The Copeland Review

Third Quarter 2023

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

Surprise!

Clark Griswold: Surprised, Eddie? If I woke up tomorrow with my head sewn to the carpet, I wouldn't be more surprised than I am right now.

"National Lampoon's Christmas Vacation," Warner Bros., 1989

Readers who have seen "Christmas Vacation," will recall that by the time the well-intentioned, but half-witted Cousin Eddie arrives at the Griswold's home, Clark's plans for a "good old fashioned family Christmas" are already in the rearview mirror. Nevertheless Eddie, and his family, manage to take the fiasco to another level.

Despite more than a year of aggressive interest rate hikes, the third quarter started strongly, with both US and international markets rallying through July as investor optimism for the end of monetary policy tightening gained steam. By the end of the period, however, with both domestic and global stock indices pulling back, and interest rates running to multi-decade peaks, faith in the once-popular soft-landing outlook moderated.[1] Instead, investors found themselves nervously waiting for the arrival of a "Cousin Eddie style event" – a specific economic debacle that would definitively signal the recession for which they'd long been waiting was finally upon them.

In this issue of the *Copeland Review*, we highlight several key ideas for investors as they attempt to navigate the current environment:

1. **Surprise! The party is in the rearview mirror:** Investors searching for a singular piece of bad news – arriving like Cousin Eddie to derail the economy or the market – are overlooking already weak data across multiple sectors. While the National Bureau of Economic Research (NBER) has yet to confirm an official recession, the effects of the Federal Reserve's (Fed) tightening campaign are increasingly apparent.
2. **Weak macro data does not closely correlate with "market" returns:** While major equity indices have rebounded off the lows of a year ago, the third quarter finished with a whimper, leaving most stocks down materially from their 2021 highs. The strength of a few large cap technology stocks have masked greater weakness among most stocks.[1]
3. **Elevated risks call for a dividend growth approach:** The recent strength in equity returns has not been universally enjoyed. Instead, we have seen significant performance divergences across style, size, and sector. Still, as shown in Chart 7, employing a dividend growth approach has helped to smooth that return pattern over the last two years – offering a favorable balance of downside protection, while also capturing meaningful upside – just as it tends to do historically.

Surprise! The party is in the rearview mirror

Aunt Bethany: What's that sound?...It's a funny squeaky sound.
Uncle Lewis: You couldn't hear a dump truck drive through a nitroglycerin plant.

In last quarter's review, "The Song Remains the Same", we called out a Fed research paper which noted that, historically, the impacts of aggressive monetary tightening peak a year or two *after* the "contractionary shock." Though the most recent Fed forecast calls for one more interest rate hike before year-end, we believe that the tightening seen in the current cycle – 525 basis points from March 2022 through July 2023 – is already having a real economic impact across multiple sectors.[2,3] Below are just some of the challenges that we have observed. Note the breadth of industries that have already suffered.

Often the most obvious place in which investors observe the impact of interest rates is the real estate market, and that's true today as well. After 40 years of steady declines, residential mortgage rates have spiked sharply over the last 18 months and are now back at levels not seen since late 2000 (Chart 1).[4]

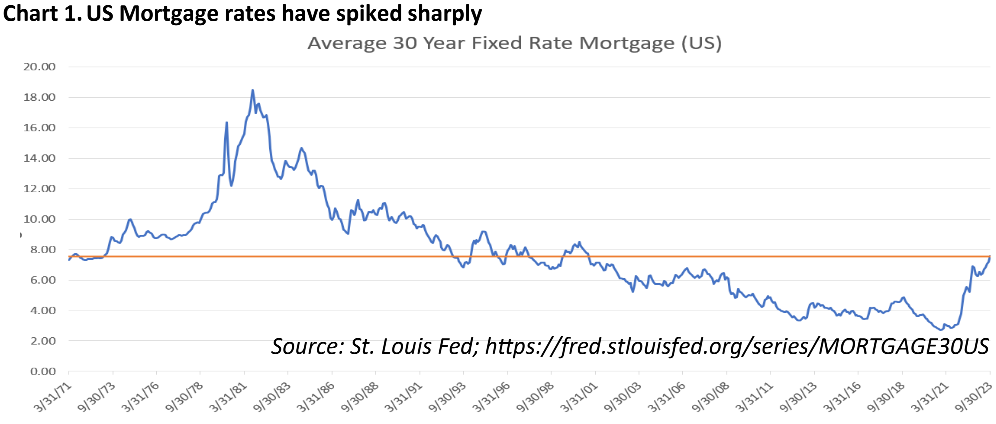
In response, mortgage applications are at 28-year lows and US existing home sales are near 2009 levels as shown in Chart 2.[5,6] Commercial real-estate activity has not fared any better, with industrial transactions down 52% year-to-date and multi-family construction starts down 32% in September.[7]

Real-estate is not the exclusive purview of bad news though.

