Second Quarter 2019

The Copeland Review

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

To Infinity and Beyond!

- *Toy Story*, 1995

BUZZ: I CAN fly.
WOODY: No, you can't.
BUZZ: Yes, I can…
Woody (voice over): YOU ARE A TOY, YOU CAN'T FLY!

As of July 2019, the Dow Jones Industrial Average (DJIA) sits over 27,000 and the S&P 500 Index recently eclipsed 3,000, both new all-time highs. Just six months ago, after an extremely rough finish to 2018, few predicted a double-digit surge during the first half of 2019. Now in year eleven of a US bull market, what is especially amazing – and perhaps concerning – is that stocks are not just climbing a wall of worry.

In apparent defiance of logic, the market is now climbing a "wall" of weakening fundamentals. Certain macroeconomic indicators are in decline and, in aggregate, earnings are trending downward, leading to worries of a US "earnings recession."[1] No matter, though! As Toy Story's Buzz Lightyear says, "To infinity and beyond!"

Yet again, the market lucidly instructs that trying to forecast short-term performance is an exercise in futility. In this Review, we (1) discuss the current surreal market environment, (2) share evidence of a slowing US and global economy, and (3) highlight what we believe to be the above average growth and lower risk of Copeland's International and Global Dividend Growth Strategies compared to their respective benchmarks.

Surreal Market Environment Overlooking Negatives

Year-to-date returns for US and world equity markets through June 2019 were up mid- to high teens (or better), depending on the benchmark. While the lion's share of those returns came during the first quarter, even an escalation in the US-China trade dispute – which shocked markets in May and led to a brief spike in the CBOE Volatility Index (VIX) – didn't preclude the achievement of low single digit incremental returns during the second quarter. At quarter-end, volatility calmed down to nearly the same low level as one year ago.[2]

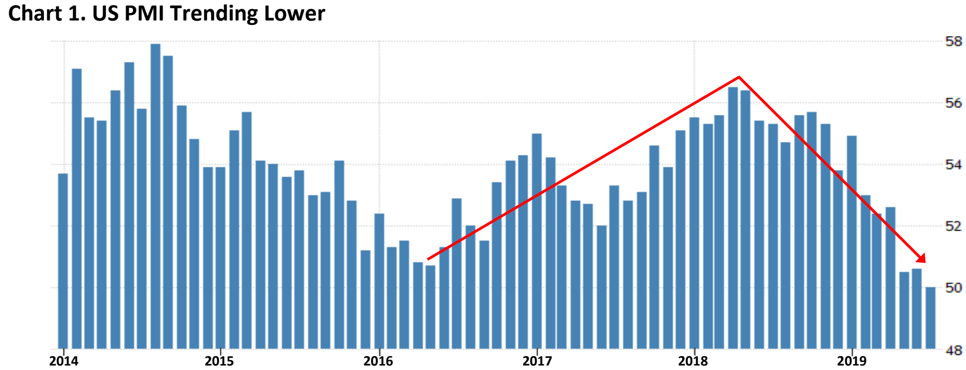
Clearly, the euphoria reflects some tangible positives. Despite concerns that the American economy would be derailed by President Trump's trade policies, real US gross domestic product (GDP) is growing close to 3%,[3] employment is strong, wages are rising, consumer confidence is high, and inflation remains low at only 1.6%.[4] Plus, even after the first half market surge, valuations are reasonable with the S&P 500 Index trading at 18 times expected 2019 earnings, in-line with the Index's 30-year median price to earnings multiple.[5] Crucially, the Federal Reserve has adopted a more accommodative stance and stands ready to come to the rescue – like Buzz Lightyear – should economic growth weaken materially. Finally, since short- and long-term US Treasury rates are trending lower to the chagrin of income investors, a case can be made for TINA – There Is No Alternative to equities – as a support for rising equity prices and higher valuation multiples.[6]

But, wait! A laundry list of negatives exists to counterbalance the positives and, arguably, makes the upward market move somewhat fantastic. At the highest level, we point to declining manufacturing Purchasing Managers' Index (PMI) readings both stateside and abroad.

