MORNINGSTAR®

Why Haven't Rising Rates Sunk Dividend-Paying Stocks?

Morningstar dividend indexes demonstrate that the relationship between equity income and interest rates is dynamic.

Morningstar Inc.
October 2022

Dan Lefkovitz
Strategist, Morningstar Indexes
dan.lefkovitz@morningstar.com

Saumya Gattani
Senior Quantitative Analyst, Morningstar Indexes, New Product Development
saumya.gattani@morningstar.com

https://indexes.morningstar.com/

Rising interest rates are bad for dividend-paying stocks. That's according to a common line of thinking, which is two-pronged in its rationale. The first prong pits dividends against cash and bonds, positing that higher yields on fixed income diminish the appeal of equity income for investors. The second prong concerns debt. Higher rates mean higher debt servicing costs for the kinds of leveraged telecom, industrials, and consumer-related businesses that also tend to pay healthy dividends. So, what have we seen in 2022? The U.S. Federal Reserve, along with central banks across the globe, have aggressively hiked rates, but dividend paying stocks have held up relatively well. Some of Morningstar's dividend indexes are actually in positive territory for 2022, while the broad equity market has declined nearly 20%. Dividend payers have proven dramatically more resilient than high-flying growth stocks, many of which pay no dividends. Now, we are told that growth stocks are falling because higher interest rates devalue their long-dated earnings. Meanwhile, stocks and bonds have both taken it on the chin this year, despite having moved in different directions in several past bear markets. Simply put: Investing isn't like physics, with its immutable laws. Relationships are not fixed. The forces that move markets are multifaceted and fluid.

Among the findings of this report:

- Dividend-paying stocks have held up far better than the overall equity market in 2022, despite rising interest rates boosting yields on cash and bonds and increasing the debt-servicing burden. The energy sector is only part of the story.
- Historically, the link between dividend payers and interest rates has been unclear. There have been plenty of periods like 2004-2006, when rates rose but dividend stocks dramatically outperformed growth stocks. The broader context is critical.
- Globally, the historical record is inconclusive. In the U.S., Europe, Japan, and Australia, there have been plenty of periods when dividend payers outperformed in rising rate environments and vice versa. A range of variables is always interacting.

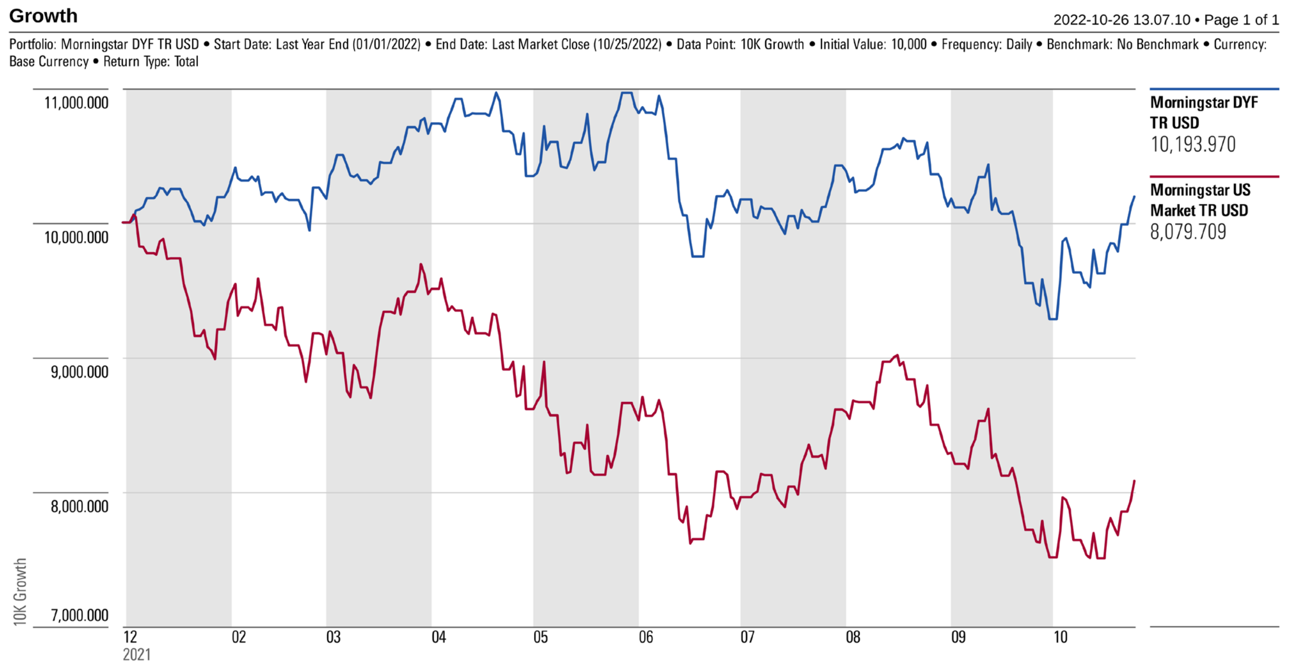
Rising Rates Are Not Kryptonite for Dividend Payers in 2022

