State of Play

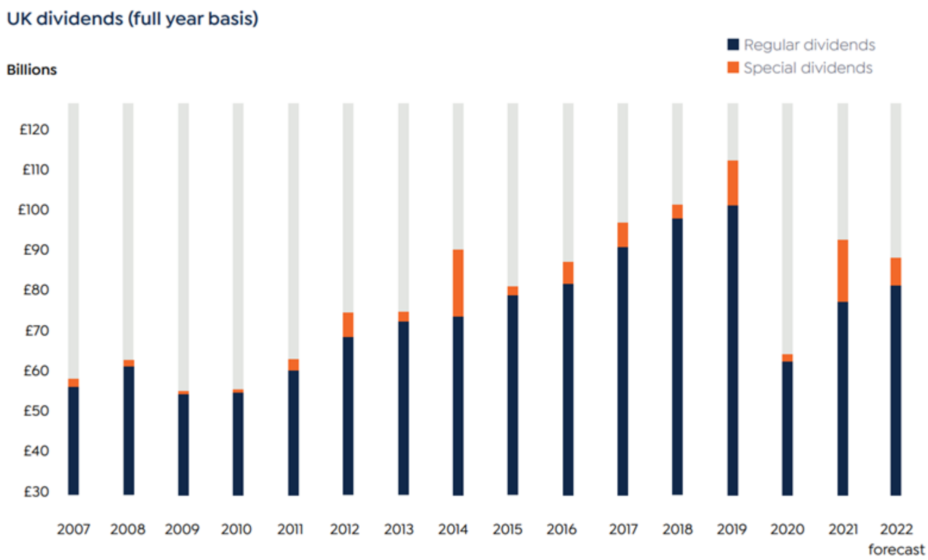
10 February 2022

Since the pandemic began, income investors have been faced with a prolonged period of reduced income amidst a challenging backdrop where companies have either cancelled or lowered their dividends and bond yields are at their lowest in history. However, following the first real signs of a recovery at the end of last year, what does the outlook hold for investment income? Our Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

UK market makes a strong recovery

Last year saw a strong recovery in UK dividends as total pay-outs grew 46%, reaching £94.1bn, according to the latest Link Group UK Dividend Monitor Report. This is comparable to mid-2017 levels but falls short of the immediate pre-pandemic period. It would be easy to reflect on these numbers and conclude that the direction of travel was one of rapid improvement and on-the-way to where we were before global lockdowns drove businesses to either reduce or cancel dividends. However, it is important we 'lift up the bonnet' to understand the origin of the dividends paid last year in order to assess what the realistic outlook is and whether last year was an anomaly or a more sustainable trend.

Firstly, let's look at the positive indicators. After nearly two years of living with COVID-19, many companies have managed to adapt successfully to different working practices and ride the recovery in 2021. Particularly, the resurgence in commodity prices following global vaccination programmes helped the mining sector record huge increases in profits, translating into a sharp rise in special dividends to a record £16.9bn, three times their normal level.[1] It does mean that the UK market was heavily reliant on the mining sector which contributed nearly one quarter of the total market dividends.[2] Mining is a cyclical sector in which pay-outs can be variable, meaning that last year's bonanza of special dividends is unlikely to be repeated this year especially given commodity price rises have slowed and, in some cases, fallen slightly in recent weeks.[3] If you remove the special dividends and just assess the underlying income from profits distributed, there is a more sobering and modest growth of 21.9% to £77.2bn, close to 2015 levels.[1]



Source: Link Group – Quarter 4 Dividend Monitor Report 2021

Oil companies have also benefited from a steady rise in prices as the global economy is struggling to meet the pent-up demand and normalisation of supply chains. Shortages of raw materials and shipping disruptions have held back many industries from firing on all cylinders but many of these short-term issues are working themselves out, however some of the increased costs remain thus maintaining the increased prices. At the time of writing BP recorded their highest profit in eight years ($12.85bn) after registering a large loss of $5.7bn in 2020 following a slump in demand during the lockdowns.[4] Oil prices continue to grind higher as life begins to return to somewhere near normal providing some reassurance that profit levels in the energy sector remain robust for now. For many other sectors, the latest wave of Omicron only added to their challenges, with increased staff absence and a drop off in orders and bookings. The sharp rebound in dividends in 2021 was encouraging, but the underlying analysis paints a picture of a cautious recovery.[1] For the UK market much will depend on several factors, including inflation, high job vacancies and the rate at which interest rates rise in response to rising prices.

