Insights
Active Quantitative Equity (AQE)

June 2020

Dividends in the COVID-19 Era

Guarav Mallik
Chief Portfolio Strategist

Lori Heinel
Deputy Global Chief Investment Officer

Dividend growth is slowing in the aftermath of the COVID-19 market crisis, but we think this trend will be relatively short-lived. Here's where dividends are most likely to be at risk, and where they're most likely to be preserved, in the months to come.

In the bull market following the Global Financial Crisis (GFC), companies dramatically increased capital distributions to shareholders. Much of that capital was returned through stock buybacks,[1] but dividend payouts also played a major role. S&P 500 stocks paid out nearly $500 billion in dividends last year, making 2019 a record year for dividend payouts by some measures.

The current crisis has changed that landscape. News reports of dividend cuts and suspensions have emerged in recent weeks[2] as companies seek to preserve cash, secure their balance sheets, and ensure stability. Growth in dividends has made a substantial contribution to stock-market returns since the GFC; a significant reduction in dividend payouts over an extended period could have a very negative effect on equity-market performance.

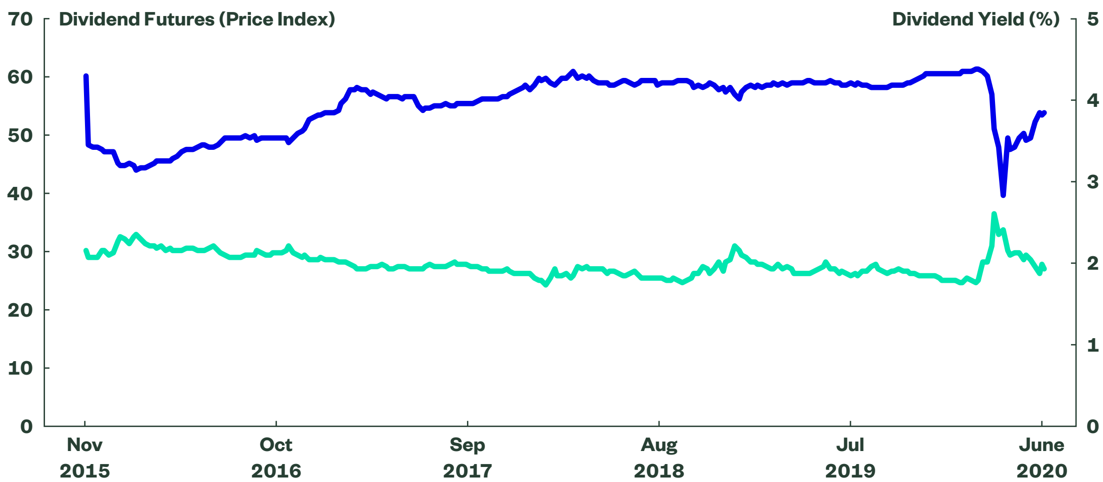
Although dividend growth may be muted in the short term, there is good reason to believe that this slowdown is likely to be short-lived. This piece will follow up on our recent discussion of stock buybacks to survey the dividend landscape in light of the COVID-19 crisis. We'll look at how dividend payouts are likely to be affected beyond the initial impact of the crisis, and examine the sectors where dividends are most likely to be at risk, and those where they're most likely to be preserved.

Markets Remain Pessimistic on Dividend Yields

Given the steep decline in economic activity stemming from pandemic-related lockdowns, market participants have understandably questioned how dividends might be affected. During the March 2020 drawdown and in the period immediately following, dividend expectations dropped substantially. For the S&P 500, for example, futures markets anticipated 30% to 50% cuts for 2020 into 2021, and around a 30% cut for 2023 (see Figure 1). A similar pattern took shape during the same time period in Europe.

