The Copeland Review

Second Quarter 2023

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

Hear my song
Yeah, people don't you listen now?
Sing along, Oh
You don't know what you're missing now…
Everything that's small has to grow
And it's gonna grow…
The song remains the same…
All you gotta do, now

- Led Zeppelin, "The Song Remains the Same," Houses of the Holy, 1973

Figure 1. DALL-E 2 Generated Chair Powell[1]

The Song Remains the Same

Greek philosopher Heraclitus is known for the idea that life is in constant flux, that "it is not possible to step into the same river twice."[2] Like continuously changing river water, so it is in technology, where new innovations enter the fray and sometimes go mainstream. All the rage today centers around the latest evolution in artificial intelligence ("AI"), which has propelled a momentum-oriented stock rally. The S&P 500 Index rose 17% in the first half of the year, a stark contrast to the 20% decline in the first half of 2022.

At the same time – despite the dynamic world and upward equity momentum – a sense of déjà vu cannot be avoided. Inflation remains elevated, war continues abroad, tensions persist with China, and interest rates are higher. The headlines were similar one year ago. In our 2Q22 *Review*, "You've Lost that Lovin' Feeling," we highlighted our views that (1) the risk of recession was high, (2) equity risk reward was more favorable following market pullbacks, and (3) it was a good time to buy dividend growth stocks.

Now, in many ways, "the song remains the same." As US Federal Reserve ("Fed") Chair Jerome Powell continues to chip away at the mountain of prior government stimulus, recession concerns linger, narrow equity market leadership has left many stocks behind, and we believe that dividend growth stocks are well-positioned to outperform. Also, the new AI fervor feels very much like the special purpose acquisition corporation ("SPAC") craze of the recent past. Hopes of quick riches take hold of emotions and drive speculation. It happens over and over. Yes, the song remains the same.

In this *Review*, we touch on these themes while also highlighting that dividend growth stocks have returned to historically extreme valuation discounts versus the market. We also emphasize our conviction in the constancy and timeliness of our dividend growth approach.

Fed's Own Research Suggests Major Negative Tightening Impacts Still to Come

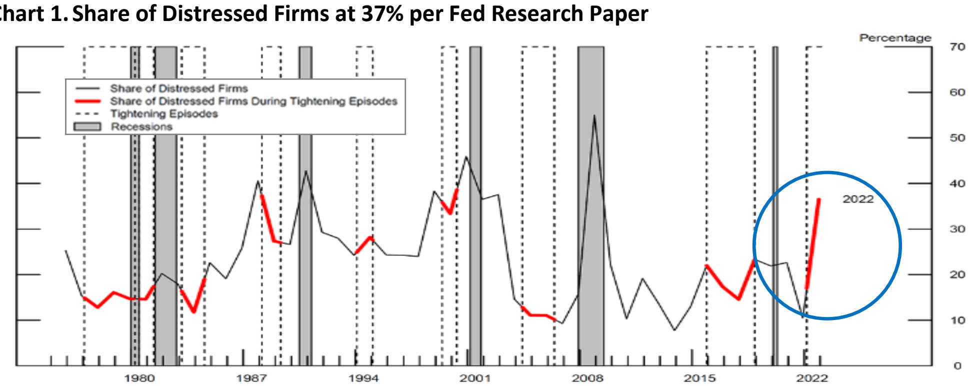
In our 4Q22 *Review*, "Flying the Plane," we underscored the folly of overreliance on forecasts and argued that the Fed was woefully late in reigning in an economy that was long "Running Hot" (1Q21 *Review*). By the time the central bank started raising the Fed Funds rate in March 2022, headline US inflation was already 8.5%, well ahead of the Fed's 2.0% target level, and labor markets were incredibly tight with unemployment at only 3.6%.[3] Until recently, the main worry among investors was that the Fed had gone too far too fast – ten consecutive hikes totaling five full percentage points until pausing in June – bringing great risk of a recession on the horizon, albeit delayed.[4] Today, that fear has been replaced largely by a fear of missing out, or "FOMO," and a growing belief of a "soft landing."[5]

