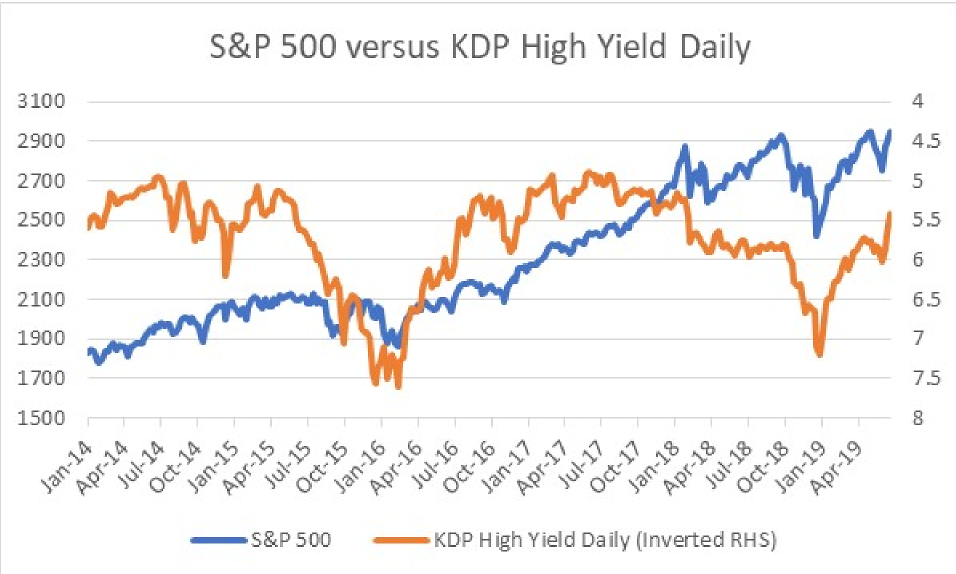
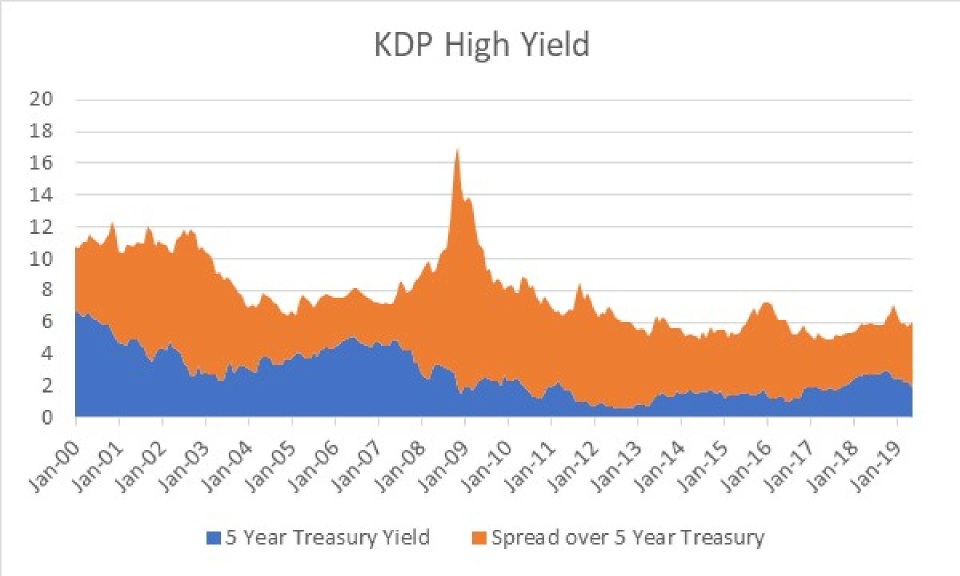
STOCK MARKETS AND DIVIDEND FUTURES

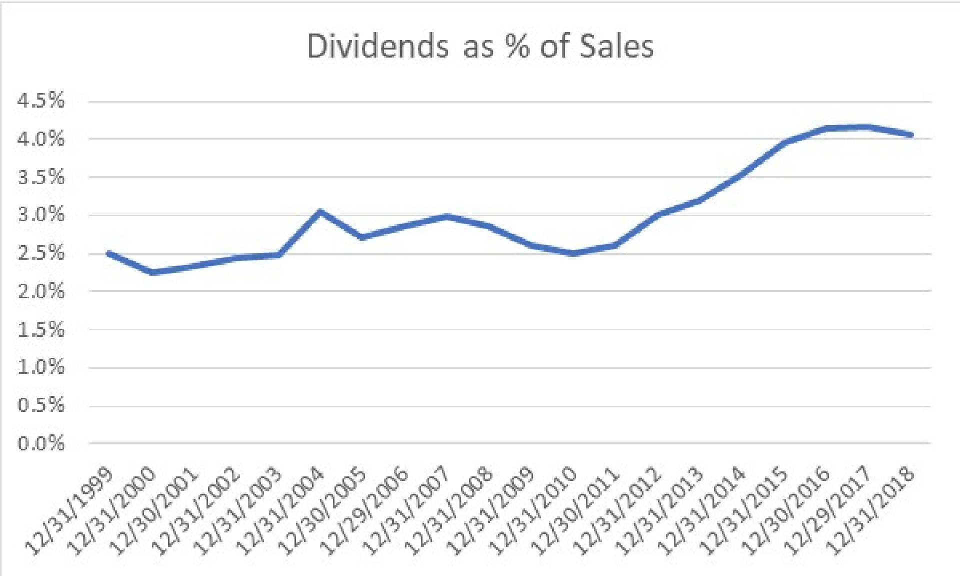
In the era of ultra-low and negative interest rates, stocks and the dividends that they provide are an important source of income. In fact, one of the reasons used to justify quantitative easing was to force investors out of safe assets and into riskier assets, with the hope this would promote growth. It is noticeable that the S&P 500 has become very highly correlated to movement in high yield.



