Market Bulletin

June 13, 2018

Dividends: Sidelined, but still in the game

In brief

- An environment of higher interest rates has seen high dividend equities perform poorly. While the perception is that a scenario of higher rates and expanding economy is negative for the more defensive high dividend stocks, this is not always the case.
- A number of factors show that we should not ignore the dividend theme. Historical data shows that the high dividend index has more favorable volatility and return results compared to the broad index and does not always underperform during times of rising interest rates, making high dividend equities a good prospect in investor portfolios.
- Although their overall makeup does lean toward the more defensive sectors, Asia stands out as an opportunity amongst high dividend equities, with a higher cyclical weight and greater number of high dividend paying stocks. Reform measures in countries such as China and Japan appear to be encouraging higher dividend payouts and shareholder returns, making them appealing choices.

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A CHALLENGING ENVIRONMENT

In previous years, the search for income from high yielding investments, such as high coupon paying bonds and high dividend equities, has been a popular theme for investors in an environment with low interest rates. Higher income payments provided extra compensation at a time when bank deposits were offering low or even negative real interest payments. However, last year saw high dividend equity yield strategies underperform as the U.S. Federal Reserve (Fed) continued tightening. While inflation is still relatively benign and the pace of tightening globally is still relatively gradual, an environment of rising rates and continued global growth is typically thought to be detrimental to high dividend equities, as they are perceived to be defensive investments that are "bond like" or "bond proxies" in behavior.

With the U.S. 10-year Treasury rate now touching the psychologically significant 3% level for the first time in four years and is expected to continue to creep higher, the outlook for such investments that are negatively correlated to interest rates looks poor. The principle is that some threshold level of higher rates typically leads to a drag on profit, financing difficulties, greater default rates and an eventual pull-back in markets.

Despite this, the dividend income theme is not over in the current scenario of rising rates; there are still a number of supportive factors, even in the face of rising rate worries.

Higher rates ≠ Income underperformance

Higher rates are also a sign of stronger growth as the Fed and other central banks move to "normality" in policy and no longer see the need to support markets or the economy with low rates and easy liquidity. Central banks are not tightening to reign in overheating or clamp down on sky-rocketing inflation, and with the U.S. economy still in the expanding but late stage of the business cycle, the gradual rate hike path we are seeing from the Fed suggests that the official fed funds rate will not reach as high as previous peaks before the next slowdown causes a shift to loosening policy again. Worries on higher rates may eventually impugn our scenario of stronger global growth and eventually lead to a slowdown, but not for at least 12 months in our view.

Other than higher U.S. rates, the recent strength in the U.S. dollar has also evoked concerns of an uptrend in emerging markets (EM) rates as their respective central banks seek to protect their currencies. However, given the twin deficit issue faced by the U.S., the dollar should weaken in the medium to long term. Hence, recent dollar strength should not last and with EM currencies still relatively undervalued, potential appreciation should take some pressure off EM central banks.

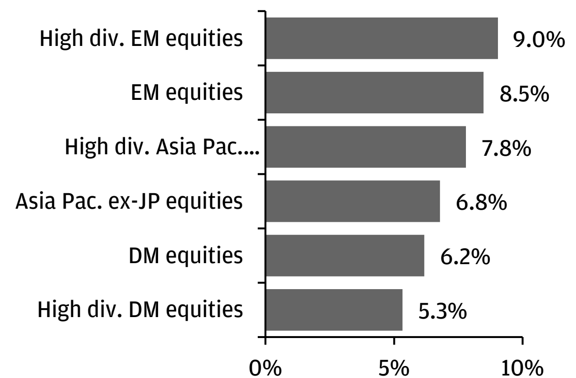
A high dividend yield stock does not always mean underperformance during times of rising rates. Looking at historical data we can investigate whether high dividend stock performance suffers when rates rise in comparison. Using daily data from 2001 to 2018, the correlation coefficient of the MSCI AC World High Dividend Total Return Index[1] only appears slightly more negative relative to that of the broad index against movements in the U.S. 10-year Treasury yield.

However, not every high dividend index performs worse versus the broad index through times of rising rates when compared with history. During periods of rising U.S. yields (which we define as rolling 3-month periods with over a 25bps increase in U.S. 10-year Treasury yields), the average 3-month total return of several global high dividend indices still manages to outperform some of their broad index counterparts slightly. Emerging markets in particular appear to come off better than developed markets.

