

Using a Quality Income Strategy in Today's Business Climate

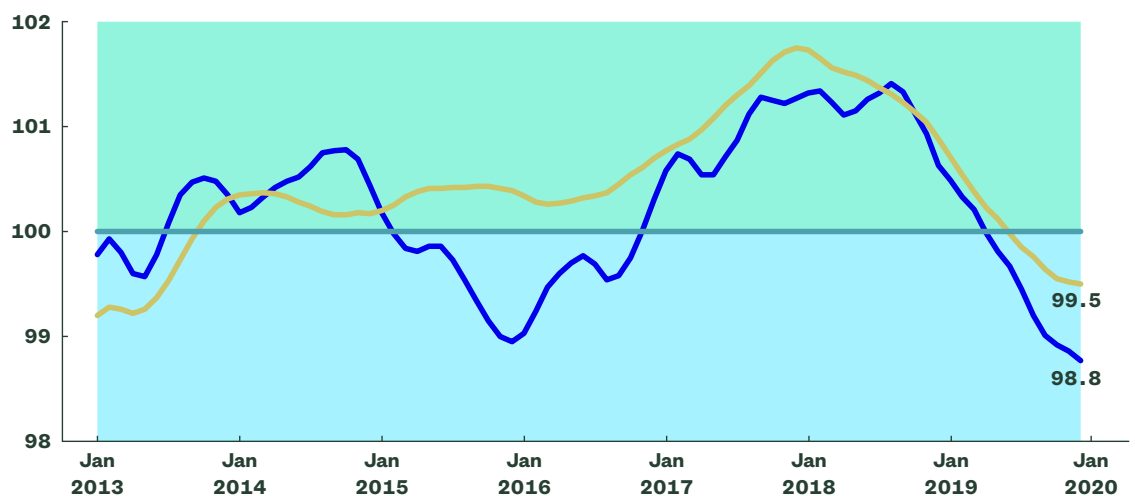
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- The reduction in key headwinds facing the US (China trade policy) and eurozone (Brexit resolution) helped to calm markets moving into 2020.
- Investors worried about geopolitical shocks and sustained stability can consider defensive equity positioning to protect against volatility.
- A selective quality income strategy, such as Dividend Aristocrats, helps investors seeking to remain long US equities and increase exposure to Europe.

At State Street Global Advisors, our baseline call last year was for investors to continue to favour US equities, based on supportive monetary and fiscal policy and a contained inflation outlook. We cautioned investors to monitor the risk of global trade disruptions (on manufacturing) and an escalation in trade tariffs (on consumers). While we remain constructive on the US market, we are beginning to also favour European equities at their current valuations.

Figure 1
Measures of Business Confidence in the US and Eurozone



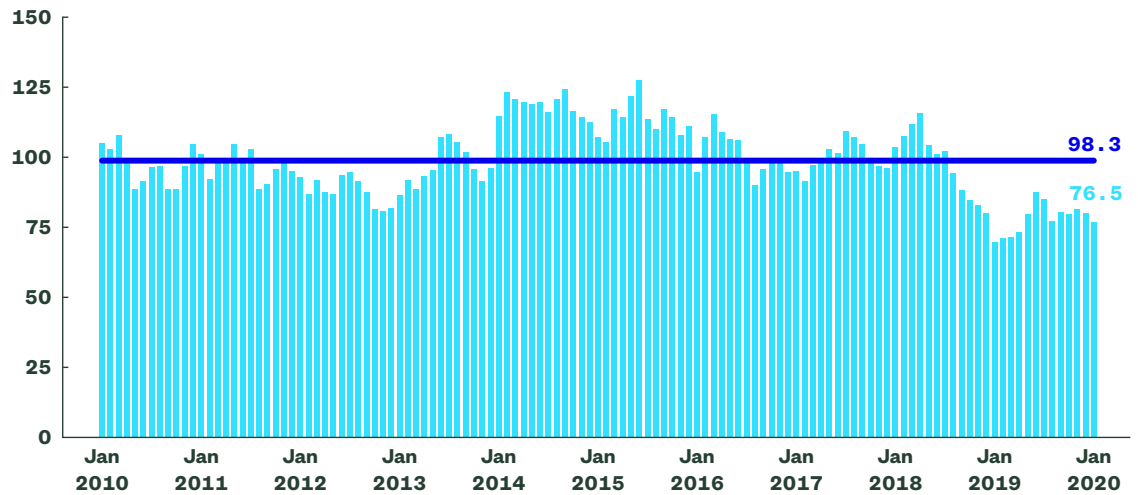
Source: OECD (2019)¹, FactSet, as of 31 January 2020.

