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Global Equity Strategy

The Rock, Part II – Don't Ignore Yield

In late 2008, we first wrote about a landmark event – the dividend yield on the S&P 500 exceeding the 10-year Treasury yield (*see: US Portfolio Strategy: The Rock: Yield Support – Nov 08*). The current spread between dividend yield and bond yield is once again driving us to re-examine this relationship. Most valuation measures (even earnings based) are reasonably supportive for the US equity market. However, the dividend yield may actually be one of the most compelling (despite not being particularly high in absolute terms at 2.1%).

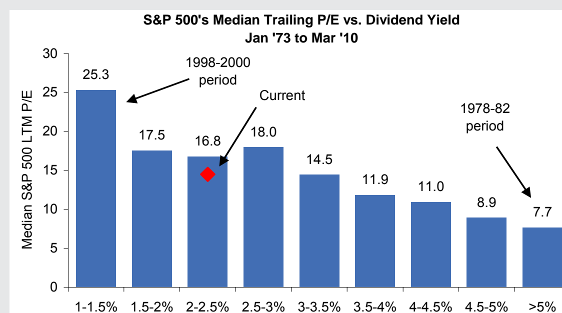
In itself, the dividend yield rising above (or close to) the long-dated government paper yield can easily be interpreted as a very bearish development. It has been a rare occurrence over the past 100 years, tending to occur only during bear markets. It was a persistent feature of the 1930s, during World War II, and again during the 2008/09 bear market phase. Recent yield shifts are once again forcing us to consider whether they represent a structural break in valuations — i.e., a permanent de-rating.

It is easy to get bearish on long-term valuations. For perspective, we consider the relationship between the dividend yield and *real* rather than nominal rates (since earnings and dividend yields are real variables). On this basis, it is unclear that valuations are unusually cheap. If inflation continues to fall and real bond yields to rise, the dividend yield gap eventually closes. Only if the dividend yield keeps rising above the rise in real bond yields would we worry about a permanent shift in valuations. Longer term this could still happen.

Dividend yield provides downside support. While cyclical growth and earnings risks remain, we think yield support beyond the risk-free rate joins a growing list of valuation measures that help limit downside risk to equities.

Top Dividend Yield Ideas

		Price	DY	MS Rating
MO	Altria Group Inc.	22.9	6.9%	E / I
T	AT&T Inc.	27.0	6.4%	O / A
LO	Lorillard Inc.	75.9	6.1%	O / I
PNW	Pinnacle West Capital Corp.	40.3	5.4%	O / I
PM	Philip Morris International Inc.	52.6	5.0%	O / I
BMY	Bristol-Myers Squibb Co.	26.6	4.8%	O / I
MCHP	Microchip Technology Inc.	29.1	4.8%	E / C
PFE	Pfizer Inc.	16.3	4.7%	O / I
MRK	Merck & Co Inc	35.5	4.5%	E / I
ETR	Entergy Corp.	79.2	4.3%	O / I
CMS	CMS Energy Corp.	17.3	4.3%	O / I
KFT	Kraft Foods Inc.	29.3	4.1%	O / C
DD	E.I. DuPont de Nemours & Co.	41.4	4.1%	E / I
COP	ConocoPhillips	55.9	4.1%	E / A
HNZ	H.J. Heinz Co.	46.5	4.0%	O / C
GPC	Genuine Parts Co.	43.1	4.0%	N / N
CAG	ConAgra Foods Inc.	21.8	3.9%	E / C
CVX	Chevron Corp.	77.8	3.8%	O / A
ABT	Abbott Laboratories	50.7	3.7%	O / A
JNJ	Johnson & Johnson	59.2	3.7%	E / A



Source: Factset, Morgan Stanley Research N = Not covered

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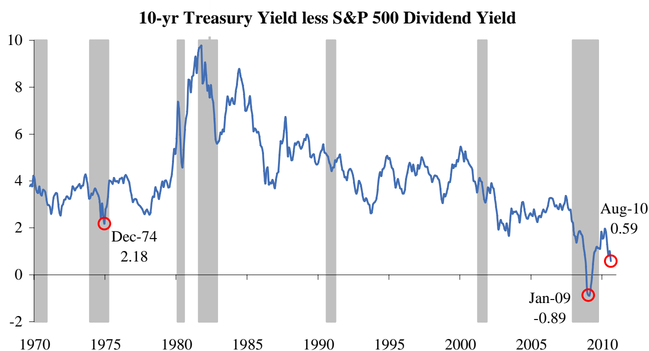
Long bear markets often have strong and violent cyclical rallies. When valuation measures become supportive, these rallies can be caused by the slightest catalyst (such as a fall in risk premium resulting from strong policy action, improved economic data from depressed levels, company-specific developments – M&A, positive earnings surprise, or unexpected positive guidance, etc.).