Stubbornly high inflation has provoked an aggressive monetary response in 2022. The U.S. Federal Reserve has raised interest rates five times so far, by an aggregate three percentage points—a stunning increase in terms of both magnitude and velocity. Global counterparts like the European Central Bank, the Bank of England, and the Reserve Bank of Australia, have also tightened in response to rising prices.

Inflation and the monetary response have sent financial markets into a tailspin. The Morningstar US Market Index, which represents 60% of global equity market capitalization, is down nearly 20% for the year through Oct. 25.

How have dividend paying stocks reacted? The Morningstar US High Dividend Yield Focus Index, which simply represents the higher yielding half of the market, is down roughly 7%. The Morningstar Dividend Yield Focus Index and Morningstar Dividend Leaders Index, both of which include screens for dividend durability and have global variants are actually in slightly positive territory. As displayed below, Dividend Yield Focus has gained nearly 2% versus a 19.2% decline for the market.

Exhibit 1 Dividend Payers Have Been Resilient in 2022



Why have dividend payers held up well this year? Several factors are at play. It's certainly true that rising rates have led to higher yields on cash and bonds. The Morningstar Core Bond Index has seen its yield rise from 1.7% at the start of 2022 to 4.7% at the close of the third quarter, while the Morningstar LSTA Leveraged Loan Index was yielding 8.7% as of Sept. 30. By contrast, the Morningstar US High Dividend Yield Focus Index yields 3.5%.

But fixed income has been a disaster from a total return perspective. The Core Bond Index is down roughly 16% for the year through late October, thanks to five rate hikes. Yields on fixed income may be up, but capital losses are repelling investors. Further rate hikes cast a dark shadow on the asset class.

Sectoral dynamics have also boosted the dividend-paying section of the market. Energy, a dividend rich area, is the only equity sector in positive territory in 2022. Even before Russia's war on Ukraine sent oil prices surging past $120 per barrel, supply/demand imbalances pushed crude to its highest level since 2014. Dividend payers like Exxon Mobil have soared. In fact, the Morningstar US Sustainability Dividend Yield Focus Index, which is light on energy, has been disadvantaged relative to its counterpart which does not consider environmental, social, and governance criteria.

In contrast to energy, which represents just 5% of global equity market value, the technology sector's share represents one fifth globally and one quarter in the U.S. Technology stocks, which are historically light on dividends, have plunged in 2022, so below-market exposure to the sector has advantaged dividend payers. Technology, along with many growth equities, carried lofty valuations coming into 2022. Highfliers have the furthest to fall when markets drop.

Meanwhile, dividend rich areas like consumer staples, utilities, and healthcare have lost less than the market this year. As fears of recession mount, companies providing nondiscretionary products and services have found themselves in investor favor. Dividend-paying stocks like General Mills, Merck, and Exelon are up in 2022, as are global counterparts like Ambev and British American Tobacco. Utilities and their ilk are seen as defensive—a good place to weather an economic downturn.

The trendy narrative now is that rising rates have been kryptonite for growth stocks. Higher interest rates, the explanation goes, raise the discount rate used to value cash flows, and since growth stocks' earnings are longer dated than value stocks, higher rates hit them harder. But research from AQR found no correlation between style performance and interest rates. Writes Cliff Asness:

> *"Growth (or often just 'tech') stocks soar on plunging interest rates" (or vice versa) has become a common wise-sounding observation in the last few years. In fact, this is all take as an axiomatic… However it's not nearly that simple, and mostly it's just not true."* [1]

Another flawed investment axiom: bonds diversify equity market losses. While the Morningstar US Core Bond Index rose during equity bear markets in 2020, 2008, and 2000-02, it is down big in 2022.

