Miller/Howard

# Navigating Crosscurrents

QUARTERLY REPORT 3Q 2023

## Navigating Crosscurrents

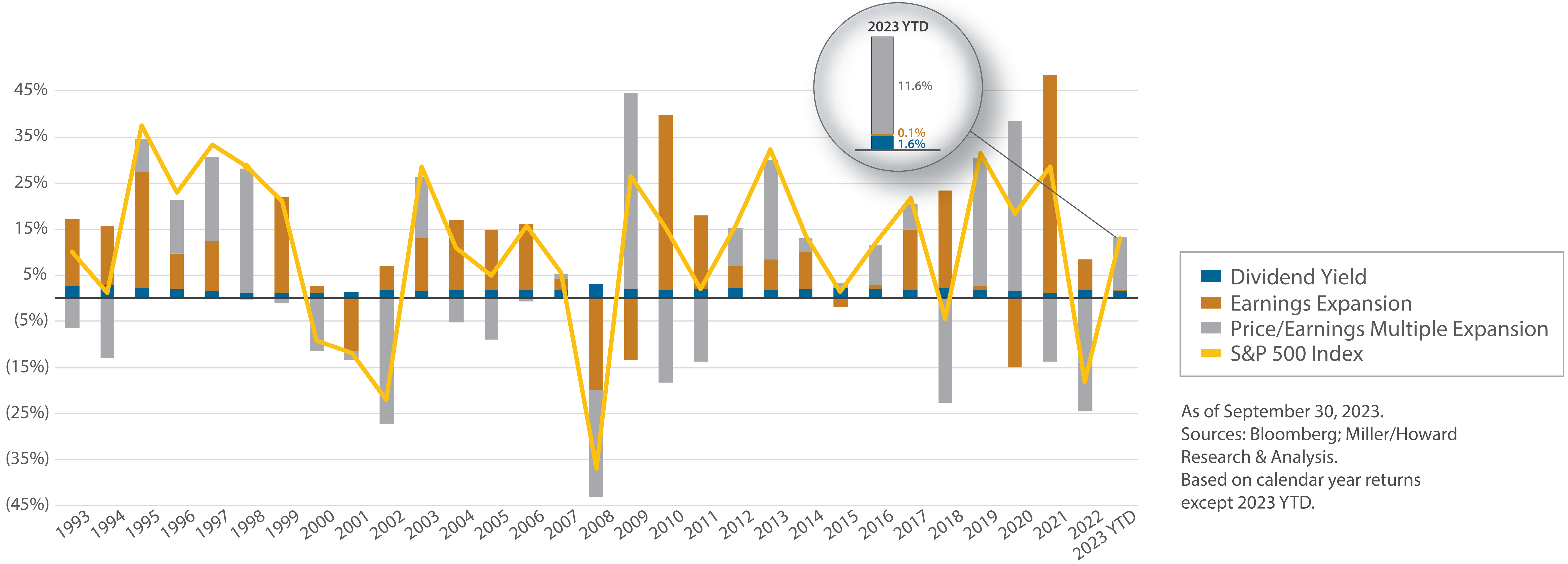
Following a dismal 2022, the S&P 500 Index has rallied hard this year, returning 13.1% over the first nine months of the year. That's a nice return, but scratching below the surface uncovers some unsettling details.

Decomposing the year-to-date S&P 500 Index total return into its three components (dividends, earnings expansion, and price/earnings (P/E) multiple expansion), we find that virtually all of this year's return has come from multiple expansion. As we have shown in past research *[Miller/Howard's 1Q 2021 Quarterly Report],* P/E multiple expansion is an undependable source of returns—gyrating up and down with the whims of the market. P/E multiple expansion was a long-term source of market returns over the last few decades, with multiples rising in response to falling interest rates. Going forward, we expect inflation fears to keep interest rates high, making P/E multiple expansion an even riskier source of returns.

Over the long term, dividends and earnings growth have been the most reliable source of investment returns. Dividends have continued to chug along this year, but economic weakness has put earnings expansion in short supply.

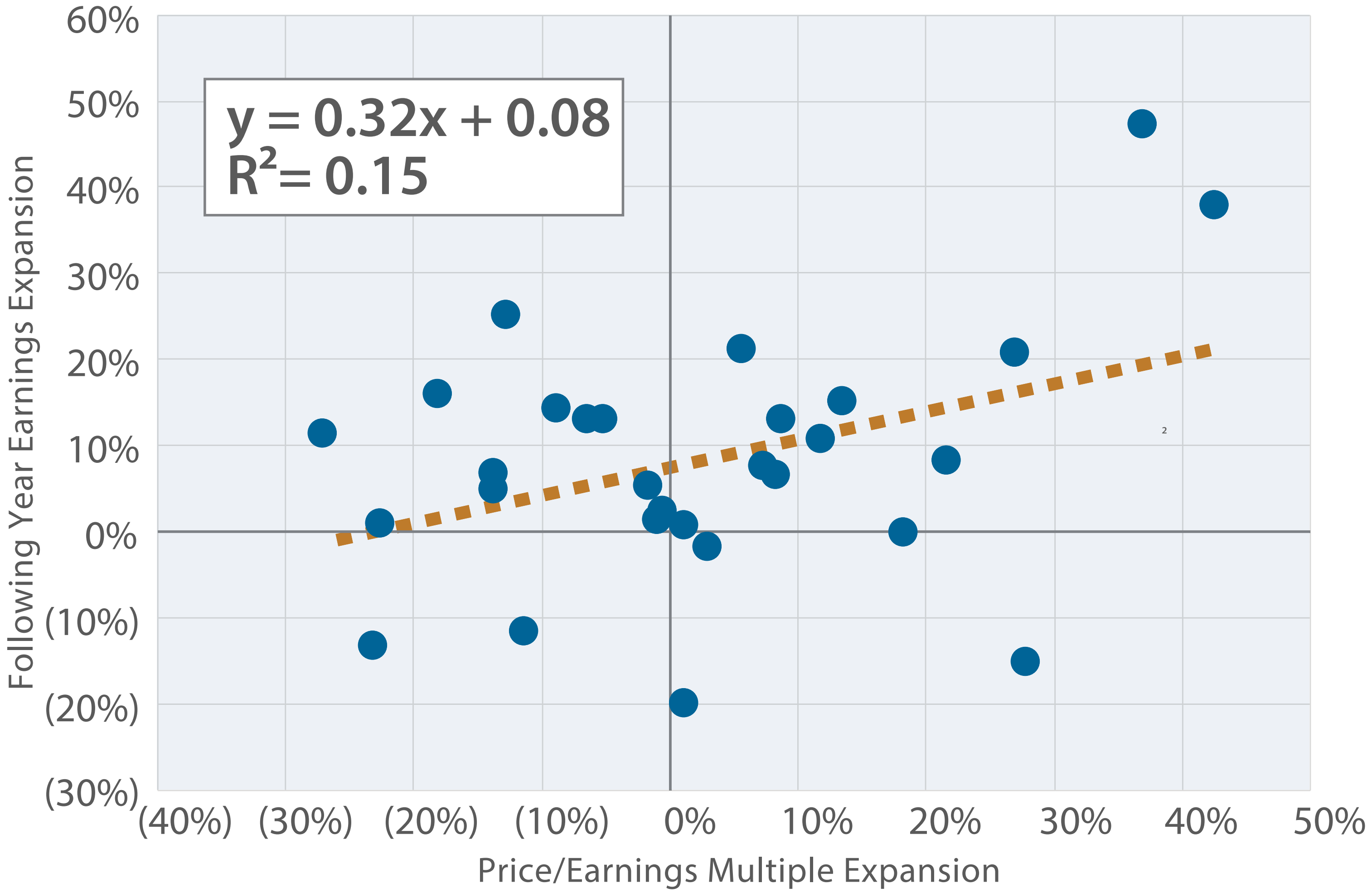
# Depend on Dividends and Earnings Growth

## S&P 500 Index Calendar Year Total Returns and Composition




As of September 30, 2023.
Sources: Bloomberg; Miller/Howard Research & Analysis.
Based on calendar year returns except 2023 YTD.

