EQUITY

UK Equity: What Dividends Can Tell Us About UK Economic Sentiment

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In light of recent regulatory pressure and fears of a UK equity market slowdown, some yield-hungry UK equity investors have run for cover. Against this backdrop, Colin Morton, vice president, portfolio manager, UK equity team, Franklin Local Asset Management, sees corporate dividends as a means to gauge general sentiment among leading UK companies. Here, he explains why he thinks high-quality companies can ride out the storm.

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Despite some fears of an equity market slowdown in light of continuing Brexit negotiations and recent geopolitical tension, UK company earnings increased much more than some observers had first anticipated, as did dividend growth.

The performance of UK-listed companies has been especially impressive against the background of rising UK inflation, and historically low and stagnant interest rates. We think UK equities are currently in a pretty compelling position compared to alternatives right now.

However, recent concerns over the pharmaceutical, and most notably the tobacco sector, serve as a reminder that even the biggest companies can fall foul to investor sentiment. Tobacco stocks slumped on the back of the US Food and Drug Administration's proposal to cut the nicotine content in cigarettes to "non-addictive" levels.

We think this may have been an overreaction, given it will be at least five years before we expect any regulatory impact to surface.

Despite the regulatory announcement, we saw dividends for tobacco stocks increase well above what the market was expecting, along with company results in the last quarterly earnings cycle. Investor sentiment negatively impacted share prices, but we don't think dividend growth will likely follow suit.

It's been 10 years since the United Kingdom enforced a smoking ban. Since then, tobacco companies have learnt to adapt and adopt new generation products, such as e-cigarettes. Regulation is nothing new to this sector and, these companies are very used to adapting.

Dividends Reflect Expectations of Muted Growth

Overall, we haven't seen any real signs of a disaster at the corporate level over the past quarter in the United Kingdom. We've seen evidence of good dividend growth, or in some cases, special dividends—a one-time dividend payment decided upon by company leaders. On the other hand, companies may be scaling back global growth ambitions.

As a result, special dividends can be considered a double-edged sword for yield-hungry investors.

Special dividends may indicate that companies would rather return money to shareholders than expand. There could be a lack of investment opportunities and potential concerns around Brexit and future UK economic growth.

Geopolitical tensions between North Korea, Japan and the United States have caused many investors to ditch equities and turn to "so-called" safe havens, just as UK equities were trading at their highs for the year.

Arguably, the market was ready for any excuse to pare things back a bit, given that valuations have been quite full. As mentioned, many investors have been inclined to move towards strong risk-off trades in the short term. However, we think the market will regain its poise, as it has during similar periods in the past.

High-quality companies were able to ride out challenging periods like the 2007-2009 global financial crisis or the tech bubble of the 1990s and we think the same applies to the volatile period we're in now. Investor concerns and market shocks have not largely affected UK company dividends. These dividend trends also show us a hint of what management teams may be thinking as we head into the next quarter.

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