



A Franklin Templeton Company

Dividend Growers Hedge Against Trump Bump to Inflation

Key Takeaways

- ▶ The combination of healthy economic data and Trump's election win have resulted in meaningful changes to interest rate expectations.
- ▶ As investors move beyond the first-order effects of Trump's victory — pro crypto, pro fossil fuels, etc. — they will need to position for the second-order effects of the new world order: higher costs, lower margins, higher rates and higher inflation.
- ▶ Dividend growers are well-positioned to navigate the evolving landscape but are under-represented in the broad market indexes, creating an opportunity for active management.

There Will Be Second-Order Effects to Trump 2.0

Trump won — buy crypto! Trump won — buy energy stocks! Trump won and will loosen regulations on financial companies — buy bank stocks!

Since the election, investors have piled into sectors expected to benefit from the second Trump administration. As we turn the page on 2024 and the joy of these quick gains subsides, equity investors will have to think through the second-order effects of Trump's presidency and position accordingly.

A second Trump presidency should be good for domestic energy production, but is higher production good for energy prices and thereby producer profits? Robust tariffs should raise import prices and thereby encourage reshoring. But, if corporations moved those jobs overseas to cut costs and save money, doesn't bringing them back invariably mean rising costs and lower profits? Deporting millions of undocumented immigrants may prove politically popular, but won't removing millions of workers from a labor market that is already tight inevitably lead to higher employment costs and inflation?

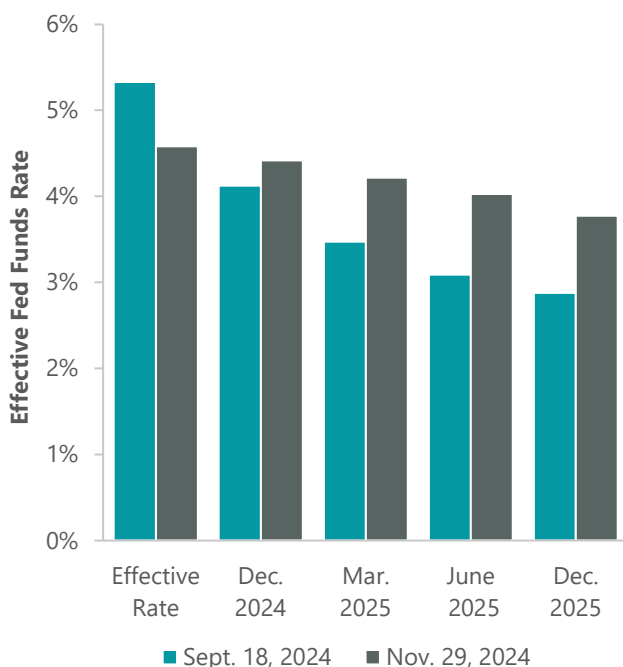
One thing seems clear: to the extent that Trump is successful in bringing manufacturing jobs home and sending undocumented immigrants packing, inflation will be permanently higher. There is no way around it: globalization benefited investors at the expense of

workers. Companies substituted higher-paid U.S. workers with lower-paid, foreign replacements, reducing wages and hurting U.S. workers, while expanding profits and benefiting shareholders.

Deglobalization will certainly have some benefits. Bringing manufacturing jobs back to the U.S. will be good for U.S. workers; by some measures the middle class has seen little real wage growth in several decades. Increasing labor costs will reduce margins and come directly out of shareholders' pockets, but it will benefit society as it reduces inequality. Reshoring manufacturing and unwinding globalization could also result in structurally higher U.S. GDP growth. The middle class has a far higher propensity to consume than the wealthy. So, as money is shifted to the working class from the rich (via higher wages and lower profits), more of that money should end up being spent, propelling economic activity.

