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MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Cyclical Yield – there is still time

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Summary

- Cyclical Yield – what is it?
- Bond Yields on the move
- How to protect a dividend portfolio

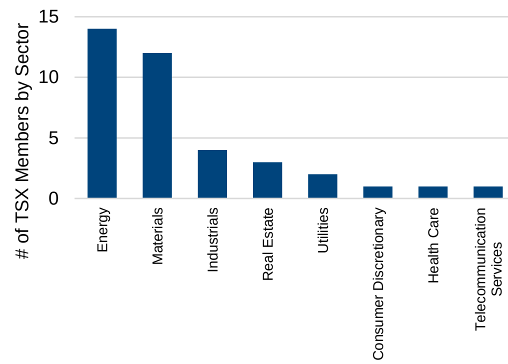
Cyclical Yield

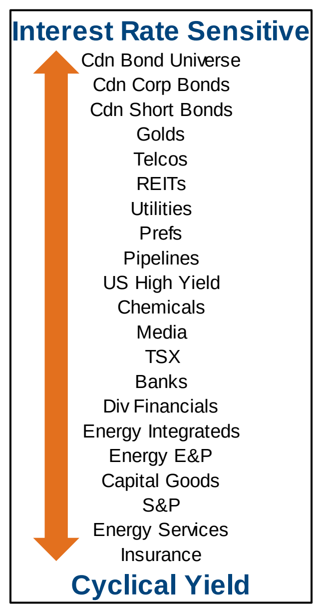
The past few years have taught investors a very valuable lesson that not all dividends are the same. This became most evident when more cyclical companies in Energy, Fertilizers, Mining and Industrials cut or eliminated dividends. The chart on the top right indicates TSX companies that cut their dividends during the past three years, Energy and Materials clearly have the lion's share. This does make sense, if you are in a cyclical business, well it is cyclical.

Looking at this chart, one could easily jump to the conclusion that for dividend focused investing you should shy clear of the more cyclical sectors and focus on those that are less cyclical, such as Telecom, Utilities, Real Estate, Financials or Consumer Staples. Perhaps, these have been the stronger performers of the past few years. But these sectors also bring a different kind of risk – interest rate sensitivity, which can cause more damage than a dividend cut, although we have not seen this in a while given the near constant trend of lower bond yields.

We believe there is a spectrum among dividend paying stocks, ranging from the most interest rate sensitive to the highest level of cyclical yield. We also believe these companies react differently to changes in the economy and the prevailing yields. Cyclical yield companies tend to be more sensitive to economic activity, meaning if yields are moving higher due to better economic data, they react more positively. While interest rate sensitives are the opposite, moving higher when yields fall (usually means softer economic data) and declining in price when yields rise.

Dividend Cutters or Eliminators





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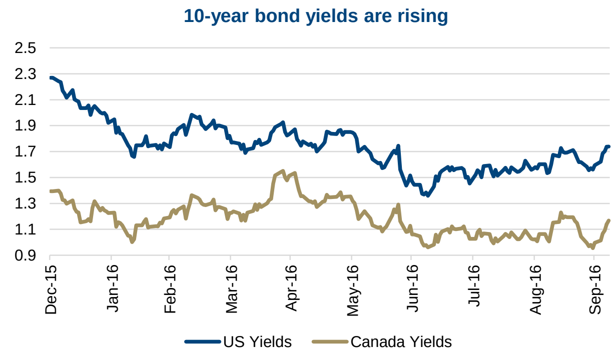
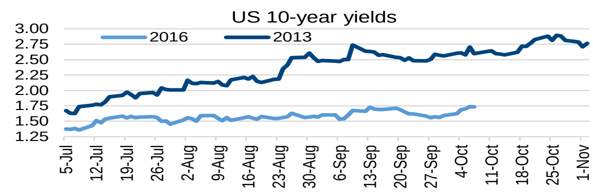
While not an exact science, the table of sectors and investments above provides a loose guideline as to what kind of investments are most interest rate sensitive and most cyclical yield. Having the correct mix is very important especially today as we have seen bond yields trending higher for the past few months.

