



Income Outlook: Q1 2022 – Fed Liftoff Triggers Rate Spike

Rohan Reddy

rreddy@globalxetfs.com

Date: May 05, 2022

Topic: **Income**

The Global X Income Outlook for Q1 2022 can be [viewed](#) here. This report seeks to provide macro-level data and insights across several income-oriented asset classes and strategies.

We spoke last quarter about the hawkish pivot by the Federal Reserve (Fed), and the likelihood of stickier inflationary pressures. These trends continued to materialize in 2022 as market expectations for aggressive monetary policy tightening took hold, and headline inflation data printed at extremely high levels by developed market standards. For investors, we believe there are some key themes and solutions to pay close attention to in the income investing markets.

Key Takeaways

- The potential for numerous rate hikes by the Fed and other central banks, as well as aggressive balance sheet unwinding seems increasingly likely for the remainder of the year.
- Low duration instruments, like variable rate preferreds, may be an alternative for fixed income investors looking to reduce interest rate risk but still pursue income objectives.
- Energy assets with strong fundamentals, like master limited partnerships (MLPs) and energy infrastructure equities, look appealing in a rising oil price environment.
- Options based strategies, such as covered calls, could be attractive with elevated volatility and the defensive posturing in the equity markets.

Hawkish Central Bank Policies Make Further Rate and Credit Spread Rises More Likely

Persistent inflation in the United States and limited monetary policy response put the Fed in a precarious position to start the year. The Fed was forced to play catch up after leaving loose monetary policies in place, despite inflationary pressures spreading across the global economy. However, the Fed reacted sharply in Q1, raising rates for the first time in three years. The Fed wasn't alone, though. The Bank of England and Bank of Canada, among others, raised rates, opening the door to broader global hawkish monetary policy this year.

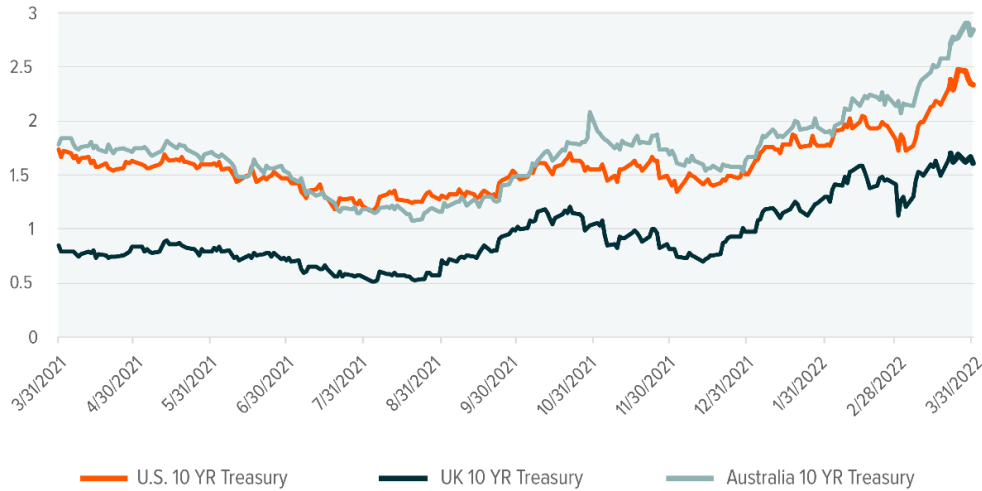
Additionally, it's unlikely this pace of rate hikes and tapering will slow down. The European Central Bank (ECB), historically very dovish compared to other developed central banks, said they could end their bond buying program in Q3.¹ The futures market is currently projecting a move to zero interest rate levels from negative 50 basis points (bps) by year end.² The U.S. and U.K. central banks are forecasted to be even more aggressive, with 125 bps in hikes by the United Kingdom and 200 bps in hikes by the United States forecasted in the futures market.³ Clearly, these would be the most aggressive policy actions in that short of a timespan that we've seen this cycle.

We think the Fed, as an example, is being forced to play catch up as inflation levels in the United States reached 8.5% in the month of March. The last time headline inflation reached these levels in the United States was in the 1980s. The bond market is already moving in lockstep with inflation, so hawkish policy was priced into sovereign bond yields.



10 YEAR TREASURY YIELDS BY COUNTRY (%)

Source: Bloomberg. Data from 3/31/2021 to 3/31/2022. Asset class representations are as follows, U.S. 10 YR Treasury, US Generic Govt 10 Yr Index; UK 10 YR Treasury, UK Gilts 10 YR Index; Australia 10 YR Treasury, Australia Govt 10 YR Index.



