

Dividend derivatives 2023 – outlook and trends

Growing economic confidence boosts dividend derivatives prospects

Architects of trusted markets EUREX

Dividend Derivatives 2023 – outlook and trends

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by S&P Global Market Intelligence



Eurex dividends survey 2023 and findings

This report is based on a survey of the dividend derivatives market undertaken earlier this year. The survey sought the opinions of market participants on their outlook for the asset class and the broader economic conditions that support it.

The key findings of the survey were:

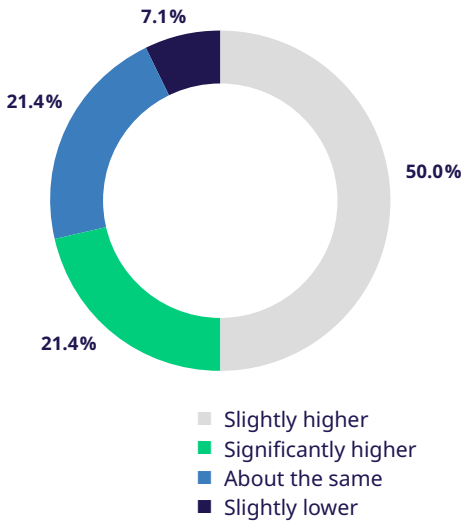
- Market participants expect realized dividends in the EURO STOXX 50 to increase through 2023
- A strong economy was cited as the most influential factor on dividend expectations
- Respondents were most bullish on EURO STOXX Bank Divided Futures contracts, but also saw upside in FTSE 100 Index Declared Dividend Futures
- Respondents were mostly sanguine about the effects of inflation on realized dividends, showing the utility of dividend derivatives as a tool for hedging inflation

Optimism is rising in the European dividend derivatives markets, with participants predicting that in 2023 the asset class will benefit from rising dividend payments and increased allocations from investors.

After an extremely challenging last year across most asset classes, this one began with a boost in optimism among traders and investors. That tone has been tempered, though, by the large amounts of uncertainty that still swirl around geopolitics, global macroeconomic conditions and the direction and impact of future interest rate policies, which were in a rapid hiking cycle in 2022.

Within European dividend derivatives however, sentiment for the year ahead is majority bullish, according to recent findings from the 2023 Eurex dividend derivatives survey, a review of market participants compromising sell-side, buy-side and vendors. This shows that the nearly three quarters of respondents expect the level of realized dividends in the EURO STOXX 50 index will increase over the next 12 months, compared to the same period last year.

What do you think the level of realized dividends in the EURO STOXX 50 over the next 12 months will be compared to the same 12 months last year?



This bias to the upside was mainly a reflection of improved economic sentiment, with more forecasts taking an upbeat line in recent months. Whereas much of last year was spent determining how deep developed economies' recessions would last in 2023, many economists are either cutting the probability they give to recessions or predicting much briefer slowdowns than before.

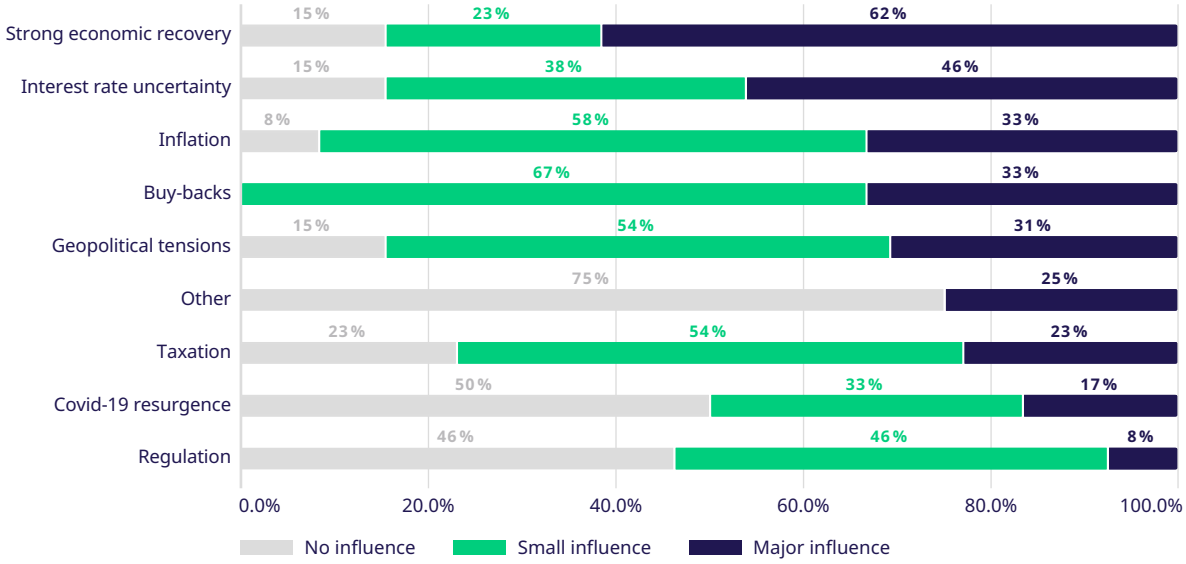
Hopes are now growing across markets that the economic fallout from central banks' rate hiking cycles, inflation and the war in Ukraine will not be as bad as many initially feared.

