Market Overview

At the end of the second quarter over 54% of Americans had received at least one dose of the vaccine, although the pace of vaccinations slowed substantially. New cases and deaths fell to levels last seen in the early days of the Pandemic, but the U.S. did pass the grim milestone of more than 600,000 deaths during the quarter. Furthermore, the vast majority of deaths occurred in unvaccinated individuals, demonstrating the efficacy of the vaccine and showing us a light at the end of the tunnel if we could get to herd immunity. As shots in arms increased, mask guidance was relaxed, and many companies began the process of returning some if not all of their employees to their offices. People began eating out more and travelling. Companies that had been decimated by COVID, especially in the hospitality industry, began staffing back up.

Unfortunately, as of this writing, the U.S. and rest of the world are experiencing a resurgence of the virus, namely that of the Delta variant that has reversed case counts, particularly among the unvaccinated. Whereas earlier in the year vaccine supply was viewed as the impediment to achieving herd immunity, that dynamic has now shifted to waning demand.

Congress struggled to pass a bipartisan infrastructure package that was much smaller than the one proposed by the Biden Administration in March but executed on his promise to work with Republicans on legislation. Expectations are the bill will be up for passage sometime before the August recess for Congress. The package currently targets $1.2 billion over eight years with half of it focused on “traditional infrastructure” (e.g., roads & bridges). The proposal included no new taxes, yet Democrats signaled their intentions to pass a much larger, partisan package through reconciliation that would likely involve increased income taxes on corporations and the ultra-wealthy, as well as an increase in capital gains taxes.

The tailwinds of central bank liquidity, fiscal stimulus and further reopening due to increased vaccination distribution continued to buoy the U.S. economy but concerns of peak economic growth and rising inflation began to percolate. The U.S. economy grew by 6.4% in the first quarter and the U.S. ISM non-manufacturing survey hit an all-time high. Headline CPI inflation rose 5.3% and Core CPI inflation rose 4.5% year over year in June, the highest readings in over 13 years and 19 years respectively. 10 year forward inflation expectations rose to an eight year high (2.6%) in the middle of May. Prices have been increasing on order backlogs (particularly due to the semiconductor shortage), supply delays, lower inventories, and increase wage pressures. Anecdotal stories about restaurants offering signing bonuses and other perks color a job market where power has shifted from employers to employees.

The Federal Reserve's message about heightened inflation concerns has consistently been that inflation will be transitory as it is a byproduct of the reopening the economy after the Pandemic. Despite the messaging, markets began to focus on the chance that high inflation may last longer than the Fed projects, which would push the Fed to tighten and raise interest rates quicker than anticipated. Expectations are rising that the Fed will begin to taper bond purchases (currently $120 million per month) as Fed Chairman Powell admitted that the Fed has begun to discuss tapering although it is still "a ways away". The Fed delivered a hawkish surprise at the June FOMC meeting in that Fed participants projected two Fed Funds Rate hikes in 2023 versus none after the March meeting. The Fed did manage to talk down inflation concerns late in the quarter, which caused forward inflation expectations to decline from mid-May highs. Interest rates also fell after sharply rising in Q1 as the 10 year Treasury rate fell from 1.74% to 1.45%.

S&P 500 earnings rose 53% year-over-year for the first quarter reporting season, no surprise given its comparison to the beginning of the pandemic shutdowns (for reference Q1 2020 earnings fell 15% from the prior year). The numbers substantially beat expectations of 24% growth due strong margin and revenue growth. Headed into the Q2 earnings season, expectations are for 64% growth (Q2 2020 earnings during the worst of the shutdown fell 32%).

The Russell 1000 Value Index rose 5.2% in the quarter while growth stocks (Russell 1000 Growth) reversed two quarters of relative underperformance by rising 11.9%. 2021 has been a tale of two parts. For the first 4 ½ months, value outperformed, but over that last 6 weeks of Q2 growth significantly outperformed as interest rates fell. Year to date, value is still outperforming growth 17.1% versus 13.0%. The S&P 500 finished the quarter up 8.6% (15.3% YTD) and small cap stocks (Russell 2000) lagged their large cap counterparts, returning 4.3% (17.5% YTD). International stocks (MSCI ACWI ex-US) rose 5.5% for the quarter and 9.2% year to date as increased COVID-19 spread and low vaccine distribution outside of Europe has hampered reopening of many economies.