# Does Price/Earnings Multiple Expansion Predict Earnings Growth?



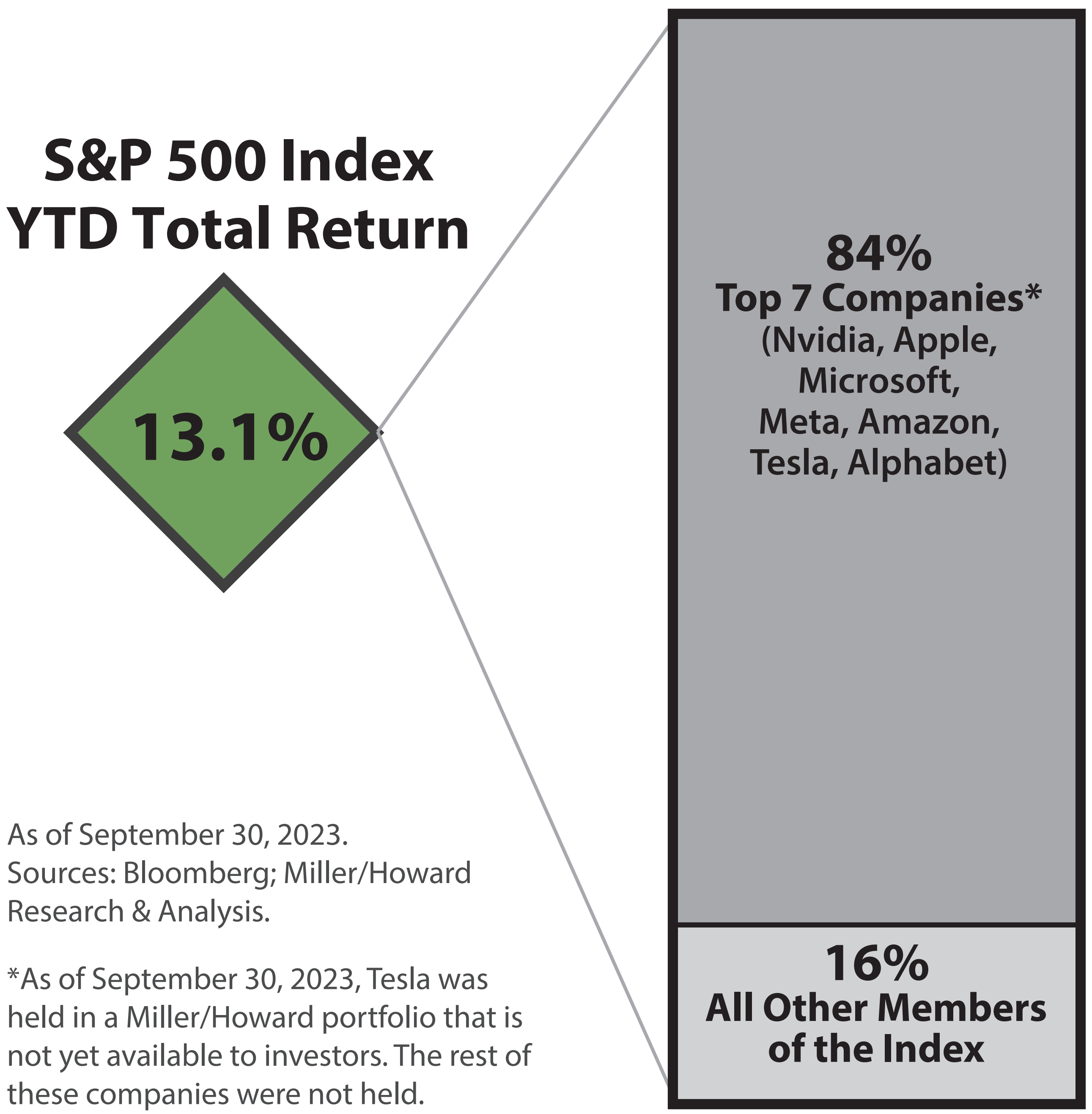

Source: Bloomberg; Miller/Howard Research & Analysis. The above scatter chart plots the S&P 500 Index estimated price/earings expansion ("multiple expansion") for calendar years 1993 through 2022 vs the S&P 500 Index estimated earnings expansion for the calendar year following the multiple expansion plot ("following year earnings expansion"). Estimates are consensus.

Some market observers argue that the market is all-knowing, meaning that every wiggle reveals some deep insight into the future. Followers of this school of thought are now pointing out that P/E multiple expansion is frequently followed by earnings growth in the subsequent year. Looking at the past 30 years, there is some basis for this argument, but the relationship is weak. **The expansion of price-to-earnings multiples is positively correlated with earnings growth the following year, but the relationship only explains 15% of the variance.**

A much better explanation for this year's market performance is excitement over the prospects for artificial intelligence (AI). Seven stocks that all have some link to artificial intelligence—Nvidia, Microsoft, Apple, Alphabet, Amazon, Meta, and Tesla*—have accounted for 84% of the S&P 500 year-to-date performance.

Overall, this year's positive broad market returns reflect a belief in AI's commercial potential combined with higher P/E multiples, hardly a vote of confidence in the general economic outlook.

## Returns are Highly Concentrated




As of September 30, 2023.
Sources: Bloomberg; Miller/Howard Research & Analysis.

*As of September 30, 2023, Tesla was held in a Miller/Howard portfolio that is not yet available to investors. The rest of these companies were not held.

History rarely repeats itself, but it can be a useful tool to tamp down investor hubris. If you ask the typical investor how they viewed the future back in the late 1990s during the Tech Bubble, you will probably hear two points: internet and telecom technologies were going to change the world, and it was clear who was going to win. Both points fall into the category of 20/20 hindsight, but easily identifying the winners of long-term technical trends is especially problematic. Garnering enormous value from a new technology requires not mere participation, but having a market position that is simultaneously valuable, unique, and difficult to replicate.

# Chasing Tech Bubbles is Dangerous

## Recent Performance of Tech Stocks

| Company | 1999 Total Return | Next 5-Years Total Return (1999 - 2004) | Next 10-Years Total Return (1999 - 2009) | Comments |
|---|---|---|---|---|
| QUALCOMM | 2619% | -51% | -43% | |
| NEXTEL COMMUNICATIONS | 337% | -42% | - | Acquired by Sprint 2005 |
| LSI | 319% | -82% | -84% | |
| NORTEL NETWORKS | 306% | -93% | -100% | Bankruptcy 2009 |
| ORACLE | 290% | -51% | -12% | |
| NETAPP | 270% | -20% | -17% | |
| NATIONAL SEMICONDUCTOR | 217% | -16% | -24% | |
| TERADYNE | 212% | -74% | -84% | |
| ENTERASYS NETWORKS | 210% | -90% | - | Delisted 2006 |
| COMVERSE TECHNOLOGY | 206% | -66% | -87% | |
| **High-Yield Stocks (Decile 7 - Decile 9)*** | **-7%** | **62%** | **63%** | |
| **S&P 500 Index** | **21%** | **-11%** | **-9%** | |

Sources: Bloomberg; Morningstar Direct; Fama-French; Miller/Howard Research & Analysis.
*High-Yield Stocks (Decile 7 - Decile 9) are an equal-weighted basket of the returns of decile 7, decile 8, and decile 9 of the the Fama-French Value-Weighted Dividend Decile Dataset where decile 1 is the lowest yielding stocks and decile 10 is the highest. Based on cumulative returns. None of the names above were held as of September 30, 2023.

Let’s look at the 10 best performing stocks in the S&P 500 in 1999—the stocks that generated the most investor excitement in that peak year. All of these names were in the tech sector, and each stock returned over 200% (a triple!) for the year.

Surely, these stocks would continue to be great investments, right? Alas, no. Every single stock on the list underperformed the S&P 500 over the next five years. Those that survived through the subsequent 10 years also underperformed. Some of the names on the list have been successful companies, but valuation matters. Excitement over new technologies led investors to bid up stocks to prices that exceeded their true financial prospects.

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One ameliorating factor for today's tech favorites is that price/earnings multiples were higher during the Tech Bubble, suggesting that we could have more frenzy ahead of us. Some investors acknowledge the growing exuberance, but they have the idea that they will quickly step aside at the first sign of trouble. That's easier said than done.

Our view continues to be that chasing today's winners is a dangerous game. Back in 1999, high-yield stocks generated a calendar year return of -7%, well behind the 21% return generated by the S&P 500. Disappointing, no doubt, but returns were up 63% over the next 10 years, while the S&P 500 was down -9%. Rather than depending on heroic forecasts, dividend investing relies on the power of compounding income over time.

