Market Overview

Stimulus and vaccine optimism ran high during the first quarter with all eyes on the reopening of the economy and a return to some sort of normalcy in the not so distant future. The third wave of a spike in COVID cases and deaths as a result of the holiday season began to subside at the same time that vaccine distribution began to ramp up across the U.S. New variants of the coronavirus began hitting Europe late in the quarter and slowing their distribution efforts, but the effort in the U.S. has been much more successful. By the end of the first quarter over 150 million vaccinations had been administered with over 17% of the population fully vaccinated (52% of over 65 population). At the end of the quarter, the seven-day average vaccination rate was nearly 2.5 million per day. More states are paring back and/or removing restrictions and travel is beginning to pick up despite a small uptick in new variant cases in parts of the U.S. Although we are not likely to see global herd immunity for some time due to vaccine hesitancy, limited vaccine access particularly in emerging countries and a delay in vaccines for children, expectations are that we will see much more normal conditions in the U.S. and rest of the developed economies by the second half of the year.

The Democrats surprise victory in the Georgia Senate runoff elections and Joe Biden's inauguration as the 46th President raised expectations of increased fiscal stimulus. Democrats pushed through a $1.9 trillion coronavirus relief package that included $1,400 stimulus checks for individuals. Shortly after signing the package into law in early March, Biden introduced a $2.2 trillion infrastructure package which is expected to also run along party lines should it be passed. Most of this new package is expected to be paid for by increasing corporate taxes. Biden also announced a doubling of his vaccination goal to 200 million doses in his first 100 days which appears to be on track.

Reopening momentum drove economic data over the course of the quarter. U.S. GDP continued to recover from the depths of the spring shutdown of the economy. Although the U.S. economy contracted by -3.5% in 2020, current estimates are for the economy to grow by over 6% for full year 2021, which would be the best calendar year growth in 37 years (1984). The unemployment rate improved to 6.0% after touching 14.8% in April of last year. Over 1.6 million new jobs were added in the quarter, with over 40% of those job coming from the leisure and hospitality sector. Retail sales rose substantially during the quarter. Consumer spending is expected to ramp up significantly going forward due to the stimulus payments, above average personal savings rates in 2020, and general pent-up demand by individuals. Indeed, goods expenditures have increased above pre-pandemic levels while services remain below prior levels, which most expect to recover this summer as pent-up travel demand will drive the leisure and hospitality sector.

Massive stimulus spending and supply shortages as a result of the pandemic have increased inflation well above the Federal Reserve's two percent target. Five-year forward inflation expectations were over 2.5% at quarter end, which also drove longer term interest rates higher. The 10 Year Treasury bond yield almost doubled over the quarter, rising from 0.92% to 1.74%, a tremendous move over such a short period. Bond markets were indicating that the Fed would likely be tapering purchases and raising short term rates sooner than projected; however, Chairman Powell reiterated in no uncertain terms that the Fed is not thinking of removing accommodation any time soon. Current Fed projections indicate that they will not raise rates until 2023 and the Fed has stated it is willing to let inflation run above target in order to get back closer to full employment. The Fed's balance sheet stands at over $7.7 trillion and is now more than 35% of GDP, well above the 15% level during the 2008 Global Financial Crisis.

March 23rd marked the one-year anniversary of the trough in the equity markets due to the pandemic and the S&P 500 has risen 75% since then. The tailwinds of the liquidity provided by the Federal Reserve has driven tremendous flows into risk assets over that period of time. Furthermore, the success of the COVID vaccine trials and subsequent rollout have also driven those flows. Equity inflows over the past five months (after the first Pfizer vaccine was approved) topped a record $570 billion. Q4 earnings unexpectedly turned positive, growing 3.9% year-over-year. After declining by 22% in 2020, Wall Street is expecting that S&P 500 earnings will grow by 25% in 2021, including 25% in Q1, which would be the highest quarterly growth in 2 ½ years. Whereas growth stocks, particularly companies benefiting from the work-from-home phenomena, led us out of the trough, the last five months have been driven by cyclical sectors and reopening beneficiaries.

The Russell 1000 Value Index rose 11.3% in the quarter while growth stocks (Russell 1000 Growth) rose 0.9%. This marks the second consecutive quarter of outperformance for value stocks, which last occurred in Q1-Q2 2016. The S&P 500 finished the quarter up 6.2% and small cap stocks (Russell 2000) continued their recent outperformance versus larger companies, rising 12.7%. International stocks (MSCI ACWI ex-US) rose 6.5% as global reopening and vaccine distribution has been less consistent than in the U.S.