To date, the US economic locomotive has been resilient in the face of the most aggressive monetary policy tightening actions since the 1970s, thanks in large part to trillions of extraordinary stimulus dollars made available in recent years. Besides excessively accommodative monetary policy that prevailed for years until the Fed ended its zero-interest rate policy in early 2022, also recall $2.2 trillion in fiscal stimulus via the CARES Act (March 2020), $900 billion follow-on spending for the CARES Act (December 2020), $1.9 trillion via the American Rescue Plan (March 2021), and $550 billion via the Infrastructure Investment and Jobs Act (November 2021). On the heels of those programs, in August 2022, US Congress authorized almost $900 billion via the Inflation Reduction Act and nearly $300 billion via the CHIPS & Science Act.[6] Adding it all up, the fiscal stimulus dollars total nearly seven trillion! While acknowledging that some programs are spread across multiple years, the grand sum represents approximately one quarter of the US's entire 2022 GDP.[7]

With those kinds of dollars slushing around, it is no wonder that inflation grew red hot and the Fed finally applied the brakes with a clear intention to cool the economy. For example, the Federal Reserve Open Market Committee (FOMC) June policy statement – like earlier statements – said the following: "Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation," though with "uncertain" effects.[8] But, per research produced by Fed's own economists, the likely effects are – wait for it – more certain!

A June 23, 2023 Fed research paper, "Distressed Firms and the Large Effects of Monetary Policy Tightenings" pointed out that, "the share of nonfinancial firms in financial distress has reached a level [37%] that is higher than during most previous tightening episodes since the 1970s" (Chart 1). The paper's conclusions amount to warnings, suggesting that (1) "the recent policy tightening is likely to have effects on investment, employment, and aggregate activity that are stronger than in most tightening episodes since the late 1970s," (2) "contractionary [tightening] shocks generate a strong and statistically significant drop in investment and employment," and (3) the effects "peak around one or two years

Chart 1. Share of Distressed Firms at 37% per Fed Research Paper



Source: https://www.federalreserve.gov/econres/notes/feds-notes/distressed-firms-and-the-large-effects-of-monetary-policy-tightenings-20230623.html after the shock." Again, note that the Fed Funds rate now stands at 5.25% versus only 0.25% 15 months ago.[9]

Although areas of strength remain, the effects of rapid tightening are taking hold and — per the study — the lagging effects are very likely to arrive. Examine Chart 2, with the top panel illustrating record construction spending in the manufacturing sector versus the bottom panel showing a June 2023 US Manufacturing Purchasing Managers' Index (PMI) level of 46.

The manufacturing construction spending – up a whopping 76% year over year for the month of May 2023[10] – is fantastically strong and visibly reflects the manifestation of a post-pandemic corporate and government desire to bring back core pieces of the supply chain stateside. These efforts should provide tailwinds supportive of US jobs and economic growth over the long-term. However, construction spending is viewed as a "lagging indicator," or confirmation of a trend that has already happened.

By contrast, the PMI is viewed as a leading indicator of things yet to come, and a reading below 50 signals contraction. Unfortunately, June's lower PMI reading marked the eight straight month of retrenchment in manufacturing activity and illustrates a broad decline in aggregate economic demand.[11]

No guesswork is required. For consumer context, look at housing and auto costs. The implied monthly mortgage payment on a median priced home increased 32% over the past 15 months.[12] For new car purchases, the average monthly car payment increased 12% from the first quarter of 2022."[13]

Finally, a downtrend is captured by persistently weak readings for the NFIB Small Business Optimism Index and The Conference Board Leading Economic Index® (LEI), with the former below trend for 17 consecutive months and the latter declining in each of the last 14 months.[14]

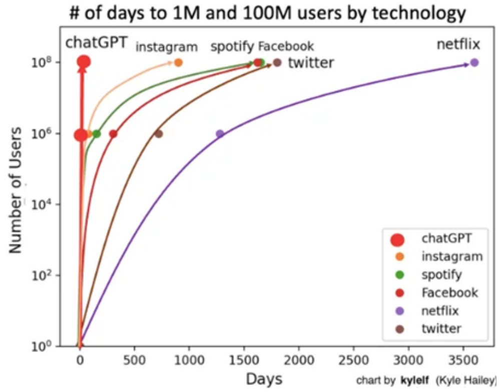
Euphoria Over AI
Drives Narrow Market Rally