One positive influence of higher interest rates is the restoration of banking dividends, following a reversal of the regulatory intervention that suspended pay-outs in the early stages of the pandemic. With an increase in interest rates this allows banks to recover margins back towards historic norms and allows them to give a better balance of interest between savers and borrowers. Given the changing outlook it is likely that base rates will continue to increase throughout 2022 but are likely to still remain below historic levels.

The final important influence on the UK results was the strength of the pound which curbed dividends by 5% in 2021, the largest negative currency effect the Link Group UK Dividend Monitor reports have ever measured.[1] Exchange rate factors diminished in the second half of 2021 and the pound ended 2021 at the same level as the end of 2020.[1] This year's dividends may receive a small boost from currency effects by the middle of 2022 if the current exchange rates remain largely unchanged.

Outlook for income

The year ahead is difficult to predict at this stage with so much uncertainty. Inflation remains the biggest threat for income investors for two important reasons. Firstly, bond assets face the prospect of rising yields and falling capital values as central banks continue to tackle rising prices with even more rate rises planned throughout this year. Whilst this improves the income prospects for investment managers who move assets into portfolios in the future, it could dent the existing holdings as their values fall. Secondly, inflation eats into the real rate of return as fixed income could struggle to match this sharp rise in prices over the next few years thus reducing returns when compared to the recent past. Turning to shares, a big driver for the rest of this year will be the ongoing restoration of banking dividends, but it seems unlikely that mining companies can sustain the current level of dividends as their income has a reliance on commodity prices which in recent weeks have levelled out, albeit, oil prices continue to grind higher.

When it comes to realistic and sustainable income, investors face limited alternatives as most asset classes, beyond traditional shares and bonds, offer a very limited yield without additional complications like liquidity risk. The rate of dividend pay-outs for 2022 is uncertain and in the UK, is still significantly below the pre-pandemic level. Companies facing uncertainty tend to hold back cash from shareholders to protect balance sheets and provide flexibility in an ever-changing world. Companies also face difficulties in growing their businesses as high job vacancy numbers and limited skilled candidates which mean offering higher wages to attract the right skilled workers on top of the expected wage demands from existing employees who face higher bills. This places additional pressure on future profits unless much of this increase is passed on to the end consumer. If a company is dominant in their sector this may be possible, but many face a competitive marketplace whereby competing on price means it is almost impossible to pass it on leading to them needing to absorb increased costs and generating lower profits.

If an investment manager is tasked with providing regular, realistic, and importantly, sustainable income for investors, projecting an amount customers can expect is crucial. This is a challenging decision and given the uncertainty, investment managers may need to adjust expectations throughout the year. As dividend pay-outs continue to improve before contemplating an increase, investment managers need to be confident any increases can be sustained to avoid having to make further cuts in the future if market conditions deteriorate. Whilst generating an income can be a specific strategy for some investors, it can also form part of the overall return for investors seeking to grow their capital. Certainly, the last couple of years have been the toughest ever recorded for income investors given the general uncertainty and lack of alternatives. Whilst last year was a rare ray of sunshine, there remain clouds on the horizon despite the improvement in the dividend mood.

Find out more!

Click **here** to read our latest A Month in the Markets, where our Head of Systematic Research for TAA and Alpha, Stefano Amato, looks at how key themes impacted markets in January.

Note: Data as at 8 February 2022.

[1] Link Group, UK Dividend Monitor Q4 2021 report, 24/01/2022
[2] Janus Henderson, Global Dividend Index November 2021, 30/09/2021
[3] Investing.com, Commodity prices, 8/02/2022
[4] Investing.com (Reuters), BP records highest profit in eight years in 2021, 8/02/2022