Ahoy there, dividend yields are here

- **Hunt for yield continues as bond yields fall across the globe and the stock of negative yielding debt continues to rise sharply**
- **High dividend yielding stocks have so far not benefitted much from this yield hunt**
- **In our view, the outlook for high dividend yielding stocks should improve in the near term**

Kishore Muktinutalapati
Equity Strategist
Tel: +971 (0)2 696 2358
kishore.muktinutalapati@adcb.com

Luciano Jannelli, Ph.D., CFA
Head Investment Strategy
Tel: +971 (0)2 696 2340
luciano.jannelli@adcb.com

Prerana Seth
Fixed Income Strategist
Tel: +971 (0)2 696 2878
prerana.seth@adcb.com

Mohammed Al Hemeiri
Analyst
Tel: +971 (0)2 696 2236
mohammed.alhemeiri@adcb.com

Noor Alameri
Analyst
Tel: +971 (0)2 694 5182
noor.alameri@adcb.com

Visit Investment Strategy Webpage to read our other reports or write to us at investmentstrategy@adcb.com

The yield hunt

Whilst the bond yields in major developed markets have been on a constant decline for more than three decades now, the sharp fall in the long-term bond yields so far this year has been striking. As such the stock of negative yielding debt globally has doubled since the beginning of this year and now sits at close to USD17trn – equivalent to a fifth of the nominal global GDP (exhibit 1). Most of this negative yielding debt is European and Japanese while US yields are still positive. Therefore investors looking for yields have moved into US treasuries, where the yields compressed significantly. At the time of writing this report, yield on 30Y treasury bonds in the US was below 2% and at its lowest level ever. High yielding bond segment has also benefitted from the yield hunt. As a result, for instance, we have seen some European high yield bonds offer negative yields. Gold prices shared a strong positive correlation with the stock of negative yielding debt and the precious metal is, at the time of writing this report, in a bull market this year. However, high dividend yielding stocks have not benefitted as much from this hunt for yield. Returns on MSCI ACWI High Dividend Yield index, Global High Yield bond index and Gold were 9%, 9% and 20% respectively on a year-to-date basis and -4%, -1% and 9% respectively on quarter-to-date basis (as of 2 September 2019). What is even more interesting is that dividend yielding stocks which tend to outperform overall stocks on a total return basis (exhibit 2), have marginally underperformed recently (exhibit 3). What is behind this underperformance of dividend yielding stocks?

Show me the earnings

One major drag on the dividend yielders has been the scepticism about earnings. Equity market analysts, for most part of the last six months (this is when large part of this year's bond yield compression did happen), have been downgrading their earnings estimates. As can be seen from exhibit 4, analyst estimates for the 12 month forward earnings have been cut by c4% over the past six months. By region, emerging market earnings saw sizable cuts followed by Europe. Whilst US has been fairly resilient in this regard, revisions there were negative too. Japan remained the only exception and saw upgrades, albeit only marginal. Cyclical sectors – primarily materials, industrials, consumer discretionary and IT – saw their earnings estimates cut significantly. Defensive sectors – utilities, health care and real estate – saw positive earnings revisions. As a result since the beginning of the year the dividend cover (a ratio of 'projected earnings' and 'projected dividends') saw sizable erosion (exhibit 5). This meant that investors turned more sceptical about earnings being high enough to have the potential dividends covered. This is the case not only for the high dividend yielding segment but also for the market overall.

What's changing now?

In our view, these concerns about dividend cover erosion have gone too far. For instance, according to Goldman Sachs Portfolio Strategy Research, for S&P 500 index, "Swap market prices imply that dividend per share (DPS) growth will slow from 8% during 2019 to just 1% during 2020". Focussing on the US, we see the earnings growth visibility improving going forward. Exhibit 6 plots the earnings growth for S&P 500 index both on a sequential basis and also on a year-over-year basis. As it can be seen, after having trended higher for most part of 2016, 2017 and 2018, EPS growth faltered over the past year. This fall could be, to a large extent, attributed to the higher base effect of the earnings boost from tax cuts in the previous one year period. However, now earnings growth is set to rebound as the base-effect drag fades. Further the current earnings season (Q2 2019) was strong enough. In the US, 74% of the S&P 500 companies that reported have delivered earnings above expectations (long-term average is 65% and prior four quarter average is 76%). On the other side of the Atlantic, things were not dire either. Of the 255 companies in the STOXX 600 that have reported earnings to date for Q2 2019 49% reported results exceeding analyst estimates (long-term average is 50%).

