Private Clients and their Quest for Income and Yield in Uncertain Times

As they search for yield and income, what should Asia's wealthy private investors be doing, when and how? Should they be recalibrating their portfolios towards fixed income, or perhaps stepping up more cautiously in light of potentially further major interest rate hikes and developed market GDP weakness to come? Should they be buying more 'yield' and 'value' equities whilst prices are depressed, or are there further falls in store in the major indices, despite recent rallies? Could the combination of inflation, higher rates and weaker economies cause revenues, profits and then dividends to stagnate or fall? And what about DM vs EM fixed income and credit? Or DM vs EM equities and yield stocks? And how about China? Active strategies, or passives such as ETFs? On November 10, a team of hand-picked experts reviewed these and other key issues in our Digital Dialogue, set against the backdrop of the current global economic and financial situation and geopolitical concerns, and sought to analyse where and how Asia's private clients can locate sustainable yield and income in such challenging and uncertain times.

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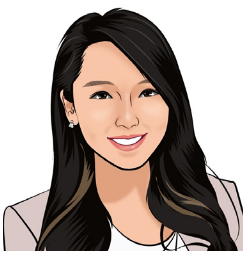

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Setting the Scene

How the world has changed! Only a year or so ago, so much of the world's highest quality sovereign and quasi-sovereign fixed income was still submerged in negative yield territory, or at best still offering insignificant yields. In early October 2021, the 10-year US Treasury yield was only a shade over 70 basis points, whereas by November 11 this year it was hovering around 4.13%, and the policy-sensitive 2-year US Treasury yield was about 4.38%.

Since the Northern Hemisphere autumn of 2021, stock prices have also fallen – the S&P hit its lifetime high of over 4700 in December 2021 and was by November 11 trading at just over 3992, in other words still down more than 15% despite a rally from 2022 lows of around 3600 in October.

Of course, inflation, rising rates, the end of QE, fears over the Russia invasion of Ukraine and other geopolitical concerns are all driving more and more analysts to recalculate their predictions on whether a deep and long recession will result, or if the developed world can steer their economies towards a short recession and then a resumption of growth.

On the plus side, Covid appears to be on the wane, at least in its most sinister guise, and the emerging market economies are dancing largely to somewhat different tunes, as the leading EM economies transition to more domestically driven GDP and more intra-regional activity, for example within the vast Asian region.

So, what should private investors do as they seek to adjust their portfolios to this newer environment and the ongoing uncertainties ahead? Risk-free bonds? Credit? Subordinated debt of high-quality issuers such as European banks? REITs? Low PE and high dividend stocks? Should investors also be looking at cleverly devised structured products as instruments to help elevate yields while providing access to either downside protection or upside potential, or both? Are the private markets the right place to go for HNW and UHNW investors in their quest for yield and income? Should private clients be investing through active funds, or ETFs, or directly by asset picking, or a combination of all these approaches? Does ESG-centricity help in this search, and if so, how?

Fixed income hit hard this year as DM rates surged after decades of declining yields

US Treasuries are down more than 15% in 2021 as major DM central banks (except Japan) have been hiking rates. But this is allowing a reset, as risk free yields of closer to 5% are available. "We do not see much likelihood of Treasuries going beyond 5%, so we have decent carry and not so much downside for fixed income prices. But that does not mean major investors and private clients are piling in, actually far from it, because the yield curve is inverted."

