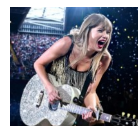
The Copeland Review

Third Quarter 2024

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

Shake it Off

'Cause the players gonna play, play, play, play, play
And the haters gonna hate, hate, hate, hate, hate
Baby, I'm just gonna shake, shake, shake, shake, shake
I shake it off, I shake it off



"Shake it Off" by Taylor Swift, 2014

Shake it Off

The resilience of US equity markets year-to-date is impressive. Optimism is underpinned by a massive surge in US infrastructure investment, artificial intelligence (AI) enthusiasm, and still low unemployment. Also, investors are embracing a "don't fight the Fed" mindset following the Federal Reserve's (Fed) mid-September shift to supportive monetary policy. Meanwhile, real US GDP growth keeps plugging along around 3%[1] and there is a sense that the economy has escaped "the recession that never was."[2]

At the same time, we see daily headlines of ongoing wars, technological disruption, and mounting government budget deficits, plus a highly contested presidential election cycle. Even with Taylor Swift's endorsement of Democratic candidate Kamala Harris, recent polling implies a toss-up between Harris and former President Donald Trump.[3] Under the hood, many businesses and consumers continue to struggle with sticky inflation and the lingering impacts of significantly higher borrowing costs. As a consequence, year-to-date earnings results have been mixed, with downward revisions especially pronounced among smaller companies.[4]

Yet, like Taylor's song, investors have shaken off the negative noise, convinced that a "soft landing" has been – or will be – achieved. In this Review, we highlight several key themes:

1. Players gonna play: Animal spirits have been rekindled on the back of global interest rate cuts, robust US infrastructure spending, and the push toward onshoring, along with the rapidly evolving AI frenzy.

2. Haters gonna hate: Risk of elevated government deficits and debt, election concerns, fears of a recession, mixed earnings trends, and geopolitical risks.

3. I'm just gonna shake: Through it all, Copeland stays the course – always honing in on dividend growth companies – whereby, we believe, our investment strategy tends to: (a) offer a significantly higher pace of growth relative to respective benchmarks, (b) provide safety in a hard landing scenario, and (c) outperform during periods of falling interest rates.

"Players Gonna Play"

Not long ago, pundits were calling for a recession.[5] Now, the prediction is for a "soft landing," especially with the Fed's recent half point reduction to the target rate and expectation for further cuts ahead. Chair Powell and team are being praised for achieving their stated goal, much like Simone Biles and the US Olympic gymnastics team did last summer, sticking the landing and winning the gold.[6]

The Fed's shift and projected downward path of interest rates led to an immediate surge in equities. Stocks of smaller cap companies, along with those in capital-intensive sectors such as real estate, banks, and utilities, bounced the most. Lower funding costs can improve bottom-line results and drive renewed transactional activity, as well as support higher valuations.

In addition to expected benefits of incrementally lower borrowing costs, investment in new US manufacturing capacity is surging (Chart 1). A good portion of the uplift can be attributed to government stimulus programs of the last few years. Yet, according to Raymond James, less than 25% of the $1.1 trillion authorized for direct investment has been utilized to date.[7] Gradual allocation of the remaining dollars should add support to the broader US economy and may have healthy multiplier effects that boost ancillary sectors and jobs.

Simultaneously, American ingenuity remains alive and well. The private sector has poured tens of billions into the promise of evolving AI technology. An incredible acceleration in data center construction is underway which, in turn, is driving a step change in demand for utility power – even nuclear – and related transmission infrastructure. These themes are long-tailed and will also benefit numerous companies across many industries.

"Haters Gonna Hate"

For all the positive themes, challenges persist, and some are interrelated. For example, the Fed's gymnastics over the last several years may have been less dramatic – or even unnecessary – had the government not provided more than nine trillion dollars in combined fiscal and monetary stimulus in response to the pandemic.[8] According to the Fed's own research, the massive fiscal injection contributed to "depletion of inventories, pronounced bottlenecks, and ultimately inflation."[9]

Two quarters ago, in "It Just Doesn't Matter," we highlighted that Federal spending on interest expense and "mandatory" outlays were increasingly likely to squeeze the ability to invest in "discretionary" areas such as education, research, defense, and even infrastructure. To this point, crowding out has not occurred because of evermore borrowing, leading to record debt levels and interest expense. Indeed, for the Federal fiscal year ended September 2024, net interest on public

Chart 1. Boom in Manufacturing Construction Spending

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

debt amounted to 14% of annual Federal outlays and, for the first time, surpassed defense spending.[10]

A new US President may exacerbate the situation regardless of the outcome. On one hand, Vice President Harris supports higher taxes on high earners, corporations, and buybacks, as well as an expanded government role in health care and housing.[11] On the other, former President Trump supports "large tax cuts" but also the implementation of "baseline tariffs on foreign-made goods."[12] The merits – or demerits – of such proposals can be debated. Yet, a unified view of their potential impacts is emerging, namely higher government deficits and debt.[13]

