Citi Wealth

Investment Strategy *Bulletin*

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The Strengthening Case for Income in a Portfolio

Key Takeaways

- Large swings in markets during the past few years were driven in phases by macroeconomic policies that went from easing to tightening to easing again (please see our November 2023 Quadrant). The 57.9% total return for the S&P 500 during 2023-2024 "closes the loop" from this multi-year period and reverses the bear market of 2022.
- 80% of medium-risk global portfolio total returns of these past two years are due to asset price appreciation. Only 20% reflects portfolio income. The historic average for this ratio is 57% and 43% respectively over the past 10 years. Our takeaway: The much higher ratio of capital appreciation of late is only the norm of a strong bull market.

  While moderately bullish, we have more conservative expectations for S&P 500 returns than the 26% average of the past two years. A steady valuation on our 2026 estimate for the S&P 500 would generate a roughly 9% total return this year. Yet a wide range of more positive or negative outcomes is possible.

Potential Portfolio Implications

- Market uncertainty over new government policies may present an opportunity to extend portfolio duration on higher US Treasury yields early in 2025. The UST 10y already reached our YE25 target of 4.75%, achieving an intraday high this week of 4.78% as of Friday morning. Should Treasury yields move higher still to 5%, adding portfolio duration may be warranted.
- Balanced portfolios might take note of both high US interest rates and positive expected economic growth by increasing their allocation to US High Yield ("HY") bonds and senior-secured bank loans that yield currently 6-8%.
- In equities markets, factors such as dividend growth and dividend yield were left in the dust again by the appreciation of US tech-related shares in 2024. In our view, this underperformance of the past year could be viewed by investors as an opportunity to add exposure into a lesser valued asset class. Our studies show that dividend growers have outperformed the S&P 500 with less volatility over 30 years.

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The Strengthening Case for Income in a Portfolio

As 2025 begins, we can report firsthand that forecasters have fingers crossed in the hopes that their views pan out during the coming year. With a US administration that avows a policy of keeping its opponents (and even allies) “off guard” with uncertainty over what it might do, one should not be overconfident.

The Federal Reserve also appears to be pausing for now in part because of this policy risk. Given a favorable economic situation as exemplified by Friday’ strong employment report showing the unemployment rate dropping from 4.2% to 4.1%, this is perfectly understandable as there is no immediate rush to cut rates quickly.

The fixed income market has also been pricing in increasing uncertainty. For example, the 10y Treasury Inflation Protected Securities (TIPS) implied inflation break-even yield has only gained just over 40bps since September to 2.44%, while the “real” TIPS yield has moved over 80bps to 2.32%, closer to the 15y high of 2.58% set in October 2023. This suggests some concern over potential new Treasury supply resulting from possible new fiscal priorities such as tax cut extensions, as well as the possibility of a higher eventual run-rate for inflation.

This policy uncertainty may provide an opportunity to extend portfolio duration on higher US Treasury yields early in 2025. The 10y UST has already reached our YE25 target of 4.75%, achieving an intraday high of 4.78% as of Friday morning. Should Treasury yields move higher to 5%, adding duration may be warranted. While it will not be possible to know if the market has fully priced in these risks even at 5% yields, it will be closer to having done so in our view.

Of course, macroeconomic and regulatory policies are far from the only drivers of markets. Yet as we noted in last week’s CIO Bulletin, large swings in markets during the past few years were indeed driven in phases by macroeconomic policies that went from easing to tightening to easing again (please see our “three phases” framework in the November 2023 Quadrant).

The 57.9% total return for the S&P 500 during 2023-2024 “closes the loop” from this multi-year period. It reversed the bear market of 2022. The latest two-year rise in share prices also reflects expected gains in corporate profits and monetary easing.

When we look at medium-risk global portfolio returns of these past two years, 23% reflects gains in asset prices. Only 6% reflects gains in portfolio income, resulting in an approximately 80/20 split between price gain and income. This is even as interest rates are now dramatically higher than circa 2020. While complicated in measurement, the historic average for this ratio is 57% and 43% respectively over the past 10 years.

