Navigating Interest Rate Changes

Stanley Druckenmiller once said, "*Earnings don't move the overall market; it's the Federal Reserve Board.*" When you look at the market with a short-term lens, the impact of interest rates and liquidity are magnified. As long-term investors, we believe earnings and dividends are key drivers of return over time. However, we acknowledge it is important to understand how stocks behave in different interest rate environments.

Historically, stocks tend to do well after interest rate cuts, particularly if a recession doesn't follow. When the Federal Reserve cuts rates, borrowing becomes cheaper, which can stimulate the economy. At the same time, lower rates tend to benefit equity valuations since risk-free returns are less attractive. Investors are incentivized to take on increased equity risk if they want to improve, or even just maintain, their returns.

Two areas of the market are often cited as potential outperformers during rate cut cycles: high-yielding stocks and growth stocks. High-yielding stocks attract investors by offering an appealing income alternative as interest rates decline. Growth stocks, on the other hand, become more appealing as their future cash flows are discounted at lower rates, and they gain access to cheaper financing, which can drive expansion for companies with strong growth potential.

When interest rates are rising, borrowing costs increase, which can lead to a slowdown in spending by businesses and consumers. Companies which are more dependent on economic growth, or which are more impacted by higher borrowing costs, are cited as underperformers in these environments. As one might expect, higher risk-free returns now have the opposite impact on equity valuations, as their gravity-like effect brings valuations back down to earth as investors can afford to take less risk.

Below, we look at how different types of dividend stocks performed around the most recent falling rate and rising rate environments. While each of these periods was unique, we think the drivers of performance are relevant as we look forward. We also think strategies that offer performance through all parts of the cycle are more likely to deliver for clients over the long term. The groups of dividend stocks are categorized based on the following criteria, with the S&P 500 constituents serving as the universe:

Cutters: Dividend-paying stocks that will cut their dividend during the calendar year.

Payers: Stocks that will pay a dividend during the calendar year.

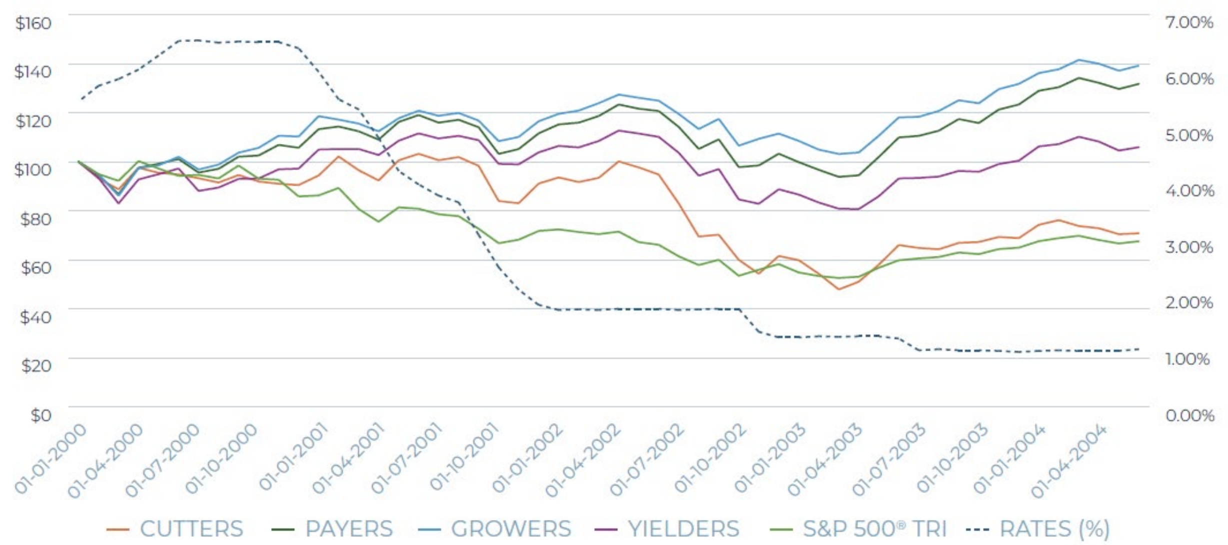
Yielders: Dividend-paying stocks whose 12-month yield during the calendar year will be higher than the S&P 500 market-cap-weighted average yield.

