Investment Insights

UBS Asset Management
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Robust corporate balance sheets, strong profits growth and rising corporate confidence make a powerful combination. Can rising dividends and share buybacks provide additional support to global equities in the coming months? *Investment Insights* investigates.

Animal spirits and the coming balance sheet bonanza

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- 'Animal spirits' have returned; still significant supports to equities eight years into the bull market as economic growth momentum broadens
- We expect equity returns broadly in line with earnings growth in 2018; returns therefore likely to be above-average but below 2017
- We believe there is material on-going support for high equity multiples from low rates and from low economic, interest rate and earnings volatility
- We see an additional boost to equities in 2018 from increasing distributions to shareholders
- Robust corporate balance sheets, strong cashflows and US tax reform suggest increasing prospect of rising ordinary and special dividends, share buy backs and earnings-enhancing M&A
- The same drivers are also likely to lead to rising capital expenditure - prolonging the growth cycle while providing an additional potential boost to productivity and margins
- Main risks to global investor risk appetite are faster-than-expected pace of monetary policy tightening, trade protectionism and hard landing in China…
- …but in aggregate the supports to global equities are broadening not narrowing

If the fact that the best macroeconomic conditions for global equity markets since the financial crisis are occurring eight years into the recovery challenges the traditional trajectory of economic and market cycles, there is at least some comfort in acknowledging that little in the post-financial crisis world of markets has followed a conventional path.

Nearly a decade has passed since the onset of the financial crisis. Most of the post-crisis backdrop has been characterized by anemic economic growth. Yet global equity investors are currently enjoying a prolonged sweet spot of nigh-on perfect conditions for risk assets: an unexpectedly strong and synchronized global growth impulse, muted core inflation, stronger-than-expected corporate earnings buoyed in the US by substantial tax reform, a more modest and better managed China slowdown than many predicted, rising but still low bond yields and accommodative monetary policy.

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We see three main risks to this 'Goldilocks' equanimity:

- a faster than expected slowdown in China
- the rising threat of stagflationary trade protectionism
- a swifter tightening of monetary policy than markets currently expect in the event that core inflation accelerate as output gaps narrow

We see the prospect of a change in the overall global policy regime as posing the greatest potential threat to risk assets, but ascribe a low probability to this outturn given the structural forces weighing on inflation. Crucially, many of the key supports to global growth and to global equity markets are durable and look likely to remain in place well into 2018. In particular, the drivers of global demand have broadened geographically and sectorally, with the recent pick-up in manufacturing and capital expenditure simultaneously prolonging the cycle while reducing the likelihood of a sharp slowdown. Have the 'animal spirits' of confidence finally been shaken from the post-crisis slumber? Given the strength of global macroeconomic survey data, it certainly looks that way.

> Our starting point is that the combination of strong cashflow, rising margins and broad deleveraging since the financial crisis have left corporate balance sheets in robust shape.