Our takeaway: The much higher ratio of capital appreciation of late is only the norm of a strong bull market.

As capital gains, especially unrealized gains, are generally taxed at lower levels than income, asset price appreciation is certainly the preferred sort of return for many investors. But it’s also the more volatile and less certain component of portfolio returns.

New developments on the AI front seem sure to generate evolving new winners and losers in equities markets. We are not looking to de-emphasize seeking growth and asset price appreciation. But as we may (*may*) be shifting from the “rapid appreciation” phase for US equities to something more modest, income in portfolios mathematically increases in importance.

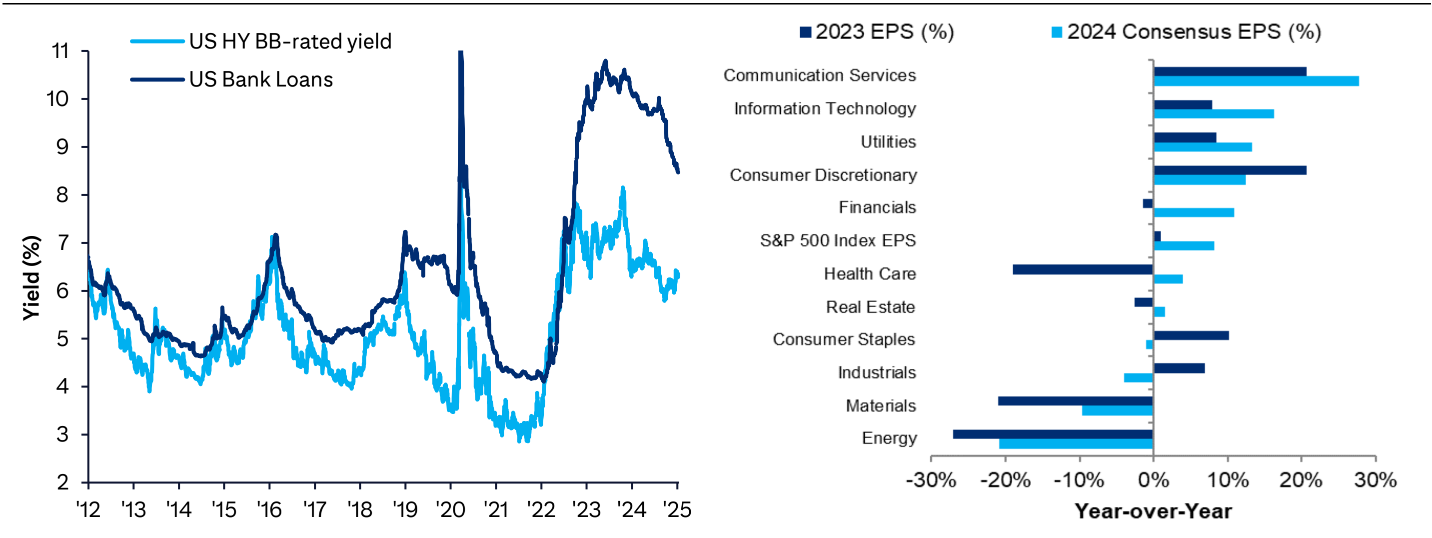
While bullish, as noted last week, we would simply have more conservative expectations for S&P 500 returns than the 26% average of the past two years (please see our Wealth Outlook 2025, and last week’s CIO Bulletin). For what it’s worth, a steady valuation on our 2026 estimate for the S&P 500 would generate a roughly 9% total return this year. Yet a wide range of more positive or negative outcomes is possible.

With this in mind, we believe the value of income rises in the calculus of returns for this year and on average in the future. As we discussed in our November Quadrant, the wide spread on high yield bank loans above US policy rates seems to reflect the expectation of policy easing ahead. The asset class should benefit some from the modest scale of Fed easing that is likely compared to recent decades when the Fed funds rate averaged just 1.75%. As such, in our tactical asset allocation, we’ve used loans to significantly fill our allocation to high yield.

