# The Copeland Review

First Quarter 2024

*“We believe that stocks with sustainable dividend growth consistently outperform the market with less risk.”*


## It Just Doesn’t Matter

*Tripper: Sure, the Mohawks have beat us 12 years in a row. But it doesn't matter. Sure, they’re terrific and have the best sports facilities money can buy. Sure, each team has their own personal masseurs… But it doesn't matter!! It just doesn’t matter.*

\- *Meatballs,* Paramount Pictures, 1979

Observing the strength of equities and the return of speculative behavior during the first quarter brings to mind the 1979 comedy, *Meatballs*, which helped launch Bill Murray’s career. In the movie, Tripper Harrison – played by Murray – makes a rousing speech to motivate demoralized campers and his fellow counselors at Camp North Star, as they compete in an Olympiad competition against their longstanding rival, Camp Mohawk. Tripper highlights a litany of perceived Mohawk strengths, but repeatedly emphasizes that they don’t matter, cannot be changed, and should not derail his team’s resolve to win.

Unlike Camp North Star, the equity markets are not lacking resolve to push upward. Broadly “higher-for-longer” borrowing rates? Doesn’t matter. Multiple bloody geopolitical conflicts? Doesn’t matter. An increasingly stretched US government fiscal condition? It just doesn’t matter!

In this *Review*, we highlight the following:

1. Yes, the economy is buoyant, supported by robust infrastructure spending, improving access to capital, and stable employment trends.
2. Yet pockets of weakness are present, and the deleterious impact of higher borrowing costs is becoming more visible for the US government, where already-ballooning interest expense is poised to further explode and crowd out critical spending.
3. We think major risks should not be ignored and emphasize that pursuing a disciplined dividend growth approach can capture most of the upside and far less of the potential downside, whenever risks start to matter.

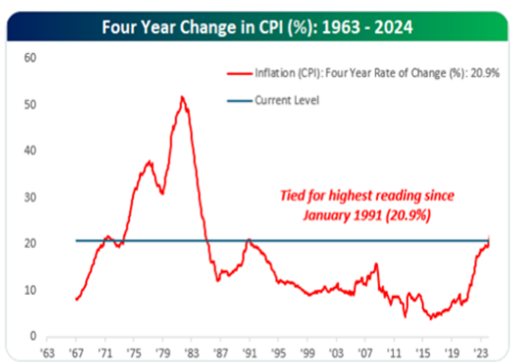
### Happy Days Are Here Again

Lo and behold, the once widely anticipated recession has not arrived, and equity markets – as a major leading indicator – are implying an indefinitely delayed arrival. During the quarter and over the last year through March, the S&P 500 Index was up 11% and 30%, respectively, on a total return basis, while the small cap Russell 2000 Index was up 5% and 20%, and the international MSCI World ex USA Index was up 6% and 16%.[1]

As discussed last quarter in “[Double Vision](#)” (4Q23), the change in mood was ignited in early November by the US Federal Reserve (“Fed”) signaling that it was not only finished increasing the federal funds rate, but also reaffirming that the rate and, therefore short-term borrowing costs, would begin to recede in 2024. The pace of potential rate cuts has been widely debated, though retrenchment in expectations from six cuts to three or fewer just didn’t matter as stocks continued to rise through March.[2]

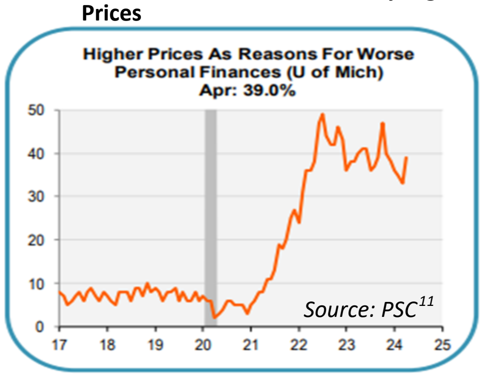
Notably, perceived interest rate visibility and prospects for a “soft landing” reopened the capital market floodgates during the first quarter of 2024. Total equity issuance during the first quarter increased 110% year-over-year while initial public offering issuance surged 239%.[3] On the credit side, US corporate bond issuance increased 81% year-over-year, and investment grade companies raised a record $538 billion, with new offerings more than three times oversubscribed, on average.[4] Even in the much-forsaken commercial real estate sector, established operators raised significant funds to help navigate the widely discussed “wall of maturities.”[5] For example, non-agency US commercial mortgage-backed security issuance spiked almost four-fold year-over-year to $18 billion.[6]