A large majority of respondents thought that the biggest driver of the increase in realized dividends would come through these rosier outlooks bearing fruit, with a strong economic recovery supporting profits and by turn dividend payments.

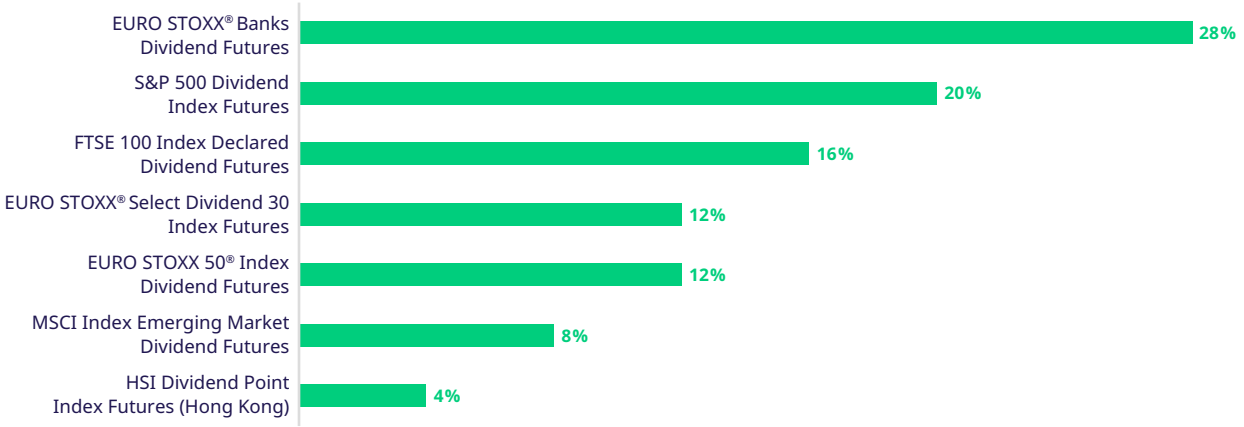
Improving economic conditions would also benefit equity indices and derivatives. But as European dividend payments are based on past earnings, investors can use the data to take more certain positions on company earnings within a specific time period.

Economic recovery would boost banks, which are also benefiting from the boost in interest income provided by 2022's rate rises. As the sector with the biggest presence in European dividend markets, this will be positive for derivatives products such as the EURO STOXX Bank Dividend Futures.

How big an influence do you think the following will have on dividend expectations over the next 12 months?



In which of the following contracts do you think there is the most upside over the next 12 months?



This was also shown by the survey's findings on where respondents saw most upside in the dividend futures suite this year, with over a quarter tipping the bank futures as having the most potential for profit over the coming 12 months.

S&P 500 dividend index futures were in second place, another reflection of rising economic optimism, especially in the US economy, where revised forecasts are most optimistic. The third most popular contract, FTSE 100 Index Declared Dividend Futures hinted at increasingly positive sentiment on the international economy too.