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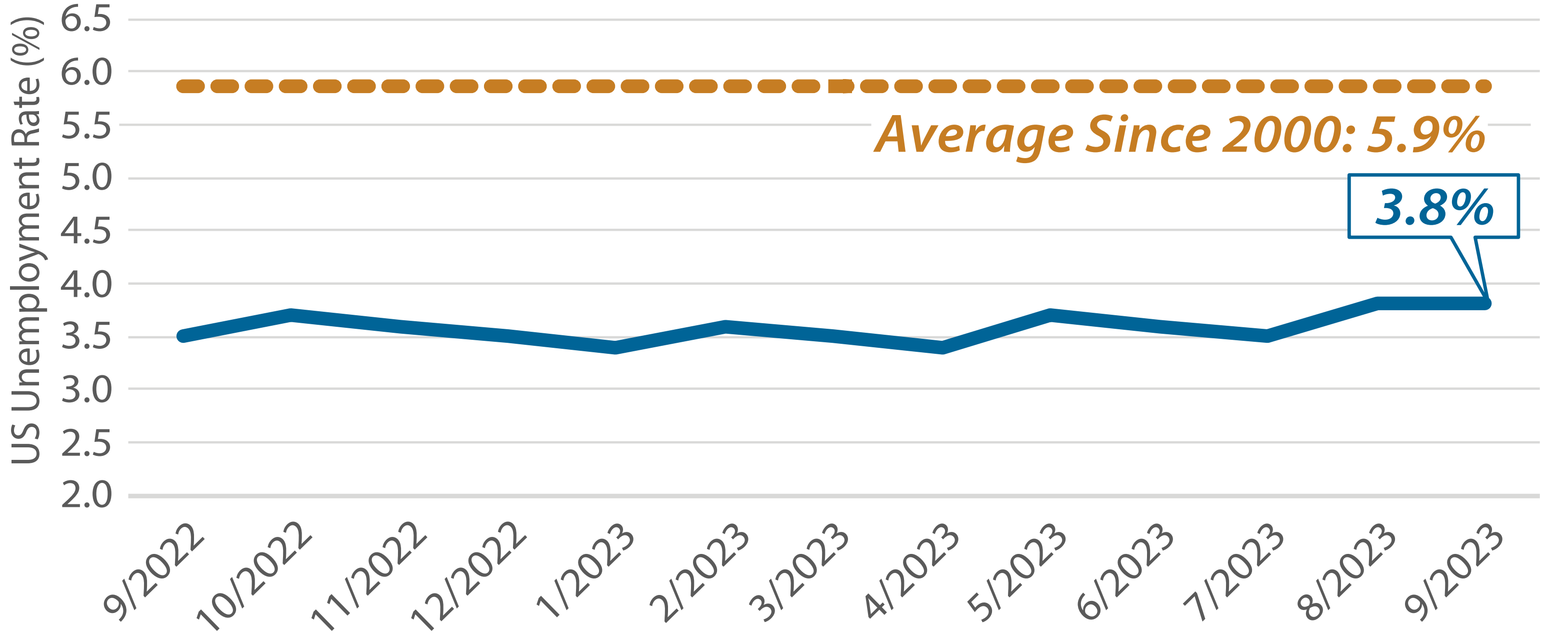
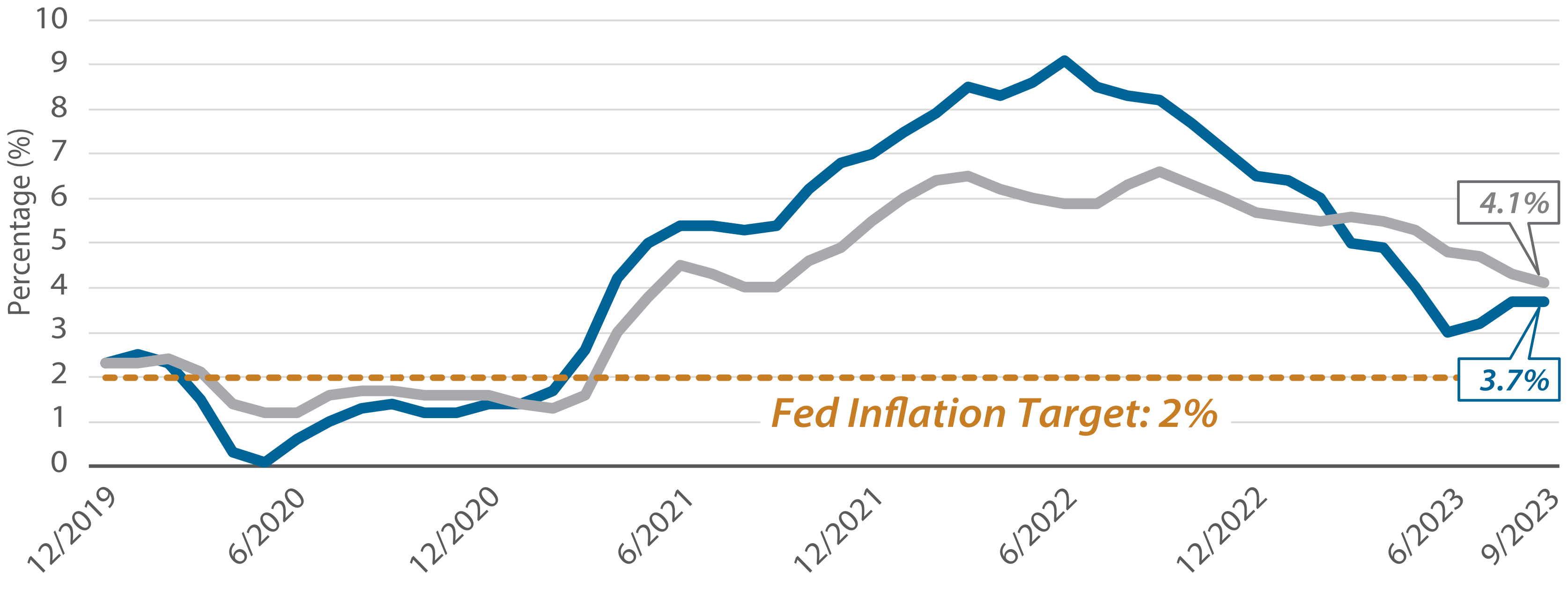
## US Unemployment Rate

(Sept 2022–Sept 2023)



