting from higher short-term rates.[1]

Key Takeaways

- Long-term rates plummeted in Q4 2023, as the market attempted to front-run the Fed's projections for policy easing.[2] Rising rates walked back much of this enthusiasm in early 2024, and interest rate volatility may reemerge the longer uncertainty remains.
- The consensus outlook for rate cuts argues for more fixed income exposure. Preferred stock funds like the Global X U.S. Preferred ETF (PFFD) and the Global X Variable Rate Preferred ETF (PFFV) provide flexibility in targeting duration while potentially delivering attractive carry, which is the return obtained from holding an investment.
- Stronger than expected economic data continue to push back the prospect for rate cuts. We believe this calls for a measured approach to allocations, balancing reinvestment risk against duration risk, which represents the risk of price movements from changes in interest rates. Ultra-short bond funds like the Global X 1-3 Month T-Bill ETF can potentially offer high yields while insulating against duration and credit risks, otherwise known as the risk of default.

Volatility May Be Over the Horizon as the Market Tracks the Fed's Balancing Act

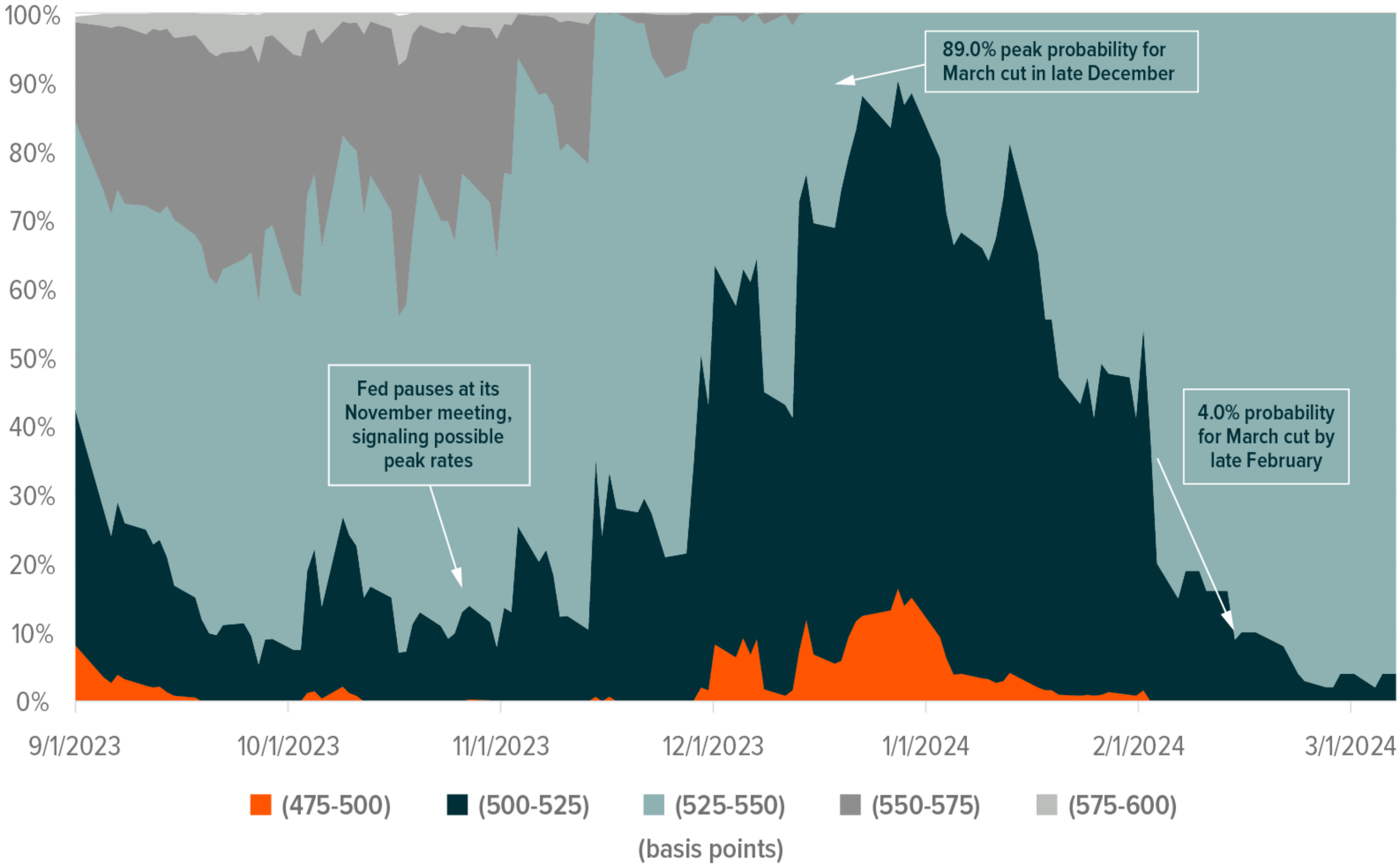
The Fed's unanimous decision to pause rate hikes in Q3 2023 sparked a frenzy among investors, promptly shifting attention toward the timing of the first rate cut. Fixed income rallied through the end of 2023, as long-term yields tumbled and hopes for easier monetary policy soared. Futures data initially suggested that the market was pricing up to six rate cuts, highlighting a wide disparity between market expectations and the Fed, which had forecast just three rate cuts in 2024.[3]

