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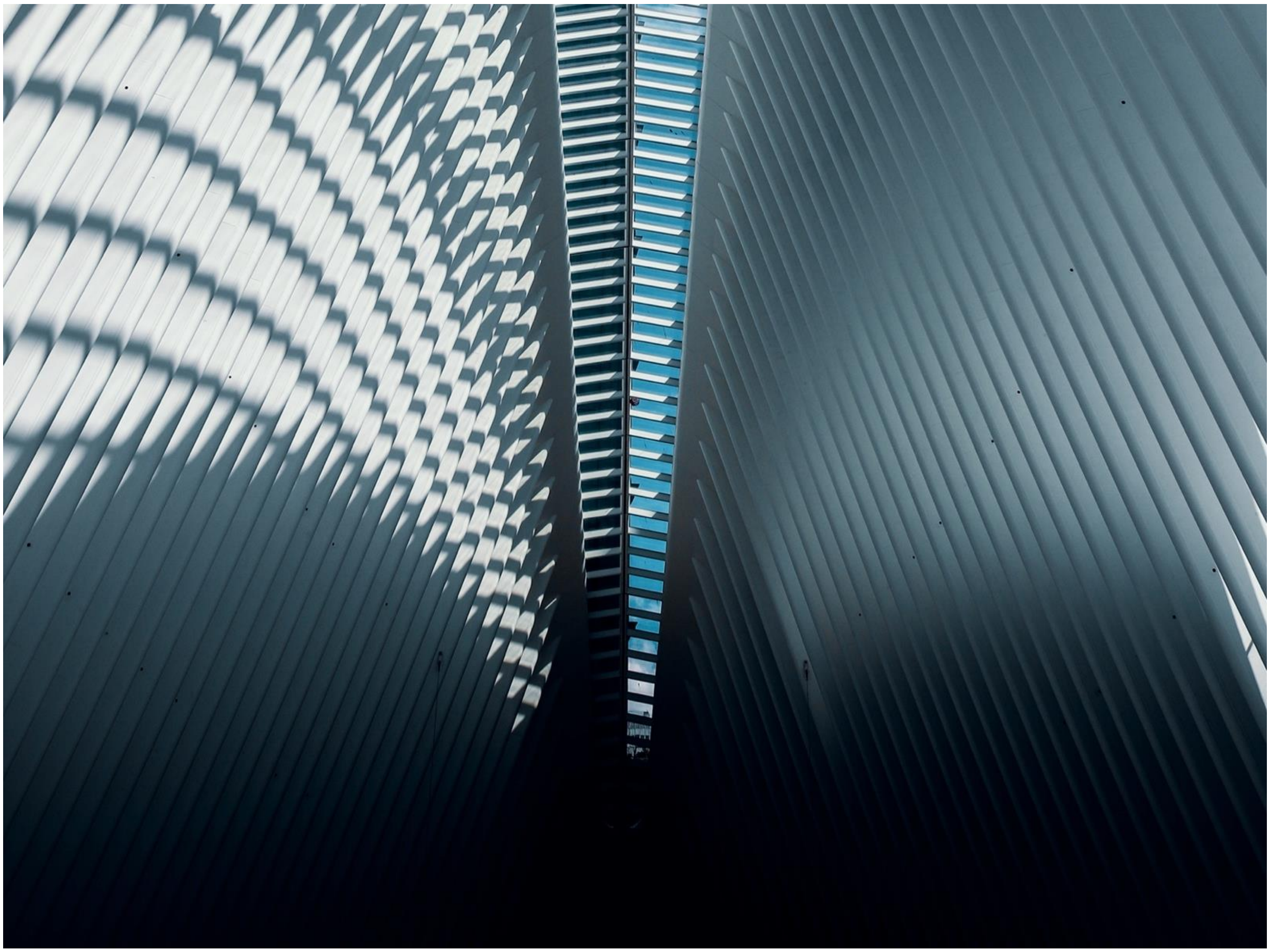
Around the Markets

April 17, 2020



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Is This the Real Life? Is This Just Fantasy?

