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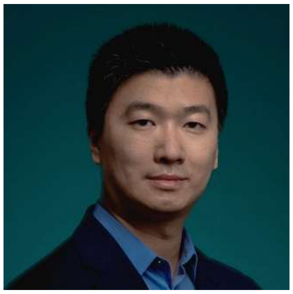

GLOBAL X ETFs RESEARCH

Quarterly Income Commentary: Portfolio Allocations in the "Higher for Longer" Rate Landscape

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Topic: Income

Related ETFs

Please click below for fund holdings and important performance information.

CLIP – Global X 1-3 Month T-Bill ETF

EMBD - Global X Emerging Markets Bond ETF

QDIV - Global X S&P 500 Quality Dividend ETF

Equity and fixed income markets were volatile during Q3 2023, giving up some of the gains during the first of half (1H) of the year as markets digested the Federal Reserve's (Fed) "higher for longer" policy trajectory. The S&P 500 and the Nasdaq Composite Indexes declined 3.27% and 3.94% respectively in the 3rd quarter, well below the robust 16.89% and 32.32% total returns in 1H.[1] Towards year-end, we expect investors to shift their attention from duration risk to credit risk, as a potential peak in interest rates solidifies as the prevailing narrative. Markets have priced in an effectively 0% chance of further rate hikes in 2023, with almost 100 basis points (bps) of rate cuts expected by the end of 2024.[2]

Investors remain on high alert for signs of slowing growth and cooling inflation data, closely watching for any impetus that might prompt the Fed to cut rates. Persistently higher rates bring the potential risk of stagnating U.S. markets, which may compel investors to reposition defensively in the coming year. One solution may be to adopt a defensive posture domestically while shifting their focus overseas in emerging markets for credit opportunities. Alternatively, investors who wish to avoid market volatility may find attractive yields in short-term Treasury bills (T-bills) for as long as rates remain elevated. Depending on how conditions unfold, we believe income investors should remain judicious in their asset allocations and emphasize quality and diversification.

Key Takeaways

- Expectations for an extended period of higher rates kept volatility high in Q3. Inflation continued to trend downward while economic data began to moderate, leading investors to shift their attention from rate hikes toward the sustainability of continued growth.
- Should tight credit conditions persist, investors have a multitude of defensive options, such as overweighting quality dividend-paying equities with robust cashflows and fortress-like balance sheets. They can also extend duration into international debt or potentially earn attractive yields in short duration T-bills.
- When market breadth narrows and the risk of an economic slowdown rises, the incentive to de-risk becomes more compelling, particularly if value-oriented sectors remain cheap and fixed income yields stay elevated. Historically, prioritizing income, quality, and diversification have been prudent risk management strategies during periods of uncertainty.

Shifting Gears as Rates Remain Elevated

A surge in GDP growth to 4.9% in the 3rd quarter cemented the case that higher rates may be here to stay. October data was mixed, as the St. Louis Fed reported an increase in the unemployment rate to 3.9% from its April low of 3.4%,[3] already exceeding the 3.8% level projected in the Fed's September Summary of Economic Projections (SEP).[4] Meanwhile, U.S. Consumer Price Index (CPI) data released in November showed that key components such as food and shelter remained stubborn despite declining inflation. These data point to a potentially slowing economy that may lack the catalysts for a potential Fed cut.

While market leaders may continue to rally in the interim, we believe that moderating economic growth, coupled with rigid Fed policy, will continue to contribute to uncertainty in the markets absent a material credit event, such as rising defaults or economic stress. As we wind down the year, investors may wish to reallocate their portfolios into defensive quality sectors and diversify across assets and borders while the opportunity remains cheap.

The Case for Defensive Positioning in Quality Dividends

During periods of cooling economic growth, investors may seek the characteristics of quality dividend equities, including lower leverage, greater cashflows, and higher return on equity metrics versus the broader S&P 500 index. These traits tend to be exhibited by large-cap stocks in mature industries, which predominate quality dividend funds. Quality dividend equities offer the potential for more sustainable dividends and growth than strategies solely fixated on high yields.

