Macro Keys
Negative Yields in Europe: Impact on Equities

Global Macro Strategy

Global

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Global Macro Team

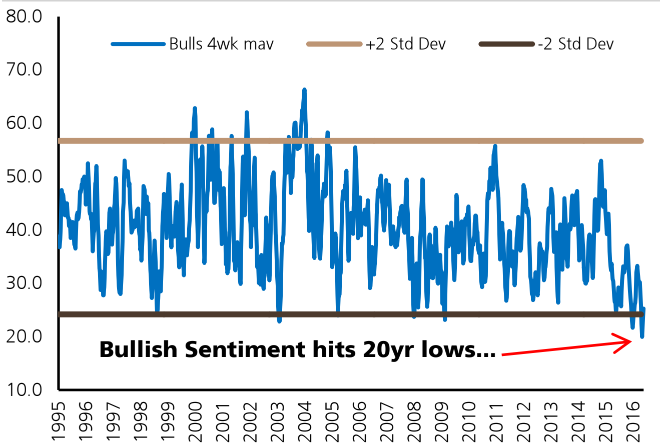
German 10yr yields turn negative for the first time…
German 10yr bond yields have turned negative and some European corporates are effectively "being paid to borrow". What are the implications for European equities? Although there has been a deepening of Global growth fears in recent weeks, economic surprise indicators and PMIs have not collapsed. Instead, risk aversion has risen sharply given event risk in June and in particular, the UK referendum. Bullish sentiment (US AAII) hit a 20 year low in the last few weeks (Figure 1) and our Macro team's Global Indicator of Risk Aversion is at extreme levels.

Gap between European Credit yields and Equity yields at extreme levels…
Lower sovereign bond yields have driven the gap between equity and credit yields to new extremes. Credit spreads have widened somewhat, but this has not offset the fall in sovereign bond yields: in the last three weeks Eurozone corporate credit yields have fallen from 1.37% to 1.21% and at the same time the equity dividend yield has risen from 3.4% to 3.7% (Figure 2).

Where are the dividends and will they get paid?
We run a Heatmap looking at where the yield is by sector and by country: Energy, Financials and Utilities have the highest yields. Mapping the dividend yield against the pay-out ratio helps indicate potential stress in dividends. Energy appears the most extended on this measure, but we would highlight cash earnings have fallen far less than EPS, suggesting dividends may be under less pressure than first appears.

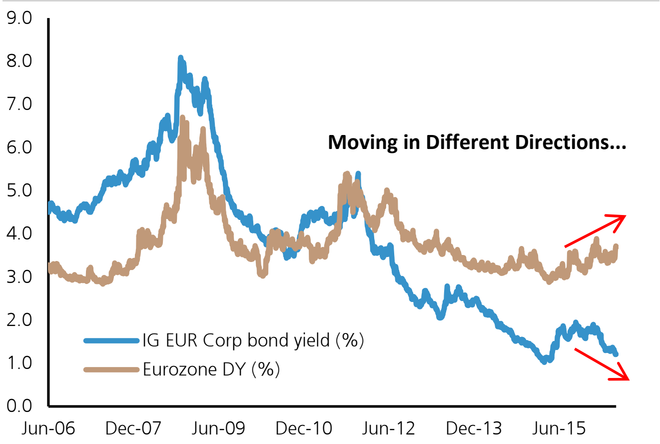
Cyclicals vs Defensives close to 15yr lows…
The change in Bond yields has been a driver for the relative performance of Cyclicals vs Defensives. This is now back below the March 2009 levels (even ex-Banks). Despite the bounce since mid-February on sector rotation, when observed from a long-term perspective, even this has hardly moved the needle.

Figure 1: US AAII Bullish Sentiment (4wk mav)



Source: Thomson Reuters Datastream, UBS European Equity Strategy

Figure 2: Eurozone: Corporate Bond Yield vs Div Yield



Source: Datastream, UBS European Equity Strategy

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Negative Yields come to Eurozone

Last week 10yr German Bund yields turned negative for the first time in modern history. Whilst this has been part of longer term structural decline in yields, the last move seems to have been brought on by some specific events and heightened risk aversion. There are some interesting implications for equities.