In last quarter's *Review* (*Tax Reform and the Trillion Dollar Question*), we noted that certain US economic indicators were slowing, including the IHS Markit US Manufacturing PMI. Recall that a PMI reading above 50.0 implies economic expansion while a reading below 50.0 implies contraction. The May 2019 US reading of 50.5 was the lowest since September 2009, June 2019 was the second lowest at 50.6, and, a preliminary reading of 50.0 for July 2019 marks another new low. The readings point to softening expansion and now sit on the verge of contraction (Chart 1).[4,7]

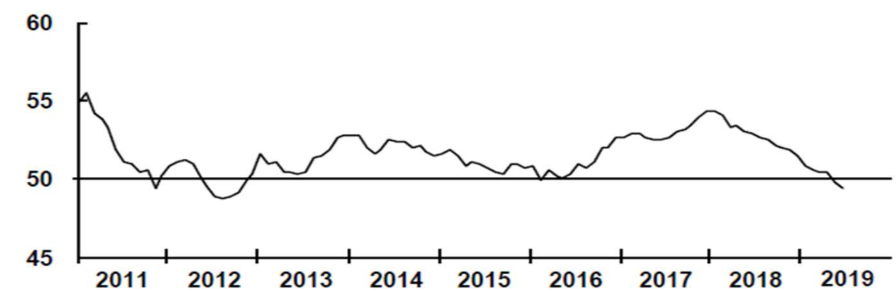
Meanwhile, numerous other countries are officially in economic contraction based on sub-50.0 PMI readings for the month of June, including China, Japan, Germany and the UK.[8] For the world in aggregate, the JP Morgan Global Manufacturing PMI registered 49.4 in June (Chart 2). Specifically, in Japan, machine tool orders declined 12% month over month in June and were down 42% over the past 17 months.[9] Slowing machine tool orders in Japan typically signal a decline in broader Asian economic ac-

Chart 1. US PMI Trending Lower



Source: Trading Economics

Chart 2. JP Morgan Global Manufacturing PMI at Lowest Level in Nearly Seven Years



Source: IHS Markit, with Global Manufacturing PMI™ Indices produced by J.P.Morgan and IHS Markit in association with Institute for Supply Management™ (ISM) and International Federation of Purchasing and Supply Management (IFPSM).

tivity. The negative trend may now be exacerbated by a new Japan-South Korea trade dispute, including newly implemented export controls by Japan.[10]

Closer to home, US freight volumes are contracting[11] and the US yield curve is nearly inverted, historically an infamous harbinger of recession. According to Professor Campbell Harvey at Duke University's Fuqua School of Business, an inverted yield curve correctly signaled each of the last seven recessions that occurred over the past four decades.[12]

From "Macro" to "Micro," in Management's Own Words

Drilling down, weaker macroeconomic conditions are translating into lower earnings results. Using management's own words, we share recent commentary from global materials bellwether BASF (BAS-DE, not held by Copeland).

On July 8th, BASF negatively preannounced June quarter results,[13] citing a host of problems (subject headers added by Copeland):

- **Industrial production weak:** "Significantly weaker-than-expected industrial production negatively impacted volumes and margin development at BASF."
- **Automotive downturn:** "The downturn in growth in the global automotive industry was particularly strong: Globally, production declined by around 6% in the first half of 2019. In China, the world's largest automotive market, the decrease was more than twice as high, at around 13%."
- **Agricultural problems:** "The weak development of the agricultural sector in North America was an additional burden: Due to difficult weather conditions, the planting of key field crops in the region was down from the previous year and far below the historical average. The decrease in earnings prospects for farmers and the trade disputes led to lower demand for crop protection products."
- **US-China Trade dispute lingering:** "To date, the conflicts between the United States and its trading partners, particularly China, have not eased – contrary to what was assumed in the BASF Report 2018. In fact, the G20 summit at the end of June has shown that a rapid détente is not to be expected in the second half of 2019."
- **Conclusion:** "Overall, uncertainty remains high."

In addition to BASF, numerous other companies revised guidance downward in recent weeks. Chart 3 illustrates the rising trend of negative earnings revisions over the past year for S&P 500 Index companies. While a negative revision trend in the fourth quarter of 2018 was met with a severe market correction, the even worse trend this quarter was met with a sustained rally. Yet, the downcast trend makes

Chart 3. Increasingly Negative Earnings Revision Breadth for S&P 500 Index Constituents Over Past Year

