

Using a Quality Income Strategy in Today's Business Climate

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At State Street Global Advisors, our baseline call in 2019 was for investors to continue to favour US equities, based on supportive monetary and fiscal policy and a contained inflation outlook. We cautioned investors to beware of volatility, on expectations of slower (albeit positive) growth late in an economic cycle.

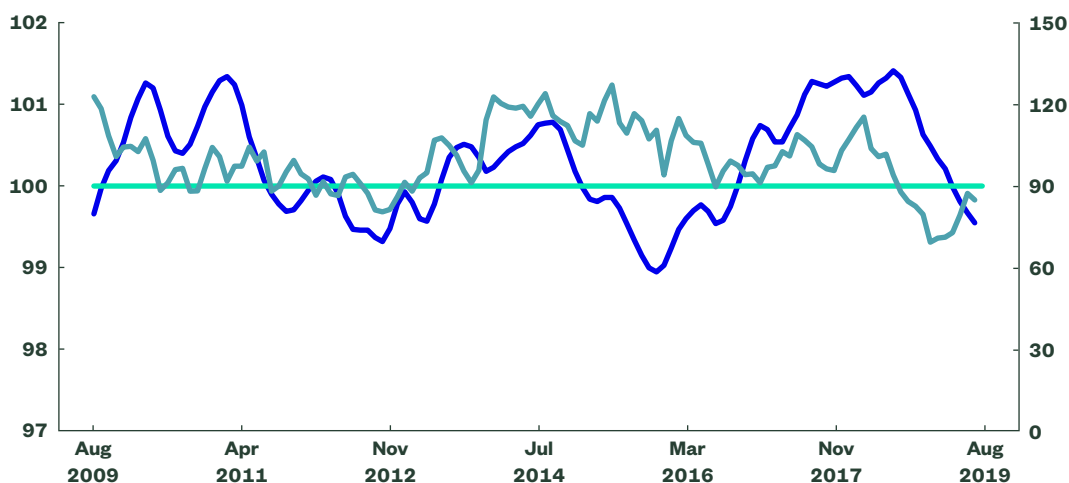
US equities have rallied over 20% year to date, as of the end of July. These returns have outpaced broader developed market equities, as the MSCI World Index was up only 18% during the same period. The primary laggards were Japan and key European manufacturing markets (i.e. Germany and France), which are suffering from an increasingly difficult global trade environment. We remain constructive on the US market, on the basis of a resilient consumer and steady inflation. However, we cannot ignore the increasing concerns reflected in current measures of investor sentiment. These concerns surround three major risks to US equity prices.

- Further global trade disruptions to the manufacturing sector could result from a failure to resolve the US-China trade conflict.
- An escalation in US-China trade tariffs could cause a significant drop in US consumer activity.
- A failure by the Fed to deliver further rate cuts, currently priced into bond yields, could help drive the US into recession.

While none of these scenarios are reflected in the base case of our mid-year Global Market Outlook, we recognise the uptick in investor concern, which may merit a more defensive equity allocation. The challenged manufacturing environment, noted above, has already affected sentiment. Despite the S&P 500 trading at all-time highs in July, we have seen a steady decline in both business and investor confidence since 2018 (Figure 1).

Figure 1
Measures of Business and Investor Confidence
(last 10 years)

■ OECD Business Confidence Index (BCI) (LHS)
■ BCI Threshold (LHS)
■ State Street Investor Confidence Index (RHS)



Source: OECD (2019), Business confidence index (BCI) and Bloomberg Finance L.P., as of 31 July 2019.

In April, the OECD Business Confidence Index crossed the critical 100 threshold, indicating pessimism towards future performance, for only the fourth time since the Global Financial Crisis (GFC). Likewise, investor confidence, though mildly stronger in the latest readings, is currently oscillating around post-GFC lows as well. These confidence measures may suggest a challenging environment for equity prices on the horizon.