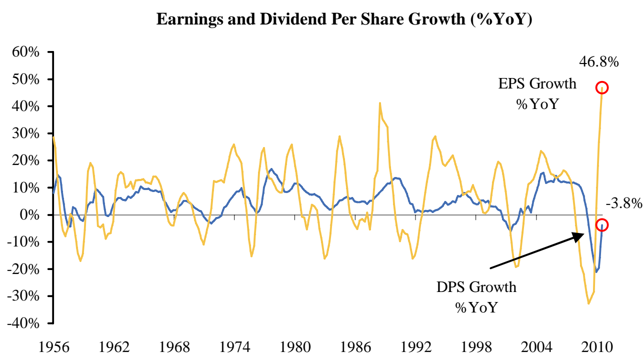
Exhibit 1
Dividend Yield Support Rising Again



Source: FactSet, Haver, Morgan Stanley Research

It is hard to know what precise catalyst will trigger a rally from very oversold levels. The appearance of dividend yield support beyond the risk-free rate suggests that earnings risks are already heavily discounted and is positive from a very near-term standpoint.

Exhibit 2
Dividend growth to follow earnings growth



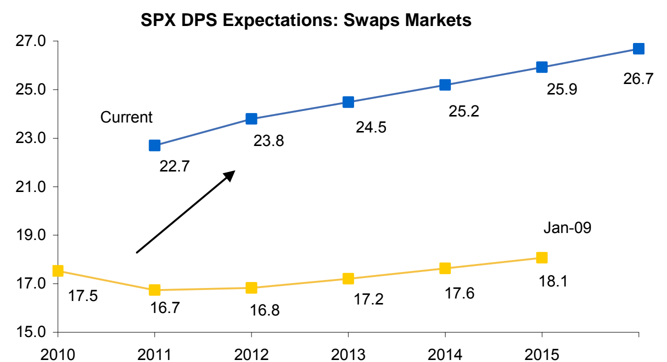
Source: Factset, Haver, Morgan Stanley Research

The problem with dividend yield metrics, as with earnings-based valuations, is their reliability. While dividend yield remains some way off the 2009 low (Exhibit 1), on a relative basis there are two striking differences that make it somewhat disconcerting to find ourselves making these comparisons again:

1) The degree of earnings risk is substantially lower now relative to expectations compared with early 2009. Year-end consensus estimates at Jan-09 stood at $75, nearly 40% above where they finished the year. For that relationship to hold true today, 2011 earnings estimates would have to fall to $62 from their current level of $95.

2) The forward dividend curve was downward sloping for much of 2009 as earnings estimates were slashed and financial dividends cut. It is now upward sloping, although still somewhat pessimistic relative to what we would consider conservative estimates. For example, the forward curve assumes DPS growth of only 5% in 2011 versus 14% EPS growth (according to consensus). This would equate to a decline in the payout ratio from 27% down to 25%. We think the payout ratio is more likely to rise than fall from current levels.

Exhibit 3
Swaps market pricing in conservative DPS profile



Source: Bloomberg, Morgan Stanley Research

Rising Dividend Yield Gap – a Structural De-Rating?

Longer term we believe the rise in the spread between dividend yield and real bond yields may represent a statement about the market's view on three things:

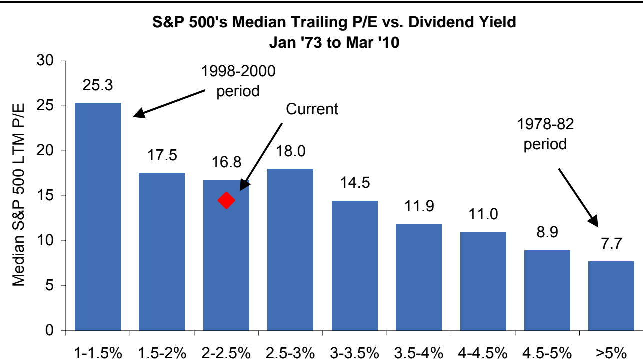
1) An outlook for weak long-term earnings growth that leaves a reduced possibility of P/E expansion, meaning that dividends have to be a dominant part of total returns. As Exhibit 4 shows, the higher the dividend yield, the lower the multiple. Historically a dividend yield of 2% would equate to a P/E multiple of nearly 17x (or alternatively a dividend yield near 3% supports the current market P/E of 14.5x). We do not think a 3% dividend yield is unrealistic. It would require the payout ratio to rise into the low 40% range – a move that would put it back close to the long-term average.

