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State of Play

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Our Investment Specialist, Simon Durling, shares his thoughts in our last update of the year, before State of Play takes a break over the festive season. Ever since the pandemic turned our lives upside down income investors have suffered lower bond yields and company dividends have either been suspended or significantly reduced. State of Play explores the latest view on income investing with one eye on the outlook for next year.

UK company dividends stage a remarkable recovery

According to the latest UK Dividend Monitor Report from the Link Group, UK dividends made a remarkable recovery of £34.9bn in quarter three this year, up by 89.2% year-on-year. This is in stark contrast to 2020, when dividend pay-outs fell by 44% to their lowest annual total since 2011. Large one-off special dividends were partly responsible for the unexpectedly large increase in quarter three, but even the underlying total (which excludes special dividends) jumped sharply, up 52.6% to £27.7bn. The large rebound in the latest quarter is not enough, however, to restore dividends to their pre-pandemic levels as most sectors have paid less year-to-date than they did in 2019.

Mining groups accounted for 60% of the total value of specials dividends which added a £7.2bn boost to the overall total - higher in these three months than in a typical full year. This unprecedented bonus in mining dividends meant the sector's quarter three pay-outs were more than the next five biggest sectors combined. Over 2021, miners will account for nearly £1 in every £4 distributed by UK-listed companies. An unprecedented rebound in

oil prices is also enabling oil companies to recover more quickly than expected, alongside banking dividends making a significant contribution to growth in quarter three. Following the dividend ban on banks in the previous year their restoration helps an improving picture even though their dividends remain well below pre-pandemic levels.

Ian Stokes, Managing Director of Corporate Markets UK and Europe for the Link Group said: 'Forecasting the rebound for UK pay-outs has been rather more difficult than working out where the cuts would fall last year. The recovery is certainly uneven, and it has caused a growing concentration on extractive industry pay-outs – not a comfortable long-term position for income investors. The good news is that we have consistently seen companies deliver more in dividends than we thought likely at the beginning of the year in the depths of the UK's longest, strictest lockdown. Now almost the whole economy here and in most developed countries is open for business, even if supply chains are in a mess. Moreover, companies were progressively less impacted by each lockdown and many of them took action to bolster their balance sheets during 2020, either with new borrowing, new equity issuance, or cost-cutting (including dividends!). Dividend firepower is now much stronger as a result. The mining sector raises an amber warning, however. Commodity prices have come down sharply recently which makes it likely their dividends will be lower next year. With banks returning to strength and other sectors continuing to recover we still expect growth in 2022, but dividends will face headwinds rather than enjoy 2021's strong, but blustery, following breeze'.

As you can imagine not all sectors have recovered yet with a wide divergence between companies restoring dividends and those still unable to pay. Most travel and hospitality companies paid nothing, while some general retailers and industrials bounced back, and others stayed on the side-lines. The travel and hospitality sectors are still hostage to the virus in many respects as the discovery of the Omicron variant has triggered a number of cancellations of Christmas parties and events, with some travellers choosing to delay their trips planned over the next few weeks following the tighter rules on travel. The announcement from Prime Minster Boris Johnson last week asking people to work from home where possible, and additional requirements for larger gatherings provides uncertainty over the immediate future.

Global dividend story

According to the Janus Henderson Global Dividend Index (JHGDI), pay-outs jumped by a record 22% on an underlying basis to reach $403.5bn, an all-time high for the third quarter. The index is a long-term study into global dividend trends measuring the progress global firms are making in paying their investors an income on their capital, using 2009 as a base year with an index value of 100. The index is calculated in US dollars, and can be broken down into regions, industries and sectors. Their latest report published last

month identified, like in the UK, large special dividends boosted the overall total. Globally 90% of companies either raised their dividends or held them steady which represents a very strong reading with the index of global pay-outs rising to 194.7, just 2% below the pre-pandemic peak in the first quarter of 2020.

Those regions and countries that saw the steepest 2020 cuts have experienced the greatest recovery, with Australia and the UK being the biggest beneficiaries as they have large exposures to both mining and banks. Europe, parts of Asia and some emerging markets benefited too, but the US which was the most resilient market last year had a more modest increase but still rose by 10% in quarter three this year. The global picture highlights how effective the financial support and interventions from both governments and central banks was in protecting jobs and company closures. Had it not been for various furlough schemes and loose monetary policy the outcomes could have been disastrous.

Outlook for income investors

State of Play outlined last week the importance of inflation for next year. For income investors this has two important consequences. Firstly, bond assets face the prospect of rising yields and falling capital values as central banks tackle rising prices with eventual rate rises. This improves the income prospects for managers who move assets into portfolios in the future but dents the existing holdings as values fall. Secondly, inflation eats into the real rate of return as fixed income struggles to match this sharp rise in prices with the prospect over the next few years much lower when compared to the recent past.

In respect of shares a big driver for 2022 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 begun to fall. Miners are therefore likely to provide a headwind for global dividend growth next year rather than the rocket booster for 2021 pay-outs. Ongoing uncertainty about the spread of the Omicron variant will likely hang over many sectors directly affected by restrictions and stricter rules.

Income investors face limited alternatives as most asset classes beyond the traditional shares and bonds offer a very limited yield without additional investment risks in seeking a realistic and sustainable income. As commodity prices have recovered strongly, this has provided a much-needed boost with strong dividend pay-outs. However, the rate of dividend pay-outs for 2022 is uncertain and in the UK, is still 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. If a manager is tasked with providing regular, realistic, and importantly, sustainable

income for investors, projecting a level customers can expect is crucial. This is a challenging decision and given the uncertainty, managers may need to adjust expectations throughout the year. As dividend pay-outs continue to improve even before contemplating an increase, managers need to be confident any increases can be sustained to avoid having to make too many cuts in the future if market conditions deteriorate. Whilst generating an income can be a completely seperate 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 on record for income investors given the suspension of dividends and general uncertainty coupled with the lack of alternatives. Whilst the third quarter was a rare ray of sunshine, there remains 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 Multi-Asset Solutions, Stefano Amato, looks at how key themes impacted markets in November.

Note: Data as at 14 December 2021.

Important Information

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