This gap began to converge in January as data from the Consumer Price Index (CPI) and the Producer Price Index (PPI), two inflationary measures of goods and services, registered "sticky" inflation readings and little justification for rate cuts in Q1 2024. By late February, the probability of a March rate cut dwindled to just 4%.[4] In response, the expected timing for the first rate cut was pushed back to the summer and market projections for rate cuts in 2024 fell to three.

We believe risks may materialize in 2024 given uncertainties about Fed policy and the heightened cost of credit for businesses and consumers alike. We believe these risks lurk ahead in the Fed's continued balancing act of guiding inflation toward its 2% target rate and avoiding an economic downturn. Any obstacles encountered in the pursuit of one goal will likely materially impact the other. In this environment, investors will need to carefully balance duration and credit exposure.

2024 TARGET RATE PROBABILITIES REMAIN IN FLUX AS THE OUTLOOK EVOLVES

Sources: Global X ETFs with information derived from the CME Group, accessed on March 8, 2024.
Graph represents historical target rate probabilities for the March 20, 2024 Federal Reserve Meeting



The Unfinished Fed Narrative Highlights the Argument for Fixed Income

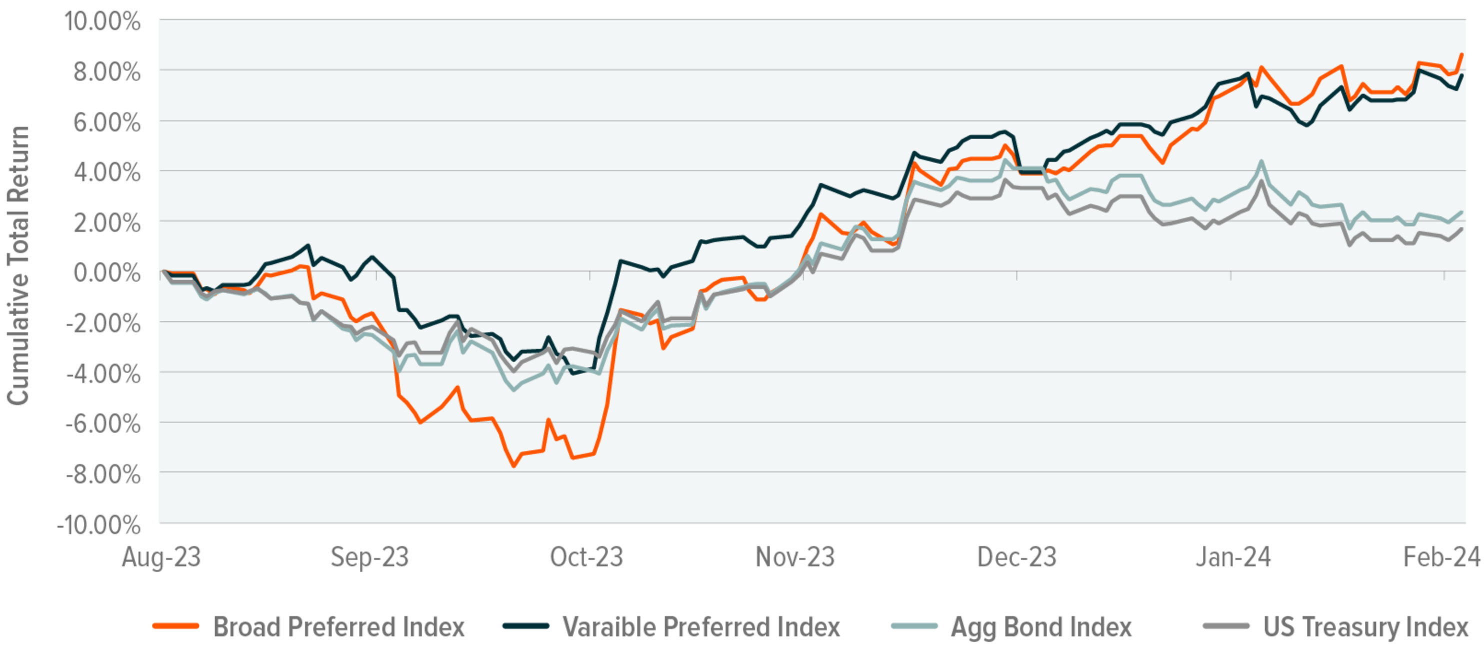
We believe that the combination of strong economic data and the consensus outlook for rate cuts in 2024 can potentially benefit long-duration fixed-income assets like preferred securities. And should the Fed succeed in engineering a soft landing, preferred securities could benefit from the combined tailwinds of falling rates and expansive monetary policy.