2) A higher risk premium (we estimate the implied ERP is now around 5.2% - Exhibit 5) that now needs to be compensated by a higher yield.

3) Investors doubt that companies can be trusted to reinvest earnings and create value. Companies are better off enhancing the payout ratio and returning money to investors, something we have yet to see in the current cycle.

Exhibit 4

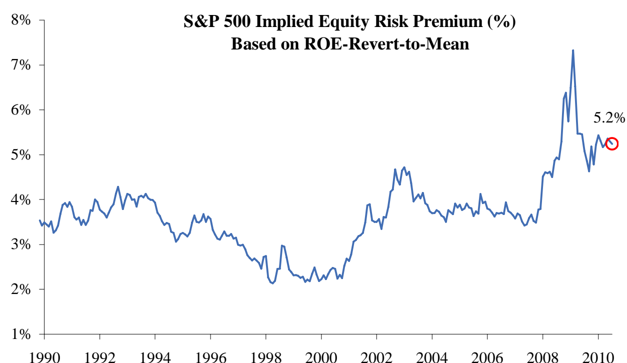
Higher Dividend Yields = Lower Multiple



Source: Haver, Thomson Financial, Morgan Stanley Research

Exhibit 5

Implied ERP close to ex LEH highs



Source: QDS, Morgan Stanley Research

These concerns are perfectly logical, as a low payout ratio signals two dangers. First, companies themselves may believe earnings growth is unsustainable and so do not raise dividends in line with earnings. Eventually earnings growth normalizes and the payout ratio rises, as earnings growth falls and dividends are either maintained or fall at a slower pace. Second, if earnings growth significantly exceeds sustainable levels, management may become complacent and instead of returning money to shareholders start to over-invest and destroy capital. Inevitably, earnings growth falls. This was the case with Tech in the late 1990s and Financials more recently, where managements for banks and broker dealers arguably did not focus on sustainable earnings based on sustainable leverage.

Even now with earnings normalizing from excessively high levels, the S&P 500 payout ratio at sub-40% is still low, and we would expect the ratio to continue to climb into the next earnings recovery, potentially stabilizing closer to 50%.

We have run some screens to highlight stocks that look attractive on a yield basis. We apply some basic filters to raise conviction levels in the sustainability of current dividends.

1. We create a buffer by only considering stocks with yields more than 1% above the Treasury yield (a cutoff of around 3.7%). See Exhibit 10.

2. We substantially lower earnings estimates for 2011, which have only just started to be downgraded. We cut consensus estimates by 20% for cyclical companies in Discretionary and Materials, 10% for Industrials, Energy and Technology, 20% for Financials, 5% for non-cyclicals (Telecoms, Utilities, Healthcare, Staples). We then assess how many companies' dividend payout ratios are still below 60%. See Exhibit 8 for a list of these stocks. Our top picks here are CVX, COP, PFE, ABT, MRK, CAG, JNJ, NEE, PEG and NU.

3. We try to eliminate the risk of future earnings and examine dividend sanctity by looking at how many times the 2011 dividend is covered by cash and marketable securities less short-term debt on the balance sheet. See Exhibit 9 for a list of these stocks. Our top picks here are LTD, LO, CVX, GPC, PFE, JNJ, MCHP, CAG, BMY and MRK.

Besides the stocks mentioned above, we also have strong conviction in T, PNW, PM, ETR, CMS, KFT and HNZ on a yield basis.

The Importance of Yield in a Changing Total Return Profile

The risk-adjusted returns between bonds and equities should be equal in the long run, although major dislocations in relative returns can easily persist for substantial periods of time.