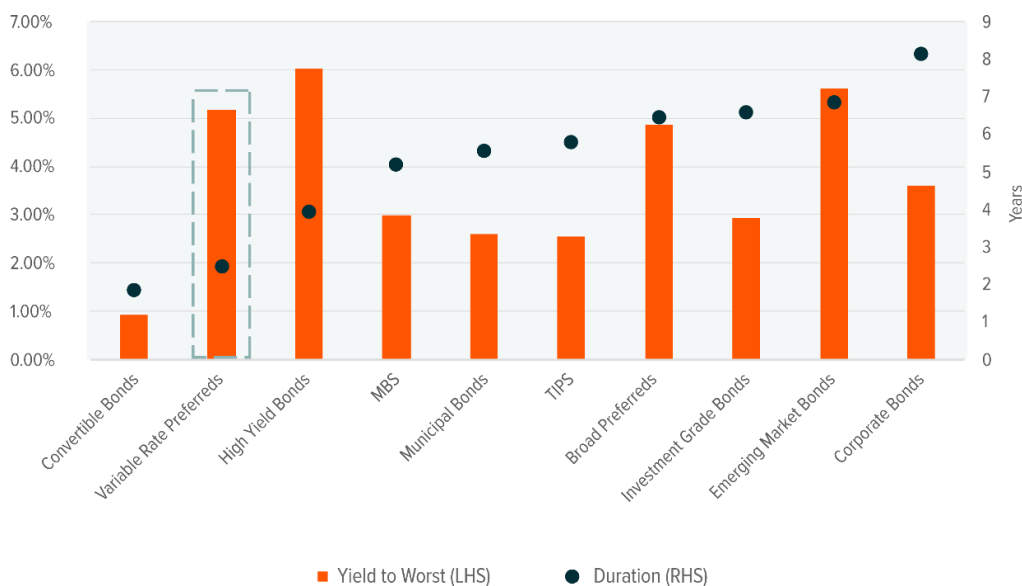
Credit spread widening is also more likely in light of central bank rate hikes and further monetary policy tightening. There was a spike in credit spreads in Q1 as the equity markets sold off and the rate hiking path began. The rise in geopolitical tensions could also make financing conditions more challenging for high yield issuers.

Variable Rate Preferreds as a Fixed Income Alternative

For fixed income investors, aggressive monetary policy shifts raise two risks: rate hikes, which are already permeating into the market, and potential credit spread widening for corporate credit. For income investors, the key in this environment is balancing interest rate risk with the need for yield.

FIXED INCOME YIELD VS. DURATION

Source: Bloomberg. Data as of 3/31/2022 Asset class representations are as follows: Convertible Bonds, Bloomberg US Convertible Bond Index; Variable Rate Preferreds, ICE US Variable Rate Preferred Securities Index; MBS, Bloomberg US MBS Index; High Yield Bonds, Bloomberg US Corporate High Yield Total Return Index; Broad Preferreds, ICE BofA Diversified Core US Preferred Securities Index; Municipal Bonds, Bloomberg Municipal Bond Index; Investment Grade Bonds, Bloomberg US Aggregate Bond Index; Emerging Market Bonds, Bloomberg EM USD Aggregate Total Return Index; TIPS, Bloomberg US Treasury Inflation Notes TR Index; Corporate Bonds, Bloomberg US Corporate Total Return Index





Real (inflation-adjusted) yields turned negative in the midst of the pandemic, putting income investors in a challenging situation. The recent rise in sovereign bond yields is mitigating some of this risk, but real yields are still barely on the brink of turning positive. Persistent inflationary pressures, such as supply chain issues and labor shortages, are causing headline inflation to keep moving higher, with March's figures coming in at 8.5%. This increases the need for real income levels to keep pace.

Variable rate preferreds historically hold up well in rising rate environments with their lower duration characteristics. The outperformance of variable rate preferreds also occurred when compared to broader fixed income as well.

PREFERRED CUMULATIVE PERFORMANCE IN RISING RATE ENVIRONMENT

Source: Bloomberg. Asset class representations are as follows: Variable Rate Preferred, S&P U.S. Variable Rate Preferred Stock Total Return Index; Fixed Rate Preferred, S&P U.S. Fixed Rate Preferred Stock Total Return Index; Broad Fixed Income, Bloomberg U.S. Aggregate Total Return Index.

