BLACKROCK INVESTMENT INSTITUTE

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Building the right defense in equities


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Equity markets are at a crossroads. Nine years into the bull run, a synchronized global economic expansion amplified by U.S. fiscal stimulus is stoking higher earnings growth expectations — and interest rates. High-yielding “bond proxy” stocks earned their stripes as equity safe havens for much of the period as bond yields were slow to revert back to pre-crisis levels. We look at what may constitute the new defense in stocks as rates transition from “lower for longer” to higher at long last.

Highlights

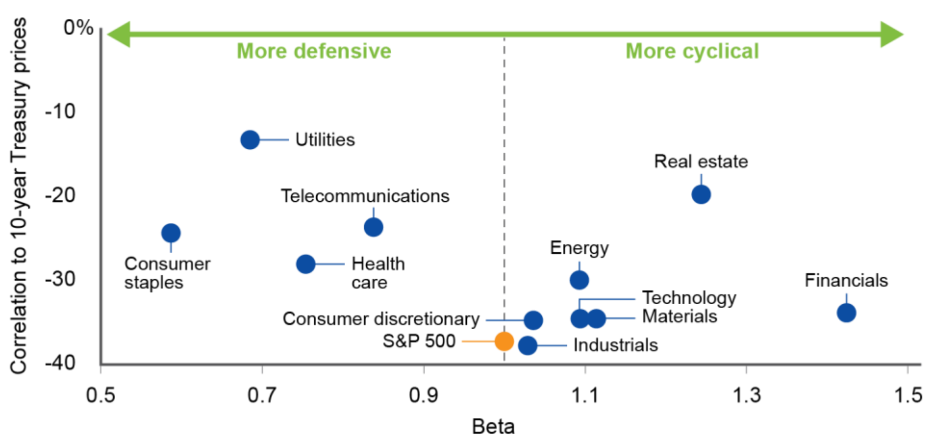
- Traditional high-dividend stocks could do more harm than good in an environment of higher rates and inflation. They have underperformed broad indexes year-to-date and are vulnerable to rate moves. Minimum-volatility (min-vol) strategies suffered a similar fate, suggesting a good defense is a multi-faceted one.
- The “why” behind rate rises is important. Different sectors tend to play better defense depending on the impetus for rising rates. When yields are increasing faster than inflation expectations, as they are today, cyclical (rather than defensive) rate-sensitive sectors can lead. U.S. banks, in particular, appear well positioned.
- Defense in stocks today is less about high yield and more about quality and the ability to outrun inflation, in our view. Companies with the free cash flow to boost dividends also tend to sport attractive valuations versus the highly bid high yielders.

Not created equal

Stock and bond prices usually move inversely. Yet not all stocks are created equal. The *Stocks in bonds’ clothing* chart reveals that defensives such as U.S. utilities and telecoms historically have more closely followed moves in Treasury prices than higher beta, or more volatile, cyclicals such as financials. This suggests offense sometimes may be the best defense when interest rates are rising and bond prices falling.

Stocks in bonds’ clothing

Rate sensitivity and market beta of U.S. stocks by sector, 2001-2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters and S&P, March 2018. Notes: The dots show the correlation of S&P 500 sectors and U.S. bond daily returns (based on the Thomson Reuters U.S. benchmark 10-year) and the beta to the S&P 500 broad market from 2001 to the present. Beta is a measure of risk relative to the broader market. Sectors are represented by their respective S&P 500 indexes.

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Taking the offense on equity defense

High-yielding bond proxies did not offer downside protection in the February stock rout. It's a role they historically have played well in drawdowns caused by economic deterioration and other risk-off periods. But this selloff came amid a steady global expansion. The impetus this time, aside from a technical matter of investors exiting strategies betting on low volatility, was fears over rising rates and inflation.