In 2019, the OECD Business Confidence Index crossed the critical 100 threshold in both the United States (April 2019) and eurozone (June 2019), indicating pessimism towards future performance. This marks the first time both regions have both been below the threshold since June 2013.

Since peaking in the first half of 2018 (see Figure 1), business confidence has been in steady decline, and now sits near 10-year lows. This has correlated with a similar slide in investor confidence, as observed by the State Street Investor Confidence Index (“SSICCONF”). Though the SSICCONF has come off a decade-low level of 69.4 (January 2019), it remains notably below its long-term average (see Figure 2). These confidence measures may suggest a challenging environment for equity prices could exist on the horizon.

Figure 2
Measure of Investor Confidence

State Street Investor Confidence Index² (“SSICCONF”)
Long-Term SSICCONF Average



Source: State Street, Bloomberg Finance L.P., as of 31 January 2020.

Despite the declining business confidence and below-average investor confidence (albeit increasing), both eurozone and US equities rallied in 2019, closing the year near (or at) all-time highs. This environment of high equity prices and low confidence may cause investors to fear near-term volatility spikes — especially as the risk of geopolitical shocks (e.g. Iran-US foreign relations) and political instability (e.g. US elections) appear to be rising.

Investors seeking to remain long equity markets globally — in the US, Europe or even the UK — could consider a quality income strategy such as Dividend Aristocrats.

Staying the Course in US Equities

Despite significant market pullbacks last year in May, August and October, the S&P 500 Index ended 2019 near an all-time record high. The federal funds rate is now expected to remain stable for the foreseeable future, and solid consumer-driven fundamentals persist in the US as the tariff headwinds from Chinese trade policy have abated in the short term.

The US and China have reached an agreement on the first phase of a reset on trade relations, marking a major step forward for the world's two largest economies. The result was an avoidance of US tariffs on the Chinese import of consumer goods, originally scheduled to come into effect in December. In addition, the deal provides support for domestic exporters to China, which benefit from Chinese commitment to increase purchases (e.g. agriculture).

However, US equities remain susceptible to domestic politics and geopolitical shocks, especially in an election year. Indeed, it remains to be seen what impact President Trump's recent impeachment acquittal will have on his approach to governing within the US and conducting international relations abroad. Furthermore, as we progress through the Democratic primaries and look ahead to the general election, harsh cross-aisle rhetoric may continue to cause headwinds to business and investor confidence.

Valuation Opportunity in Europe

We still believe US economic outperformance can continue. Although, we see increasing potential in other regions to close the performance gap in 2020. Structural challenges in Europe (including the UK) are largely reflected in current valuations. With real progress being made to address uncertainties related to European Central Bank ("ECB") policy and Brexit resolution, Europe should be able to refocus in 2020 on economic growth.

Eurozone manufacturing (e.g. Germany and France) appears to have hit a near-term bottom in 2019. The ECB has replaced the technocratic Mario Draghi, largely remembered for his now famous "*do whatever it takes to preserve the euro*" speech (London 2012), with the diplomatic Christine Lagarde. With this change, market participants are becoming increasingly optimistic that Lagarde can successfully lobby for fiscal stimulus, in countries such as Germany, to stimulate growth. While negative interest rates in Europe have helped stabilise the manufacturing sector, market participants are looking for new (fiscal) investment to stimulate demand, which can help growth.

With investors questioning whether 2020 can bring about a long-anticipated convergence in the eurozone (relative to the US), and with most of the remaining headwinds baked into current valuations, this could present an opportunity for European equities.

