The Copeland Review

First Quarter 2022

"We believe that stocks with sustainable dividend growth consistently outperform the market with less risk."

White Rabbit

I'm late, I'm late, for a very important date!

The White Rabbit in Alice's Adventures in Wonderland
by Lewis Carroll, 1865

With Russia waging war in Ukraine as this piece went to print, our hearts go out to the Ukrainian people, and we hope for a swift end to this tragic conflict.

It may be difficult to believe that when we delivered our last missive, the Russia-Ukraine situation seemed like nothing more than saber-rattling by Russian President, Vladimir Putin. Indeed, while geopolitical pundits' views at the time ranged from dire to sanguine, the bias appeared to tilt heavily toward the latter. Many thought that by bearing his proverbial teeth, Putin would – at worst – annex a small piece of the former Soviet Union and return to Moscow claiming a political victory.

We now know Russia's intention was always to commandeer its geographic neighbor through force and against its collective will to maintain its independence. In response, though NATO has not been drawn into the fight directly, its member countries, among others, have provided billions in military aid to Ukraine while also taking aggressive economic actions against Russia, ranging from removing many Russian banks from SWIFT (a global financial messaging system which enables international trade), to sanctioning dozens of Russian oligarchs, and freezing Russia's access to foreign currency reserves held in Western banks.[1] Moreover, many Western companies who'd previously been doing business in Russia voluntarily shut down operations there or exited the country entirely.[2]

Not surprisingly, these punitive actions sparked vast economic repercussions.

In this edition of the Copeland Review, we turn our attention to three concepts:

1) With Russia's invasion of Ukraine, inflation accelerated, further amplifying the risk that aggressive Federal Reserve interest rate hikes will stall the economy.
2) Investor sentiment, which we have regarded as overly bullish in recent quarters, finally took a nosedive, with equity and bond markets following suit. Now, though, bears may be ignoring *some* positives that could cushion the downside in the market and the economy.
3) Against this mixed backdrop, lower returns and higher volatility seem likely to continue. As a result, we believe Copeland's Dividend Growth strategy is particularly well-suited to shine.

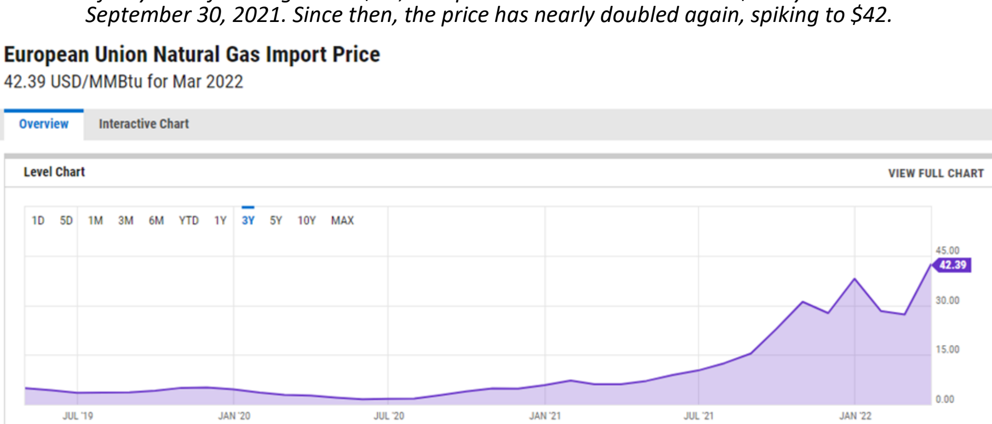
Russian Invasion Exacerbates Recession Risk

With Russia moving into Ukraine, Western countries and companies scrambled to find alternative suppliers of oil, crops, and metals that they had previously sourced from that region. While we expressed concern about inflation in our last two pieces (*Same As it Ever Was* and *Reality Bites*), the challenge only worsened. In the US, while crude oil prices had already jumped from $75 to $92 between year-end 2021 and February 25th, they spiked another 35% over the subsequent two weeks as Russian troops made their initial move on Kyiv.[3] Wheat spent years below $5 per bushel but ended the quarter above $9. In Europe – which is heavily reliant on Russian natural gas and oil – the impact was even more dramatic (Chart 1).