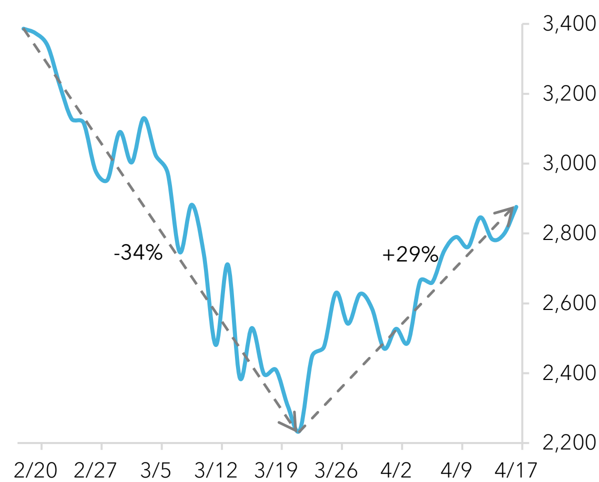
In the last few weeks, we have heard the word "surreal" used by many – families, friends, colleagues, journalists, politicians, and healthcare workers – in describing their respective experience of living in a time of pandemic. The definition of surreal is "not seeming real; like a dream," according to the Cambridge Dictionary, which also suggests a list of synonyms, including "strange" and "suspicious."[1]

Indeed, it is surreal as we survey the world today through the lens of investors. As of yesterday's market close, the Nasdaq 100 Index recovered the entirety of its losses for 2020.[2] Meanwhile, another five million Americans filed for unemployment benefits, bringing the total number over the past four weeks to roughly 22 million[3] suggesting an unemployment rate of nearly 20% or twice the figure reached in the Global Financial Crisis of 2008-2009.[4]

The equity market is not the economy. It is, however, anticipatory of the future conditions of the economy. Rarely have we seen such tremendous divergence in views between the bulls and the bears, with each side convinced that the other side is living in a dream, not reality. Indeed, these are strange, surreal times.

We believe that the 29% bounce back in the S&P 500 Index since late-March is a temporary relief recovery, following the most intense equity market decline in history in terms of the combination of its magnitude and speed. For now, the equity market is bathing in the euphoria of the greatest monetary and fiscal intervention of all time. Over the last few weeks, we witnessed central bank actions that were beyond speculation when we first wrote on the Federal Reserve's potential toolkit.[5] On March 26th, Fed Chairman Jerome Powell said in an interview that "We are not going to run out of ammunition. That doesn't happen." His statement was powerfully validated two weeks later, when the Fed announced that it would expand its corporate bond-buying program to include "fallen angels" (i.e., corporate bonds recently downgraded from investment grade to high yield). By providing relief to the BBB-segment of the US corporate bond market, the Fed substantially mitigated what was potentially one of the largest pockets of risk in the US financial system. These bonds account for roughly one-half of the entire investment grade corporate bond market and are more than twice the size of the entire high yield corporate bond market.[6]

S&P 500 Index[7]

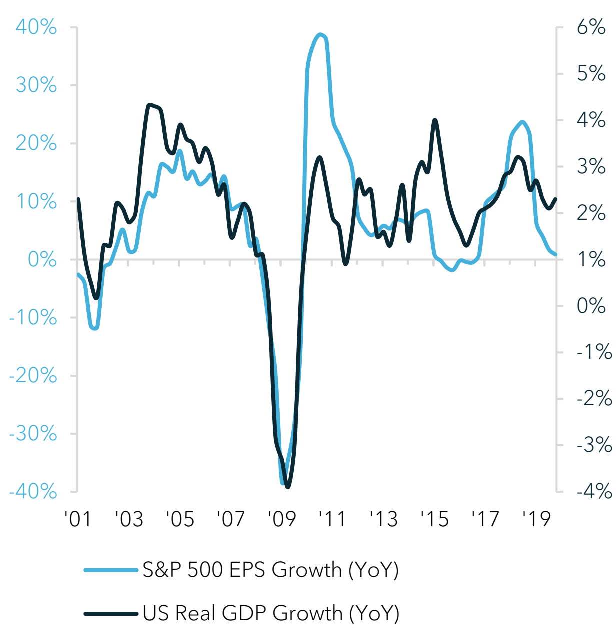


The aggressive policy response should provide a backstop to the financial markets and support the speed of the eventual economic recovery. However, given the rapid, broad-based collapse in consumer and business spending, it has become abundantly clear that we will experience a sharp contraction in the US and global economies in the

[1] Cambridge Dictionary
[2] Bloomberg, 4/16/2020
[3] US Department of Labor, 4/16/2020
[4] Bloomberg, 4/16/2020
[5] Rockefeller Insights, Around the Markets, 3/11/2020
[6] Bloomberg & RCM, 4/17/2020
[7] Bloomberg, 4/17/2020

second quarter of 2020. The median of economists' forecasts reported on Bloomberg now estimates annualized quarter over quarter real US GDP growth of -25.2% in Q2, with the more recently reported forecasts skewed towards the -30% to -40% range.[8] What we find more worrisome, however, is the dispersion of forecasts for GDP growth in the third and fourth quarters. This points to the inherently extreme tail risk present given the source of the current economic crisis and, correspondingly, the wide range of potential scenarios for the eventual economic recovery path.