Credit is looking more appealing in this environment

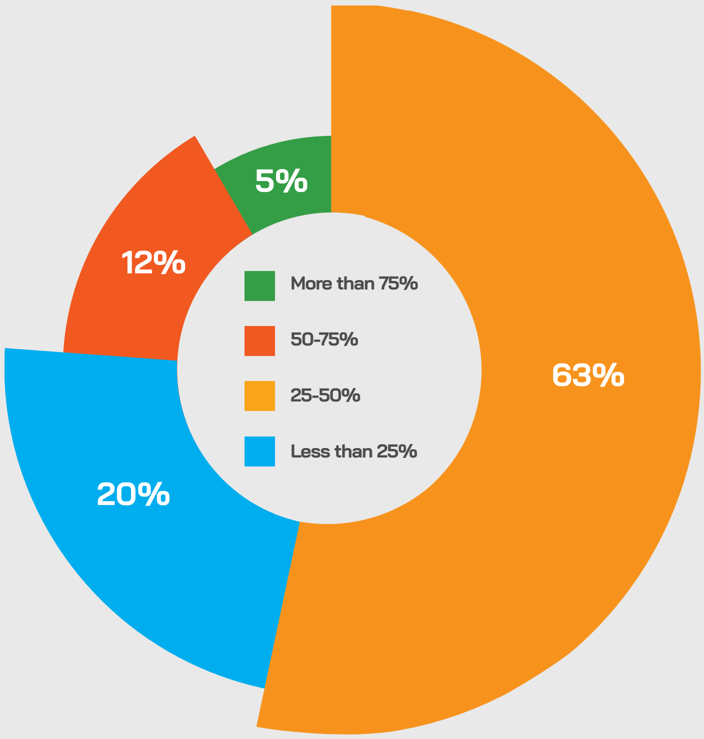
The same guest said they like credit, especially private credit, with relatively high yields and reasonable risk, especially subordinated debt. "And if you look at the credit protection available in private credit," he explained, "these loans are often collateralised, and are either floating rate or short-term revolving, so you don't have either the duration risk or interest rate risk. Default rates are still pretty low. And we are in the camp that we strongly believe we're not headed for a big global recession."

When the risk-free rate became the rate free risk!

A guest quipped that at the beginning of this year, they thought fixed income the riskiest place of all in the public markets and joked that they were looking at the rate-free risk instead of a risk-free rate! "In short, there was no return for mounting risks," he said. "Today, the yields on investment grade bonds are roughly equal to the yields that on high yield just a few months ago."

The Hubbis Post-Event Survey

ROUGHLY WHAT PERCENTAGE OF YOUR HNW AND UHNW CLIENTS' PORTFOLIOS TODAY ARE ALLOCATED TO DEBT/FIXED INCOME?



Singapore REITs can offer robust income and reasonable valuations but weakened prices are not yet on the rise

And in Singapore, he explained they had loaded back up on REITs, which are successful and popular there. He said that trade has still not done well yet in price, but the income is there, and they are trading at very close to NAV, or even below NAV.

The rising appeal of US private credit

A guest highlighted the attractions of private credit in the US, focusing on mid-market borrowers which the banks are not so keen on. "The US is a unified market with one legal and robust framework, with strong collateral rules in case of troubles, and that is not always the case in Europe and in Asia where you have different legal systems, different court systems, and sometimes things take much longer," he reported."

And he said the US economy is still in better shape than most right now, and distant from the turmoil in Europe and meanwhile Asia is still not cranking up, with very low growth in China and Japan still. "In short, if we look from the top-down viewpoint, the US looks like a less risky place to be from an economic perspective," he stated. "Yes, profit margins are under pressure, but revenue growth is actually pretty strong, making it easier for companies to be able to service their debt, hence default rates in the US are very low while yields have gone up a lot."

He explained that private credit is similar to high yield in terms of credit risk, but they think that the default rates that the market is pricing in are too negative, as they imply a major recession that his firm does not foresee. "We like this sector, and as there are some private credit managers with tens of billions under management, so it is relatively easier to spread the risk in US private credit," he concluded.

The return of yield means the return of more interested structured products

Another guest reported that the evolving conditions had again opened the doors to structured products not available for many years. "We're seeing now the return of products that we haven't been able to structure for probably about 15 years, in terms of minimum returns (i.e. the original capital) and access to either some kind of interest rate linked structured payout, or some kind of equity linked structured pay-out," he explained. "It has become rather exciting again to look at those types of things with clients."

He said that on the assumption that rates remain higher for a period of time, the yield curve would start to steepen, so people will again start looking longer term.