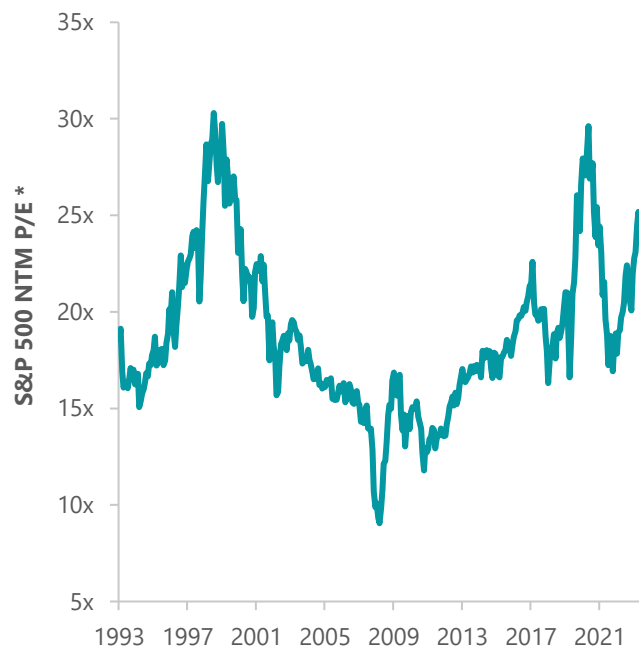
At the same time that the market has been processing the implications of Trump's victory, economic data has come in better than expected. While it previously seemed a slowing economy would give the Fed space to significantly cut interest rates, recent data suggests the economy remains robust. The combination of healthy economic data and Trump's election win have resulted in meaningful changes to interest rate expectations (Exhibit 1).

Exhibit 1: Expectations of Higher Rates Have Risen Since Election



As of Dec. 3, 2024. Source: ClearBridge Investments, Bloomberg Finance.

Exhibit 2: Market Valuations Are Looking Full



As of Nov. 29, 2024. Source: ClearBridge Investments, Bloomberg Finance.
*Excludes negative earnings.

With the market at all-time highs, valuations on the fuller side (Exhibit 2) and interest rate expectations becoming less dovish, investor positioning must become more nuanced. The economy is healthy, Republicans should provide help on taxes and several sectors should benefit from regulatory changes under the incoming Trump administration. Consequently, corporate earnings in 2025 should also be healthy. But security analysis requires more than just forecasting earnings; investors must also decide how to value that stream of earnings.

Parsing the net impact of a Trump presidency is complicated. Trump's economy should entail higher wages, higher consumer spending and higher U.S. growth, but also lower margins, higher inflation and higher interest rates. Higher growth, higher wages and reduced inequality are invariably good for the top line and good for society. But lower margins, higher inflation and higher interest rates all augur for lower multiples on investments.

As we look to 2025 and position for this brave new world, the case for high-quality dividend payers — companies that are typically leaders in their sectors, with strong balance sheets, low debt, recurrent predictable revenues and economic moats — has almost never seemed stronger. High-quality dividend payers possess three key attributes critical for times like these: downside protection, current income and growth.

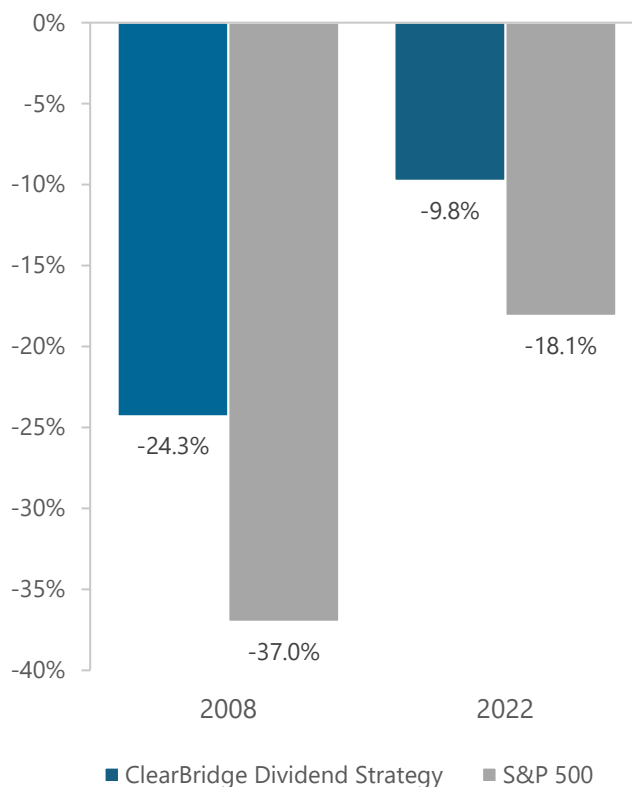
Downside protection: After a two-year period in which the market has soared over 60%, stocks may be extended. Dividend payers, such as those targeted by the ClearBridge Dividend Strategy, tend to outperform during turbulent periods as investors gravitate toward the safety of their healthy payouts (Exhibit 3).