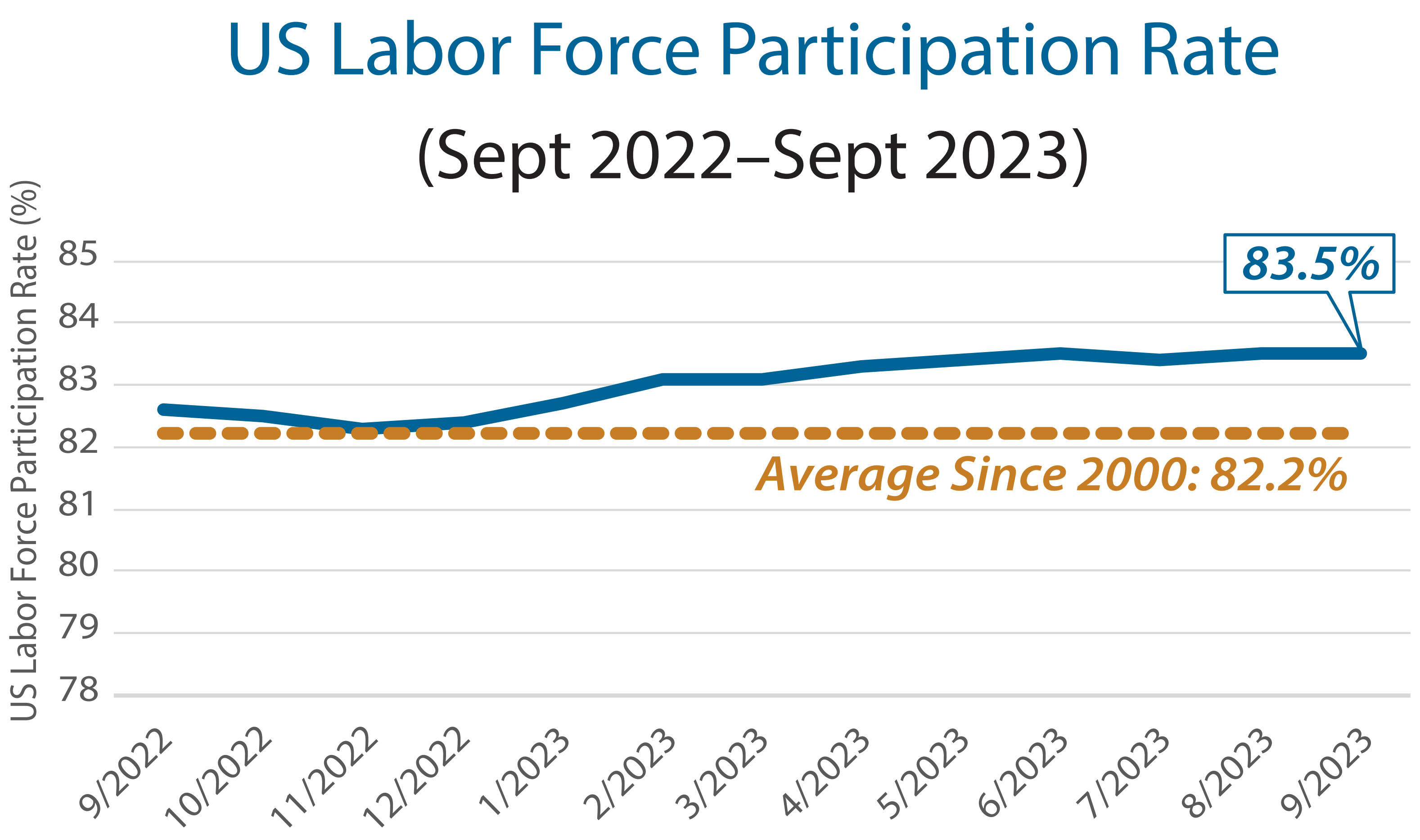

## US CPI Urban Consumers YoY

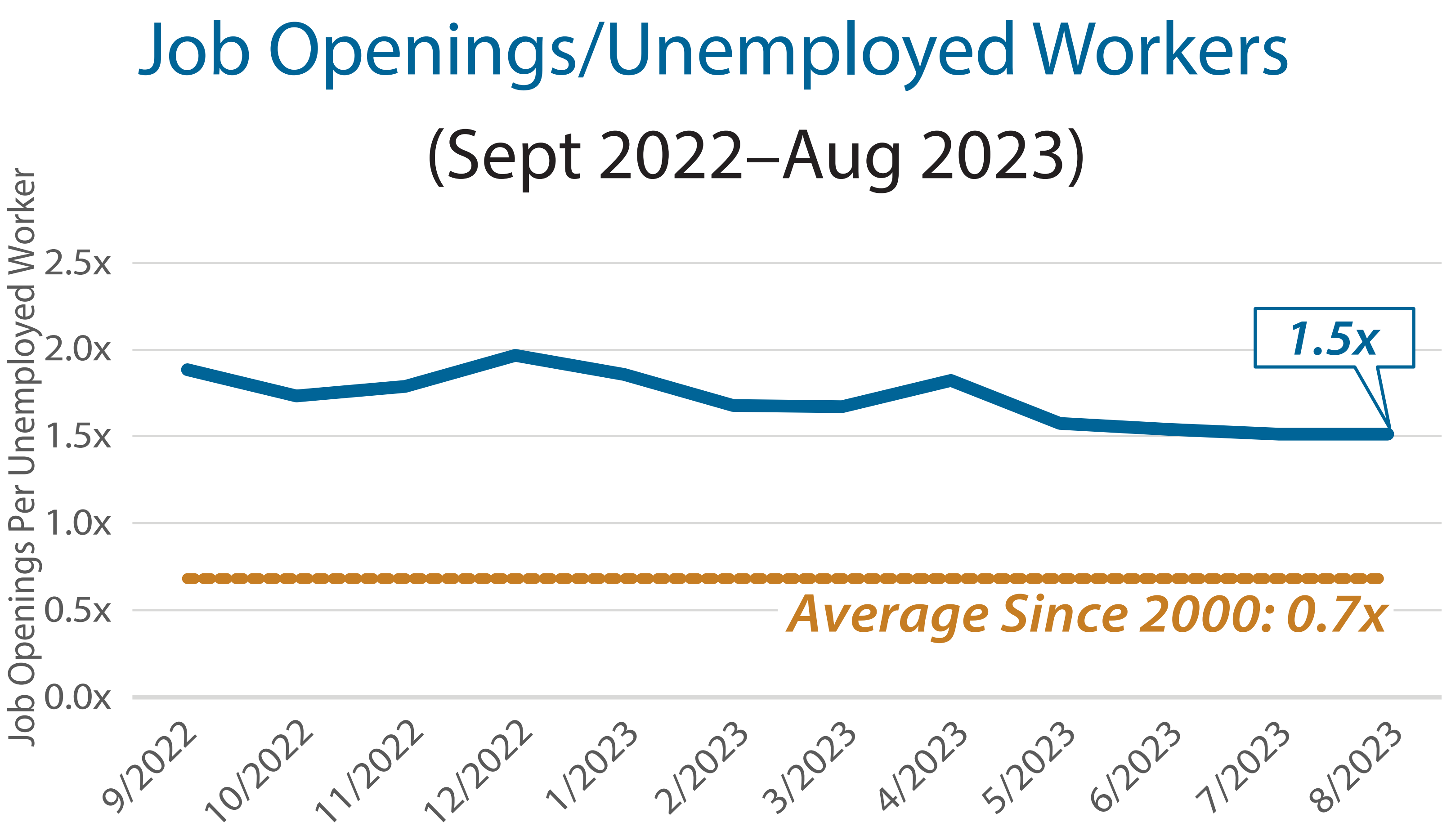
(Dec 2019–Sept 2023)




As of September 30, 2023. Sources: Bloomberg; Bureau of Labor Statistics. CPI=Consumer Price Index.
**Unemployment Rate:** number of unemployed persons as a percentage of the labor force (total number of employed plus unemployed); as determined by household labor force surveys.

Economic uncertainty continues to be sky high, in our view. On the positive side, inflation has trended down as a result of the Fed's aggressive interest rate hikes combined with the resolution of most of the supply chain problems that were plaguing the global economy. Inflation is still well above the Fed's 2% target, but it is encouraging that inflation has ratcheted down so far with a very modest rise in unemployment.




As of September 30, 2023. Sources: Bloomberg; Bureau of Labor Statistics. **Labor Force Participation Rate:** total labor force as a percent of the working age population (25-54 Years). **Job Openings:** US Job Openings By Industry Total SA. Number of specific job openings in an economy. **Job Vacancies** generally include either newly created or unoccupied positions (or those that are about to become vacant) where an employer is taking specific actions to fill these positions. **Unemployed Workers:** total number of unemployed workers in the US labor force.

Labor market statistics remain almost uniformly good. Labor force participation for peak age workers (age 25-55) reached the highest rate in 20 years. The Fed would love to see higher labor supply dampen wage growth, creating a path for lower inflation without requiring a recession. The number of job openings per unemployed has come down but remains well above 1x. Note that the average number of job openings per unemployed person has averaged 0.7x since 2000, so today’s labor market is truly a positive outlier.

There are those who argue the case for a soft-landing point to easing inflation and a robust labor market. They also make the case that the economy is not as interest-rate sensitive as it used to be. There is definitely some truth to this, as services have grown relative to manufacturing, and home buyers have shifted away from variable rate mortgages.

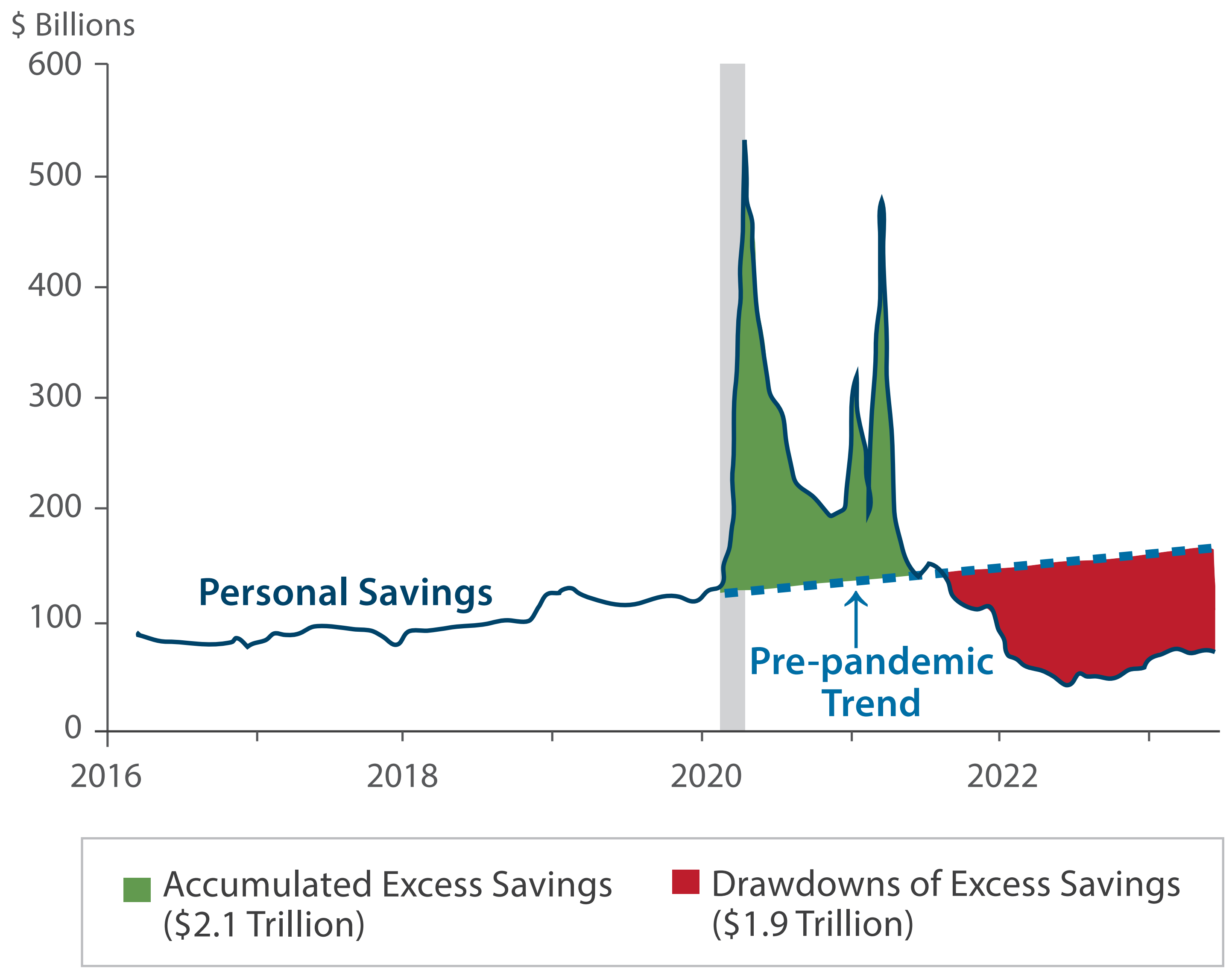
## Dose Makes the Poison

To evaluate the notion that interest rates don't matter much anymore, let's examine how we ended up with a resurgence of inflation. Since 2000, the United States has run enormous budget deficits. For years, inflation hawks argued that budget deficits would lead to inflation, and for years, those pessimists were wrong.

The pandemic presented us with enormous challenges, and both administrations spent heartily on a variety of programs to help individuals and businesses survive. Bills passed in 2020 and 2021 provided a panoply of programs including direct cash payments, expanded unemployment benefits, and loan forbearance. Combined with an inability to spend on restaurants and travel, personal savings ballooned.

