MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 009 // **8 February 2021**

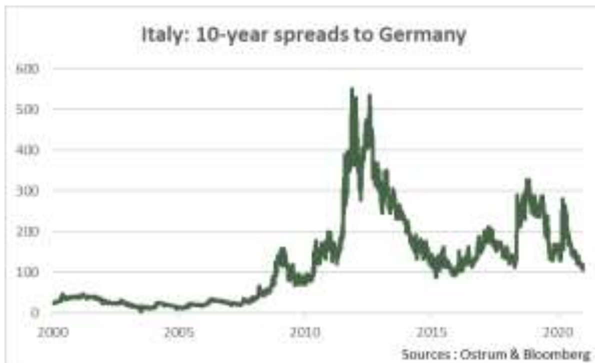
Topic of the week: Dividend policy and financial strategies

- **Shareholder retribution policies is an essential element to analyze equity markets.**
- **Dividend payments et share buybacks send different signals as regards corporate profitability,**
- **After a tough year 2020, the outlook for increased distribution will likely sustain the dividend investment theme looking out a few years.**

Market review: Infinite reflation

- **Equities burst higher as GameStop dust settles amid stronger USD**
- **US yield curve steepening resumes**
- **Draghi asked to form government, BTP spreads shrink under 100bp**
- **Credit: spread compression remains the trend**

Chart of the week



At the time of writing, Mario Draghi is still looking for a majority to govern. However, the markets have already reacted. Italian 10-year spreads fell below 100 basis points for the first time since 13 January 2016.

It should also be remembered that last year the spread had touched 279 bp on March 17 (the day before the PEPP announcement).

We can also note that during the last decade the Italian spread has been less than 100 bps for only 60 days! The lowest in the last decade was 88 bp, we're at 5 bp tonight.

Figure of the week

40%

Source : Ostrum AM

The vaccination effort is in full swing, but is extremely poorly distributed. According to Bloomberg, out of the 119.8 million doses administered last week, 45.4 million were administered in the United Kingdom or the United States, or 40%.

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● **Topic of the week**

Dividend policy and financial market strategies

The shareholder retribution policy is a key element of equity market analysis. Dividend payments contribute a large share of total equity return. After a tough year 2020, the outlook for increased distribution should underpin the dividend investment theme going forward.

Dividend payments make up a large share of total returns on equity investments. The recurrent cash payment indeed contributes to reduce downside risks to equity holdings, which tend to be highly sensitive to economic growth.

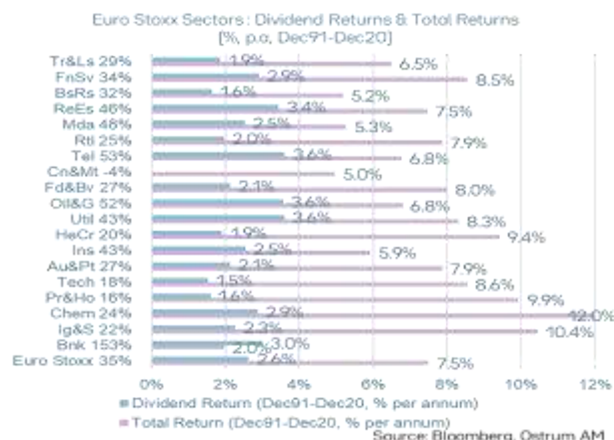
The corporate earnings distribution policy is a reliable signal for investors as regards prospects for profitability through the economic cycle. Consequently, the dividend yield is often used as a criterion to define factor-based investment strategy within equity markets. Dividend factor returns may improve over years to come after a difficult year 2020. The consensus projections and marketable financial instruments indexed to dividend flows provide insight as regards the outlook for increased payouts.

In parallel, equity buyback programs entail an alternative to dividend payments responding to different imperatives and corporate financial strategies.

Dividends account for a third of equity returns in Europe

In the first instance, it is worth giving some background as regards the importance of dividends for equity investors. Using the Euro Stoxx equity index, a broad gauge of euro area equities, it appears that dividend contribution to total returns has averaged 2.6% per annum between December 1991 and December 2020.