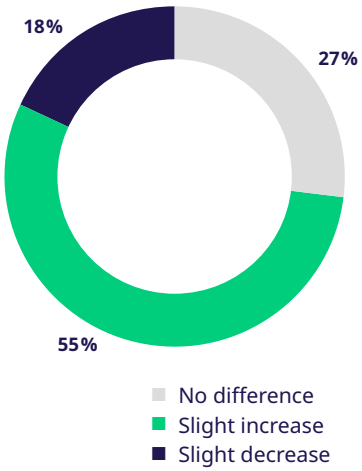
There was also interest in EURO STOXX Select Dividend 30 Index Futures. This contract creates more exposure to higher yielding companies, and respondents' interest in the contracts suggest a rekindling of risk appetite in 2023.

Dividends as a hedge

One of the attractions of trading dividends as an asset class it its potential to act as a hedge against inflation. Indeed, respondents cited interest rate uncertainty and inflation as the second and third most influential factors to drive their dividend expectations over the next 12 months.

This is due to most corporates' ability to respond to inflationary pressures by increasing their own prices, and thus maintaining their capacity to pay dividends as well as the need to keep payouts in line with inflation. Over half of respondents thought that higher than expected inflation this year would lead to a slight increase in realized dividends in the EURO STOXX.

What impact will higher-than-expected inflation during 2023 have on the realized dividends in the EURO STOXX?

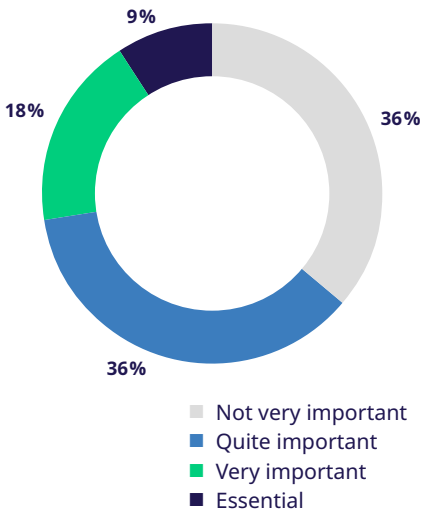


If inflation proves more stubborn than investors hope, the recent optimism that has crept into many asset classes is unlikely to hold.

But given corporates' capacity to adjust dividend payments with inflation, the derivatives stand out as a potential tool to hedge such a scenario.

Over a third of respondents said the expected inflation levels for 2023 were not important to their forecasts, while the same amount said it was only quite important.

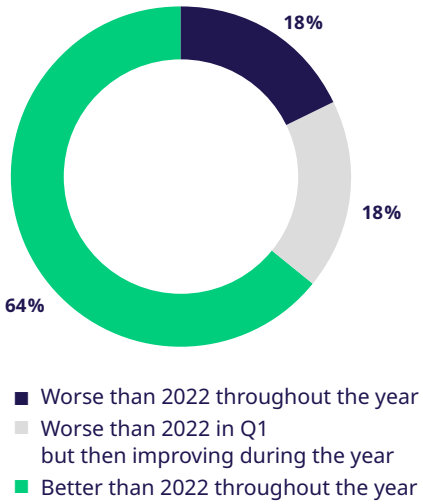
How important is the expected reduction in inflation during 2023 to your dividend forecast?



Corporates' advantage in responding to inflation was already on display last year, in the record profits posted by majors in the energy sector, the second largest sector in the dividend market. These returns came from the energy shock following the Russian invasion of Ukraine that sent prices soaring in global energy markets.

Most respondents expected these advantageous conditions to last through this year, with a large majority predicting UK-listed energy companies would deliver better dividend performance than 2022 throughout the year. Nearly a fifth thought that performance would be worse than 2022 in the first quarter but then improve through the rest of the year.

How do you expect the dividend performance of UK-listed energy companies to perform during the year?



One headwind for dividend payments in the energy sector has been political risk, through measures like windfall taxes and price increases. In the latter case, the EU introduced a price cap on natural gas late last year.

But respondents were relatively sanguine about the policy's impact on dividend payments from the European energy sector. Just under half thought it would have a slight negative impact on payments while most though it would have no impact at all.

Against this more benign backdrop, more investors are looking at the European dividend derivatives market with interest. All respondents to the survey said that they expected the volume of dividend futures that they trade to increase over the next 12 months.

Conclusion

While this year started with optimism that central banks are winning their fight against inflation and will start to cut rates this year, the resilience of developed economies' labour markets thus far has introduced doubt that rate setters will reverse course so soon.