Monetary policy has followed a similar storyline in recent years. Coming out of the Great Financial Recession, the Fed kept interest rates abnormally low for years. The Fed also engaged in quantitative easing–printing cash to buy bonds. As with fiscal spending, inflation hawks squawked, but contrary to textbook theory, inflation remained low. Given the exigencies of the pandemic, the Fed quickly dropped short-term rates to virtually zero and expanded its balance sheet (buying bonds) by an astounding 70% in the first three months of the crisis.

# Unusual Trends in Aggregate Personal Savings




As of June 30, 2023. Sources: Bureau of Economic Analysis; Economic Research Department at the Federal Reserve Bank of San Francisco. Note: Excess savings calculated as the accumulated difference in actual de-annualized personal savings and the trend implied by data for the 48 months leading up to the first month of the 2020 recession as defined by the National Bureau of Economic Research.

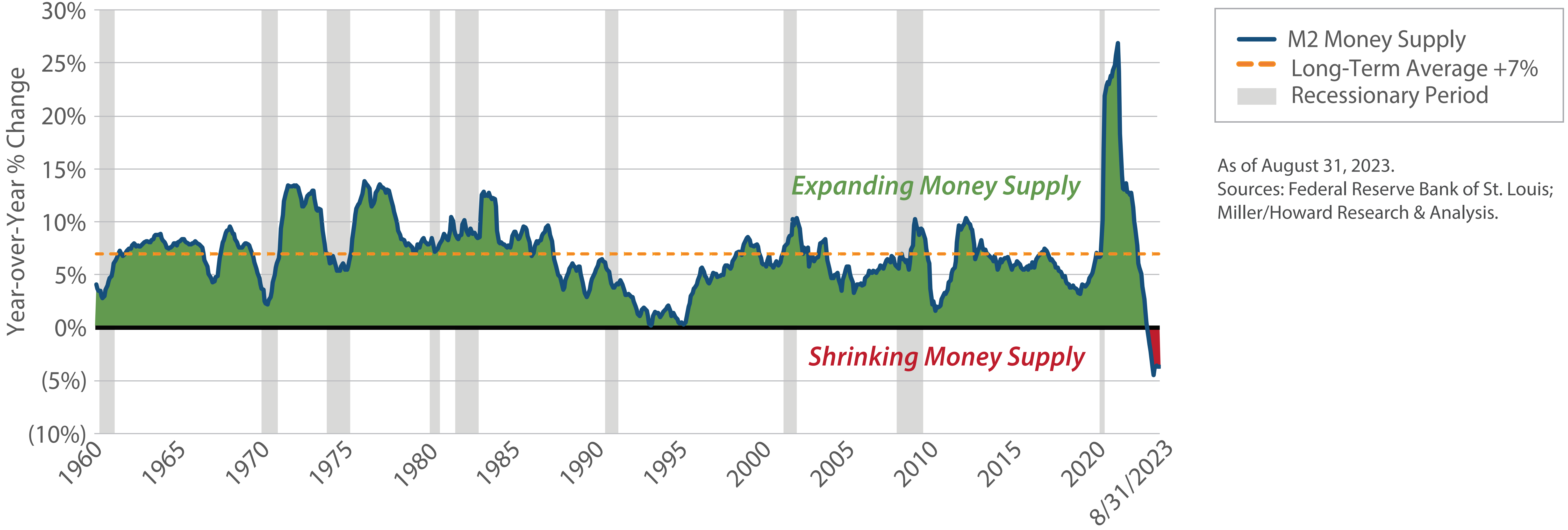
As the pandemic faded, consumers began to spend their excess savings and the lagged impact from monetary stimulus kicked in. Inflation accelerated, finally fulfilling the predictions of the inflation hawks.

For both fiscal spending and monetary policy, we can draw the same conclusion—too much money chasing too few goods can indeed cause inflation, at least when fiscal and monetary policy levers are pushed to the extreme. The medical adage, Dose Makes the Poison, captures the situation perfectly.

Now that the challenge has shifted to inflation-fighting, the question becomes whether the Fed has hit the brakes too hard. So far, inflation has been moderating without much of an uptick in unemployment, but it is concerning that money supply has shrunk for the first time in over 70 years. Money supply growth has not proven to be very predictive of economic growth or inflation in the last few decades, but the risk is that this unprecedented policy "dose" may prove to be poison.

## Money Supply Shrinking for the First Time

(Since at least 1960)



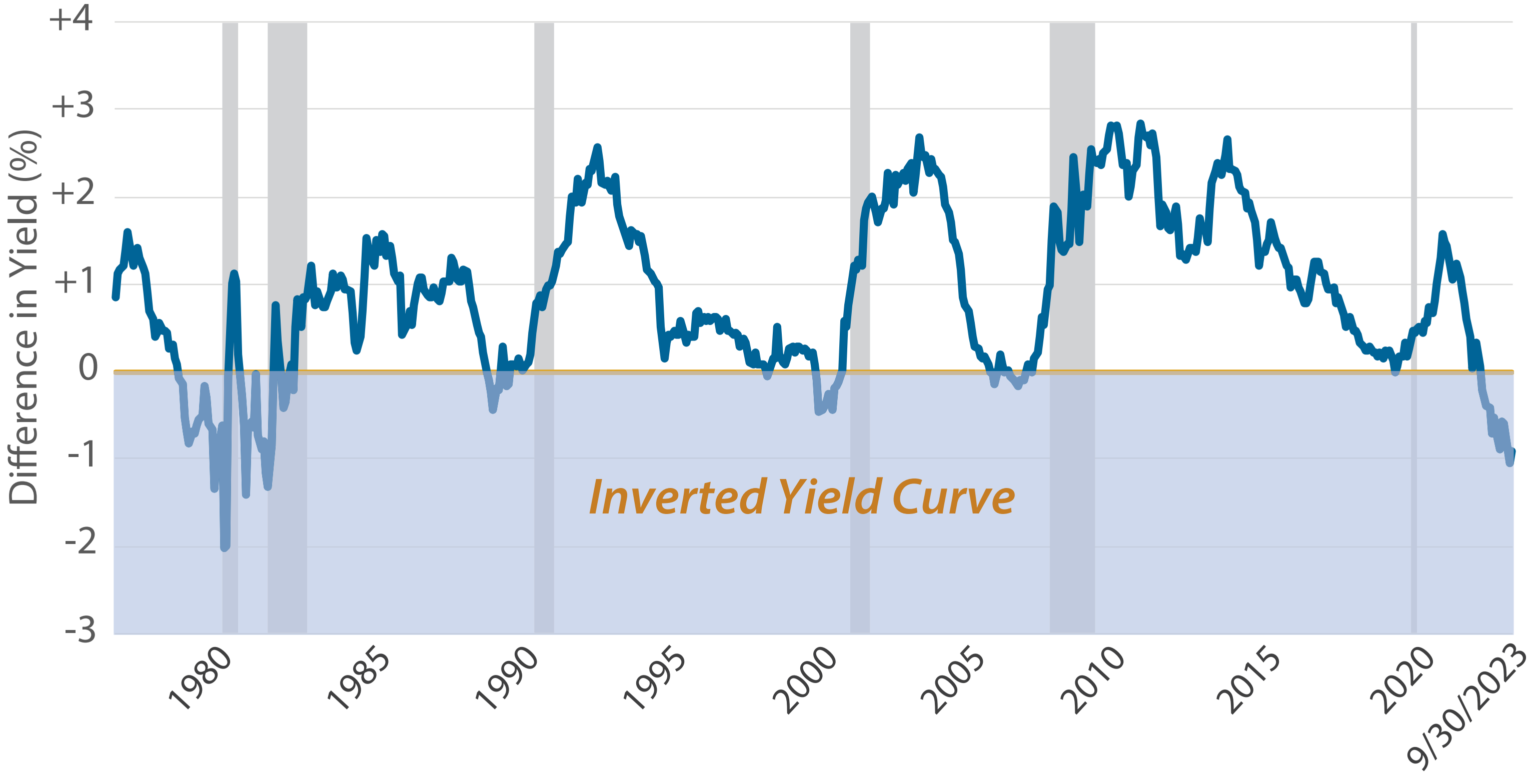

As of August 31, 2023.
Sources: Federal Reserve Bank of St. Louis; Miller/Howard Research & Analysis.

## Warning Signals

Traditional recession indicators continue to flash yellow. The view of the bond market is usually summarized by comparing the interest rate on 2-year Treasury bonds versus those with a 10-year tenor. In good times, investors normally require a higher rate to take more duration risk. But when the bond market views the future with trepidation, long-term bond rates are lower, reflecting the view that the Fed will be forced to cut rates in the face of a recession. The yield curve has been inverted for over a year. Yield curve inversions have preceded the last eight recessions, going back decades.

