CIO Thematic Research | 4Q19

# Dividend stocks, new bond proxies


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# Theme I: Dividend Stocks

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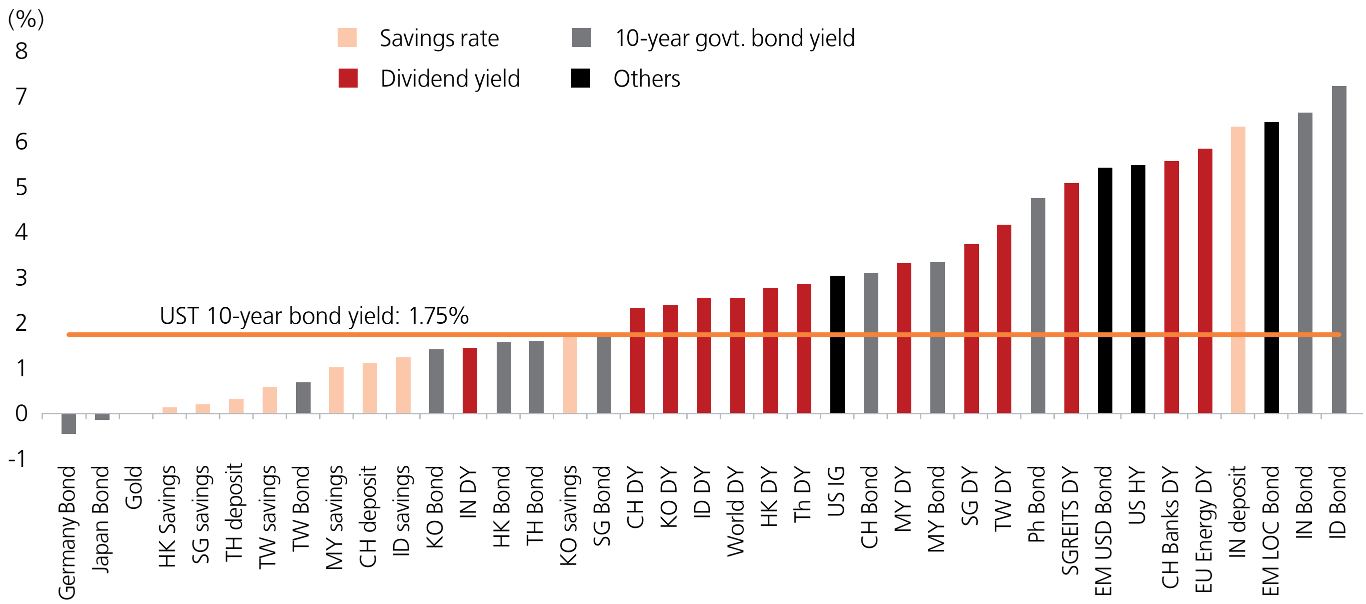
## New bond proxies in a world of disappearing yield

As the trend of ever-lowering bond yields continues on the back of a renewed cycle of policy easing by global central banks, other higher yielding asset classes have risen to be the next "bond proxies".

Today, the UST 10-year yield is at a near-historic low of 1.5%, while European and Japanese government yields are in the negative zone. This certainly enhances the attractiveness of other instruments including EM and HY bonds on the other end of the bond spectrum, as well as equities that pay attractive and sustainable dividends.

