bordier | 1844

The outlook for income

1 May 2020

Since the outbreak of the Covid-19 virus we have sent a number of updates on our views on markets and on how we are positioning investment portfolios. We will of course continue to provide these broader updates, however we believe it is useful at this juncture to focus on the outlook for a key component of asset returns – dividend income.

We have become accustomed in recent years to interest rates being historically low and the impact of Covid-19 on growth expectations has clearly pushed rate expectations even lower. With the Bank of England recently cutting the base rate to just 10 basis points, and 10-year gilts yielding just 20 basis points at the time of writing, de minimis yields from cash and sovereign bonds look here to stay for a while yet. With the exception of some emerging markets it's a similar story across sovereign bond markets globally.

So, what is the opportunity set now for yield within other areas of fixed income markets? The market turmoil in recent weeks led to some huge price movements in corporate debt (credit) markets, driven both by heightened default risk concerns, but also more mechanically by a short-term liquidity crunch. For a brief period, this pushed spreads (the yield in excess of government bonds) in investment grade bonds to just under 350 basis points and spreads in high yield bonds to nearly 1,100 basis points, in both cases substantially wider than we would typically expect going into a 'normal' recession. This has created buying opportunities for our specialist bond managers, some of whom have acted to increase credit risk in the funds they manage and lock in these yields.

Encouragingly, credit markets have already recovered quite strongly since the collapse in March, buoyed by the substantial stimulus packages put forward by central banks. Unlike in the period following the global financial crisis in 2008, where new issuance basically dried up for six months in the US and 18 months in Europe, we have seen record issuance of investment grade corporate bonds in the last few weeks (year-to-date it is now at c$600 billion, which could put us on course for new issuance in 2020 being the highest on record). We are not in, nor at present do we believe we are heading for, a financial crisis.

Looking ahead we expect high yield bonds in general, which bear the brunt of default risk, to oscillate with the movements of equity markets. Higher quality investment grade bonds now look to be on a relatively firm footing. Defaults within the investment grade area of bond markets are very rare and the feedback that we are getting from our third-party managers, who we believe are best qualified to give an opinion at present, is that they do not expect defaults to materially increase even in the face of current events. Corporate bonds are less liquid than equities, but we should not forget that they are less risky by virtue of having seniority over equity holders in the capital structure. In the event of a default, servicing debt payments takes priority over repaying capital. At a time when equity dividends are being cut (we will come onto that shortly) the yield they provide will be even more valued by investors.

We should also not forget that the recent step up in quantitative easing from central banks should provide further support to the sector. The US Federal Reserve, for example, is likely to buy around $200 billion of investment grade bonds by the end of Q3 this year. Importantly 'fallen angels', bonds that have lost their investment grade status due to the issuer facing financial challenges, are also in scope for this round of central bank purchases.

Selectivity will continue to be paramount as the likely outlook for different industries and individual companies is now hugely disparate. This is why we outsource security selection to specialist active managers who have the resources and experience to perform detailed analysis on each issuer.

In summary, though, we believe that bonds can continue to fulfil their traditional role of providing a stable income stream and providing valuable diversification benefits to a balanced portfolio. We are continuing to tread carefully in the more speculative high yield area of the market. We have some measured and very selective exposure via our strategic managers where they believe that the risk/reward profile is compelling. Investment grade bonds will continue to be a bedrock in our income, and indeed all our multi asset, portfolios. The recent market turmoil has created some opportunities in terms of enhanced yields, however we must accept that current risk-free rates still dictate relatively modest absolute yields from bonds in general.

Which brings us on to equities. Here the guidance and outlook for dividend payments has changed significantly in recent weeks. With lockdowns in place many companies are facing a period of zero revenue and are, quite naturally, looking to protect their balance sheets. As a result we are seeing widespread cuts and suspensions in dividend payments (and share buybacks). In the UK alone, over £4 billion worth of dividend payments were suspended last month and some of our equity income managers are forecasting that dividends in the UK may halve this year. There are likely more announcements to come, not least because the logistics of holding an AGM (which is usually required to approve such a suspension) is proving a challenge for some in the current environment.

