Market Overview

The COVID-19 pandemic continued to upend the global economy in the third quarter as cases and deaths rose. U.S. cases increased by 4.6 million and close to 80,000 additional Americans lost their lives to the virus. After spiking in July, U.S. new case growth dropped into the end of the quarter, but as of this writing cases are once again approaching July's levels. Global daily new cases remained over 250,000 per day in Q3 as cases in Europe fell but developing nations saw large increases. There is also a growing concern about case growth as we enter the colder months as people will be forced indoors. Economic reopening occurred in various stages across the U.S. as wearing masks, washing hands and social distancing have become a part of everyday life. Although the virus has become a political issue, the vast majority of Americans are implementing safeguards to stem the spread. Four vaccines began phase 3 trials in the U.S. with the hope that one or more will achieve emergency use authorization before the end of 2020. In addition, treatments and testing breakthroughs are also occurring.

U.S. GDP fell by a whopping 31.4% in the second quarter, the largest drop since the Great Depression; however, there were signs that the economy was rebounding during the third quarter as the country learned to deal with the virus and get back to work. Q3 GDP is currently forecast to grow by 30%. The U.S. lost 22.2 million jobs during the shutdown in March and April, and 11.4 million jobs have been added back in the months since. The unemployment rate peaked at 14.7% in April but has fallen for 5 straight months (7.9% currently). The housing market has been a real strong spot for the economy as the work-from-home movement is causing Americans to reconsider their home situation. Although the third quarter showed momentum, there are concerns that it may be slowing and that instead of a V-shaped recovery we may be witnessing a K-shaped recovery as various sections of the populace are not seeing improvement in their employment and financial situation. Several companies have recently announced new layoffs (for instance Disney announced 28,000 employees who were furloughed will now be permanently let go).

Stimulus from the Federal Reserve and Congress have been the main drivers of keeping the economy going. The Fed has increased its balance sheet by close to $3 trillion since March and announced that it will change with prior inflation policy and allow the labor market to run hotter than in the past to not impede a recovery. After dropping the Fed Funds rate back to zero-bound levels, the Fed is indicating that it will keep rates low until at least 2023. Congress had passed over $2.4 trillion in fiscal stimulus since the pandemic began, and over the course of Q3 news headlines focused on negotiations of an additional package in the $1-3 trillion range depending on the side proposing it. However, negotiations between House Democrats and the White House stalled and do not appear to be on track for passage until after the election.

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Although S&P 500 earnings fell 31% year over year for the Q2 reporting period, final numbers came in much stronger than originally anticipated (-44%). Many management commentaries were optimistic and aggressive cost cutting and the growing acceleration of many secular growth stories (e.g. work-from-home, cloud, etc.) led to better than expected earnings projections. Many management teams remain reluctant to provide much in the way of forward earnings guidance until COVID-19 is more fully under control, but there is at least more clarity as to what the economic impacts from the virus will be allowing consumers to spend once again and management to focus on future growth. Third quarter earnings for the S&P 500 are projected to decline by -20% year over year but are already signaling that those numbers may be overly pessimistic.

Equity markets were forward looking rather than focused on the past as returns were strong again for the second straight quarter. The Russell 1000 Value Index rose 5.6% and had rallied 41% off its March 23 lows. Despite the rally, the index remained -18% below its February 19 high and down -11.6% for the year. Growth stocks (Russell 1000 Growth followed its record return in Q2 with another strong quarter (+13.2%). Growth stocks fully recovered from the March drawdown in early June and are now up 24.3% for the year. By mid-August, the S&P 500 had also fully recovered from its March 23rd lows before faltering in September; however, the broad market index finished the quarter up 8.9% and 5.6% for the year. Small cap stocks (Russell 2000) rose 4.9% (-8.7% YTD) and international stocks (MSCI ACWI ex-US) rose 6.3% (-5.4% YTD).

The divergence between the mega-cap secular growth companies (Facebook, Apple, Amazon, Microsoft and Google) and the rest of the market persisted in the third quarter as these 5 companies are now an astounding 23% of the market capitalization of the S&P 500. Indeed, even as the S&P 500 was up 5.6% for the year, the equal-weighted S&P 500 remains down -4.7% year to date, reflecting how many of the remaining 500 companies in the index (the S&P 500 actually consists of 505 companies) are struggling this year. I sound like a broken record, but the growth outperformance versus value stocks continues to widen by historic proportions. The selloff in September was the first month that value stocks was bested growth stocks in a year. Value has underperformed by 36% so far this year, and if this gap were to be maintained for the remainder of 2020 it would mark the worst relative year ever by a wide margin (-26% in 1999 being the prior record). Relative valuations of value vs. growth stocks is at Tech Bubble (2000) levels.

Portfolio Review and Outlook

The Principal Street Equity Income Strategy returned 3.3% gross of fees (3.2% net) in the third quarter versus 5.6% for the benchmark Russell 1000 Value. All eight sectors represented in the portfolio were positive for the quarter and 27 out of 40 companies were positive. For the year, our strategy is down -22.9% gross (-23.3% net) versus -11.6% for the benchmark.