	Last 5 Quarters Positive vs. Negative Revisions				
	2Q18	3Q18	4Q18	1Q19	2Q19
S&P 500	9.8%	0.2%	-5.2%	1.4%	-7.3%
Technology	23.9%	5.6%	1.4%	7.0%	-1.5%
Healthcare	7.9%	-1.6%	-1.6%	0.0%	0.0%
Consumer Discretionary	6.6%	6.6%	0.0%	17.1%	-9.7%
Consumer Staples	0.0%	-9.4%	-12.5%	-9.4%	12.1%
Energy	45.2%	3.2%	-12.9%	-22.6%	-51.7%
Materials	8.3%	-16.7%	-12.5%	-8.3%	-39.3%
Industrials	0.0%	-4.3%	60.0%	-8.6%	-4.4%
Financials	1.5%	4.4%	-26.5%	-7.4%	-17.6%
Real Estate	12.1%	0.0%	6.1%	3.0%	12.5%
Utilities	0.0%	-3.4%	3.4%	34.5%	0.0%
Communication Services	33.3%	-33.3%	0.0%	0.0%	4.5%

Source: Raymond James Research, FactSet. For each quarter, represents the percentage of constituent companies with positive EPS estimate revisions minus the percentage of constituent companies with negative EPS estimate revisions.

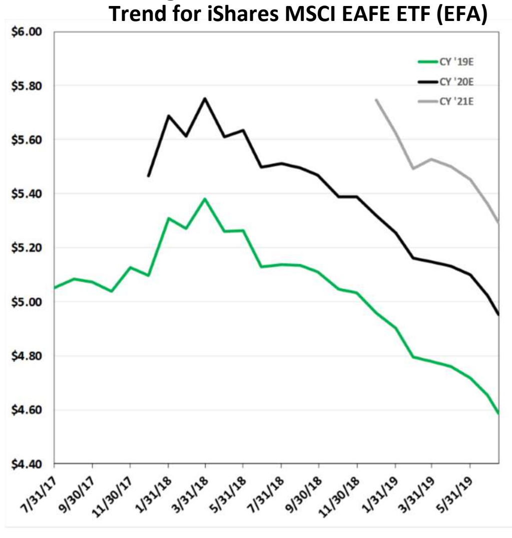
immediately apparent that real economic behavior – e.g. corporate purchasing and investing decisions – is being impacted by heightened global uncertainty and fundamental challenges.

The result is slower or even negative year over year earnings, particularly in the face of already more difficult comparisons following tax reform fueled double digit earnings growth in 2018. In aggregate, S&P 500 operating earnings are expected to decline 3% year over year for the second quarter following a slight 0.3% decline for the first quarter.[1] Outside of the US, earnings estimates are also coming down (Chart 4).

In Uncertain World, Copeland Finds Growth…

Thus, the surreal bullishness of the market seemingly fails to acknowledge a deteriorating business environment, possibly due to expected support from the Federal Reserve. From

Chart 4. Outside of the US, Estimates Are Also Rolling Over – Consensus EPS Estimate Trend for iShares MSCI EAFE ETF (EFA)



Source: FactSet, iShares MSCI EAFE ETF (EFA). EFA tracks a market-cap-weighted index of developed-market securities based in Europe, Australia and the Far East. It excludes the US and Canada, and small-caps.

a theoretical standpoint, if corporate equity valuations are derived from a discounted future stream of expected dividends to equity owners – as espoused by the Dividend Discount Model (DDM) – weaker earnings growth translates into weaker dividend growth and reduced equity valuations. While a lower discount rate – based on lower prevailing interest rates – can offset some of that pressure, expected growth is an equally significant driver of value. We believe current trends suggest future expectations may be too high, presenting downside risk to equity market valuations.

At Copeland, we strive to understand how changes in macroeconomic conditions impact our companies. But, at the root of our investment discipline, we are most concerned with the underlying pace of dividend growth and how a company's competitive market position, coupled with company-specific fundamentals, affect the sustainability and trajectory of growth. Our research process also aims to mitigate valuation mistakes, that is, to avoid overpaying for our companies.

We continue to find and own companies that are outpacing their relevant benchmarks in terms of both earnings and dividend growth. In last quarter's *Review*, we highlighted the higher growth of our US Dividend Growth Strategies. Here, we share the higher relative growth of our International and Global Dividend Growth Strategies compared to their respective benchmarks (Table 1). Frequently, the pace of growth is meaningfully higher than that of the relevant benchmark, which we believe leads to better share performance over time.