For many asset classes, this uncertainty about the direction of economic performance and monetary policy is a considerable headwind to performance in 2023. Against this backdrop, dividend derivatives stand out as products that can capture upside regardless of where inflation moves this year.

This has been demonstrated by survey respondents' plans to increase allocations to the product suite and relatively sanguine attitudes to how inflation will affect that decision. The case for optimism is furthered by the dominant weighting of bank and energy sectors in dividend indices, both industries that are well-placed to benefit from current conditions.

Dividend derivatives buoyed by fundamentals in 2023

Interview with Lorenzo Longo at Goldman Sachs

With the European market halfway through its dividend payment season, Eurex caught up with Lorenzo Longo, Head of EMEA Equity Forwards Trading at Goldman Sachs to get his views on the route ahead and prospects for the dividend derivatives market for the rest of this year. We also took the opportunity to look back on a survey conducted earlier this year and measure how the expectations of respondents have played out since then, both for the asset class and the broader economic conditions that underlie it.

What are your expectations for the European dividend market for the rest of this year?

We expect and see that 2023 will continue to play out as a very, very strong year for the European dividends market. We are already seeing pricing levels in the EURO STOXX 50 that we haven't really seen since the global financial crisis. We are also finally enjoying a few sequential years of significant growth in dividends. Our overarching view is that there's clearly been strength in earnings from companies globally, with Europe being a relative standout – both in 2022 and 2023.

This has led to a higher dividend re-rating relative to other regions, but also compared to the history of Europe itself. We expect this trend to continue – as it stands, there's clearly a lot of uncertainty in the economic scenario globally but in Europe we have seen a general resilience in economic activity. So, while there is not much economic growth out there, there is enough resilience that companies should be able to sustain growing dividend payments for the remainder of the year.

What are the drivers of those expectations?

There is economic and earnings resilience but as well as that, inflation, and the environment that we've been in for the last couple of years is mechanically a boost to dividends. This is because dividends are really a claim on the nominal earnings and nominal cash flows of companies.

In a relatively high inflationary environment where you still have real economic growth, with boosted nominal growth, a product that gives an investor exposure to that nominal growth is powerful and will be supported and that's what we're observing thus far.

This is an advantage that dividends have in this macroeconomic environment compared to equities. Investing in the latter, you have to worry not solely about nominal earnings, but also how to discount those earnings. Whereas with dividends you get exposure, just to the numerator of that equation.

“ There is economic and earnings resilience but also inflation. This is an advantage that dividends have in this macroeconomic environment compared to equities.

Lorenzo Longo
Head of EMEA Equity Forwards Trading, Goldman Sachs

If you want to have exposure to nominal cash and nominal earnings, dividends can give you that. I don’t see any other product that can deliver that return profile in such a neat way. It's not perfect but it is difficult for us to identify anything that is a better expression of nominal earnings growth.

What are the advantages of using dividend derivatives in trading strategies?

If we look historically at the dividend futures market, a large percentage of the volumes in the product itself was predicated on structured products and risk coming from such a product that exotic desks would be looking to hedge. Using dividend derivatives was a very nice and efficient way to do that.

Banks are the natural sellers in this market, which is the root cause of the supply and demand imbalance that typically causes these products to trade relatively cheap to fundamental expectations.

One factor that continues to make us feel bullish about the asset class and see the curve steepen over time, is that we expect contracts further out in maturity to appreciate more than at the front end.

This is largely due to two factors. Firstly, because of the moves seen during Covid there’s been less risk appetite from banks to issue products with this dividend profile after some very public mark-to-market losses.

There’s since been a pivot to issue products that would carry less dividend risk for the dealers.

Secondly, in the positive rates world that we live in now, you just have naturally less demand for that type of product, such as autocallables, which were at the forefront of the dividend risk profiles that banks were carrying.

That was a product that the end user mainly saw as a way to earn some coupons and carry. You don't need that type of product so much in a world where interest rates are at 3–4% in Europe.

We are now seeing investors going back to products that were more popular before the global financial crisis, structured in a capital-protective form and carrying a very different risk profile for banks. So, we see and expect less exotic structured product activity from dealers and therefore less need to use the asset class as a hedging instrument.

As a result, we expect that the risk premia currently in the curve should be compressing over time. This is already playing out to some extent in 2023 and should continue to strengthen as a trend.