Opportunities are increasing, especially in sub debt, but taking the active approach is the right way in challenging conditions

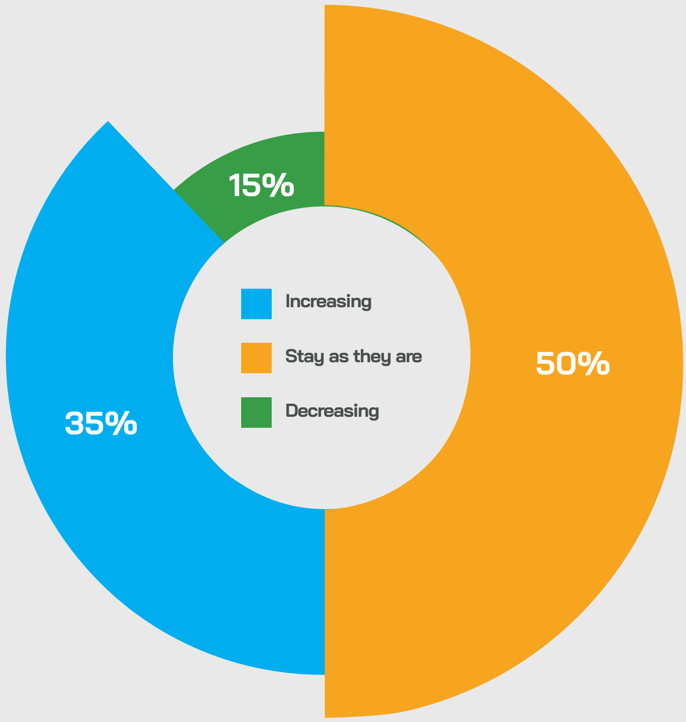
An expert declared that there are opportunities today, but the active and highly selective approach is the right way. He said they specialise in subordinate debt, which presents one of the best environments seen for decades. He explained that in this results season, the banks in Europe are telling them they see a huge pickup in terms of net interest margin, profitability, earnings, something they really haven't heard from the bank sector for some two decades. "And look at sub paper capturing a yield to call of more than 9%, in Euro bonds, Dollar bonds, and all for very strong investment grade issuers."

He explained that if he looks at their asset class, they are getting income nearer to 6% but looking potentially at double-digit returns on top from price appreciation, meaning a total return of 10% to 20% over the next 12 months with no leverage.

"This is a world where active managers can make a real difference, you've got to have conviction, you have to identify risks, you have to position the portfolio accordingly," he stated. "And if you have concerns about the risk of upcoming recession, you definitely want to go for this quality yield, don't take excess credit risk, and these are all A-rated issuers, where you can get 9% yield to call. There are tons of opportunities."

He also remarked that subordinated debt structurally has low sensitivity to rates, as the coupons are so-called fixed to floater, meaning not fixed for life and callable. "And right now, we are capturing a yield

SHOULD YOUR CLIENTS BE INCREASING OR DECREASING THEIR ALLOCATIONS TO DEBT/FIXED INCOME?



which is higher than available in dividend yield of European banks, meaning a screaming buy for the asset class," he stated. "The spreads we're capturing now is pretty much between five to eight times more than pre global financial crisis, even though credit quality has never been as strong. We're seeing European names now issuing coupons at 10% plus for investment grade issuers."

His final comment was that in a quantitative tightening environment, it is all about active management, being selective. "There's value everywhere, but you've got to do your homework," he stated.

The US subordinated debt market also offers real appeal

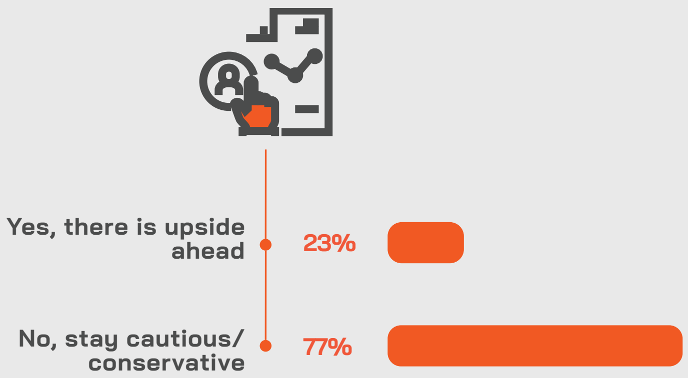
Another guest agreed, adding that the US is also appealing for the same reasons. "This may be an oversimplification of the point, but we are getting high yield from investment grade risks. We know it's more complicated than that, of course, but essentially, that's what it is. If you read the definition of what of A means, and then you look at it, and they have some bonds that are being issued at say, BBB+, I'll be happy to take that extra yield for now, as I'm not at all worried about those issuers."

However, he added a more general comment that income might be relatively easy to find now, but capital protection and capital upside will likely take longer to materialise. "For now, stick with quality," he concluded.