The average total return on the index over the period under review hovering about 7.5% per annum, dividend payments have accounted for roughly a third (35%) of European equity performance.



The dividend contribution can be even greater. For example, the banking sector index has effectively posted a capital loss of 1% on average over this period. This compares to a 3% dividend yield on average. That said, dividend payments have at times been suspended during years of financial crises including the 2009 US subprime crisis or the sovereign and European banking crises in 2011-2012.

The dividend share can be even greater. In sectors linked to energy, utilities and telecommunication services, the contribution of dividends to total returns is quite significant as it exceeds 40% or even 50% in the case of telecommunication companies. The insurance sector, given its bond-like characteristics, also tends to maintain higher-than-average payouts. Real estate companies, which earnings are tied to rent income, also distribute a larger-than-average share of profits.

In sectors linked to energy, utilities and telecommunications, dividend contribution to total equity returns have exceeded 40%.

Conversely, as growth, either internal or external, requires excess disposable cash, the most dynamic sectors tend to opt for a less generous shareholder payout policy at least in the short run. It is worth underlining that the period under review is characterized by a prolonged period of declining interest rates which tends to raise the present value of earnings flows far out in the future. It is hence a rational response for firms with strong growth prospects to differ dividend outlays to fund current investment spending and potential acquisitions by retaining a greater share of earnings.

Hence, among the sectors offering the lowest dividend yields, it is only natural to find the personal products sector, the luxury sector and technology where existing opportunities to grow require enhanced financial flexibility.

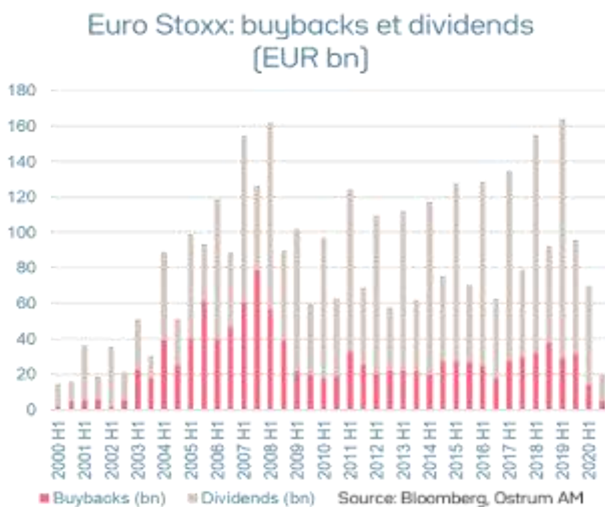
In this regard, the requirement of costly investments to ensure the energy transition risks weighing on sectors, such as integrated oil companies for example, which are used to paying high dividends to gain loyalty in their shareholder base.

That being said, corporate financing structures may be optimized to preserve the level of dividend payments or initiate a regular distribution policy. This is indeed the case of large US technology companies which borrow to fund dividend streams and launch equity buyback programs.

Dividends vs. equity buybacks

The choice to pay a dividend hence carries some message. Whilst it entails a loss of financial flexibility in a bid to anchor payout expectations and stock valuations, regular payouts are often suboptimal for a tax perspective relative to equity buyback programs. Stock repurchases, which may be linked to corporate manager compensation, may be useful to correct under-valuations of stocks in the marketplace… albeit higher financial leverage induced by the destruction of shares.

The informational content of these two shareholder remuneration policies is quite different. The case of banking stocks is quite interesting in this regard. The destruction of shareholder value in a sector confronted with the erosion of interest margins caused a sharp discount in bank stocks. Market prices for bank shares is markedly below the net asset value. In other words, the historical discount is a direct market-determined measure of expected value destruction.



In this context, banks may have an interest to support their own market value directly if it is indeed impossible to convince market participants of the possibility of a sustained improvement in profitability. Current recommendations of the ECB, using its bank supervisor hat, are however to limit distribution, either via share buybacks or dividend payouts.