The tight spreads of the high yield bond market have discouraged many investors, representing an historically high valuation for the asset class (see **FIGURE 1**). However, it also reflects a shift toward higher quality borrowers in the high yield bond market, with a scarcity of issuance. Private credit has filled an increasing share of demand for loans, leaving the higher quality issuers in the high yield bond market looking more akin to low investment grade borrowers. The broadening we expect in corporate profit gains and easing of bank lending standards suggests tight high yield credit spreads will be maintained (see **FIGURES 2-3**).

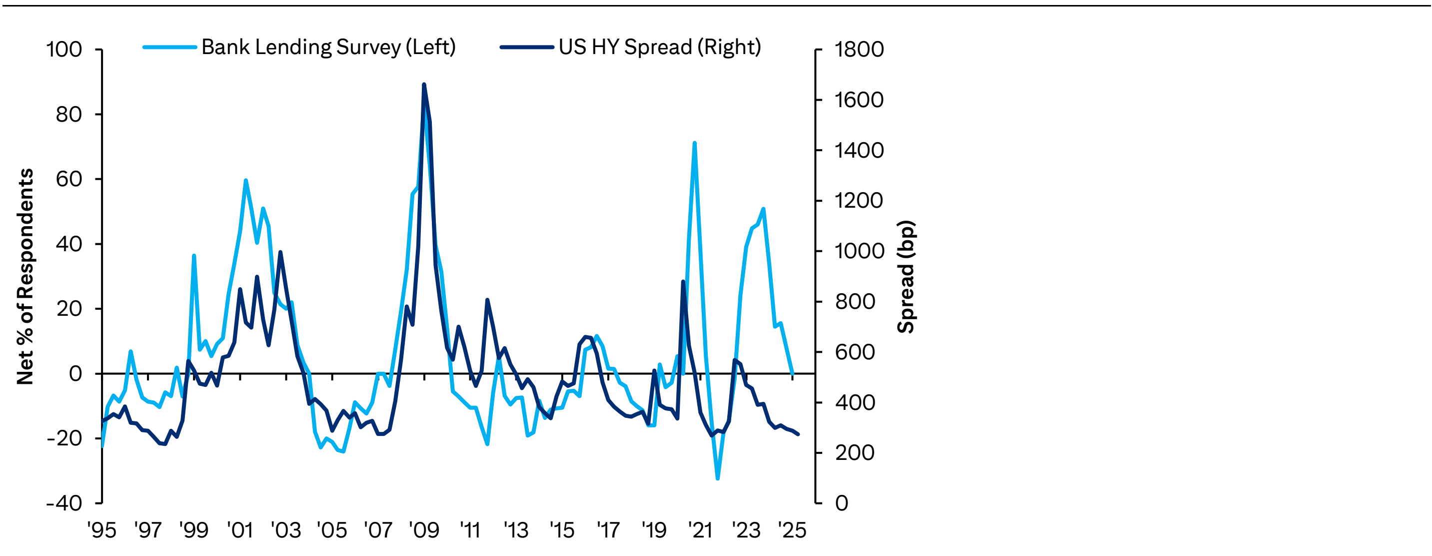
FIGURE 1: High yield loan yield vs BB high yield bonds

FIGURE 2: 2023/2024 EPS gains for S&P sectors



Source: Bloomberg as of January 3, 2025. Indices used as proxy are Bloomberg High Yield BB Corporate Bond index and Morningstar/LSTA US Leveraged Loan Index. S&P indices are used as proxy for sectors. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

FIGURE 3: Net easing/tightening of bank lending standards vs HY spread



Source: Bloomberg as of January 3, 2025. Fed Senior Loan Officer Survey and Bloomberg High Yield Corporate Bond index used. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

High yield bonds with yields in the 6%-7% range are a far cry from past crisis peaks but seem quite fundamentally well assessed. The interest rate backup, particularly among shorter-term government bonds since the autumn of 2024, makes the total return potential for the asset class more appealing within a diversified portfolio. The default rates of BB-rated securities and BBB bonds may turn out to be trivial in our base case view of the coming two years.