**Figure 1: The yield spectrum**




Source: Thomson Reuters, Bloomberg, DBS

## High dividend-yielding equities are good substitutes for bonds

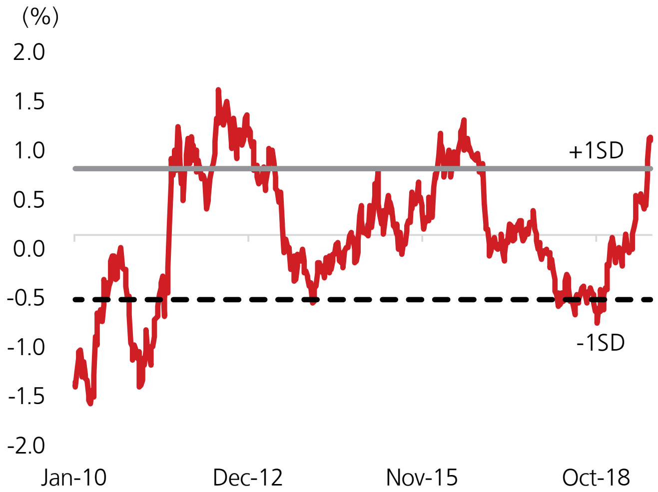
The yield spread between global equities' dividend yield and UST 10-year bond yield is at a near historical high (Figure 2) today. The 1% spread would provide buffer for yield compression should bond yields rise. Given that the Federal Reserve is unlikely to hike rates going forward, this premium yield obtained from dividend stocks is a strong proposition for this asset class to be the next "bond proxy".

## Constant dividend stream acts as volatility dampener

When held over a market cycle, dividend-yielding equities stand out as having the characteristics of both equity and fixed income markets due to the constant stream of cashflow from dividends. Thus, they demonstrate lower volatility vis-à-vis the overall equity market (Figure 3).

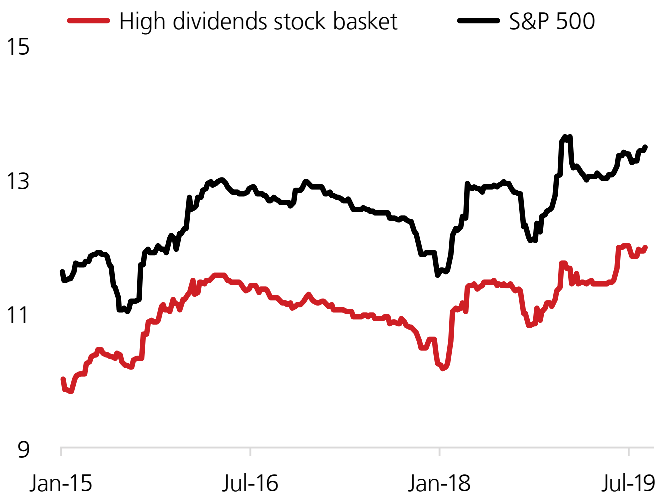
Dividend-paying stocks are also believed to have more resilient earnings with steady businesses, good capital management policies, and that they embrace creating shareholder value. Strong price support from longer-term investors also dampens share price volatility.

**Figure 2: World's dividend yield spread (dividend yield minus UST 10-year yields)**




Source: Thomson Reuters, DBS

**Figure 3: Volatility of US high dividend yield basket vs S&P 500**



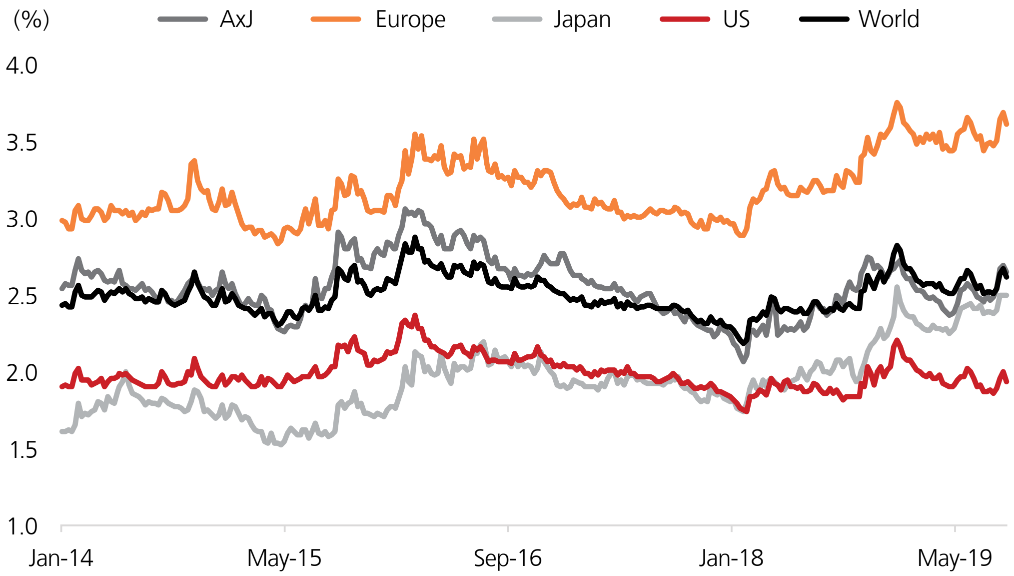

Source: Thomson Reuters, DBS
Calculated as three-year rolling SD of weekly returns (annualised)