In a steady state:

Nominal Bond Yields + Risk Premium = Return from Stocks

or

Nominal Bond Yields + Risk Premium = ΔP/E + ΔE + DY

Effectively, we can say that in the long run the nominal risk-free rate plus risk premium will equal total returns for equities (i.e., earnings growth plus P/E change plus dividend yield). But we know that over time the nominal bond yield, nominal GDP, and earnings growth are largely the same (see Exhibit 6). Therefore, assuming a long-term stable P/E, the dividend yield and the risk premium are closely linked.

Exhibit 6

Average Yield, Earnings and GDP Growth

	Treasury Yield (Average)	Earnings Growth (CAGR)	GDP Growth (CAGR)
Last 10 Years	3.96	0.57	4.20
Last 20 Years	5.03	4.09	4.84
Last 30 Years	6.62	4.19	5.85
Last 40 Years	6.98	5.59	6.88
Last 50 Years	6.62	5.65	6.88

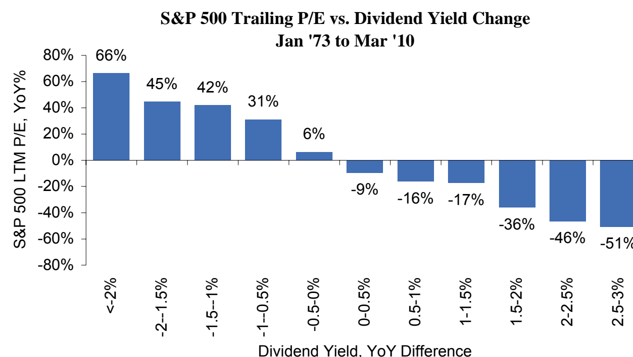
Source: Factset, Haver, Morgan Stanley Research

If the sustainable state for the next several years includes an average 4-5% nominal 10-year Treasury yield and a slightly enhanced equity risk premium (say around 4-5%), but earnings growth underperforms nominal GDP growth (i.e., sub-4%), it must follow that dividends yields could rise to 4-5% and that yield has finally earned its place in the total return profile for US equities.

For a very long time the S&P 500 offered a yield of only 2% against a risk premium of 3.5%. A rise in the dividend yield can be interpreted in two ways. Either the risk premium has risen permanently (maybe to 4-5%) and the dividend yield has to rise accordingly. Or alternatively, the long-term earnings growth expectation has shifted down, implying expectations of low GDP growth and even weaker earnings growth, so that the rise in the dividend yield is necessary to compensate within the total return profile.

Exhibit 7

1% DY increase = 17% P/E Multiple Decline



Source: Haver, Thomson Financial, Morgan Stanley Research

The acceptance of a low payout ratio and low dividend yield in the second half of the 1990s reflected a significant rise in long-term earnings growth expectations from 12% to an absurd 18%. Usually such a rise in growth expectations is accompanied by a rise in risk premium (higher growth is generally associated with higher risk). And a rise in risk premium should have caused a commensurate decline in the P/E. But instead, during the bubble period the P/E expanded despite the lower dividend yield and higher risk premium associated with higher growth expectations. As Exhibit 7 shows, the decline in the dividend yield over this period would have traditionally been associated with a decline in the P/E of nearly 50%. Instead, we saw an almost tripling of the multiple.

We may well be entering a phase that is the exact opposite of the second half of the 1990s, consisting of persistently falling long-term earnings growth expectations, no scope for P/E multiples to expand, and demand for higher payout ratios and rising dividend yields as the dominant feature in total returns.