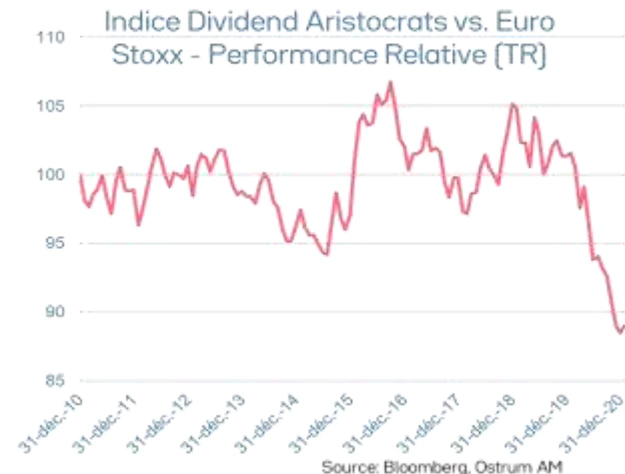
In general, equity buyback programs have made up about a quarter of total shareholder payouts in the past ten years in the euro area. The proportion of buybacks has declined sharply since the financial crisis of 2008. The pandemic sharply reduced corporate profitability and firms' ability to pay. Buybacks have been cut by 70% in 2020 compared with dividend reductions of 64%.

The dividend criterion as an allocation factor

Dividend distribution is usually put forward as a criterion of stock selection. There exist many benchmark equity indices built around the dividend thematic with weightings tied to payouts instead of market capitalization.

To illustrate the dividend factor, we use the S&P Dividend Aristocrats index, which comprises 40 stocks with high dividend yields and a history of payout discipline over a long period of time.

We have observed a sharp decline in the relative performance of stocks tied to the dividend investment theme. The underperformance was 12.7% in 2020. The historic cut in dividends penalized the group to the benefit of other equity risk factors including growth, small capitalization stocks and ESG leaders.



The sharp underperformance likely highlights the need to reconsider this forgotten source of equity performance. Nonetheless, a pickup in returns of the dividend may require a recovery in payouts.

Financial analysts make dividend projections which can be used to form expectations for future payouts over the years to come.

Using the Euro Stoxx index, the forecasted increase in dividends stands at 34% in 2021, then 11% in 2022 and a further 8% in 2023. This spectacular recovery is the mirror image of sharp cutbacks recorded in 2020. Bloomberg consensus estimates are consistent with a full recovery in dividend payments by 2023.

The dividend factor underperformed in 2020. Projected payouts lead us to reconsider the dividend theme going forward.

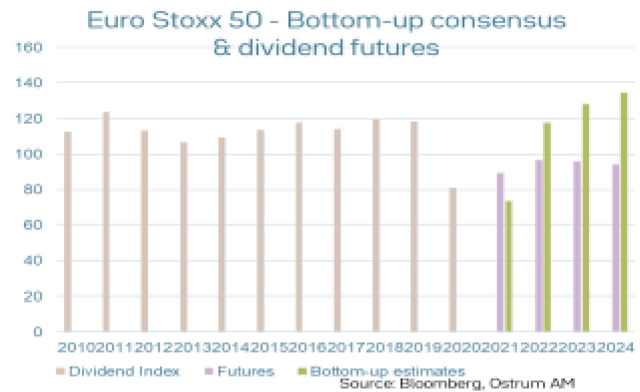
It is important to note that at current prices, the dividend yield on the Euro Stoxx index will rise to 3.3% by 2023. Indeed, no other asset class offers financial production comparable to the equity class, except for private debt and select tranches of structured credit. The euro bond universe no longer offers decent yields. Euro investment grade credit barely yields 0.3% currently. Furthermore, the income return on commercial real estate investment now appears riskier due to economic profound changes imposed by the pandemic.

The dividend futures market

In turn, there is another way to gain exposure to the dividend investment theme. Financial instruments indexed to the sum of dividend paid by the constituents of an equity index are now listed in markets. These future contracts have been used extensively by banks seeking to hedge their dividend exposure linked to equity-linked structured products.

In the euro area, the benchmark dividend future is that on the Euro Stoxx 50. Futures reflect market expectations for regular dividends to be paid over a period of one year (in practice until mid-December). Analysis of single-stock dividend forecasts indicates that a majority of index constituents would be able to raise dividends in 2021. Furthermore, 13 stocks should maintain their dividend payments unchanged and 7 may have to cut. The decision to maintain dividend payments depends heavily on balance sheet quality (financial leverage, free-cash flows, credit rating downgrade risk…) but also on the willingness of companies to reward shareholder loyalty. Hence a cut in payments is all but anecdotal.

