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Investment Strategy Update #108

Where to go for yield

- Bond yields have risen at an unprecedented pace over the past 12 months – with developed sovereign yields more than tripling from ~0.7% to ~2.4%. The bond rout has driven a painful correction across many other asset classes including equities but the silver lining is that risk adjusted yields are now looking far more appealing.
- Against a backdrop of elevated volatility and falling asset class returns, yield is increasingly valuable. We think there are multiple ways to source steady, sustainable, risk-adjusted yield for investors who seek this form of return. Our four preferred areas for yield are:
  - **Bonds:** Sovereign bonds now provide appealing risk-adjusted returns, with the US 10-year at ~2.9% versus 1.3% a year ago (and Australian yields now at ~3.6%). In addition, Investment Grade credit spreads have widened ~75bps year to date, with US IG credit now yielding above 4%.
  - **Real assets:** Real assets offer attractive yields relative to other risk assets, while also providing a hedge against inflation. Within our preferred exposure areas, direct infrastructure assets are yielding in the region of ~5% and direct real estate assets in the region of ~4%. In addition, these yields are very stable and secure particularly infrastructure, which has non-cyclical and often regulated cash flows.
  - **Equities:** Australian equities offer a 12-month forward dividend yield of ~5% and franking credits providing an additional yield pick-up of 1-2%. In addition, there are areas within the equity market that are offering significantly more attractive yield (albeit with higher risk such as Materials and Energy stocks). While equities are a riskier area for yield given cyclical growth risks, we don't see much long-term risk to dividends (or dividend growth) given the high capital returning nature of domestic equities.
  - **Cash:** Rising interest rates are also pushing cash deposit rates higher, with 6-and 12-month term deposit rates having risen to 1.9% and 2.7% respectively (versus a third of this only a year ago). However, with inflation running in excess of 6%, real rates are still firmly in the negative. We recommend cash as a capital preservation strategy or a short-term hold whilst awaiting deployment.

Bonds (and yields) are making a comeback

The pace and magnitude at which central banks have hiked interest rates has been unprecedented outside of the early 1980's. This has in turn seen long sovereign yields more than triple across developed bond markets relative to where they were just a year ago (from an average yield of 0.7% a year ago to 2.4% now). While this rapid repricing has been painful for investors across all asset classes, investors can now earn a (relatively) attractive yield from both cash and fixed income markets that have not seen for most of the last decade.

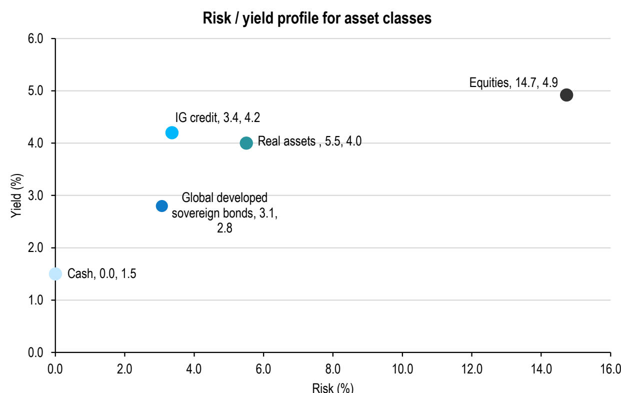
10Y sovereign bond yields have more than tripled since a year ago

	Yield as at 22-Jul-22 (%)	Yield 12M ago (%)
Australia	3.6	1.2
US	2.9	1.3
UK	2.0	0.6
Eurozone	1.2	-0.4
Average	**2.4**	**0.7**

Source: Factset, MWM Research, July 2022

Against a backdrop of slowing global growth and high uncertainty, the ability for portfolios to provide reliable, sustainable risk-adjusted yield is even more valuable now. We think that investors should take this opportunity to reassess / optimise their sources for risk-adjusted yield.

Risk / yield profiles of our preferred areas



Source: Factset, Morningstar, MWM Research, July 2022

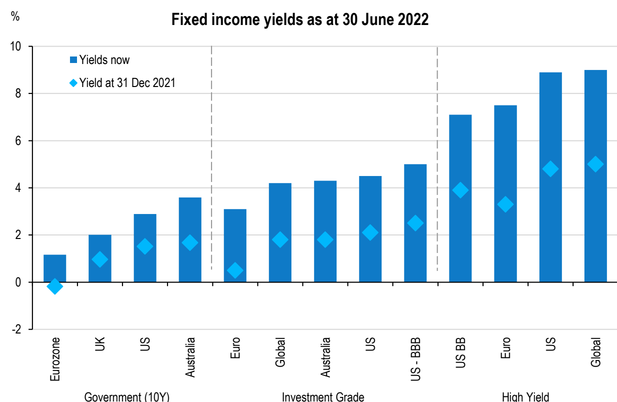
Our preferred areas for (risk-adjusted) yield

1. Bonds – elevated yields and a growth hedge

After years of low rates that drove investors to seek income elsewhere (TINA), and often in exchange for taking on higher risk, yields in quality investment grade and sovereign debt markets have once again become attractive. Markets are forward-looking, so further central bank rate rises, while potentially causing some short-term volatility, are already reflected in bond prices.

We think sovereign bonds are now an appealing source for defensive, risk-adjusted returns with yield levels now providing a buffer should rates move higher while offering an attractive yield. Also, with IG credit spreads having widened ~75bps and still strong corporate fundamentals, Investment Grade credit now offers competitive yields relative to other risk assets.