## What kind of companies pay high, sustainable dividends?

We look for companies that pay dividends consistently from peak through trough of an economic cycle. This includes companies with fixed payout ratio policies, which would result in dividends growing with their underlying earnings. In this instance, companies that demonstrate the ability to generate free cashflows and have a track record of dividend payments are preferred.

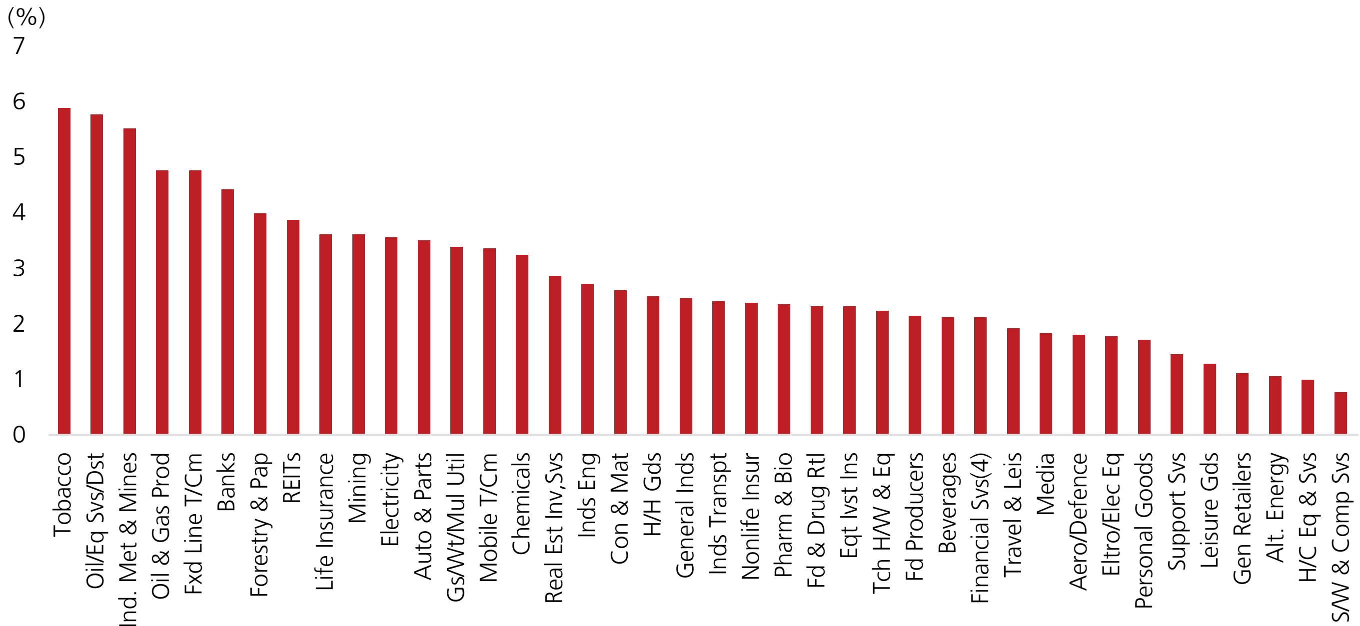
Generally, asset-light companies and defensive businesses such as telecommunications and utilities are able to generate healthy cashflows. Established mining and oil production companies with good capex discipline and high EBITDA margins can also be expected to pay high dividends. In addition, companies which are state-owned or have substantial shareholders (such as insurance companies and mining companies) will tend to fall under this category. Globally, Europe has the highest dividend yields, followed by Asia ex-Japan.