Using a Quality Dividend Strategy to Stay Long

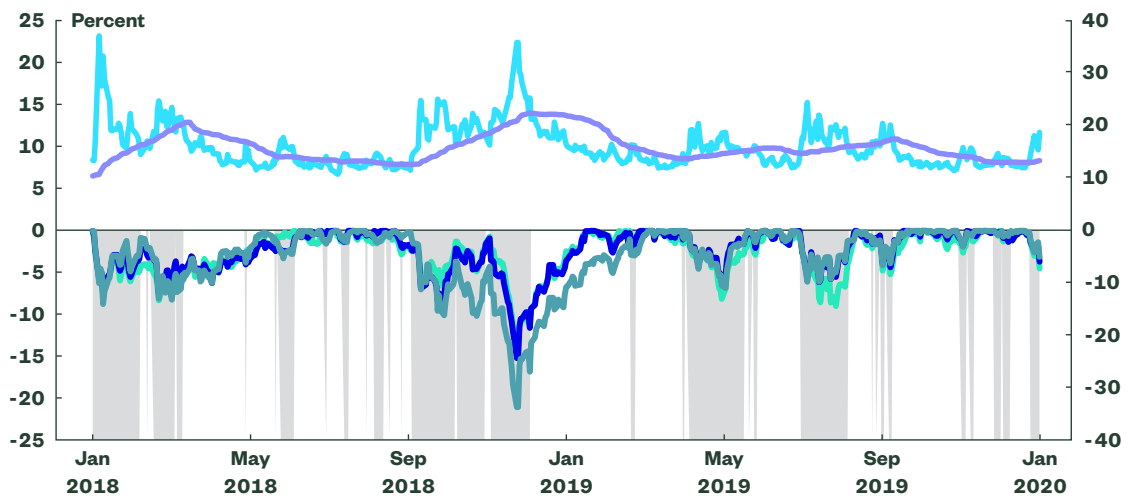
Although equity volatility is currently normalising at historical levels, we believe that the major drivers of volatility — including geopolitical uncertainty, global trade risks and a widening gap between fundamentals and returns — are likely to endure in 2020. These risks could materialise in dramatic spikes in volatility, with markets repricing assets rapidly based on changes in sentiment.

With all of this in mind, in 2020 investors will be challenged to take full advantage of market upsides while adopting or maintaining defensive positioning. Investors who believe that the developed market economies of the US and Europe may have further to run, but who are concerned about potential headwinds, should consider a quality income strategy, such as that offered by the Dividend Aristocrats exposure. In order to demonstrate this approach, we can look at how Dividend Aristocrats strategies have performed recently during periodic spikes in volatility.

Following the episode in early 2018 now referred to as “Volmageddon,” we have seen a stabilisation in trend volatility, but with periodic market disruptions. In the following charts (see Figures 3 and 4), we explore the relationship between these spikes in volatility and the performance of Dividend Aristocrats strategies.

Figure 3
Trend VIX and Drawdown Analysis
(Last 2 years)

- S&P U.S. Dividend Aristocrats Index (LHS)
- S&P 500 High Dividend Index (LHS)
- S&P 500 Index (LHS)
- VIX Index (RHS)
- VIX 50D Moving Avg. (RHS)
- VIX > 50D Moving Avg



Source: State Street, Bloomberg Finance L.P., as of 31 January 2020. *Reference drawdown baseline date 31 January 2018.

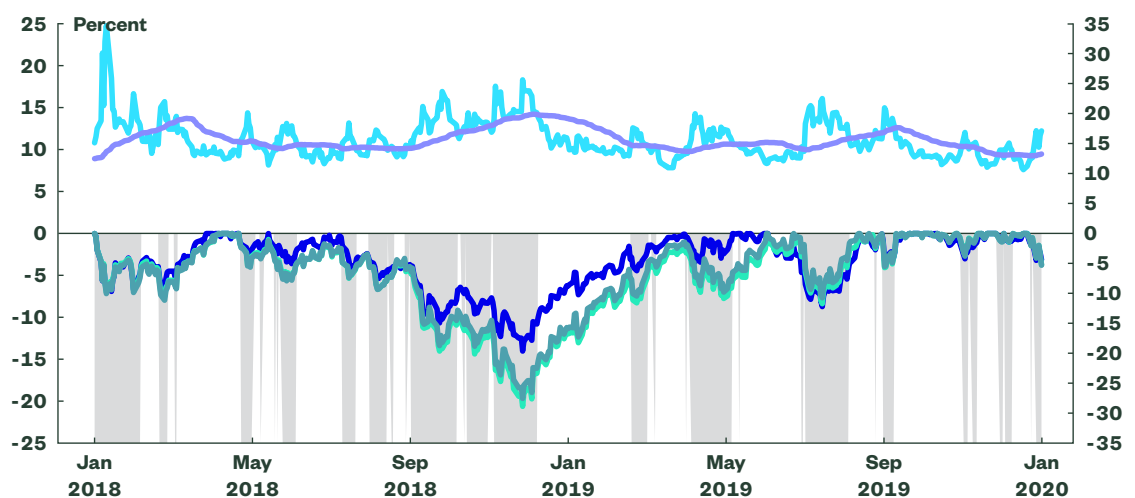
For this illustration, we use the Chicago Board Options Exchange Volatility Index (“VIX”) — also commonly referred to as the “fear gauge” — as the reference for the US market. We notice that during periods of significant VIX elevation (i.e. when the VIX moves above its 50-day moving average), the market was more susceptible to significant drawdowns.