In response to these inflationary price moves, US interest rates – which had already been rising for months from their June 2021 low – jumped to levels not seen in more than three years.[3] The Fed funds rate, which had been expected to climb toward 1.50% by year end 2023, is now projected to exceed 2.50%, while the ten-year treasury yield surged more than 80 basis points and the average 30-year fixed mortgage ripped higher by more than 150 basis points over the course of the quarter.[4]

This brings us to our eponymous White Rabbit and his legendary tardiness. The Federal Reserve has been notoriously slow to reverse policy, raising interest rates only once during this cycle – a modest 25 basis point hike at its March meeting. As a result, like the rabbit, the Fed must now pick up the pace. Future rate hikes are likely to be both greater and compressed into a shorter time frame, raising the risk of recession as they "slam on the brakes." Just after the quarter ended, even notable Fed "dove," Lael Brainard , seemed to turn toward the hawkish side, commenting that the Fed should begin drawing down its balance sheet "at a rapid pace."[5]

Chart 1. Commodity prices jumped aggressively as Russia Invaded Ukraine.
After years of trading below $10, European Natural Gas climbed to $23 by September 30, 2021. Since then, the price has nearly doubled again, spiking to $42.



Source: https://ycharts.com/indicators/europe_natural_gas_price

All is Not Lost

Still, amidst the geopolitical strife and inflationary pressures which have driven stocks and bonds lower in 2022, it's important to highlight several signs that we believe will cushion the downside for the economy, and for Copeland's portfolios specifically, going forward.

Supply Chain Bottlenecks Are Starting to Clear

One of the most widely referenced concerns amidst the global supply chain morass has been the number of ships floating off the ports of Los Angeles and Long Beach, waiting to be unloaded. When ships are slow to unload, not only are fewer ships available for future deliveries, but perishable goods often spoil, and cargo that manages to make it off the ships frequently needs to be expedited to its final destination. Each of these issues, in its own way, leaves companies scrambling to push cost increases through to their customers. Encouragingly however, even amidst the issues in Russia and a reacceleration of COVID cases in China, port congestion is moderating significantly from its February peak and containerized ocean freight prices have drifted down a bit (Chart 2).[6]

Like ocean freight rates, trucking prices also skyrocketed over the last year. Again though, there is some evidence that relief is coming (Chart 3).

Employment & Wages Remain Robust

The US unemployment rate declined to 3.6% in March, reaching its lowest level since before the onset of the pandemic two years ago.[7] At the same time, although job openings are marginally down from their all-time high in December 2021 due to accelerated hiring activity, they remain nearly 50% above their pre-COVID peak.[9] These dynamics have put strong upward pressure on wage rates, with average hourly earnings rising to $31.73, a 5.6% increase versus the prior year.[9]

Not only does improved compensation help consumers to offset inflation, it also encourages labor force participation. At this time in 2021, only 81.3% of 25- to 54-year-olds were working, well down from pre-COVID levels. While there may be many reasons for that, they appear to have collectively receded of late with participation steadily rising to a new high post-COVID high of 82.5% in March 2022.[10] As workers return wage inflation should moderate.

Consumer Balance Sheets are In Good Shape

There has been much debate about how consumers, especially those within the lower- and middle-income cohorts, would fare amidst high inflation. There is, however, some favorable news on this front that may surprise investors.

First, financial obligations as a percentage of disposable income, although off the lows, remain well below the levels that have presaged the last two recessions. Additionally, the total cash held among the bottom 50% of households by wealth is now at unprecedented levels, with balances experiencing particularly rapid growth in the last three quarters, despite declining fiscal stimulus and rising inflation (Chart 4). Finally, though the savings rate has fallen back to normal levels, the excess savings accrued during COVID will likely take months to unwind, even accounting for inflation.[11]

Dividend Growth Stocks Are Made for Times Like These

While we've provided several reasons for optimism, there is no doubt also ample justification – from rising interest rates to pockets of severely elevated valuations – for expecting lower returns and increased volatility in the coming years. We believe this backdrop supports maintaining exposure to high quality, low risk equities, such as those found in the Dividend Growth universe.

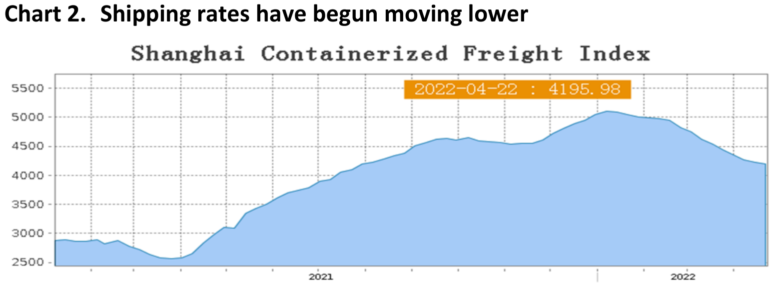
Dividend Growth Stocks Remain Plentiful, Inexpensive and Positioned for Outperformance