Valuations of high dividend yielding segment look attractive both in relation to overall equities and also particularly in relation to bonds. The dividend yield spread of the high dividend yielding segment (MSCI ACWI High Dividend Yield index) relative to overall equities (MSCI ACWI) is close to all-time high and two standard deviations above the seven year average of the spread (exhibit 7). High dividend yielding segment looks attractive relative to the overall index even on the Price/Earnings multiple (exhibit 8). The attraction of dividend yields is evident when compared with the bond yields. Exhibit 9 plots the dividend yields of both MSCI ACWI High Dividend Yield index and MSCI ACWI index against the bond yields in the US (which is now the major market where the yields are positive). It can be seen that bond yields across the tenors have recently dropped below the dividend yields.

Buy high dividend yielding stocks for the near-term

Overall, we recommend buying high dividend yielding stocks for the near-term. We continue to prefer growth over value in our equity strategy framework (exhibit 11 shows our equity strategy summary). However, in the near-term we find opportunity in high dividend yielding segments which represent value.

Exhibit 10 shows the 12month forward dividend yield for various regions/countries and sectors globally. Readers should note that the chart shows prospective dividend yields for overall markets and not just the high yielding indices there.

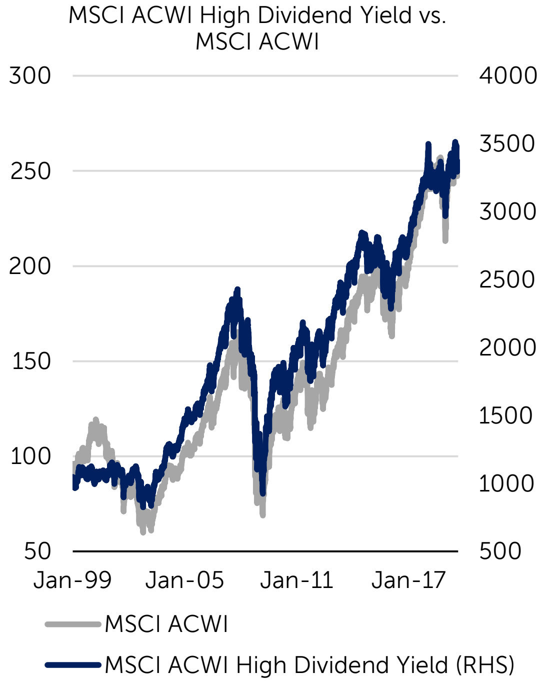
The dividend yield on MSCI ACWI stands at 2.7%. By country/region, UK, EM EMEA and Europe ex UK stand out with higher levels of yields. US equities offer 2.0% as dividend yield over the next 12 months but we regard them as 'quality dividends'. Among sectors, energy, financials, utilities, real estate and materials sectors offer higher dividend yields. GCC equity markets (also considered a part of EM EMEA) offer rich dividends.

Key risks to the high dividend yielding stocks are a sharp rise in bond yields and a slump in earnings.

Exhibit 1: Negative yielding debt stock rose sharply creating 'yield rush' and 'gold rush' but not 'dividend rush'

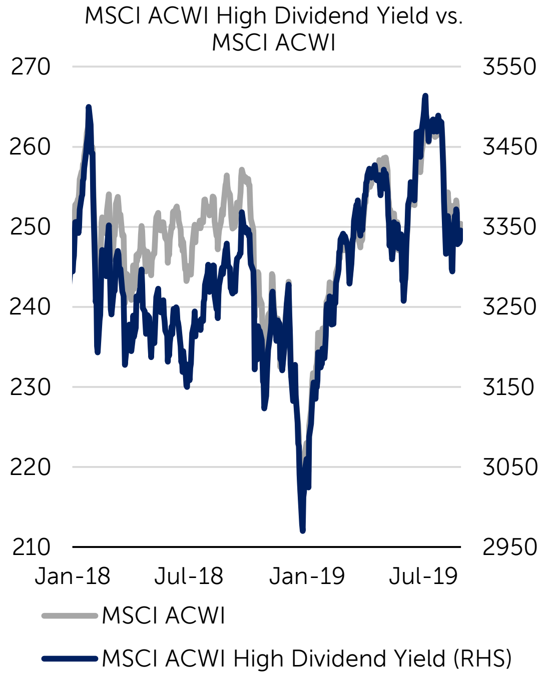
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 2: High dividend yielders have outperformed over the long-run…