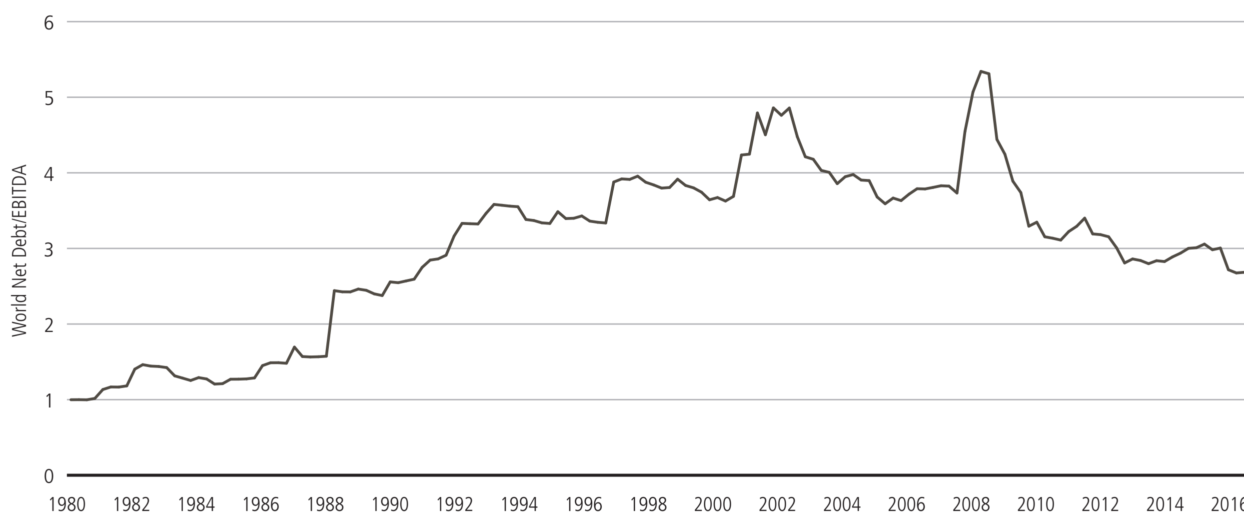
Despite the improving growth backdrop, our base case is that monetary policy globally remains broadly accommodative, with aggregate liquidity continuing to expand, at least in the first half of the year, as on-going Quantitative Easing (QE) programs in Europe and Japan more than offset the slow reversal of QE in the US. US rate hikes are also likely to be gradual under new Federal Reserve chair Jerome Powell. Meanwhile, after a year in which profits growth generally outpaced the rises in equity markets, equity valuations on PE multiples have moderated marginally and, crucially in our view, remain compelling against bonds despite the recent back-up in yields globally.

Given the strength of demand and earnings momentum we see further upside to global equities in 2018. And while returns for global equities in the coming year may not match those of 2017, the prospect of double digit global earnings growth suggests investors may still enjoy a year of above-average returns even without any additional multiple expansion.

Importantly, there is also likely to be fresh support to global equities from higher distributions to shareholders. Flush with cash from strong earnings growth and in the US, from recent tax reform, the current backdrop suggests strongly that special dividends, rising ordinary dividends, share buy backs and earnings-enhancing M&A are all likely to increase in the year. Our starting point is that the combination of strong cashflow, rising margins and broad deleveraging since the financial crisis have left corporate balance sheets in robust shape. Key metrics including Net Debt/EBITDA (Chart 1) and interest cover (Chart 2) reveal the healthy state of corporates in aggregate at a time when corporate margins continue to rise (Chart 3).