Figure 4: Dividend yields by region




Source: Thomson Reuters, DBS

Figure 5: Global markets' dividend yields by sectors




Source: Thomson Reuters, DBS

## REITs, banks, and oil play for the Barbell portfolio

Within our Barbell Strategy, Singapore REITs, China large banks, and Europe oil majors are favoured as holdings in the income-generating side of the portfolio given their solid fundamentals and convincing operating framework.

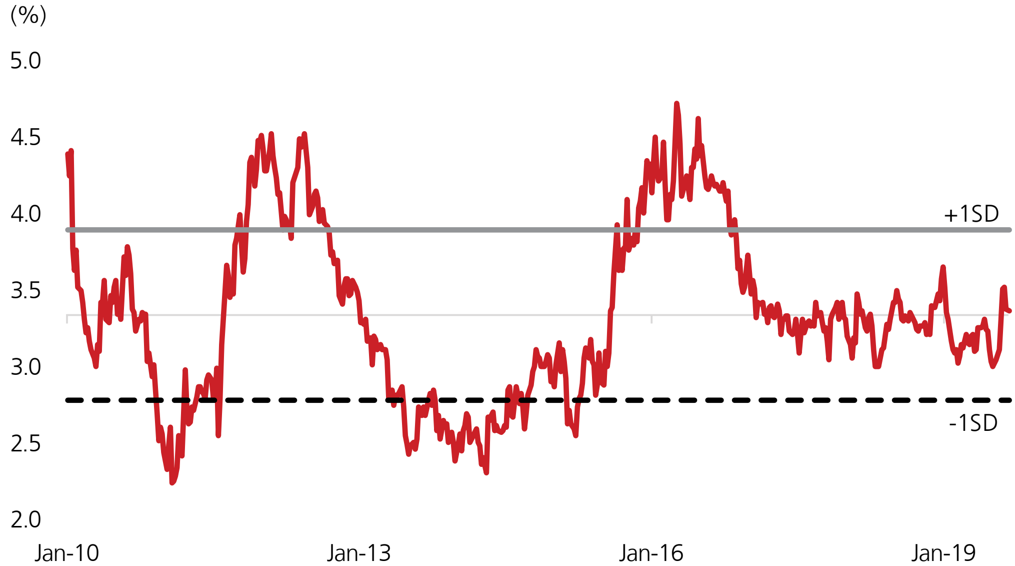
## Singapore REITs offer both yield and growth

REITs typically disburse at least 90% of their distributable income to investors. Retail and industrial REITs should continue to see good rental revision rates and room to grow their DPUs as the new retail strategy from O2O is becoming popular. Demand for industrial, logistics, and warehousing are expected to increase on the back of growth in e-Commerce as well as from companies looking to diversify from operations from China.

In the past year, many REITs also engaged in fundraising exercises to make yield-accretive acquisitions. Currently, there is a policy consideration to increase the debt-to-equity ratio. This, if raised, could offer opportunities to yield-accretive acquisitions amid a low interest rate environment.

The yield spread between REIT dividends and government bond yields has returned to above-average levels, despite REITs' strong year-to-date performance. We remain constructive on this sector.

**Figure 6: Singapore REITs dividend over 10-year SGS yield**




Source: Thomson Reuters, DBS

## China banks are to benefit from the interest rate reform

In a move toward lower effective borrowing rates for corporates, the PBOC initiated an interest rate reform – a new loan rate quotation method that changes the way commercial banks set their lending rates.

We expect China's banking sector to stay resilient as the drop in new lending rates is compensated by a lower cost of funding and a potential boost to loan growth. Large banks with a stronger deposit franchise may stand to perform better given their ability to better manage their balance sheets. Meanwhile, NPLs for Chinese banks remain contained at 1.8%, and valuations remain attractive at 0.65x P/B. China large banks offer dividend yield of c.6% and earnings are expected to stay stable amid policy stimulus to the negative impact from the trade war.