# Inversions Historically Precede Recessions

### 10-Year Treasury Constant Maturity Minus 2-Year

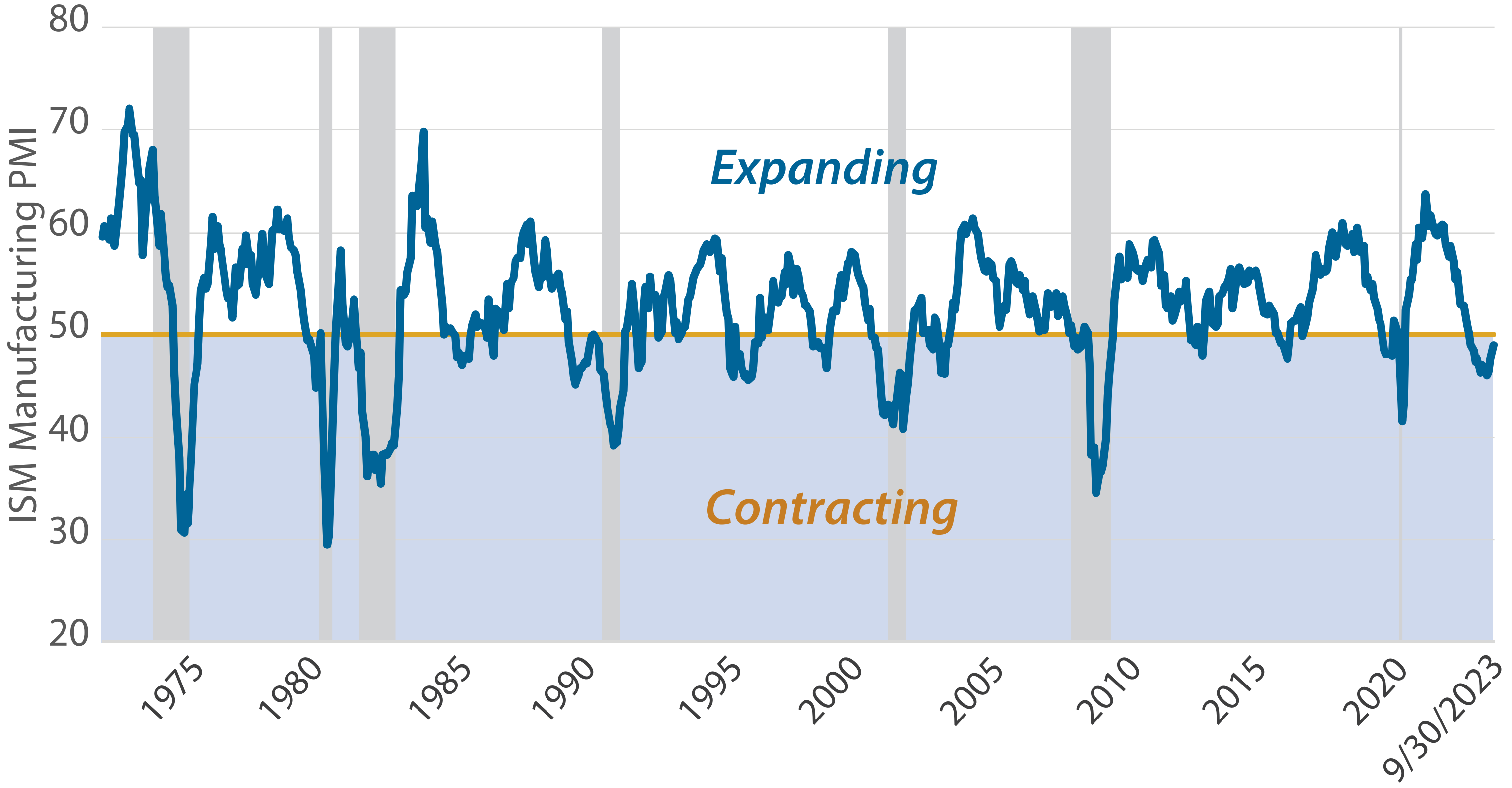



As of September 30, 2023. Sources: Federal Reserve Bank of St. Louis; Bloomberg; Miller/Howard Research & Analysis. Grey vertical lines represent recessionary periods.

The Manufacturing Purchasing Managers Index is another indicator with a good track record of forecasting recessions. In aggregate, purchasing managers began to see a contraction in November 2022.

## Contraction Seen Since Late 2022

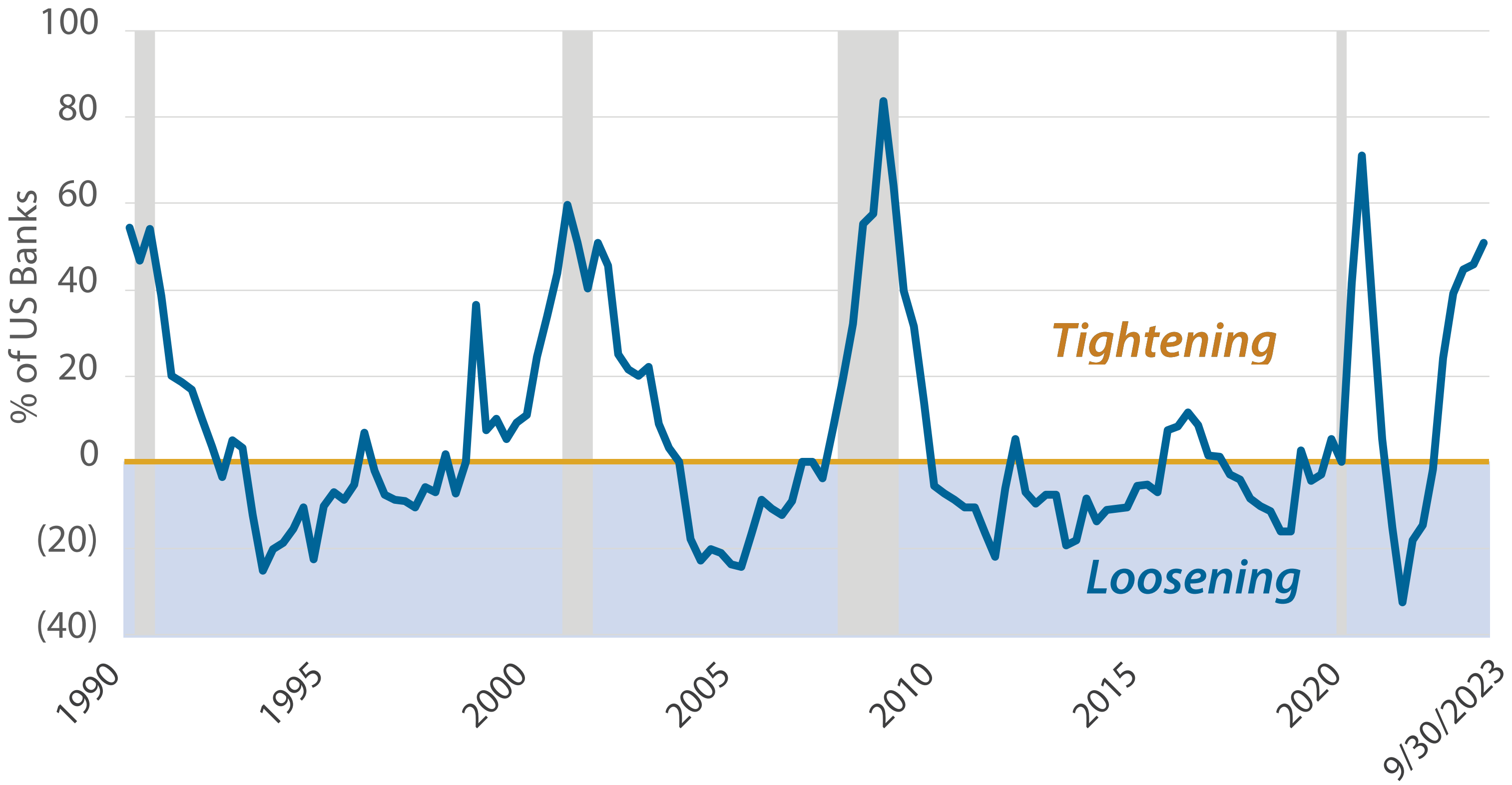
### ISM Manufacturing PMI®




As of September 30, 2023. Source: Federal Reserve Bank of St. Louis. A Manufacturing PMI® reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining. A Manufacturing PMI® above 48.7 percent, over a period of time, indicates that the overall economy, or gross domestic product (GDP), is generally expanding; below 48.7 percent, it is generally declining. The distance from 50 percent or 48.7 percent is indicative of the extent of the expansion or decline. Grey vertical lines represent recessionary periods.

The Fed's regular survey of bank senior loan officers has also proved useful in forecasting past recessions. For firms that are too small to access the bond market, bank loans are an essential source of capital. Credit standards began tightening in the third quarter of 2022.