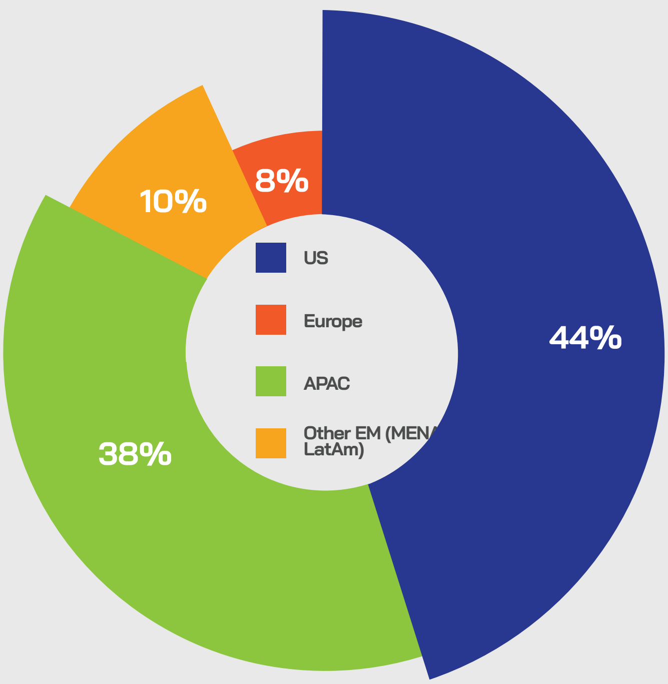
In terms of dividends and income, focus on diversification, value, and quality

A guest said that sector and geographical diversification,

IS THIS THE RIGHT TIME TO BE LEVERAGING FIXED INCOME PORTFOLIOS?



IN VERY BROAD TERMS, IN THE SEARCH FOR YIELD FROM FIXED INCOME/DEBT, WHICH REGIONS ARE YOUR HNW/UHNW INVESTORS IN ASIA TARGETING TODAY?



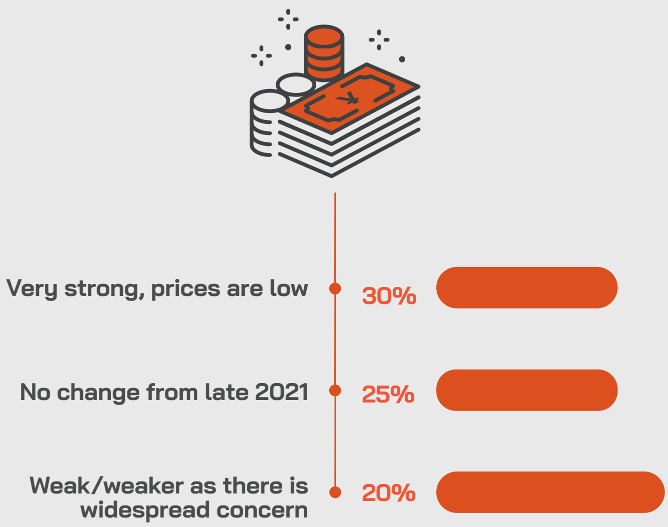
often through the use of ETFs, is advisable, with a strong focus on quality. China is well worth following, but selectively and only in areas benefitting from government policy. Singapore REITs are more interesting today than for a long time, they added, noting the yields on quality assets of 6% plus available.

Another expert advised stocks in the UK, Europe, and Japan, all with weakened currencies. "We run large cap blue chip portfolios with an average PE ratio of 10 and income yields of between 5% and 6.5%," he reported. "The UK is particularly attractive for non-taxpaying clients because there is no withholding tax on dividends. With relatively limited risk, you can increase your yields by potentially adding Swiss Franc leverage because Euro and Sterling have weakened tremendously against Swiss Franc without any particularly fundamental economic reason. And the Swiss Franc is still one of the cheapest currencies to borrow, so you can invest in some high-quality dividend stocks in Swiss Francs."