Historically, fixed income performs well after tightening cycles end, as long-term yields typically fall in anticipation of rate cuts. Following these cycles, preferred securities tend to benefit from their high interest-rate sensitivity. The ICE BofA Diversified Core U.S. Preferred Securities Index's (the Preferred Index) illustrates this sensitivity with an option-adjusted duration of 6.23, option-adjusted duration is a duration metric which considers the effects of any embedded options on its expected maturity. Interest rates falling by 1% would translate to a nearly 6.23% return from capital appreciation alone, without factoring in impacts for credit or convexity.

Long duration credit excelled in Q4 2023, with the Preferred Index returning 5.62%. The ICE U.S. Variable Rate Preferred Securities Index (the Variable Index), which more wholly represents credit exposure, returned 3.36% due to continued support from credit spreads, which measure the difference between two-similar maturity bonds of varying credit quality.[5] We believe this performance illustrates the underlying strength in the U.S. economy, which includes a robust labor market, with an unemployment rate still beneath 4% as of late February.[6] Generally, these represent favorable conditions for credit-related assets like preferred stock and high yield corporate debt.

PREFERRED SHARES OUTPERFORMED TREASURIES AND CORPORATE BONDS OVER THE PAST 6 MONTHS

Sources: Global X ETFs with information derived from Bloomberg, data from 8/31/2023 to 2/29/2024. Broad Preferred Index is represented by the ICE BofA Diversified Core U.S. Preferred Securities Index; Variable Preferred Index is represented by the ICE U.S. Variable Rate Preferred Securities Index; Agg Bond Index is represented by the Bloomberg U.S. Aggregate Index Total Return Value Unhedged USD; Treasury Index is represented by the Bloomberg U.S. Treasury Index Total Return Unhedged USD.



Indexes are unmanaged, do not incur management fees, costs or expenses and cannot be invested in directly. Past performance is no guarantee of future results.