Notwithstanding the bevy of macroeconomic concerns, the investment world is going bananas over generative AI. Through June 2023, the Nasdaq Composite Index rose 32%, marking the best first half performance since 1983 and almost double the 17% total return of the S&P 500 Index.[15] Meanwhile, for the S&P 500 Index, what some pundits dubbed the "Magnificent Seven" large cap stocks[16] – Apple, Microsoft, Nvidia, Alphabet, Amazon, Meta Platforms, and Tesla – contributed nearly three quarters of the index return to date, leaving the balance of the S&P 500 Index up only 4% in the first half.[17] According to BofA Securities,

Chart 2. Current Fed Tightening Cycle Versus Prior Fed Tightening Cycles

Source: Berenberg, PSC Research

Chart 3. ChatGPT is the Fastest Growing Consumer Software Application Ever!



Source: https://johnnosta.medium.com/the-most-important-chart-in-100-years-1095915e1605

"the first half of 2023 marked the narrowest first half breadth in history."[18]

While forms of AI have been implemented into products and services for many years – think Amazon's Alexa – the latest innovations appear to mark a step change. ChatGPT, or Chat Generative Pre-Trained Transformer, was launched by OpenAI at the end of November 2022 and, by January, became "the fastest-growing consumer software application in history" (Chart 3).[19] OpenAI also made available DALL-E 2 in September 2022, which generates digital images from "natural language" prompts (Figure 1). Both tools are easily accessible by users of all ages around the world and can be utilized for a range of tasks.

On January 23, 2023, Microsoft announced that it was making a "multiyear, multibillion-dollar" investment in OpenAI that is believed to total $10 billion.[20] This ignited a feeding frenzy for all things related to AI, which gained further momentum when Nvidia posted strong results May 24, 2023 fueled by a rapid and broad-based increase in demand for the company's "accelerated computing" chips. In the venture capital world, Mistral AI – a French startup with no product or service – raised $113 million just one month after founding with only a mission "to develop the best generative AI models."[21]

Not Enough to Offset
Negative Estimate Revisions

Certainly, the AI advances and ongoing enhancements may be transformational. Plus, as exemplified by Nvidia, AI-related computing demand is driving pockets of significant technology hardware buying amidst a broadly weaker information technology marketplace.

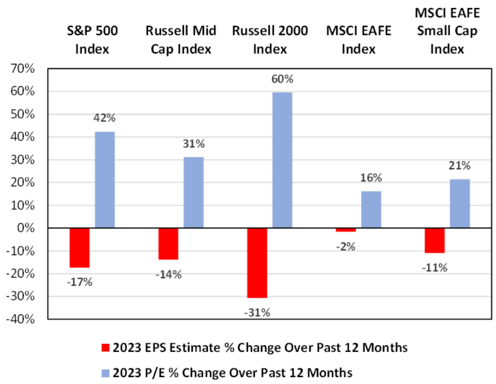
However, even with an expected boost related to incremental AI demand, estimated S&P 500 Index technology sector earnings for 2023 are down 7% since the start of the year.[22] On an aggregate Index basis, 2023 estimates are also tracking lower across all cap ranges, both in the US and abroad. Yet, upward equity prices – even if by narrow leadership – coupled with lower estimates produced marked multiple expansion over the past year (Chart 4).

The negative revisions in 2023 should not be a surprise given slowing business conditions, and again highlight the challenge of forecasting and that forecasts tend to be overly optimistic. That said, although many stocks have been left behind, relatively robust equity sentiment suggests that investors are looking through the "wall of worry," for the time being.