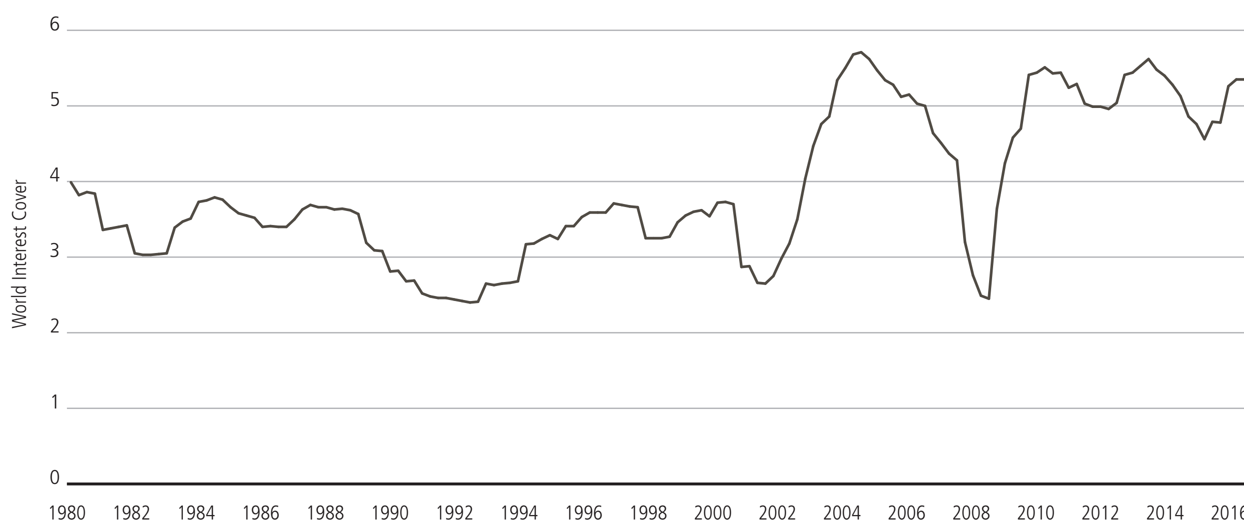
Improving corporate balance sheets

Chart 1 Datastream World Index Net Debt/EBITDA (Dec 1980 – Dec 2017, Quarterly Data)



Source: UBS and Datastream as at December 31, 2017

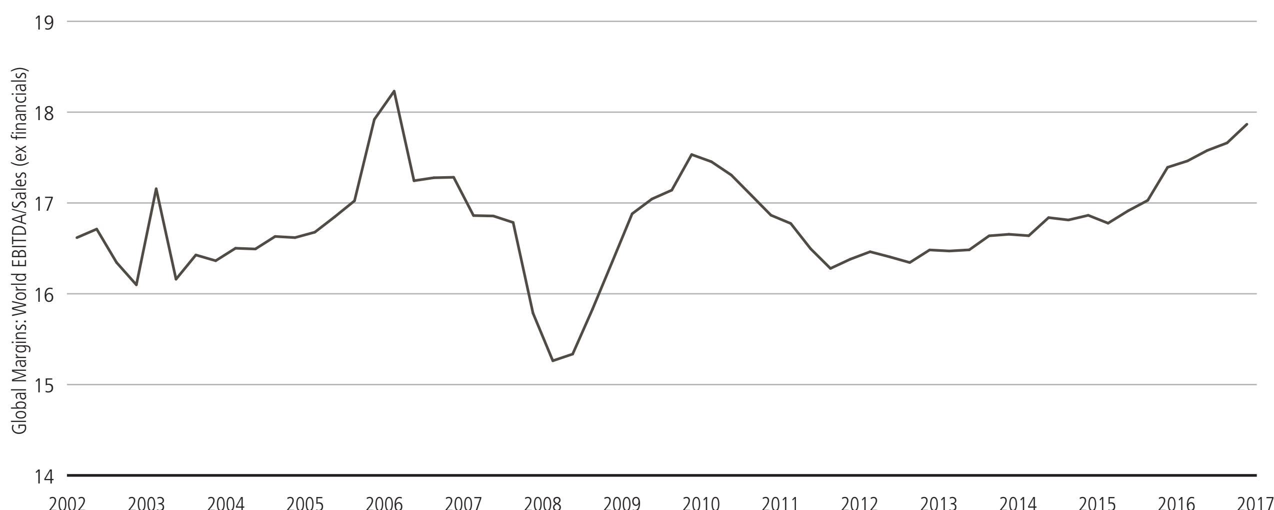
Chart 2 Datastream World Index Interest Cover (Dec 1980 – Dec 2017, Quarterly Data)



Source: UBS and Datastream as at December 31, 2017
Interest Cover = earnings per share divided by debt interest charge per share

Rising global corporate profit margins

Chart 3 Datastream World Index EBITDA/Sales (Dec 2002 – Dec 2017, Quarterly Data)



Source: UBS and Datastream as at December 31, 2017

In particular, we believe that the outlook for corporate dividends generally remains robust. Adjusting for inflation, dividend per share (DPS) growth globally has risen sharply since the lows of the late 1990s and early 2000s (Chart 4). Principally, we believe that this higher rate of real dividend growth simply reflects the gradual return of corporate dividend payout ratios to their long-term average.