Dividends and Rising Rates: The Historical Record Is Inconclusive

So, is 2022 an anomaly? How did dividend payers perform during previous periods of rising rates? Interest rates have been low in absolute terms since the global financial crisis of 2007-2009. But the Fed did increase its funds rate by 2.25% percentage points from December 2015 to December 2018 in a normalization effort—a total of nine hikes of 0.25% apiece. The Dividend Yield Focus Index, which was launched in 2010, outperformed the market in 2016, before lagging in most of 2017 and 2018 as displayed below.

1 Asness, Cliff. Is Value Just an Interest Rate Bet? Spoiler Alert: Not Even Close. Aug. 11, 2022.

Exhibit 2 Dividends Slightly Lagged the Market in the Rising Rate Environment of 2016-18, a Regime Led by the FAANG Stocks

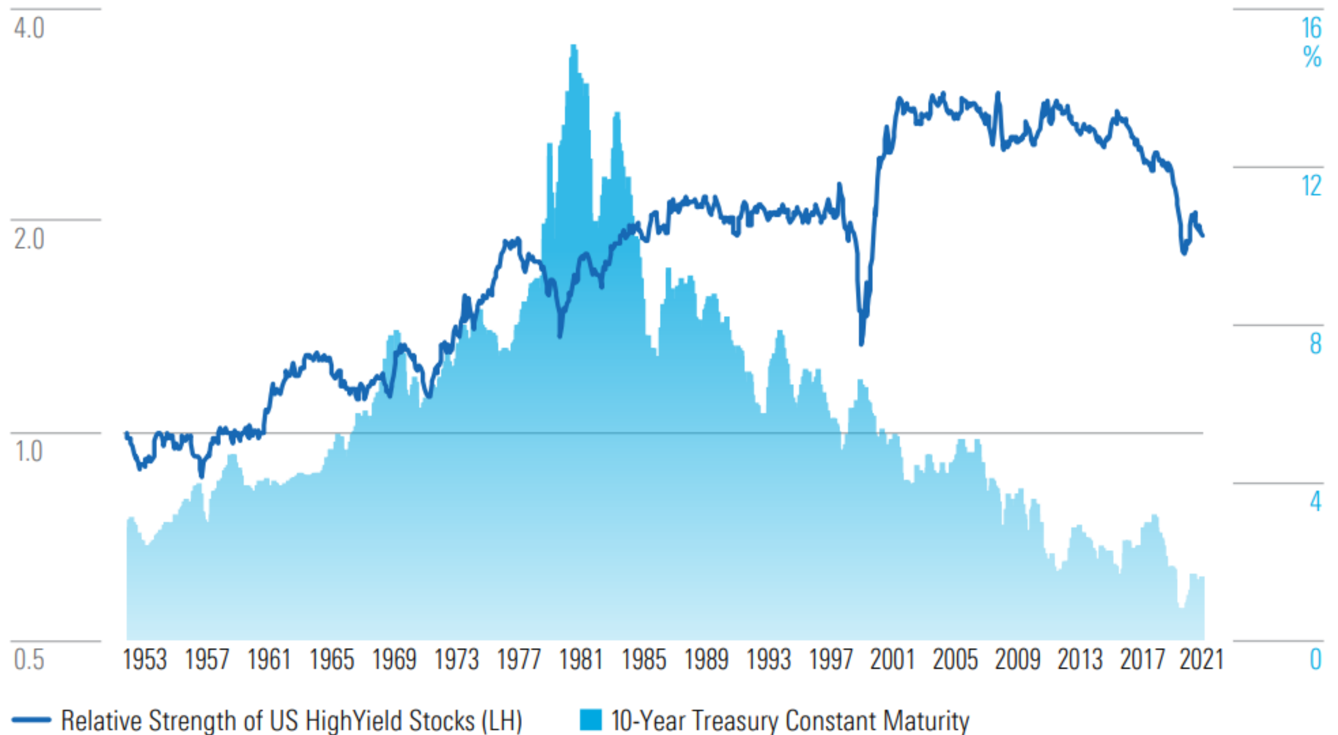
Source: Morningstar Direct.