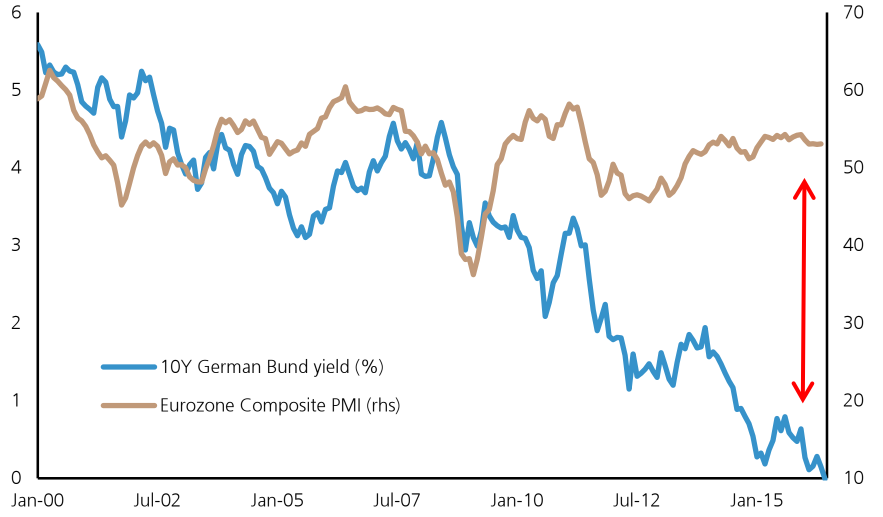
German yields turn negative for the first time…

Why are we where we are?

Whilst there are clearly growth fears over the global economy that have deepened in recent weeks, we don't see this as the sole cause. Economic surprise indices and PMIs have not deteriorated dramatically (Figure 3).

Our Macro team believe that core European yields are at least 70bps too low. *For more details please see:* Global Macro Strategy - Euro-area Yields: Too Low Anyway You Cut It 25 May 2016.

Figure 3: Germany Bund yields and Eurozone Composite PMI



Source: Datastream, UBS European Equity Strategy

The fall in Bond yields has not all been about the economy…

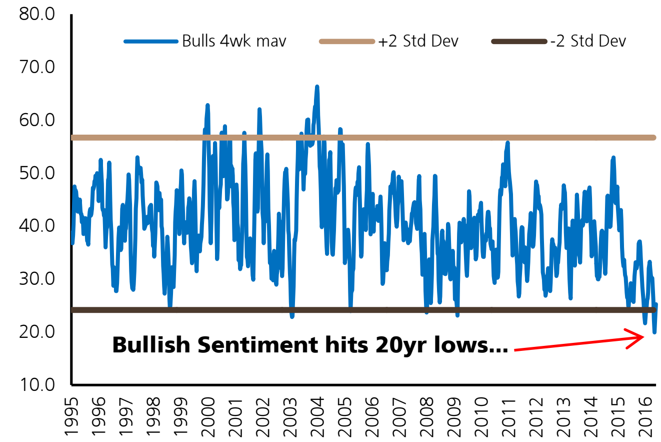
We have seen a sharp rise in risk aversion. The 4-week moving average of Bullish sentiment fell to a 20yr low at the end of May and volatility on European equities (Vstoxx) got close to a post-2011 high.

There has been a sharp rise in risk aversion….

Much of this can be attributed to the event risk around this month and in particular, growing focus on the UK Referendum vote on June 23. (*For more details on market implications around Brexit please see our full note:* Full Brexit: Stocks, EU Risk and Swiss Protection 13 April 2016 *and more recently from our Global macro team*: Global Macro Strategy – What to do before Thursday's referendum? 15 June 2016.

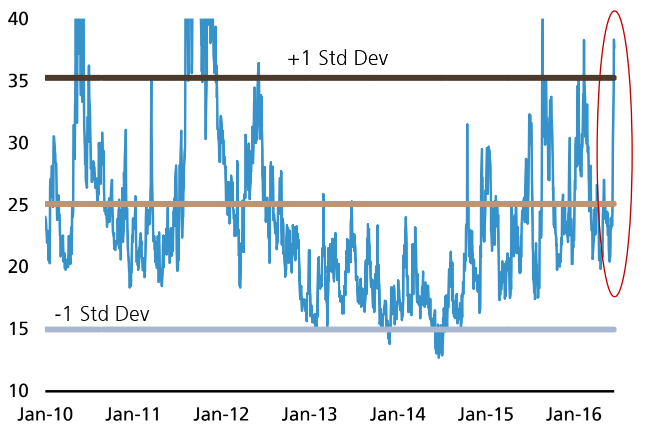
…Bullish sentiment at a 20yr low and VSTOXX rising