In the last two years* (since January 2018), the S&P 500 Index experienced extended periods of drawdown, correlating with the VIX breaking above its 50-day moving average. The most significant pullback occurred in Q4 2018, when the S&P traded down more than 21% (since January). Over the same time period, investors in the Dividend Aristocrats strategy (down ~15%) would have benefited from the lower drawdown and realised and excess performance of nearly 6%.

Using the EURO STOXX 50 Volatility Index (“VSTOXX”) we can run similar analysis for a eurozone exposure (see Figure 4), where we observe the same relationship between relative volatility and index performance.

Figure 4
Trend VSTOXX and Drawdown Analysis
(Last 2 years)

- S&P Euro Dividend Aristocrats Index (LHS)
- S&P Eurozone BMI Index (LHS)
- MSCI EMU Index (LHS)
- VSTOXX Index (RHS)
- VSTOXX 50D Moving Avg. (RHS)
- VSTOXX > 50D Moving Avg.



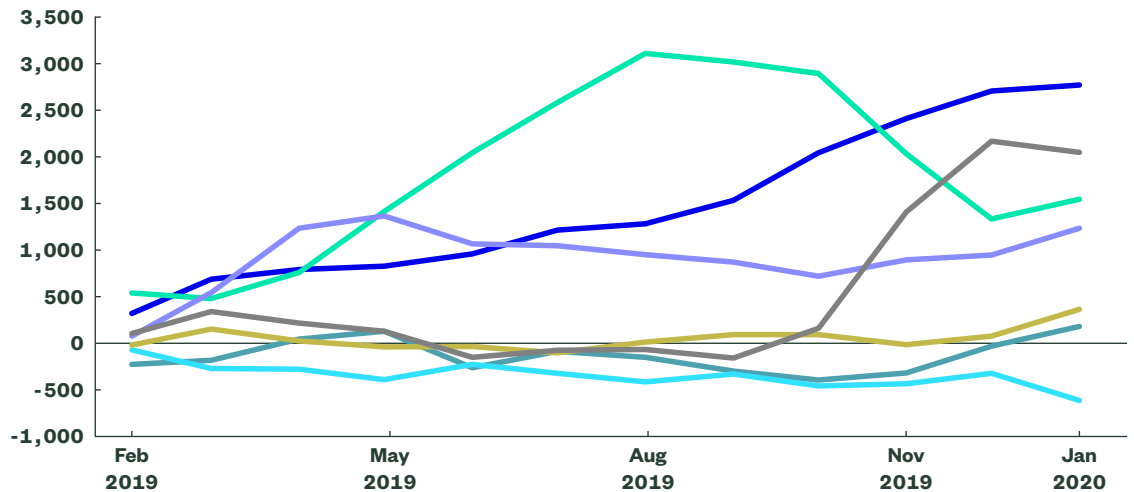
Source: State Street, Bloomberg Finance L.P., as of 31 January 2020. *Reference drawdown baseline date 31 January 2018.

The eurozone indices also experienced their largest drawdown of the last 2 years* in Q4 of 2018. Over this time period, the Euro Dividend Aristocrats strategy's maximum drawdown of 14% would have realised an excess performance of around 6% versus the pullback observed in the market cap indices: S&P Eurozone BMI (down 20.6%) and MSCI EMU (down 19.7%), as of 27 December 2018.

Beginning in 2019, investors allocated to defensive factor exposures in European-listed ETFs (see Figure 5), mainly Quality, Low Volatility and Dividend funds. In the second half of 2019, flows into Quality leveled out, with investors concerned on valuations. Low volatility began to see outflows, as rhetoric turned more constructive following significant market pullbacks in May and August.

Figure 5
Cumulative Flows in European-listed Smart Beta ETFs
(Last 12 months)

- Dividend
- Low Volatility
- Momentum
- Multifactor
- Quality
- Size
- Value



Source: State Street and Bloomberg Finance L.P., as of 31 January 2020. Flows are as of date indicated and shouldn't be relied thereafter.

Dividend factor funds experienced sustained inflows throughout 2019. These flows made sense as (quality) dividend exposures, such as Dividend Aristocrats, are meant offer investors some downside protection, while not as purely risk-off as a low volatility exposure. Following two years of deteriorating confidence and volatile markets, investors appear to be welcoming signs that near-term pessimism is fading. Moving into 2020, we believe investors will continue to allocate to dividend factor funds in order to position for a cautiously optimistic market outlook.