	10 Year Treasury Increase	Variable Rate Preferred Cumulative Performance	Fixed Rate Preferred Cumulative Performance	Broad Fixed Income Cumulative Performance
1/30/2015 to 6/10/2015	84 bps	1.72%	0.62%	-2.77%
7/8/2016 to 11/8/2018	188 bps	7.79%	4.51%	-2.47%
8/4/2020 to 4/19/2022	241bps	10.99%	-1.87%	-11.07%

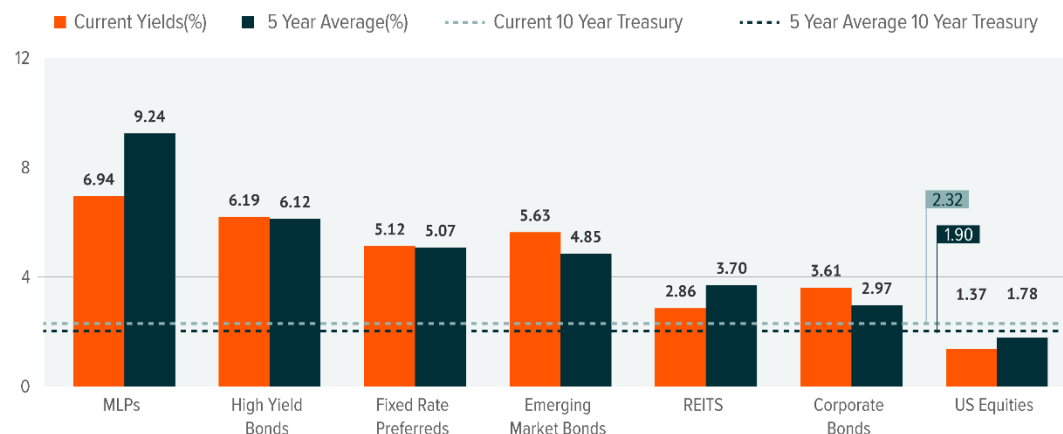
Master Limited Partnerships as an Income Play on Commodities

Commodity investments have been one of the shining spots in the market this year, as global supply shortages and inflationary pressures drove raw material prices higher. For income investors, though, the non-yielding nature of commodities futures makes that route less appealing to generate cash flow. The equity of companies in commodities businesses are more attractive given the return of capital potential through dividends or share buybacks.

Master Limited Partnerships (MLPs) are one avenue for income investors to potentially both generate income and benefit from the commodity trade of oil. These pipeline businesses could be well positioned for a rise in U.S. energy production, and this year's spike in oil and gas prices has also boosted natural resource assets, such as MLPs. The **tax advantaged nature of the distributions** and yield spreads compared to other asset classes could make MLPs a compelling option for income investors.

YIELD BY ASSET CLASS(%)

Source: Bloomberg and Federal Reserve as of 3/31/2022. Asset class representations are as follows, MLPs, S&P MLP Index; High Yield Bonds, Bloomberg US Corporate High Yield Total Return Index; Emerging Market (EM) Bonds, Bloomberg EM USD Aggregate Total Return Index; Corporate Bonds, Bloomberg US Corporate Total Return Index; REITs, FTSE NAREIT All Equity REITs Index; Equities, S&P 500 Index; and Preferreds, ICE BofA Fixed Rate Preferred Securities Index.





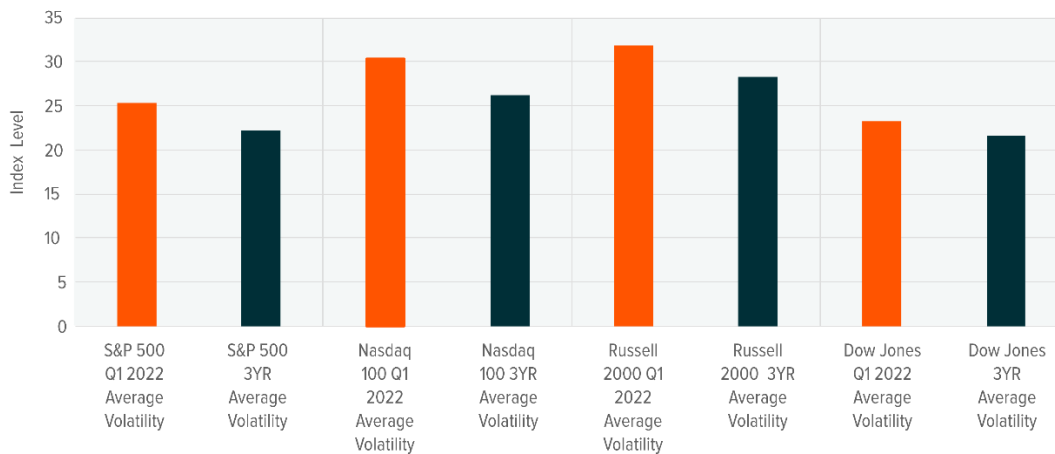
Elevated Volatility Makes Covered Call Strategies Attractive in a Rising Rate Environment