Figure 1
Dividend Expectations Dropped Sharply During the March 2020 Drawdown
S&P 500 Dividend Futures Versus Actual Dividend Yields

S&P 500 Dividend Futures
S&P 500 Dividend Yield

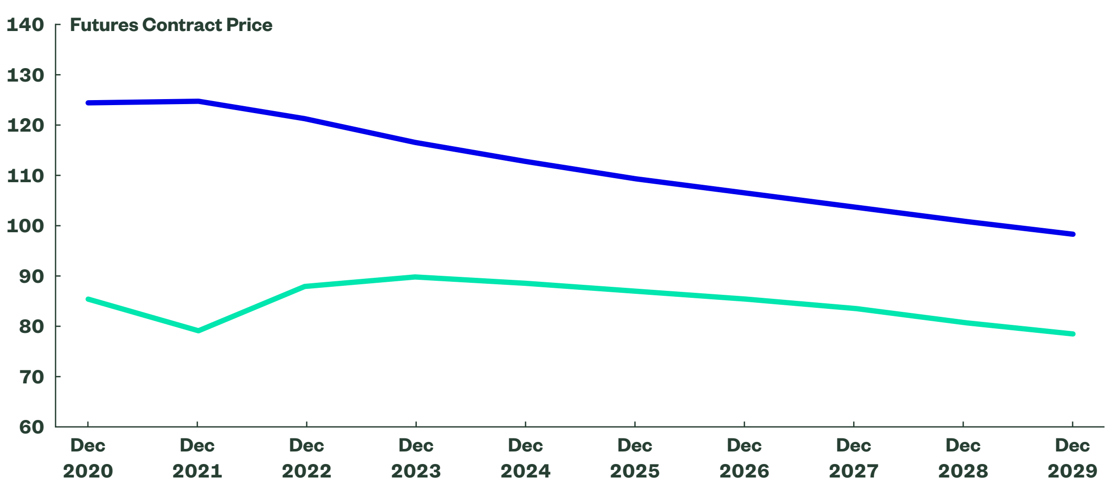


Source: Bloomberg, as of June 16, 2020.

Futures pricing further indicated that market participants expected dividend cuts to be sustained over the long term. Dividend futures on Euro Stoxx, for example, suggested that impairment would persist for 10 years or more (see Figure 2).

Figure 2
At the Time of the March 2020 Drawdown, Dividend Futures Anticipated Impairment in Dividend Payouts for 10 Years or More
Euro Stoxx Dividend Futures Through June 15, 2020

Euro Stoxx 50 DVD : EUX : Last Price : 06/15/2020
Euro Stoxx 50 DVD : EUX : Last Price : 01/02/2020

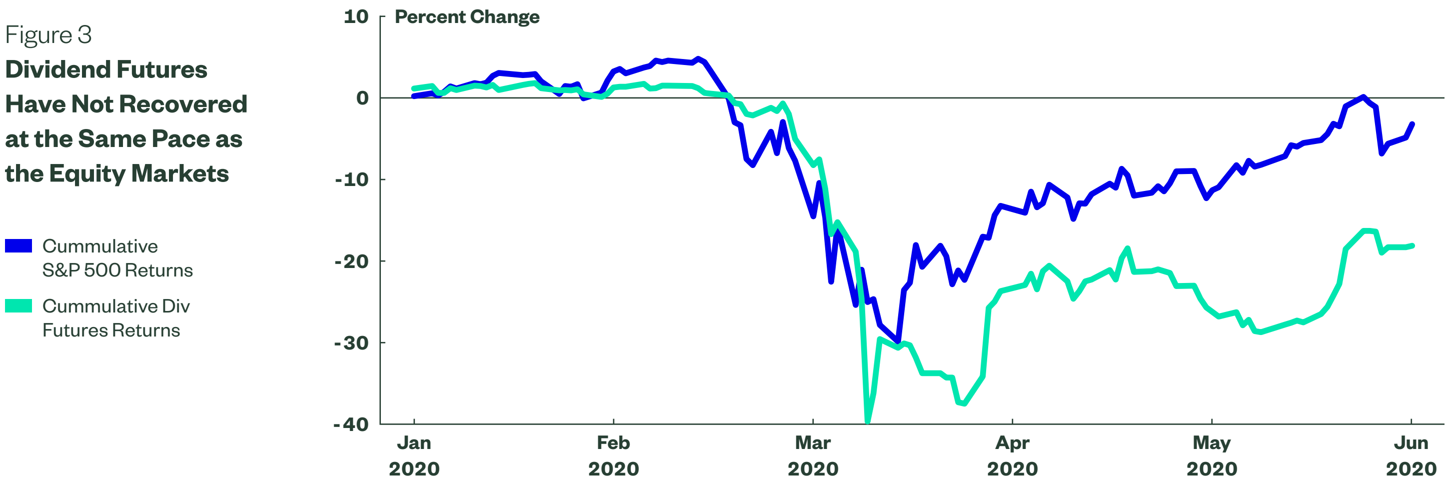


Source: Bloomberg Finance L.P., as of April 20, 2020.

