Will Rising Interest Rates Make Dividend Investing Unprofitable?

Description

Donald Trump's election as US President is likely to have a major impact on dividend investing over the medium term. His fiscal policies are set to be a step-change from those of his predecessor, which means that inflation and interest rates may move higher across the globe. As such, investing in shares with high yields may be a relatively less profitable endeavour than in the past, since their income return when compared to other income-producing assets may be lower. However, investing in dividend stocks could still be hugely profitable in the long run. Here's why.

Relative return

In the last decade, low interest rates across the developed world have meant the income return on dividend stocks has been far superior to that of other income-producing assets, such as cash. A threat of deflation has meant that Central Banks across the globe have been able to adopt ultra-loose monetary policies in order to stimulate their economies without causing higher rates of inflation. As such, buying higher-yielding stocks has led to a generous income return – even when the effects of inflation have been deducted.

Higher inflation

However, this period now looks to be at an end. Buying higher-yielding shares may prove less profitable on a relative basis than it has done in the past. Donald Trump's plan for lower taxes and higher spending may cause the inflation rate to rise. Since the US is the largest economy in the world, a higher rate of inflation could be exported across the globe and cause interest rates to rise. This could lessen the appeal of dividend stocks when compared to other income-producing assets.

Share price declines

Of course, a higher interest rate could cause share prices in general to decline to some degree. It may cause risky assets such as shares to become less attractive when compared to their lower risk alternatives. However, since dividend shares have been popular specifically because they have been a rare source of high income returns, the effect on them from a rising interest rate could be more pronounced than for growth stocks in the short run.

Long-term outlook

While higher interest rates may be bad news for income shares in the short run, it could present a buying opportunity for long-term investors. Dividend investing may have enjoyed a highly prosperous era in recent years on a global basis, but this does not mean it will become unprofitable in the long run. Shares yielding 4% or more are still likely to offer an attractive income return even if interest rates move higher at a rapid pace. As such, they are set to be of high value to investors who may become unsure as to the future path of the global economy.

In fact, dividend shares could provide a tonic for nervous investors in the near term. Higher-yielding stocks tend to have relatively defensive characteristics and they could prove popular given the uncertain outlook for the global economy. This could help to offset the reduced income return of dividend shares compared to other income-producing assets. As such, they seem to have the potential to outperform the wider market over the long run, in what may prove to be a challenging period for global stock markets.

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