Related to decelerating trends, *The Wall Street Journal* published two noteworthy articles. First, on June 1, 2023, the *WSJ* pointed out that companies are more prone to use "nontraditional ways to boost the bottom line," such as reallocating costs, unwinding charges, and/or delaying depreciation.[23] Then, on July 2, 2023, a piece titled "Investors Spurn Dividend-Paying Stocks as AI Booms" stated: "Investors who last year embraced dividend-paying stocks now see greater promise in growth-focused tech stocks that don't typically pay dividends."[24]

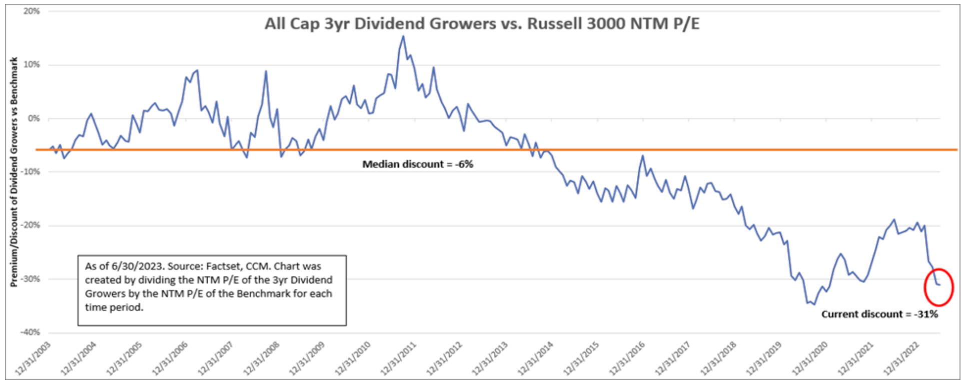
"Greater promise?" Instead, we echo Led Zeppelin, "Don't you listen, now?... You don't know what you're missing," and risking. The rapid AI-focused valuation ascent and euphoria draws shades of the both the late 1990s technology bubble and the more recent, stimulus induced SPAC craze. These periods did not end well for speculators, although bad memories somehow fade and actions repeat.

Chart 4. 2023 Earnings Estimates Decline While P/Es Rise Across Major Indices



Source: FactSet. Please see Disclosures below for information about the Indices above. You cannot invest directly in an Index.

Chart 5. Striking Relative Discount for Dividend Growth Stocks versus Russell 3000 Index P/E



Source: FactSet, CCM as of 6/30/23. Benchmark data is sourced from Bloomberg and Dividend Grower data is sourced from FactSet. Both calculations exclude companies with negative earnings and use a weighted harmonic average NTM P/E. Dividend Growers include All Cap companies that have raised their dividend for three consecutive years. Valuation discounts or premiums do not guarantee future returns will be greater or lower than the benchmark. There is no guarantee that companies will declare dividends or, if declared, that they will remain at current levels or increase over time. You cannot invest directly in an Index. For information on the Index shown above as well as other important information, please refer to the Disclosures herein.

The Song Remains the Same: Dividend as Signal

Ultimately, what matters most for equity investors are profits, cash flow, and dividends. More specifically, we believe that dividends tell the truth, particularly a rising cash dividend. This is a constant amidst a world of flux, notwithstanding any déjà vu feelings.

There is no need to rely upon a rosy but uncertain forecast, or upon earnings concocted by fuzzy accounting. Nor must we attempt to predict the outcome of the Fed's incredible battle against the massive stimulus in the system. Further, we believe that dividend growth stocks are well-situated to weather potentially significant volatility that may result from a slower macro-economic environment that the Fed is engineering. Hear our song.

By leveraging dividend actions as a signal and only investing in dividend growth stocks, we believe that investors can garner a significant advantage, especially amidst a potentially difficult backdrop where corporate disappointments and stock "blow-ups" may be more frequent. To the extent our companies or investment candidates are benefitting from AI-related demand – or other growth drivers – this benefit should show up in tangible dividend growth.

Notably, like last year, we believe that dividend growth stocks remain attractively valued. Chart 5 reveals a striking valuation discount for all cap three-year dividend growth stocks. Moreover, we feel that Copeland's selected dividend growth stocks continue to offer strong absolute and relative growth, both in terms of earnings and dividend growth.

Again, "The song remains the same… all you gotta do, now."