These initial expectations appear to have moderated somewhat for a variety of reasons. Corporate cash flow impairment has not been as significant as initially feared, and companies have shown more balance-sheet resilience than anticipated. Equity markets have rallied to regain the losses they sustained in the downturn. These and other factors have led market participants to discount many worst-case scenarios, including worries that dividends would be cut drastically.

Even so, we believe that the dividend cuts that have been priced in may still be excessive. Index returns and dividend futures historically have been closely related. As equity markets have regained ground in the recent rally, however, an unusually large gap has opened up between index performance and dividend futures, suggesting that dividend expectations are out of line with actual values (see Figure 3). In the next section, we'll explore the key reasons why we believe this gap represents an underestimation of the dividends' durability.

Figure 3
Dividend Futures Have Not Recovered at the Same Pace as the Equity Markets



Source: Bloomberg; Goldman Sachs, as of June 16, 2020. Normalized as of 1 January 2020.

Dividend Reductions Are Likely to Be Smaller in Scale and Relatively Short-lived

We believe that the market is overly pessimistic regarding dividend prospects for several reasons. First, the market seems to be underestimating the historical persistence of dividend payouts. In fact, dividend payouts have been very consistent over time, with dividend growth increasingly markedly in recent years (see Figure 4).[3] At the same time, the dividend payout ratio — a measure of total dividends paid relative to net income — has declined in recent years. This decline may provide a degree of cushion that would allow companies to sustain a payout ratio in line with historical averages, even if their earnings contract.

Figure 4
Dividend Payouts Have Been Historically Persistent
S&P 500 Returns, Earnings Per Share Growth, Dividends Per Share Growth, and Payout Ratio, 1970–2020

	S&P 500 Returns (%)	S&P 500 — EPS Growth (%)	S&P 500 — DPS Growth (%)	Payout Ratio
10 Years	11.20	10.00	10.30	43.95854
20 Years	4.02	5.71	6.81	47.34247
30 Years	7.66	6.35	5.68	52.61467
50 Years	7.19	6.92	6.18	52.61467

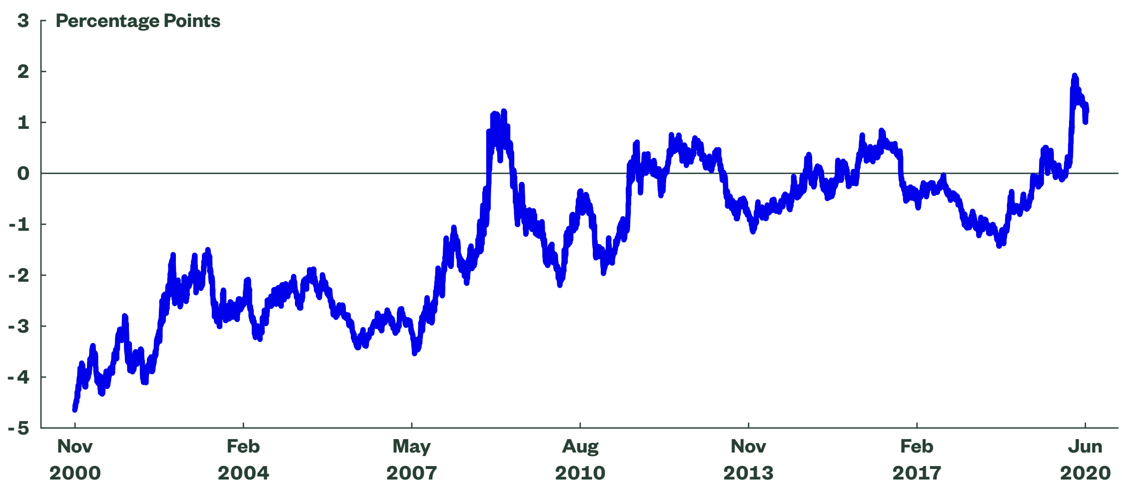
Source: Bloomberg, as of March 31, 2020.