Figure 4: US AAII Bullish Sentiment (4wk mav)



Source: Thomson Reuters Datastream, UBS European Equity Strategy

Figure 5: VSTOXX



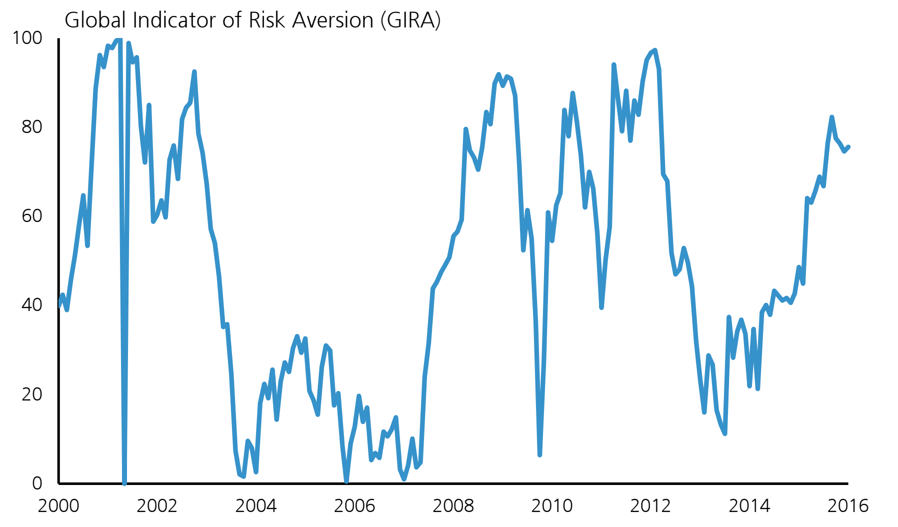
Source: Thomson Reuters Datastream, UBS European Equity Strategy

Additionally, our Global Macro team's Global Indicator of Risk Aversion is at extended levels – the highest since the summer 2012 Eurozone crisis and not that far from the levels hit around the failure of Lehman's in September 2008.

Negative YoY returns in global stocks (ex US) and very low yields typical occur either when growth is sharply deteriorating or when risk aversion is high. The indicator helps us identify how much of the increase in risk premia is primarily driven by sentiment (rather than growth damage) - hard as it is to fully separate the two. See [Global Macro Strategy – Scaling a Wall of Worry] 13 April 2016.

Our Global Macro team's risk aversion indicator is at extended levels

Figure 6: Global Indicator of Risk Aversion (GIRA)



Source: UBS Global Macro Strategy

What's the impact on European Equities?

(1) Gap between Credit Yields and Equity Yields driven to extremes

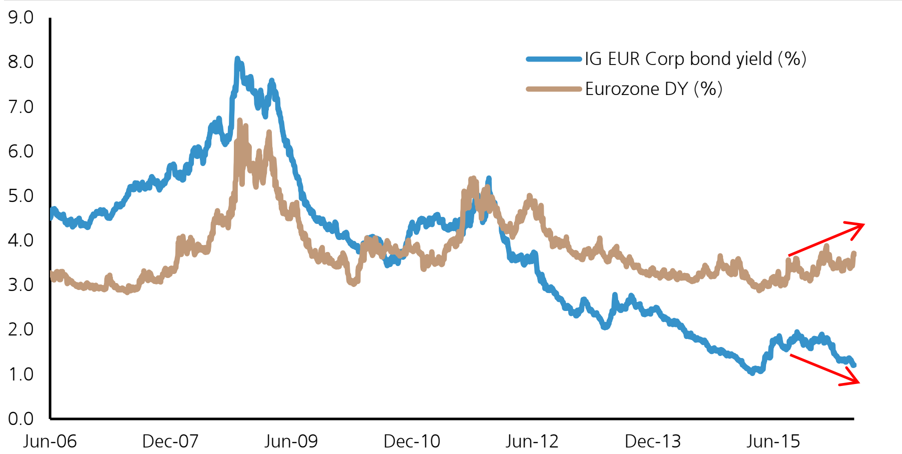
Even though there has been some sell off in credit spreads as risk aversion picks up, the total credit yield for IG Eurozone corporates has actually *fallen* from 1.37% to 1.21% over the recent weeks at the same time as the dividend yield has *risen.* Indeed, there are anecdotal indicators that are showing how extreme this is: the yield on LVMH's Nov-2019 bond shifting to a negative yield (compared to a 3.0% dividend yield on the stock).