Conclusion

Despite markets entering 2020 at (or near) record high equity prices, the environment remains challenged by the global growth outlook, the risk of geopolitical shocks and systemically low interest rates. We remain constructive on US equities on the basis of a resilient consumer and steady inflation. We also see increasing opportunities for investors outside the US, mainly Europe and the UK, on a relative valuation basis. Investors seeking to remain long developed market equities, but who seek some downside protection, should look at a quality income strategy to combat spikes in volatility.

The family of S&P Dividend Aristocrats Indices pick from a diversified base of quality companies offering regular cash dividends, combining dividend growth with dividend yield, to help investors navigate uncertainty by taking a more defensive portfolio posture.

SPDR® ETFs

The investment objective of the SPDR® family of Dividend Aristocrats Indices seek to offer a selective exposure to US and eurozone broad market equities through companies that have historically demonstrated a strong track record of increasing or maintaining regular cash dividends. Historically, both the S&P® High Yield Dividend Aristocrats Index and S&P® Euro High Yield Dividend Aristocrats Index have demonstrated better absolute and risk-adjusted returns versus the benchmark universes of which they select their constituent stocks, in part by offering lower historical drawdowns.

SPDR® S&P® U.S. Dividend Aristocrats UCITS ETF

The S&P High Yield Dividend Aristocrats Index is comprised of the stocks of the S&P Composite 1500® Index that have increased dividends every year for at least 20 consecutive years. These stocks have both capital growth and dividend income characteristics, as opposed to stocks that are pure yield, or pure capital oriented.

SPDR® S&P® Euro Dividend Aristocrats UCITS ETF

The S&P Euro High Yield Dividend Aristocrats Index is designed to measure the performance of the 40 highest dividend-yielding Eurozone companies within the S&P Europe Broad Market Index (BMI), as determined in accordance with the Index methodology, that have followed a managed dividends policy of increasing or stable dividends for at least 10 consecutive years.

Figure 6
Standard Performance

Fund/Index Name	1 Month	3 Months	6 Months	YTD	1 Year	3 Years	5 Years	Since Inception
Inception Date 14 October 2011								
SPDR S&P US Dividend Aristocrats UCITS ETF (Dist)	-2.85	0.88	3.88	-2.85	12.28	9.82	10.07	12.70
S&P High Yield Dividend Aristocrats Index	-2.86	0.86	3.86	-2.86	12.23	9.74	10.04	12.66
Difference	0.01	0.02	0.02	0.01	0.05	0.08	0.03	0.04
Inception Date 28 February 2012								
SPDR S&P Euro Dividend Aristocrats UCITS ETF (Dist)	-1.51	1.35	7.50	-1.51	13.47	8.00	6.70	9.72
S&P Euro High Yield Dividend Aristocrats Index	-1.51	1.31	7.57	-1.51	12.94	7.56	6.34	9.39
Difference	0.00	0.04	-0.07	0.00	0.53	0.44	0.36	0.33

Source: State Street and Bloomberg Finance L.P., as of 31 January 2020. **Performance is net of fees. Performance quoted represents past performance, which is no guarantee of future results. Investment return and principal value will fluctuate, so you may have a gain or loss when shares are sold. Current performance may be higher or lower than that quoted. All results are historical and assume the reinvestment of dividends and capital gains. The performance data do not take account of the commissions and costs incurred on the issue and redemption, or purchases and sale, of units. Visit spdrs.com for most recent month-end performance.** Performance returns for periods of less than one year are not annualised. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. **Some of the products are not available to investors in certain jurisdictions. Please contact your relationship manager in regards to availability.**

Endnotes

- 1 Organisation for Economic Co-operation and Development (OECD) Business confidence index (BCI)** This business confidence indicator provides information on future developments, based upon opinion surveys on developments in production, orders and stocks of finished goods in the industry sector. It can be used to monitor output growth and to anticipate turning points in economic activity. Numbers above 100 suggest an increased confidence in near future business performance, and numbers below 100 indicate pessimism towards future performance.
- 2 State Street Investor Confidence Index®** The index provides an objective, quantitative measure of global risk tolerance of the world's sophisticated investors. State Street's approach measures confidence directly and quantitatively by assessing the changes in investor holdings of risky assets, implementing a research model developed by Harvard Professor Ken Froot and Managing Director Paul O'Connell of State Street Global Markets' research partnership — State Street Associates®.

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