The term structure of dividend futures does not reflect current analysts' optimism. It is likely that bank hedging needs weigh on implied payout forecasts. The next chart shows the dividend future fair value built from bottom-up forecasts. We have observed a sharp discount on 2022 expiries and beyond relative to a more bullish consensus.



Source: Bloomberg, Ostrum AM

The apparent undervaluation of dividend futures points to an investment opportunity. The first phase of the equity rally is traceable to recovery expectations rooted in very expansionary monetary and fiscal policies. The second phase of the stock market rally may come from improvement in activity growth, corporate earnings and hence the ability of listed companies to enhance payments to shareholders.

Conclusion

Dividends make up an essential component of equity investments. In the long run, dividend payments represent about a third of total equity returns in the euro area. Dividend payouts are not anecdotal for firms as distribution policies entail signals about future corporate profitability. The European market currently offers dividend yields of 2.8% and the outlook for future payouts derived from analysts' projections is quite upbeat. Yet the dividend investment theme appears to be neglected by market participants at present after a sharp underperformance recorded in 2020. Rotation in favor of the dividend factor seems fully justified by the potential for higher distribution.

Axel Botte
Global Strategist

Market review

Infinite reflation

Rebound in equities, spread tightening amid steepening. BTP spreads zoomed past 100bp mark as Draghi

As GameStop dust settles, market volatility declined, and major equity benchmark staged a sharp rebound strongly fueled by quarterly earnings publications and buoyant economic data. VIX fell by as much as 16pp last week. The S&P500 index (3885, new record high) had its best week since November as the US yield curve steepened sharply. The US dollar bounce highlights a change in market psychology in currency markets. This is in line with the dollar smile pattern as US economy emerges from recession, as market participants leave aside their concerns about external imbalances. However, the budget reconciliation procedure adopted by the Senate should allow for a swift vote on the $1900b plan over the coming weeks.

Besides fiscal stimulus, the rise in commodity prices continues to underpin the reflation theme through asset markets. All 18 sectors of the ISM manufacturing survey report rising input prices. Tensions along the supply chain are significant. Delivery times have lengthened. The ISM service (ISM 58.7 January) also depicts solid growth. In this context, January job data leaves us perplex. Labor market indicators have rarely been as inconsistent. The decline in the jobless rate (-0.4pp to 6.3%) is inconsistent with modest job creations in January (+49k) and downward revisions in the prior two months (-149k). Strength in business investment, evident in revised shipments o capital goods in December, sends an upbeat growth signal.

T-note remains the main driver of global bond markets. The steepening in the US yield curve resumed in the US. The 2s10s spread stands at 2017 highs above 100bp whilst 30-year bond yields reach 2%. Unchanged auction sizes in the short run could have reduced steepening pressure but the US Treasury's refunding announcement does not take include Biden's stimulus program. The Treasury's general account may shrink by about $1T from 1630b currently by the end of the first half. Conversely, TIPS borrowings will be raised by $10-20b in 2021 in the context of large investor demand for index-linked bonds. The rise in crude prices (close to $57 on WTI prices) amplified last week by declining Asian and US stockpiles will continue to underpin US breakeven inflation rates. Speculative positioning keeps accumulating on oil markets, as markets price in potential restrictions on shale oil to be implemented by the Biden Administration. The inflation swap with 10-year maturity is now trading near 2.38%. Furthermore, we note a sharp widening in long-dated swap spreads. Paying flows accelerated as mortgage refinancing slows.

In the euro area, US steepening pushed 30-year Bund yields back in positive territory. Bund closed last week at -0,45%. Recent syndications of long-term bonds (Finlande, Belgium, France…) have all been met with strong investor interest. Hedging of long bon deals has weighed on 30-year rates. In Italy, the failure of Giuseppe Conte to assemble a majority led President Mattarella to ask Mario Draghi to form a new coalition government and establish a plan to spend European funds. The broad coalition may span from M5S to Forza Italia. The news sparked a sharp rally in BTP spreads past the 100bp mark. Sovereign spreads have also narrowed in Spain, in Portugal and in Greece. In addition, inflation surprised on the upside in the euro area. The revised sector breakdown and transitory factors (VAT rise in Germany, postponing of winter sales) explain in large part the January inflation spurt. Euro area inflation was 0.9%y in January. Furthermore, the BoE kept policy unchanged. The MPC is still undecided about negative rates and may rather opt for additional QE this spring.

