With cash rates likely approaching a peak, investors should act soon to seek more quality sources of income before markets start to price much lower interest rates. (UBS)

Lock in durable income amid rate uncertainty

21 March 2024, 12:55 pm CET, written by UBS Editorial Team

The yield on 3-month US Treasuries has remained close to a 20-year high, as investors continue to debate the outlook for US monetary policy.

While markets now suggest a high probability that the Federal Reserve will refrain from hiking rates at its policy meeting next week, federal fund futures still imply one further increase in US rates. Such a move would further increase the attraction of cash and money market funds.

But we believe their appeal will fade. Despite recent evidence that inflation is falling less swiftly than expected, an end to rate hikes is not far away. With cash rates likely approaching a peak, investors should act soon to seek more quality sources of income before markets start to price much lower interest rates. We see several ways of doing this:

Lock in higher yields in fixed income markets. Instead of focusing on the ultra-short end of the yield curve, we see opportunities in high-quality medium- to long-duration fixed income. While yields on 2- and 5-year US Treasuries are down from their recent peaks in early March—prior to the emergence of worries over the health of the banking system—we think they remain attractive at 4.49% and 3.67%, respectively. We see the potential for capital gains if growth slows more abruptly than currently expected. Equally, investment grade bond returns should outperform in tougher economic times.

We also see upside for US dollar emerging market sovereign debt. Although the speed and breadth of China's economic recovery has disappointed, we still expect GDP growth to pick up to around 5.7% this year, from 3% in 2022. This should help emerging market sovereign bonds, and the current yield of 8.5% for the JPMorgan EMBIG Div index looks attractive, in our view.

Investors can also find attractive income opportunities in equity markets, through high-dividend and quality stocks. The MSCI World High Dividend Yield index is offering 3.9% yield, as of 7 June. These stocks are mostly in more defensive parts of the market and are relatively resilient when the economy slows—as we expect these dividend payments to be relatively stable even in the event of a recession, based on historical experience. And since companies in this category often have strong pricing power, enabling them to pass on higher costs to customers, this part of the equity market should perform well while inflation remains above central bank targets.

Real assets along with yield-generating structured investments offer alternative ways to add durable returns. Exposure to "real assets," including commodities, infrastructure, and real estate, can provide investors with additional portfolio diversification and income, as well as the potential for long-term inflation mitigation. We currently see appeal in direct and indirect infrastructure exposure, and direct commodity exposure.

Strategies involving options selling have particular appeal at present, in our view. Such strategies tend to outperform in rangebound equity markets, which is what we expect for the remainder of 2023. Also, the volatility risk premium is relatively high at present, meaning that actual swings in equity markets have been low relative to implied volatility measures. That increases the potential gains for investors from selling options.

So, we advise investors against assuming that current cash and money market yields will last for long. Building durable income into portfolios will be increasingly important if, as we expect, the recent equity rally runs into headwinds in the rest of the year.

Main contributors - Solita Marcelli, Mark Haefele, Christopher Swann, Jon Gordon

Content is a product of the Chief Investment Office (CIO).

Original report - **Lock in durable income amid rate uncertainty, 7 June 2023.**