Dividend payments have tended to persist over time for several reasons. First and perhaps most importantly, dividends retain strong signaling power because they're usually funded with cash generated from operations. A consistent track record of maintaining or increasing dividends payments indicates robust financial health, balance-sheet stability, and sound management. In contrast, dividend cuts can signal the opposite — flagging finances, balance-sheet insecurity, and weak management.

Markets may anticipate deep dividend cuts in part because of an expectation that not only would cuts become necessary to ensure financial stability, the stigma of those cuts would also be reduced as companies took cover in widespread dividend reductions. But recent data suggests that dividend payments actually have been rather resilient. For example, according to Strategas Research Partners, 151 dividend increases were announced between January 1, 2020 and May 26, 2020. Thirty-one of these announcements — more than 20% of the total — were made following the start of the COVID-19 pandemic.

Another reason that dividends tend to persist is investor expectations. Income investors, in particular, hold on to stocks with the expectation that cash will be returned to them. As recent announcements demonstrate, many dividend issuers are reluctant to defy those expectations, even in times of crisis. Furthermore, historically low interest rates and widening spreads between very low bond yields and higher dividend yields are likely to stimulate demand for dividends. Spreads between 10-year US treasury bond yields and the estimated dividend yield for S&P 500 companies are the widest they've been since the GFC (see Figure 5). Companies seeking to attract equity capital should therefore have an incentive to maintain dividend payouts to continue to distinguish themselves from income investors' other options.

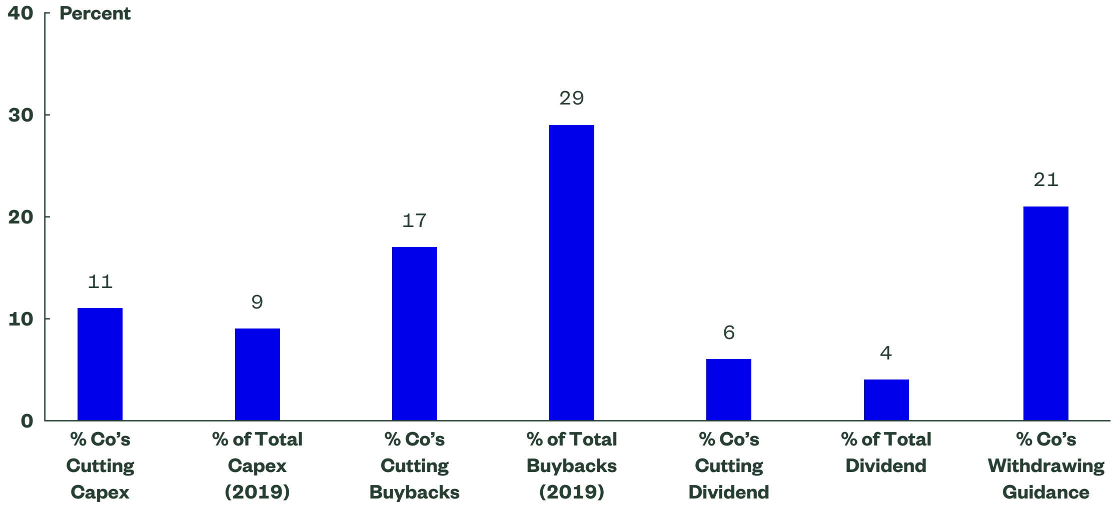
Figure 5
Spreads Between 10-Year US Treasury Bond Yields and Estimated Dividend Yield For the S&P 500 Are the Widest They've Been Since the GFC
S&P 500 Dividend Payout Ratio Versus 10-Year Treasury Yield



Source: Bloomberg Finance L.P., as of June 16, 2020.