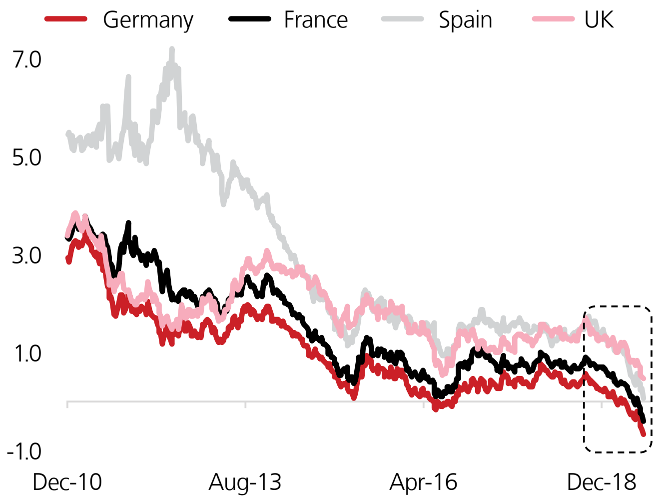
## Europe oil majors, a new dividend play

European energy stocks offer attractive dividend yields, especially in the falling rates environment

This quarter, we introduce Europe energy equities to our existing basket of high dividend-yielding equities that includes China banks and Singapore REITs.

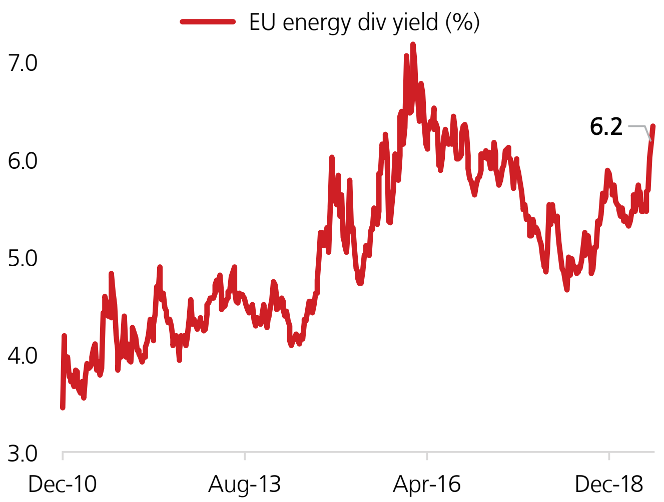
After more than 10 years of aggressive monetary easing measures including QE, Eurozone rates and bond yields are plunging again (Figure 7). This is supported by the widespread belief that the incoming ECB President, Christine Lagarde, would maintain her predecessor's policy stance. As investors frantically seek yield amid falling rates, Europe energy equities offer attractive dividend yields of between 5-6% (Figure 8).

**Figure 7: Europe rates plunging again…**




Source: Thomson Reuters, DBS

**Figure 8: … and the energy sector offers compelling yields**



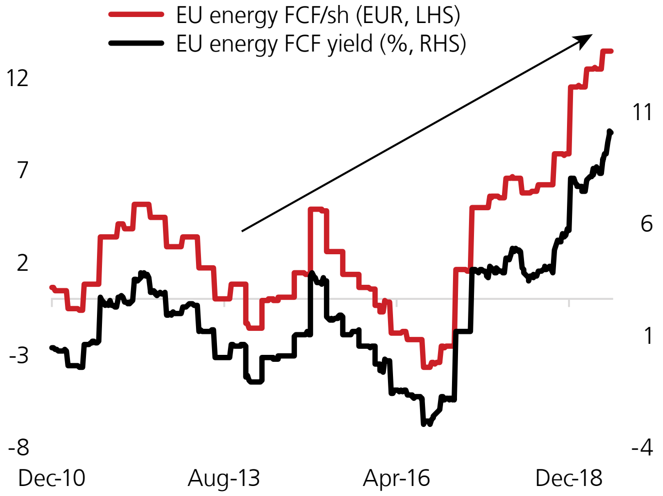

Source: Bloomberg, DBS

Absolute dividend per share has stayed firm, independent of oil price movements

Notably, the free cashflow per share among energy companies in this region has demonstrated consistent increases over the past three to five years (Figure 9), reaffirming their ability to maintain this attractive level of payout.