- Investment banking activity has stalled. The number of IPOs is on pace to end the year near its 2009 low and M&A transaction volume has receded to 2013 levels.[8,9]
- Transportation rates have plunged. Trucking spot rates are near ten-year lows and the largest global container index has slipped more than 80% from its 2021 peak.[10,11]
- The consumer is strained. Both the RV and boat industries are projecting unit sales to finish 2023 at their lowest level in nine years. Meanwhile credit card company net charge-off and delinquency rates are rising rapidly, and balances sit at all-time highs.[13,14]

Of course, there are some strong economic readings. Employment has been persistently robust, with average hourly earnings up 4.2% in the year ended September 30th and almost 20% higher than at the end of 2019, while unemployment – at 3.8% -- is only marginally above the cycle low of 3.4%. Further, estimated third quarter GDP (Gross Domestic Product) increased at a remarkable 8.5% rate or 4.9% on an inflation-adjusted basis.[15,16,17]

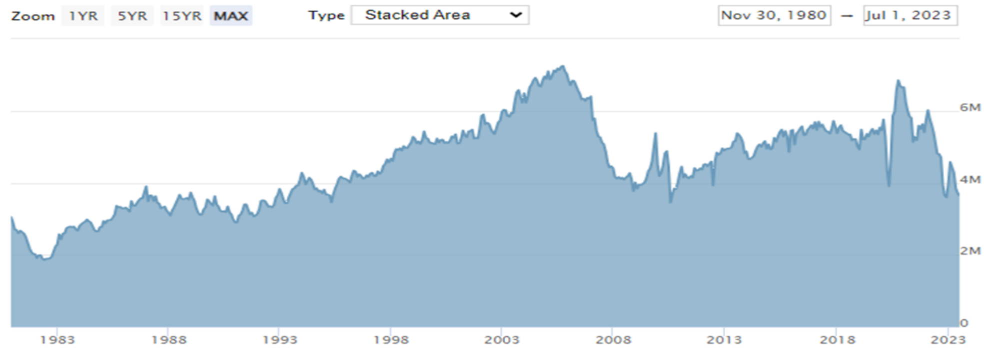
Chart 1. US Mortgage rates have spiked sharply



Nevertheless, we find arguments in support of continued economic strength that are predicated on employment and GDP data underwhelming. These metrics are typically lagging, not leading, economic indicators. Alternatively, the collection of observations listed above strikes us as "the dump truck in the nitroglycerin plant" – impossible to ignore as it alerts investors in no uncertain terms that the economy is slowing materially.

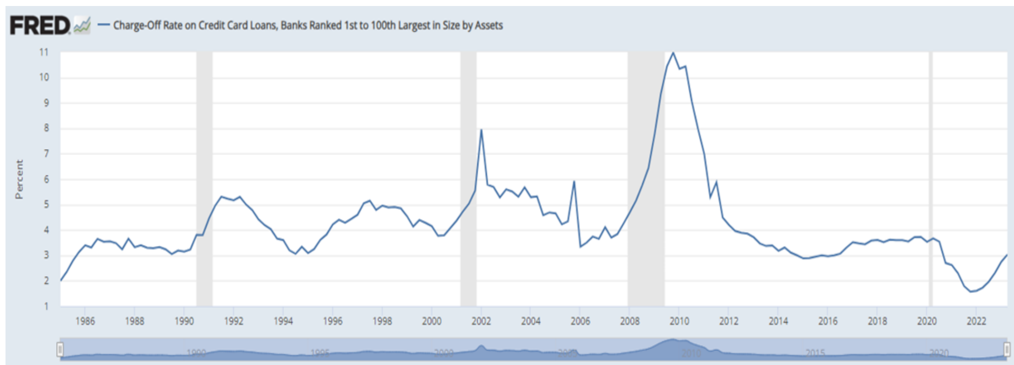
These pressures are only compounded by the recent escalation of conflict in the Middle East. In response, oil prices moved higher, and concerns about the deficit – already over $2.0T – worsened, as the US pledged to provide military support in addition to its ongoing contributions in Ukraine.[18,19] If the considerations above are not sufficient to raise alarm, recall that in both 1973 and 1990, the US economy found itself in a similarly precarious economic position, only to be tipped into recession by spikes in oil due to conflicts in the Middle East. True, on the plus side, the US has reduced its dependence on foreign oil over the subsequent decades. However, the US Strategic Petroleum Reserve was drawn down last year and now holds only 17 days of supply – approximately one half of its historical average – leaving limited flexibility in the event of a price spike.[20,21]

Chart 2. Existing home sales have fallen sharply



Source: Mortgage News Daily, https://www.mortgagenewsdaily.com/data/existing-home-sales