Reduction in buyback activity[4] may also provide room for companies to continue paying dividends. In recent years, buybacks have consumed about 25% of operating cash flow at S&P 500 companies. Corporate guidance issued during the Q1 2020 reporting period suggests that buybacks are much more likely than dividends to be cut in 2020. Seventeen percent of S&P 500 companies reported that they plan to cut stock buybacks in response to COVID-19, representing a 29% reduction in the total dollar value of repurchases across the index. In contrast, only 6% of S&P 500 companies reported that they would cut dividends, representing a 4% reduction in the total dollar value of dividend cuts across the index (see Figure 6). This suggests that, in many instances, companies will seek to preserve dividends over maintaining share repurchase programs. Indeed, according to recent guidance, more companies plan to cut capital expenditures than plan to cut dividends.[5]

Figure 6
More Companies Plan to Cut Back on Buybacks Than Anticipate Cutting Dividends
Capital Plans for S&P 500 Companies, Q1 2020 Reporting Period



Source: JPMorgan, as of May 15, 2020.

The Sector View

Although we believe that dividends in the aggregate are likely to be quite durable, for investors who are focused on seeking out pockets of sustainable and increasing dividends, sector-level differences in dividend payouts are a crucial consideration. The high dividend payers of the past may not be the high dividend payers of the future.

A comparison of sector-level dividend activity in 2009 (immediately following the GFC) with 2019 activity suggests that a shift is under way. In 2009, more mature sectors such as Financials tended to deliver dividends more often than other sectors. By 2019, dividend delivery had shifted to growth sectors, including Information Technology (see Figure 7).

Figure 7
Dividend Activity has Shifted From Mature Sectors to Growth Sectors
Average Dividend Payout Per Sector in the S&P 500 Index for Each Year

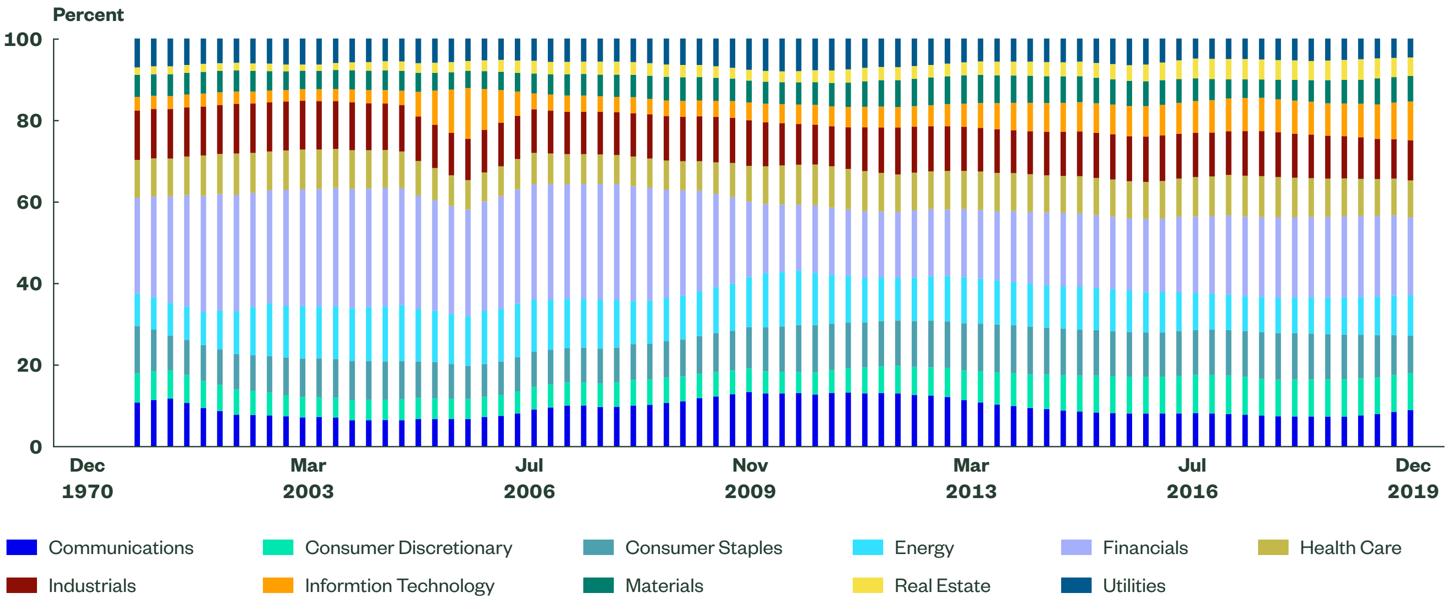
	2019 (%)	2009 (%)	Difference (%)
Communications	9	11	-2
Consumer Discretionary	9	6	3
Consumer Staples	9	9	0
Energy	10	11	-1
Financials	19	26	-7
Health Care	9	7	2
Industrials	10	11	-1
Information Technology	10	4	6
Materials	6	6	0
Real Estate	5	3	2
Utilities	5	6	-2

Source: FactSet.