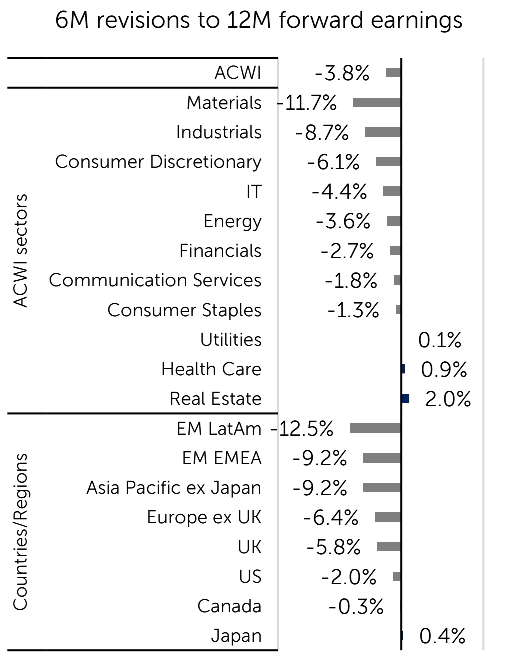
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 3: …but have slightly underperformed recently



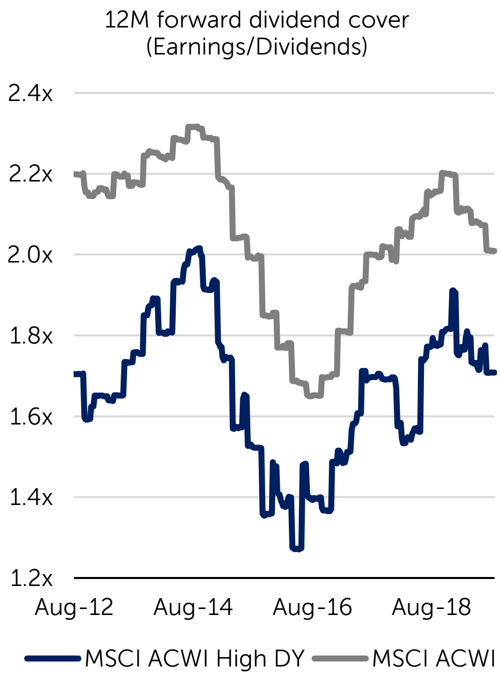
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 4: 12M forward earnings were revised down significantly over the past six months



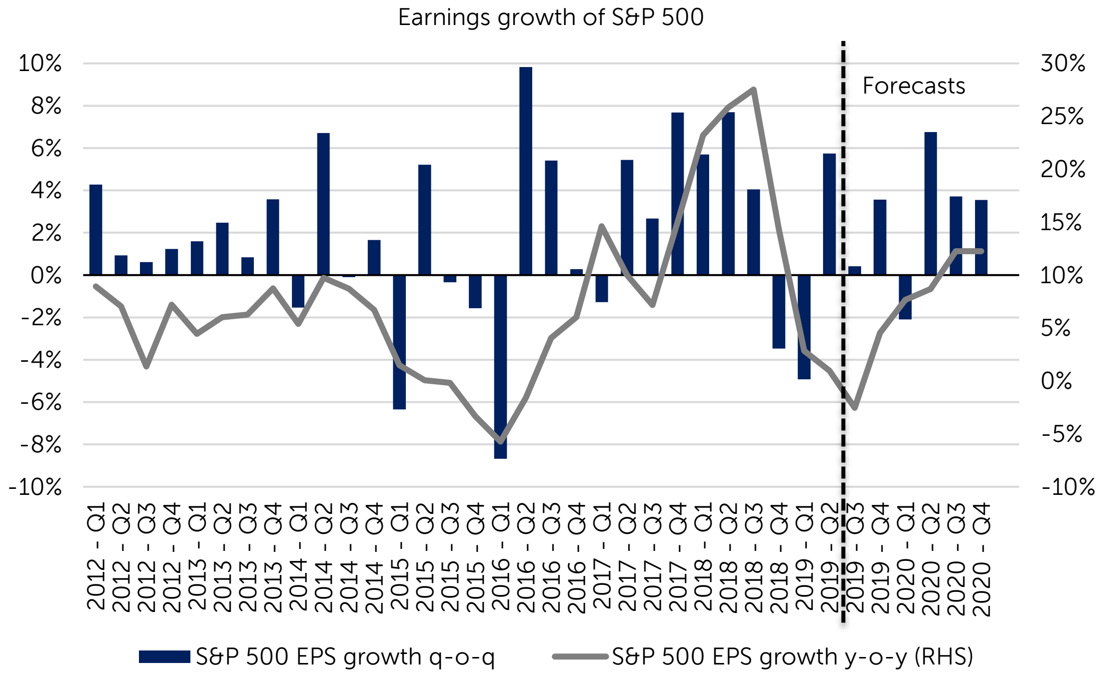
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 5: Concerns about dividend cover erosion have surfaced