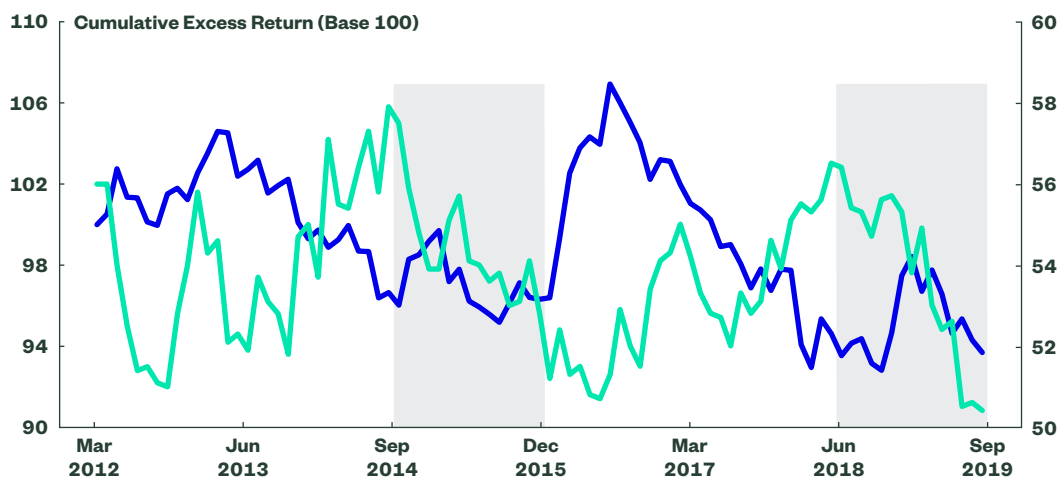
Trade Concerns Continue to Cast a Shadow

An escalation in the US-China trade conflict has already shifted the outlook on manufacturing fundamentals. The US Markit PMI Manufacturing read, which peaked in April 2018, is currently experiencing the sharpest decline since the previous peak in August of 2014. As demonstrated in Figure 2, the previous manufacturing slide lasted 21 months from peak to trough before recovering mid-2016.

During this period, we saw an interesting contrast between the behaviour of the S&P High Yield Dividend Aristocrats Index (SPHYDA) and the S&P 500 Index (SPX). In the first 15 months, as the data began deteriorating, SPHYDA mildly outperformed SPX within a somewhat volatile range. In the final six months of the manufacturing decline, when the data approached levels of potential contraction, the relative performance of SPHYDA broke out significantly. Over the final two quarters of PMI decline, SPHYDA picked up nearly 11% of excess performance against SPX.

Figure 2
Comparison of US Manufacturing PMIs with US Dividend Aristocrats Performance
 (vs. S&P 500)

■ S&P Dividend Aristocrats vs S&P 500 (LHS)
 ■ Markit PMI Manufacturing (RHS)
 ■ Manufacturing PMI (Downtrend)

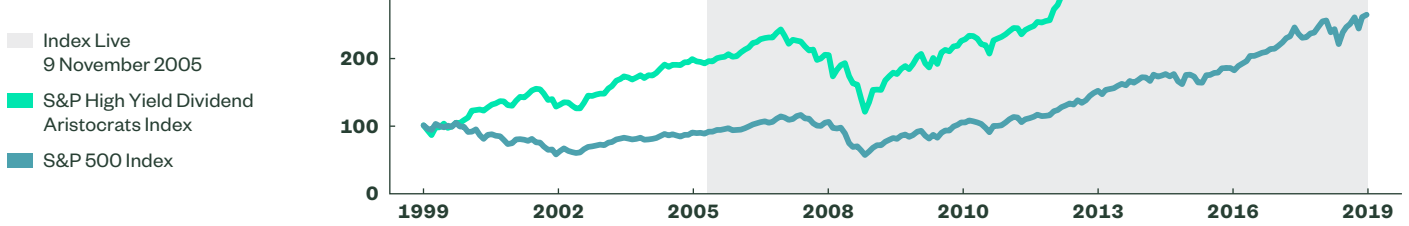


Source: State Street Global Advisors, Bloomberg Finance L.P., as of 31 July 2019. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

As Figure 2 also shows, we are currently 15 months into this latest manufacturing decline. This decline came about in April 2018 when the Chinese imposed tariffs on imports from the US, in retaliation for the Trump administration's own steel and aluminium tariffs on China. Following a series of escalations, many market commentators see a continuation of pressure on US manufacturers. Even if we were to see an immediate resolution on the US-China trade conflict, it would take time for such a resolution to impact purchasing decisions. Therefore, it is reasonable for investors to once again fear that manufacturing may be entering the first period of contraction, as measured by PMIs, since the GFC.