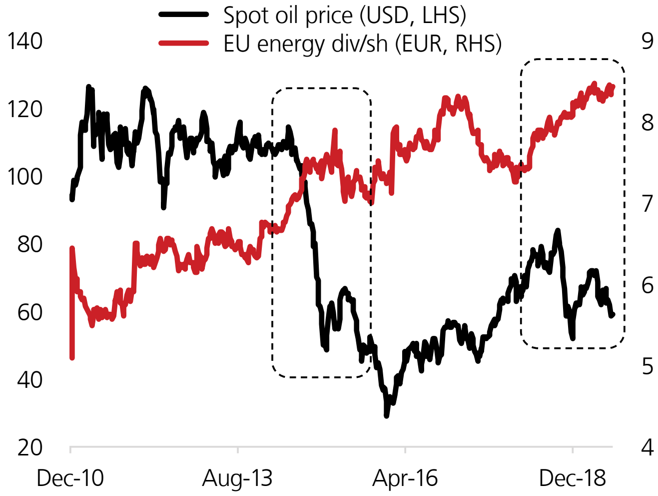
It is reassuring to note that the absolute per share dividend was not negatively impacted by falling oil price in recent years (Figure 10). At USD60 a barrel, the oil price is way below what it used to be, but the high dividend payout never looked back.

**Figure 9: Admirable free cashflow and FCF yields**




Source: Bloomberg, DBS

**Figure 10: Europe energy dividend per share unfazed by oil price volatility**




Source: Bloomberg, DBS

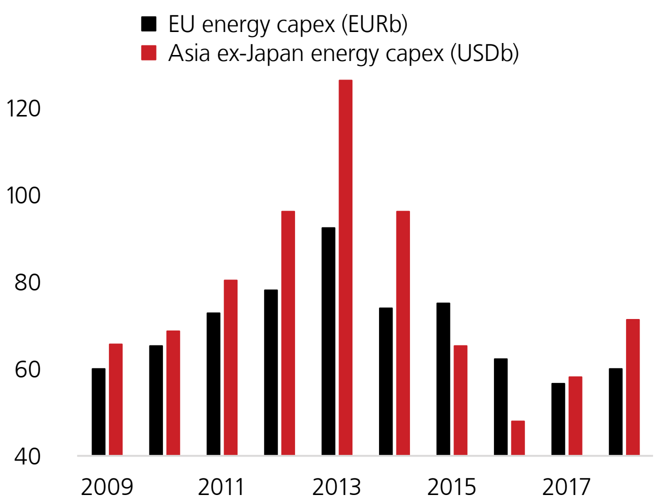
Capex discipline to sustan the dividend payout ability

One key factor that enables these energy companies to increase and sustain free cashflow generation has been their capex discipline after 2013's peak (Figure 11). European oil majors are now in stronger financial and operational positions to weather the slowing global growth brought about by trade tensions. Such industry-wide capex discipline has been consistent across European and Asian oil majors. On USD total return basis, the Europe energy sector has outperformed oil prices (Figure 12).

Perfer European oil majors on high dividend yields and diversified revenue model

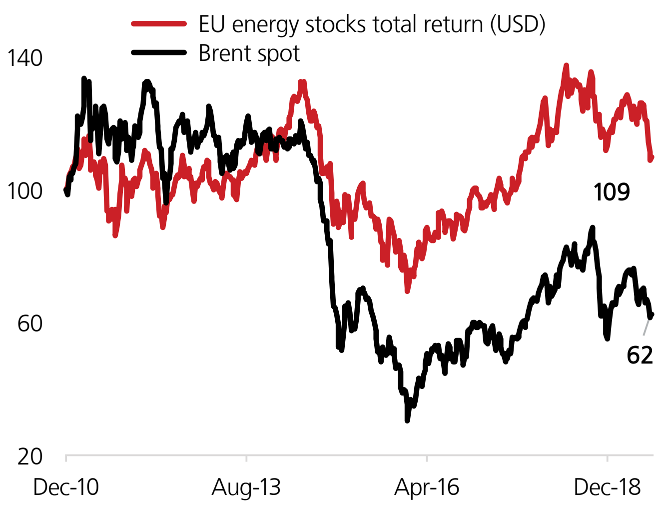
Within the energy sector, we prefer oil majors because of their diversified business models. Typically, these large players have operations spanning across a wide range of related vertical and horizontal segments, including upstream exploration, production, and storage, as well as downstream refining, petrochemical/specialty chemicals/natural gas productions, marketing, and distribution. The nature of this diversified business mix helps to offset impacts to the earnings trend during different economic cycles.