Exhibit 8

Stocks with Dividend Yield >3.7% and Payout Ratio <60% on Lowered EPS Estimates

Ticker	Company	Sector	Price	NTM Dividend Yield	Adjusted Payout Ratio	DPS Growth (2010-12)	NTM DPS Revisions	3m Price Change
CVX	Chevron Corp.	Energy	77.8	3.8%	32.0%	5.2%	3.2%	-0.4%
COP	ConocoPhillips	Energy	55.9	4.1%	34.9%	8.2%	5.6%	-2.0%
PFE	Pfizer Inc.	Health Care	16.3	4.7%	35.0%	2.6%	2.6%	-0.6%
ABT	Abbott Laboratories	Health Care	50.7	3.7%	42.5%	11.3%	5.0%	3.6%
MRK	Merck & Co Inc	Health Care	35.5	4.5%	43.3%	2.1%	0.5%	6.1%
CAG	ConAgra Foods Inc.	Consumer Staples	21.8	3.9%	44.6%	6.1%	1.0%	-11.5%
JNJ	Johnson & Johnson	Health Care	59.2	3.7%	45.1%	6.7%	1.4%	-9.6%
NEE	NextEra Energy Inc	Utilities	52.5	4.0%	48.2%	5.2%	1.5%	-0.8%
PEG	Public Service Enterprise Group Inc.	Utilities	32.1	4.4%	49.4%	3.2%	0.9%	-0.1%
NU	Northeast Utilities	Utilities	29.2	3.8%	51.4%	8.4%	2.2%	8.3%
ETR	Entergy Corp.	Utilities	79.2	4.3%	51.9%	5.8%	2.8%	0.8%
PCG	PG&E Corp.	Utilities	46.0	4.1%	53.4%	7.3%	1.1%	4.8%
MAT	Mattel Inc.	Consumer Discretionary	22.2	3.9%	53.9%	6.9%	3.8%	-1.6%
CMS	CMS Energy Corp.	Utilities	17.3	4.3%	53.9%	17.6%	21.1%	11.8%
KMB	Kimberly-Clark Corp.	Consumer Staples	64.9	4.2%	54.7%	8.8%	2.0%	5.0%
KFT	Kraft Foods Inc.	Consumer Staples	29.3	4.1%	55.0%	3.3%	1.3%	-1.8%
EXC	Exelon Corp.	Utilities	41.4	5.2%	55.7%	0.3%	0.4%	-1.1%
AEP	American Electric Power Co. Inc.	Utilities	35.8	4.8%	56.7%	3.7%	1.4%	8.1%
BMY	Bristol-Myers Squibb Co.	Health Care	26.6	4.8%	57.1%	0.4%	0.8%	11.7%
NYX	NYSE Euronext	Financials	29.4	4.1%	57.2%	1.5%	1.1%	-3.2%
HNZ	H.J. Heinz Co.	Consumer Staples	46.5	4.0%	59.9%	6.5%	3.7%	-0.9%

Source: Factset, IBES, Morgan Stanley Research. Share prices are closing prices on August 17, 2010. Please note that all important disclosures including personal holdings disclosures and Morgan Stanley disclosures appear on the Morgan Stanley public website at www.morganstanley.com/researchdisclosures.

Exhibit 9

Stocks Yielding > 3.7% With Adequate Coverage in Cash and Equivalents

Ticker	Company	Sector	Price	NTM Dividend Yield	Adjusted Payout Ratio	DPS Growth (2010-12)	NTM DPS Revisions	3m Price Change	Years Covered by Cash
LTD	Limited Brands Inc.	Consumer Discretionary	25.6	4.1%	63.0%	0.0%	35.4%	-2.5%	3.6
LO	Lorillard Inc.	Consumer Staples	75.9	6.1%	67.9%	11.8%	5.2%	-4.9%	2.6
CVX	Chevron Corp.	Energy	77.8	3.8%	32.0%	5.2%	3.2%	-0.4%	2.2
GPC	Genuine Parts Co.	Consumer Discretionary	43.1	4.0%	65.5%	3.0%	2.6%	1.8%	1.6
PFE	Pfizer Inc.	Health Care	16.3	4.7%	35.0%	2.6%	2.6%	-0.6%	1.6
JNJ	Johnson & Johnson	Health Care	59.2	3.7%	45.1%	6.7%	1.4%	-9.6%	2.6
MCHP	Microchip Technology Inc.	Information Technology	29.1	4.8%	66.6%	2.3%	1.1%	3.6%	5.1
CAG	ConAgra Foods Inc.	Consumer Staples	21.8	3.9%	44.6%	6.1%	1.0%	-11.5%	1.9
BMY	Bristol-Myers Squibb Co.	Health Care	26.6	4.8%	57.1%	0.4%	0.8%	11.7%	3.3
MRK	Merck & Co Inc	Health Care	35.5	4.5%	43.3%	2.1%	0.5%	6.1%	1.2
DD	E.I. DuPont de Nemours & Co.	Materials	41.4	4.1%	63.7%	0.6%	0.1%	7.5%	2.2

Source: Factset, IBES, Morgan Stanley Research. Share prices are closing prices on August 17, 2010