See our credit team's recent Macro Keys for more details on the linkages between volatility and credit spreads: Macro Keys - What spread would make European HY attractive? 17 June 2016

For other extreme gaps, including bank dividends and bonds, see our previous Macro Keys report: Macro Keys - Europe is stuck: 4 charts at 40-year highs 23 May 2016

Corporate credit yields and dividend yields are moving in different directions…

Figure 7: Eurozone: Corporate Bond Yield and Dividend yield: moving in different directions…..

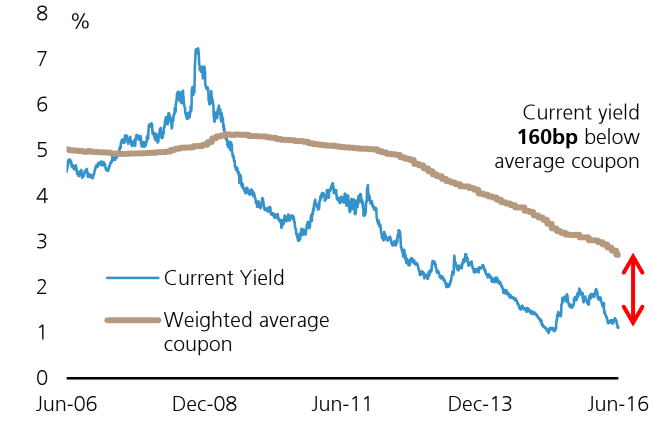


Source: Datastream, UBS European Equity Strategy

The gap has widened further

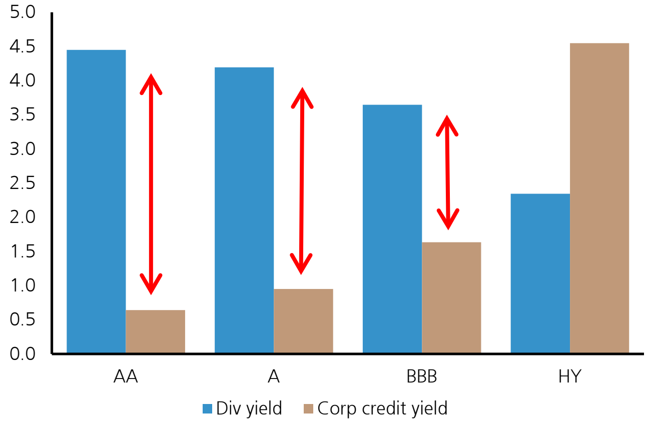
The effect is that corporates can fund at a cheaper level. Refinancing all outstanding debt at the current rates would boost market earnings by c.11% (although clearly this happens over time rather than instantly). The impact differs by sector as there is generally a larger earnings boost for the more levered sectors. *For more details, see:* What Boost to Earnings from Cheaper Refinancing? 19 May 2016 and ECB Corporate Bond buying – Impact on Equities 29 April 2016.