Current income: In big bull markets people tend to overlook dividends. When a handful of mega cap growth stocks drive the preponderance of equity market performance, people predictably focus on capital appreciation. But bear markets remind us that dividends — albeit prosaic — are responsible for 40% of total return over the long term. In flat-to-down markets, meanwhile, dividends provide a cash flow return to investors that offsets share price stagnation or depreciation.

Growth: While strong upfront yield is attractive, the real power of equity is in its long-term compounding and growth. Unlike bonds, which typically offer fixed coupons, dividends have the potential to offer rising cash flow streams over time. Dividend growth is great in regular periods, but absolutely critical during inflationary periods. As inflation erodes the value of a dollar, growing dividends help to maintain purchasing power despite the increasing cost of living (Exhibit 4).

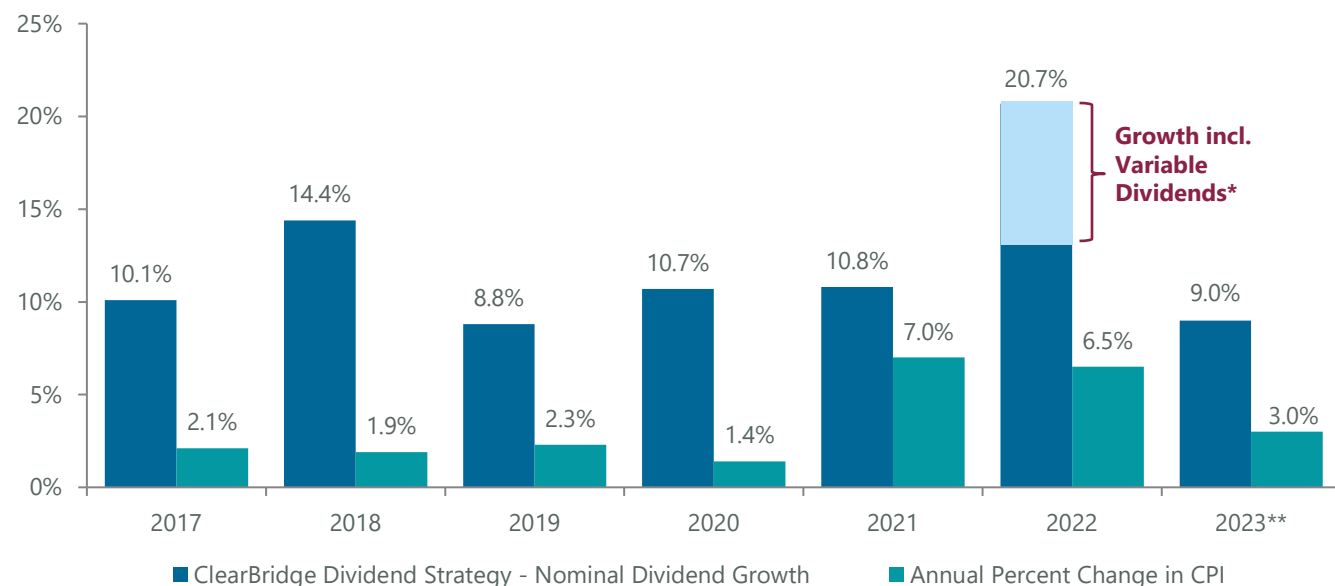
Dividend growers have a history of being rewarded by the market over time (Exhibit 5). A look at the returns of S&P 500 Index stocks sorted by dividend policy over the past 50 years shows that dividend payers outperformed the broad market.

