Market Overview

In the third quarter of 2023 (Q3), global equity markets grappled with a combination of positive and negative forces. They ultimately concluded in a summertime decline driven by ongoing concerns about inflation, which continued to exceed target levels. Oil prices surged by more than 30% over the past three months, as OPEC (Organization of the Petroleum Exporting Countries) members deepened their supply cuts due to concerns about global demand. Despite the Federal Reserve Bank (Fed) opting for a 25 basis points (bps) hike during its July meeting, pushing the rates to 5.50% (the highest it has been in 22 years), there were still fears that the underlying inflationary pressures would remain sticky for a while. However, after the Fed’s September meeting, the market sentiment quickly swung from soft landing relief to concerns about “higher for longer” rates.

Meanwhile, the economic recovery stalled in China as data indicated a weaker property market, further amplifying concerns among global investors regarding potential worldwide consequences. In Europe, policymakers faced a dilemma from rising inflation, high borrowing costs and the impact of the downturn in China. Against this backdrop, the European Central Bank (ECB) decided to raise its key interest rate to 4%, immediately sending a message that the hiking cycle had reached its tail end. Despite this prevailing market volatility, recent economic indicators demonstrated consumer-driven resilience, suggesting continued growth, notwithstanding the burden of higher interest rates. Wage pressures gradually eased, signalling a more balanced supply and demand and instilling confidence that labour markets may continue to cool off. Amid the challenging supply-chain landscape, the U.S. ISM Manufacturing Purchasing Managers’ Index (PMI) showed signs of improvement, reflecting a move toward recovery driven by an increase in factory employment and a rise in new orders. However, it should be noted that U.S. ISM Services PMI contracted, led by a decline in non-manufacturing new orders, contributing to the aforementioned market volatility.

Value stocks demonstrated notable resilience compared to their pricier growth counterparts, buoyed by a robust performance in the Energy sector. Despite facing the negative energy shock and higher rates, growth stocks had significant outperformance when considering performance year-to-date. In this climate, economic and earnings growth forecasts, which faced downgrades earlier in the year, have adjusted upward, and concerns about a significant near-term economic downturn have been muted.

In Canadian dollar terms, both the MSCI World Index and S&P 500 Index ended the quarter down approximately 1%. The best-performing sectors were the Energy, Communication Services, and Financials, while Utilities, Real Estate, and Consumer Staples lagged.

Quarter in Review

On a sector level, Health Care was the largest contributor to relative performance. Positions in Novo-Nordisk, AbbVie, Amgen and United Health Group led to a positive stock selection effect. Oil rallied this quarter and the mandate’s overweight in Energy led to a positive allocation effect. Strong performance from Costco led to a positive selection effect in the Consumer Staples sector. An underweight in Utilities led to a positive allocation effect in the Utilities sector.

In the Communications sector, a continuation of the rally in benchmark heavy names Alphabet and Meta outperformed. The mandate’s positions in Verizon, BCE and Telus led to a negative stock selection effect. Positions in ASML and Apple led to a negative stock selection effect in the Information Technology sector. In the Industrials sector, Waste Management and Schneider Electric positions led to a negative stock selection effect.

Positions in LVMH and McDonald’s led to a negative stock selection effect in the Consumer Discretionary sector. In the Financials sector, RBC underperformed the sector and led to a negative stock selection effect.

There were no transactions in the third quarter.
Outlook and Positioning

Focusing on companies with positive earnings growth coupled with strong dividend growth, in an environment that has seen declining earnings, is imperative. Dividend growth predictions came down since the end of 2022, but are on the rise near the end of 2023 and into 2024. In the U.S., our models predict the strongest dividend growth from the Consumer Discretionary sector with the lower dividend growth from Utilities and Communications. Dividend growth estimates have a wider sector dispersion in Europe with Financials, Energy and Consumer Discretionary being the strongest sector, and Materials and REITs the lowest for dividend growth forecasts. With AI predictions of EPS flat-lining and starting to increase near the end of 2023 and the beginning of 2024, dividend growth is following the same trajectory. EPS looks stronger in the U.S., but we are also seeing a bottoming in Europe and strength beginning near year-end. In Europe, we favour the higher-yielding companies with a low probability of dividend cuts, while in the U.S., we are more positioned for dividend growth. Over the past 12 months, 100% of the companies in our portfolio have increased their dividends.

The mandate is overweight the Energy, Consumer Staples and Health Care sectors and underweight the Consumer Discretionary, Communication Services, Financials and Utilities sectors. Regionally, the mandate has approximately 35% weight in Europe, 64% in North America and 1% in Asia and the Pacific Basin.

After years of muted performance versus other equity styles, we believe it is time to consider the duration and credit cycles within the dividend asset class. We believe dividends offer the best of many worlds through owning companies that can continue to reward shareholders through dividends, buybacks and debt reduction, combined with careful consideration of stock and sector allocations.