Figure 8: iBoxx Euro Non-Financials corporate bond index vs. average Coupon



Source: Datastream, iBoxx, UBS European Equity Strategy

Figure 9: Div yield vs credit yield gap



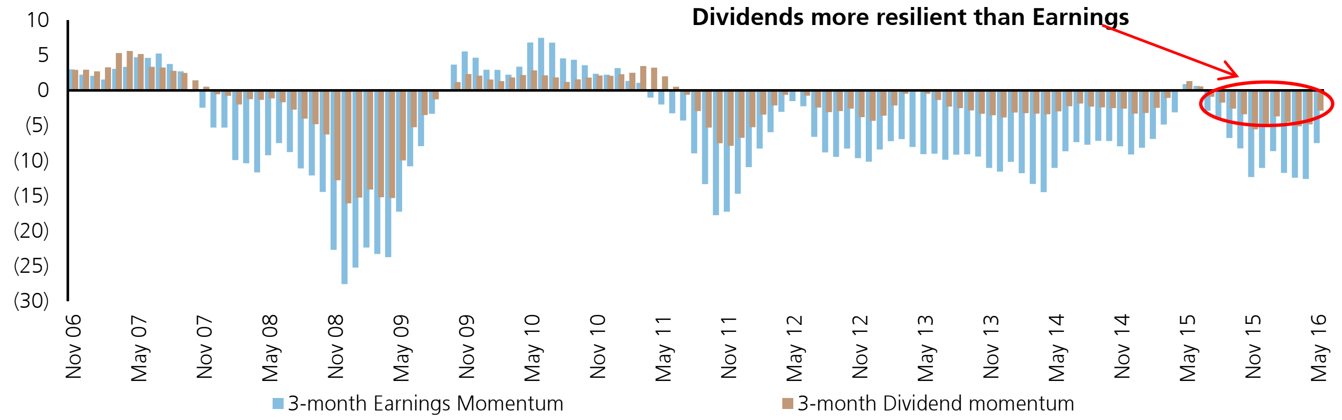
Source: Bloomberg, Datastream, iBoxx, UBS European Equity Strategy

(2) Dividend yields…even more important…

This increases the focus on dividends. The question is will they be paid? Despite seeing the most earnings downgrades for 7 years in February dividends have held up better, with only modest downgrades.

European dividend momentum is proving more resilient than earnings momentum

Figure 10: Dividend and Earnings Momentum (upgrades less downgrades as % total estimates)

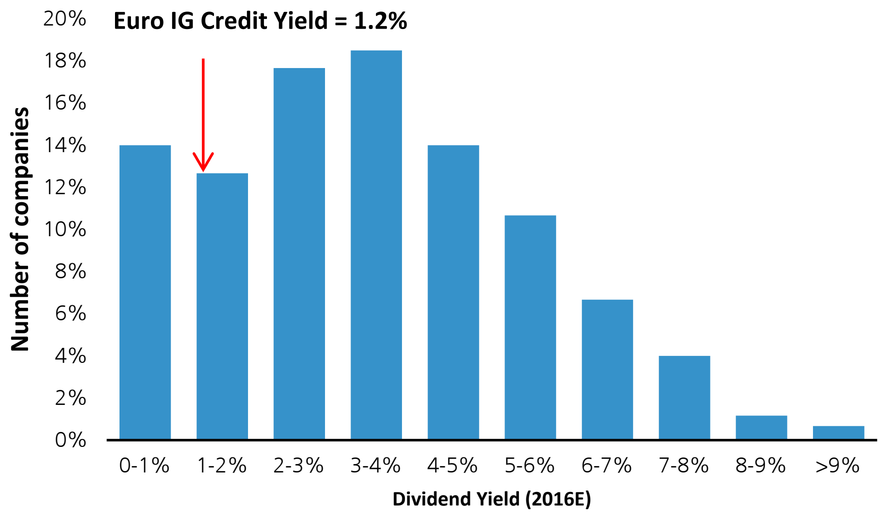


Source: Datastream, UBS European Equity Strategy

Where is the yield?

The 2016E dividend yield for the Pan-European Market (Stoxx 600) is 4.0%. Over a third of the companies in the index have a dividend yield over 4% and just fewer than 15% of the companies have a yield over 6%.

Figure 11: Stoxx 600 Dividend Yield (2016E): Distribution by number of companies



Source: Datastream, UBS European Equity Strategy

The vast majority of companies have a dividend yield above the IG credit yield

But this is split by a number of ways. We draw up a Heatmap to drill down at a country and sector level for where the yield is. Three sectors stand out: Financials, Energy and Utilities. Telcos is somewhat more mixed, given lower yields in Italy.