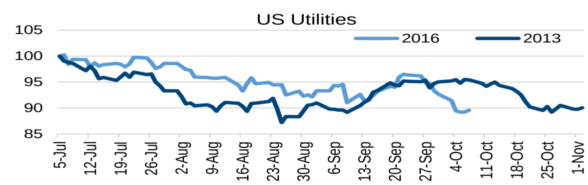


Bond Yields on the move

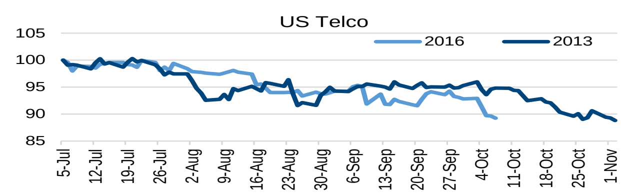
For many quarters it has not been the economic data that was putting downward pressure on North American bond yields, it was global bond yields. Quantitative easing and other efforts globally had pushed many more countries into negative yield territory, and since markets are interconnected, this put downward pressure on yields closer to home. This has created a disconnect between yields and economic data, which has continued to gradually improve. At some point the economic data will matter more, putting upward pressure on bond yields and opening the door further for the Fed to raise rates before the year ends. It may already be starting given Consumer Price Index Ex Food & Energy and the Core Personal Consumption Expenditures (PCE) deflator sitting at or near cycle highs.



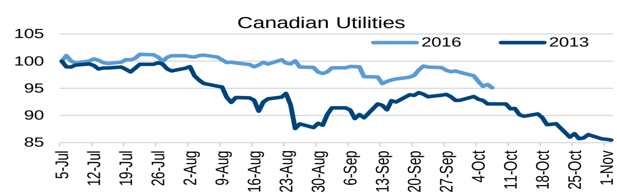
With improving economic data and some cooling of quantitative easing, we are seeing bond yields move higher globally. Ten-year yields are now positive again in Germany and Japan is close to positive. That is removing or diminishing the previous downward pressure and presto, U.S. and Canadian yields move higher (top chart).



Here is the risk, much of the stronger performing sectors during the past couple of years have been the more interest rate sensitives. This component of the market has been pushed higher by lower yields and now is even more sensitive to yields than before. Similar to a bond, duration rises as yields fall.

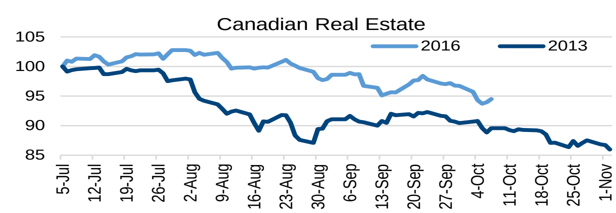


To see just how interest rate sensitive these sectors are, we compared recent performance to the taper tantrum of 2013. In 2013 the U.S. Ten-year yield rose from 1.75% to 2.75%. Today, we have seen yields rise from 1.40% to 1.75%, a fraction of the move in 2013. Yet the interest rate sensitive sectors have fallen almost as much. The five charts on the right contrast the taper tantrum to today.



How to protect a dividend portfolio

We are strong believers in dividend investing and most of the money we manage has an explicit dividend component in the mandate. That being said, this may be a difficult time for dividend strategies especially if bond yields continue to move higher. The interest rate sensitives are very sensitive at the moment, adding to the risk.



One way we mitigate this risk is leaning more on cyclical yield names. The spectrum on page 1 may prove useful if you are wondering where to find more cyclical yield names to better diversify a dividend focused portfolio. It should not come as a surprise that we are overweight insurance companies, and have decent weights in many of the other sectors near the bottom of the spectrum. Meanwhile we are lighter at the top end.

Charts are sourced to Bloomberg unless otherwise noted.