Preferred Shares Provide Their Most Attractive Yields in 15 Years

We believe that the higher yields offered by preferred stocks present attractive carry opportunities for investors while presenting a defensive income buffer against duration and spread widenings, which can negatively impact the relative value of fixed income holdings. As of February 2024, the ICE BofA Fixed Diversified Core US Preferred Securities Index yielded 6.03%, substantially above its five-year historical average of 4.03% and close to comparable asset classes like high yield bonds (7.86%) and emerging market debt (7.22%). Variable rate preferreds yielded an attractive 6.11% as of February 29, 2024.[7]

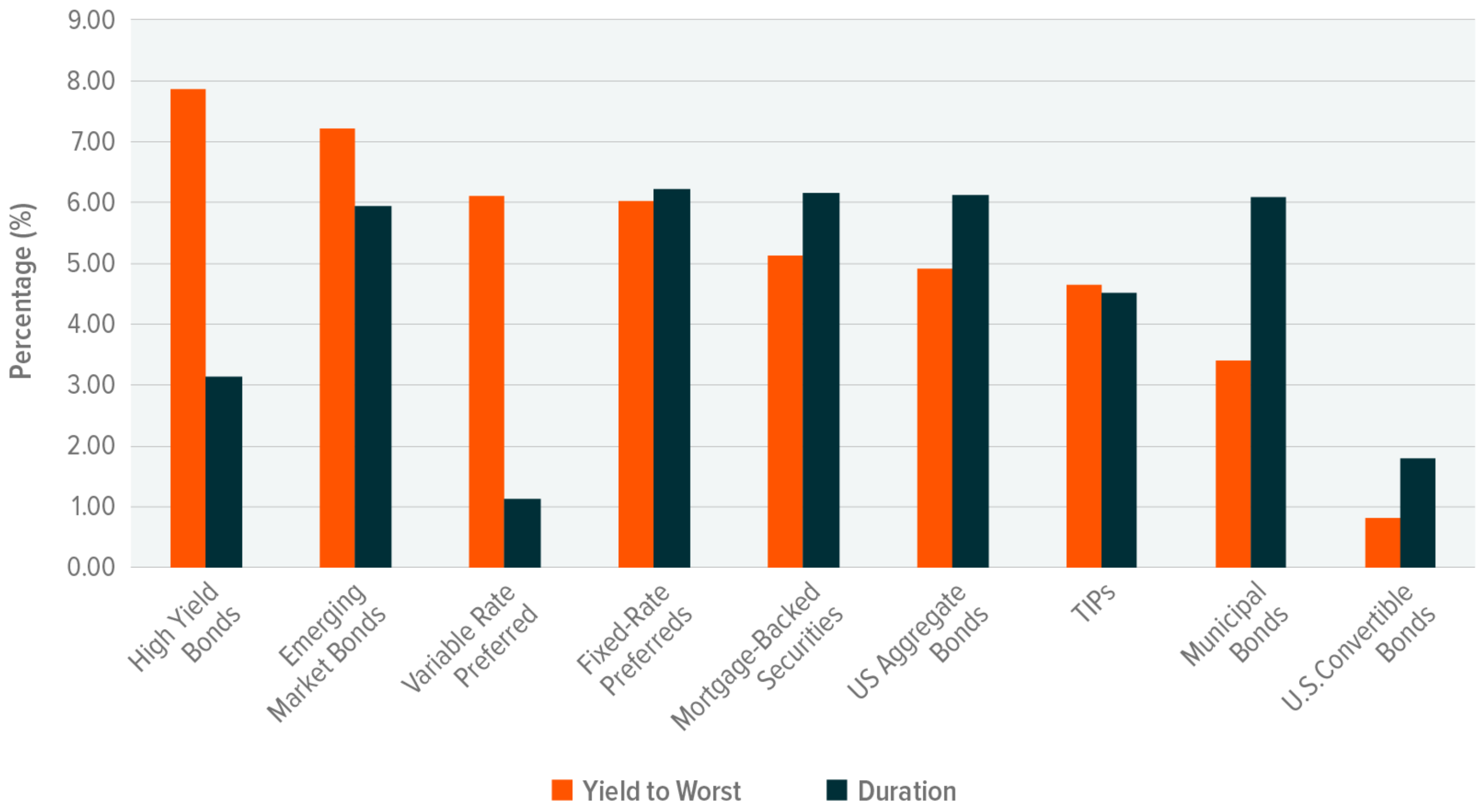
Preferred shares may offer lower yields currently, but they have a credit advantage over high yield bonds and emerging market debt that helps position them against moderate widenings in credit spreads, should economic conditions deteriorate. Investment-grade credits comprise the majority of the preferred space; as of February 29, over 65% of the preferred issues in the Preferred Index were rated investment-grade or better by one of the three major credit ratings agencies.[8]