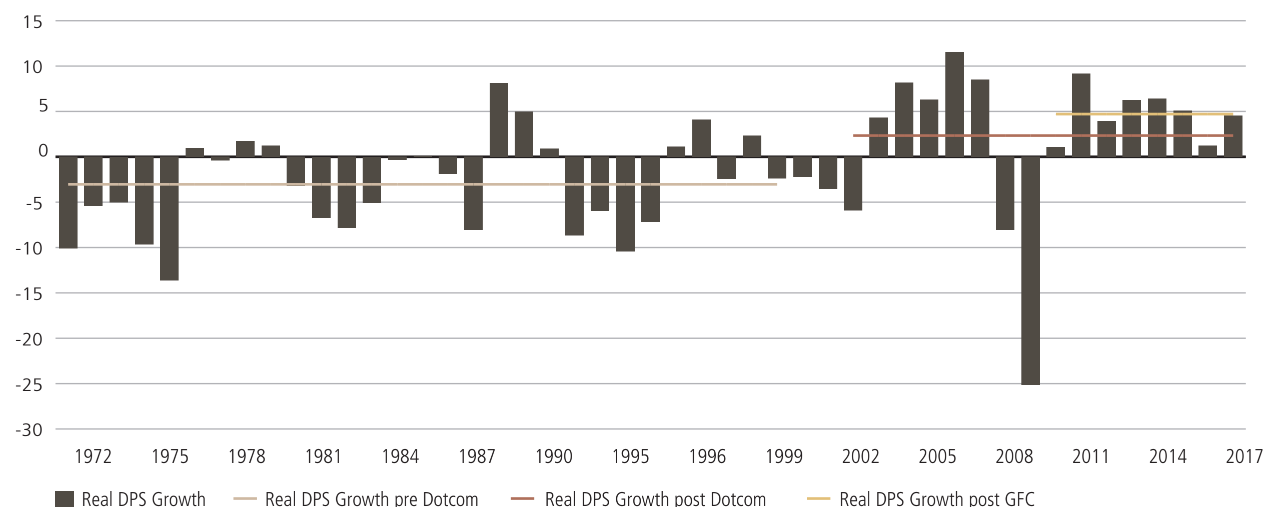
However, we also believe that both the subsequent rise in real DPS growth and in corporate dividend payout ratios globally reflect the impact of ageing investor populations and their broader preference for capital return over capital investment in a world of low yields (Chart 5). Given the structural nature of these demographic shifts we do not expect the pressure on corporates to return capital to shareholders to abate anytime soon.

Despite the step change higher in real DPS growth since the financial crisis, global payout ratios do not look stretched (Charts 6 and 7) – particularly

We expect payout ratios to rise further in the coming years as demand for income stays high and as corporate confidence in both the earnings and policy outlook increases.

Rising global real DPS growth

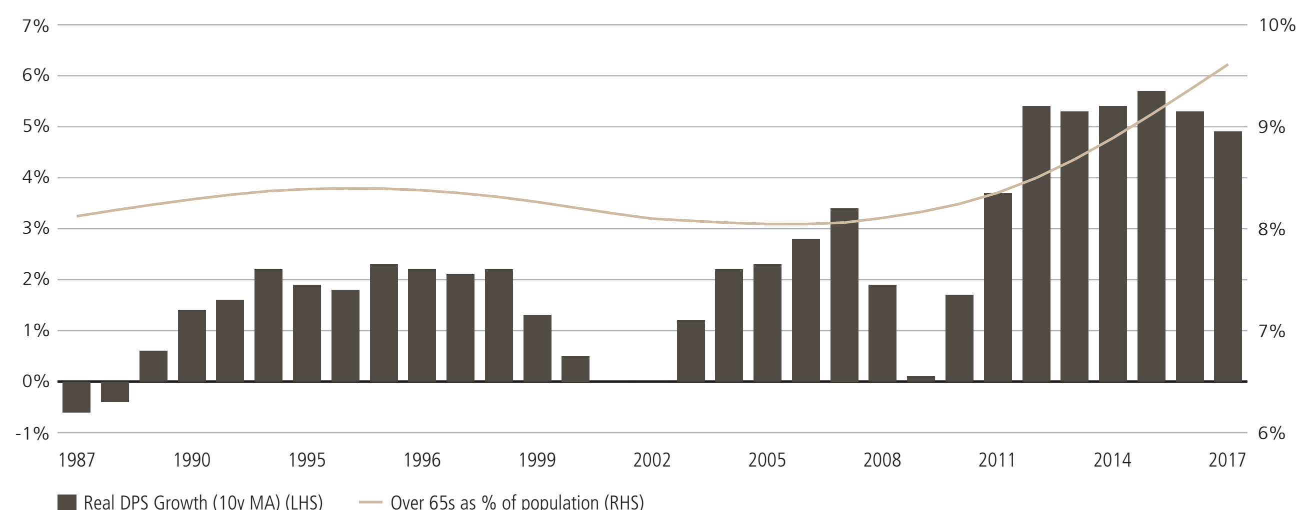
Chart 4 MSCI World Real DPS Growth 1971–2017