Chart 3. After falling to all-time lows, credit card charge-offs are rising rapidly



Source: St. Louis Fed; https://fred.stlouisfed.org/series/CORCCT100S

Weak macro data does not closely correlate with "market" returns

Seemingly against all odds, given the data points called out above, both US and non-US equity benchmarks were down only modestly in the most recent quarter, and actually rose over the last 12 months, including the S&P 500 and MSCI EAFE Indices both popping more than 20%. Readers might recall that we referred to this phenomenon of the market moving opposite of the economic data as "The Costanza Market" in this piece one year ago.[1]

Even more striking perhaps is the fact that the strength of the indices cannot be traced to the earnings outlook, with all three US indices' earnings estimates moving lower over the past year and the MSCI EAFE Index earnings estimate rising only marginally (See Chart 4).[1]

Nor can these favorable results be attributed to a supportive interest rate environment. In fact, after two separate pullbacks in the fourth quarter of 2022 and the first quarter of 2023, both the two-year and ten-year US Treasury yields broke out to fresh cycle highs, finishing the third quarter at levels not seen since 2007.[1]

Instead, the gains accrued by just seven stocks – the so-called Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla), which we touched on in "The Song Remains the Same" – have carried the day. With an average market capitalization of $1.5T at the end of the period, and a collective market cap weighted return of 38% over the trailing 12 months, these names provided a significant performance boost to the S&P 500 Index, versus the remaining 493 names – with an average market cap of $56B – which returned only 17%. In fact, despite accounting for less than 25% of the total market cap of the S&P 500 Index as of September 30, 2022, the Magnificent Seven drove nearly 50% of all gains within the index over the ensuing twelve months.[1]

No doubt, the Magnificent Seven companies have been successful in recent years, capturing market share and delivering innovative new products. Those things are in the rearview mirror however, and it might surprise investors to learn that – rather than strong earnings momentum – their year-to-date performance mostly reflects massive valuation expansion, with the collective price-to-earnings ratio rallying from 29x to 45x in only nine months. Meanwhile, the remaining companies in the S&P 500 Index – colloquially known as the "S&P 493" – have seen virtually no valuation change, with their average price-to-earnings (P/E) stagnating at 19x, as illustrated in Chart 5.

On the other hand, the average S&P 500 constituent stock – down 10% – and the S&P 600 Small Cap Index – down 19% – from their respective highs better reflect the developing economic weakness noted previously.[1]

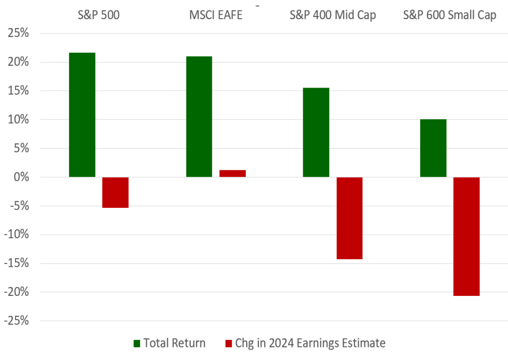
Elevated risks call for a dividend growth approach

Clark: WORSE? How could things get any worse? Take a look around here, Ellen. We're at the threshold of hell.

As the last two years prove, any short-term connection between economic and market performance is tenuous at best. Maybe we really are "at the threshold of hell" today. If so, in a year the Fed will likely have cut interest rates aggressively, and perhaps stocks will have found support, even if economic weakness persists – another leg in "The Costanza Market," if you will.

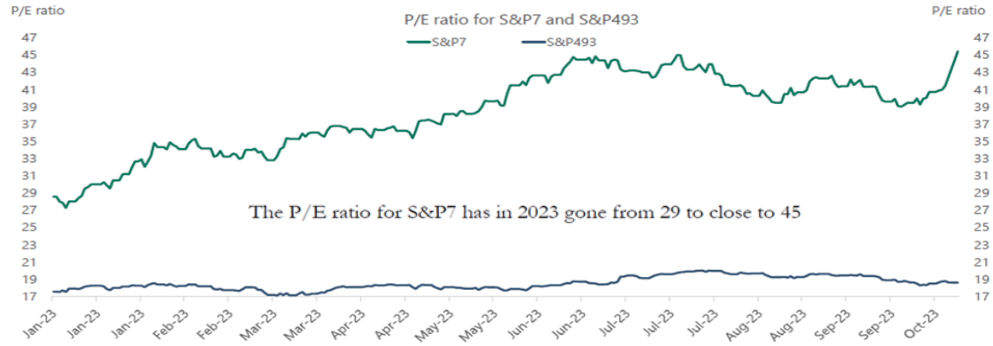
Yet, there's certainly no guarantee of this outcome. For one thing, the current Middle East conflict is likely to put further upward pressure on energy prices. This will in turn prevent inflation from moderating as rapidly as it otherwise would and will provide incremental support to the "higher for longer" narrative for the Fed Funds rate. Moreover, even if one could accurately call the directions of both the economy AND the market, Chart 6 illustrates that the "stock market" is not a monolith. There are often substantial performance divergences along the lines of growth versus value, by economic sector, and between small caps and large caps. Such divergences can easily derail the return