The Strategy's materials sector allocation was the top performing sector for the quarter (+12%) followed by industrials and communications services. Cummins Inc. (+23%), Comcast (+19%) and Clearway

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Energy (+18%) were the best performers. The Strategy's worst performing sectors were financials (+0.1%) and health care (+0.7%). Gilead Sciences (-17%), Cisco Systems (-15%) and Walgreens Boots Alliance (-14%) were the worst performing companies.

Nine portfolio companies announced dividend increases this quarter, led by Clearway Energy (+49%), Texas Instruments (+13%) and PepsiCo (+7%). The average quarterly increase for the companies that increased dividends was 9.4% percent. Six portfolio companies paid increased dividends during the quarter, averaging a 10.8% increase. Our portfolio continues to provide above-market dividend growth with a 5-year dividend growth rate of 9.1% compared to 6.6% for Russell 1000 Value. The portfolio's dividend yield is 3.9%; in line with our historical average of 3.7% and well above the Russell 1000 Value's dividend yield of 2.6%.

We made one change to the portfolio last quarter, replacing Dominion Energy (D) with Pinnacle West Capital (PNW). Dominion announced a 34% "rebasing" of their dividend due to selling their gas transmission and storage assets to Berkshire Hathaway Energy, causing us to replace the holding. Our allocation remained dynamically overweighted to consumer staples (20% target), information technology, health care and utilities (each a 15% target) We still equal weight portfolio positions at 2.5% target.

Our portfolio finished the quarter at a 13.5x forward earnings multiple, which is far below the 17.2x of the Russell 1000 Value benchmark and the 21.5x of the S&P 500. Furthermore, our 3.9% ending dividend yield is in line with our long-term average and well above the Russell (2.6%) and S&P (1.7%) yields. Even though the market's dividend growth was stunted during the 2nd quarter as many companies cut/suspended dividends or at least paused dividend increases, our portfolio companies continue to grow their dividends in many cases, which will also should help with long-term growth in values.

Our strategy invests in higher yielding dividend-paying companies, which unfortunately have come under tremendous pressure in 2020. The top two quintiles of dividend payers in the Russell 1000 (2.6% yield and higher) have returned an average of -22% this year. This is our target universe (2.5% yield or higher when included in the portfolio). By contrast, lower dividend yielders are down -5% and non-dividend payers are up 12% for the year. We have found that in the typical bear market rally investors gravitate to dividend payers as they desire cash flow, safety of margin (value) and more conservative balance sheets. The unique nature of this past bear market is that many higher multiple technology-driven companies have seen their services in even higher demand despite many value-oriented sectors experiencing difficulties as a result of the shutdown and shifting consumer behaviors (work from home, reduced travel, telehealth, etc.). Although we remain in uncertain times, we are encouraged that medical advancements in combating the coronavirus are imminent, which will be a major boost to many of our portfolio companies and for many value and dividend-oriented companies as well. Many value stocks are cyclical in nature and have been more negatively impacted by the pandemic. A breakthrough on the vaccine front and the subsequent acceleration in reopening of the domestic and global economy would be a significant tailwind for many of these cyclical sectors.

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Value stock sectors are more reflective of the overall U.S. economy than growth companies and their overweight in the S&P 500. Information technology and communications services sectors make up 39% of the S&P 500, yet those sectors account for only 2% of employment and 6% of GDP in the second quarter[1]. Traditional value sectors (financials, health care, industrials and consumer staples are 52% of Russell 1000 Value Index) also account for 39% of the S&P 500 but are over 50% of employment and 59% of GDP. So, when the economy reaccelerates, it is logical that these sectors would be the primary beneficiaries of that momentum.

As I mentioned earlier in this letter, the relative value of value vs. growth are at levels last seen during the Tech Bubble. We are also seeing a tremendous valuation dichotomy between low yielding stocks and high yielding stocks. Our research has demonstrated that from 1989-2018, dividend payers outperformed non-dividend payers by over 3% annualized and that companies in the top 2 quintiles of dividend yield (companies with 2.5% yields or higher) were the top performers[2]. The current valuation differences we are seeing are also at 40 year highs, leading us to believe that a reversion to the mean will happen eventually. Trees do not grow to the sky and investors will eventually rediscover the attractiveness of companies with strong balance sheets and a history of steady and growing dividend policy. There are a lot of potential land mines for the mega-cap technology-oriented stock market leaders – potential increased government oversight, stretched valuations and crowded positioning; and we believe that we will see a rotation into value and dividend payers in the near term.

As always, we appreciate your continued trust in our team as we wade through a difficult year for our strategy and remain ever confident that dividend investing is a sensible long-term strategy that will once again prove its mettle in these trying times.

James West, CFA

[1] JP Morgan: *Guide to the Markets 4Q 2020*
[2] Principal Street Partners: *A Perspective on Dividend Investing 2019 Revision*

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