Additionally, while acknowledging the asset class's high allocation towards the financial sector, approximately 39% of issuance came from large, diversified banks, with just under 6% of the index allocated toward smaller regional and community banks. Also, the index has no direct exposure to European preferred issues like contingent convertibles (Co-cos).[9] We think these holdings underscore the higher credit quality of the U.S. preferred stock market versus high yield bonds, which is comprised of speculative grade issuers.

The Global X U.S. Preferred ETF (PFFD) offers broad exposure to the U.S. preferred share market, which predominantly consists of retail fixed rate preferreds, allowing it to maintain a high overall duration measure. By contrast, the Global X Variable Rate Preferred ETF (PFFV) largely consists of preferred stocks that carry floating rate, which can fluctuate over the life of the investment, or fixed-to-floating rate variable coupon structures, allowing it to maintain proximity with prevailing market rates. Should rate cuts take longer than expected to materialize, we believe PFFD and PFFV offer investors the flexibility to dynamically adjust their target duration in response to shifts in the U.S. yield curve, which reflects the prevailing rates on a series of U.S. Treasury maturities.

PREFERREDS OFFER COMPETITIVE YIELDS AND OPPORTUNITIES IN DURATION

Sources: Global X ETFs with information derived from Bloomberg, data as of 2/29/2024. High yield bonds is represented by the Bloomberg US High Yield Bond Index; Emerging Market Bonds is represented by the Bloomberg EM USD Aggregate Total Return Index; Variable Rate Preferreds is represented by the ICE U.S. Variable Rate Preferred Securities Index; Fixed-Rate Preferreds is represented by the ICE BofA Fixed Rate Preferred Securities Index; Mortgage-Backed Securities is represented by the Bloomberg US Mortgage Backed Securities (MBS) Index; US Aggregate Bonds is represented by the Bloomberg U.S. Aggregate Bond Index; TIPs is represented by the Bloomberg US Treasury Inflation-Linked Bond Index (Series L); Municipal Bonds is represented by the Bloomberg U.S. Municipal Bond Index; U.S. Convertible Bonds is represented by the Bloomberg US Convertibles Composite Total Return Unhedged USD.



Indexes are unmanaged, do not incur management fees, costs or expenses and cannot be invested in directly. Past performance is no guarantee of future results.

A Barbell Fixed-Income Portfolio Can Help Balance Duration and Reinvestment Risks

The barbell investment strategy has been popular with bond investors leading up to the Fed's de-facto pivot. A fixed-income barbell strategy seeks to allocate to both short and long-duration securities across high-quality and subprime assets to balance both duration and credit risks within a fixed-income portfolio. We believe that this strategy makes sense in 2024 as the forecast for rate cuts continues to be delayed amid consecutive hotter than expected inflation reports.[10]

By allocating to both short and long-duration bonds, investors may be able to achieve a better weighted-average yield across their fixed income holdings. As of the end of February, the spread between long-duration 10-year Treasury bonds and short-duration 2-year Treasury Notes rose to -0.39%, a differential that remains tight relative to the long-term average (0.87%) as well as recent history (-.89%, 1-yr ago).[11] This differential is even more pronounced at the longest maturities, where 20-year Treasury bonds trade at spreads nearly a dozen basis points (0.12%) tight to 2-year Treasury bonds. This presents opportunities for investors to potentially capture value by securing yields on longer duration bonds.