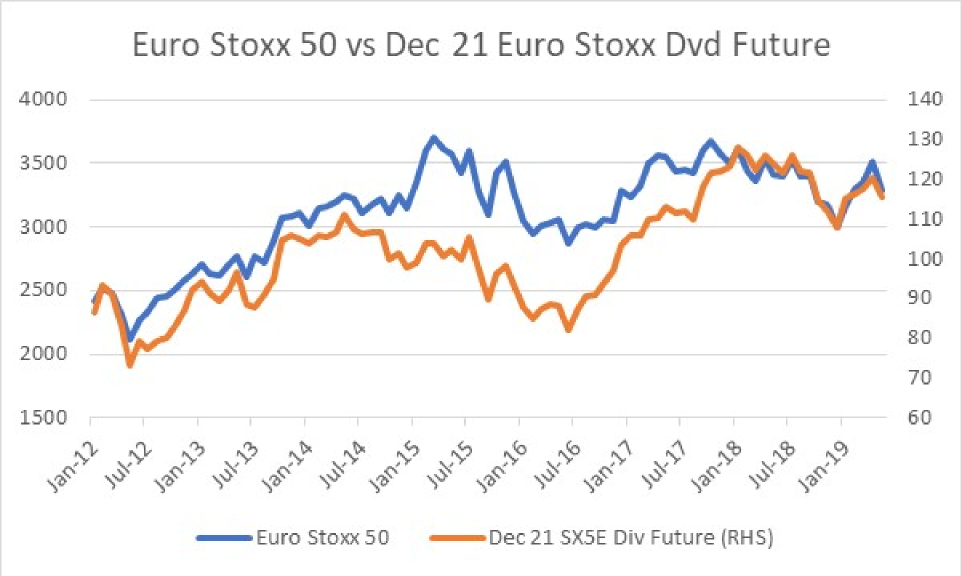
If we decompose the KDP high yield daily, we can see that most of the yield is made up of the premium over treasuries. If we just look at the premium, we can see that it tends to contract and widen with the economic cycle, with a 2% low seen in 2007, and highs ranging from 6% to 15%. One thing that is noticeable is high yield spread tends to widen in downturns. If US yields drop due to slowing growth, spreads tend to widen, leaving corporate bond yields higher.



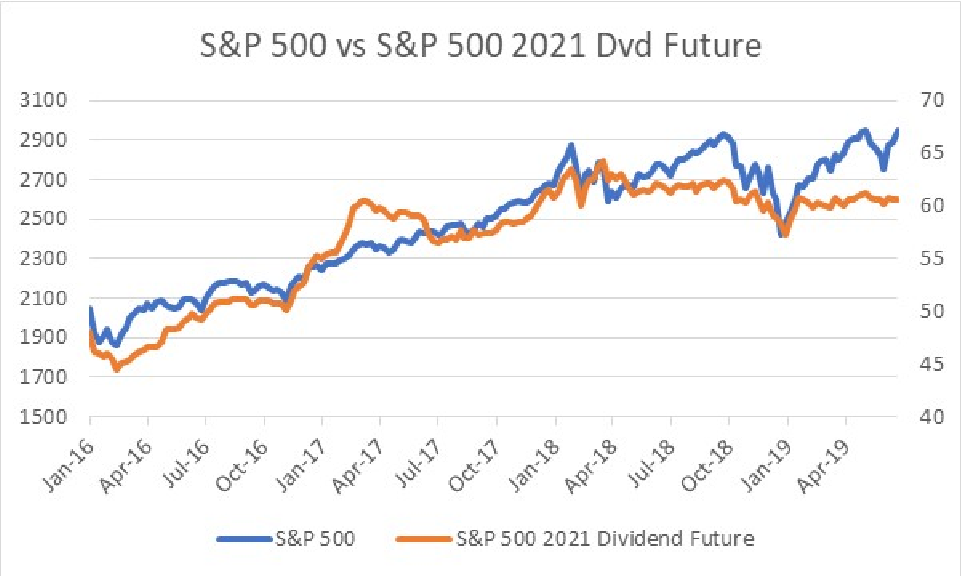
S&P 500 dividends are trickier. If we look at S&P 500 dividends as a percentage of sales, they have never been higher. This is in line with companies' management attempting to return as much capital as possible to owners. Many investors would just assume that dividends will grow with sales, and as long as this ratio does not change, then dividends should grow in line with nominal GDP.



However, there is another way to think about future dividends. Due to the large issuance of autocallables, which are long future dividends on stock market indices, there is a large market in index dividend futures. The 2021 Euro Stoxx Dividend Futures began to diverge from the Euro Stoxx 50 in late 2014, and ultimately preceded the sell off in the Euro Stoxx seen in 2015 and 2016.



The 2021 S&P Dividend Futures have only been trading since 2016 but peaked in early 2018. They were a strong lead indicator on the Q4 2018 sell off. Intriguingly, they are not following the S&P higher in 2019.



If investors are looking at the stock market as an alternative to corporate bonds, then the risk/reward looks poor. Not only do high yield spreads have scope to widen from here, dividends paid are at historically high four percent of sales and dividend futures have already peaked from levels seen last year.

INFORMATION

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