Growers: Dividend-paying stocks that will increase their dividend during the calendar year.

All portfolios are constructed on January 1st of each calendar year using perfect foresight of dividend actions that will occur during that year. This approach is employed to analytically isolate and understand the direct impact of dividend actions on stock performance. For reference, we are showing the Federal Funds Effective Rate as the relevant interest rate.

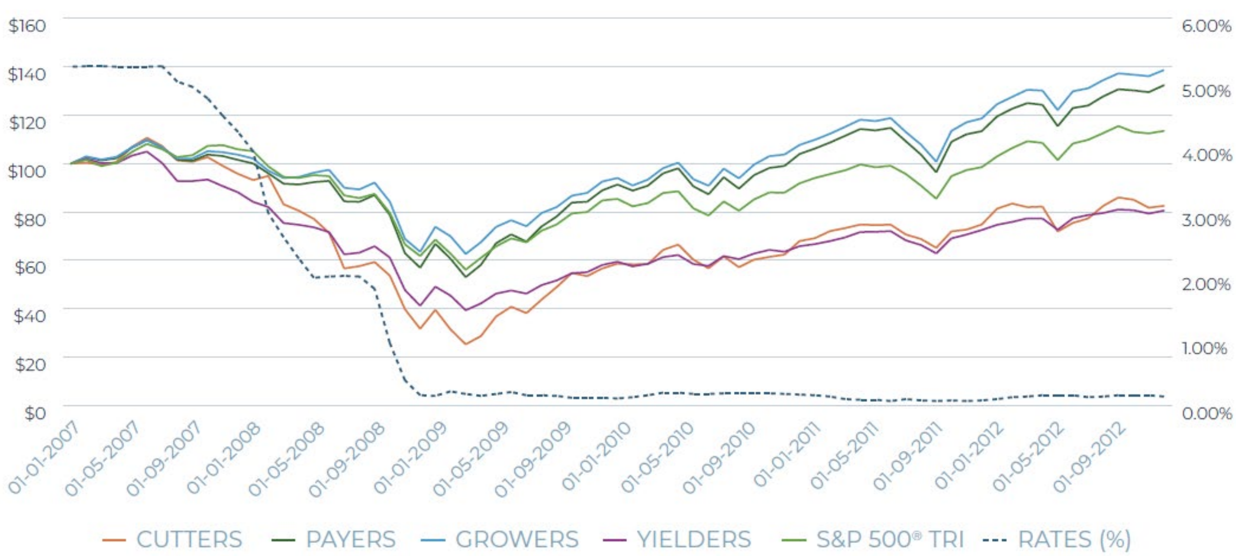
Falling Rate Environment

TECH BUBBLE



Source: Bloomberg, Bristol Gate. Data from January 1, 2000 – June 1, 2004

GLOBAL FINANCIAL CRISIS



Source: Bloomberg, Bristol Gate. Data from January 1, 2007 – December 31, 2012

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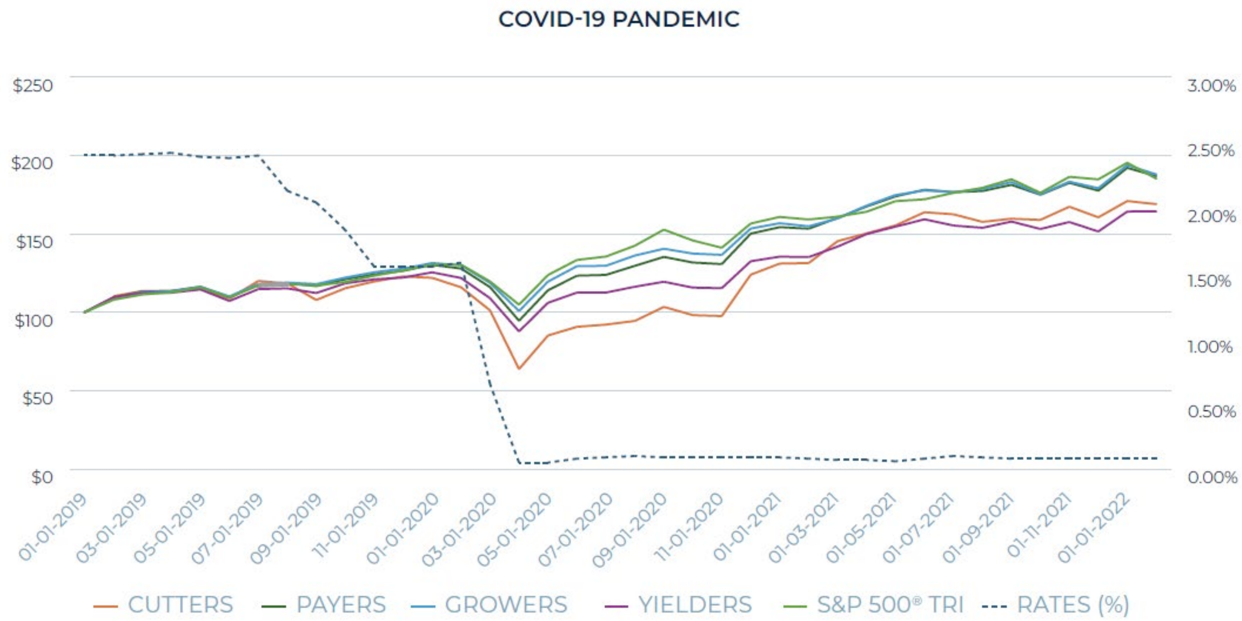
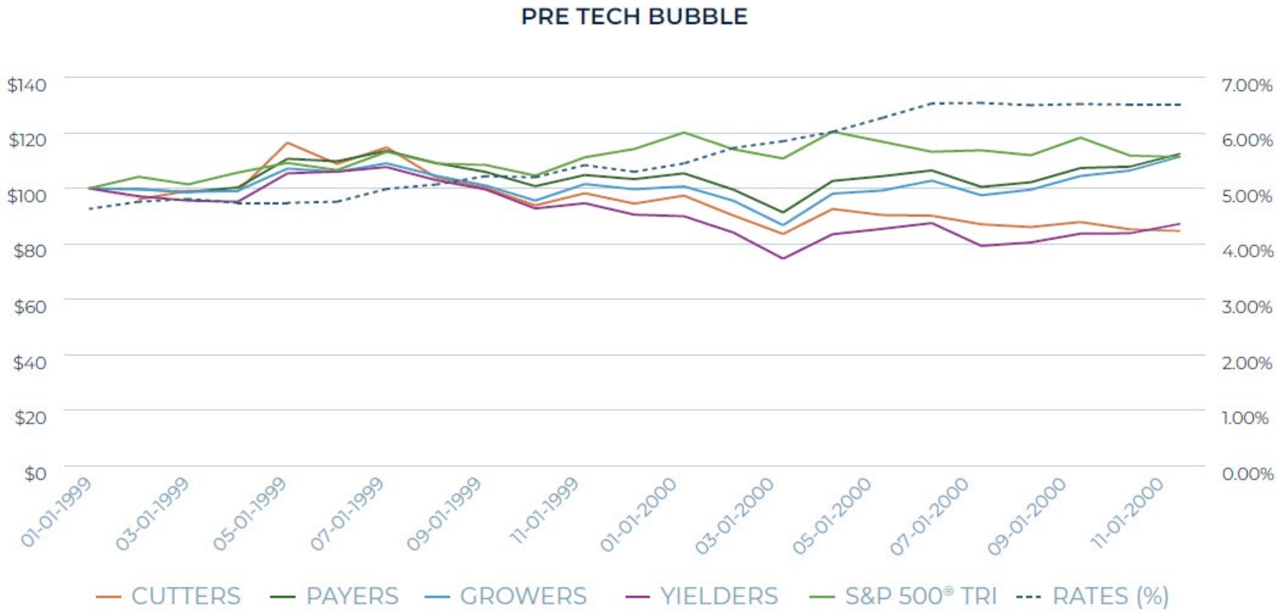