What was going on? It's difficult to attribute dividend underperformance to interest rates given their low absolute levels during this time. The equity market was climbing high, and dividend payers often look sluggish during rallies. Growth stocks were dominating in 2016-18. This period saw the meteoric rise of the FAANG or FAAGM stocks (Facebook (now Meta Platforms), Apple, Amazon, Netflix, Google (now Alphabet), and Microsoft), a cohort not exactly rich in dividends. In fact, Amazon, Alphabet, and Meta pay no dividends, and Apple and Microsoft are not exactly high yielding. But these companies were earning massive profits on the back of dominant positions.

What if we go back decades? The below graph was initially created by Morningstar's director of equity income strategy, Josh Peters in 2015, to test the conventional wisdom that dividend payers thrive in low-rate environments and vice versa. The graph shows the relative performance of high-yield stocks in the U.S. to the overall market on the left-hand side. When the line is moving up, dividends are outperforming and vice versa. In the background is the 10-year Treasury yield (scale on the right). It utilizes publicly available data from Professor Kenneth French's data library as well as the St. Louis Federal Reserve and has been updated by Morningstar Indexes through the end of 2021.

No clear pattern emerges. The relationship between dividend payers and interest rates is inconsistent. What the graph does show is that high-yield equities have outperformed the market over time.

Exhibit 3 Long Term, the Relationship Between Dividend-Paying Stocks and Interest Rates is Unclear (U.S.)



Source: French Data Library and St. Louis Federal Reserve

In some periods of rising rates, such as the mid-1970s, dividend payers outperformed. As rates fell from the mid-1980s to the mid-1990s, the performance of high-yield stocks was fairly flat. When the Federal Reserve cut rates in the late 1990s in the wake of the Asian Financial Crisis, it did not benefit dividend payers. During the technology bubble, investors cared little for earnings, let alone dividends.

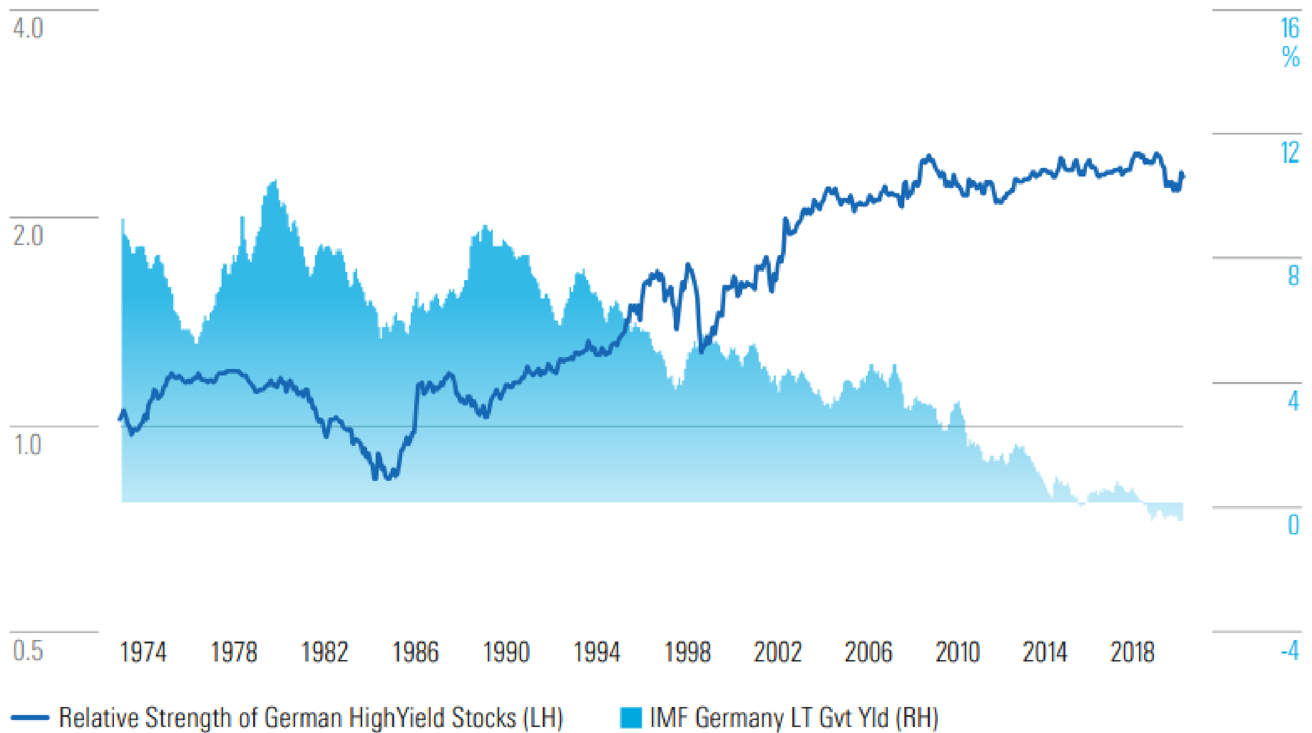
From mid-2004 to mid-2006, the Fed jacked up its funds rate from 1.0% to 5.25% in an effort to dampen economic activity and combat a growing housing bubble, which eventually led to the global financial crisis in 2007. What happened to dividend payers? They dominated the market. The dividend rich financial services sector was dominant. Energy and material stocks were riding a "commodities supercycle" driven by China's economic growth. This era was defined by value stocks from the "Old Economy," ascendant after the popping of the dotcom bubble in 2000.