July 25, 2023

[1] *OpenAI DALL-E 2 generated image with prompt "Jerome Powell chipping away at a mountain of cash with a pickaxe" https://openai.com/dall-e-2*

[2] *Stanford University https://plato.stanford.edu/entries/heraclitus/#Flu*

[3] *BLS https://www.bls.gov/news.release/archives/cpi_04122022.htm, https://www.bls.gov/news.release/archives/empsit_05062022.htm*

[4] *USA Today https://www.usatoday.com/story/money/2023/06/09/are-we-in-recession/70304424007/*

[5] *WSJ https://www.wsj.com/articles/markets-appear-convinced-the-fed-can-pull-off-a-soft-landing-700a40dd*

[6] *Wikipedia https://en.wikipedia.org/wiki/CARES_Act , https://en.wikipedia.org/wiki/American_Rescue_Plan_Act_of_2021, https://en.wikipedia.org/wiki/Infrastructure_Investment_and_Jobs_Act, https://en.wikipedia.org/wiki/Inflation_Reduction_Act, https://en.wikipedia.org/wiki/CHIPS_and_Science_Act*

[7] *Trading Economics https://tradingeconomics.com/united-states/gdp*

[8] *Federal Reserve https://www.federalreserve.gov/newsevents/pressreleases/monetary20230614a.htm*

[9] *New York Fed https://www.newyorkfed.org/markets/reference-rates/effr*

[10] *US Census Bureau https://www.census.gov/construction/c30/pdf/release.pdf*

[11] *Briefing.com*

[12] *Redfin https://www.redfin.com/news/housing-market-update-homes-selling-above-asking-price/ , https://www.redfin.com/news/housing-market-update-mortgage-payment-record-high/*

[13] *LendingTree for week ending June 29, 2023 https://www.lendingtree.com/auto/debt-statistics/#Averagemonthlycarpayments*

[14] *NFIB https://www.nfib.com/surveys/small-business-economic-trends/, The Conference Board https://www.conference-board.org/topics/us-leading-indicators*

[15] *FT https://on.ft.com/3NKwAE9*

[16] *Yahoo! Finance https://finance.yahoo.com/news/the-magnificent-seven-tech-stocks-drive-markets-higher-as-ai-mania-grips-investors-123029634.html*

[17] *FactSet*

[18] *BofA Global Research, "Everyone was bearish, everything rallied," Subramanian et al., 7/3/23*

[19] *Wikipedia https://en.wikipedia.org/wiki/ChatGPT#Further_reading*

[20] *NYTs https://www.nytimes.com/2023/01/23/business/microsoft-chatgpt-artificial-intelligence.html*

[21] *Reuters https://www.reuters.com/technology/french-company-mistral-ai-raises-105-mln-euros-shortly-after-being-set-up-2023-06-13/, https://mistral.ai/*

[22] *S&P Dow Jones Indices https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview*

[23] *WSJ https://www.wsj.com/articles/profit-numbers-get-spruced-up-as-business-slows-8eec5017?st=tjec4kdbrwpmshb&reflink=desktopwebshare_permalink*

[24] *WSJ https://www.wsj.com/articles/investors-spurn-dividend-paying-stocks-as-ai-booms-344f431d?st=ax8shjkpntrr38r&reflink=desktopwebshare_permalink*

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Currency - Unless otherwise specified or disclosed, the currency used for data in the report is US Dollar (USD).

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Definitions

Conference Board Leading Economic Index® (LEI) - The LEI provides an early indication of significant turning points in the business cycle and where the economy is heading in the near term.

Consumer Price Index (CPI) – A measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

Dividend Growth Rate – The annualized percentage rate of growth that a particular stock's dividend undergoes over a period of time.

EPS Growth - Earnings Per Share Growth illustrates the growth of earnings per share over time.

Gross Domestic Product (GDP) – GDP measures the monetary value of final goods and services produced in a country in a given period of time.

NFIB Small Business Optimism Index: The National Federation of Independent Business (NFIB) Small Business Optimism Index is a composite of ten seasonally adjusted components. It provides a indication of the health of small businesses in the U.S., which account of roughly 50% of the nation's private workforce.

NTM – Next twelve months.

P/E Ratio – The 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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