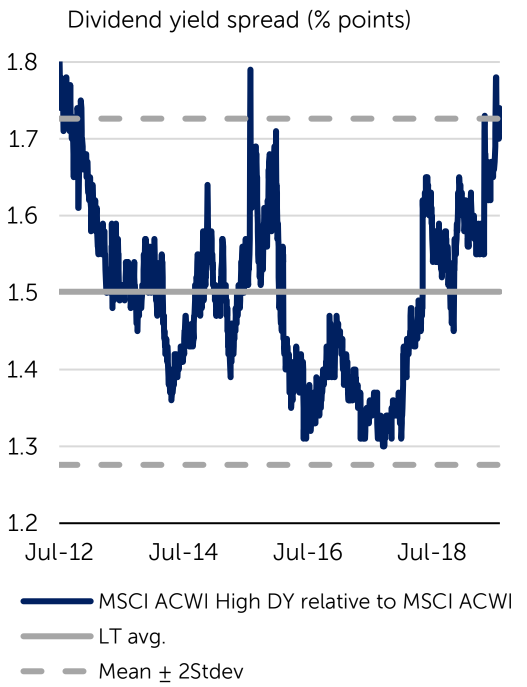
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 6: In the US, earnings recovery is becoming visible



Source: S&P, Bloomberg and ADCB Asset Management

Exhibit 7: High dividend yielding stocks look attractive not only on yield spreads...

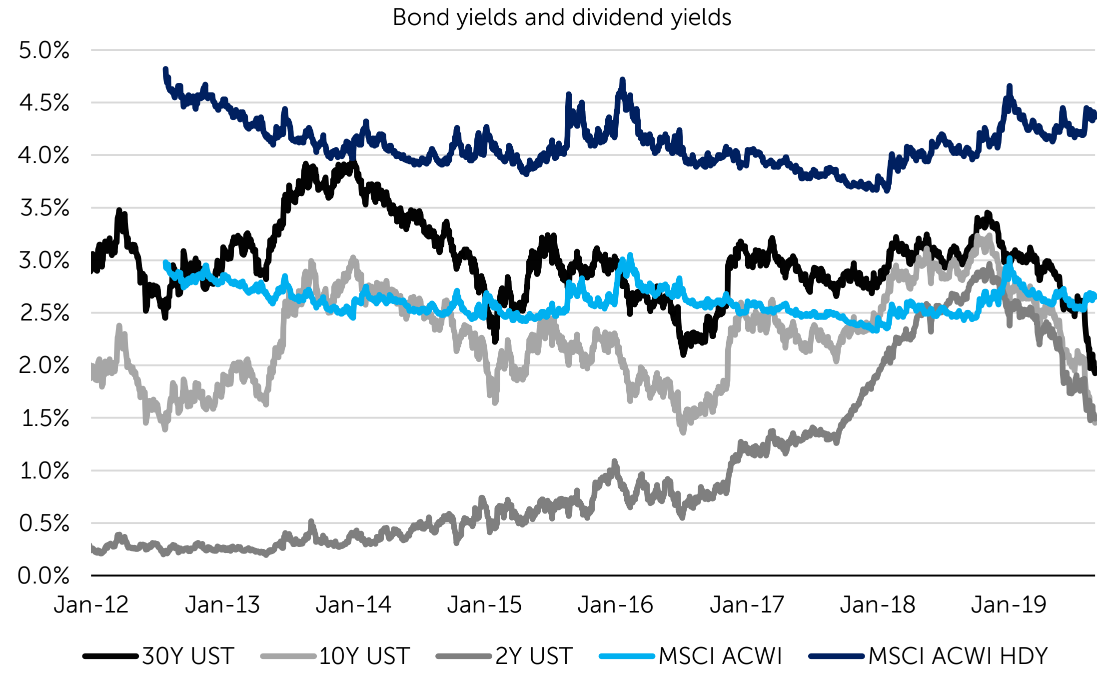


Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 8: ...but also on relative PE multiples