That should create a stronger two-way flow where there is less natural supply from banks. And dividends become more of an asset class where two sides express their views on dividends.

There will still be net long risk from dealers and constraints that are still lingering after COVID, but future flows should be more driven by macro and micro fundamental expectations of what dividends will be realised. That dynamic has existed before but usually only at the very front end of the curve.



About Lorenzo Longo

Lorenzo is Head of EMEA Equity Forwards Trading at Goldman Sachs. Previously, he was a member of the Synthetics Product Group. Lorenzo joined Goldman Sachs in 2012 as an analyst and was named managing director in 2019. Lorenzo earned a BSc in Economics and Finance and an MSc in Finance from Bocconi University in 2010 and 2012, respectively.

Which dividend contracts do you anticipate demand for during the rest of this year and why?

The constituents of the Eurozone bank dividend index have been in focus during the last couple of years for various different reasons, but in the environment that we're living in, clearly banks are doing well from an earnings perspective, reaping the benefits of higher interest rates and expanding their net interest margin for the first time in over a decade.

European banks also have very solid capital positions. even if they have been caught in the crossfires of what has happened recently to US regional banks. Due to their differ-ent regulatory positions, we don't generally see them impacted from the same issues. But the dividend futures still give significant discounts relative to expectations and company guidance.

We think that dividend bank contracts continue to suffer from a post Covid hangover coming from regulator recommendations to consider limiting cash distributions in 2020 and the resulting FY19 dividend cancellations. As such, bad news continues to over affect the contracts versus what expectation should be. This is even happening in an environment where these companies are significantly more profitable than they have been in well over a decade.

European dividend forecasting 2023

Source: S&P Global Market Intelligence

For 2023, the dividend estimates from S&P Global Market intelligence are close to the market levels except for the European Oil & Gas (SXEE) and FTSE 100 indices. For 2024 and 2025, the dividend growth is expected to slow down to a mid-to-high single digit (except for SD3E) but still offers decent upside compared to market expectations.

The bumper profits of 2022 and the buyback programmes from the European companies have supported the increase in dividend per share announced in Q1 2023 (see report here). While the macroeconomic environment remains uncertain with higher interest rates and inflation, the European companies paying the biggest dividends have been able to transfer the cost inflation to their clients and consumers without penalizing their profits and dividends in the short term. We expect the dividends to remain resilient in the coming months helped by the energy sector, the banks, and the recovery from companies that reduced their payout during the pandemic.

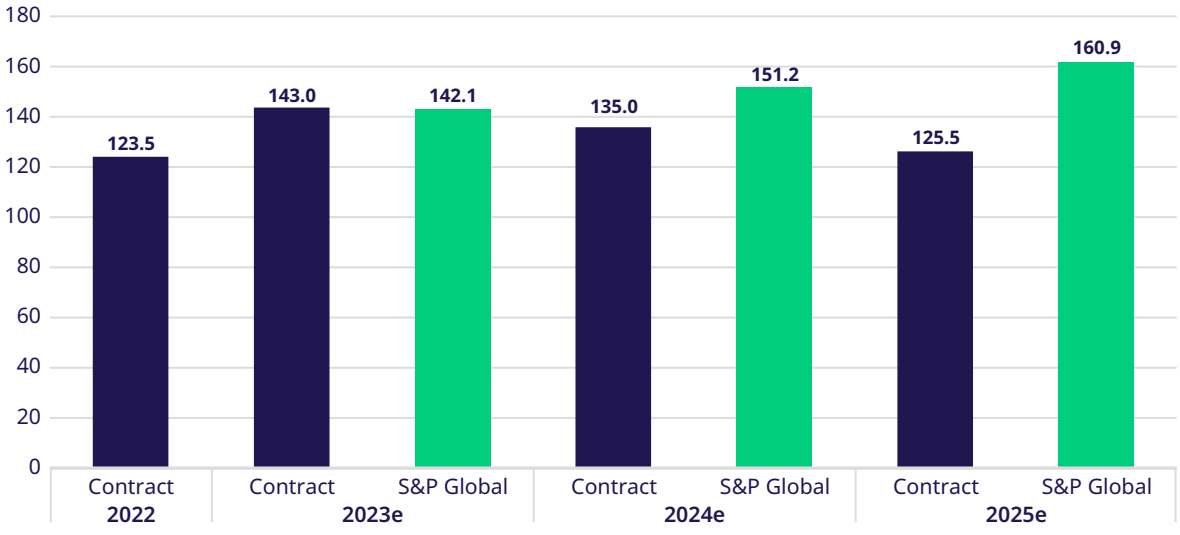
The oil majors Shell and BP have room to boost their dividend above their target of 4% each year. We currently expect them to raise their dividend between 10-20% each year in the medium term while using buyback to complement their shareholders return. TotalEnergies has paid a special dividend at the end of 2022 and aims to grow its dividend by 7% per annum.