Source: Bloomberg, Bristol Gate. Data from January 1, 2019 – February 1, 2022

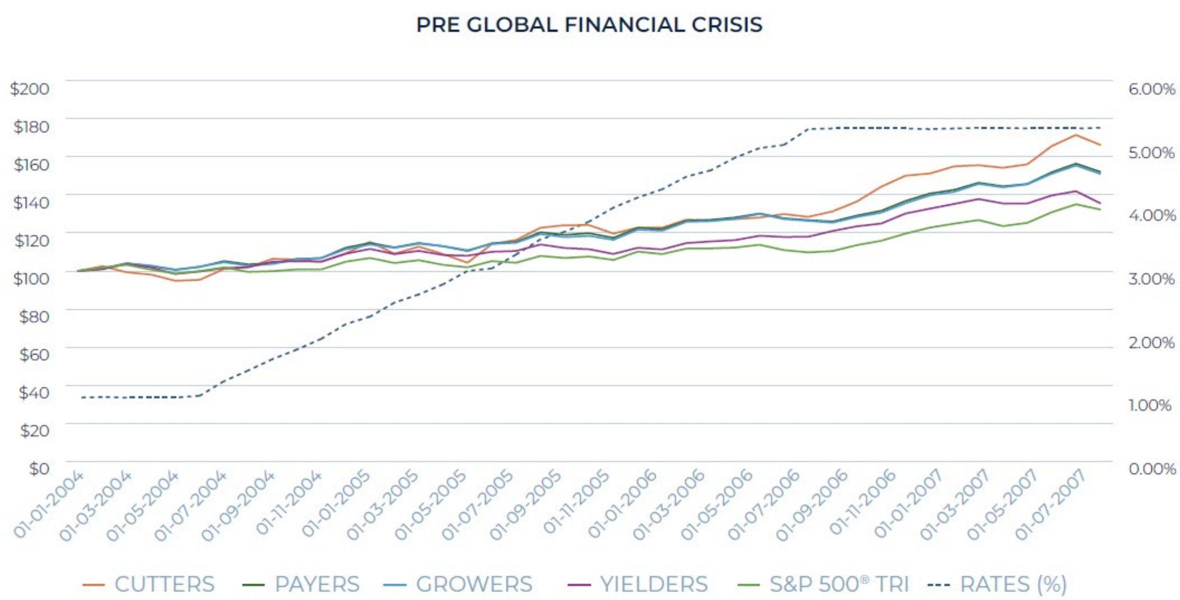
The charts above show how the Growers tend to outperform other categories of dividend-paying stocks during recent rate cutting cycles, each of which was accompanied by significant economic downturns. While the Cutters suffered the most, Yielders also underperformed in these periods. As a whole, Payers represented a better investment during these periods than the overall market, but Growers demonstrated the highest returns.

We note that many investors separate dividend-paying stocks from growth stocks, assuming that dividend-paying companies have less potential for reinvestment opportunities and capital appreciation. We believe high-quality dividend growth stocks often have significant opportunities to reinvest capital at high rates of return, all while providing the added comfort of a growing income stream, and this seems to be reflected in the past rate cutting cycles.