Portfolio Review and Outlook

The Principal Street Equity Income Strategy returned 13.3% gross of fees (13.1% net) in the first quarter versus 11.3% for the benchmark Russell 1000 Value. All ten sectors represented in the portfolio were positive for the quarter and 37 out of 40 companies were positive.

The Strategy's consumer discretionary sector allocation was the top performing sector for the quarter (+29%) followed by materials (24%) and financials (23%). Travel + Leisure (42%), Penske Automotive (41%) and Steel Dynamics (38%) were the best performers. The Strategy's worst performing sector was utilities (2%) and health care (4%). Clearway Energy (-11%), PepsiCo (-4%) and Pfizer (-1%) were the only negative performing companies for the quarter.

Twelve portfolio companies announced dividend increases this quarter, led by NRG Energy, General Dynamics and Hartford Financial (all with an 8% increase). The average quarterly increase for the companies that increased dividends was 5% percent. Twelve portfolio companies paid increased dividends during the quarter, averaging a 6% increase. Our portfolio continues to provide above-market dividend growth with a 5-year dividend growth rate of 9.7% compared to 6.6% for Russell 1000 Value. The portfolio's dividend yield is 3.1%, well above the Russell 1000 Value's dividend yield of 2.0% and the S&P 500's yield of 1.4%.

Early in the quarter, we swapped out four companies in the portfolio. We liquidated Lumen Technologies (LUMN), General Mills (GIS), Gilead Sciences (GILD) and Intel (INTC). The new additions to the portfolio were Interpublic Group (IPG), Chevron (CVX), Wyndham Destinations (later renamed Travel + Leisure (TNL)) and Penske Automotive Group (PAG). These new four companies were immediately additive to portfolio performance, rising by an average of 34% since purchase. The portfolio changes increased our exposures to more cyclical industries that will benefit from the reopening of the economy while reducing exposure to more defensive sectors. Our allocation remained dynamically overweighted to utilities (15% target) as well as financials, consumer staples, information technology and health care (each a 12.5% target) We still equal weight portfolio positions at 2.5% target.

Our portfolio finished the quarter at a 14.9x forward earnings multiple, which is far lower the 18.2x of the Russell 1000 Value benchmark and the 21.8x of the S&P 500.

We have seen strong rotation into cyclical sectors and value stocks over the past two quarters as the vaccine rollout has picked up steam and we have seen green shoots in the economy. Despite that, relative valuation of value versus growth is still very low compared to last 20 years. Growth outperformed value by 121% from 2015 through 2020, and we believe that we may be entering a period where we will continue to see value make up lost ground. Investors remain overweight growth vs. value (the top 10 companies in the S&P 500 are mainly growth companies and make up 27% of the index), which we believe still provides a tailwind for the rotation to continue.

Rising interest rates have negatively impacted growth stocks this year as they pressure valuations. Despite the move in rates over the past 7 months, value and more importantly dividend stocks have outperformed, which we believe is reflective of the fact that these companies will do well if the economy is growing. Historically, value stocks outperform growth stocks when corporate earnings are growing, which is even more of a positive for dividend payers as earnings growth and dividend growth go hand in hand. The fact that higher dividend stocks are outperforming lower dividend stocks over the past two quarters as the economy improved, we believe is indicative of this.

The yield on our benchmark Russell 1000 Value is the lowest it has been over our strategy's existence (13 years) and the yield on the S&P 500 is at its lowest since 2002. Our current yield of 3.1% is the lowest it has been in 11 years. That being said, we believe that our portfolio companies are poised to begin ramping up dividend increases at a much higher level than the past few years. Many of our companies made the prudent decision in 2020 to conserve cash and slow dividend increases or not increase at all. As conditions have improved, companies have more clarity and are able to increase dividends at higher rates than in 2020. Furthermore, during the pandemic the Fed prohibited major banks from increasing dividends or buying back stock. The Fed announced recently that it will allow banks that pass the stress tests to begin increasing dividends again, which we believe will unlock substantial increases in financial sector dividend yields.

In the depths of the pandemic, we dynamically weighted our portfolio towards defensive sectors as well as technology to ride out the storm. Over the past few quarters, we have begun transitioning the portfolio into the reopening theme by increasing our allocation to more cyclical sectors like financials and industrials. We are likely to continue this reweighting in the future to take advantage of this momentum which we believe will improve not only portfolio yields but also total returns.

As always, we appreciate your continued trust in our team. We remain ever confident that dividend investing is a sensible long-term strategy and that will lead to attractive income generation and total returns over time.

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