

### Is it time to focus on income?

Just as the negative impact of European debt concerns had begun to fade, investor confidence has been further shaken by confirmation that the US and global economic recoveries are losing momentum. Matthew Sherwood, Perpetual's Head of Investment Market Research discusses the outlook and concludes that with global growth slowing and markets being volatile, but trading sideways, investors might increasingly focus on income.

#### Key takeouts:

- Economic growth rates in most national economies are lessening
- Returns are likely to be more moderate going forward
- Dividend income offers a reliable source of return, with potential tax advantages as well
- Credit spreads remain very attractive relative to cash and history

#### Introduction

When markets are volatile and sentiment is pessimistic it can be hard for investors not to be nervous - and emotions can be a wonderful servant, but a terrible master. We see this in Shakespeare's Othello, who is one of Shakespeare's most famous characters that has been played by Oscar winning actors including Emil Jannings, Laurence Olivier and Anthony Hopkins. The title character is a coloured North Africa former slave who works his way up to be a General in the Venetian army. Everyone initially respects this racial and cultural outsider, but then they decide that he's a monster after he marries the local Venetian Desdemona. Iago (a jealous, conniving fellow soldier) decides to destroy Othello's marriage by first of all convincing his father-in-law that the marriage has been forced and when this fails he convinces Othello that she is having an affair. Through escalating manipulation and deception, Iago pushes Othello into a violent and destructive rage and thereby gives Iago the told-you-so moment that he sought.

#### Markets are rarely rational in the short-term

Othello is famous for his overreaction to seemingly innocuous information and leaping to the wrong conclusion at a critical time. The same can be said, at times, about investors and investment markets. Financial markets trade on information and, like Othello, they are not always rational in the short-term. Over the past few months, markets have been captive to fears about European government debt (even though the US's and Japan's is considerably worse relative to economic output). However, these fears appear to have stabilised after a new European financial stability arrangement was established, most European governments underwent a program of fiscal consolidation and most regional banks passed their respective stress tests.

#### Investors are now concerned about a double-dip recession

Market attention has subsequently swung from Europe to the US and from government debt to economic growth, which is quite clearly decelerating. After troughing in mid-2009, the US economy was growing at an annualised pace of 5% by end-2009 and the preliminary June quarter 2010 US GDP result suggested this had further slowed to 2.4%, but subsequent data suggests that the growth figure is likely to be revised down to just 1.3%. The growth outlook remains constrained as US Government stimulus to support household incomes begins to fade. The Obama administration has contributed 5% to household income growth over the past year, without which household savings would have remained negative. With the stimulus now easing off, the flow from income growth to household spending will be less than normal, which suggests that employment gains are the key to US growth prospects.

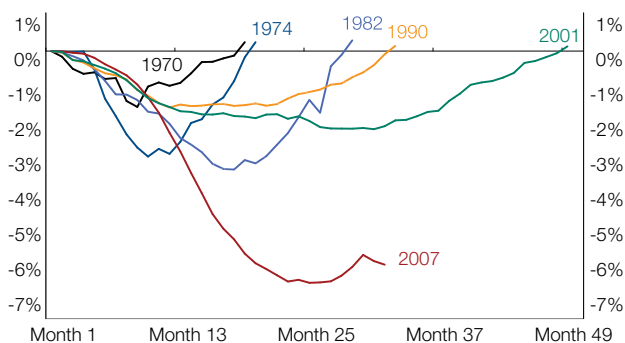
## The US labour market will constrain spending

The equation here is reasonably simple. The consumer is the backbone of the US economy (representing 70% of US activity and 15% of global economic activity) and recessions occur when consumer spending contracts and recoveries can't be sustained without a significant contribution from household spending. Indeed, the July 2010 retail sales confirm that the US consumer remains constrained.

For consumer spending to increase at a trend pace, US households need to reduce their savings, increase their income or have more people employed doing either. Recent US employment data has been softening; the three-month average of non-farm payroll growth (excluding the temporary impact of the US Government's 10-year Census) has slowed from +143,000 in April to just +13,000 in July. While US economic growth has remained positive it has not been enough to underpin a sizable reduction in US unemployment (see Chart 1). Indeed over the past 40 years, the downturns in the US labour market have progressively become deeper and the recoveries have become more protracted. For example, while it took the US economy 18 months to recover the job losses from the recession of 1970, this duration of the recovery rose to 20, 29, 33 and 49 months after the recessions of 1974, 1982, 1990 and 2001, respectively, even though the associated economic recessions tended to be shallower on each occasion.

**Chart 1: The US labour market recovery is one of the worst in history**

US Labour Market Cycles (% from economic peak)



Source: US Department of Labor as at 31 July 2010

## ... but the risk of a US double-dip is low

For the US labour market to return to the peak number of jobs (137,951,000 in December 2007) within 60 months (that is, by the end of 2012), 275,000 jobs would have to be created every month for 28 consecutive months. This will be very difficult considering economic growth remains subdued. Indeed, a slowdown in the new orders component of the Institute of Supply Managers manufacturing survey points to a moderation in US industrial production in the months ahead.