High dividend strategies often fall victim to dividend value traps, due to their sometimes-formulaic methodologies that focus solely on delivering the highest dividend yield. These methodologies may overlook fundamental warning signs that aren't always evident in the level of a company's dividend payout. This may include artificially inflated dividend yields, due to poor price performance dragging down stock share price in the denominator in the calculation, or unsustainable dividend policies, implemented by managers to draw investor interest towards otherwise stagnant or declining industries. Such factors may increase the risk of dividend cuts and underperformance due to a lack of capital appreciation. By contrast, a strategy focused on quality dividends may be able to address these challenges.

The Global X S&P 500 Quality Dividend ETF (QDIV) is designed to have a balanced total return approach, which seeks to deliver income and capital appreciation potential. QDIV seeks to replicate the S&P 500 Quality High Dividend Index (the "Quality Index"), which selects the intersection of the 200 highest dividend-yielding companies in the S&P 500 Index and the 200 highest scoring companies based on profitability, accrual, and leverage metrics. These factors result in holdings that have exhibited higher long-run earnings growth, seeks to minimize the risk of dividend cuts among index constituents, and strategically tilts portfolio exposure towards large caps in mature industries, traits that historically serve investors well in late cycle markets.

The importance of quality factors becomes evident when contrasting the underlying fundamentals of high dividend portfolios. We compared a collection of fundamental metrics on the Quality Index with the same metrics featured on the S&P 500 High Dividend Index (the "High Dividend Inex"), an index which measures the performance of the highest dividend-yielding companies within the S&P 500. These metrics included Return-on-Equity, trailing 12-month debt-to-capital ratio, and historical earnings growth. By introducing a quality overlay over a universe of the highest yielding constituents in the S&P 500, the Quality Index was able to achieve higher return-on-equity and earnings growth over the last five years, while maintaining a lower overall debt-to-capital ratio than the High Dividend Index. Such metrics are indicative of growing profit margins and earnings growth, which over time, may correlate with higher capital appreciation potential and sustainable dividend growth.

ADDING A QUALITY SCREEN TO A HIGH DIVIDEND STRATEGY MAY IMPROVE PORTFOLIO FUNDAMENTALS

Source: Morningstar Direct, measured by taking the monthly median from 10/2018 to 09/2023.

Quality Fundamental Factors Historically Outperformed the S&P 500 High Dividend Index

Quality fundamentals may reduce the likelihood that underlying holdings will require capital infusions under adverse market conditions, freeing up cashflow for productive endeavors such as capital investment, stock repurchases, or dividend payouts. This flexibility may provide a lower volatility of returns in adverse markets and support the potential sustainability of dividend payments.

Quality metrics tied to balance sheets and profitability may mitigate the risk of dividend cuts during economic downturns. Historically, dividend cuts have been detrimental to equity values due to the deteriorating fundamentals that precipitate most cuts and the reputational harm suffered by the firm. The risk of dividend cuts is magnified in decelerating markets, as firms' after-tax earnings shrink and interest costs rise, reducing distributable earnings.

We believe the perpetual risk of dividend cuts underscores the importance of adopting a quality-oriented approach in the current market. As shown in comparisons of performance between the S&P 500 Quality High Dividend Index and the S&P 500 High Dividend Index, a quality dividend strategy can generate more consistent returns and reduce portfolio volatility over time when compared to a strategy solely focused on dividend maximization.

S&P 500 QUALITY HIGH DIVIDEND TOTAL RETURN INDEX AND S&P 500 HIGH DIVIDEND TOTAL RETURN INDEX – TOTAL RETURNS YTD

Sources: Global X ETFs with information derived from Bloomberg. December 30, 2022 to November 24, 2023.

Past performance is not a guarantee of future results.

The Case for Fixed Income Diversification in Emerging Markets

Investors weary of stagnating U.S. markets may wish to turn their attention outwards, as Emerging Market assets have cheapened considerably. Rising dollar strength measured by the U.S. dollar index (DXY), shifting manufacturing trends, and volatility in materials prices have presented headwinds for emerging markets (EM) over the past year. Despite these challenges, the market for EM debt may be entering a more favorable environment in 2024, heralded by the widely anticipated peak in interest rates and a potential peak in the U.S. dollar (USD).