**Figure 11: Consistent capex discipline**




Source: Bloomberg, DBS

**Figure 12: Europe energy stocks did better than oil prices (Dec 2010 = 100)**




Source: Bloomberg, DBS

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# Glossary of Terms:

| Acronym | Definition |
|---|---|
| ASEAN | Association of Southeast Asian Nations |
| AxJ | Asia ex-Japan |
| bbl | barrel |
| BI | Bank Indonesia |
| BNM | Bank Negara Malaysia |
| BOE | Bank of England |
| boepd | barrels of oil equivalent per day |
| BOJ | Bank of Japan |
| BOK | Bank of Korea |
| BOT | Bank of Thailand |
| bpd | barrels per day |
| BSP | Bangko Sentral ng Pilipinas |
| CAGR | compound annual growth rate |
| capex | capital expenditure |
| CAR | capital adequacy ratio |
| CET1 | common equity tier 1 |
| CPI | conusmer price index |
| DM | Developed Markets |
| DPS | dividend per share |
| DPM | discretionary portfolio mandates |
| DPU | distribution per unit |
| DXY | US Dollar Index |
| EBITDA | earnings before interest, tax, depreciation, and amortisation |
| EC | European Commission |
| ECB | European Central Bank |
| EIA | Energy Information Administration |
| EM | Emerging Markets |
| EPFR | Emerging Portfolio Fund Research |
| EPS | earnings per share |
| ETF | exchange-traded fund |
| EU | European Union |
| FCF | free cashflow |
| FDI | foreign direct investment |
| FTA | free trade agreement |
| FX | foreign exchange |
| GDP | gross domestic product |
| GFC | Global Financial Crisis |
| HY | high yield |

| Acronym | Definition |
|---|---|
| IEA | International Energy Agency |
| IG | investment-grade |
| IMF | International Monetary Fund |
| IP | intellectual property |
| ISM | Institute for Supply Management |
| IT | Information Technology |
| JGB | Japanese Government Bond |
| KTB | Korean Treasury Bonds |
| LTRO | long term refinancing operation |
| M&A | merger & acquisition |
| MAS | Monetary Authority of Singapore |
| mmbbl | million barrels |
| mmbpd | million barrels per day |
| MSG | Malaysia Government Securities |
| NAV | net asset value |
| NEER | nominal effective exchange rate |
| NII | net interest income |
| NIM | net interest margin |
| NPL | non-performing loan |
| O2O | online to offline |
| OMO | open market operations |
| OPEC | Organization of the Petroleum Exporting Countries |
| OPM | operating profit margin |
| P/B | price-to-book |
| P/E | price-to-earnings |
| P/NAV | price-to-net asset value |
| PBOC | People's Bank of China |
| PCE | personal consumption expenditure |
| PM | portfolio manager |
| PMI | purchasing managers' index |
| QE | quantitative easing |
| RBA | Reserve Bank of Australia |
| RBI | Reserve Bank of India |
| REIT | real estate investment trust |
| RM | relationship manager |
| ROA | return on asset |
| ROE | return on equity |
| RPGB | Philipine local government bonds |

| Acronym | Definition |
|---|---|
| RRR | reserve requirement ratio |
| SAA | Strategic Asset Allocation |
| saar | seasonally adjusted annual rate |
| SD | standard deviation |
| SGD NEER | Singapore dollar nominal effective exchange rate |
| SGS | Singapore Government Securities |
| SOE | state-owned enterprise |
| SOR | swap offer rate |
| TAA | Tactical Asset Allocation |
| UCITS | Undertakings for Collective Investment in Transferable Securities |

| Acronym | Definition |
|---|---|
| UST | US Treasury |
| VaR | value at risk |
| VAT | value-added tax |
| VIX | CBOE Volatility Index |
| WTI | West Texas Intermediate |
| YTD | year-to-date |
| YTW | yield to worst |
| WTO | World Trade Organization |
| ZIRP | zero interest rate policy |