However, this alone is not enough to engineer a recession. US recessions typically follow a large rise in cyclical factors including housing construction, retail sales, employment growth and investment which have grown at an above-trend pace and start to unwind. Accordingly, the US economy is unlikely to have a prolonged major downturn as the sectors which typically drive a recession remain muted. This suggests that a further sizable drop in spending would require a significant negative shock, most likely of a financial nature, which while possible is unlikely in the medium-term. Consequently, the risk of a double-dip US recession does exist, but at this stage it remains low, or put another way, anaemic growth does not equal recession.

## Does anaemic growth equal lower earnings growth?

If the recovery in the US and other advanced economies remains anaemic, the global sharemarket is unlikely to experience the large earnings rebound that was evident after the past two global

recessions. Historically, earnings growth in the global sharemarket has only been positive when global economic growth has been greater than 3% and this appears easily achievable given Asia's continued industrialisation. However, the less-than-normal recovery in the advanced economies indicates that earnings growth is likely to be modest and rates of return in the next few years in major sharemarkets may be considerably more subdued than the historical average (which has been 6.5% per annum total return since end-1989 as represented by the MSCI World Accumulation Index in Australian dollar terms).

## Income is key

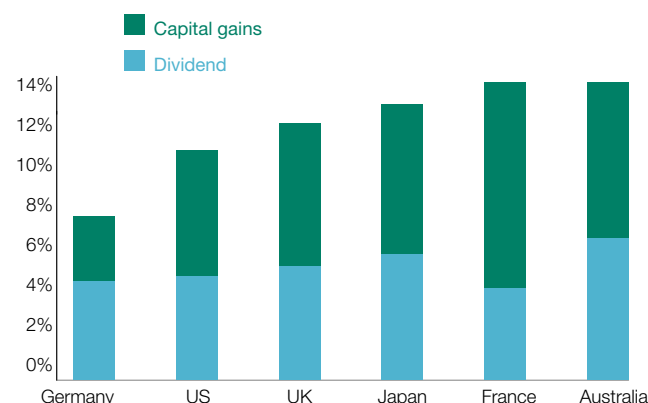
In a lower-return world, irrespective of the asset class, income will be a significantly larger contributor to total return than it has been in the past two decades. In the 20 years to the global sharemarket peak in late 2007, investors were spoilt with capital gains being well above their long-term trend and dividend income contributing only modestly to total return (only 21% of total return in France and 22%, 26%, 29% 40% and 42% in US, Canada, Germany, UK and Australia, respectively). There are several reasons for this including the increased use of buybacks to distribute retained earnings and firms re-investing their earnings given the seemingly higher potential rates of return available.

## Were the past 20 years atypical?

The contribution from dividend for the two decades to 2007 was much lower than the average since 1900, where dividends in most countries represented around half of total returns (see Chart 2). This suggests that the composition of total returns in the past two decades has been quite atypical and that going forward, things may return to the historic norm. Accordingly, the key question for investors is which companies can sustain earnings and dividend growth in an anaemic economic environment, given the strong correlation between the two factors and economic growth. The ideal company is likely to have a strong balance sheet, sustainable operating model that generates high surplus cash flow and is shareholder focused in its payout strategies.

**Chart 2: Dividends have contributed half of total returns since 1900**

Composition of Investment Returns since 1900 (% pa)



Source: Australian Stock Exchange, Reserve Bank of Australia and DataStream as at 30 June 2010. Japan returns are from 1913 and UK returns are from 1923 due to lack of data.

## Australian shares – income or yield?

If the contribution from dividends to total returns is set to reverse, the key focus from local investors should be income growth rather than dividend yield. Income is a cash payment, whereas yield divides this payment by an asset's value. If a security pays 10% more income each year and its share value increases 10% per annum, its yield won't change, but the cashflow to investors will double every seven years. Over the past 30 years, the annual

<sup>1</sup> See Perpetual Perspective "Is Government Debt the Next Sub-prime?" November 2009, page 3.

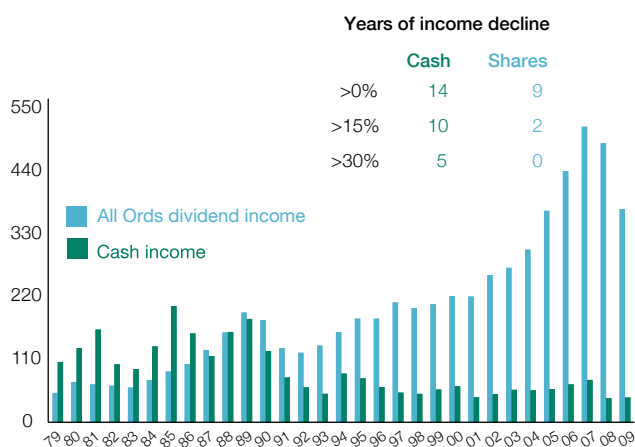
income from shares has increased by a total of 624% (excluding the impact of franking credits), whereas annual cash income has declined by 59% (including annual declines of more than 15% in 10 of the 30 years – see Chart 3). The key to listed company income growth is capital structure, franking credits, the payout ratio (of profits to investors) and earnings growth.