Rising Rate Environments

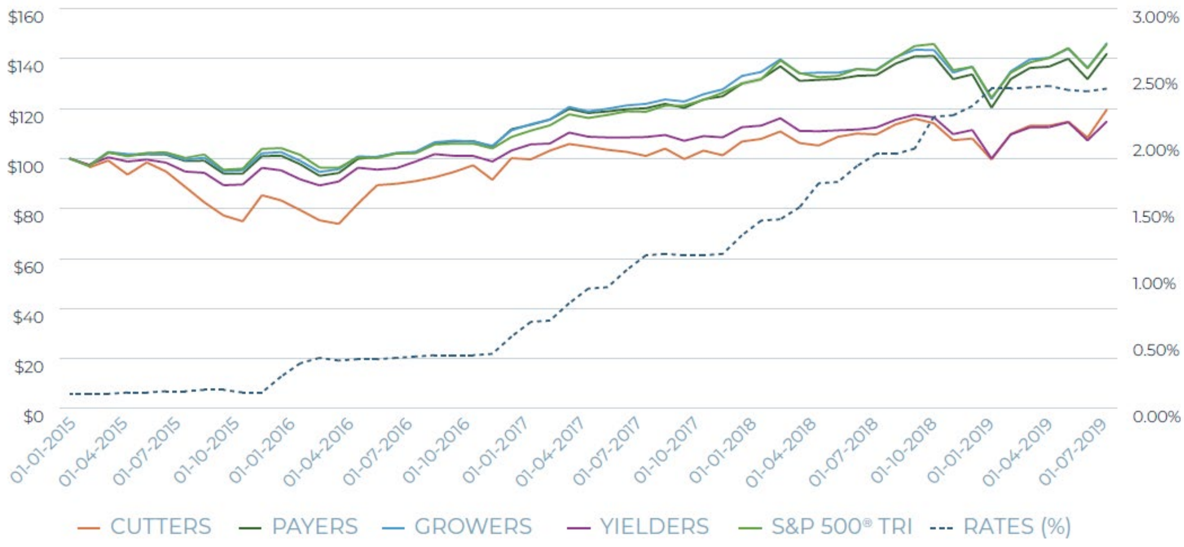


Source: Bloomberg, Bristol Gate. Data from January 1, 1999 – November 1, 2000



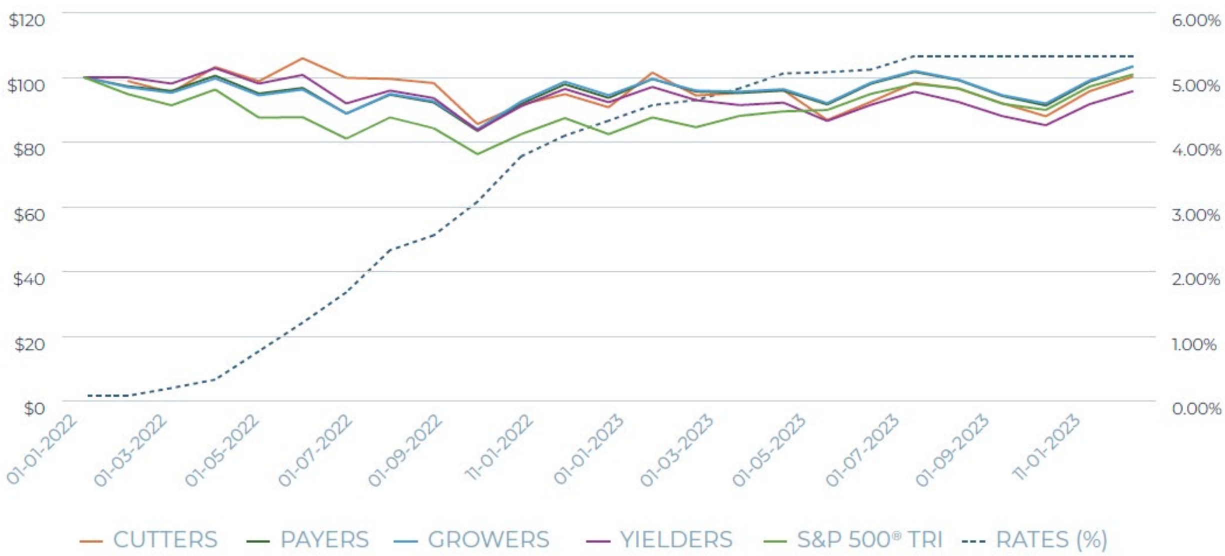
Source: Bloomberg, Bristol Gate. Data from January 1, 2004 – July 1, 2007

PRE COVID-19 PANDEMIC



Source: Bloomberg, Bristol Gate. Data from January 1, 2015 – July 1, 2019

POST COVID-19 PANDEMIC



Source: Bloomberg, Bristol Gate. Data from January 1, 2022 – December 31, 2023

The charts above outline how the same groupings of dividend stocks perform through various rate hiking cycles. Over each cycle, Payers were able to perform more or less in line with the index, but the performance of the different groups was mixed. Growers showed strong performance in each period, while Yielders and Cutters performed poorly. Yielders, in particular, may struggle during rising rate environments as investors have a safer way to access income through higher interest rates, reducing the appeal of high-yield stocks.

Conclusion

Combining aspects of income-yielding and growth companies, dividend growth companies provide investors with the dual benefit of income and the potential for capital appreciation. In contrast to some high-yielding stocks, dividend growth stocks not only provide a source of income, but a source of growing income. These companies typically have a history of consistently increasing their dividend payouts over time, which can help investors keep pace with inflation and benefit on a total return basis.

In both rising and falling interest rate environments, dividend growth stocks have shown their strength. The consistent and stable growth that high-quality dividend growth stocks can provide, along with a rising income stream, make them a valuable component of any diversified portfolio.

As you think about how to navigate changing market conditions, considering the role of dividend growth stocks in your portfolio could be worthwhile. A growing income stream with the opportunity for capital appreciation may provide the balance you need over time.

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