Equity Forward Earnings Growth vs. GDP Growth[9]



Until a vaccine is developed and widely distributed, the future path of US and global economic growth remains highly unpredictable. Although we are seeing positive signals in the progression of virus cases in Italy and Spain, many other places around the world are at earlier stages of the COVID 19 outbreak. The ability of less developed countries to implement effective measures to contain the virus remains questionable. In some of the more developed countries, where the spread had previously been suppressed, rebounds are occurring, prompting even more extensive and stringent economic shutdowns.

There is a high correlation between corporate earnings growth and GDP growth, particularly during economic downturns. At current valuation levels for the US stock market, we believe that equity investors are not demanding sufficient compensation – or equity risk premium – for assuming the amount of uncertainty in future earnings growth.

Reconciling with Reality

The earnings season, which kicked off on Tuesday, may serve as a wake-up call for the equity market.

Until very recently, the impact of the COVID-19 pandemic's impact on corporate earnings had been largely a theoretical matter. As the pandemic crisis worsened, it became increasingly common for managements to withdraw financial guidance due to a lack of confidence in their forecasts. This translated into some staleness in earnings estimates. Although analysts had been lowering their forecasts heading into the earnings season, we saw a rapid acceleration in the decline of S&P 500 Index earnings per share (EPS) this week as banks released disappointing earnings, driven by increased reserves for anticipated loan losses. This was a sobering reminder that policymakers, despite their aggressive actions, are limited in their ability to materially mitigate the current economic impact from the COVID-19 pandemic.

On April 15th, 2020, the S&P 500 Index suffered the largest daily loss since the beginning of April. The adverse price action coincided with a decline of 3.4 (or 2.2%) in the next-12-month EPS of the index, the largest daily percentage decline in earnings in nearly twenty years. To put things in perspective,

[8] Bloomberg, 4/17/2020

[9] Bloomberg & RCM, 4/17/2020

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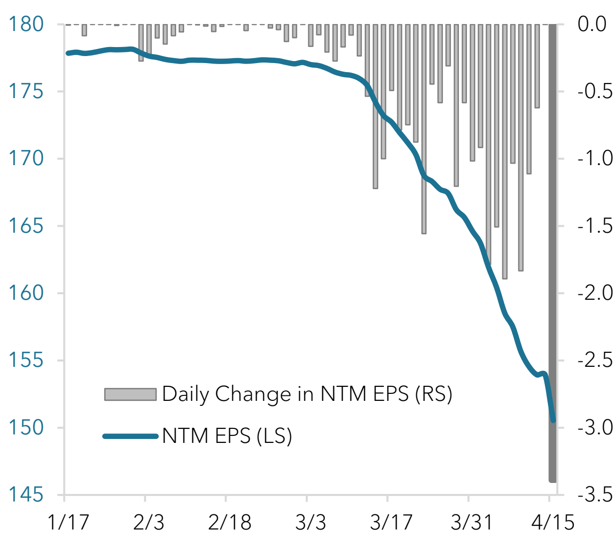
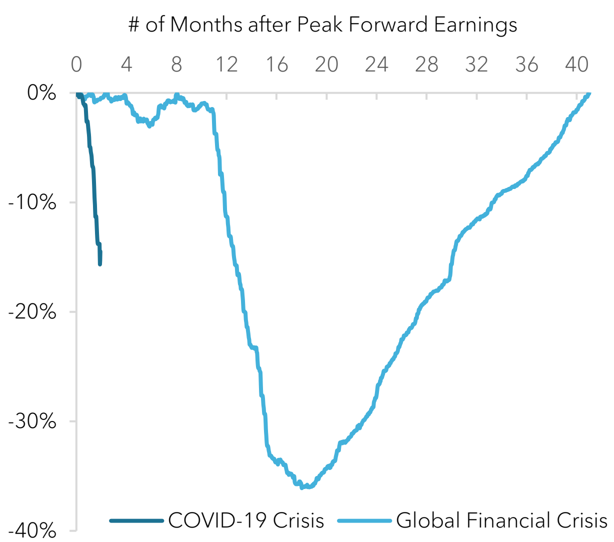
the largest daily percentage earnings decline of the S&P 500 Index during the Global Financial Crisis was 1.5%, which took place in January 2009.[10]