**Chart 1. Four-Year Inflation Weighs on Consumers**




Source: https://x.com/bespokeinvest/status/1778407868665929902

**Chart 2. Personal Finances Stretched by Higher Prices**




Further, a massive increase in capital spending by large technology companies is occurring, driven by surging internet traffic and a build out for rapidly evolving artificial intelligence (AI) applications. At the same time, the $1.2 trillion “Infrastructure Act,” the $50 billion “CHIPS Act,” and numerous corporate re-shoring initiatives are supporting substantial investment across a range of sectors.

Adding it all up, real US GDP growth is tracking close to 3%[7] and unemployment remains extraordinarily low with (1) job openings still scarce while (2) layoffs are relatively stable.[8] Hence, credible support for market optimism.

### Still, Melancholy and Challenges Persist

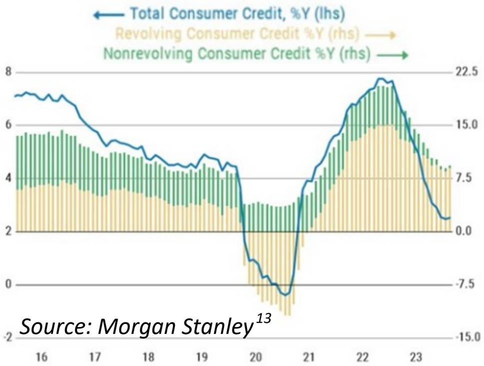
Despite higher equity markets and ginormous gains in home prices, the consumer sentiment index remains in the doldrums at 79 in March versus a pre-pandemic high of 101 in February 2020.[9] Why?

One probable explanation: “sticky” inflation and the associated impacts of monetary tightening. First, after a sustained decline in headline inflation for “all items” from a peak of 9% in June 2022 to 3.1% in January of this year, inflation ticked slightly upward to 3.2% in February and then to 3.5% in March.[10] Higher prices appear persistent and the perceived – or in many cases actual – loss of purchasing power over the last handful of years is a challenge for both consumers and businesses.

Four-year inflation recently touched 21%, the highest reading since 1991 (Chart 1) and consumers point to “higher prices” as a top reason for worse personal finances (Chart 2). Everything seems to cost more, stretching household budgets and fueling a broad sense of overall malaise. The latest Gallup Poll on economic conditions found that 63% of Americans believe the economy is “getting worse,” almost double only 33% in January 2020.[12]

Second, approximately two years after the Fed’s tightening spree began, the effects are increasingly visible. The economy is slowing, consumer demand – which accounts for 68% of

**Chart 3. Consumer Credit is Slowing**




*Source: Morgan Stanley*[13]

US GDP[14] – is softening, and the pace of borrowing by US consumers is decelerating (Chart 3). Unsurprisingly, growth in nonrevolving consumer credit – which includes loans for autos, boats, mobile homes, and education – has stalled out because of higher rates.