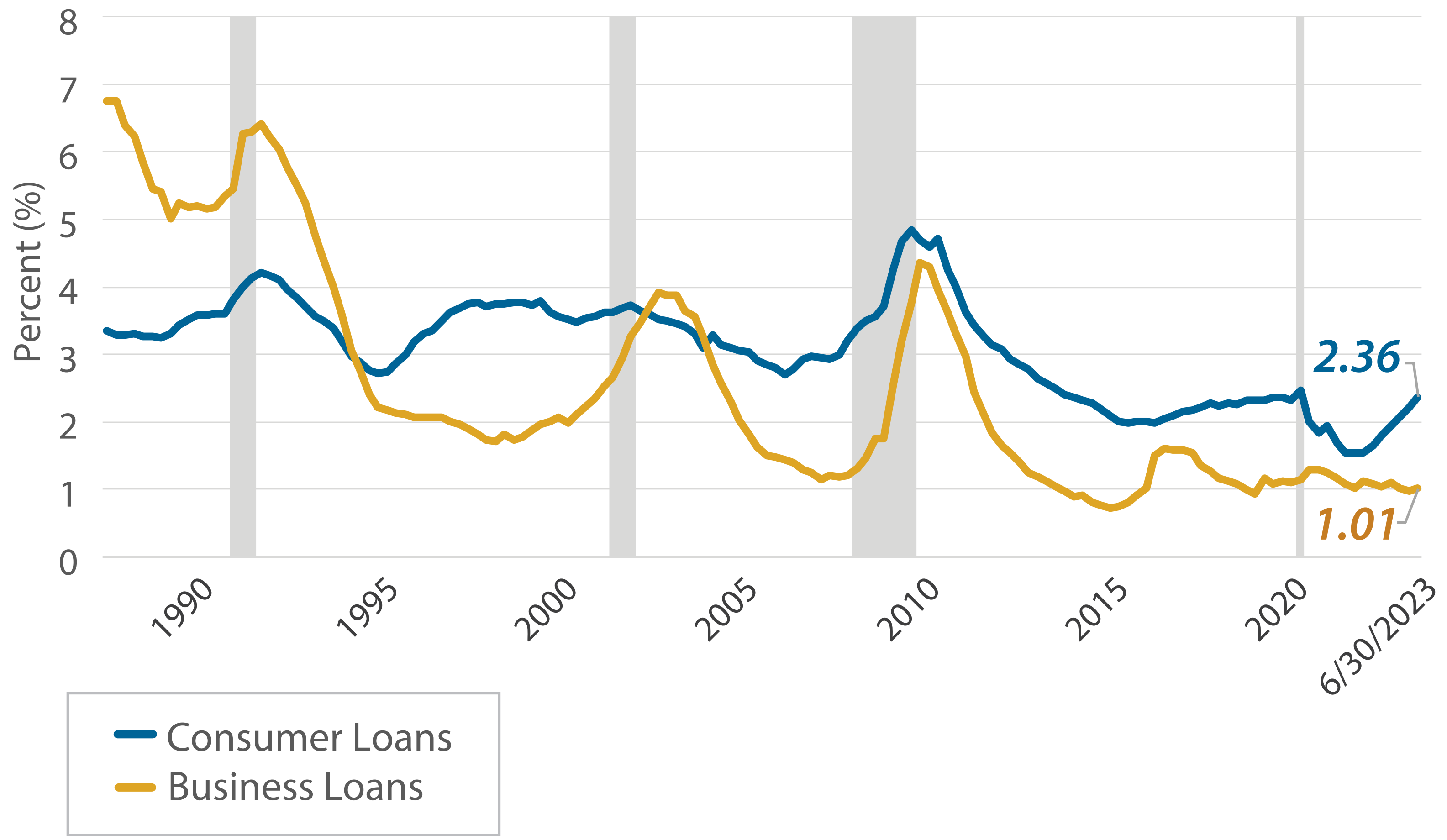
## US Banks Are Tightening Lending Standards




As of September 30, 2023. Source: Federal Reserve Bank of St. Louis. Note: Large- and middle-market firms have annual sales of $50 million or more. Data reflects the percent of domestic banks tightening standards for C&I loans to large- and middle-market firms. Grey vertical lines represent recessionary periods.

On the positive side, consumer loan delinquencies have bounced off their pandemic lows, but delinquencies for both consumers and businesses continue to be low. On the consumer side, this could worsen as the pandemic-initiated student-loan repayment moratorium ends.

## Loan Delinquency Rates Remain Low



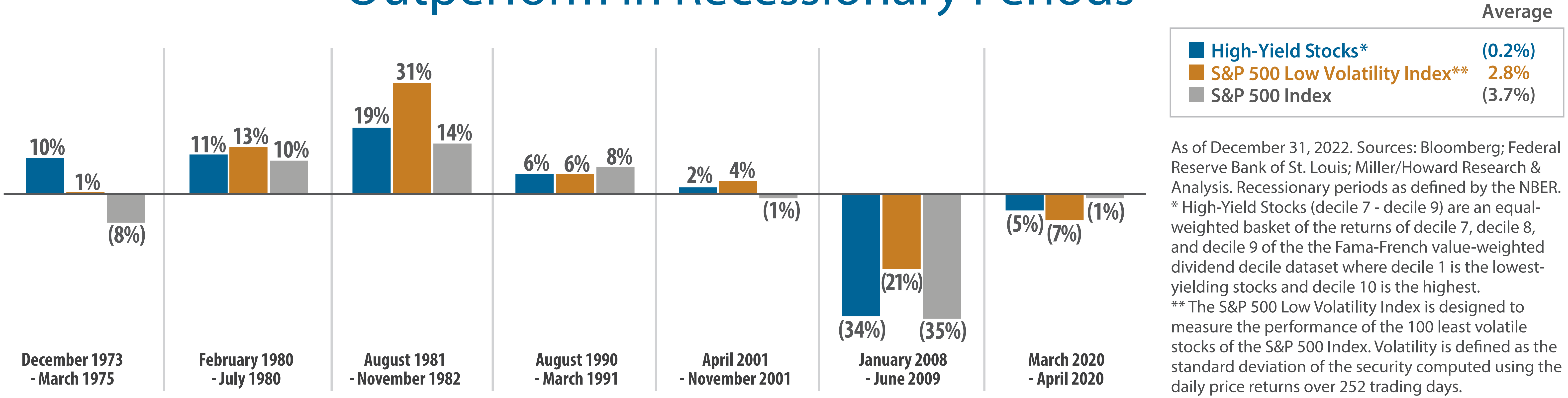

As of June 30, 2023.
Source: Federal Reserve Bank of St. Louis.
Grey vertical lines represent recessionary periods.

## Investing without Hubris

The economic backdrop remains truly unprecedented. Bullish analysts can rightfully argue that unemployment is lower than we typically have seen at the beginning of a recession. Optimists also point out that inflation has dropped significantly, sometimes adding that perhaps the Fed will raise their 2% target. Bearish signals, however, cannot be ignored: an inverted yield curve, tightening loan standards, and weakness reported by companies in cyclical industries. What's an investor to do?

The first step is to drop the notion that investment success requires accurate forecasts. Wall Street firms employ a hoard of people who are paid to have table-pounding views of the future. Regardless of whether they are bullish or bearish, the hubris involved in the exercise is breathtaking. Let's all admit that we just do not know how this situation will end. **The key is to choose an investment strategy that can work in various environments.**

# High-Yield Dividend Stocks and Low-Volatility Typically Outperform in Recessionary Periods




As of December 31, 2022. Sources: Bloomberg; Federal Reserve Bank of St. Louis; Miller/Howard Research & Analysis. Recessionary periods as defined by the NBER.
* High-Yield Stocks (decile 7 - decile 9) are an equal-weighted basket of the returns of decile 7, decile 8, and decile 9 of the the Fama-French value-weighted dividend decile dataset where decile 1 is the lowest-yielding stocks and decile 10 is the highest.
** The S&P 500 Low Volatility Index is designed to measure the performance of the 100 least volatile stocks of the S&P 500 Index. Volatility is defined as the standard deviation of the security computed using the daily price returns over 252 trading days.

Looking at the eight recessions over the past 50 years, high-dividend-yield stocks (deciles 7-9) have outperformed the S&P 500 by a compound annual growth rate (CAGR) of 3.5% during recession months. This should not be a surprise as high-dividend-yield stocks typically continue to produce income during recessions. A high regular dividend also suggests that management views their business as mature, with a positive long-term outlook.

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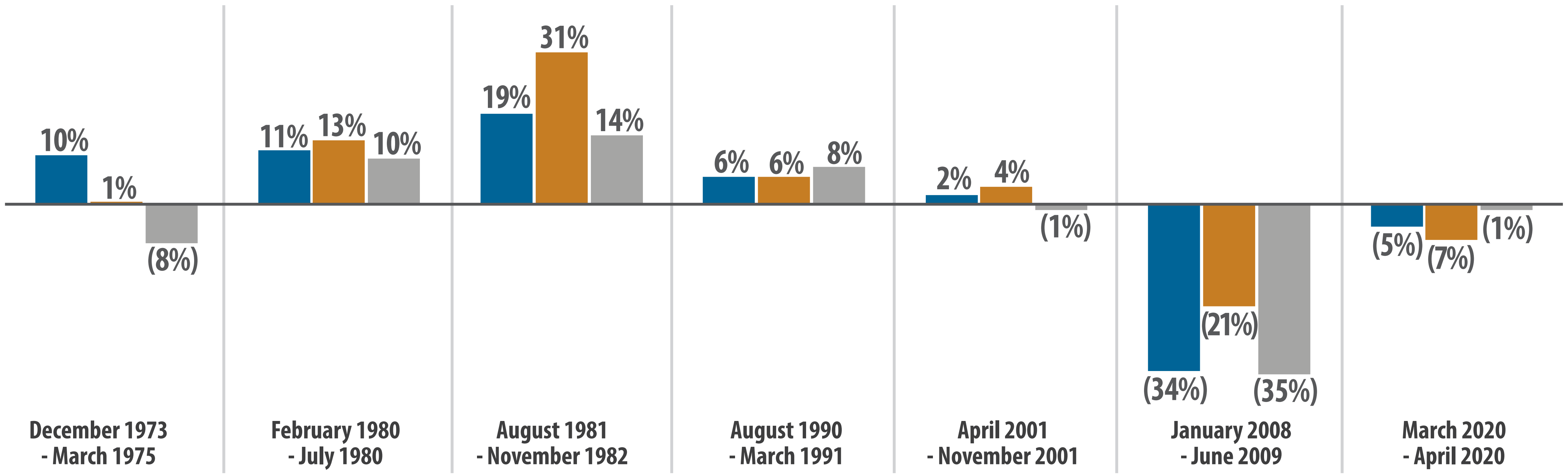