- *Plentiful:* As we've expressed before, when COVID hit, many companies took abrupt action to ensure their survival. For some this meant laying off or furloughing employees and suspending bonuses. Others issued debt or equity to fortify their balance sheets. Some – particularly in the consumer space – opted (or were required) to suspend their dividends. As a result, while those with the strongest competitive advantages and commitments to dividend growth largely sustained their track-records of returning capital, the universe of SMID cap dividend growers shrunk by over 20% versus pre-COVID levels. Today, the universe has nearly fully recovered, both because companies have initiated new dividends and because historical dividend growers have returned to the mix (Chart 5). We believe this demonstrates the financial health of our opportunity set.

- *Inexpensive:* Since 1995, SMID Cap Dividend Growth stocks have commanded a median premium of 8% versus non-dividend paying SMID Cap stocks based on their forward price-to-sales ratio. We use the price-to-sales ratio, rather than price-to-earnings, as many non-dividend paying stocks are not profitable. Today, even as the universe of non-dividend paying stocks has sold off sharply – falling 19% in the last two quarters – dividend growers remain steeply undervalued versus history at a 17% discount (Chart 6).[12] This reflects the post-pandemic rebound in speculative stocks, aided by massive Federal stimulus which is now poised to unwind.

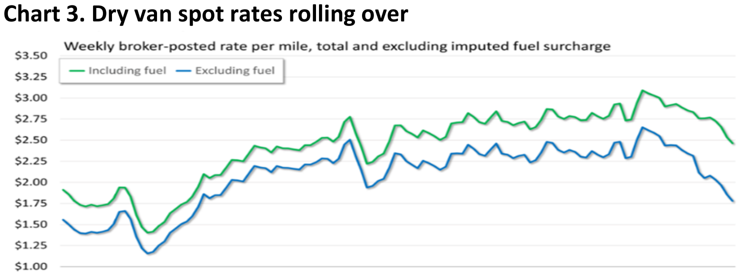
- *Positioned for Outperformance:* We've addressed this subject before, but it can't be overemphasized. Dividend Growth stocks are not – like high-yield stocks – primed to fall as interest rates climb. Instead, divi-

Chart 2. Shipping rates have begun moving lower



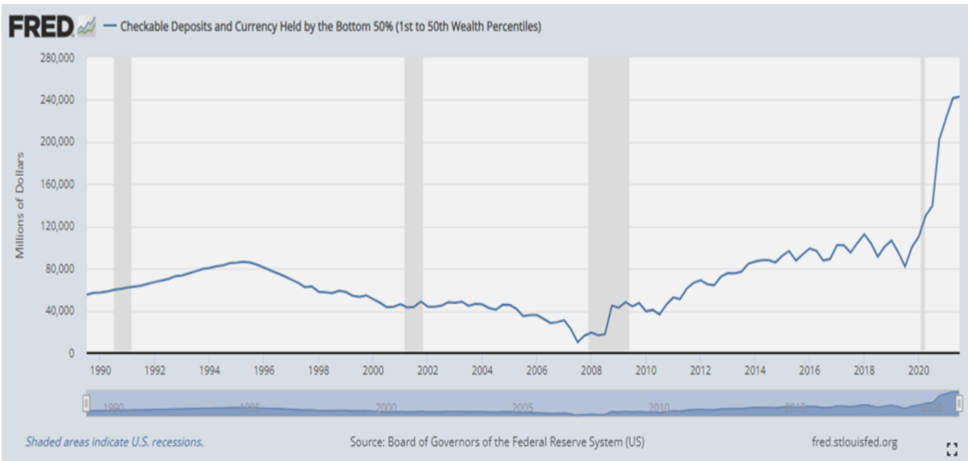
Source: *https://en.sse.net.cn/indices/scfinew.jsp*

Chart 3. Dry van spot rates rolling over



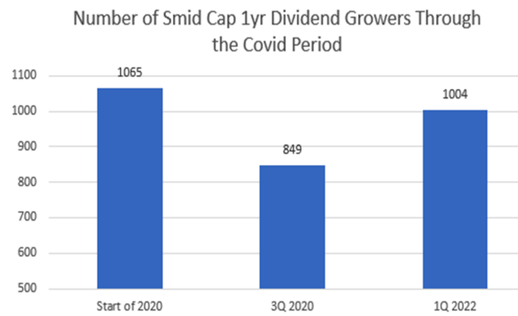
Source: *https://freight.ftrintel.com/spotmarketinsights/2022-04-25*

Chart 4. Total cash held by the bottom 50% of households by wealth is far above prior highs



Source: https://fred.stlouisfed.org/series/WFRBLB50086

Chart 5. Ample opportunity to find high quality companies amid the Dividend Growth universe



Source: Factset.