Rising U.S. yields don't always mean poor performance

EXHIBIT 1: TOTAL RETURN IN A RISING YIELD ENVIRONMENT*

ANNUALIZED AVERAGE OF ROLLING 3-MONTH TOTAL RETURN (USD) FROM 1998-2018



Source: FactSet, MSCI, J.P. Morgan Asset Management. Based on MSCI World Index (DM Equity), MSCI World High Dividend Index (High div. DM Equity), MSCI Emerging Market Index (EM Equity), MSCI Emerging Market High Dividend Index (High div. EM Equity), MSCI AC Asia Pacific Index (Asia Pac.), MSCI AC Asia Pacific High Dividend Index (High div. Asia Pac.) *Trigger to count returns is if the 10-year yield rose more than 25bps in prior 3 months. Past performance is not a reliable indicator of current and future results. Data are as of May 31, 2018.

[1]The MSCI High Dividend Yield Indexes are designed to focus on dividend yield and to represent the opportunity set of securities with high dividend Income and quality characteristics. They are derived from their parent country, regional or composite level MSCI Equity indexes and include only securities that offer a higher than average dividend yield relative to their respective Parent Index and pass dividend sustainability screens. (*https://www.msci.com/eqb/methodology/meth_docs/MSCI_High_Dividend_Yield_Indexes_Methodology_2015.pdf*)

Favorable valuations and fundamentals

Valuations and fundamentals for high dividend indices also paint a favorable picture in comparison with some compelling figures. As shown in **Exhibit 2**, the high dividend indices are generally less volatile and have higher risk-adjusted returns over history. The recent pullback in performance of high dividend stocks has also resulted in the AC World High Dividend Index currently trading with a 12-month forward price-to-earnings ratio of 12.7 and a trailing price-to-book ratio of 2.2, a discount of 14% and 4%, respectively, against the broad index.

All this suggests that not only do high dividend stocks not always underperform when yields rise, but also they tend to outperform in the longer term, making them a good investment choice despite rate hike fears.

Annualized risk and return comparisons favorable

EXHIBIT 2: RISK AND RETURN PROFILE

HIGH DIVIDEND VERSUS BROAD INDEX

MSCI indices	AC World		EM		DM	
	HD	Broad	HD	Broad	HD	Broad
Annualized return*	6.7%	5.3%	11.3%	8.2%	6.2%	5.3%
Annualized volatility*	15.0%	15.3%	20.6%	21.7%	14.8%	14.9%
Risk-adjusted return**	**0.44**	**0.35**	**0.55**	**0.38**	**0.42**	**0.35**

Source: MSCI, J.P. Morgan Asset Management. *Annualized return and volatility are based on the most recent 20 years of total monthly return data in U.S. dollars. **Risk-adjusted return is calculated by annualized return over volatility. Data are as of May 31, 2018.

High dividend strategies do not need to be defensive

A possible strike against the high dividend theme is that they are seen as a defensive investment. If we are in a late stage cycle of an expansion, with still some significant time before a slowdown hits, cyclical sectors are still seen as having greater potential for returns. Dividend stocks may be less volatile but the general perception is that they also have a higher proportion of defensive sectors.

We can see that it is currently true for the MSCI AC World Index as can be seen in **Exhibit 3**. The broad index has 27.3% weight in defensive sectors, less than the 40.2% in the high dividend index. Even looking to other regions, the make-up of the EM index is similar, although less prominently defensive.

High dividend indices still has a large cyclical weighting

EXHIBIT 3: CYCLICAL VERSUS DEFENSIVE SPLIT

SECTOR % WEIGHTING

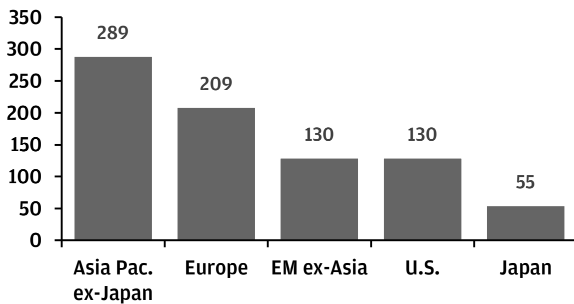
	Defensives*	Cyclicals**	Financials
MSCI AC World	27.3%	54.9%	17.8%
MSCI AC World High Dividend	40.2%	44.5%	15.4%
MSCI World	28.4%	54.5%	17.1%
MSCI World High Dividend	43.7%	43.1%	13.3%
MSCI EM	19.0%	58.0%	23.1%
MSCI EM High Dividend	22.9%	45.0%	32.1%

Source: MSCI, J.P. Morgan Asset Management. *GICS sectors classified as Defensives are Telecommunication Services, Consumer Staples, Utilities, Health Care and Real Estate. **GICS sectors classified as Cyclicals are Materials, Energy, Industrials, Information Technology and Consumer Discretionary. Data are as of May 31, 2018.