Historically, EMs have a strong inverse correlation with the USD; according to the International Monetary Fund (IMF), a 10% appreciation in the dollar's value can result in a 1.9% decrease in EM economic output.[5] Recent underperformance of EM debt, materials, and equities, all of which declined over the past year as the US dollar index soared, illustrate this correlation.

However, we saw EM markets rebound in July as the US dollar sold off following a decline in Treasury yields. This contributed to a robust short-term rally in materials and EM. Although this rally ultimately fizzled, we anticipate a resurgence in this trend, as the prospect for a peak in interest rates could pave the way for a more sustainable rally in emerging markets.

EMERGING MARKET PERFORMANCE 2023 YTD VS. U.S. DOLLAR INDEX

Sources: Global X ETFs with information derived from Bloomberg as of November 17, 2023. EM Debt represented by the J.P. Morgan EMBI Global Core Index; Materials represented by the MSCI Emerging Markets Materials Total Return Index (Net) (USD); 10-Yr Tsy represented by the U.S. Government 10-Year Generic Treasury Bond; EM Equity represented by the MSCI Emerging Markets Total Return Index (Net) (USD); U.S. Dollar represented by the U.S. Dollar Index.

Emerging Markets Are Where Active Managers May Shine

We believe that active management has the potential to add value over traditional passive indexing strategies in opaque markets like EM. Active managers can implement a broad array of strategies, enabling them to make tactical and strategic allocation decisions across countries, currencies, and credits when appropriate. We believe this level of versatility is important, particularly when navigating vast and complex markets like EM debt.

Investors have historically pursued passive indexing strategies to minimize costs and maximize diversification in their portfolios. Passive management removes the element of discretion from portfolio managers, instead seeking to mimic the performance of an underlying index based on rules or formulas. While passive indexing has generally been a sound strategy for investors in transparent developed markets, such strategies may oversimplify the politically and economically disparate nature of EM.

EM debt issuers encompass a diverse spectrum, ranging from export-dependent resource-rich regions like Central America, to technologically advanced nations in Asia-Pacific with rapidly expanding service economies. Adding a layer of complexity are nations with varying levels of social and political instability, which can introduce a level of geo-political risk unique to EM markets. Given the wide range of political and socioeconomic regimes underlying EM, regions can often exhibit broadly diverging fundamentals, illustrating the difficulty of drawing broad inferences within this group.

Passive managers may also struggle when seeking to replicate the performance of EM indices, which are generally not designed to account for trading costs, volatile bid/ask spreads, or illiquidity. According to Morningstar, passive EM debt funds tend to exhibit higher tracking errors than domestic U.S. bond funds.[6] This may reflect the increased informational asymmetry and logistical complexity surrounding emerging markets, which may increase benchmark drift for passive funds, and support arguments for an active benchmark-agnostic approach to investing.

The divergent nature of EM debt markets introduces additional risks that can complicate the traditional duration and credit analysis required of fixed income investors. This may call for a more nuanced approach than what may be offered through passive index strategies. Active strategies like the one employed by the Global X Emerging Markets Bond ETF (EMBD) may be equipped to navigate these additional risks, potentially achieving better risk-adjusted returns.

Emerging Market Debt May Offer Opportunities for Proactive Portfolio Managers

EMBD primarily invests in U.S. Dollar Denominated debt but also carries a degree of flexibility when considering allocations within local-currencies or regional exposures. This affords it the ability to take defensive actions to hedge EM risk on a regional, currency, or credit basis, depending on the nature of the underlying analysis. It also may allow for the potential to capitalize on regional differences in monetary or fiscal policy, as well as diverging growth trends between various EM regions.

Investing in EM debt entails additional risks relative to investing in U.S. Corporate debt. While credit risk and duration risk are hallmark concerns for all fixed income investors, EM debt also introduces additional risk factors in the form of currency risk and political risk. Combined, these added risks comprise the “EM Risk Premium” that investors expect to earn when investing in EM debt over comparable “risk-free” debt like Treasury bonds. These added risks introduce analytical complexity and increase the number of variables that impact debt pricing. Depending on how market conditions unfold, any of these risk factors may serve to enhance or detract from returns.