Source: UBS and Datastream as at December 31, 2017

Aging populations influencing dividend policy?

Chart 5 MSCI US Real DPS Growth v US over 65s as % of population



Source: UBS, Datastream and UN DESA Population Division *'World Population Prospects 2017'*

in light of the strength of corporate balance sheets and current earnings momentum. We expect payout ratios to rise further in the coming years as demand for income stays high and as corporate confidence in both the earnings and policy outlook increases.

Regionally however, the picture is more nuanced. Corporates in Europe (ex UK) and Japan have, in aggregate, spent the post-financial crisis period restoring balance sheets. US corporates however, have sought to exploit low interest rates by refinancing and raising fresh debt capital at lower rates. Much of that capital has been returned to shareholders in the form of earnings-enhancing share buy backs as companies exploit the current gap between corporate bond yields and equity earnings yields.

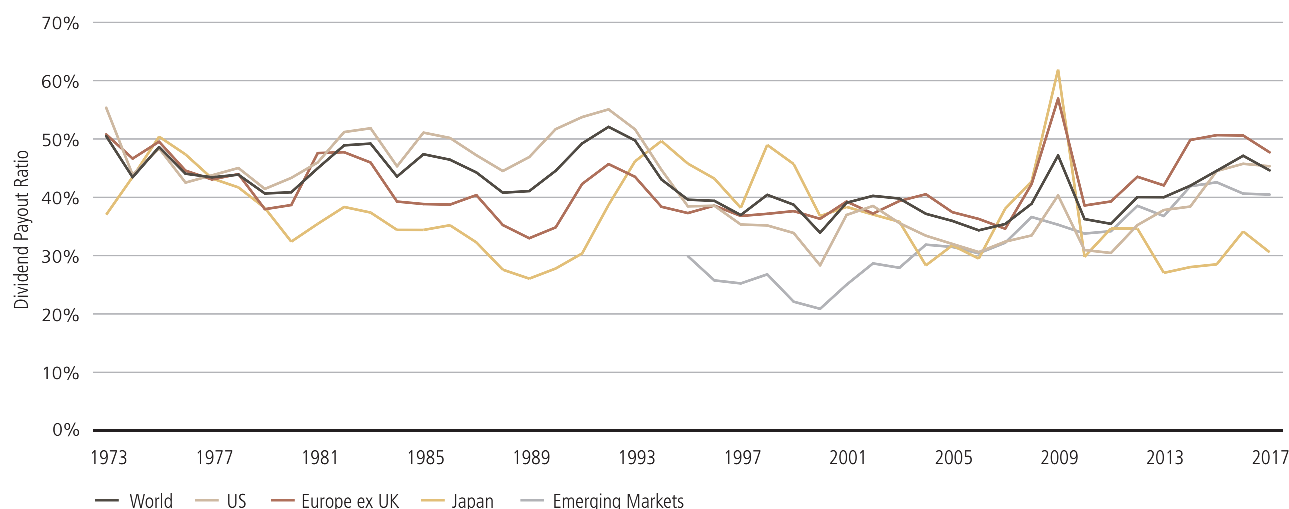
So while the US is the only major developed country where measures of corporate leverage have been rising in recent years, we do not believe that this development precludes further returns to shareholders or dividend growth in the near–term, particularly in light of the obvious boost to the US economy and to short-term US profitability from corporate tax reform. In fact, there are strong arguments that US corporates have simply adopted a more efficient capital structure than their international peers in raising debt to buy back shares.