Similarly, activity in the residential real estate market remains depressed. Existing-home sales in the US for the month of March were down 37% from a cycle peak in January 2021 due to higher borrowing costs and limited home supply.[15] Economic research shows that a slump in real estate transactions leads to meaningfully reduced spending on consumer durables as well as on home improvement and maintenance.[16]

Consumer spending has shifted toward services (e.g. travel, dining out, concerts), leaving swollen inventory levels across multiple goods categories. In turn, inventory contraction is impacting areas such as trucking and warehousing. Elsewhere, notwithstanding euphoria around AI and data center demand, many areas of spending on information technology and services remains muted. As a result, job opportunities in these areas are less plentiful.[17]

The net result of the two forces – inflation and restrictive monetary policy – are leading to fundamental headwinds for numerous companies. Correspondingly, earnings expectations for small- to large-cap US companies have contracted since year-end.[18]

### The Elephant in the Room is Problematic

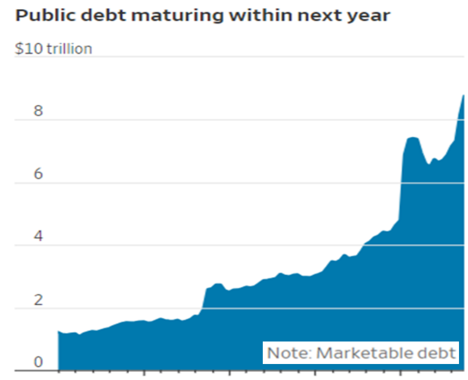
Most families, businesses, and organizations are either trained – or forced by necessity – to live within their means. By contrast, the US government has not – thus far – had to live within its means, operating with consistent deficits since the 1970s. Even as the world has witnessed frequent US Congressional battles over the "debt ceiling" and downgrades of the US government credit ratings, most onlookers shrug off the news.[19] It just hasn't mattered.

Instead, thanks to the US dollar's position as the world's primary reserve currency,[20] the US Treasury has been allowed to run its printing press with reckless abandon. Persistently higher outlays than receipts have increased total public debt outstanding to $34 trillion at year-end 2023, up almost 50% from year-end 2019 and a nearly threefold increase from year-end 2009. Now, with interest rates at their highest level since before the GFC,[21] the situation appears particularly precarious.

The Congressional Budget Office (CBO) outlook calls for widening shortfalls through 2054 (Chart 4).[22] Moreover, the US government faces its own "wall of maturities," with nearly nine trillion dollars – or more than one-quarter of its debt – maturing over the next year (Chart 5). This makes the commercial real estate "wall" of $1.2 trillion maturing in 2024-25 pale by comparison.[5] Just like families and businesses that are now refinancing low-cost debt at much higher rates, the US government will need to do the same.

According to the CBO, the weighted average cost of all outstanding US government debt in 2023 was 2.69%, well below current Treasury rates, which range from nearly 4.8% for 30-year bonds to 5.4% for one-month T-bills as of this writing. An incremental wrinkle is that weaker institutional demand for Treasuries may require yields to push higher to absorb the implicit surge in new issuance required to refinance maturing securities as well as fund ongoing operating deficits and higher interest expense.

**Chart 5. Wall of Maturities**




*Source:* https://www.wsj.com/finance/americas-bonds-are-getting-harder-to-sell-c3fde4de?st=gg9exy2x1ib3hfa

### Connecting the Dots

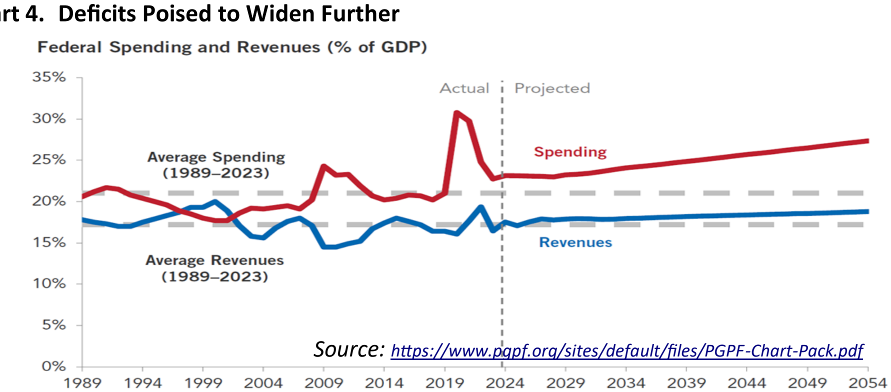
At Copeland, as conveyed in prior *Reviews*, we are macro-aware but not macro-driven. We pursue a bottom-up, company specific investment approach that centers around the ability of each company to sustain healthy dividend growth over time. Period.