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Exhibit 10

Highest Dividend Yielding Stocks

Ticker	Company	Sector	Price	NTM Dividend Yield	Adjusted Payout Ratio	DPS Growth (2010-12)	NTM DPS Revisions	3m Price Change
RAI	Reynolds American Inc.	Consumer Staples	57.5	6.6%	75.0%	5.1%	2.0%	5.9%
T	AT&T Inc.	Telecommunication Services	27.0	6.4%	72.3%	2.9%	0.4%	4.8%
LO	Lorillard Inc.	Consumer Staples	75.9	6.1%	67.9%	11.8%	5.2%	-4.9%
AEE	Ameren Corp.	Utilities	28.0	5.6%	73.5%	0.1%	0.2%	10.4%
NI	NiSource Inc.	Utilities	16.9	5.6%	76.1%	0.0%	0.0%	4.6%
CNP	CenterPoint Energy Inc.	Utilities	14.8	5.5%	70.1%	2.8%	1.1%	2.8%
PNW	Pinnacle West Capital Corp.	Utilities	40.3	5.4%	72.5%	1.0%	0.1%	9.1%
EXC	Exelon Corp.	Utilities	41.4	5.2%	55.7%	0.3%	0.4%	-1.1%
SO	Southern Co.	Utilities	36.1	5.2%	77.0%	3.6%	1.9%	4.0%
TE	TECO Energy Inc.	Utilities	16.8	5.1%	60.7%	2.0%	1.1%	2.0%
ED	Consolidated Edison Inc.	Utilities	47.4	5.0%	72.6%	1.0%	0.1%	5.0%
PM	Philip Morris International Inc.	Consumer Staples	52.6	5.0%	65.6%	10.6%	2.2%	11.2%
AEP	American Electric Power Co. Inc.	Utilities	35.8	4.8%	56.7%	3.7%	1.4%	8.1%
SE	Spectra Energy Corp.	Energy	21.6	4.8%	66.7%	2.0%	0.7%	-4.2%
BMY	Bristol-Myers Squibb Co.	Health Care	26.6	4.8%	57.1%	0.4%	0.8%	11.7%
DTE	DTE Energy Co.	Utilities	46.6	4.8%	62.9%	3.1%	2.8%	-1.9%
MCHP	Microchip Technology Inc.	Information Technology	29.1	4.8%	66.6%	2.3%	1.1%	3.6%
PFE	Pfizer Inc.	Health Care	16.3	4.7%	35.0%	2.6%	2.6%	-0.6%
XEL	Xcel Energy Inc.	Utilities	22.4	4.6%	61.6%	3.4%	0.8%	4.9%
MRK	Merck & Co Inc	Health Care	35.5	4.5%	43.3%	2.1%	0.5%	6.1%
PEG	Public Service Enterprise Group Inc.	Utilities	32.1	4.4%	49.4%	3.2%	0.9%	-0.1%
ETR	Entergy Corp.	Utilities	79.2	4.3%	51.9%	5.8%	2.8%	0.8%
D	Dominion Resources Inc. (Virginia)	Utilities	44.7	4.3%	61.1%	3.9%	2.9%	7.1%
CMS	CMS Energy Corp.	Utilities	17.3	4.3%	53.9%	17.6%	21.1%	11.8%
KMB	Kimberly-Clark Corp.	Consumer Staples	64.9	4.2%	54.7%	8.8%	2.0%	5.0%
OKE	ONEOK Inc.	Utilities	45.8	4.1%	61.8%	6.7%	3.4%	-4.8%
PCG	PG&E Corp.	Utilities	46.0	4.1%	53.4%	7.3%	1.1%	4.8%
KFT	Kraft Foods Inc.	Consumer Staples	29.3	4.1%	55.0%	3.3%	1.3%	-1.8%
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MAT	Mattel Inc.	Consumer Discretionary	22.2	3.9%	53.9%	6.9%	3.8%	-1.6%
NU	Northeast Utilities	Utilities	29.2	3.8%	51.4%	8.4%	2.2%	8.3%
CVX	Chevron Corp.	Energy	77.8	3.8%	32.0%	5.2%	3.2%	-0.4%

Source: Factset, IBES, Morgan Stanley Research. Share prices are closing prices on August 17, 2010

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(as of July 31, 2010)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**1095**	**42%**	**380**	**44%**	**35%**
Equal-weight/Hold	**1123**	**43%**	**388**	**45%**	**35%**
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Underweight/Sell	**362**	**14%**	**93**	**11%**	**26%**
Total	**2,594**		**865**		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

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Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
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Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
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Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.
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