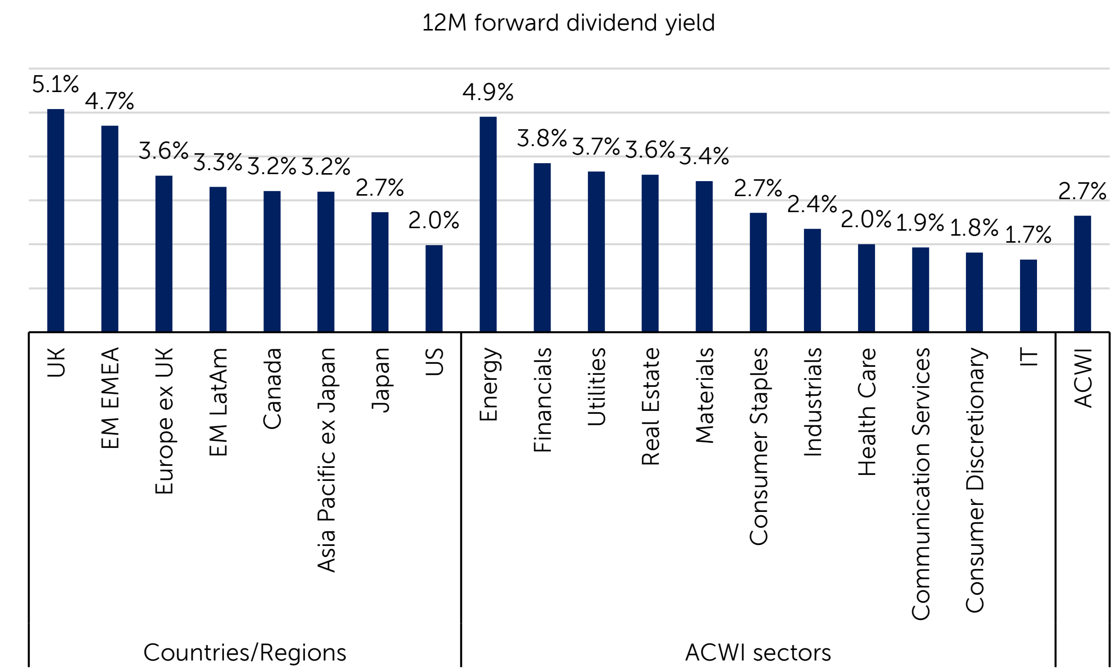
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 9: Valuations of high dividend yielding stocks are especially attractive in relation to bonds



Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 10: Dividend yields are attractive all over



Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 11: Equity strategy summary

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Regions				
US			■	Higher quality, higher RoE/RoA
Canada		■		Stick with the benchmark
Europe ex UK	■			Selective OW Switzerland and Spain
UK		■		Stick with the benchmark
Japan		■		Prefer a cyclical tilt
Asia Pacific ex Japan	■			Structurally OW India; OW Australia and HK
EM LatAm	■			Tactically OW Brazil
EM EMEA	■			Tactically OW South Africa
GCC		■		Prefer KSA; regional banks
Global sectors				
Comm. Services			■	Prefer US exposure over rest of the world
Consumer Discr.		■		Prefer Consumer Services to Auto & Components
Consumer Staples			■	Prefer Household & personal products
Energy			■	Companies with positive cash flow to outperform
Financials		■		Prefer Banks with diversified business models
Health Care		■		Risks from US presidential elections
Industrials		■		Prefer Commercial & Professional Services
IT	■			UW Tech H/W and Semiconductor sub-sectors
Materials	■			UW Materials hedged with OW Brazil and SA
Real Estate		■		Prefer US exposure over Europe
Utilities		■		Stick with the benchmark
Factors/styles/sizes				
Large cap			■	Strong balance sheet, earnings visibility
Mid cap		■		Likely to be market-performers
Small cap	■			US small cap strained by leverage
Growth			■	Prefer non-cyclical growth
Value		■		Growth at a reasonable price (GARP)
Dividend yield			■	Prefer quality dividends
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Watch momentum for leadership change
Legend	*New* ■	*Old* □	*No change* ■	

Source: ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

Disclaimer