By selectively positioning where yields are highest, investors may be able to achieve a higher level of income per unit duration while reducing both duration and reinvestment risks. These yields may be further enhanced by selectively adding credit exposure at either end of the curve. According to the CFA Institute, yields are often the best long-term predictor of total returns for bonds and given the elevated level of both nominal and real yields, which represent the yields before and after inflation adjustments respectively across all maturities relative to the past decade, we believe it makes sense to capitalize on these opportunities.[12] A measured approach to duration targeting may allow investors to potentially enhance carry returns in the short run, while also positioning for the eventuality of Fed rate cuts.

Having already covered longer-duration assets in our segment on preferred stocks, we believe investors should also consider opportunities in short-term bonds. 1–3-month Treasury Bills currently offer yields over 5.3% while effectively insulating against both credit and duration risks. The Global X 1-3 Month T-Bill ETF (CLIP) aims to provide exposure to 1-3 Month T-Bills at a competitive expense ratio of 0.07%,[13] a fee one-third the cost of comparable ultra-short bond ETFs at 0.22%.[14] We believe a high-quality short-term investment vehicle like CLIP could serve as an attractive counterbalance to a portfolio of longer duration bonds, lowering the portfolio's weighted average duration, thereby reducing the portfolio's overall sensitivity to interest rates, while enhancing its overall credit quality.

SPREADS BETWEEN LONG AND SHORT DURATION TREASURY BONDS HAVE TIGHTENED OVER THE PAST DECADE

Sources: Global X ETFs with information derived from the Federal Reserve Bank of St. Louis, data as of 3/14/2024. Graph represents interest rate spreads between the 10-Year Treasury Constant Maturity Minus 2 Year Treasury Constant Maturity Yield from 3/14/2014 through 3/14/2024.

For illustrative purposes only.

Conclusion: Fixed Income Securities Can Pave the Rocky Road to Rate Cuts

We believe that the current market environment offers attractive income opportunities with bond yields at their highest level in 15 years and economic conditions conducive to credit overall. For investors, extending portfolio duration while tactically positioning for potential shifts in the yield curve may be prudent. In the coming year, a barbell portfolio, consisting of long and short duration bonds across different credit qualities could offer a suitable approach for managing both duration and credit risks. The path to interest rate cuts is likely to be turbulent as the economic narrative unfolds; factors such as duration, credit, and reinvestment risks are all likely to influence the road ahead.

Related ETFs

PFFD – Global X U.S. Preferred ETF

PFFV – Global X Variable Rate Preferred ETF

SPFF – Global X SuperIncome Preferred ETF

CLIP – Global X 1-3 Month T-Bill ETF

Click the fund name above to view current performance and holdings. Holdings are subject to change. Current and future holdings are subject to risk.

Footnotes

1. Federal Reserve Bank of St. Louis. (2024, March 18). Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis.
2. Reuters. (2023, December 29). Biggest two-month rally in decades rescues beaten-up bond markets.
3. The Wall Street Journal. (2024, January 31). Fed Signals Cuts Are Possible but Not Imminent as it Holds Rates Steady.
4. CME Group. (n.d.) CME FedWatch Tool. Target Rate Probabilities for 20 Mar 2024 Fed Meeting.
5. Bloomberg L.P. (n.d.). COMP function, total returns. Performance data through December 31, 2023.
6. The Wall Street Journal. (2024, March 8). Hiring Boom Continues, but Signs of a Cooling Labor Market Boost Rate-Cut Hopes.
7. Bloomberg L.P. (n.d.). yield-to-worst. Performance data as of February 29, 2024.
8. Bloomberg L.P. (n.d.). PORT function, characteristics. Ratings data as of February 29, 2024.
9. Bloomberg L.P. (n.d.). PORT function, characteristics. Holdings data as of February 29, 2024.
10. The Wall Street Journal. (2024, March 12). Inflation Picks Up to 3.2%, Slightly Hotter Than Expected.
11. Federal Reserve Bank of St. Louis. (2024, February 29). 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity.
12. The CFA Institute. (2023, November 10). Return to Tradition? Three Reasons to Consider a Bond Allocation.
13. Global X ETFs. (2024, March 19). Expense ratio as of 3/19/2024.
14. Morningstar Direct, measured as of 3/15/2024 and accessed on March 15th, 2024. Based on Morningstar's categorization of surviving, Ultrashort Bond ETFs.