### Australian reporting season has been mixed at best

With the August reporting season half completed results have been slightly disappointing in some banks, telcos and several mid caps stocks such as James Hardie (principally guidance related). While weaker guidance has been a notable theme, some stocks such as Myer and David Jones have defied the economic backdrop (probably at the expense of high-end brand names). This suggests that some firms with significant market power are in a favourable position to squeeze the margins of their suppliers and price competitors out of a highly competitive market place.

### Chart 3: Investors need to focus on income growth rather than yield

Investment Income: Cash vs Shares (AUD1,000 initial investment)



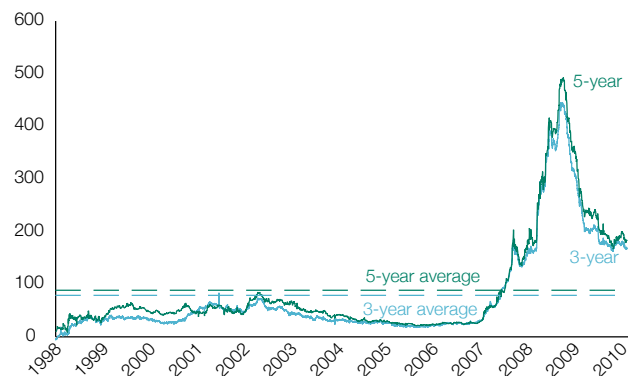
Source: Datastream as at 31 July 2010.

### Credit spreads in Australian floating rate notes are attractive

Income is also key in fixed income markets. At present, credit spreads over the bank bill swap rate (BBSW, which is equivalent to the Reserve Bank of Australia's target cash rate) are more than double their average since 1998 in medium-duration (167 basis points relative to a 12-year average of 78 points) and long-duration sectors (182, 89, respectively - see Chart 4). With the Australian economic outlook in the next five years appearing robust in the wake of an anticipated investment and export boom (which starts in the resource sector, but subsequently spreads throughout the entire economy), default risk appears to be quite low. At this stage, investment grade credit appears to be over-compensating investors for modest default risk and as such income in credit markets remains highly attractive relative to history and term deposits.

### Chart 4: Income from Australian credit securities is attractive relative to cash and history

A-rated Credit Spreads Relative to BBSW (basis points)



Source: CBA Spectrum as at 12 August 2010.

Risk over-compensation in credit tends to be highest in times of market stress such as the corporate scandals of Enron and WorldCom in 2002 and the GFC in 2008/09. However, after these sorts of market shocks, issued bonds tend to be better structured and are on more investor friendly terms with features such as secured lending (rather than unsecured) with improved credit enhancement (through greater subordination for senior bonds, coupon step ups in the event of ratings downgrades, change of control provisions, stronger covenant protection (such as gearing limits), interest cover requirements and so on).

### Implications for investors

There is little doubt that the economic environment is quite clouded at present and it is hard to see the end of the market volatility. That does not mean that it won't ever end and that markets will trend sideways forever – capital gains will eventually recover, but the economic backdrop is not overly supportive at present. Unlike Othello, investors need to ensure that they are managing their emotions and are not having their emotions manage them. Emotions can be beneficial, but can also stop investors from making wise decisions for a new environment.

The economic terrain is likely to see income become a significant contributor to total returns as was the case for the best part of 100 years. As such, the critical question for investors is where could I spend my risk budget to receive reliable income (and potential franking credits)? Companies with strong balance sheets, dominant market positions, high surplus cashflow and that are shareholder focused seem best placed to deliver, not only income, but more importantly income growth to investors. Although Australia's economic backdrop remains favourable relative to other advanced economies, risk remains a key focus, (even though valuations appear attractive) and income has had considerably less volatility than capital gains for the past century and beyond.

**Matthew Sherwood**  
**Head of Investment Markets Research**  
**Perpetual Investments**

This analysis has been prepared by Perpetual Investment Management Limited (PIML) ABN 18 000 866 535, AFSL 234426 for the use of financial advisers only, it is general information and is not intended to provide you with financial advice. The views expressed in the article are the opinions of the author at the time of writing and do not constitute a recommendation to act. Any information referenced in the article is believed to be accurate at the time of compilation and is provided by Perpetual in good faith. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.