The European banks have benefited from the higher interest rates and hiked their dividend to a level close to or above their pre-pandemic level. They are conducting buyback programs which be stopped at any time to protect the dividends. The UK banks are in a good place to keep boosting their dividends as they currently allocate a large part of their capital allocation to buyback. We expect HSBC to almost double its dividend per share in FY23 to 56 cents.

We also predict a 62% rise from Intesa Sanpaolo following their latest profit guidance upgrade. ING is foreseen to hike its dividend by 30% this year on the back of higher profits.

The consumer discretionary especially the Luxury goods companies are defying the low consumer confidence by publishing double digit revenues growth for the Q1 2023 period and should be able to keep increasing their dividends this year.

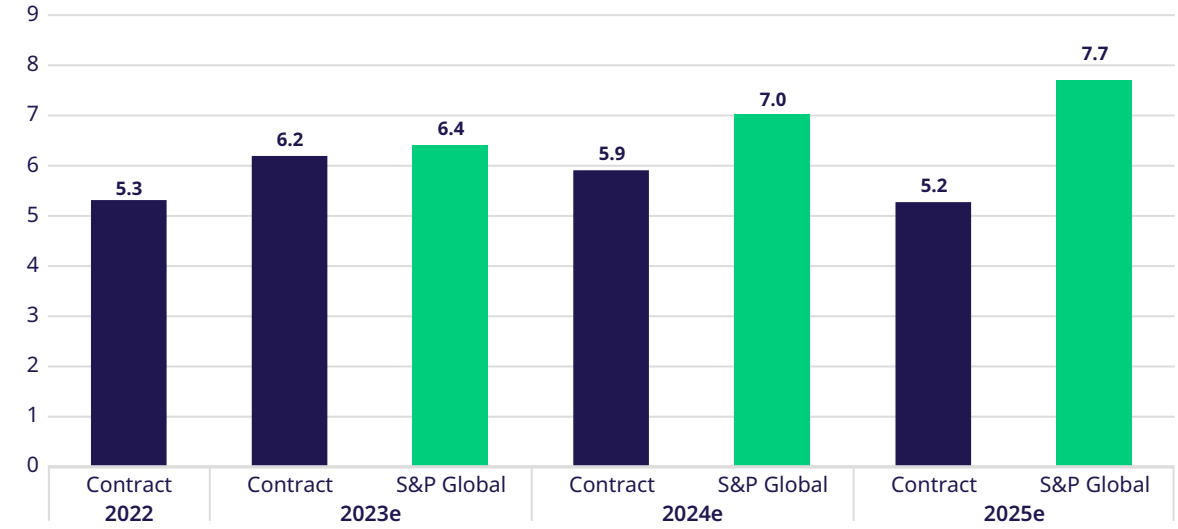
EURO STOXX 50® Index Dividend Futures (FEXD)



Data compiled 11 May 2023. Source: Dividend Forecasting, S&P Global Market Intelligence.

