MOOREINSIGHTS

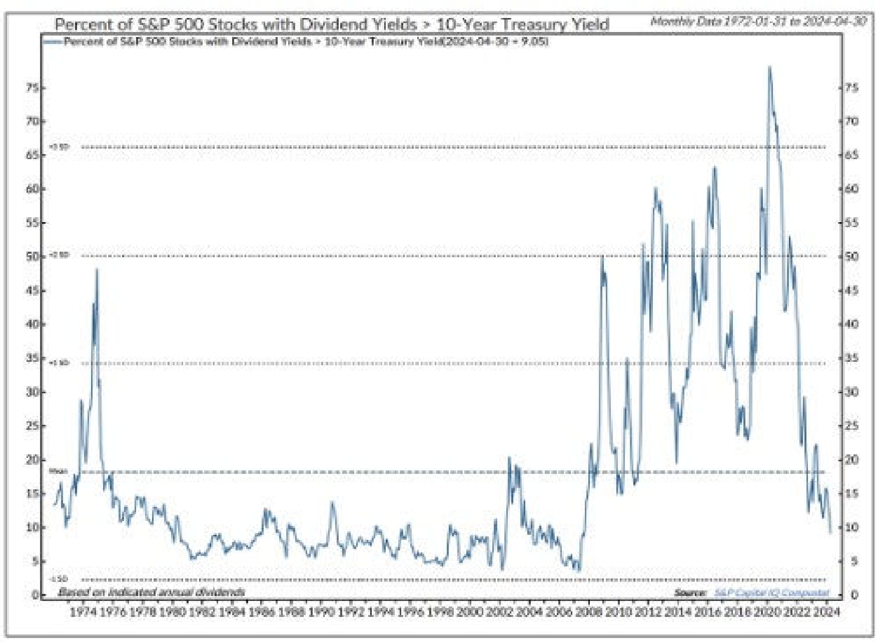
Why Stocks Have Rallied Despite Higher Rates

Not the Only Game in Town

One of NDR's themes over the past two years has been that higher interest rates make stocks less attractive versus bonds. To paraphrase quotes from several clients, "Why not allocate some to fixed income when I can get over 4% from bonds and over 5% from cash?" To use acronyms, the world has transitioned from TINA (there is no alternative to equities) to TARA (there are reasonable alternatives to equities).

The chart below perhaps illustrates the transition best. The percentage of S&P 500 stocks with dividend yields above the 10-year Treasury yield has fallen from a record high of 78.2% in March 2020 to 9.1% as of April 30. The last time the percentage was this low was September 2007, eerily just days before the S&P 500 peaked ahead of the financial crisis. For income-seeking investors especially, the bond market represents a more-than-reasonable alternative.

Figure 1 - % of Stocks with Dividend Above Treasury Yields Lowest Since 2007



Three Considerations

One reason stocks have continued to rally despite juicy bond yields is that economic growth, and therefore earnings growth, has been solid. Widespread calls for recession have kept some investors on the sidelines, creating a wall of worry for the market to climb.

Second, as London Stockton wrote on April 17, while relative valuations are the least attractive for stocks in over a decade, several indicators have merely returned to their pre-financial crisis ranges (see Fig. 2, below).

As central banks and the economy exit ZIRP, it stands to reason that relative valuations should adjust as well. Stocks may not be cheap, but looking at the pre-crisis ranges, they are not expensive, either.