Fixed income yields have increased meaningfully in 2022



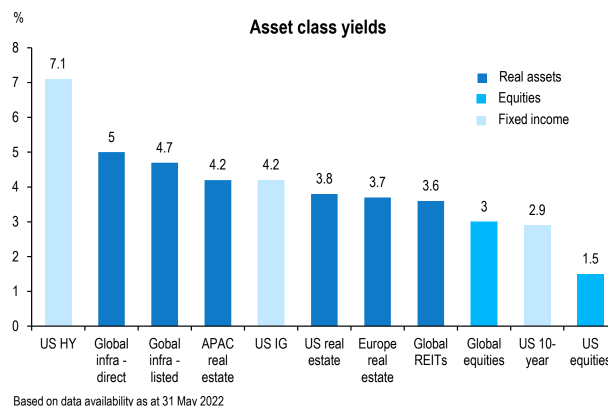
Source: Bloomberg, FactSet, JPMorgan Asset Management, July 2022

2. Real assets – stable yield and an inflation hedge

Real estate and infrastructure assets offer relatively attractive yields, although at a slightly higher risk (volatility) level compared with fixed income assets. Within the asset class, direct exposures often provide the higher yields (direct infrastructure yielding 5% and direct real estate yielding ~4%), although this may come at the cost of liquidity.

The advantage of real assets is that during persistent inflationary environments, real assets can also provide a hedge against inflation, with real estate rents often stepped to inflation and infrastructure assets often regulated and contractually linked to inflation. Real assets (particularly direct) can also improve the risk/return profile of a portfolio given the lower volatility of returns and lack of correlation with traditional assets (bonds / equities).

Real Assets provide a yield pick-up relative to traditional risk asset classes



Source: Bloomberg, MSCI, NCREIF, Factset, JPMorgan Asset Management, July 2022

We prefer infrastructure over real estate given the contractual nature of their cashflows and monopoly-like characteristics. Within real estate, we prefer industrial (due to strong fundamentals) and office (due to reopening) and are cautious on residential (due to a weakening housing market) and retail (due to weakening consumption and structural headwinds).

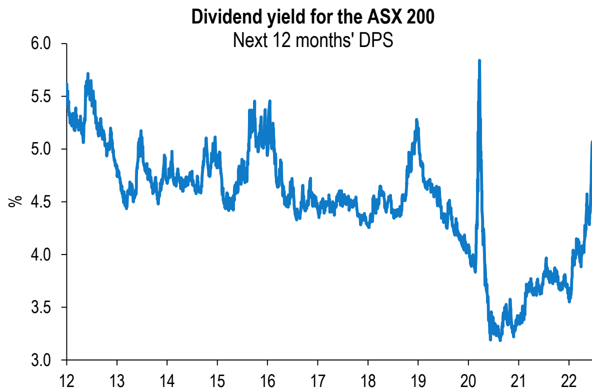
3. Equities – franking credits offering additional yield pick-up

Australian equities offer a solid dividend yield that has a long history of growth (average dividend growth rate of ~4%). Forward dividend yields for the ASX 200 are currently sitting around ~5%, with Financials and Materials / Energy sectors in particular offering some of the highest yields in the coming 12 months (albeit resource dividends are likely to be much riskier given their dependence on volatile commodity prices and so may underperform other high-yielding sectors on a risk-adjusted basis).

Australian equities have also been an attractive source of income for investors due to the treatment of franking credits, providing an average 1-2% additional yield pick-up

which brings the gross yield to ~6-7%. However, it is possible that equities underperform other yielding assets such as bonds and real assets on a risk-adjusted basis given further headwinds for the asset class as growth / recession risks mount which will see earnings fall under pressure. We prefer to look towards global equities for long term capital growth rather than yield given the yield advantages available for domestic stocks.

Australian equities are expected to yield ~5%



Source: Factset, MWM Research, July 2022

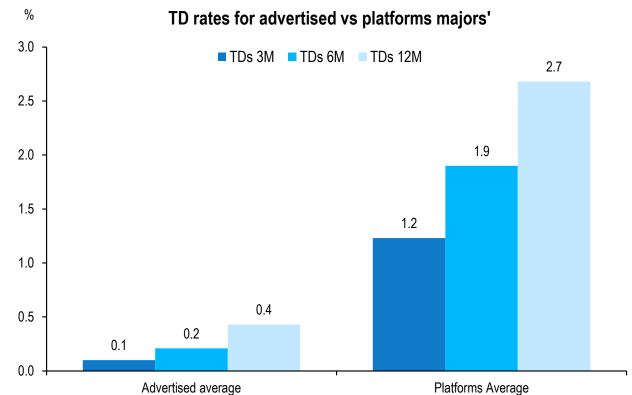
4. Cash – real yields are still negative but less so

Cash and term deposit rates have been held at historical lows due to a prolonged period of accommodative monetary policy / low interest rates. However, with central banks around the world, including the Reserve Bank of Australia (RBA), committed to fighting inflation and taking their foot off the QE pedal, cash is now relatively more attractive than in the past, although real cash / deposit rates are still firmly negative with inflation running in excess of 6%.

While deposit rates can be expected to follow the cash rate higher, and the risk-free nature of cash providing a natural hedge against further downside risks, a prolonged period of inflation can erode the real value (purchasing power) of cash. For investors willing to give up some liquidity, term deposits offer a further competitive step up in yield relatively to at-call cash accounts (current average rate for a 6-month term deposit at ~1.9% versus at-call savings accounts of ~0.40%).

At this stage, we would not recommend investors use cash / deposits for yield unless they have a capital preservation strategy (i.e., avoiding capital losses in the remainder of their portfolio) or as a short-term option until cash is put to use.

Deposit rates have risen from record lows



Source: Company data, Netwealth, AustralianSuper, Macquarie Research, June 2022

Macquarie WM Investment Strategy Team

The report was finalised on 2 August 2022.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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