While passive strategies implicitly assume all the risks embedded in the EM Risk Premium, active strategies may be able to decompose the individual risk factors and reposition to adjust for potential threats to portfolio performance, or otherwise exploit catalysts across these risk factors.

OPPORTUNITIES TO ADD VALUE THROUGH ACTIVE MANAGEMENT

Sources: Global X ETFs, for illustrative purposes only. These factors may also be detractors from performance.

One example of a potential catalyst for EM debt in 2024 is the difference in central bank hiking cycles. EM Central Banks were more proactive than their developed market counterparts in initiating rate hikes, which contributed to CPIs falling faster in many emerging markets from 2022 to 2023, while most developed markets saw inflation recede at a slower pace. While certain parts of the developed world continue to grapple with inflation, numerous EM Central Banks have already commenced rate cuts, which may serve as a tailwind for EM debt in the coming year. As developed markets have largely mirrored the US Federal Reserve in their policy actions, EM monetary authorities have operated according to the needs of their respective regions, thereby presenting an opportunity for EM active managers to capitalize on interest rate differentials.

CENTRAL BANK POLICY RATE: UNITED STATES, DEVELOPED MARKETS, AND EMERGING MARKETS

Sources: Global X ETFs with information derived from Bloomberg. Data from December 31, 2021 to November 30, 2023.

Reducing Correlations and Diversifying Credit Exposure

While EM debt represents a “risk-on” allocation, it is more diversified and less correlated with U.S. equities than comparable high-yield corporate debt, offering the potential for better risk-adjusted returns should market conditions improve. As illustrated in the chart below, the five-year correlation of Emerging Market Bonds to U.S. equities was just 0.68, compared to 0.84 correlation between high yield bonds and U.S. equities. In our view, this correlation represents an opportunity to diversify beyond high yield debt, which may face headwinds from tight credit conditions and slowing economic activity in the coming year.

Also, unlike high yield bonds, which represent a subset of U.S. corporate debt, EM debt encompasses a diverse spectrum of international sovereigns and corporates across various credit classes. EMBD’s active selection process favors investment-grade credits over EM high yield and exposes investors to a wider spectrum of credits and issuers versus the U.S. high-yield index. Additionally, EM debt can provide further diversification via its exposure to both local and hard-currency denominated debt, which has the potential to reduce correlation to US-dollar denominated assets while further boosting the yield potential on a diversified income-oriented portfolio.

ASSET CLASS CORRELATIONS (5-YEAR)

Sources: Global X ETFs with information derived from: Bloomberg as of September 30, 2023; Asset class representations are as follows: High Yield Bonds, Bloomberg US Corporate High Yield Bond Total Return Index; Emerging Market Bonds, Bloomberg EM USD Aggregate Total Return Index; Corporate Bonds, Bloomberg US Corporate Bond Total Return Index; REITs, FTSE NAREIT All Equity REITS Index; US Equities, S&P 500 Index; and Fixed Rate Preferreds, ICE BofA Fixed Rate Preferred Securities Index.

Asset Class	High Yield Bonds	Fixed Rate Preferreds	Emerging Market Bonds	REITS	Corporate Bonds	US Equities
High Yield Bonds	1.00	0.821	0.85	0.79	0.77	0.84
Fixed Rate Preferreds	0.82	1.00	0.76	0.76	0.77	0.73
Emerging Market Bonds	0.85	0.76	1.00	0.70	0.88	0.68
REITS	0.79	0.76	0.70	1.00	0.67	0.85
Corporate Bonds	0.77	0.77	0.88	0.67	1.00	0.63
US Equities	0.84	0.73	0.68	0.85	0.63	1.00