Chart 6. Although non-dividend stocks have underperformed recently, Dividend Growers remain at a discount

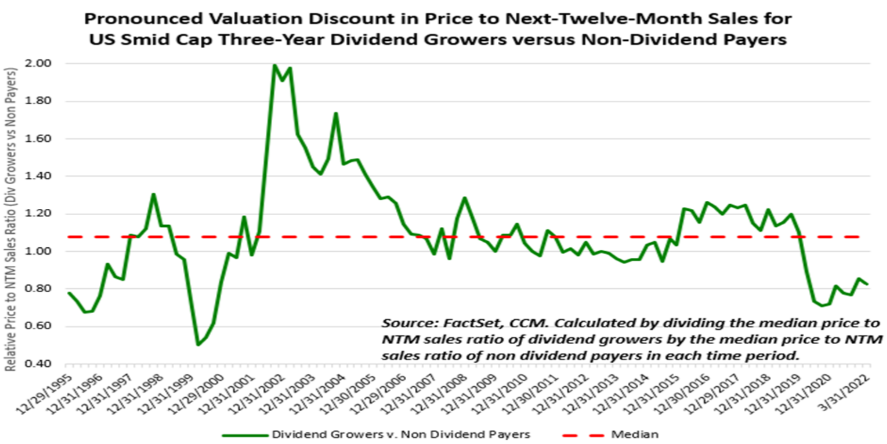
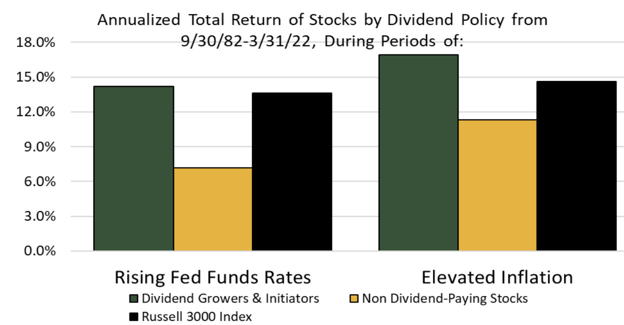


Chart 7. Dividend Growers have outperformed during both rising Fed Funds and high inflation environments



Source: Ned Davis Research, Bloomberg, https://fred.stlouisfed.org/series/PCEPILFE.

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dend growers have historically outperformed both the Russell 3000 Index and the universe of non-dividend paying stocks over nearly 40 years, during both rising interest rate and high inflation environments.[13] In fact, the performance advantage of dividend growers versus non-dividend payers has been most pronounced as rates were rising, with the former outpacing the latter by more than 7% on annualized basis (Chart 7).

Circling back to our White Rabbit, while he's perhaps best known for the title quote, the follow-on admonishment of Alice, "Don't just do something! Stand there!," has its own value in the current environment. While others may feel compelled to make significant changes in their portfolios in response to the current market volatility, we are as comfortable as ever remaining exposed to the dividend growth universe. Therein we believe strong business models will continue to support significant cash generation, high returns on capital, and outperformance with less risk than the market over time.

April 28, 2022

1 *https://www.bbc.com/news/world-60542433, https://www.whitehouse.gov/briefing-room/statements-releases/2022/03/24/fact-sheet-united-states-and-allies-and-partners-impose-additional-costs-on-russia/*
2 *https://www.economist.com/graphic-detail/2022/03/10/which-western-companies-are-leaving-russia*
3 *FactSet*
4 *https://fred.stlouisfed.org/series/MORTGAGE30US*
5 *https://www.ubs.com/us/en/wealth-management/insights/market-news/article.1562697.html*
6 *Bank of America Merrill Lynch, https://en.sse.net.cn/indices/ccfinew.jsp*
7 *https://fred.stlouisfed.org/series/UNRATE*
8 *https://fred.stlouisfed.org/series/JTSJOL*
9 *https://fred.stlouisfed.org/series/CES0500000003*
10 *https://fred.stlouisfed.org/series/LNS11300060*
11 *Raymond James, April 1, 2022*
12 *FactSet, Ned Davis Research*
13 *NDR companies-are-leaving-russia*

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Definitions

NTM P/E Ratio - The Next Twelve Months Price-to-Earnings Ratio of a stock is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share.

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