On the Minds of Investors

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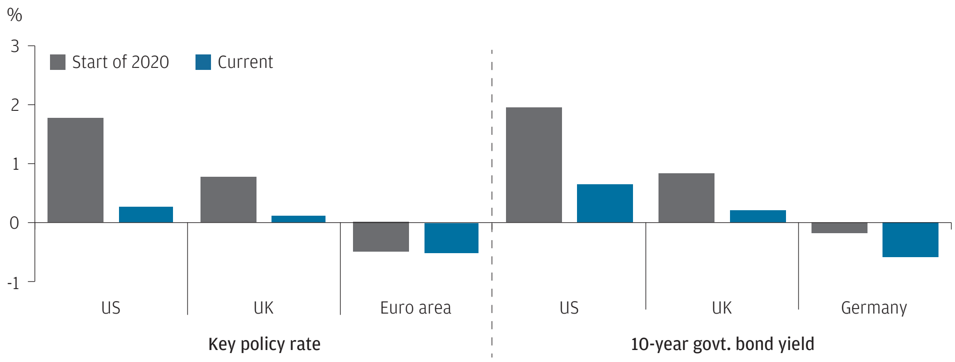
Income hunting: If life was tough before, it's even tougher now

For income-hungry investors, the menu of low-risk options already looked fairly sparse at the start of this year. Fast forward a few months and the challenge is even greater.

With little safe income available, many investors had been forced to take on higher risk to chase higher yields, as we highlighted in January.[1] This year's market volatility has been a very clear demonstration of why overstretching for yield can be an unwise approach. Yet today, income requirements remain substantial, and cash and government bond yields—which had started 2020 close to record lows—have been driven even lower.

Central banks across developed markets have cut rates aggressively and launched huge quantitative easing programmes. While these actions are performing a crucial role in ensuring that governments can afford sizeable fiscal stimulus packages, a side effect is that low-risk income is now even harder to find. See **Exhibit 1**.

EXHIBIT 1: KEY POLICY RATES AND 10-YEAR GOVERNMENT BOND YIELDS



Source: Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 30 April 2020.

As income from traditional fixed "income" sources has shrunk over recent years, equity income has been steadily growing in importance. Yet the outlook for dividends is now being called into question, as many companies refrain from returning cash to shareholders in order to shore up balance sheets given the current economic shock. While acknowledging that dividends in some regions will face pressure over the coming months, we argue that now is absolutely not the time to give up on dividends as a key source of income for multi-asset portfolios.

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[1] On the Minds of Investors *"A menu of options for income-hungry investors"* (27 January 2020, Hugh Gimber).

Dividend dilemmas?

Corporate earnings are set to contract sharply in 2020 following the hit to activity from the coronavirus outbreak. While making robust forecasts is still very challenging, economic growth downgrades imply a hit to earnings in the ballpark of 20%-30% across most developed markets. The relationship between dividends and earnings has historically been quite strong. Intuitively this makes sense: the more money a company makes, the more it has available to return to shareholders (**Exhibit 2**).

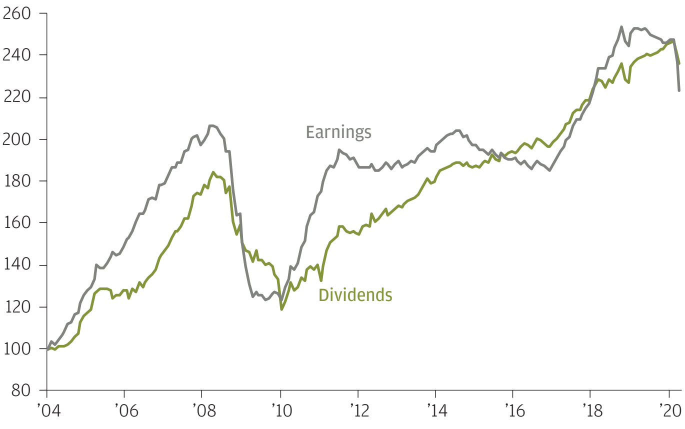
The energy and financial sectors have seen some of the largest earnings downgrades this year, and these sectors are also the two largest contributors to dividends over the last 12 months. Payouts from both sectors are coming under pressure. Banks in the UK and continental Europe have been told by regulators to hold off from paying dividends to ensure that capital is available for lending. Energy company earnings have been hit hard by the collapse in the oil price[2], and dividend cuts by some of the UK market's most revered dividend payers in this sector have attracted attention.

Other sectors will also see dividend pressure in the near term, particularly while companies receive substantial government support. Consider the wage subsidy schemes that have been a key part of the coronavirus policy response. The goal of preventing lasting scars to the jobs market is absolutely appropriate, but it will be very hard for companies that are receiving wage subsidies to simultaneously pay out money to shareholders. In the US, any company that receives a government loan cannot pay dividends or buyback shares until 12 months after loans are repaid.