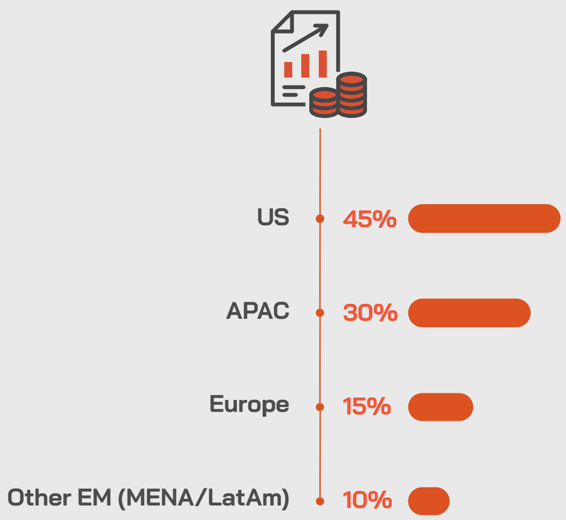
Cash is much more valuable today, according to one panellist who explained they are heavily in cash currently as they are happy with the nominal yields on deposits, achieving 3% to 4% on three months deposits. "We worry that equity markets still look suspect, and recent rallies have some of the hallmarks of another bear market rally like we had in summer. We're not jumping into anything yet."

He added that they have certain targets as far as where we believe EPS might land, where they believe the PE might land on the S&P500. "We won't actually wait till we get there but we believe that the direction is towards these lower targets," he reported. "There will be a chance to accumulate before those levels are reached, and until we see that there must be a question on any rally's sustainability in terms of fundamentals. Yes, relative strength indices are all oversold, but the wider picture has inflation hovering around 8%, war in Ukraine, China is still zero covid and shut, supply chain troubles aplenty, so there are many reasons with this sort of confluence of bad events. When things improve and when we meet some of our quantitative targets, we will have the signals to go back in." ■

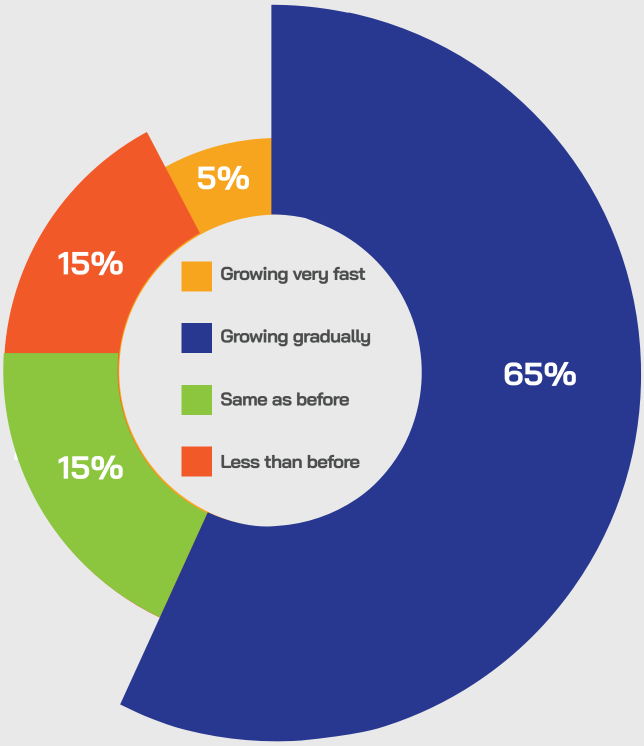
IN TERMS OF THE SEARCH FOR INCOME/DIVIDENDS, HOW WOULD YOU CHARACTERISE CURRENT DEMAND AMONGST HNW AND UHNW INVESTORS IN ASIA FOR PUBLIC MARKET EQUITIES?



IN VERY BROAD TERMS, IN THE SEARCH FOR INCOME/DIVIDENDS FROM EQUITIES, WHAT PERCENTAGES BY REGIONS SHOULD BE ALLOCATED FOR YOUR HNW/UHNW INVESTORS IN ASIA?



LOOKING AHEAD OVER THE NEXT 2-3 YEARS, WHAT PERCENTAGE OF YOUR MASS AFFLUENT CLIENTS' INVESTMENT PORTFOLIOS WILL BE INVESTED IN OFFSHORE/INTERNATIONAL FINANCIAL ASSETS?



WHICH WEALTH MANAGEMENT INSTITUTIONS ARE BEST IN THE HNW AND UHNW SEGMENTS AT PROVIDING THESE CLIENTS WITH THE RIGHT SOLUTIONS AND IDEAS FOR YIELD/FIXED INCOME IN TODAY'S ENVIRONMENT?