There is reason to believe that the COVID-19 crisis could further accelerate this sector shift. The sectors that are delivering the most dividends today are Financials, Health Care, and IT (see Figure 8.) Of these, Financials are most at risk for cutting dividends, due to the need to preserve capital in the face of rising default risk. Health care providers are also at risk for dividend cuts, because their financial results have suffered in the pivot away from lucrative elective procedures toward COVID-19 care. In line with these expectations, companies in each sector were more likely than their peers to report plans to reduce or suspend dividends in the most recent reporting season.

In contrast, IT companies may have room to expand payouts due to their strong cash positions and profitability. Apple, Microsoft, and Google currently have approximately $500 billion in cash sitting on their combined balance sheet. Between them, these three firms distribute $100 billion in cash dividends each year to their shareholders.

Figure 8
The Sectors Delivering the Most Dividends Today Are Financials, Health Care, and IT
Contribution to Total Dividend Payouts, by Sector, for the S&P 500



Source: FactSet, as of December 31, 2019.

Closing Thoughts

In the immediate wake of the COVID-19 crisis, dividends have come under pressure, but we think the slowdown in dividend growth will be relatively brief. Although the dividend payers of the future may not be the same as those of the past at a sector level, dividend payouts in general have been very persistent historically. Even in crisis periods, companies with balance sheet capacity have many incentives to sustain their dividends programs.

We believe that equity investors seeking opportunity in the COVID-19 era will find the greatest potential for outperformance in high-quality companies with proven managers, resilient business models, and sound balance sheets — and we expect that, for many of these firms, dividends will remain a pillar of equity returns in the months to come.

Endnotes

1 As discussed in our recent paper, Stock Buybacks Through the Lens of the COVID-19 Crisis (April 2020).

2 The roster of companies cutting or suspending dividends as a result of the COVID-19 crisis span a wide range of sectors, including manufacturers (Boeing, Ford Motor), retailers (Macy's), restaurant chains (Brinker International, Dave & Busters), transportation services (Macquarie Infrastructure Group), and more. US airlines accepting federal aid packages are restricting from paying dividends for a period of time. Several large British banks have also announced that they will not pay dividends in 2020, in response to central bank regulators' urging to preserve capital to help support the economy.

3 Our discussion in this section cites S&P 500 data as an example for clarity and reading ease. Our analysis applies equally in Europe, where dividend payout ratios are in fact higher than in the US (around 62%), and buybacks are used less frequently. Dividend payouts in Europe are also highly concentrated in the financial sector.

4 Until the full impact of the COVID-19 pandemic on the economy is known, we expect companies with strong market positions to continue buying back their shares, but at a reduced scale. For more information, see Stock Buybacks Through the Lens of the COVID-19 Crisis (April 2020).

5 Note that substantial uncertainty on each of these points remains: 21% of S&P 500 companies withdrew guidance on capital expenditures and distributions during this reporting period.

ssga.com

State Street Global Advisors Worldwide Entities

Investing involves risk including the risk of loss of principal. The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor. All material has been obtained from sources believed to be reliable. There is no representation or warranty as to the accuracy of the information and State Street shall have no liability for decisions based on such information.

The views expressed are the views of Gaurav Mallik and Lori Heinel through June 16, 2020, and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected. Investing involves risk including the risk of loss of principal.

For use in EMEA:
The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the Markets in Financial Instruments Directive (2014/65/EU) or applicable Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This communication is directed at professional clients (this includes eligible counterparties as defined by the appropriate EU regulator) who are deemed both knowledgeable and experienced in matters relating to investments. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) should not rely on this communication.

All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA's express written consent.

© 2020 State Street Corporation.
All Rights Reserved.
ID237262-3132601.1.1.GBL.RTL 0620
Exp. Date: 06/30/2020