Seeking Shelter in Short-Duration Treasury Bills

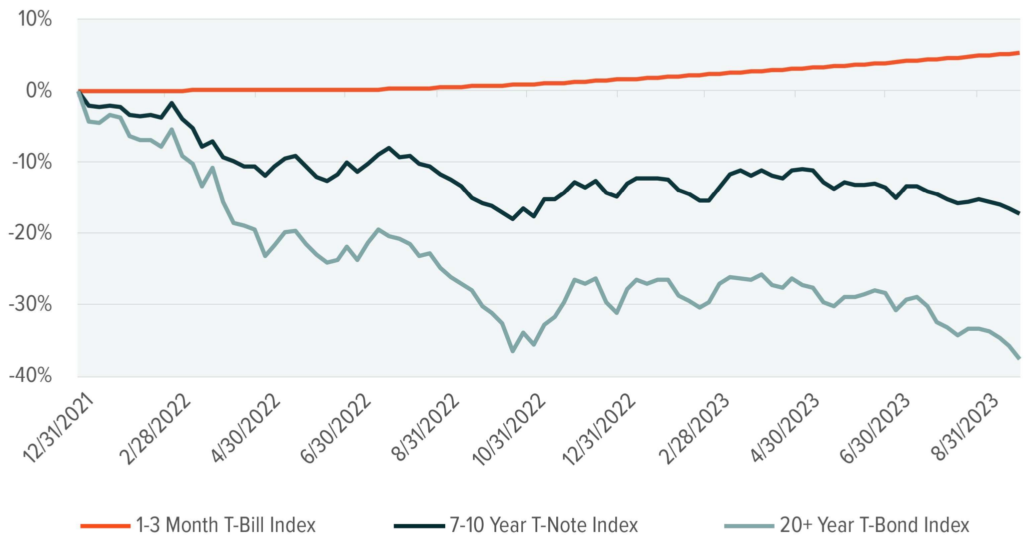
Investors weary of volatility in both credit and duration may prefer to position defensively in ultra-short duration T-Bills. Despite mixed forecasts and market volatility over the past two years, T-bills have remained a “safe haven” for investors, generating consistent returns and attractive yields. The yield on the 3-month T-bill, roughly 5.54% as of November 22nd,[7] exceeded the 4.32% earnings yield on the S&P 500.[8] With risk-free rates reaching their highest point since the Global Financial Crisis, short-term T-bills remain an attractive option offering liquidity and yield.

Fixed income returns varied widely over the past year due to rising rates and shifting expectations in credit markets. Long duration bonds are particularly susceptible to changes in inflation expectations, growth expectations, and fluctuations in supply and demand. By contrast, short duration T-Bills are tied to the Federal Funds rate (“Fed Funds”) and are driven primarily by shifts in Fed policy while remaining resistant to factors that might otherwise influence longer duration or credit-risky bonds.

The Global X 1–3 Month T-Bill ETF (CLIP) seeks to mitigate duration and credit risk by investing in T-Bills issued in the 1–3-month segment of the Treasury curve. This feature provides investors with rolling exposure to the most liquid portion of the curve, where yields are currently at their highest. CLIP’s cash-like characteristics prioritize income and capital preservation, allowing investors to potentially benefit from elevated short-term rates and potentially reduce overall portfolio volatility.

TREASURY INDEX TOTAL RETURNS FOR DIFFERENT MATURITY BUCKETS

Sources: Global X ETFs with information derived from: Bloomberg data: 12/31/2021 to 9/29/2023. 1-3 Month T-Bill Index represents the Bloomberg U.S. Treasury Bills 1-3 Month TR Index; 7-10 Year T-Note Index represents the Bloomberg U.S. Treasury 7-10 Year TR Index Unhedged; 20+ Year T-Bond Index represents the Bloomberg U.S. Treasury 20+ Year TR Index Unhedged.



Treasury ETFs Can Provide Income and Convenience

Passively managed T-bill ETFs relieve investors of the administrative burden of having to purchase and roll over T-bills directly from the U.S. Treasury Department, an arduous and often time-consuming task. Notably, these ETFs track the ultra-short-term Treasury market, offering exposure to the most recently issued T-bills while automatically rolling over maturing bonds into the newest index constituents.

Compared to direct T-bill ownership, passive Treasury ETFs may also offer more frequent distributions. T-bills are zero-coupon securities issued at discount that only pay a single cashflow at maturity. Individual T-bill holders may have to wait three months or more to receive the distribution of principal and interest. If the investor is buying one T-bill at a time or buying multiple that mature at the same time, it may be suboptimal from an income and reinvestment perspective. By contrast, passive Treasury ETFs may be able to pay regular monthly distributions from their large portfolios of underlying Treasury holdings. This allows for a more consistent flow of distributions on individual T-Bill holdings without having to purchase Treasuries individually to build a laddered portfolio, a strategy that would be both capital-intensive and time-consuming to replicate.

