Brompton Insights

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How to position your portfolio for a declining interest rate environment

Concerns about slowing global growth, the trade war, and declining inflation expectations set the stage for the Federal Reserve to lower its policy rate by 25 bps last month. Furthermore, the market is currently projecting approximately 100 bps of additional cuts through September 2020, while global bond yields are currently trading at or near all-time lows. While lower interest rates typically have a positive impact on most asset classes, portfolio positioning during a period of declining rates can be extremely important.

In this note, we discuss some key themes that may resonate in the current market cycle and how to incorporate these views in your portfolio.

1. Lock in higher yields

Dividend yields may continue to fall if rates decline further. Income producing assets will likely rise in price which may result in a decrease in their future dividend yield. Also, amid concerns of slow global growth, trade tensions between the U.S. and China, and a lower earnings growth rate in the US, we may continue to see elevated levels of volatility in equity markets.

What to consider? U.S. investment grade preferred shares offer a combination of high yield and high credit quality relative to other fixed income asset classes. In addition, U.S. preferred shares have historically exhibited lower volatility compared to high yield bonds and equities, and may help generate yield during periods of market uncertainty. An active investment strategy, can provide the beneift of focusing on resilient businesses that can maintain stable cash flows to pay dividends should there be an economic slowdown.

Related Brompton Funds

Brompton Flaherty & Crumrine Investment Grade Preferred ETF (BPRF and BPRF.U)

2. Go defensive without sacrificing yield

Despite market concerns around global growth and the risk of a prolonged trade war, the US economy remains relatively strong, as unemployment is near historical lows and consumer confidence is high. Nevertheless, the Fed decided to cut rates in July. It seems apparent that the cut is pre-emptive, one which sees impending risks and is used as insurance to mitigate the possibility or impact of a recession.

A good strategy might be to move to a defensive portfolio position while maintaining equity market exposure, as selling equities entirely may result in a missed opportunity if the economy continues to do well and global growth concerns end up being misguided.

What to consider?

High yielding equities of companies in defensive sectors such as utilities, health care, telecom, consumer staples, and real estate investment trusts (REITs), can help increase income in your portfolio and potentially lower volatility as these sectors typically perform well in declining rate environments. Companies operating in defensive sectors tend to have relatively stable earnings through out the business cycle and therefore can be less sensitive to equity market declines. In addition, defensive stocks generally have higher dividend yields relative to the broader market, which makes them attractive to investors seeking income in a low or declining interest rate environment.

Related Brompton Funds

Brompton European Dividend Growth ETF (EDGF)

Brompton Global Dividend Growth ETF (BDIV)

Brompton Global Healthcare Income & Growth ETF (HIG and HIG.U)

3. Invest in a covered call strategy

Another option is a covered call strategy which involves investing in a portfolio of stocks and then writing call options on the same stocks that are held in the portfolio. This strategy aims to generate income from selling call options, in addition to receiving any dividend income from the stocks held in the portfolio, and provides the opportunity to participate in equity market returns with potentially less volatility.

What to consider?

Large capitalization equities that provide regular distributions, have resilient business models, strong cash flows and strong management teams may outperform during periods of market stress and increased volatility. Additionaly, covered call strategies typically work well in falling or volatile markets as the option premiums received may reduce the impact of any market declines.

Related Brompton Funds

Brompton European Dividend Growth ETF (EDGF)

Brompton Global Dividend Growth ETF (BDIV)

Brompton North American Financials Dividend ETF (BFIN and BFIN.U)

Brompton Global Healthcare Income & Growth ETF (HIG and HIG.U)

Brompton Tech Leaders Income ETF (TLF and TLF.U)

4. Invest in Dividend Growth Strategies

Dividend paying equities currently look attractive relative to bonds. As of August 20, 2019, the dividend yield of the S&P 500 Index was 2.4%, well above the 10-year U.S. Treasury bond yield of 1.6%.[1] Furthermore companies that grow their dividends have historically outperformed the broader market with lower volatility. Over the last 10 years, global dividend growth companies delivered outperformance of 2.8% per annum compared to the broad market while volatility was 12% lower.[2] Firms that can increase their dividends, particularly during times of falling rates, are usually more resilient firms that are less exposed to market risk.

What to consider?

Global large capitalization firms with strong business fundamentals may provide opportunity for diversification and the potential for enhanced returns, particularly for investors in Canadian equities who have their risk concentrated in a few sectors such as materials, energy and financials.

Related Brompton Funds

Brompton European Dividend Growth ETF (EDGF)

Brompton Global Dividend Growth ETF (BDIV)

(1) Source: Thompson Reuters, as at August 20, 2019.

(2) Source: MSCI, as at July 30, 2019. Global dividend growth companies are represented by the MSCI World Dividend Masters Index and broad market is represented buy the MSCI World Index.

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