Exhibit 3: Dividend Focus Consistent with Lower Down Market Capture



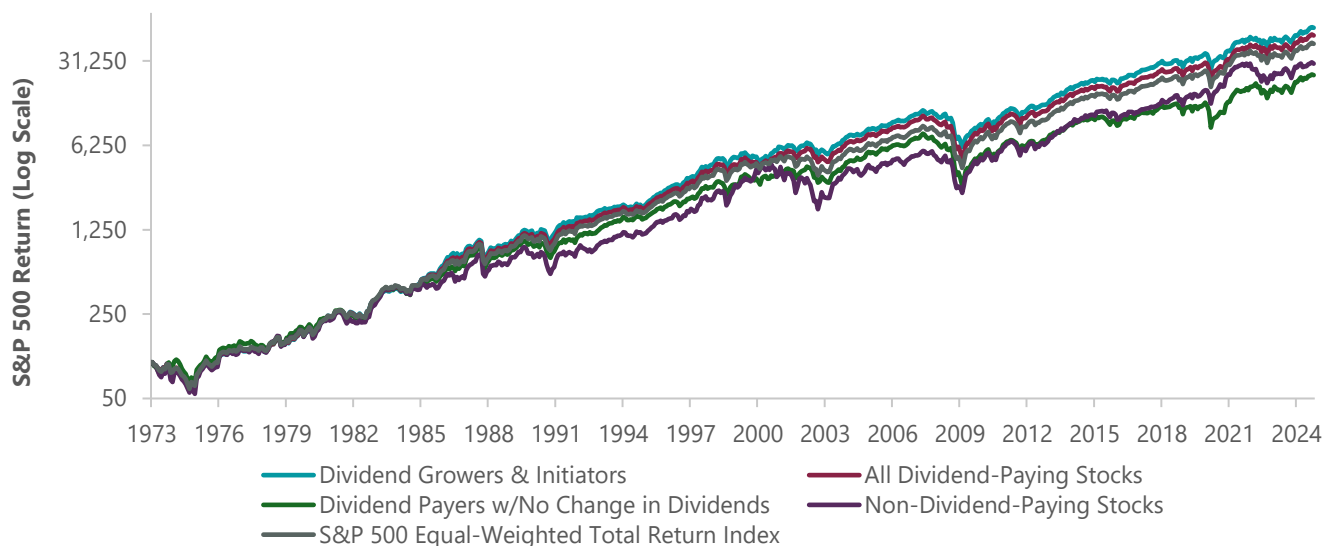
Source: ClearBridge Investments. Shows two largest calendar year drawdowns of the S&P 500 Index since inception of strategy.

Exhibit 4: Dividend Growers Combat Inflation Out of the Pandemic



As of Dec. 31, 2023. Source: FactSet, BLS, St. Louis Fed (FRED), Federal Reserve Bank of Minneapolis. *Includes variable dividends from PXD, CHK.
**2023 Nominal Dividend Growth calculated using 2022 dividend growth excluding PXD, CHK.

Exhibit 5: Dividend Policy Counts Over Time



As of Oct. 31, 2024. Source: Ned Davis Research. S&P 500 is the S&P 500 Equal-Weighted Total Return Index. Dividend policy indexes are equal-dollar-weighted with monthly rebalancing. Monthly data (log scale indexed to 100).

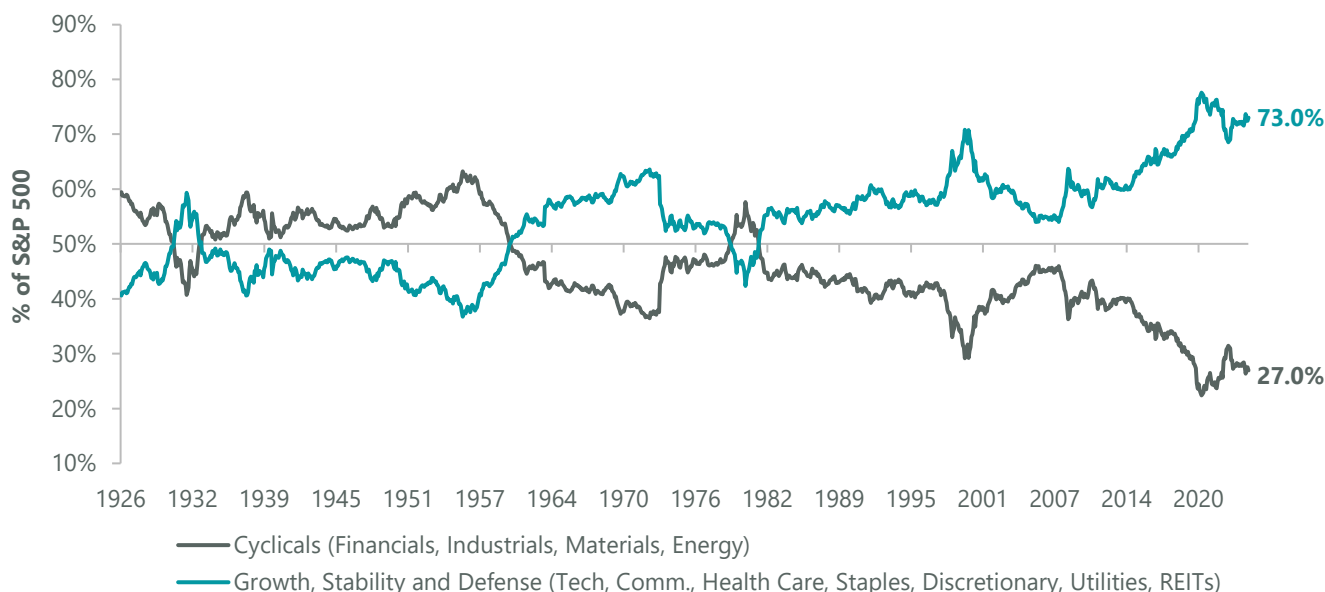
Actively Targeting Dividend Growers in a Skewed Market