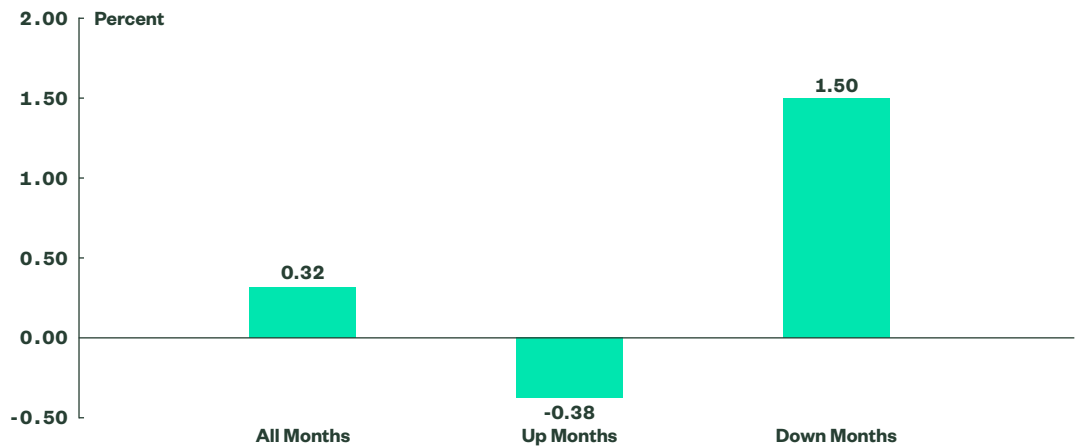
The latest round of tariffs, announced in August, now threatens to affect US consumers directly, which have been a key source of continued economic growth in the current cycle. The increasingly negative outlook for US manufacturing, combined with a potential weakening of the US consumer, may lead investors to seek a more defensive stance in US equities. The S&P High Yield Dividend Aristocrats Index has outperformed the S&P 500 Index historically (Figure 3), primarily due to the excess performance displayed in down markets (Figure 4).

Figure 3
Cumulative Performance of US Dividend Aristocrats versus the S&P 500
 (since 2000)



Source: S&P Dow Jones Indices, State Street Global Advisors, as of 31 July 2019.*

Figure 4
Average Historical Excess Return in Different Markets



Source: S&P Dow Jones Indices, State Street Global Advisors, as of 31 July 2019.

* Index performance based on net total return in USD. Monthly Data from January 2000 to July 2019. Past performance is no guarantee of future results. It is not possible to invest directly into an index. The S&P High Yield Dividend Aristocrats Index was inceptioned on 9 November 2005. Results prior to this date were calculated by using available data at the time in accordance with the Index's current methodology. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Investors concerned that headwinds facing US manufacturers and consumers may soon impact equity prices could consider a quality income strategy, such as that offered by the Dividend Aristocrats exposure.

Conclusion

Despite the US market entering Q3 at record high equity prices, the environment remains challenged by increasing global trade concerns and declining bond yields. We remain constructive on the US market on the basis of a resilient consumer and steady inflation. Investors seeking to remain long US equities, but fearful of these increasing risks, should look at a quality income strategy.

The S&P High Yield Dividend Aristocrats Index picks from a diversified base of quality companies offering regular cash dividends, combining dividend growth with dividend yield, to help investors navigate uncertainty by taking a more defensive portfolio posture.

SPDR ETFs

Available in both unhedged and EUR-hedged share classes, the SPDR S&P U.S. Dividend Aristocrats UCITS ETF (which tracks the S&P High Yield Dividend Aristocrats Index) can offer quality income by investing in US equities that have increased dividends every year for at least 20 consecutive years. Historically, the index has demonstrated better absolute and risk-adjusted returns versus the S&P Composite 1500, in part by offering a higher average dividend yield, with lower drawdowns.

- **SPDR® S&P® U.S. Dividend Aristocrats UCITS ETF**
- **SPDR® S&P® U.S. Dividend Aristocrats EUR Hdg UCITS ETF**

ETF	ISIN	TER	Primary Ticker (Xetra)	LSE (£)	LSE (\$)	SIX (CHF)	Borsa Italiana (€)
SPDR S&P US Dividend Aristocrats UCITS ETF	IE00B6YX5D40	0.35	SPYD	USDV	UDVD	USDV	USDV
SPDR S&P US Dividend Aristocrats EUR Hdg UCITS ETF	IE00B979GK47	0.40	SPPD	—	—	—	—

Source: State Street Global Advisors. The EUR-hedged share class was launched on 17 June 2019.

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Glossary

Organisation for Economic Co-operation and Development (OECD) Business confidence index (BCI)

This business confidence indicator provides information on future developments, based upon opinion surveys on developments in production, orders and stocks of finished goods in the industry sector. It can be used to monitor output growth and to anticipate turning points in economic activity. Numbers above 100 suggest an increased confidence in near future business performance, and numbers below 100 indicate pessimism towards future performance.

State Street Investor Confidence Index®

The index provides an objective, quantitative measure of global risk tolerance of the world's sophisticated investors. State Street's approach measures confidence directly and quantitatively by assessing the changes in investor holdings of risky assets, implementing a research model developed by Harvard Professor Ken Froot and Managing Director Paul O'Connell of State Street Global Markets' research partnership – State Street Associates®.

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ID40774-2705059.1.1.EMEA.INST 0819
Exp. Date: 31/08/2020