… and Minimizes Portfolio Risk

Importantly, our emphasis on competitive market position and dividend growth tends to produce healthy returns and lower portfolio risk across our US, International, and Global strategies over time. As we shared in the Fourth Quarter 2016 *Review* (*Never Tell Me the Odds!*), our disciplined Dividend Growth investment approach can result in a superior Efficient Frontier relative to US benchmarks. Likewise, in Chart 5, we illustrate the tendency of Interna-

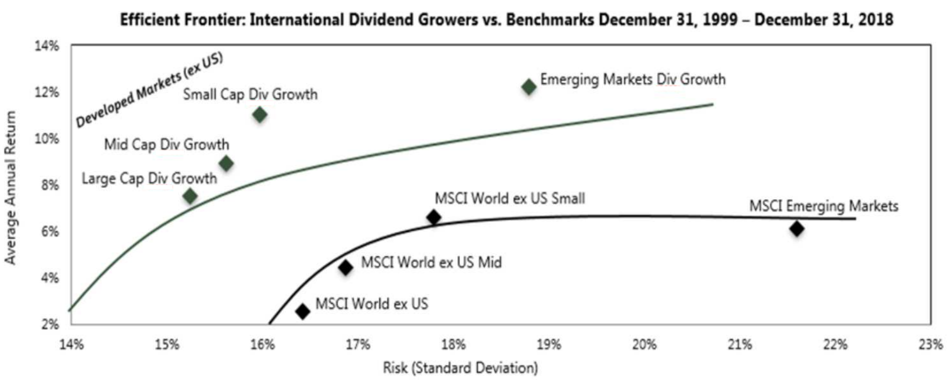
Table 1. Copeland International and Global Dividend Growth Strategies:

Higher Earnings and Dividend Growth with Reasonable Valuation

Summary As of 06/30/19	Copeland International Small Cap	MSCI World Ex US Small Cap Index	Copeland International All Cap	MSCI World Ex US Index	Copeland Global Small Cap	MSCI World Small Cap Index	Copeland Global All Cap	MSCI World Index
One-Year EPS Growth (Median)	13.0%	5.5%	10.2%	5.6%	16.7%	9.9%	17.5%	11.2%
One-Year Dividend Growth Rate (Median)	12.5%	5.3%	11.1%	6.8%	14.3%	5.4%	13.2%	7.1%
NTM P/E Ratio	18.9	16.3	16.6	14.4	20.8	19.4	19.5	16.3
Dividend Yield (Weighted)	1.9%	2.7%	2.3%	3.1%	1.7%	2.1%	1.8%	2.3%

Source: FactSet and Copeland Capital
The table above shows the median dividend growth and median earnings growth for the Copeland Dividend Growth strategies and Indexes referenced for one year. There is no guarantee that investors will experience the type of growth reflected in the information presented. The portfolio characteristics of the Indexes may differ from other providers due to the source of the data and differences in calculation methodology. Historical data does not guarantee similar future results. 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 Indexes shown above as well as other important information, please refer to the Disclosures below.

Chart 5. International Dividend Growth Efficient Frontier



Sources: FactSet/Bloomberg/Copeland Capital Management.
Past performance is no guarantee of future results. The information presented is intended to illustrate the return and volatility of International Dividend Growers broken down by capitalization compared to their respective benchmarks. Returns shown include dividends reinvested. This is not the performance of any strategy overseen by Copeland and there is no guarantee that investors will experience the type of performance reflected in the information presented. Strategies managed by Copeland's investment team are subject to transaction costs, management fees, trading fees or other expenses not represented in the information presented. For the purpose of the above graph, Dividend Growers included stocks that raised dividends for five consecutive years. Standard deviation is a measure of the variability of returns-the higher the standard deviation, the greater the range of performance (i.e., volatility). You cannot invest directly in an Index. For information on the Indices shown above as well as other important information, please refer to the Appendix.

tional Dividend Growth stocks across all market capitalization ranges to produce more attractive risk adjusted returns relative to their respective benchmarks.

The market seems to imply that the US will soon reach a trade deal with China to resolve intellectual property and other key issues, ameliorating macro and corporate trends. This is a possible outcome. Yet, in a bearish scenario, current challenges – as summarized by BASF – could intensify and further impact forward operating results.

While Buzz Lightyear is confident he can fly "to infinity and beyond," Woody is correct that Buzz is "just a toy" and cannot really fly. In a similar vein, the market will not keep going up in boundless fashion into perpetuity. Upward movement will be dictated by future earnings and dividend growth. With above average growth profiles, lower risk characteristics, and reasonable valuations, we continue to believe our Disciplined Dividend Growth approach puts clients in a strong position to outperform benchmarks over time regardless of cyclical ebbs and flows.