In a market myopically focused on a few technology stocks, active investors may find opportunities to target dividend growers in more value-oriented sectors. Cyclical sector representation is near a 100-year low (Exhibit 6), and we may be at the tail end of a trend that started 40 years ago when interest rates peaked.

There is plenty of room to actively diversify exposure away from higher-multiple stocks to dividend-friendly sectors underweighted in the broad market (Exhibit 7):

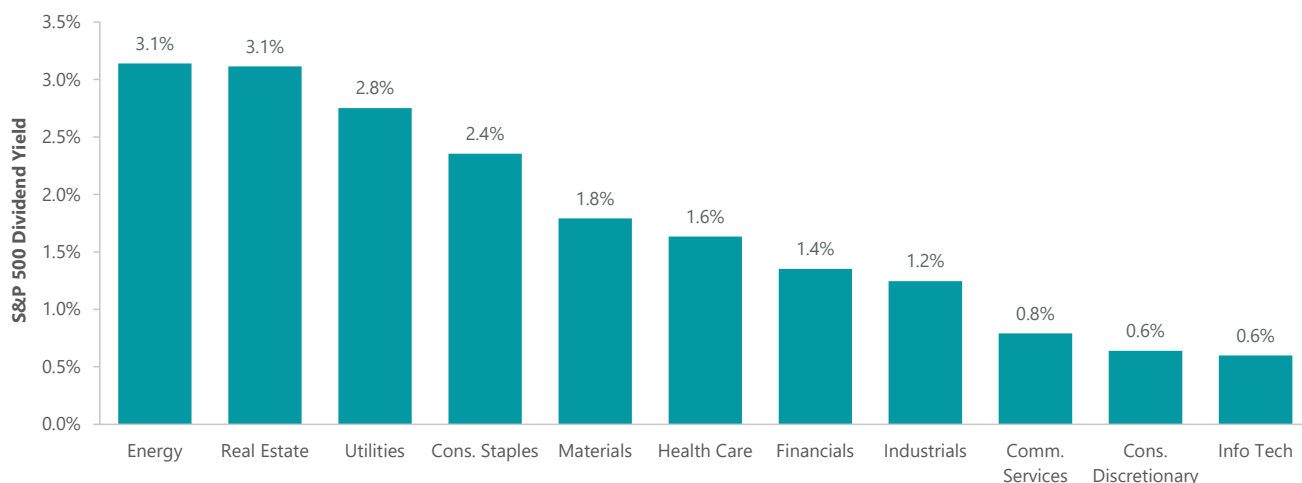
Energy: With energy production poised to benefit from a supportive regulatory regime, midstream operators of pipelines and related infrastructure, which offer a combination of strong upfront yields and a tendency toward contracts with built-in inflation escalators, are poised to benefit.

Exhibit 6: Index Skewed by Handful of High P/E Growth Stocks



As of Sept. 30, 2024. Source: Piper Sandler, FactSet, S&P, ClearBridge Investments.

Exhibit 7: S&P 500 Sectors by Dividend Yield



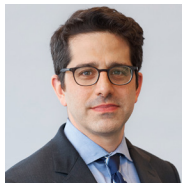
As of Nov. 29, 2024. Source: ClearBridge Investments, FactSet.

Financials: The financials sector should benefit from reduced regulatory pressure and positive leverage to rising interest rates. Banks, for example, directly benefit from higher interest rates as they raise the rates they charge to borrowers.

Consumer staples: Consumer staples have significantly underperformed as they lapped comparisons from the Covid era when people stayed home and prices soared. A robust business cycle and healthier long-term wage growth should result in better long-term demand and earnings growth.

With passive investment products overexposed to a narrow subset of expensive technology stocks, we advocate being selective in targeting dividend growers. Amid persistent inflation and potential weakness in higher-multiple stocks over time, there is good reason to invest in companies with a track record of dividend increases and the combination of financial strength and growth that should enable them to continue raising their dividend payments. It is these companies, we believe, that have the ability to compound dividends over the long term, offering the best tack into inflationary headwinds.

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