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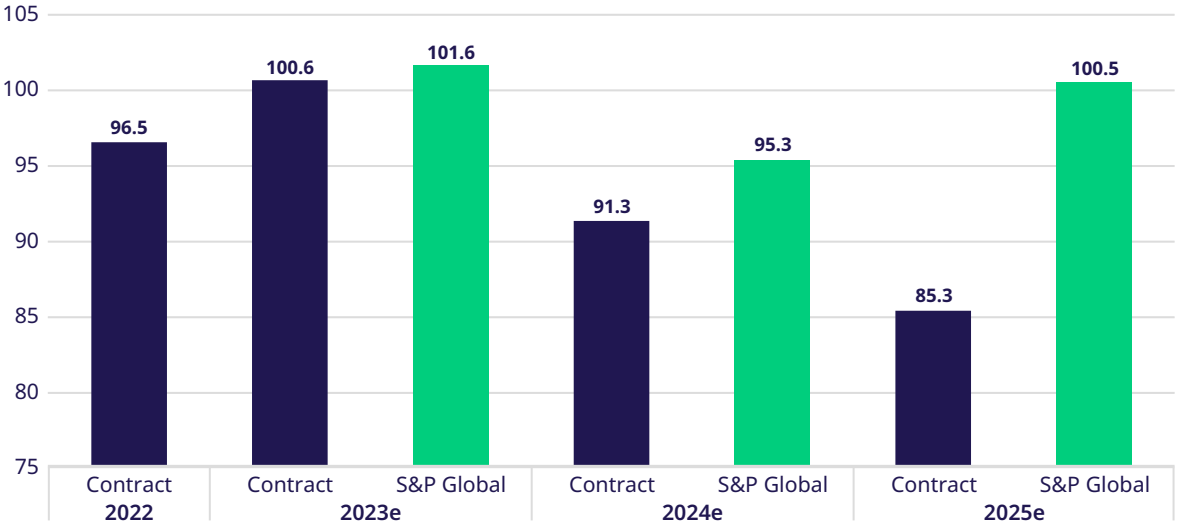
EURO STOXX® Banks Dividend Futures (FEBD)



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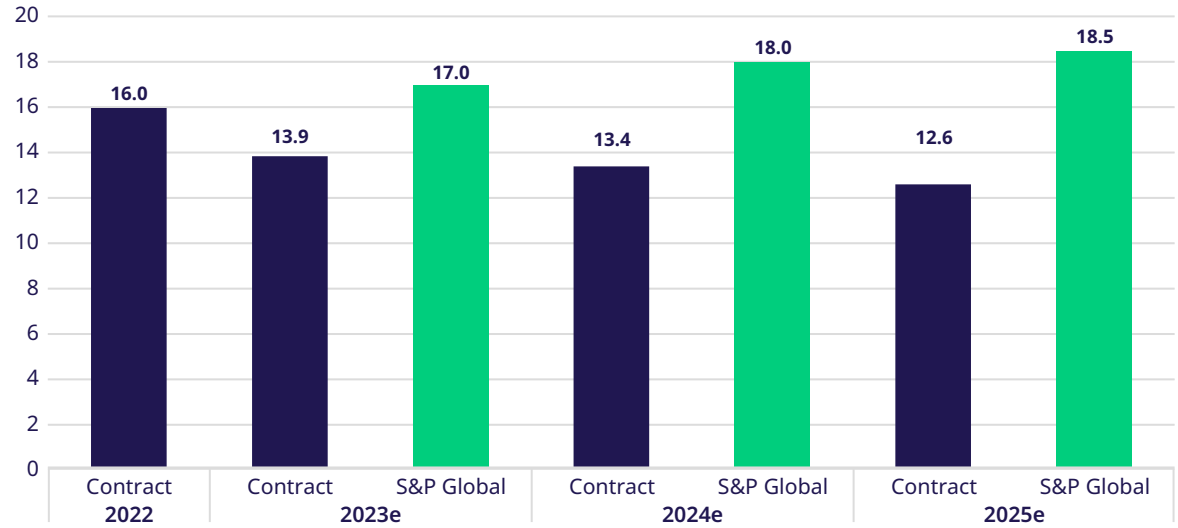
EURO STOXX® Select Dividend 30 Index Dividend Futures (FD3D)



Data compiled 11 May 2023. Source: Dividend Forecasting, S&P Global Market Intelligence.