- July 2019

[1] *"An earnings recession looms for first time in 3 years," MarketWatch, 12 July 2019, https://www.marketwatch.com/story/earnings-recession-risk-increases-as-a-flood-of-warnings-hit-2019-07-02.*

[2] *FactSet.*

[3] *"Gross Domestic Product, First Quarter 2019 (Third Estimate)," US Bureau of Economic Analysis, 27 June 2019, https://www.bea.gov/news/2019/gross-domestic-product-first-quarter-2019-third-estimate-corporate-profits-first-quarter.*

[4] *Trading Economics, https://tradingeconomics.com/united-states/indicators.*

[5] *S&P Dow Jones Indices, CCM.*

[6] *"Why Stocks Are Hitting Records as Economic Fears Rise," New York Times, 11 July 2019, https://www.nytimes.com/2019/07/11/business/stock-market-record.html.*

[7] *IHS Markit US Manufacturing PMI™, IHS Markit, 1 July 2019 https://www.markiteconomics.com/Public/Home/PressReease/53d67f8f09fc416791d73ca523b3c5e7.*

[8] *JP Morgan Global Manufacturing PMI, HIS Markit, 1 July 2019, https://www.markiteconomics.com/Public/Home/PressRelease/f83452ee0ff14466acab4184f5c3b705.*

[9] *"Machine Tool Orders Suggests Japan Economy in Recession Territory," Japan Research, Evercore ISI Research, 9 July 2019.*

[10] *"North Korea's Weapons Program Fuels Tokyo's Trade Spat With Seoul," WSJ, 10 July 2019, https://www.wsj.com/articles/north-koreas-weapons-program-fuels-tokyos-trade-spat-with-seoul-11562757564.*

[11] *"Cass Freight Index Report," Cass Information Systems, Inc., June 2019, https://www.cassinfo.com/.*

[12] *"This yield curve expert with a perfect track record sees recession risk growing," MarketWatch, 5 June 2019, https://www.marketwatch.com/story/this-yield-curve-expert-with-a-perfect-track-record-sees-recession-risk-growing-2019-06-05.*

[13] *BASF, 8 July 2019 https://www.basf.com/global/en/media/news-releases/2019/07/p-19-268.html.*

About Copeland Capital Management — Copeland Capital Management is an employee owned, registered investment adviser with offices in Conshohocken PA, Wellesley MA and Atlanta GA. The firm specializes in managing Dividend Growth strategies for both institutions and high net worth individuals. For more information, please contact Chuck Barrett, Senior Vice President - Director of Sales and Marketing at (484) 351-3665, cbarrett@copelandcapital.com or Robin Lane, Marketing Manager at (484) 351-3624, rlane@copelandcapital.com.

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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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The Indexes mentioned are unmanaged, are not available for investment and do not incur expenses. With respect to the comparison of the Copeland strategies to their comparative benchmarks, the number of holdings and volatility of an unmanaged Index is different from that of an actively managed portfolio of Dividend Growth stocks. The **S&P 500® Index** is a market-capitalization-weighted index of the stocks of 500 leading companies in major industries of the U.S. economy. The **CBOE Volatility Index® (VIX® Index®)** is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. The **MSCI World Ex-US Small Cap® Index** captures small cap representation across 22 of 23 Developed Markets (DM) countries (excluding the United States). With 2,437 constituents, the Index covers approximately 14% of the free float-adjusted market capitalization in each country. The **MSCI World Ex-US® Index** is a market capitalization-weighted index designed to provide a broad measure of stock performance throughout the developed world, excluding U.S. stocks. The **MSCI World® Index** is a market cap weighted stock market index of 1,653 stocks from companies throughout the world. **The MSCI World Small Cap® Index** captures small cap representation across 23 Developed Markets (DM) countries. With 4,320 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country.

Definitions

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

Dividend Yield – The company's total annual dividend payments divided by its market capitalization, or the dividend per share, divided by the price per share.

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

Net Income – Net Income is equal to net earnings (profit) calculated as sales less cost of goods sold, selling, general and administrative expenses, operating expenses, depreciation, interest, taxes and other expenses. This number appears on a company's income statement and is an important measure of how profitable the company is.

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.

Copeland's fees can be found in our ADV Part 2 which is available by calling (484) 351-3700 and requesting a copy, or on our website at www.copelandcapital.com.

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