Financials, Energy and Utilities carry the highest yields

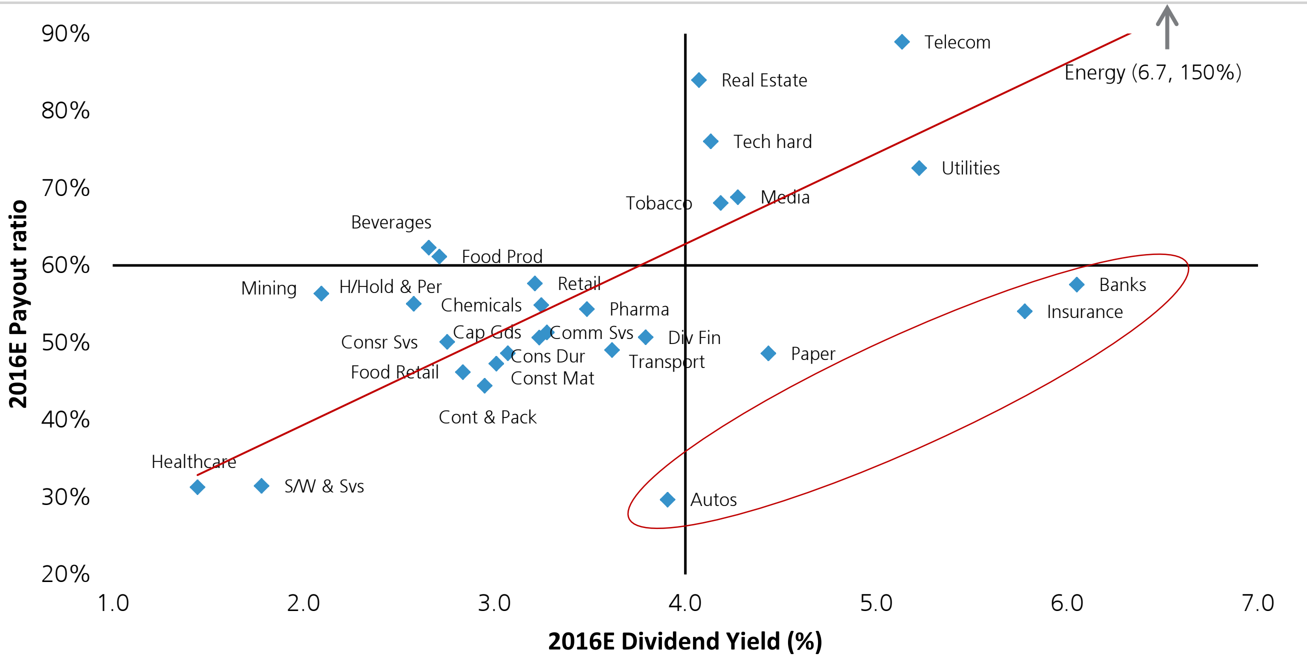
Figure 12: European Dividend Yield Heatmap

	Financials	Cons Discr	Cons Stap	Energy	Health Care	Industrials	IT	Materials	Telecom	Utilities
UK	5.4	4.1	3.3	7.4	4.1	3.3	1.4	2.5	5.0	5.1
Germany	4.7	4.2	1.8		2.3	3.8	2.0	3.6	4.5	4.2
France	5.8	3.6	2.6	5.7	3.7	3.2	1.8	2.8	3.7	5.8
Italy	8.0	1.4		5.4		3.3			0.8	4.9
Spain	5.6	2.5	4.2	6.4	1.9	4.3	2.4		8.2	5.3
Switzerland	5.6	2.8	2.8		3.5	3.5		3.3	4.9	

Source: Datastream, UBS European Equity Strategy

Below we look at the trade-off between the level of the dividend yield and the pay-out ratio. Unsurprisingly, there is a reasonable correlation between the two. The sectors that have the best trade off on this measure are the Autos sector as well as the Banks and Insurance but in some cases, pay-out coverage ratios may be flattering given the need for capital build through retained earnings etc.