In essence, interest payments that deliver 7% in 2025 are considerably more certain than capital gains in the equity market. The upside for returns on credit are of course more limited than for equities. But this follows a period of sharp equity price appreciation, making the case for credit stronger at the margin.

Taking risk with a fixed income

As stated above, balanced portfolios might take note of both high U.S. interest rates and positive expected economic growth by increasing allocation to U.S. High Yield ("HY") bonds and senior-secured bank loans. As of January 9th, the investment grade ("IG") index yielded about 5.42%, while the HY index yielded about 7.42%[1]. The HY loan index yielded about 8.47%, with the largest 100 loan facilities of this index yielding about 7.77% (loans can only be accessed via funds).

HY bonds and loans pay higher yields than IG bonds because the credit risk is significantly greater for HY issuers primarily due to higher balance sheet leverage (a measure of company debt levels vs earnings), and accordingly default with a much higher frequency. For HY bonds and loans and including "distressed exchanges" for loans (a type of restructuring of the loan agreement), overall HY defaults in 2024 were near 5% (see **FIGURE 4**). However, pure payment defaults for loans were below 2% (see **FIGURE 5**), while defaults for HY bonds were less than 3% in 2024.

Given our expectation of robust real GDP growth this year of 2.4%, we expect credit spreads to be relatively stable and defaults to decline somewhat from current levels. Moreover, ample liquidity from both the public market and increasingly the substitution of "private credit" lending has reduced public market supply. The HY bond index, for example, has declined from almost $1.6 trillion notional value in 2021 to about $1.4 trillion today. Credit quality in the index has also improved, with about 50% of the index at "BB" rating, compared to under 45% in late-2023.

We maintain an overweight to HY overall through a position in HY bank loans. We think that unsecured HY bond positions in a portfolio should be slightly higher quality, around a "BB" credit rating. The index for this rating band yielded just under 6.36% as of January 9th. Issuers with lower credit ratings such as "B" and "CCC" – while typically offering higher yields – usually tend to have more involved credit risk dynamics. However, we are comfortable with lower-rate HY senior-secured bank loans (average index rating of "B") since typically the lenders both hold the borrowing company's assets as collateral and are "primed" to be paid first before unsecured creditors under a recovery scenario.

Despite being near multi-decade lows, we do not expect meaningful spread widening for BB-rated HY bonds or the loan index in 2025. We see the possibility to blend the two types of HY exposure within a portfolio allocation and potentially generate coupon income of around 7%, albeit while taking interest and credit spread movement risk, as well as default risk of the issuers.

[1] High yield proxy is the Bloomberg High Yield Corporate Bond index, IG proxy is Bloomberg Corporate Investment Grade index, and Bank Loans proxy is the Morningstar LSTA Leveraged Loan index.

FIGURE 4: S&P US speculative default rate vs high yield spread

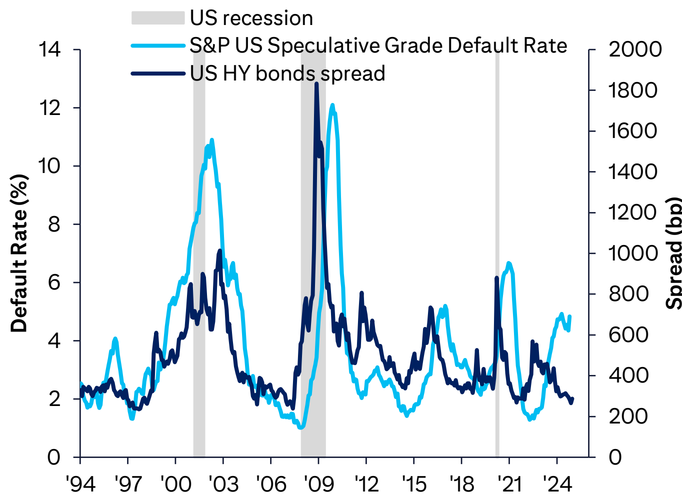
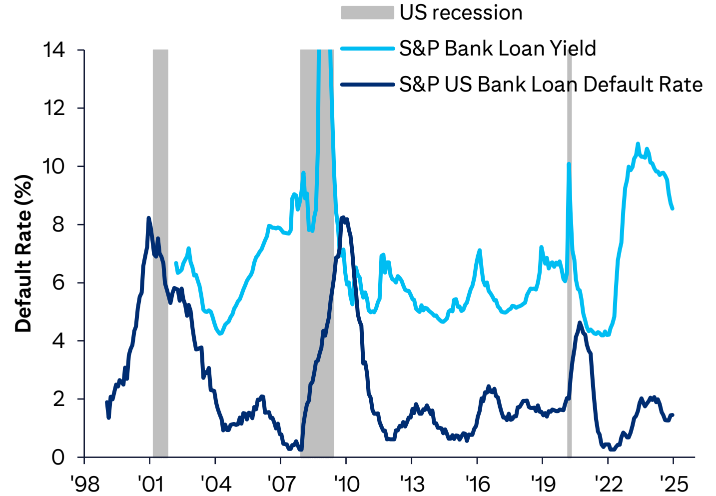


