Brompton Insights

Time for Dividend Stocks to Outperform?

BROMPTON FUNDS

December 19, 2023

Fund in focus: Dividend Growth Split Corp. (DGS, DGS.PR.A), Global Dividend Growth Split Corp. (GDV, GDV.PR.A), Brompton Global Dividend Growth ETF (BDIV)

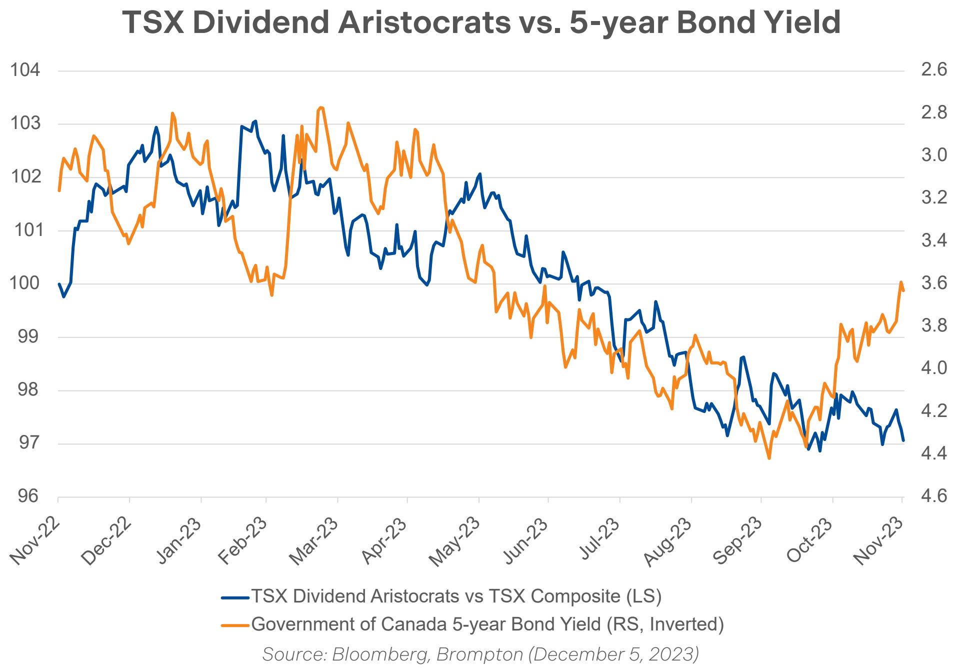
Over the last 20 months, interest rates have been rising as central banks, including the Bank of Canada, have raised short term rates to battle inflation, while longer term bond yields have risen in response. This has put pressure on dividend paying stocks such as those in the Utilities, Real Estate, Telecommunications, Financials, and other sectors. However, as it becomes increasingly clear that this hiking cycle is over, we think it's time for these stocks to stage a comeback.

What's Happening with Rates?

The 5-year Canadian government bond yield peaked in October 2023 and has since been falling. Inflation is coming under control (CPI at 3.1% in November[1]), the economy is slowing (Q3 2023 Real GDP at -1.1%, projected at 0.2% for each of Q1 and Q2 2024[2]), and the unemployment rate is rising (projected to be at 6.5% by year end 2024 vs 5.5% currently[3]). Additionally, approximately 45% of outstanding Canadian mortgages are up for renewal in 2024 & 2025[4], and it looks increasingly likely that the Bank of Canada is at the end of the rate hiking cycle and could start cutting rates in 2024.

Dividend Stocks Have Underperformed as Rates Have Risen

The chart below illustrates the message. The orange line shows 5-year Government of Canada bond yield on an inverted scale, while the blue line shows the performance of the TSX Dividend Aristocrat Index relative to the TSX Composite Index over the last year. As you can see, dividend growth stocks have underperformed the market as rates have risen.



Source: Bloomberg, Brompton (December 5, 2023)

This typically makes sense, as investors who buy stocks with a high dividend yield, are buying them for the income they generate, and their relative stability compared to high growth stocks. However, when Government of Canada yields rise (as it did from ~0.4% at the end of 2020, to a high of 4.3% in October 20235 on the 5-year), investors had a safer alternative to dividend stocks.

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[1] *Source: Bloomberg: ECO*

[2] *Source: Bloomberg: ECFC*

[3] *Source: Bloomberg: ECFC*

[4] *https://vancouver.citynews.ca/2023/11/10/canada-mortgage-interest-rates-renewal-shock/*

[5] *Bloomberg: GCAN5YR Index*

Logically, investors sell their dividend paying stocks and move their money into higher yielding and safer government bonds. This rotation out of dividend paying stocks has pushed up the yields on sectors that have a higher proportion of dividend paying stocks, as illustrated in the chart below which compares how yield sensitive dividend equities have reacted to the sharp rise in rates over the past 20 months:

Sector	Dividend Yield December 5, 2023	Dividend Yield March 31, 2022
TSX Dividend Aristocrats[6]	4.09%	3.12%
Equal Weighted Banks[7]	5.18%	3.20%
Equal Weighted Utilities[8]	4.80%	3.24%
Equal Weighted Real Estate[9]	6.08%	3.87%
Equal Weighted Telecom[10]	5.68%	3.99%

Looking Forward

Despite this relationship holding true until rates peaked in early October, there has been a divergence between rates that have continued to decline and dividend stocks that have not recovered yet. We believe that peaking rates should mark the bottom for these high dividend stocks, and that they should outperform into 2024. The higher dividend yields on these stocks, coupled with the falling yields on government bonds once again make the dividend stocks an attractive investment opportunity.

[6]*Bloomberg: CDZ CN Equity*

[7]*Bloomberg: SOLCBEW Index*

[8]*Bloomberg: SOLCUEW Index*

[9]*Bloomberg: SOLCREW Index*

[10]*Bloomberg: STTELS Index*

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