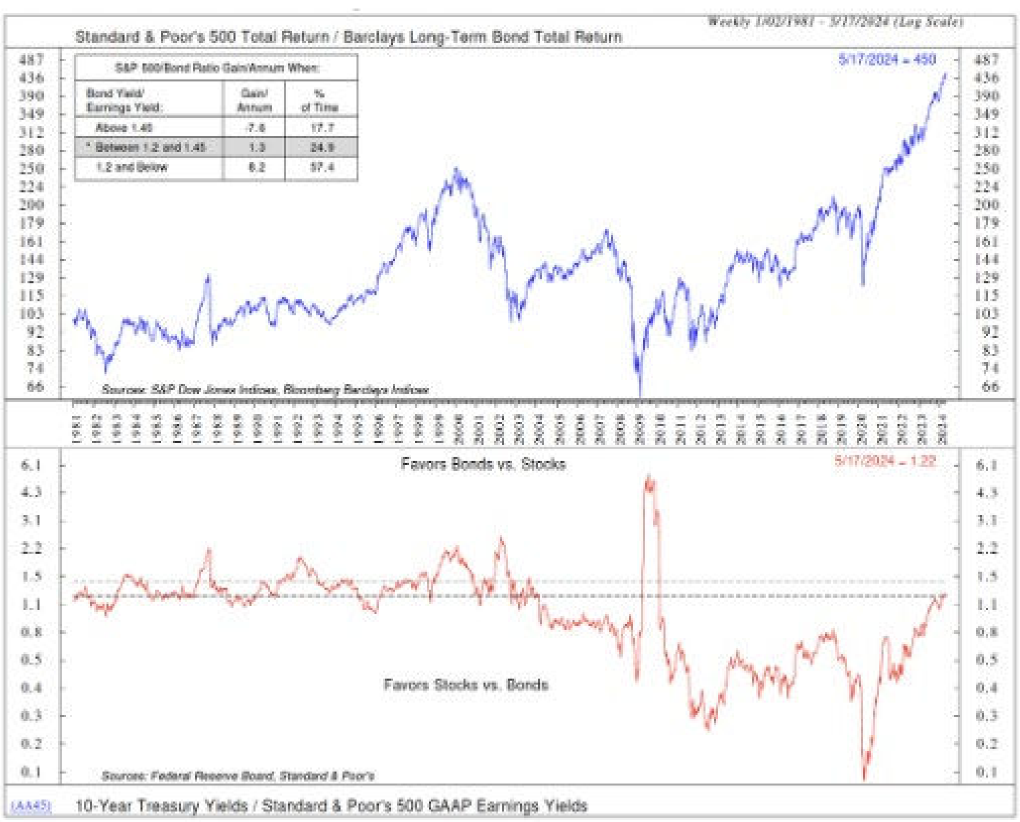
A third reason is that dividends do not tell the entire story of how companies return capital to shareholders. S&P 500 net repurchases have exceeded dividends for all but six quarters since 2011.

Relative Valuations Highest Since 2010, But in Line with Pre-GFC

One reason for buybacks' popularity is their lower tax rate (1% for buybacks versus ordinary income rates for dividends). Another is flexibility. Whereas a dividend cut sends a message that future cash flows are in jeopardy, a suspended or canceled repurchases program often has no repercussions for the stock price.

The S&P 500 dividend yield of 1.33% is 69 basis points, or 34.2%, below its 40-year average of 2.02% (chart, below). Conversely, the net repurchase yield of 1.73% is 41 basis points, or 30.8%, above its 40-year norm of 1.32%. The net payout yield, which combines the dividend yield and net repurchase yield, of 3.06% is 29 basis points, or 8.5%, below its 40-year average of 3.35%.

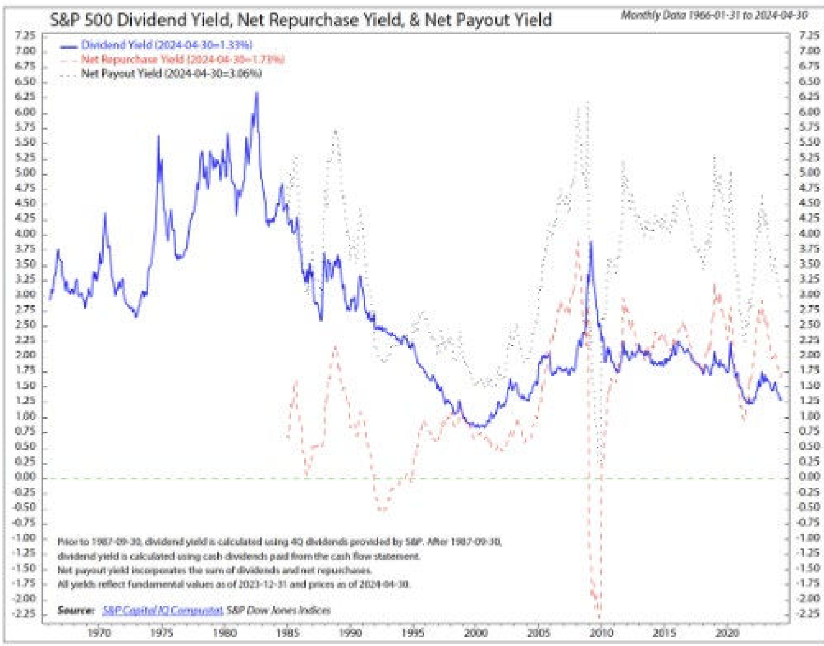
Figure 2



Repurchases Make Up Higher Percentage of Net Payout Yield

Repurchases are not as direct as dividends because investors have to sell shares to generate cash. As Jamie Dimon implied recently, a poorly timed repurchase destroys capital. But recognizing that buybacks are likely here to stay, the net payout yield is a relevant valuation tool.

Figure 3



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