We believe that the boost to underlying US earnings from recent tax reform, to cash levels from continued revenue growth in combination with high

Payout ratios not stretched

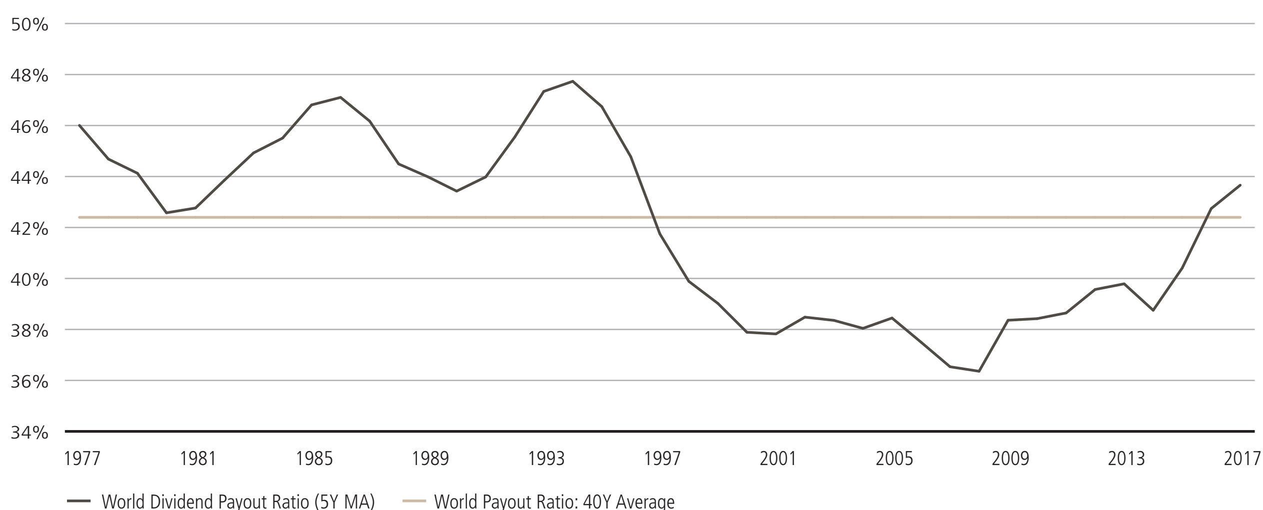
Chart 6 Dividend Payout Ratios

Datastream World, US, Europe ex UK, Japan and Emerging Market Indexes (1973 - 2017, Annual Data)



Source: UBS and Datastream as at December 31, 2017
Payout Ratio = Dividends per share as a proportion of earnings per share

Chart 7 MSCI World Dividend Payout Ratio (5y Moving Average)



Source: UBS and Datastream as at December 31, 2017

margins (Chart 3), and from the repatriation of cash held by US corporates in overseas subsidiaries, is likely to see further special dividends and buy backs provide fresh support to equities. Strong cash positions are also likely to drive an increase in corporate M&A and in capital investment. Both developments, should they occur, are likely to be positive for equities, with an increase in capital expenditure prolonging the cycle while potentially boosting productivity and margins.

The argument for rising cash returns elsewhere in the world is more straightforward and not complicated by the vagaries of the US corporate tax code. There is little question that the biggest upside surprises in growth in 2017 came from Europe and from Emerging Markets rather than from the US.