Meanwhile, the corporate earnings trend has been mixed. Certain sectors such as technology and financials have fared better, while others such as energy, health care, materials, and industrials have experienced deteriorating earnings. In aggregate, expected 2024 earnings for large- and mid-sized companies are little changed from the start of the year.[14] By contrast, the aggregate estimate for smaller companies is 24% lower than the original expectation.[4]

Now, the expectation is that 2025 will bring a resurgence in growth, especially for smaller companies and sectors that are currently challenged. Yet, forward expectations may prove optimistic. Although consumer spending and employment remain solid, trends are not strong. Consumer sentiment remains at recessionary levels[15] – squarely at odds with higher stock prices – and household budgets are still strained by higher prices.[16] As an example, Bank of America's aggregated credit and debit card spending per household fell 0.9% year-over-year for the month of September.[17]

On the corporate side, small business uncertainty for the month of September was at an all-time high.[18] At the same time, the NFIB Optimism index has been stuck below the 50-year average for 33 consecutive months. The net result is leading to lower-than-average capital expenditures and fewer job openings at smaller companies.[18] This matters more broadly since 55% of US net job creation from 2013 through 2023 was by small businesses.[19]

On a separate note, recall the infamous inverted US yield curve, which historically has presaged a recession. The "10-2" curve recently reverted upward – e.g. the yield on the 10-year Treasury bond is, at last, higher than the two-year Treasury bond. In each of the last three reversions dating to the early 1990s, a recession ensued shortly thereafter (Chart 2).[4] This historical correlation likely occurs because the Fed is typically cutting rates in reaction to weakening macroeconomic conditions.

Finally, geopolitical strife is elevated as two wars rage in the Middle East and Eastern Europe. At the same time, trade relations with China are increasingly strained. These challenges will likely continue to impact global trade as well as supply chain and input costs.

"I'm Just Gonna Shake"

Meanwhile, the equity market keeps shaking off risk factors, climbing the perennial "wall of worry" and looking to the future. Indeed, positive drivers may provide continued economic support to offset pockets of weakness. Yet, the amorphous "soft landing" narrative does not necessarily imply growth, but – rather – simply no harsh contraction. Hopes for a broad, robust earnings recovery in 2025 could be dashed if realization is again delayed for a wide swath of companies.

Regardless of market conditions, we believe that dividend growth stocks are poised to "shake it off" for several reasons. First, across Copeland's strategies, our portfolio holdings continue to deliver a meaningfully higher pace of dividend growth relative to respective benchmarks (Chart 3). The deltas are consistent with our historical dividend growth advantage.

Next, a consistently rising dividend is usually made possible by competitively advantaged business models that tend to have high profitability and strong balance sheets. The combination of these characteristics enables upside participation in an upward moving market while also providing downside protection should a recession scenario come to the fore.

Finally, dividend growth stocks tend to outperform during periods of falling interest rates (Chart 4). Historically, periods of declining rates often accompany weakening economic conditions. Under these circumstances, we believe investors are again likely to favor higher quality, dividend growth companies.

"Keep cruisin'" with Dividend Growth

At present, the balance of good and bad news is precarious, while the corporate earnings outlook remains fluid, and the election outcome is uncertain.

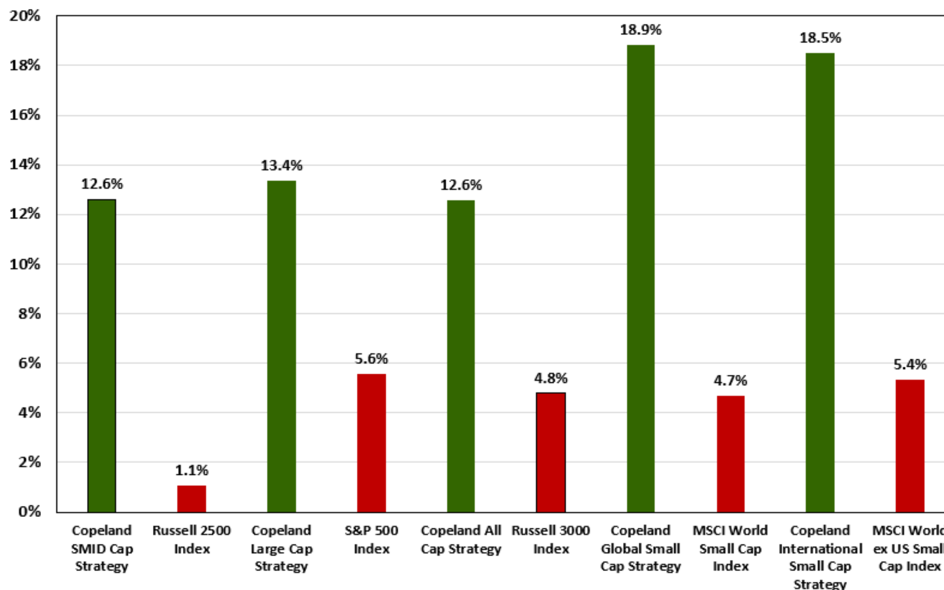
Chart 2. Last Three Reversions of Yield Curve Preceded Recession

Understanding the fundamental puts and takes at the company level is our emphasis, zeroing in on each company's underlying ability to support a consistently higher dividend. Rather than rely on a forecast that may prove inaccurate, we pay special heed to dividends and their growth, both of which inform equity valuations and performance. Further, a corporate dividend action is a tangible, real-time indication of strength or weakness, confidence or concern.