There are some important points to make here. The first is that it is crucial to understand the specific motivation/justification for each individual company that is cutting or suspending its dividend. For example, in some countries the banking sector has simply been told to suspend dividend payments by the regulator. While this has typically not been the case for other areas of financials, regulators have also been writing stern letters to insurance companies reminding them of their financial obligations and systemic importance.

Then there are companies who are accepting government support to furlough employees, many of whom feel it would be inappropriate to then pay out this cash as dividends to shareholders. This has been particularly prevalent in more cyclical industrial and consumer discretionary companies.

We remain very close to all of our equity income managers in recent weeks and the message is clear: they will support their investee companies that are suspending dividends for the right reasons. Most consider it prudent for a company to suspend dividends payments if this helps ensure they remain financially solvent and avoids the necessity of raising more capital from shareholders. We saw coming out of the global financial crisis in 2008 that companies that had secured their financial position were able to cement their market positions and take market share from competitors.

It is also very important to stress that the equity components of our portfolio strategies are global in nature and that there is less pressure on dividend income outside of Europe. Our managers in Asia in particular are not reporting anything like the same level of pressure on dividends in their local markets. Similarly, in the US we expect our managers to be much better able to protect current yields, in part because of the market's much higher weighting to sectors such as technology and healthcare, which are proving relatively resilient in the current environment. We should therefore expect our overall level of income from UK and European equities to be quite significantly down this year. At a portfolio level however, we expect this effect to be diluted to some extent by income arising from elsewhere.

Looking ahead, dividends will without doubt recover. Much of the guidance is currently for suspension rather than cancellation, as companies hold cash for security and there are substantial sectors of the market that should not need to cut. We do expect the recovery in dividends to be a gradual process however, and likely to start from a lower base.

bordier | 1844

This is not an easy environment for our income managers to make investment decisions. In the short term we are living in a world where companies are not just withdrawing their guidance on future dividend policy but are withdrawing their financial guidance altogether. We are confident, however, that we have selected some of the most capable managers in the industry to make these decisions.

This is also undeniably a challenging environment in which to produce income. And in the shorter term we need to adjust our expectations of what is an achievable yield down a little bit more. It may take some time for interest rates, and bond yields, to 'normalise' however a recovery in equity dividends will hopefully come rather quicker if we do see some economic recovery later in the year. Income is only one component of asset class returns and we are always focused on total return and growing income streams over time rather than simply maximising yield. It is therefore important to note that we may well see a recovery in capital values before a full resumption in income payments if companies continue to be prudent with their cash.

Our task remains to ensure that we are both highly active and selective in terms of individual securities and well diversified in terms of asset allocation and region. Fortunately, sources of dividend income are now much more widespread geographically than in the past. As a result, the impact of dividend suspensions and cuts on the overall yield in portfolios should be significantly mitigated.

We are here for anyone who wishes to discuss this in more detail.

Risk warnings

This document is issued and approved by Bordier & Cie (UK) PLC ('Bordier UK'). Incorporated in England No: 1583393, registered address 23 King Street, St James's, London, SW1Y 6QY. The company is authorised and regulated by the Financial Conduct Authority ('FCA').

Bordier UK is a specialist investment manager dedicated to providing portfolio management services. We offer Restricted advice as defined by the FCA, which means that if we make a personal recommendation of an investment solution to you, it will be from Bordier UK's range of investment propositions and will reflect your needs and your approach to risk.

This document is not intended as an offer to acquire or dispose of any security or interest in any security. Potential investors should take their own independent advice to assess the suitability of investments. Whilst every effort has been made to ensure that the information contained in this presentation is correct, the directors of Bordier UK can take no responsibility for any action taken (or not taken) as a result of the matters discussed within it.

CL5819/20200501/1.01