Quarterly Investment Update — *The Outlook for Dividends in a World of Yield Starvation*

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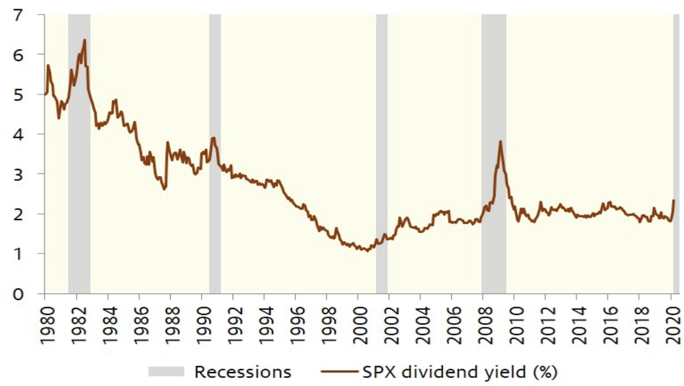
There remains much uncertainty regarding the depth, breadth and length of the COVID-19 recession. For example, the Global Economic Policy Uncertainty Index (compiled by academics from Stanford, Chicago, and Northwestern) stands at a record high and almost twice its level during the global financial crisis (GFC). This raises many challenges for investors, including understanding how corporate dividend and buyback policies are likely to change during the COVID-19 recession and its aftermath.

One thing we can be certain of is that companies will be tightening their wallets. It appears that EPS growth for the S&P 500 is likely to decline by something in the range of 20% to 35% this year. Earnings visibility is always poor in the midst of a recession and currently the dispersion among consensus estimates is close to the record high set during the GFC. Regardless of the lack of clarity, it seems the nadir will probably occur in the second quarter, with profits down roughly 100% year-over-year (the 1 standard deviation band around this estimate is uncommonly wide). This is an eye-popping number that would have been all but unimaginable even two months ago.

For context, S&P EPS typically declines by about 20% peak-to-trough during recessions (but was down 45% in the case of the GFC, the worst outcome since the 1930s). While the descent is usually swift and steep, it normally takes two to three years for earnings to climb back to the prior peak. That appears to be a reasonable assumption for this cycle as well, given that we expect a swoosh-shaped recovery (rather than the V optimistically assumed by many forecasters).

Over the long-term, U.S. EPS and DPS (dividends per share) are tied at the hip (they've been 97% correlated since 1871), but during recessions, dividends typically decline by only one-third as much as earnings. We expect this recession to be a bit different, with dividends falling by around 25%; that is, roughly one-to-one with earnings. The consensus sees a small rebound in 2021, with dividend growth averaging 3% to 5% for the remainder of the decade (in line with earnings). This suggests a somewhat slower recovery than is historically the norm. In previous recessions, dividends normally took 6 to 8 quarters to recover from the trough to the prior high. This time around 12 to 16 quarters strikes us as a more reasonable assumption, reflecting the swoosh-shaped recovery we foresee in earnings.



Regardless, since at least 1980, dividend yields have increased during every downturn (Figure 1).

FIGURE 1: THE DIVIDEND YIELD HAS INCREASED DURING EACH OF THE LAST FIVE RECESSIONS

Source: Bloomberg, NBER, Epoch Investment Partners

While 2020 is likely not a repeat of 2008 for earnings in the U.S., it might be for buybacks, which act as an important shock absorber for many sectors. Share repurchases totaled $750 billion last year, but appear set to decline by around 50% this year, followed by a smaller dip in 2021 and then a rebound to trend. This is roughly consistent with the 8-quarter, 67% peak-to-trough decline experienced during the GFC.

Leading the charge have been banks, with America's eight largest announcing on March 15 that they would suspend buybacks through at least July. While their action on share repurchases was appropriately fast and furious, the big banks have defended their plans to continue paying dividends, unless "an extremely adverse scenario" unfolds. This stance has attracted substantial controversy, partially because banks were central to the financial crisis of 2008 and are still viewed with some suspicion.

Many pundits argue that this time U.S. banks must grasp the opportunity to ensure they are not only part of the solution but are seen to be so. To make the optics even more contentious for domestic lenders, on March 27 the ECB issued its "recommendation" that, at least until October 1, 2020, European banks refrain from both dividends and share buybacks. Similarly, on April 1 the U.K. regulator "advised" all major U.K. banks to suspend dividends and buybacks until the end of 2020. Although the U.S. Fed has adopted a more accommodative attitude regarding dividend payouts by domestic banks, its stance is clearly subject to change.