Central bank tightening did not just lead to a spike in yields and credit implications. Increased volatility began flowing into the equity markets as investors began re-pricing valuation multiples and growth equities began selling off in favor of value.

Volatility increases were notable across major indices, after the equity market selloff earlier in Q1. For income investors, covered call strategies on major indices like the Nasdaq 100 or S&P 500 could be a way to generate income outside of traditional dividend paying stocks and fixed income.

Q1 2022 VS. 3 YR AVERAGE VOLATILITY

Source: Bloomberg. Data from 3/31/2019 to 3/31/2022. Volatility measured using the following: S&P 500 Volatility, CBOE Volatility Index (VIX); Nasdaq 100 Volatility, CBOE NASDAQ-100 Volatility Index (VXN); Russell 2000 Volatility, CBOE Russell 2000 Volatility Index (RVX); Dow Jones Industrial Average Volatility, CBOE DJIA Volatility Index (VXD).



The potential for earnings growth may lead investors to desire some level of equity upside potential, while also collecting a potential income stream. With 6.5% earnings growth for Q2 expected in the S&P 500, and 11.1% for Q3, some income investors may want to maintain equity exposure.⁴ To that end, covered call & growth opportunities that seek to use only 50% notional coverage could represent an opportunity.

Conclusion

The ramp up in Treasury yields and other sovereign bonds globally means income investors need to be on the lookout for the impact on their income portfolios. Broader fixed income assets are likely to face pressure amid aggressive tightening policies by central banks, and growth equity assets may be volatile for the foreseeable future with rising rates. Variable rate preferreds offer a balanced approach to duration risk and income levels from the preferreds. Sectors able to withstand inflation pushed through the supply chain could bode well in this environment compared to other segments of the market. Energy related assets, like MLPs, and options strategies, such as covered calls, that are able to monetize volatility could be solutions in this rising rate environment.

Related ETFs

MLPA: The [Global X MLP ETF](#) invests in some of the largest, most liquid midstream Master Limited Partnerships (MLPs).

MLPX: The [Global X MLP & Energy Infrastructure ETF](#) is a tax-efficient vehicle for gaining access to MLPs and similar entities, such as the General Partners of MLPs and energy infrastructure corporations.

PFFV: The [Global X Variable Rate Preferred ETF](#) invests in a broad basket of U.S. variable rate preferred stocks, providing benchmark-like exposure to the asset class

QYLD: The [Global X Nasdaq 100 Covered Call ETF](#) follows a “buy-write” (also called a covered call) investment strategy in which the Fund buys a basket of stocks, and also writes (or sells) call options that correspond to the basket of stocks. The Fund uses this strategy in an attempt to enhance its portfolio’s risk-adjusted returns, reduce its volatility, and generate monthly income from the premiums received from writing the call options.

XYLD: The [Global X S&P 500 Covered Call ETF](#) follows a “covered call” or “buy-write” strategy, in which the Fund buys the stocks in the S&P 500 Index and “writes” or “sells” corresponding call options on the same index.

RYLD: The [Global X Russell 2000 Covered Call ETF](#) follows a “covered call” or “buy-write” strategy, in which the Fund buys exposure to the stocks in the Russell 2000 Index and “writes” or “sells” corresponding call options on the same index.



DJIA: The **Global X Dow 30 Covered Call ETF** follows a “covered call” or “buy-write” strategy, in which the Fund buys the stocks in the Dow Jones Industrial Average (also known as the Dow 30 Index) and “writes” or “sells” corresponding call options on the same index.

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. European Central Bank. (2022, April 14). Monetary policy decisions.
2. Saphir, A. (2022, April 18). Fed's Bullard wants to get rates up to 3.5% by year end. Reuters.
3. Inman, P. (2022, April 9). High prices and low growth should nip UK and eurozone interest rate rises in the bud. The Guardian.
4. FactSet Research Systems. (n.d.). FactSet earnings insight. Factiva. Accessed on April 19, 2022.