S&P 500 Index NTM Earnings per Share (EPS)



% Decline in S&P 500 Index NTM EPS from Peak[11]



Given the severity of the anticipated economic contraction, we believe that the bulk of earnings cuts still lie ahead. Investment firm Goldman Sachs expects the 2020 EPS of the S&P 500 Index to decline year-over-year by 33%, similar to the Global Financial Crisis.[12]

As 2020 earnings continue to be adjusted downwards, we expect elevated volatility and some equity market pullbacks, with forward price multiples becoming increasingly stretched.

Under Pressure

In addition to earnings risk, equity dividends are now under siege. Business interruptions resulting from the coronavirus are prompting many companies to re-think their approaches to capital allocation, particularly the return of capital to shareholders in the form of dividends and share buybacks. Recent government and Federal Reserve-sponsored assistance programs designed to alleviate the stress on virus-affected businesses come with restrictions.

Coronavirus Aid, Relief, and Economic Security (CARES) Act recipients may not pay dividends or buy back stock during the duration of the loan or for 12 months after it has been repaid.[13] This has prompted some analysts to question the security of dividends in general, arguing that companies across a wide swath of industries are likely to implement capital conservation strategies.

The futures market has already priced in material cuts to dividends. Dividend futures on the S&P 500 Index are now suggesting year-over-year declines of 18% and 10% for 2020 and 2021, respectively. The discounts are even more severe on European stocks. Dividend futures on the Euro STOXX 50 Index are suggesting a year-over-year decline of 44% in 2020, and a further decline of 7% in 2021.[14]

[10] FactSet & RCM, 4/15/2020
[11] FactSet & RCM, 4/16/2020
[12] Goldman Sachs, 4/6/2020s
[13] The Wall Street Journal, 4/10/2020
[14] Bloomberg & RCM, 4/17/2020

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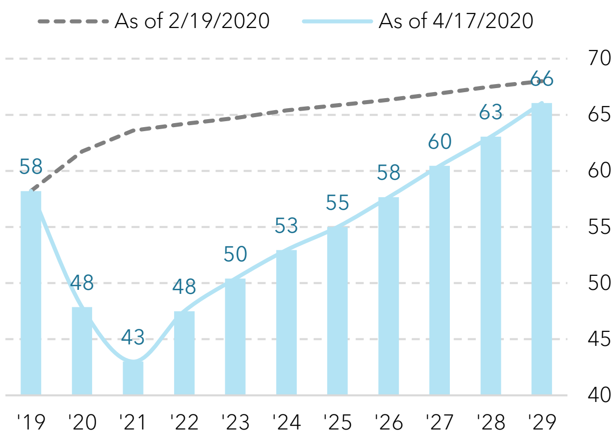
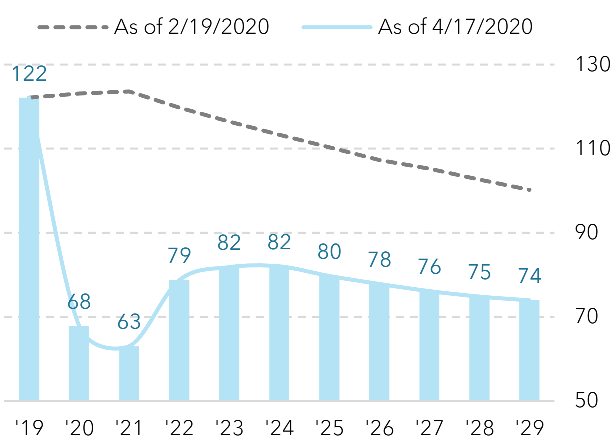
S&P 500 Index Dividend Futures (USD)



Euro STOXX 50 Index Dividend Futures (EUR)



It is important to note that these implied dividend cuts are likely too severe. The dividend futures market is much less liquid than the index futures market. As investors seek to hedge both price and dividend exposure, the lack of liquidity in the dividend futures market coupled with a mismatch between supply and demand (both of which generally become more exaggerated during distressed times) cause dividend futures to trade at excessive discounts.