Figure 13: 2016E Dividend Yield and Dividend Pay-out Ratio

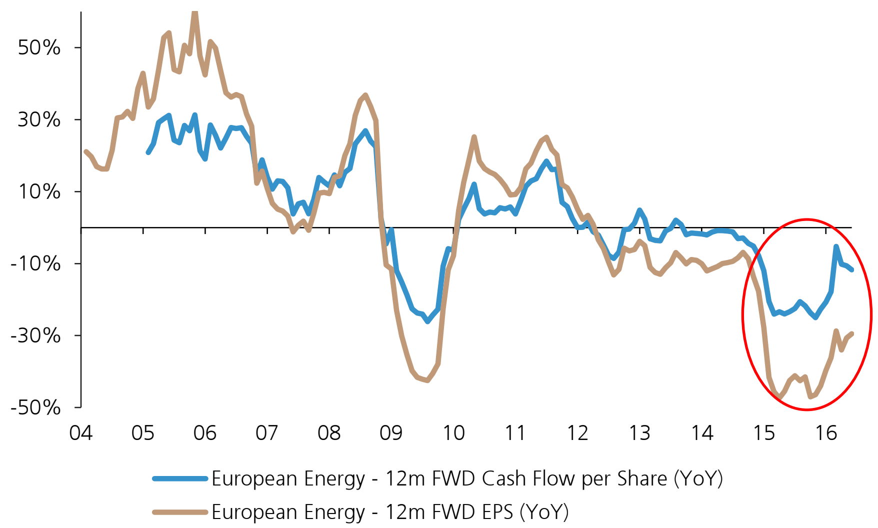


Source: Datastream, UBS European Equity Strategy

Despite the extremely high pay-out ratio for energy (off the scale on our chart above), this may be more achievable than at first appears. Dividends are paid out of cash and cash earnings are falling considerably less than EPS.

Figure 14: European Energy Sector: EPS growth vs Cashflow per share growth

The high pay-out ratio in Energy looks less stressed on cashflow than EPS



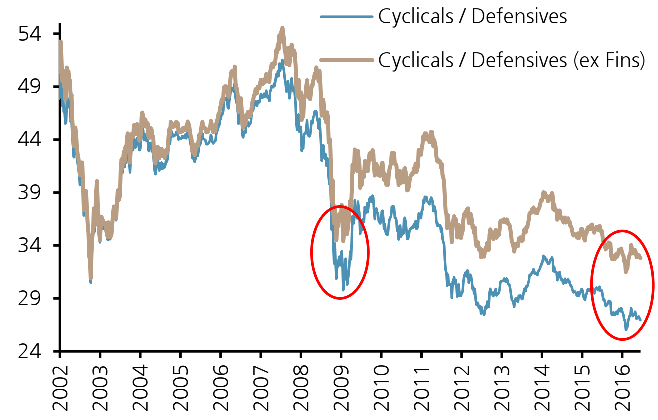
Source: Datastream, IBES

(3) Bond yields have pushed Cyclicals to close to 15yr lows…

The relative performance of the Cyclicals vs Defensive is back down through the March 2009 low. And this is not just the banks – it is the same case if we ex out the Financials. There has been a modest bounce since mid-February given large scale sector rotation into cyclicals, but even this has barely moved the needle from a long term perspective.

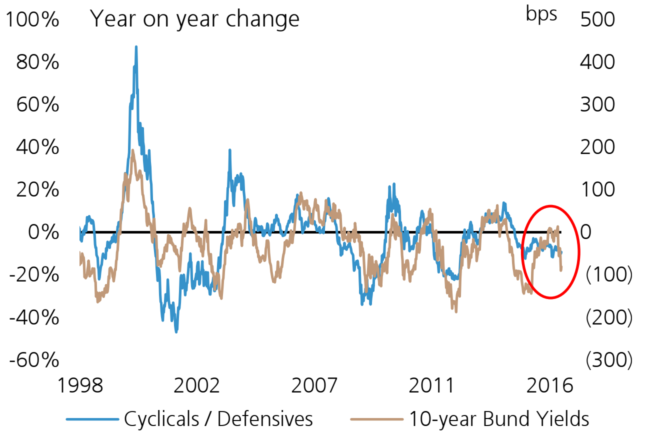
The relative performance of Cyclicals has bounced since February…but close to 15yr lows

Figure 15: Cyclicals/Defensives inc. and exc. financials



Source: Datastream, UBS European Equity Strategy

Figure 16: Cyclicals' performance closely reflects the change in yields



Source: Datastream, UBS European Equity Strategy

Valuation Method and Risk Statement

Although there are many uncertainties with equity investing, generally economic and policy surprises pose the most consistent and continuous risks. Economic growth can be volatile, leading to earnings uncertainty. Inflation volatility can likewise lead to interest rate uncertainty. The direction and level of policy rates has a substantial impact upon equity valuations.

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