Portfolio Review and Outlook

The Principal Street Equity Income Strategy returned 3.1% gross of fees (2.9% net) in the second quarter versus 5.2% for the benchmark Russell 1000 Value. All ten sectors represented in the portfolio were positive for the quarter and 25 out of 40 companies were positive.

Year to date, the Strategy returned 16.8% gross (16.4% net) versus 17.1% for the benchmark Russell 1000 Value.

The Strategy's materials sector allocation was the top performing sector for the quarter (+12%) followed by information technology (7%) and health care (4%). Morgan Stanley (19%), Steel Dynamics (18%) and NetApp (13%) were the best performers. The Strategy's worst performing sectors were industrials (1%) and utilities (1%). Hartford Financial Services (-7%), Penske Automotive (-5%) and Cummins (-5%) were the worst performing companies for the quarter.

Nine portfolio companies announced dividend increases this quarter, led by Morgan Stanley (100%) and PepsiCo, Leggett & Platt, and Johnson & Johnson (all with an 5% increase). The average quarterly increase for the companies that increased dividends was 14% percent. Ten portfolio companies paid increased dividends during the quarter, averaging a 4% increase. Our portfolio continues to provide above-market dividend growth with a 5-year dividend growth rate of 10.0% compared to 6.0% for Russell 1000 Value. The portfolio's dividend yield is 3.2%, well above the Russell 1000 Value's dividend yield of 1.8% and the S&P 500's yield of 1.3%. Most importantly, our companies are generating significant cash flow to cover their common dividend payments (3.8x coverage ratio).

Early in the quarter, we swapped out three companies in the portfolio. We liquidated Comcast (CMCSA), Goldman Sachs (GS) and Pinnacle West (PNW). Comcast and Goldman outperformed our expectations in the short run (+47% & 119% respectively since being added last Spring) and were removed because their dividend yields had gotten very low (+1.8% and 1.5%). The new additions to the portfolio were First Horizon (FHN), Leggett & Platt (LEG) and Regions Financial (RF). The portfolio changes increased our financials sector exposure as interest rates are forecast to rise on strong economic growth and in the consumer discretionary sector that should also benefit from the reopening. Our allocation is currently dynamically overweighted to financials (15% target) as well as utilities, consumer staples, information technology and health care (each a 12.5% target) We still equal weight portfolio positions at a 2.5% target.

Our portfolio finished the quarter at a 14.5x forward earnings multiple, which is far lower the 17.0x of the Russell 1000 Value benchmark and the 21.3x of the S&P 500.

Market dividend yields continue to fall. The current 1.31% yield on the S&P is the lowest of any time save for the Tech Bubble in 1999-2001. The tremendous rebound in prices since March 2020 and many dividends being suspended, cut, or not increased for much of last year is a primary driver of the drop in yields. Despite current levels, we continue to see dividend momentum, particularly in our focus companies. At the conclusion of the Fed stress tests in late June, many of the major banks were able to release reserves on improving credit trends. This led to many banks announcing their intention to increase dividend payouts and restart stock buyback activity. We had specifically increased our exposure to the financial sector in anticipation of this. Portfolio holdings State Street indicated a 10% raise, JP Morgan Chase an 11% raise and Morgan Stanley a whopping 100% increase.

We recognize that the current rate of economic and earnings growth is not sustainable long term, but we also do not think that peak growth means things will go negative. We expect economic growth to slow, but still remain above where it was pre-COVID. Some sectors still are just emerging from their depths and have room to run while others will likely begin to moderate. Furthermore, we expect earnings growth will remain strong, especially for higher quality companies with a history of generating consistent cash flows that fund above-market dividend policies. High quality dividend payers tend to perform well in the mid to late economic cycle due to their earnings consistency. We are also encouraged that we are allocated to some industries, like travel, that are still in the early stages of recovery and that we expect will see strong forward earnings in the quarters to come.

The shift in relative performance between value and growth stocks that occurred in mid-May coincided with interest rates falling after inflation expectations fell. Falling interest rates are a positive for "long duration" stocks like growth companies because it increases the valuation of future growth. Despite the recent drop in interest rates, it is our expectation that rates will increase over the next few years, which will benefit value over growth. Relative valuations of value stocks versus growth stocks remains very low compared to the last 20 years despite the value's outperformance in late 2020 and early 2021. We recognize value will not outperform in every quarter, but the fact that value companies tend to outperform in periods of strong economic growth gives us comfort. Pair that with relative valuations between high dividend payers and low dividend payers still being quite sizeable and we continue to believe that we are settling into a very favorable period for our Equity Income Strategy.

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.

James West, CFA

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