FIGURE 5: S&P bank loan yield vs default rate



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Increasing value in equity income

In equities markets, factors such as dividend growth and dividend yield were left in the dust again by the appreciation of US tech-related shares in 2024. Yet even during the past thirty years of tech-led growth, reinvested dividends have contributed to roughly half of equity total returns (see **FIGURES 6-7**).

FIGURE 6: S&P 500 vs S&P Dividend Aristocrats (Y/Y)

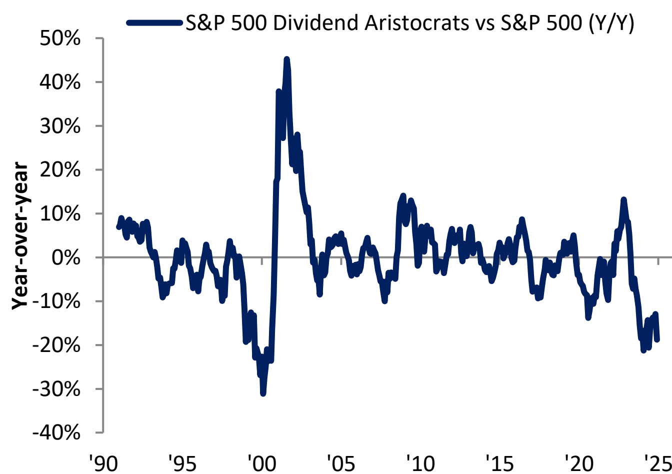
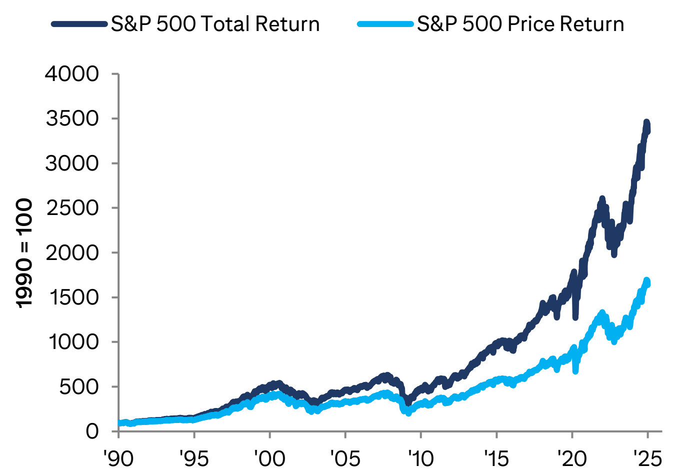


FIGURE 7: S&P 500 price vs total return



Source: Factset as of January 3, 2025. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

We've long highlighted consistent dividend growth as a useful proxy for quality. Firms that are able to regularly raise dividends across business cycles tend to boast resilient business models and a strong management culture. Indeed,

dividend growers have outperformed the S&P 500 over the last 30 years. Of course, the growth-driven Nasdaq 100 outperformed even this. But on a volatility-adjusted basis, dividend growers have shined (see **FIGURE 8**).