We expect actual dividend payouts to be greater and recover more quickly than the dividend futures curves currently suggest. We think of the futures curve as a lower bound of market consensus expectations on dividend payouts.

The Bark is Worse than the Bite

We think the bark is worse than the bite here. So far in the US, very few companies have announced pandemic-induced dividend cuts. Within the S&P 500 Index, 420 companies currently pay a cash dividend. Of those, only 37 have announced dividend suspensions or cuts as of April 13, 2020.[15] These are concentrated in industries where Federal assistance has been extended: retailers/apparel, hotels, gaming, airlines and retail REITs. Excluding the REITs, these industries are not typically where investors find an abundance of income-oriented stocks and in aggregate they represent a modest portion of US equity market capitalization. But could the contagion spread to other market participants?

We think it unlikely that widespread dividend cuts will emerge. It is important to keep in mind that companies do not like to cut dividends as it sends a signal to investors that business operations are stressed; and stocks generally underperform the market, at least in the short-term, when dividends are cut. In the case of the announced cuts, however, many were forced by the CARES Act provisions and we expect most of those dividends to eventually be restored.

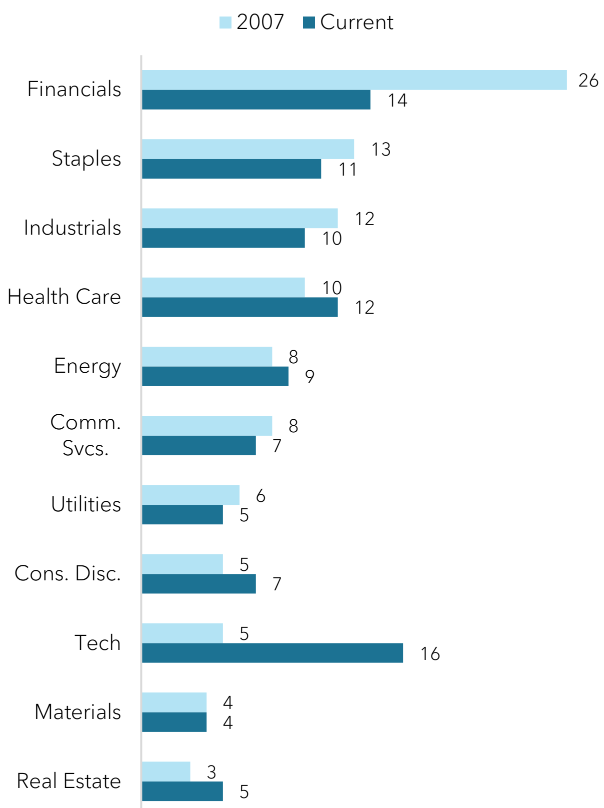
Investors may remember the effect of the Global Financial Crisis on dividend payments. Bank of America notes that more than 80 companies in the S&P 500 Index cut their dividends then, for a 24% drop in dividends per share for the Index.[16] Most of these companies were banks and other financial-related stocks where the crisis was centered. The effect on dividends was severe because Financials represented the largest contributing sector to Index

[15] Bloomberg, 4/13/2020

[16] BofA Global Research, 4/7/2020

dividends. Today, Financials and other income-generating sectors appear to have healthy balance sheets and are likely able to continue their dividend payments.

% of Contribution by Sector to Total S&P 500 Index Dividends[17]



There has been much written recently about the safety of bank dividends. Some current and former Federal Reserve officials, along with economists, have suggested that banks should suspend their dividends to shore up capital in case economic conditions (e.g., bad loans) are more dire than suspected.

European and U.K. regulatory authorities have directed banks there to suspend payment of all 2020 dividends as well as those still due for 2019; most banks have complied. This decision has major consequences for investors in European banks, as dividends comprise 75% of capital contributions vs. just 25% in the US.[18] Dividend cuts have had an immediate negative impact on share prices of European banks. The Euro STOXX 600 Banks Index has fallen by nearly 39% just since the end of February.[19]

US banks generally have stronger balance sheets than their European counterparts, and most of the larger US banks have already suspended share buybacks. For now, it does not appear that the Fed will force US banks to stop paying dividends. But the dividend question mark is likely to remain at least until the next round of annual "stress tests" are announced in June. Those tests show how the big banks would fare under recessionary scenarios; this year's results are likely to be closely scrutinized.