Conclusion: An Opportunity to Diversify into Year-End

Following a promising first half, investors experienced a tumultuous Q3 2023 as markets priced in a higher-for-longer rate forecast. While a soft landing seems to remain the consensus outlook for 2024, we believe that the risk of additional market volatility may be underestimated heading into next year. Year-end can be an opportune time to realign portfolios defensively as value and fixed income assets remain attractively priced. Depending on individual risk tolerance, adopting a defensive strategy that prioritizes quality, diversification, and income may be prudent, particularly if the growth outlook remains murky.

Footnotes

1. Bloomberg. Comparative daily total returns from June 30, 2023 to September 30, 2023, and December 30, 2022 to June 30, 2023.
2. CME Group. (2023, November, 21). CME FedWatch Tool: “Probability % 1 Week 21 Nov 2023.”.
3. St. Louis Fed. (2023, November 3, 2023). FRED Economic Data: Unemployment Rate as of October 2023.
4. Federal Open Market Committee (2023, September 23). Summary of Economic Projections.
5. IMF Blog (2023, July 19). Emerging Market Economies Bear the Brunt of a Stronger Dollar.
6. Morningstar (2023, March 28). Pay Close Attention When Selecting an Emerging Markets Bond Fund.
7. U.S. Department of the Treasury (2023, November 22). Daily Treasury Par Yield Curve Rates.
8. Yardeni Research, Inc. (2023, November 22). S&P 500 Dividend & Earnings Yield.

Glossary

Correlation: A measure that shows how two securities move in relation to each other. A correlation of 1 implies that the securities will exhibit the same price movements. A correlation of 0 means the securities demonstrate completely unrelated price movements. A negative 1 correlation implies that the securities move in proportion and opposite directions from one another.

Debt-to-Capital Ratio: A leverage ratio which measures the proportion of a company’s debt to its overall capital. This serves as a measure of the firm’s leverage.

Duration: A measure of a bond’s price sensitivity to changes in interest rates. In general, the higher the duration, the more a bond’s price will drop as interest rates rise (and the greater the interest rate risk).

DXY Index: The US dollar index measures the relative value of the US dollar in relation to a basket of international currencies. Note that the value expressed is hypothetical, one cannot invest directly in an index.

Earnings Yield: A financial ratio that measures the relationship between earnings and market price. It is calculated by dividing the trailing 12-months earnings per share on the underlying asset/index by its market price.

Hard Currency: A globally-traded currency that is generally issued by developed nations and is expected to serve as a liquid and reliable store of value.

Return-on-Equity: A profitability ratio that divides the firm’s return by the value of its shareholders’ equity. This gauges a company’s profitability and how efficiently it generates those profits.

Risk-Free Rate: The interest rate of return that investors can expect to earn on an investment that theoretically carries zero risk. In this context, it generally refers to short-term Treasury Bills.

S&P 500 High Dividend Index: An index designed by S&P Global to measure the performance of 80 equally weighted high-yield companies within the S&P 500.

S&P 500 Quality High Dividend Index: An index designed by S&P Global to measure the performance of S&P 500 constituents that exhibit both high quality and high dividend yield characteristics.

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. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Carefully consider the funds' investment objectives, risks, and charges and expenses before investing. This and other information can be found in the funds' full or summary prospectuses, which may be obtained at globalxetfs.com. Please read the prospectus carefully before investing.

Investing involves risk, including the possible loss of principal. Diversification does not ensure a profit nor guarantee against a loss.

There is no guarantee dividends will be paid. Companies may reduce or eliminate dividends at any time.

International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Fixed income securities are subject to loss of principal during periods of rising interest rates. 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.

As an actively managed Fund, EMBD does not seek to replicate a specified index and is subject to increased credit and default risk, where there is an inability or unwillingness by the issuer of a fixed income security to meet its financial obligations, debt extension risk, where an issuer may exercise its right to pay principal on an obligation later than expected, as well as interest rate/maturity risk, where the value of the Fund's fixed income assets will decline because of rising interest rates. EMBD is non-diversified.

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 CLIP is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. CLIP 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.

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