Glossary

Barbell Strategy: An investment strategy that consists of both long-term and short-term bonds.
Basis Point: One-hundredth of one percent (0.01%); a common unit of percentage measure.
Carry Returns: Refers to the income generated from holding an investment over time.
Consumer Price Index (CPI): A measure of the average change in prices paid by urban consumers over time.
Contingent Convertible (CoCo): A debt security that carries an option to convert to a stock if the underlying strike price on its option is exceeded. These are typically high yield securities issued by European financial institutions to meet regulatory capital requirements.
Convexity: A non-linear measure of the change in duration in relation to changes in interest rates.
Credit Risk: The risk of loss due to default or failure to meet contractual obligations.
Credit Spreads: The difference in yield between bonds of similar maturity but differing credit quality.
Duration: Metric of interest rate sensitivity which measures the weighted average number of years it takes to receive all expected cashflows on a fixed-income security.
Duration Risk: The risk of price changes on a bond due to shifts in interest rates.
Floating Rate: An interest rate which adjusts periodically in accordance with prevailing market rates, typically in relation to a benchmark.
ICE BofA Diversified Core U.S. Preferred Securities Index: Tracks the performance of exchange-listed U.S. dollar denominated preferred stock and convertible preferred stock publicly issued by corporations in the U.S. domestic market.
ICE BofA Fixed Rate Preferred Securities Index: Tracks the performance of fixed rate US dollar denominated preferred securities issued in the US domestic market.
ICE U.S. Variable Rate Preferred Securities Index: Tracks the performance of floating rate and fixed-to-floating rate exchange-listed U.S. dollar denominated preferred and convertible preferred securities publicly issued in the U.S. domestic market.
Nominal Yield: The stated yield which investors can expect to earn from a bond; not adjusted for inflation.
Option-Adjusted Duration: A duration metric which accounts for the effects of any embedded options on a bond's expected maturity.
Producer Price Index (PPI): A measure of the average change in selling prices received by domestic producers over time.
Real Yield: The yield of a bond which adjusts for the impact of inflation.
Spread Widening: An expansion of yield differentials between different credit classes which is often indicative of rising credit risks.
U.S. Yield Curve: A graphical depiction of interest rates across the range of Treasury maturities.
Weighted Average Duration: A measure of the average time it takes to receive all cashflows on a portfolio of bonds, proportional to their respective weights within the portfolio.
Yield to Worst: Represents the minimum annualized return that can be earned from buying and holding a bond until maturity, accounting for the potential impact of embedded options.

Investing involves risk, including the possible loss of principal. 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 and the Fund's performance. PFFD and SPFF are non-diversified.

International investments may involve risk of capital loss from unfavourable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Variable and Floating Rate Securities may have limits on the maximum increases in coupon rates and may lag behind changes in market rates. A downward adjustment in coupon rates may decrease the Fund's income as a result of its investment in variable or floating rate securities. Performance of companies in the Financials sector may be adversely impacted by many factors, including, among others, government regulations, economic conditions, credit rating downgrades, changes in interest rates, and decreased liquidity in credit markets. PFFV is non-diversified.

Fixed income securities are subject to loss of principal during periods of rising interest rates. U.S. Treasury obligations may differ in their interest rates, maturities, times of issuance and other characteristics. Similar to other issuers, changes to the financial condition or credit rating of the U.S. Government may cause the value of the Fund's investments in U.S. Treasury obligations to decline. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund is not a money market fund, does not seek to maintain a stable net asset value, and is not subject to the risk limiting provisions applicable to money market funds.

Shares of ETFs are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Brokerage commissions will reduce returns. Indices are unmanaged and do not include the effect of fees, expenses or sales charges. One cannot invest directly in an index.

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