A final factor weighing on U.S. dividends this year is government restrictions related to the Coronavirus Aid, Relief and Economic Security Act (CARES). CARES stipulates that any company that borrows money from the federal government may not pay a dividend or repurchase stock until 12 months after the loan is repaid in full. The bill explicitly provisions assistance for airlines, air cargo and aerospace companies, but any company receiving assistance from the Treasury will also be subject to these restrictions.

Turning to Europe, we expect EPS to fall by 30% to 50% in 2020. This is moderately worse than what appears likely for the U.S., but similar in severity to the continent's experience during the GFC. Regarding dividends, the consensus foresees a decline of 25% to 50% in 2020, with the wide range being indicative of the acute degree of uncertainty. For example, the lower bound would be hit if bank and energy dividends declined toward zero, while other sectors experienced falls similar to the GFC. Additionally, and comparable to the U.S., all major European countries have made access to state financial support this year conditional on companies scrapping dividend payments.

Across the channel, hefty exposure to energy and financials suggest the U.K. dividend base looks especially vulnerable. According to the Link Group's UK Dividend Monitor, dividends could decline by 27% to 53% in 2020. However, it also predicts "classic defensive sectors," such as food retailers, health care and basic consumer goods, will continue paying their dividends.

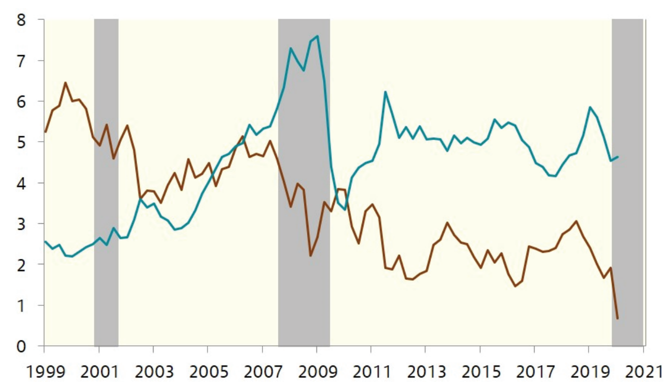
THIS TOO SHALL PASS

The above discussion largely concerns our outlook for the next year or two. Beyond the short-to-medium term, though, we believe the drivers that have led to strong dividend payouts over the last two decades should remain intact. First, as emphasized in our "Tech Is the New Macro" discussions, the shift from atoms to bits, or asset-heavy to asset-lite business models (more tech and health care and less capital-intensive cyclicals) is, if anything, accelerating. As our DuPont RoE decomposition has demonstrated, this implies higher profit margins and lower capital requirement, freeing up a higher proportion of cash to be distributed to shareholders.

Second, rates are likely to stay lower for even longer, which incentivizes companies to maintain lean balance sheets and return excess cash earnings to shareholders. This is consistent with QE's raison d'etre, which is to discourage holding cash (by investors, corporates or households) in favor of opportunities further out on the risk curve. Third, if buybacks continue to be vilified by the press and some politicians, then S&P 500 companies could opt for boosting dividends. Total shareholder yield has averaged well over 4% for decades, and we don't see it declining materially during the 2020s.

Further, we have been in a world of yield starvation for well over a decade now. Bond yields had been driven lower by demographic challenges, benign inflation (reflecting the digitization of the economy), hyper aggressive central banks and elevated policy uncertainty. With COVID-19, bond yields plummeted yet again to new record lows. We expect this interest rate environment, characterized by sub-2% GDP growth and large government deficits, to persist for many years to come.

The Economist forecasts global payouts to shareholders (dividends and buybacks) to decline by a thumping 36% in 2020. Moreover, the historical experience suggests that, post-recession, a swoosh-shaped recovery is most likely. Further, in previous recessions dividend yields and dividend payout ratios almost always increased, as DPS declined by less than both EPS and market cap. Although this cycle might be somewhat different, with dividends declining by roughly the same percentage as earnings, we expect the yield available from equities to remain far superior to that attainable in fixed



income markets (Figure 2). And as dividends recover from 2021 onward, it is possible that this gap will expand even further.

FIGURE 2: OVER THE LAST DECADE, TOTAL EQUITY YIELD HAS FAR SURPASSED THAT OBTAINED FROM BONDS

Source: Bloomberg, NBER, Epoch Investment Partners

As a result of the above points, we believe the companies best positioned for this challenging environment are those that have a demonstrated ability to produce sustainable free cash flow and allocate that cash flow effectively between return of capital options and reinvestment/acquisition opportunities.