Unusually, the rebound in the dollar did not hurt risky assets. The dollar-bearish consensus traceable to expansionary economic policy is caught wrong-footed. The implementation of the Biden stimulus program could revive downside risk. The dollar rebound weighed on gold prices (down 41$ last week). Sterling is an enigma, sort of an imposter in the risk rally. The euro depreciated below $1.20 before edging higher on Friday afternoon.

Credit participated to the rally in risky assets. The Euro IG spread tightened by 6bp to 89bp vs. German Bunds. The ECB still let its presence felt in markets as CSPP redemption flows are quite heavy in the month ahead. Primary issuance was slightly busier last week in the financial sector. Nevertheless, financial bond spreads outperform last week (-8bp).

The overwhelming trend remains spread compression. The iTraxx Crossover has now fully erased upward pressure seen early on in 2021 drifting down to about 240bp. European high yield narrowed by some 30bp. Bank AT1 securities have performed well echoing the rebound in bank stock prices (that of peripheral countries in particular). The earnings season is off to a strong start even though investors should keep in mind that corporate profits remain down some 19% from a year ago. Profitability may pick more decisively in 2022. In the United States, equity ETF recorded massive inflows last week. Half of the S&P500 constituents have published their quarterly earnings. Annual earnings growth was 7% in the first quarter with a strong majority of positive surprises.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	08-Feb-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.71 %	+1	-1	-1
EUR Bunds 10y	-0.43%	+9	+10	+15
EUR Bunds 2s10s	29 bp	+8	+11	+16
USD Treasuries 2y	0.11 %	0	-3	-2
USD Treasuries 10y	1.19 %	+11	+7	+28
USD Treasuries 2s10s	108 bp	+11	+10	+29
GBP Gilt 10y	0.51 %	+19	+22	+31
JPY JGB 10y	0.07 %	+1	+4	+5
€ Sovereign Spreads (10y)	**08-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	22 bp	-2	+1	-1
Italy	94 bp	-20	-11	-18
Spain	57 bp	-4	+1	-5
Inflation Break-evens (10y)	**08-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	99 bp	+2	+8	-
USD TIPS	222 bp	+12	+14	+23
GBP Gilt Index-Linked	314 bp	+2	+12	+14
EUR Credit Indices	**08-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	88 bp	-5	-2	-4
EUR Agencies OAS	39 bp	-2	-1	-2
EUR Securitized - Covered OAS	31 bp	-1	+0	-1
EUR Pan-European High Yield OAS	327 bp	-25	-24	-31
EUR/USD CDS Indices 5y	**08-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	47 bp	-5	0	-1
iTraxx Crossover	243 bp	-24	-4	+1
CDX IG	50 bp	-5	+1	+0
CDX High Yield	286 bp	-30	-9	-8
Emerging Markets	**08-Feb-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	339 bp	-14	-13	-13
Currencies	**08-Feb-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.202	-0.39	-1.6	-1.65
GBP/USD	$1.369	+0.09	+0.88	+0.27
USD/JPY	¥105.59	-0.56	-1.56	-2.17
Commodity Futures	**08-Feb-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$60.1	$3.8	$4.3	$8.3
Gold	$1 823.5	-$41.4	-$25.5	-$70.9
Equity Market Indices	**08-Feb-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 887	4.65	1.62	3.48
EuroStoxx 50	3 678	4.18	0.91	3.54
CAC 40	5 708	4.52	0.03	2.83
Nikkei 225	29 389	4.62	4.44	7.08
Shanghai Composite	3 532	0.77	-1.05	1.71
VIX - Implied Volatility Index	21.81	-29.73	-1.44	-6.59

Source: Bloomberg, Ostrum Asset Management

Additional notes

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