Then, in the extremely low interest rate environment extending from 2008 to 2015, dividend payers lagged. The cycle had turned to growth stocks, especially technology. In short, the wider context is critical. Interest rates are one of many variables affecting the relative performance of equity income.

Going Global: No Clear Relationship Emerges Between Dividends and Rates

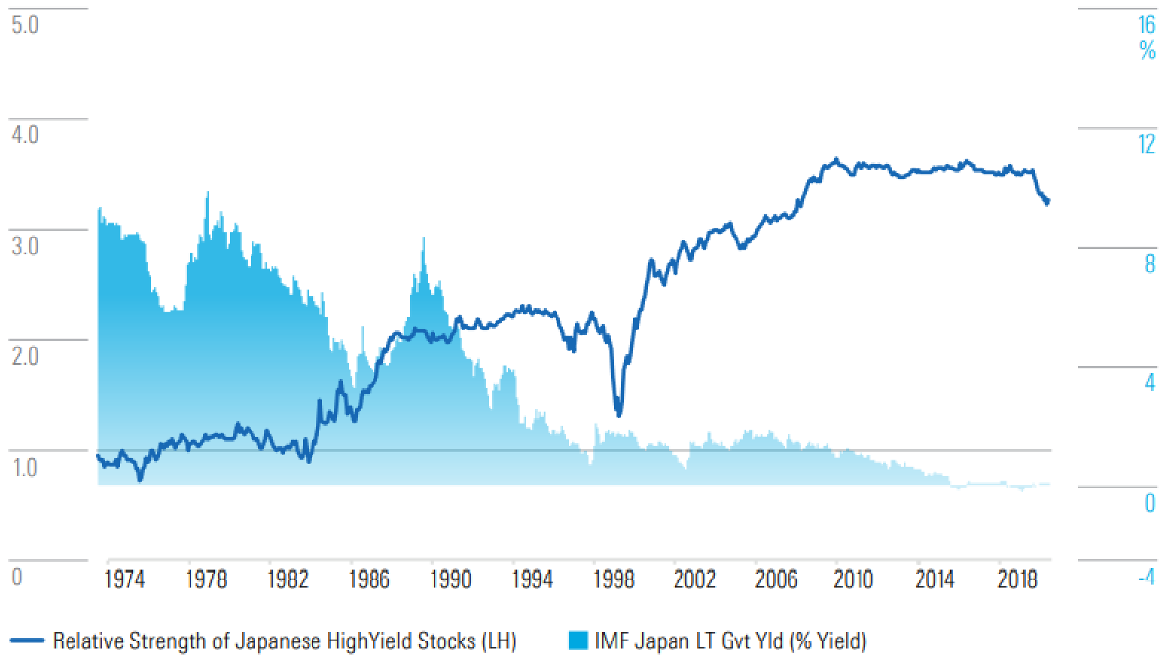
Interest rates are market specific, though the globalized economy often sees inflation, rates, and investment performance move in the same direction. When we test the relative performance of dividend payers compared with interest rates in several markets across the globe, again, no clear relationship emerges, except that equity income outperforms the broader market over time. Consider Germany, Japan, the U.K., and Australia.