Given the size of this shock, dividend cuts in many regions will likely exceed the hit to earnings in 2020. The relatively higher weights to financials and energy in UK and continental European indices does not help the near-term dividend outlook for these markets. On a more positive note, high dividend yielders have already materially underperformed broad European benchmarks in 2020. For companies with robust financials that will survive this hit to activity, market pricing suggests that in some cases investors may be mistaking cyclical headwinds to dividends for something more structural.

EXHIBIT 2: TRAILING EARNINGS AND DIVIDENDS PER SHARE FOR DEVELOPED MARKETS

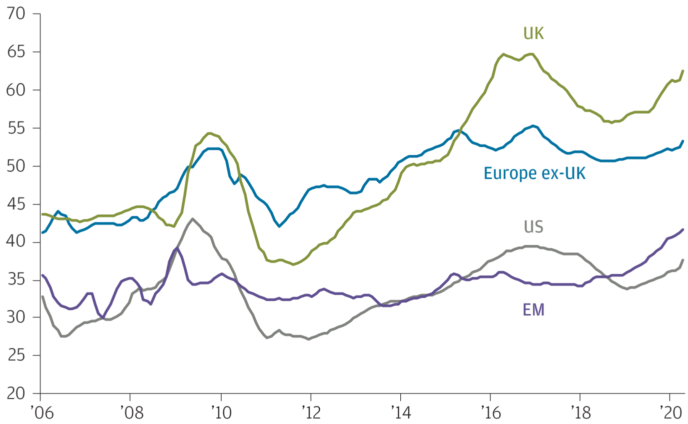
Index level



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Index used is MSCI World. Trailing earnings and dividends per share are rebased to 100 as of January 2004. Past performance is not a reliable indicator of current and future results. Data as of 30 April 2020.

EXHIBIT 3: DIVIDEND PAYOUT RATIOS

Percent, three-month rolling average



Source: FTSE, MSCI, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. US: S&P 500; Europe ex-UK: MSCI Europe ex-UK; UK: FTSE All-Share; EM: MSCI Emerging Markets. Dividend payout ratio shows 12-month trailing dividend per share divided by 12-month trailing earnings per share. Past performance is not a reliable indicator of current and future results. Data as of 30 April 2020.

US dividend income will also come under pressure in 2020, but is likely to be more resilient than other regions. First, the US market benefits from a lower dividend payout ratio - that is, dividend payouts as a proportion of earnings. Lower payout ratios provide companies more flexibility to maintain dividends during periods where earnings are weaker (**Exhibit 3**). Part of the reason for this lower payout ratio is that US companies tend to use buybacks more aggressively to return cash to shareholders. Buybacks are more likely to be cut first when corporate earnings are challenged, providing income investors with a buffer before dividends are hit. Regulatory pressure on bank dividends is also lower in the US.

The earnings season has so far confirmed the relative resilience of the US stock market. While many flagship European companies have made dividend cuts, US rivals have often been able to maintain their payouts.

Emerging market equities also deserve selective consideration for income generation, but investors must consider both the ability and willingness of emerging market corporates to pay dividends. Despite similar payout ratios to the US, dividends in emerging markets have fallen sharply in previous downturns. Historically, this drop in dividends has been due to a combination of earnings weakness and a reluctance to return cash to shareholders. Today, while emerging markets (like developed markets) are facing earnings downgrades, we believe that the willingness of companies to return cash to shareholders has improved significantly.

On a regional basis within emerging markets, we see dividends as relatively more resilient in Asia, where a combination of lower pressure from regulators to cut bank dividends, less commodity-focused index composition, a higher proportion of state-owned enterprises, and a more stable currency outlook when translating foreign dividends into home currency are all providing support.

Ultimately, it is high-quality companies—those with strong balance sheets and high levels of free cashflow—that are likely best placed, regardless of the region. Rather than stretching for the highest yields, investors should focus on companies that combine decent yields, strong dividend growth, and a robust financial position.

[2] On the Minds of Investors *"The Great Glut: A historic supply and demand shock in the oil market"* (20 April 2020, Tilmann Galler).

Conclusion

Central bank actions that are pinning down government bond yields pose material challenges for income investors, and will continue to do so for the foreseeable future. Dividends will be pressured in the near term, particularly while many corporates receive substantial government support, yet income from stocks will remain an essential part of a multi-asset portfolio for income-seeking investors.

US dividends appear relatively resilient on a regional basis. Rather than stretching for the highest dividend yielders, we focus on high-quality companies with a combination of healthy dividends, a track record of dividend growth and strong balance sheets.

As we begin a new investment cycle, the core thesis that we laid out in January remains intact: with safe income increasingly scarce, income investors must embrace the widest range of options available—both from a regional perspective and across the capital structure—to achieve a healthy balance of risk and return. Equity income is a key part of the solution.

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