State of Play

UK dividend recovery?

11 August 2022

There is little doubt that the global pandemic had a huge impact on our lives financially with some consequences that are obvious, like rising prices, and others that are less so. Many of the largest companies listed on the UK stock market stopped distributing their profits, in the form of dividends, which affected income investors. Whilst many companies have resumed paying dividends more recently, it does not mean however that the economy is back to normal. So how does the current environment and outlook affect the prospects for income investors? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

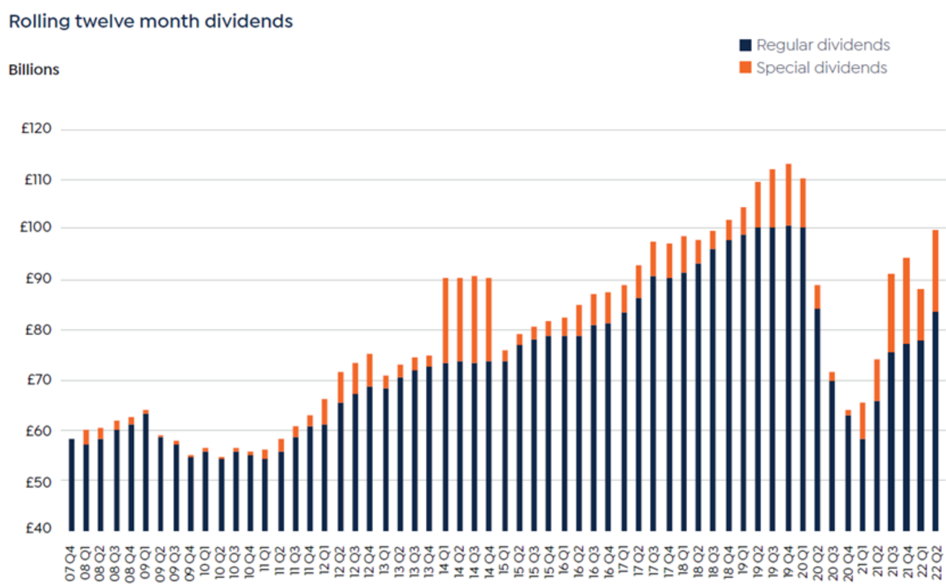
Dividend falls during lockdown

Over two years ago the emergence of the COVID-19 global pandemic triggered national lockdowns and severe restrictions on our day-to-day lives to protect the NHS and save lives. The impact on income investors was severe as lots of companies, across nearly all sectors of the market, cancelled or reduced their dividend payments as they attempted to navigate the economic shock and tried to prepare for an uncertain future. Regulators also stepped in to stop banks from paying dividends to shareholders.[1]

Dividend payments remain, especially in the UK, a popular method of investing to create income where shares are bought in companies that historically share some of their annual profit with shareholders. As interest rates have remained at record lows, over the last decade dividend payments have grown significantly.[2] Investors who were prepared to ride the ups and downs of the market over the longer-term, have seen the benefits of income growth and to a lesser extent capital growth, which has often offset the rise in prices, albeit inflation has been much lower over the last decade than in the past.[3] However, this all changed when the lockdowns and restrictions reduced the flow of income significantly and has yet to recover to the levels seen before the virus emerged. So let's explore what has happened and what the prospects might be.

UK market continues the recovery

According to Link's latest Dividend Monitor Report[2] which covers quarter two of this year, underlying dividends which exclude special pay-outs were £32bn, a rise of 27% when compared to last year. Special dividends, which can be volatile and unreliable, made a huge difference to last year's total dividends paid as mining companies benefited from soaring commodity prices. This bonanza appears to be peaking as commodity prices ease against a backdrop of slowing global growth in the wake of soaring inflation.[2] However, other sectors, like financials, where banks have had a strong second quarter with a 64% increase in pay-outs, and housebuilders who have been supported by rising house prices.[4] That being said, housebuilders are facing headwinds in rising raw material costs and wages[5], coupled with increased mortgage rates creating uncertainty about future house sales. The one silver lining that supports them in the short-term is the continuing lack of supply to meet the current demand.



Source: Link Group, 27 July 2022.

Oil companies appear to be catching up mining companies this year with bumper profits. Oil giant BP announced the second highest profit of $8.5bn in the three months to June, not far off the record set in 2008, this was helped by higher oil prices and a strong performance from their oil traders.[6] Sometimes companies use large profits to re-invest back into developing and growing a company preparing for the future. They can also pay special dividends sharing the boosted earnings with shareholders, or as with BP, they can utilise some of this profit to initiate buybacks.[6] This is where they use cash from their balance sheet to buy shares in the company thus reducing the shares available to the stock market. By doing so, it could be argued that by reducing the supply of shares if demand for the shares remains constant the price should rise. Whilst this does not help income investors directly, it does at least support the value of their investment, especially if the share price does indeed rise consequently.

Finally, there are two other important observations to comment upon. Firstly, there is a big difference in the growth of dividends being paid by large companies, as defined by the FTSE 100, when compared to the next size down, as defined by the FTSE 250. Larger companies have bounced back quicker than their slightly smaller peers as they cope better with the inflationary environment and challenging market conditions. Secondly, the other consideration is the gap between the other income options, like bonds and cash, when compared to dividends has narrowed. Bond yields have risen significantly in the last year, as have interest rates, with the best savings accounts now paying 1.4% compared 0.45% 12 months ago.[2]

Outlook for dividends

Ian Stokes Managing Director at Link for Corporate Markets, EMEA UK and Europe provided his view on the outlook for the remainder of 2022 citing the value of the pound as a significant factor.[2] He said, ‘The weakness of the pound is also proving a key swing factor this year. Sterling was relatively strong in 2021 at key moments in the dividend cycle and has been correspondingly extremely weak this year. In 2021 this held back the sterling value of UK pay-outs by £3.5bn. If it holds its current low level for the rest of 2022, exchange-rate effects could boost dividends by £4.5bn (£1bn more than currently factored into our forecast). This is an astonishing £8bn swing from one year to the next, the largest we have ever measured. For the second half of 2022, we have slightly reduced our core forecast, first to reflect the probability that mining dividends have now peaked, having come in a whisker lighter than our optimistic Q2 expectations, and secondly to balance the positive calendar effects that flattered Q2. Once we have folded in the good second-quarter figures and allowed for the exchange rates in the second half, our underlying forecast (which excludes special dividends) rises just over a percentage point to £86.8bn, an increase of 12.5% compared to 2021.’

Conclusions

Ordinarily it would be easy to conclude that we are close to business as usual. However, there are headwinds which could affect future revenues and profits of dividend payers in the next couple of years. Not least of which is the challenge of bringing down inflation to the target of 2%. This means interest rates will likely rise further, pushing up bond yields and cash savings rates in the process. The most recent fall in share values[7] does mean that new investors benefit from slightly higher yields than last year as the assets are cheaper to buy. However, slowing economic growth, higher rates and potentially lower profits as margins are squeezed, makes predicting what might happen very difficult indeed. Whilst much of the recent pain for income investors has eased, yet more uncertainty means we are still some way off business as usual.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing **here**.

Note: Data as at 10 August 2022.

[1] The Times, 2 April 2020
[2] Link Group, 27 July 2022
[3] Office for National Statistics, 20 July 2022
[4] Office for National Statistics, 20 July 2022
[4] The Guardian, 27 February 2022
[5] The Times, 2 August 2022
[6] FE Analytics, 10 August 2022