Exhibit 4 Long Term, the Relationship Between Dividend-Paying Stocks and Interest Rates Is Unclear (Germany)



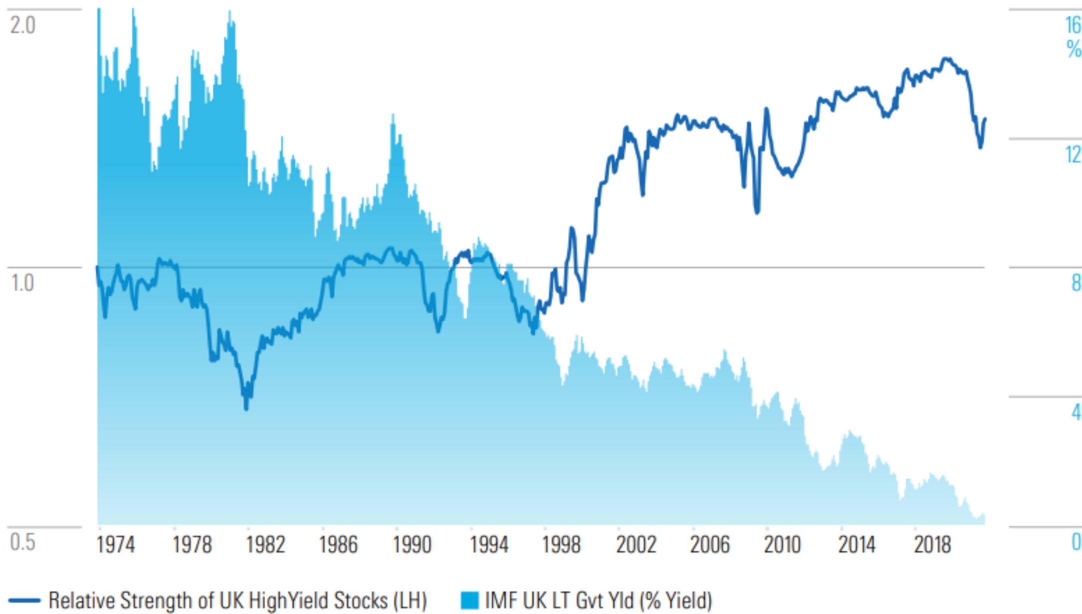
Source: French Data Library and IMF

Exhibit 5 Long Term, the Relationship Between Dividend-Paying Stocks and Interest Rates Is Unclear (Japan)



