Dividends strike back

UBS Asset Management | Amid uncertain markets, investor interest in high quality, higher yielding stocks is rising quickly

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Highlights:

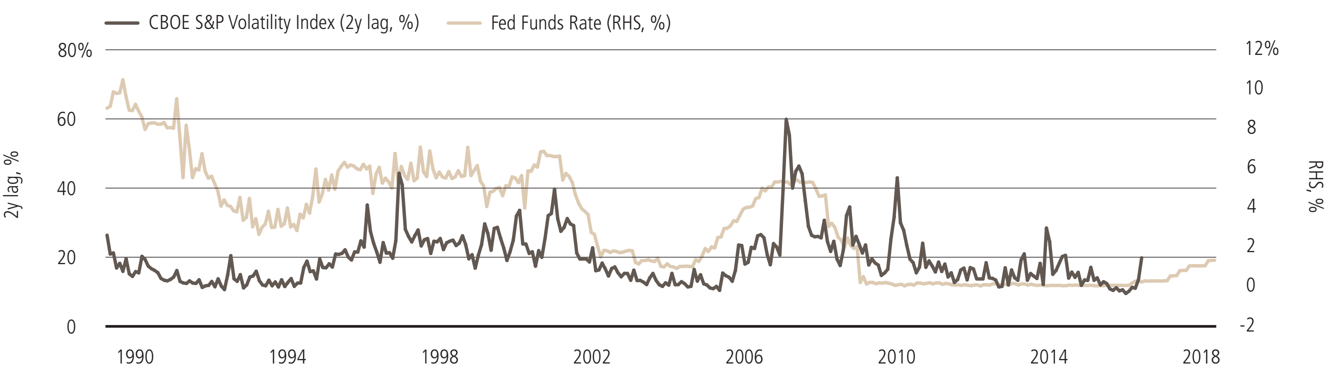
– Rising geopolitical risks, the gradual withdrawal of liquidity by central banks, and a higher degree of uncertainty around key macroeconomic variables including global growth and inflation suggest a higher volatility regime may persist in equity markets.
– Following the strong equity market rally of recent years, equity returns going forward may be lower as concerns about higher inflation and a global growth slowdown weigh on investor risk appetite.
– Historically, higher yielding stocks in the US outperformed the broader market in both rising volatility environments and when overall market returns are below the long-term average.
– Against this backdrop, we believe that investor focus will turn once again to the merits of potential cash returns in higher yielding equities where that yield is sustainable, and to dividend growth in particular.

Low volatility and strong returns couldn't last forever. And investors are now looking for equity strategies that are better equipped to weather what many believe will be a bumpier ride in the coming years. We believe dividend stocks may offer a solution.

2017 saw equity markets benefit from strong and synchronized global growth, muted core inflation, stronger-than-expected corporate earnings, and accommodative monetary policy. While some of these key characteristics remain in place in 2018, a number of circumstances have changed, suggesting the investment journey going forward is unlikely to be as smooth. Uncertainty is focused on issues that include the interaction between unemployment and inflation as developed world jobless rates continue to fall, the potential for increased fiscal stimulus in a number of major developed economies, the outlook for China as the pace of deleveraging policies accelerates, the 'neutral' rate in the US and how quickly and to what level the Federal Reserve will raise rates. Under these circumstances, many investors are looking to dividend stocks as a potential source of steady returns.

When it comes to market reaction to rising interest rates, history gives us a very clear guide on what to expect. As Exhibit 1 shows, there has been a lag of around two years between changes in benchmark US interest rates and a change in market conditions in the past.

Exhibit 1: CBOE S&P 500 Volatility index (LHS, %, 2y lag) v Fed Funds Rate (RHS, %)



Source: Datastream, UBS Asset Management.

All this comes at a time when global geopolitical risks focused on protectionism and trade wars are at their highest level in years. While we do not see a significant impact on the global growth rate from the current posturing, there are clearly risks of an escalation in tariffs between China and the US that would raise prices and reduce trade globally, constraining market returns.

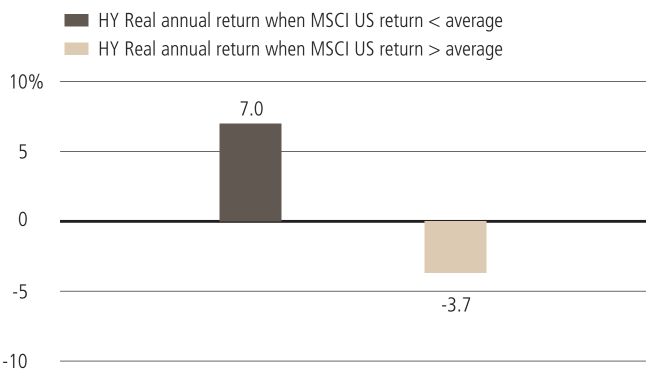
Historically, higher yielding stocks in the US outperformed the broader market in both rising volatility environments (Exhibit 2) and when overall market returns are below the long-term average (Exhibit 3) Against this backdrop, we believe that investors' focus will turn once again to the merits of potential cash returns in higher yielding equities where that yield is sustainable, and to dividend growth in particular.

Of course, looking at dividend yields in isolation tells investors nothing about the health of underlying corporate balance sheets, the sustainability of the dividend or the potential for continued dividend growth.

But looking forward, we believe that the outlook for corporate dividends generally remains robust. At current levels, global payout ratios, while marginally above their 40-year average,[1] do not look stretched. Critically, corporate balance sheets globally are in good health—bolstered by lower debt levels, low interest rates, as well as strong growth in profits and cash generation.

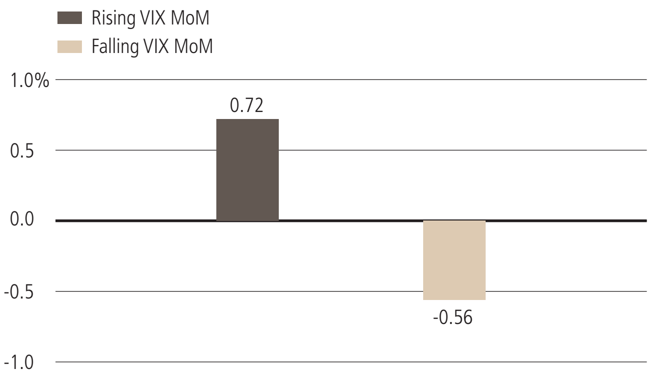
In a world where lower expected returns and higher volatility are likely to persist, we believe the case for equities with attractive yields and sustainable dividend growth looks compelling.

Exhibit 2: Relative average annual performance of MSCI US Investable High Yield vs MSCI USA when MSCI US returns are above and below average (1995–2017)



Source: Datastream, UBS Asset Management.

Exhibit 3: Relative average monthly performance of MSCI US Investable High Yield vs MSCI US by change in VIX 1995–early 2018



Source: Datastream, UBS Asset Management.

[1] Source: Datastream, UBS Asset Management.

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