Chart 4. Benchmark returns have bounced but earnings have not



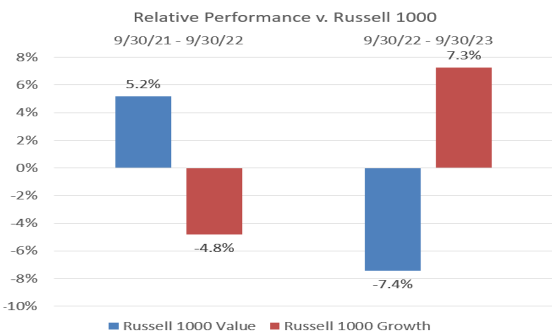
Source: CCM, FactSet. The Indexes mentioned are unmanaged, are not available for investment and do not incur expenses.

Chart 5. The Magnificent Seven is benefitting from valuation gains; other stocks are not[23]



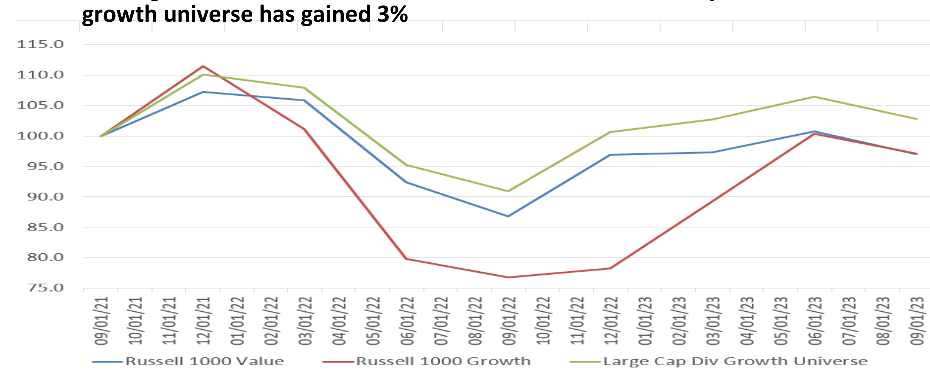
Source: Apollo; https://apolloacademy.com/p-e-ratio-for-sp7-vs-sp493/#:~:text=And%20the%20P%2FE%20ratio,become%20more%20and%20more%20overvalued

Chart 6. Growth and value leadership has flip-flopped



Source: FactSet. The Indexes mentioned are unmanaged, are not available for investment and do not incur expenses.

Chart 7. While growth & value are both down -3% over the last two years, the dividend growth universe has gained 3%



Source: Source: FactSet, Ned Davis Research. A stock is classified as a ***Dividend Grower*** *if it initiated or raised its existing cash dividend at any time during the previous 12 months. The Indexes mentioned are unmanaged, are not available for investment and do not incur expenses.*

experience of investors who attempt to call them correctly, even when "the market" – as measured by the major indices – appears to be working in their favor.

These wild swings in performance highlight why, at Copeland, we believe that employing a dividend growth approach is so attractive. Our "all-weather" strategy is designed to provide a smoother return pattern relative to the dramatic shifts in investor preferences shown above, and thus to attempt to drive a favorable risk-reward balance over time.

Consider the last two years. Above, we showed the year-by-year relative performance of value versus growth stocks. In spite of the significant variance in the return pattern from year-to-year, when we look at the two-year performance, results are nearly identical with both the Russell 1000 Growth and Russell 1000 Value indices falling -3.0%. In Chart 7, we compare those results to the performance of the universe of dividend growth stocks. With less downside in the earlier period, and solid upside capture in the more recent timeframe, the dividend growers gained 3%.

Given the unpredictability of the economy, and its inconsistent correlation with market returns, at Copeland we'll happily avoid the prognostications that continue to frustrate most investors. Instead, we'll endeavor to find companies with consistent track-records of dividend growth backed by business models that generate consistently growing cash flows, have limited capital requirements, and drive strong returns on capital due to their competitive positions. Looking forward, with considerable potential for surprises on the horizon, we believe the advantages of such companies are likely to be as compelling as ever.

October 31, 2023

[1] *Factset*
[2] *https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20230920.pdf*
[3] *https://www.forbes.com/advisor/investing/fed-funds-rate-history/*
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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

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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