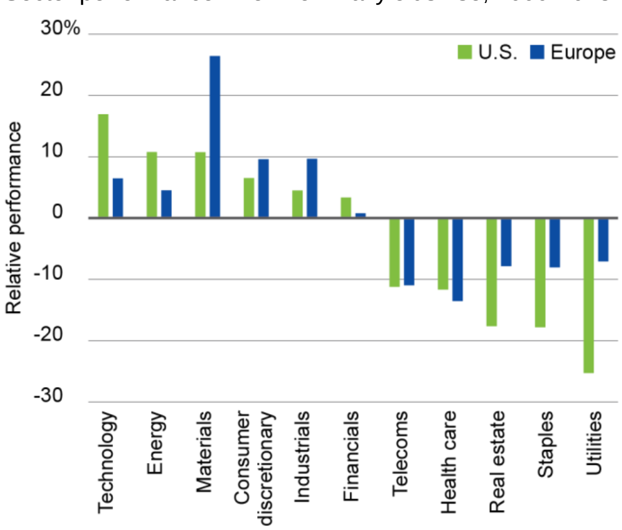
Strong growth provides a solid foundation for stocks, we believe, but this experience makes it worth considering whether bond proxies can provide the same downside protection in the coming quarters as they have historically. They may even face competition from bonds for the first time in nearly 10 years.

We analyzed S&P 500 sector performance from 2000 to present to isolate vulnerabilities. The findings: Traditional defensive sectors such as utilities, telecommunications, real estate and consumer staples provided minimal protection when nominal yields moved higher.

We considered three cases: 1) rising 10-year yields; 2) rising 10-year breakevens (a market gauge of expected inflation); and 3) rising 10-year real (inflation-adjusted) yields. A rate increase greater than 15 basis points in a month constituted a "rise." Based on our analysis, the split between sectors that benefited from rising nominal yields and those that suffered was clear: Defense-oriented sectors — those that are income-driven but light on growth — fared worse as the opportunity cost for holding them grew. Cyclical stocks, whose performance coincides with an expanding business cycle, predictably performed better. Our analysis reveals this relationship has held outside the U.S. as well. See the *Yields up, defensive stocks down* chart.

Yields up, defensive stocks down

Sector performance when nominal yields rise, 2000-2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Thomson Reuters, S&P, MSCI and the European Central Bank, March 2018. Notes: The bars show the average annualized monthly performance of U.S. and European equity sectors during months when 10-year yields rose. Sector performance is relative to the broad market; indexes used are the S&P 500 and the MSCI Europe. We define a rise in the 10-year as a change greater than 15 basis points. We use the 10-year Treasury for the U.S. and a GDP-weighted 10-year rate for the euro area.

The "why" matters

The "why" behind rate rises is important. Yields can and do rise for different reasons — some better than others. If the economy is growing, and inflation along with it, an inflation hedge is warranted. Commodity-oriented sectors historically have fit the bill: As demand for goods and services rises, commodity prices have tended to follow suit. We prefer to gain exposure to commodities through related equities and debt today. Companies have become more disciplined in their spending and both assets have lagged underlying spot prices, leaving room for greater appreciation potential. We offer our take in our latest Global investment outlook.

We find energy and materials stocks historically have been the best performing when U.S. inflation breakevens perk up. And they have dropped when breakevens dipped. Real estate investment trusts (REITs), a sector we saw decline when nominal yields rose, tend to perform much better when the rate increase is spurred by inflation expectations. Why? Rents and real estate values tend to increase with higher prices broadly in an expanding economy.

When nominal yields are rising faster than inflation expectations — as has been the case in the first few months of 2018 — financials have ended up taking the reins. This is a boon for U.S. banks in particular, which are able to lend at higher rates as the Fed gradually ups its target rate. This puts U.S. banks among our favored sectors, with deregulation and the prospect of increasing dividends offering the potential for an additional boost.

A similar analysis for Europe reveals some parallels in the response to a rising GDP-weighted 10-year government bond yield: Cyclicals rise, defensives drop.