More Vulnerability to European Stock Dividends

In Europe, broader-based dividend interruptions are more likely. US and European companies return capital to shareholders through both dividends and stock buybacks. US companies mostly focus on buybacks to preserve cash flow, while European companies skew toward dividends. As with the banks, dividends comprise nearly 75% of total cash returned to shareholders of European stocks.[20]

As earnings become more compromised because of virus-induced revenue declines, it seems logical that European dividends are at risk. During the Global Financial Crisis, earnings per share for the MSCI Europe Index fell 43% and dividends fell almost as much–36%.[21] According to Barclays, as the earnings downgrade cycle materializes,

[17] BofA Global Research, 4/7/2020
[18] The Wall Street Journal, 4/3/2020
[19] Bloomberg & RCM, 4/17/2020
[20] Barclays Research, 4/1/2020
[21] Barclays Research, 4/1/2020

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dividends in the Energy, Banks, Insurance, Mining and Real Estate sectors could be most vulnerable.

Capital allocation decisions become increasingly complex as unemployment rates rise. Unlike the US, many industry leading European companies are partially owned by the government. It can be uncomfortable for corporations to distribute dividends to shareholders while laying off employees. Regulators have asked companies receiving aid to suspend dividends and buybacks, but even for those not receiving assistance, social responsibility issues can impact dividend decisions.

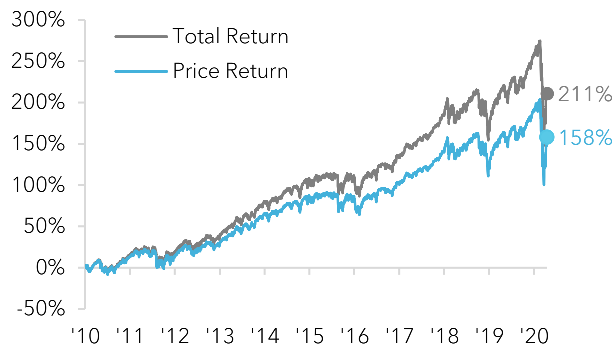
Reaping Dividends

Investors own stocks for their superior appreciation potential to other asset classes; many investors also desire the income produced by stock dividends. Dividend paying stocks have been attractive investments to a certain group of investors, but their appeal has broadened since bond yields have fallen precipitously since late 2018 and cash yields hover near zero. Relative yields on stocks are attractive vs. bonds, and investors who value consistent streams of dividend income have traded interest rate risk for balance sheet risk.

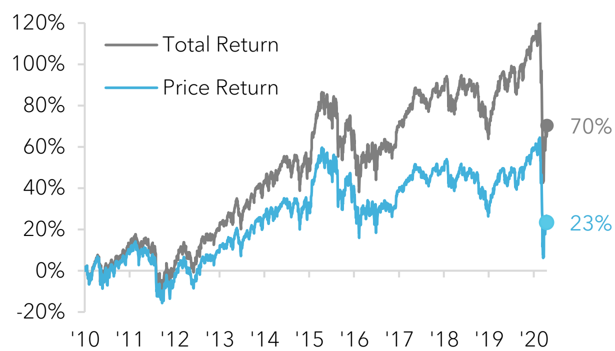
Dividends are not just a "nice-to-have" feature of equities but are also a powerful force in driving return. For example, the annualized price return on the S&P 500 Index over the past roughly ten years (i.e. from 1/1/2010 to 4/17/2020) is 9.6%. When dividends are reinvested in the Index, the average annualized return increases to 11.6%. Over this period, on a cumulative basis, dividends have provided 25% of the total return.[22]

Dividends on European stocks play an even more important role in generating investment returns. Over the same investment period as the prior example, dividends on the MSCI Europe Index have provided 67% of the cumulative total return.[23]

S&P 500 Index Total vs. Price Return (USD)[22]



MSCI Europe Index Total vs. Price Return (EUR)[23]



Time to Review Portfolios

Investors seeking income should not be worried about broad-based dividend suspensions, but in our view, it would be prudent to make sure that portfolios are not overly exposed to industries that are under stress from a drop in consumer spending. Small and mid-sized companies in those industries are likely to be more severely compromised in their ability to continue dividend payments. Instead, investors will want to ensure that individual security selections have ample free cash flow to cover dividends and relatively low debt levels. Good sources of dividend income may be found within Consumer Staples, Utilities, Industrials and selectively within the Financials and Real Estate sectors.

[22] Bloomberg & RCM, 4/17/2020

[23] Bloomberg & RCM, 4/17/2020

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