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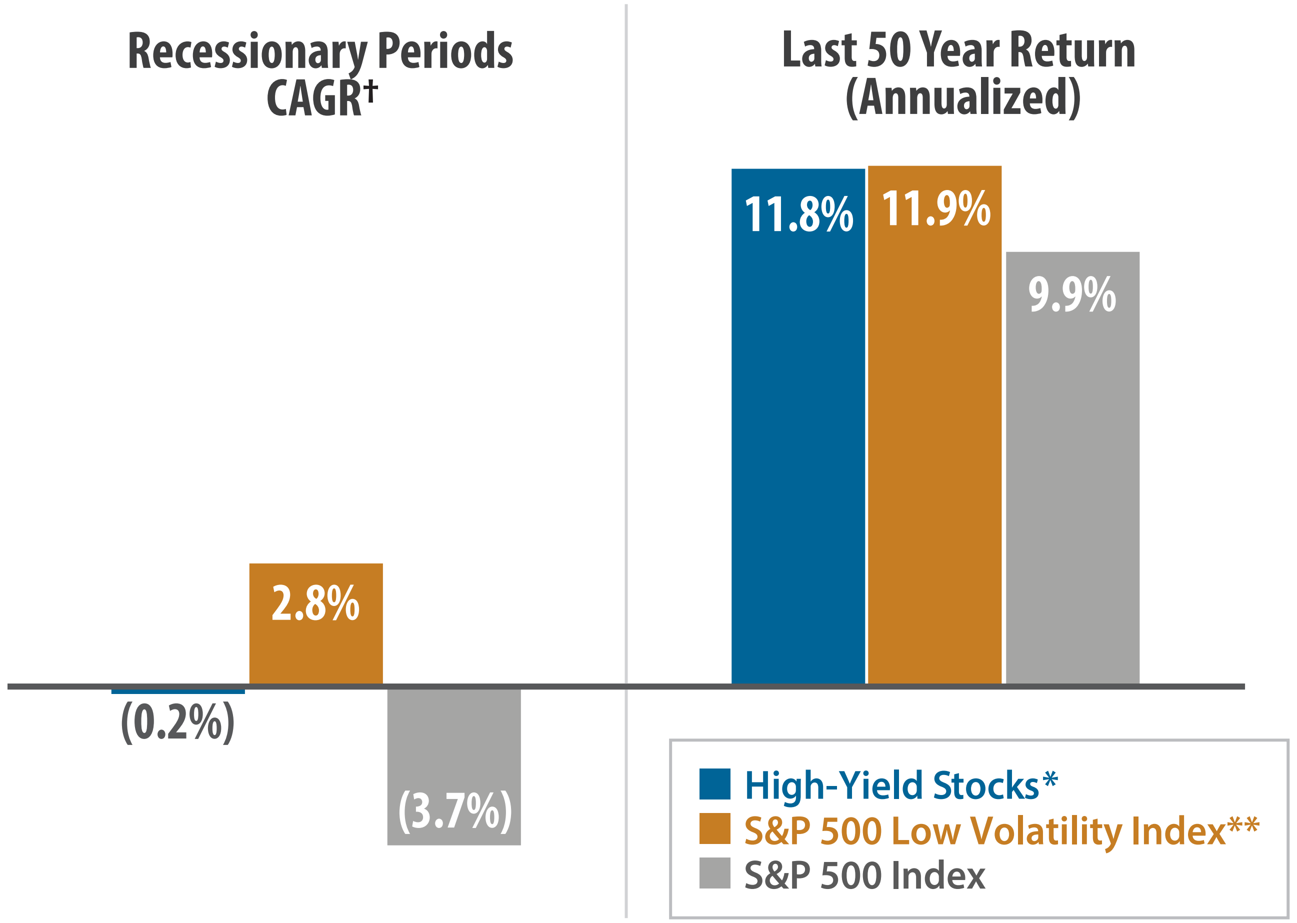
In a hard downturn, just being a high-dividend-yield stock may not be enough. Some high-dividend-yield stocks in cyclical industries could be at risk. Another layer of protection can be added by investing in stocks with low volatility. S&P 500 stocks in the lowest quintile of volatility have outperformed the overall market by a CAGR of 6.5% during recession months.

Investing in high-dividend-yield stocks with a tilt towards lower volatility opportunities has historically outperformed the broad market during recessions. But the story is better than that. Both high-dividend-yield and low-volatility stocks have significantly outperformed the broad market over the past 50 years. Investing without hubris means adopting an approach that has worked over long periods without requiring a crystal-ball.

# High-Yield Dividend Stocks and Low Volatility Outperformed Last 50 Years

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Miller/Howard
INVESTMENTS

## DISCLOSURE

Miller/Howard Investments Inc. is an independent, research-driven investment boutique with over three decades of experience managing portfolios for major institutions, mutual funds, and individuals in dividend-focused investment strategies. The firm is 100% employee-owned through an Employee Stock Ownership Plan (ESOP).

We continue to evolve and develop strategies that strive to provide investors with various levels of current income and dividend growth. Our objectives are to generate total returns in line with the broad equity market and provide a high and rising stream of income with the lower volatility that an investor might seek from bonds or other income alternatives. With a primary goal of reliable income and long-term returns, coupled with a belief that investors can play an important role in securing a sustainable future, our shareholder advocacy efforts include environmental, social, and governance (ESG) research and/or screening, direct engagement with companies, filing shareholder resolutions, proxy voting, coalition building, and public policy involvement.

This report represents Miller/Howard Investments' views. The statistics and projections cited in this report have been provided by sources generally considered to be reliable, but are not guaranteed. Opinions and estimates offered constitute Miller/Howard Investments' judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. This material is solely informational. The information and analyses contained herein are not intended as tax, legal, or investment advice and may not be appropriate fr your specific circumstances; accordingly, you should consult your own tax, legal, investment, or other advisors, at both the outset of any transaction and on an ongoing basis, to determine such appropriateness. The material may also contain forward-looking statements that involve risk and uncertainty, and there is no guarantee they will come to pass. Any investment returns—past, hypothetical, or otherwise—are not indicative of future performance. The information provided should not be considered a recommendation to buy or sell any security, and should not be considered investment, legal, or tax advice. Securities mentioned are being shown for informational purposes only. Buy and sell rationales are the express opinions of MHI's investment team. These securities should not be considered a recommendation to buy, sell, or hold any of the securities and are not intended to imply that any one security listed above, or the portfolio as a whole, is suitable for a particular client. There is no assurance that the securities purchased have remained or will remain in the portfolio or that securities sold have not been or will not be repurchased. To receive a list of all recommendations for the previous year, please email **compliance@mhinvest.com**. Common stocks do not assure dividend payments. Dividends are paid only when declared by an issuer's board of directors, and the amount of any dividend may vary over time. Dividend yield is one component of performance and should not be the only consideration for investment. The returns on a portfolio that utilizes environmental, social, or governance (ESG) criteria for stock selection may be lower or higher than portfolios where ESG factors are not considered, and the investment opportunities available to such portfolios may differ.

**DEFINITIONS**

**S&P 500 Index®** widely regarded as the best single gauge of large-cap US equities and serves as the foundation for a wide range of investment products. The Index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

**Price-Earnings Ratio (P/E)**—The ratio of a company's share price to its earnings per share. The ratio is used as a valuation tool and can help determine whether a company is overvalued or undervalued.

**Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)**—A non-GAAP measure used to provide an approximation of a company's profitability. This measure excludes the potential distortion that accounting and financing rules may have on a company's earnings; therefore, EBITDA is a useful tool when comparing companies that incur large amounts of depreciation expense because it excludes these noncash items, which could understate the company's true performance.

**High-Dividend Yield Stocks** consists of Decile 7, 8, and 9 of a universe of US dividend paying common stocks with a market capitalization equal to or greater than $1 billion.

**Net Debt to EBITDA**—A measure that computes the company's ability to pay off its debt by utilizing the earnings before interest, taxes, depreciation, and amortization (EBITDA).

**Russell 1000 Index®** measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000 Index® and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 Index® represents approximately 92% of market capitalization of the US market.

**US Treasury 10-Year Yields** are yield to maturity and pretax. Indexes have increased in precision as of May 20, 2008, to 4 decimal places. The rates comprise Generic US Government on-the-run government bill/note/bond indexes.

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