We find the average dividend yield of common "bond-proxy" sectors in the MSCI USA Index stands near 4% today, almost two percentage points higher than the broad index. This makes defensive companies an appealing income source. But as interest rates — and the short end of the yield curve — grow more attractive for investors, the risk/reward proposition changes. Defensive stocks begin to lose their luster, particularly at still-demanding valuations in some regions.

All defensive sectors have cheapened since reaching peak valuations when bond yields bottomed in 2016. Yet defensive stocks globally are still trading at a 7% premium to the broad market today, based on our analysis of MSCI index data. European defensives stand at a 11% premium, while the U.S. comes in at a 3% discount relative to the broader market.

Idiosyncratic challenges atop such broad transitions make picking stocks even more complicated than usual. Technology disruption has created gray area in many spots. And consumer staples, in particular, face notable business challenges. Take beverages and packaged goods, two of the biggest: The former struggles with changing consumer preferences. The latter faces competition from private-label goods sold by big-name retailers as brands have less sway over cost-conscious consumers. Margin compression is also a challenge as rising input costs are difficult to pass through. These, we find, are global phenomena.

Building a better ballast

Investors may be tempted to add to bond proxies and related defensive stocks as their premium valuations to the rest of the market have lessened. Yet the nominal and real rate backdrop may well warrant this relative multiple compression. We find some of these companies, in fact, have been unable to increase cash flows — even against an economic backdrop where profitability has reached new highs for most of the market. The weakness in these businesses justifies the de-rating.

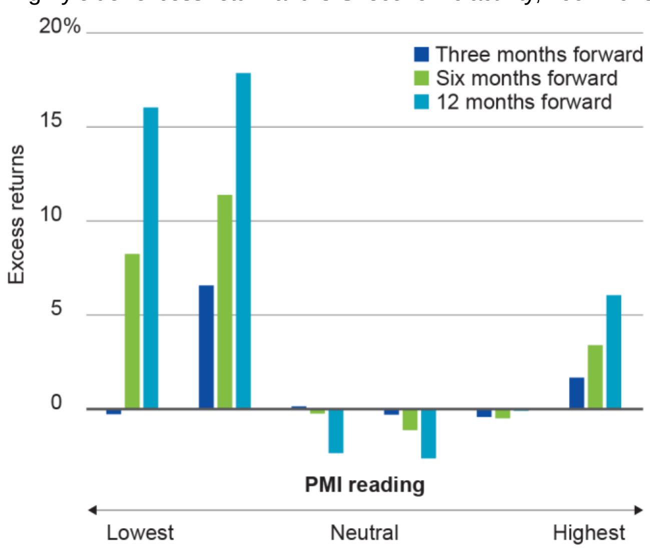
We also find the ability of these high-yielding stocks to outperform depends heavily on the economic growth regime. Using Institute for Supply Management (ISM) manufacturing data as a proxy for economic activity, our analysis shows that in times of economic contraction (PMI readings below 50), high yielders have tended to outperform broad equity indexes. The effect wanes significantly in periods of steady expansion. See the *A time and place for yield* chart.

We believe stocks need to do more than generate stable income to earn investors' attention today. Defense in equity portfolios should focus on quality as a style characteristic and dividend growth, in our view. Quality companies, by our definition, are those able to generate and grow free cash flow while maintaining healthy balance sheets. Companies with the fundamental ability — and demonstrated willingness — to increase dividend payouts appear better positioned to offer portfolio protection than those with only high dividend yields.

Dividend growers also show tendencies to be more "all-weather" and we find currently sport relatively attractive valuations versus the highest yielders that were bid up after years of low rates and investor thirst for income.