Right now, the trillions of fiscal and monetary stimulus dollars infused into the US economy since 2020 remain supportive of growth. Such funding often produces beneficial multiplier effects across sectors as is currently happening in manufacturing and infrastructure. Yet, the arguably overdone splurge of the last several years – go back to "Running Hot" (1Q21) – comes at a price.

As interest expense explodes higher, the government's ability to sustain investment in so-called "discretionary" areas such as education, research, infrastructure, and defense will be evermore constrained (Chart 6). As these categories garner a smaller share of spending, their multiplier effect wanes. Additionally, should the economy enter recession, the government's ability to provide further fiscal stimulus will also be impaired. Being levered to the hilt "just doesn't matter." Until it does.

Finally, the significant near-term government borrowing requirements may keep interest rates elevated in general, thereby impacting borrowing costs as well as budget plans for corporations and consumers alike. Not only does higher interest expense directly reduce corporate earnings and dividend power, the drag on cash flow leaves less available for both maintenance spending and new investments, which may negatively impact employment. The situation could become a perverse negative cycle.

**Chart 4. Deficits Poised to Widen Further**




*Source:* https://www.pgpf.org/sites/default/files/PGPF-Chart-Pack.pdf

### Finding Dividend Growth

Equity markets frequently tend to climb a wall of worry, sometimes for extended periods. Perhaps the trend will continue. Yet, all humans worry, and we worry that some risk factors are being ignored. Copeland continues to manage risk and seek growth. We believe the best means to do both is via our disciplined dividend growth approach.

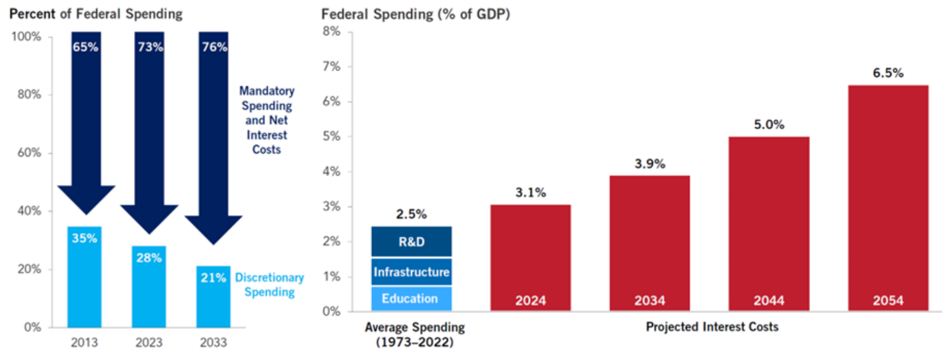
Fortunately, the universe of dividend growth candidates remains large (Chart 7). While the number of companies raising dividends declined to just over one thousand, the pool remains healthy and above pre-pandemic levels. At a broad benchmark level, the overall pace of dividend growth ticked upward during the March quarter to 4%, up from a low of 2% last year (Chart 8).

The benefits of exclusively researching and owning companies that drive a high pace of dividend growth over time can be significant. Notably, we believe that a portfolio of companies with strong dividend growth can provide meaningful upside market participation as well as downside protection, should market conditions become more tenuous.

As sure as the sun rises and regardless of market conditions, Copeland will invest only in competitively advantaged companies that we believe are best positioned to sustain long-term dividend growth. That's what matters, and we think even Tripper would agree.