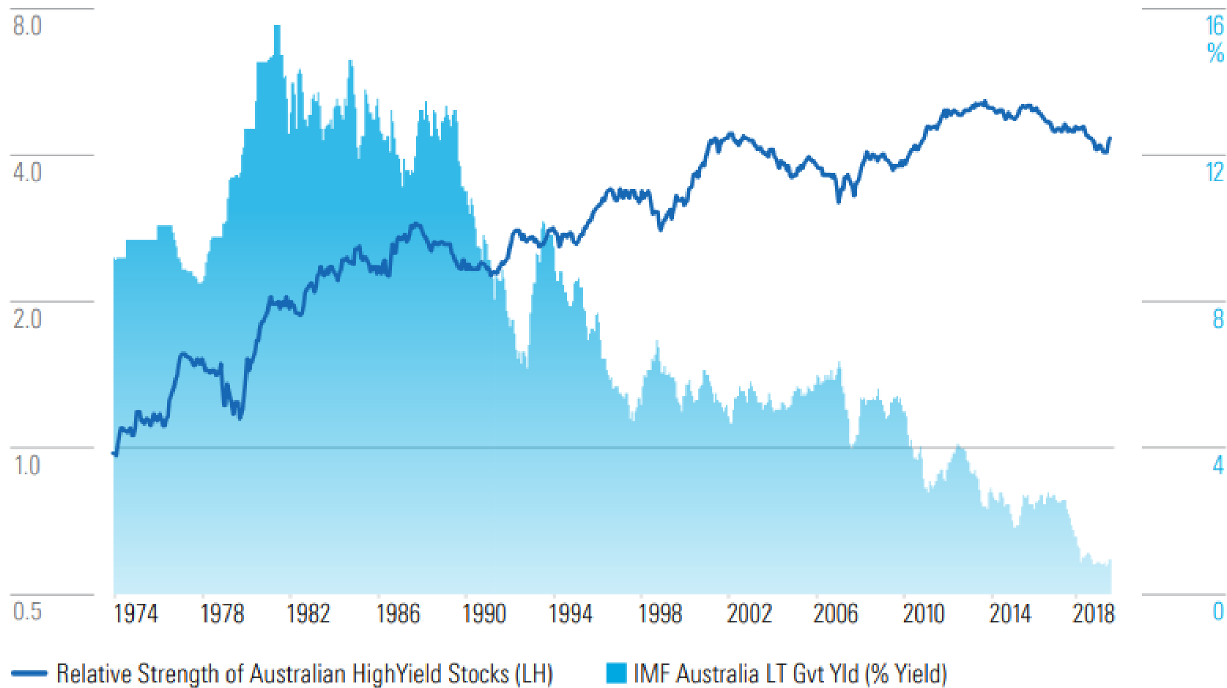
Source: French Data Library and IMF

Exhibit 6 Long Term, the Relationship Between Dividend-Paying Stocks and Interest Rates Is Unclear (U.K.)



Source: French Data Library and IMF

Exhibit 7 Long Term, the Relationship Between Dividend-Paying Stocks and Interest Rates Is Unclear (Australia)



Source: French Data Library and IMF

Dividend Durability: A More Important Consideration Than Rates

If interest rates are not necessarily a nemesis of dividend paying stocks, what risks should occupy equity income investors? Fundamental factors are by far more important considerations. Dividends are not guaranteed; in fact, they are last in line to be paid out of a corporation's resources. The term "dividend trap" refers to a stock that lures investors with a juicy yield that's ultimately untenable.

Simply buying stocks with high yields can lead investors to risky pockets of the market. When a stock's price declines, its yield rises. High yields are often found in troubled sectors, industries, and securities that ultimately cut their dividend due to financial distress. During the global financial crisis of 2007-09, dozens of dividend payers ran into trouble, including some equity income champions. In 2020, the pandemic-driven economic collapse led more than one third of the dividend payers tracked by Morningstar to cut payouts. It's for this reason that Morningstar dividend indexes employ screens for dividend durability.

Dividend payers have a strong track record historically. In all the markets depicted above, the high-yield segment has outperformed over the long term. Dividend payers tend to be solid, established businesses, and the dividend commitment focuses corporate management on steering a steady ship. Dividend payers have been a wonderful means of participating in equity markets, for both income and total return. The key is not to sacrifice the latter for the former. M

About Morningstar Indexes

Morningstar Indexes was built to keep up with the evolving needs of investors—and to be a leading-edge advocate for them. Our rich heritage as a transparent, investor-focused leader in data and research uniquely equips us to support individuals, institutions, wealth managers and advisors in navigating investment opportunities across major asset classes, styles and strategies. From traditional benchmarks and unique IP-driven indexes, to index design, calculation and distribution services, our solutions span an investment landscape as diverse as investors themselves.

Please visit indexes.morningstar.com for more information.

Contact:
indexes@morningstar.com

© 2022 Morningstar. All rights reserved. The information, data, analyses and opinions contained herein (1) include the proprietary information of Morningstar, (2) may not be copied or redistributed, (3) do not constitute investment advice offered by Morningstar, (4) are provided solely for informational purposes and therefore are not an offer to buy or sell a security, and (5) are not warranted to be correct, complete or accurate. Morningstar has not given its consent to be deemed an "expert" under the federal Securities Act of 1933. Except as otherwise required by law, Morningstar is not responsible for any trading decisions, damages or other losses resulting from, or related to, this information, data, analyses or opinions or their use. Past performance does not guarantee future results. Before making any investment decision, consider if the investment is suitable for you by referencing your own financial position, investment objectives, and risk profile. Always consult with your financial advisor before investing.

22 West Washington Street
Chicago, IL 60602 USA

©2022 Morningstar. All Rights Reserved.