A time and place for yield

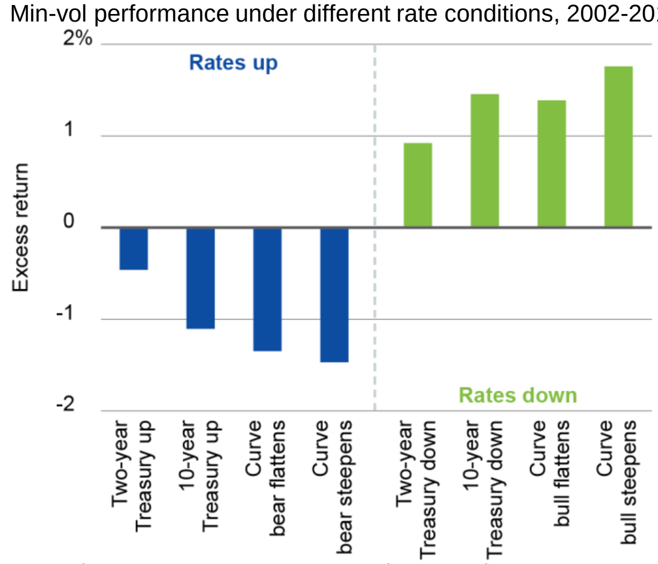
High-yielder excess return and U.S. economic activity, 1991-2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock, with data from Bloomberg, S&P and ISM, March 2018. Notes: The bars show average forward excess returns of the S&P 500 High Dividend Index relative to the S&P 500 over three-, six- and 12-month horizons for various levels of the ISM's U.S. manufacturing PMI. A reading above 50 represents economic expansion and below marks contraction. "Lowest" is a reading of 34.5-39.5 and "highest" is 59.5-64.5.

When rising rates de-rate

Min-vol performance under different rate conditions, 2002-2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock, with data from Thomson Reuters and MSCI, March 2018. Notes: The bars represent the average annualized risk-adjusted excess return of minimum volatility from 2002 to 2018. Treasury yields up or down is any move above or below zero. Bear flattener is rates up and the 2-10 curve flatter. Bear steepener is rates up and 2-10 curve steeper. Bull flattener is rates down and 2-10 curve flatter. Bear steepener is rates down and 2-10 curve steeper. Min vol is represented by the MSCI ACWI Minimum Volatility Index and the comparative benchmark is the MSCI ACWI. The Min Vol index was launched on May 30, 2008. Earlier data are back-tested. See Important notes at back.

The vagaries of volatility

For much of this cycle, when market volatility picked up, low-volatility stocks and related min-vol strategies provided a comfortable cushion. But February was different.

In two rocky periods for stocks — the first quarter of 2016 and first quarter 2018 — the VIX volatility gauge was at similar levels. Yet the performance of min-vol strategies was very different: outperformance two years ago and underperformance today. The reason: 2016 was about macro growth fears and a China slowdown; 2018 was more about rates and inflation, and worsened by leveraged strategies betting on low vol. The *When rising rates de-rate* chart shows that min-vol strategies historically have floundered in various rising-rate scenarios.

This illustrates the vagaries of volatility, and the need to prepare for it in different ways. Volatility tends to move in regimes — high or low — our research suggests. We see a low-volatility regime with room to go in 2018. Yet within it, bouts of heightened vol are likely, and the triggers matter for building a proper defense.

Our bottom line: High-yielders and min-vol strategies hold an important place in portfolios. They historically have offered cushion in risk-off periods, but their buffer may be limited amid rising rates and inflation. We see short-term bonds as an increasingly compelling alternative to "stable" dividend stocks. Nominal two-year yields are higher than the dividend yield in the U.S. for the first time since 2008. Other regions are not far behind as central banks begin to gradually move to normalize policy. We elaborate in A mighty (tail)wind. Within our overall preference for stocks, we believe investors are well served by an allocation to quality companies with the ability to increase dividend payouts and generate revenues that can outrun inflation.

Important notes: Back-tested data are calculations of how an index might have performed prior to the index's inception. There are frequently material differences between back-tested performance and actual results. Past performance — whether actual or back-tested — is no indication or guarantee of future performance.

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