Glossary

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

VIX: The Chicago Board Options Exchange SPX Volatility Index commonly referred to as VIX, reflects a market estimate of future volatility of the S&P 500 index options, based on the weighted average of the implied volatilities.

VXN: The Chicago Board Options Exchange NDX Volatility Index commonly referred to as VXN, reflects a market estimate of future volatility of the Nasdaq 100 index options, based on the weighted average of the implied volatilities.

RVX: The Chicago Board Options Exchange RUT Volatility Index commonly referred to as RVX, reflects a market estimate of future volatility of the Russell 2000 index options, based on the weighted average of the implied volatilities.

VXD: The Chicago Board Options Exchange DJIA Volatility Index commonly referred to as VXD, reflects a market estimate of future volatility of the Dow Jones Industrial Average index options, based on the weighted average of the implied volatilities.

Nasdaq 100 Index: The Nasdaq-100 Index includes 100 of the largest domestic and international non-financial companies listed on The Nasdaq Stock Market based on market capitalization. The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It does not contain securities of financial companies including investment companies.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.

Russell 2000 Index: A small-cap stock market index that includes 2,000 smaller companies that focus on the U.S. market.

Dow Jones Industrial Average Index: The Dow Jones Industrial Average Index (DJIA) is one of the most popular stock market indexes in the US, and often used as a barometer of US market health in tandem with S&P 500.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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.

Investing involves risk, including possible loss of principal. 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. 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.

Real estate is highly sensitive to general and local economic conditions and developments, and characterized by intense competition and periodic overbuilding. Many real estate companies, including REITs, utilize leverage (and some may be highly leveraged), which increases risk and could adversely affect a real estate company's operations and market value in periods of rising interest rates.

Investments in securities of MLPs involve risk that differ from investments in common stock including risks related to limited control and limited rights to vote on matters affecting the MLP. MLP common units and other equity securities can be affected by macro-economic and other factors affecting the stock market in general, expectations of interest rates, investor sentiment towards MLPs or the energy sector, changes in a particular issuer's financial condition, or unfavorable or unanticipated poor performance of a particular issuer (in the case of MLPs, generally measured in terms of distributable cash flow).

MLPA has a different and more complex tax structure than traditional ETFs and investors should consider carefully the significant tax implications of an investment in the Fund. MLPA is taxed as a regular corporation for federal income tax purposes, which differs from most investment companies. Due to its investment in MLPs, the Fund will be obligated to pay applicable federal and state corporate income taxes on its taxable income, as opposed to most other investment companies. The Fund expects that a portion of the distributions it receives from MLPs may be treated as tax-deferred return of capital. The amount of taxes currently paid by the Fund will vary depending on the amount of income and gains derived from MLP interests and such taxes will reduce an investor's return. The Fund will accrue deferred income taxes for any future tax liability associated certain MLP interests. Upon the sale of an MLP security, the Fund may be liable for previously deferred taxes which may increase expenses and lower the Fund's NAV.

The potential tax benefits from investing in MLPs depend on them being treated as partnerships for federal income tax purposes. If the MLP is deemed to be a corporation then its income would be subject to federal taxation at the entity level, reducing the amount of cash available for distribution to the Fund which could result in a reduction of the Fund's value.

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.



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.

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. By purchasing put options, in return for the payment of premiums, the investor may be protected from a significant decline in the price of the underlying asset if the put options become in the money (the underlying asset closes below the strike price as of the expiration date); but during periods where the underlying asset appreciates, the investor will underperform due to the cost of the premiums paid. 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.

This material is not intended as investment advice. There is no guarantee that strategies discussed will be successful. Please consult your financial advisor for further information.

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

Global X Management Company LLC serves as an advisor to Global X Funds. The Funds are distributed by SEI Investments Distribution Co. (SIDCO), which is not affiliated with Global X Management Company LLC. Global X Funds are not sponsored, endorsed, issued, sold or promoted by Solactive AG, FTSE, Standard & Poors, NASDAQ, Indxx, Dow Jones, or MSCI nor do these companies make any representations regarding the advisability of investing in the Global X Funds. Neither SIDCO nor Global X is affiliated with Solactive AG, FTSE, Standard & Poors, NASDAQ, Indxx, Dow Jones, or MSCI.