Importantly, we believe Copeland's portfolio companies are positioned with healthy earnings and dividend growth potential. Alongside other favorable attributes, this combination should aid performance over the full market cycle. As Taylor continues in her song, we believe dividend growth stocks can "keep cruisin', can't stop, won't stop groovin'."

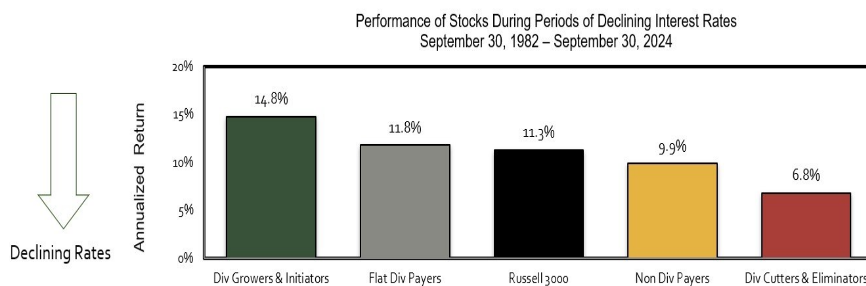
October 2024

Chart 3. Copeland's Growth Advantage – Pace of One-Year Dividend Growth versus Respective Benchmarks as of September 30, 2024



Source: FactSet, Bloomberg and Copeland Capital Management. The information presented is intended to compare the holdings by dividend policy of Copeland strategies and their respective benchmarks. For US companies, the bars represent the weighted last-twelve-month pace of dividend growth. For international companies, the bars represent the weighted pace of dividend growth during the most recently completed fiscal year. Dividend Growers included stocks that raised their existing dividend or initiated a new dividend during the previous 12 months. 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.

Chart 4. Performance of Smid Cap Dividend Growers in Declining Rate Environments as of September 30, 2024



Source: Copyright 2024 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. The information presented is intended to illustrate performance of Smid Cap stocks according to their dividend policy during periods of rising and declining interest rates as determined by the Fed Funds rate. 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. Dividend Growers included stocks that raised their existing dividend or initiated a new dividend during the previous 12 months. Flat Dividend Payers included stocks that pay a dividend but have not raised or lowered their existing dividend during the previous 12 months. Non-Dividend Payers included stocks that have not paid a dividend during the previous 12 months. Dividend Cutters included stocks that lowered their existing dividend or eliminated their dividend during the previous 12 months. 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.

[1] *BEA https://www.bea.gov/data/gdp/gross-domestic-product*

[2] *Reuters https://www.reuters.com/markets/global-markets-recession-analysis-2024-01-11/*

[3] *https://www.realclearpolitics.com/*

[4] *FactSet*

[5] *NYTs https://www.nytimes.com/2024/01/26/business/economy/economy-recession-soft-landing.html*

[6] *https://results.nbcolympics.com/gymnastics/womens-team/final/2689481*

[7] *"How Much Fiscal Stimulus is Left? (Hint: More Than You Think)," Raymond James, Washington Policy Research, 10/4/24*

[8] *NYTs https://www.nytimes.com/interactive/2022/03/11/us/how-covid-stimulus-money-was-spent.html; Federal Reserve https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm*

[9] *Federal Reserve https://www.federalreserve.gov/econres/notes/feds-notes/fiscal-policy-and-excess-inflation-during-covid-19-a-cross-country-view-20220715.html*

[10] *CBO https://www.cbo.gov/publication/60730/html#total-receipts-up-by-11-percent-in-fiscal-year-2024*

[11] *Kamala Harris https://kamalaharris.com/issues/*

[12] *Donald J. Trump https://www.donaldjtrump.com/platform*

[13] *WSJ https://www.wsj.com/politics/policy/trump-plan-boosts-budget-deficits-by-7-5-trillion-double-harris-proposal-526effd2?st=YGZtAE&reflink=desktopwebshare_permalink*

[14] *FactSet using estimates for the S&P 500 Index, the Russell Mid Cap Index, and the Russell 2000 Small Cap Index*

[15] *Trading Economics https://tradingeconomics.com/united-states/consumer-confidence*

[16] *Bankrate https://www.bankrate.com/insurance/homeowners-insurance/cost-of-living-statistics/?tpt=b#cost-of-living-by-state*

[17] *"Consumer Checkpoint," Bank of America Institute, 10/10/24*

[18] *NFIB https://strgnfibcom.blob.core.windows.net/nfibcom/SBET-Sept-2024.pdf*

[19] *BLS https://www.bls.gov/opub/ted/2024/small-businesses-contributed-55-percent-of-the-total-net-job-creation-from-2013-to-2023.htm*

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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

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

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