While sector differences account for some of the divergence in both EPS and DPS growth between the US and the rest of the world since the financial crisis, the remainder is accounted for chiefly by the quick rebound in demand and the US economy's more advanced state. In short, there is more significant cyclical upside in both earnings growth and dividend growth outside of the US (Chart 8) as companies in Europe, Japan

and in Emerging Markets enjoy the operational gearing and rising return on equity (ROE) as their recovery matures and gathers pace.

Given the current low rates and spreads for corporate debt, there is also the opportunity for non-US companies to mimic their American counterparts and optimize their capital structure by releveraging and using the capital to retire equity – raising Earnings Per Share and Dividends per Share mechanically by reducing the number of shares in issue. As corporate confidence grows in the sustainability of the recovery grows, we expect to see a degree of releveraging in Europe and Japan in particular.

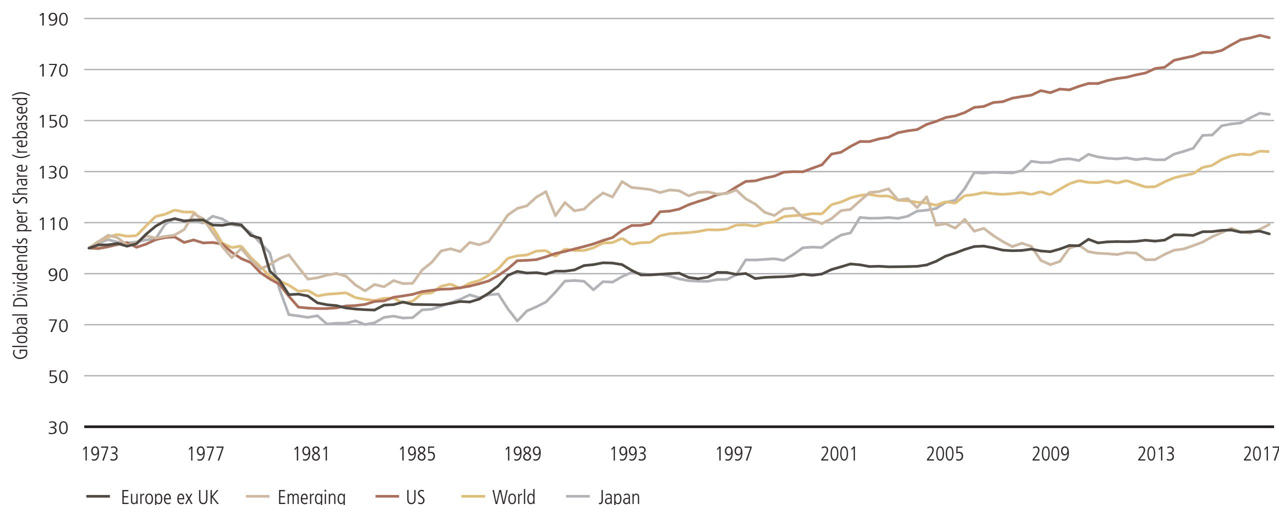
Given the better growth and higher return opportunities available in emerging markets, a lower payout ratio in EM than exists in developed countries seems entirely logical (Chart 9). Nonetheless, a gradual convergence to the higher payout ratios of developed countries seems likely as emerging economies slowly mature.

We see continued upside for global equities in 2018 as synchronized global demand growth drives earnings higher. If that were not enough, robust corporate balance sheets, rising cash positions and the continued valuation discount of equities relative to bonds create a very strong likelihood of rising special dividends, share buy backs, balance sheet optimization, capital investment and M&A – all of which are likely to provide further support to equities.

It feels an odd thing to write some eight years into a global bull market, but while there are clearly risks to global equities, on balance the supports are broadening and not narrowing.

Chart 8 Global Dividend Per Share Growth by Region

MSCI World, US, Europe ex UK, Japan, Emerging Markets Dividends Per Share (Dec 2007 to Dec 2017, Monthly data rebased to 100)



Source: UBS and Datastream as at December 31, 2017

Chart 9 EM Payout Ratio relative to World

Source: UBS and Datastream as at December 31, 2017

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