From our results earlier in **Exhibit 1** on page two, it would appear that developed market equities are not the best performers when U.S. rates rise. Not only does the data suggest that the Asia index performs better, it also has more cyclical and financial weightings, where we can still take advantage of greater price appreciation in the current economic stage of rising growth and slowly rising rates. The Asia index also has a larger number of individual stocks offering higher dividend payments, as shown in **Exhibit 4** below.

Asia offers a greater number of high dividend stocks

EXHIBIT 4: NUMBER OF COMPANIES YIELDING GREATER THAN 3% BY REGION



Source: FactSet, MSCI, J.P. Morgan Asset Management. Data are as of May 31, 2018.

Seeking income in Asia

Across Asia, there is also backing for the high dividend story with the benefit of improving corporate governance driving higher payout ratios. To take advantage of the current environment, opportunities should lie where there is growth in dividend payments from companies that are benefiting from global growth and higher profits. Developments in a number of countries have some appealing implications for performance and improvements in dividend payouts. These may not translate into immediate gains in the short term, but provide longer-term structural support for the income theme. Particular standouts are changes in China and Japan.

China: Dividend payouts on the rise

In China, there have been attempts to open up financial markets further and also ongoing efforts to improve corporate governance and shareholder returns. With the inclusion of China's A-share market in benchmark indices, scrutiny from overseas investors should only increase, spurring more reform. Dividend payouts are increasing, and there appears to be a growing trend of higher and more stable policies. This behavior should be a reflection of an improvement in the quality of management in Chinese companies, with greater regulatory scrutiny and a better regulatory environment that encourages dividends.

There has been an increasing number of Shanghai-listed firms maintaining a high dividend payout ratio. In the past three years, 390 firms maintained a ratio of over 30%, 57 firms over 50%. In 2017, the numbers improved further with 778 out of 1100 companies with over 30% dividend payout ratio, 194 firms over 50% and 67 over 80%. The Shanghai Stock Exchange has emphasized its focus on ensuring dividends are paid out to reward shareholders for their investments, and companies that have historically not paid dividends have also shown signs of loosening up. This positive trend should continue, but may see some hiccups this year due to continued deleveraging efforts from the government to maintain steady growth.

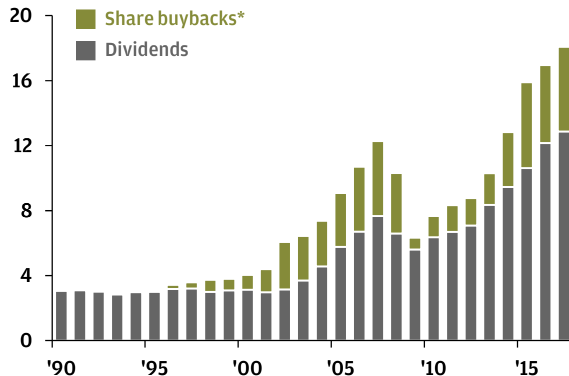
Japan: Corporate reforms push dividends higher

Another country where we see positive reform trends leading to greater dividend payouts and returns is in Japan. Japan has seen low dividend payouts and return on equity compared to other markets in the past, but this is slowly changing. The adoption of a Stewardship Code and Corporate Governance Code aimed at improving corporate growth and focusing on promoting more active investor involvement has led to some slow but steady progress that will benefit the Japanese market. When the Stewardship Code was first rolled out in 2014, expectations were high and initial results may have been disappointing. We have nonetheless seen increases in ROE, more independent directors appointed and greater dividends paid out. In 2017, Japan saw a record amount of dividends paid out as seen in **Exhibit 5**. We expect this to continue to develop positively as companies face more pressure to reduce excess capital and return it to shareholders. The potential for higher dividends and improved performance remain appealing points.

Corporate governance reforms are leading to greater shareholder returns

EXHIBIT 5: LISTED JAPANESE COMPANIES' DIVIDEND PAYOUTS AND SHARE BUYBACKS

YEN TRILLIONS



Source: Nomura, J.P. Morgan Asset Management. *Share buyback data is for repurchases of common stock, excluding repurchases from Resolution and Collection Corp. and repurchases of preferred stock collected by Nomura. Past performance is not a reliable indicator of current and future results. Data are as of May 31, 2018.

Investment implication

Dividend focused strategies may have suffered last year, but this is no reason to ignore them, even in the current environment of global growth and rising rates. High dividend stocks can still outperform during times of rising rates despite being seen as typically more defensive. There is a risk from a stronger U.S. dollar and slowly rising inflationary pressure which may have negative effects on both performance and foreign exchange that we should be aware of, but our view is that these are contained if the USD weakens in the medium to long term as we expect.

Under the current circumstances, we favor high dividend equities where there is dividend growth driven by the global expansion. Countries such as China and Japan, which have a number of cyclical sectors paying higher dividends and also seeing greater shareholder return from reform measures, look set to benefit.

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