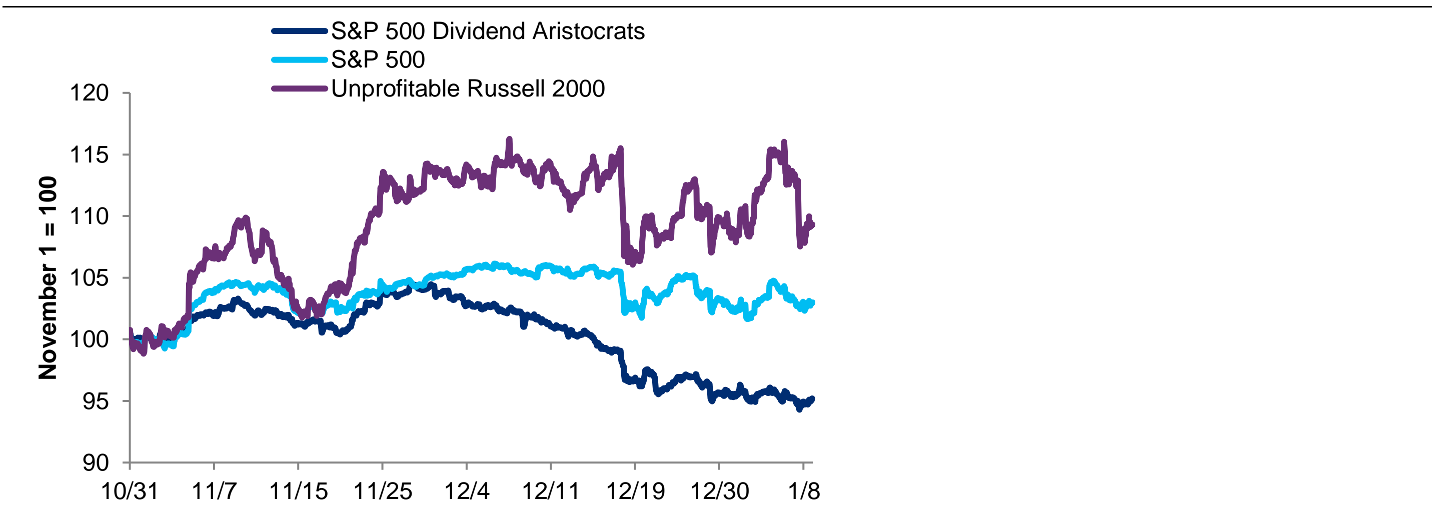
FIGURE 8: Dividend growers outperform the S&P 500 with less volatility

	S&P 500	Nasdaq 100	S&P Dividend Aristocrats
Average Annual Return	11.2%	15.6%	11.7%
Average Annual Volatility	15.1%	23.8%	14.0%
Information Ratio	0.74	0.66	0.84

Source: Bloomberg as of January 3, 2025. The information ratio is annual return divided by annual volatility. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Since November's US election, dividend growth strategies have underperformed high beta and lower quality shares (see **FIGURE 9**). Hopes for a more pro-business policy environment grew to arguably exuberant levels by mid-December, with unprofitable small caps tied to themes like AI, crypto, and quantum computing surging far ahead of blue chip large caps. Some of this excitement has since been tempered by the sharp rise in long-term yields over the past 3 weeks, leaving investors with a notably higher risk free rate to contend with. A backdrop of somewhat higher interest rates only heightens the importance of owning quality businesses that can deliver cash to shareholders in the near future – and diminishes the attractiveness of shares years away from achieving profitability.

FIGURE 9: Dividend growth has underperformed since the election



Source: Bloomberg as of January 3, 2025. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Asset allocation looks to achieve alpha for individual asset classes – stronger returns per unit of risk. It also looks to low or negative correlation between these individual asset classes to improve overall portfolio returns on a volatility-adjusted basis. We believe a risk-seeking portfolio has some room for "moonshots." As we noted last week, suitable and qualified investors may be able to find opportunistic strategies in alternatives including venture capital exposure. At the same time, completely ignoring income in portfolios – even for risk takers – would be risking a historic mistake in our view.

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Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

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