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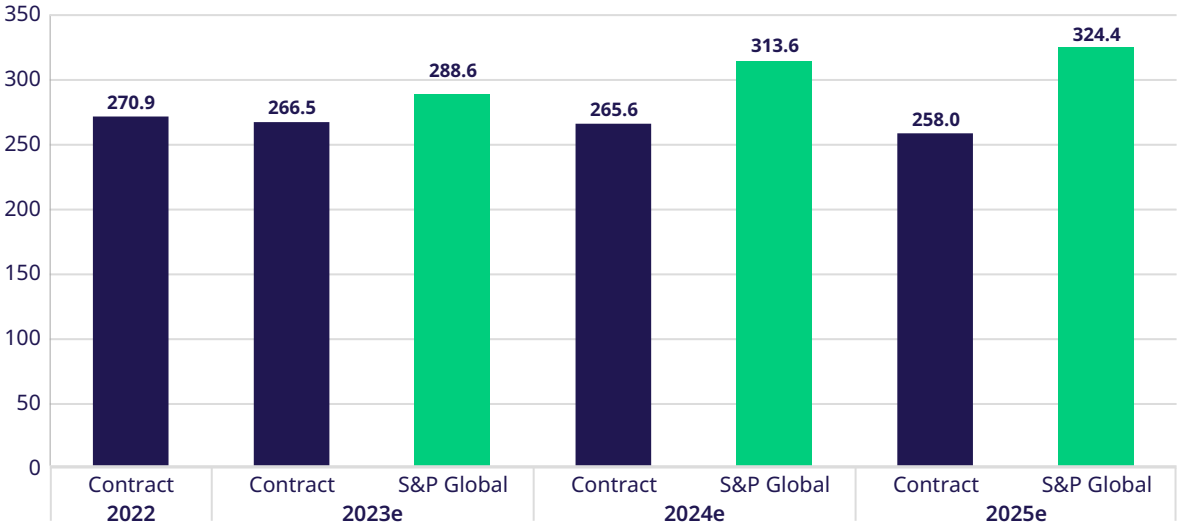
STOXX® Europe 600 Oil & Gas Dividend Futures (FSED)



Data compiled 11 May 2023. Source: Dividend Forecasting, S&P Global Market Intelligence.

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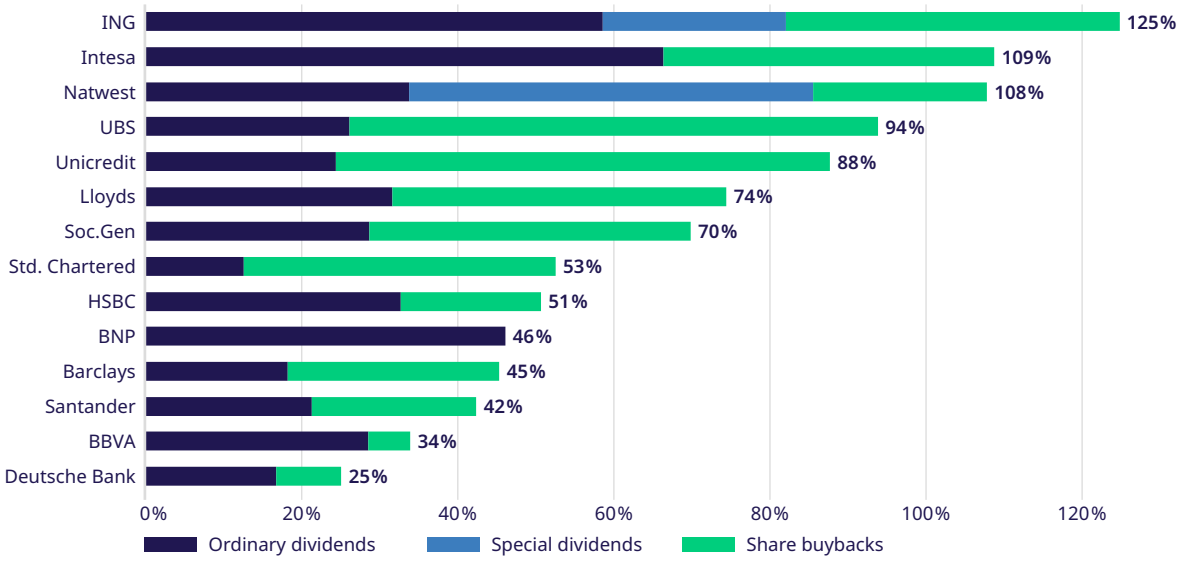
FTSE 100 Declared Dividend Index Futures (FTDD)



Data compiled 11 May 2023. Source: Dividend Forecasting, S&P Global Market Intelligence.

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Shareholder return allocation in 2022 (as a percentage of underlying profits)



Data compiled 16 January 2023. Source: S&P Global Market Intelligence.

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