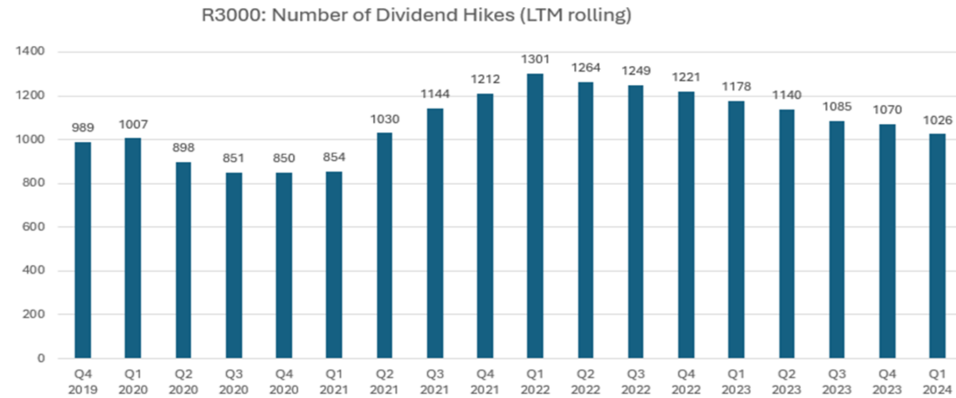
April 2024

**Chart 6. Crowding Out Evermore "Discretionary Spending"**




*Source: https://www.pgpf.org/sites/default/files/PGPF-Chart-Pack.pdf*

**Chart 7. Number of Dividend Hikes for the US All-Cap Universe**




*Source: FactSet and CCM*

**Chart 8. Russell 3000® Index Overall Pace of Dividend Growth**


*Source: Factset and CCM. Calculation based on the sum of all dividends paid by companies in the benchmark compared to the prior year period, excluding new initiations.*

1 *Bloomberg*

2 *CNBC https://www.cnbc.com/2024/04/17/wall-street-pushes-out-rate-cut-expectations-sees-risk-of-no-action-until-2025.html*

3 *SIFMA https://www.sifma.org/resources/research/research-quarterly-equities/*

4 *SIFMA https://www.sifma.org/resources/research/us-corporate-bonds-statistics/ and Reuters https://www.reuters.com/markets/rates-bonds/relentless-us-credit-demand-seen-driving-second-quarter-rally-2024-04-01/*

5 *Guggenheim Investments https://www.guggenheiminvestments.com/perspectives/sector-views/commercial-real-estate-when-maturity-means-default*

6 *Trepp https://www.trepp.com/trepptalk/cmbs-issuance-during-1q-skyrockets-as-spreads-tighten*

7 *Atlanta Fed https://www.atlantafed.org/cqer/research/gdpnow*

8 *FRED https://fred.stlouisfed.org/series/JTSJOL and https://fred.stlouisfed.org/series/JTSLDL*

9 *Trading Economics https://tradingeconomics.com/united-states/consumer-confidence*

10 *BLS https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.htm*

11 *Piper Sandler, Consumer Tracker, "Sticky Inflation, Downbeat Consumers," 4/13/24*

12 *Gallup https://news.gallup.com/poll/642692/march-economic-confidence-steady-improved-fall.aspx*

13 *Morgan Stanley, Consumer Retail, "Is the Consumer Slowing, Or Is It Just Recency Bias?" 4/22/14*

14 *FRED https://fred.stlouisfed.org/series/DPCERE1Q156NBEA*

15 *Trading Economics https://tradingeconomics.com/united-states/existing-home-sales*

16 *BLS https://www.bls.gov/opub/mlr/2017/beyond-bls/housing-and-consumption-the-home-purchase-connection.htm*

17 *Census Bureau and Indeed https://data.indeed.com/#/postings*

18 *Factset estimate history for SPX, IWM, IWR*

19 *AP News https://apnews.com/article/fitch-debt-downgrade-interest-rates-bed220f3876eadd7451df4cbd96f0bc7*

20 *Council on Foreign Relations https://www.cfr.org/backgrounder/dollar-worlds-reserve-currency*

21 *FactSet*

22 *CBO https://www.cbo.gov/data/budget-*

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**Definitions**

**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.

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

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