Principal Asset Management[SM]

PRINCIPAL SMA REAL ESTATE EQUITY SECURITIES

Quarterly commentary

FIRST QUARTER 2024

Market review

United States property stocks (FTSE NAREIT All Equity REITs Index) modestly retreated to start the year, returning -1.3%. Real estate stocks lagged broader equity markets (S&P 500, +10.6%), which saw continued strength driven by large capitalization technology stocks on further artificial intelligence (AI) enthusiasm.

Following growing optimism for a near term Federal Reserve (Fed) pivot to end 2023, markets pushed back the timing of expected rate cuts on stalled disinflation momentum. Inflation readings during the quarter came in stronger than expected with upward pressure from housing and energy prices. Fedspeak continued to emphasize data dependence with Chair Jerome Powell noting the two-sided risks to easing policy too quickly (potentially reigniting inflation) versus maintaining restrictive policy for too long (potentially impairing economic growth prospects). While uncertainty remains, market expectations are for the first cut to occur this summer, and for a total of three reductions during the year. This outlook now approximately matches the Fed's own projections. Meanwhile, economic data was mixed during quarter but viewed favorably and supportive of a soft landing. Labor markets remained firm, without a material pickup in unemployment and wage growth exhibited some welcomed signs of cooling. Retail sales decelerated, yet it was seen as unclear whether this clouded the recent pillar of consumer-resiliency.

Slightly weaker than expected 2024 outlooks and higher rates contributed to underperformance of real estate stocks. 10-year yields were less volatile but expanded by approximately 32 basis points during the quarter. Real Estate investment trusts (REITs) are calling for earnings growth in the low single digits on average, with higher interest rates and potentially conservatism at play. This compared negatively to broader equity markets where earnings growth of close to 10% is anticipated. Leadership during the quarter favored cyclicals, with malls and lodging posting the strongest returns on increased soft-landing hopes and less pressure from rates given lower valuation multiples. Conversely, net lease, manufactured housing, and storage trailed, pressured by longer lease duration (greater rate sensitivity), idiosyncratic company issues, and weak pricing power, respectively.

Portfolio Performance

The portfolio lagged the index on a gross basis due to negative allocation. An underweight to the more cyclical mall and advertising sectors, which outperformed on signs of resilient economic data and retail spending was the main culprit. Selection within industrial was also detractive because of questionable capital allocation decisions at a key portfolio holding and below expectations guidance at another. Contribution came mainly from the net lease sector where the portfolio avoided owning companies that missed consensus earnings and are encountering tenant credit issues. An overweight to single family rental which outperformed on solid operating results and guidance was also additive.

Outlook

After a strong performance in the fourth quarter of 2023, REITs have lagged equities once again in the first quarter of 2024 as interest rate cut expectations have been dialed back. We continue to believe that REITs offer an attractive investment opportunity with valuations looking very cheap both when measured against public equities and private real estate. Rate cuts, which have historically been a strong tailwind for REITs, also look to be increasingly a matter of “when” not “if” given the dovish leanings out of the March Fed meeting. Whilst U.S. economic data have been broadly resilient, there remain signs of weakness under the surface with sluggish bank loan growth and a weak household employment survey.

Recent commentary from Jerome Powell suggests Fed remains on course to deliver three rate cuts later this year, likely commencing from June despite resilient economic data. This is likely intended to pre-emptively ward off downside risks to the economy. Provided inflation continues to moderate, these rate cuts could allow the Fed to achieve the much talked about soft landing—a virtuous cocktail of decelerating inflation driven by easing supply side constraints and improving economic momentum. It is however fair to say that history is not on the Fed’s side —most interest rate increases of such magnitude have tended to ultimately end in recession.

Regardless of outcome, be it soft landing or recession, there is a strong case for owning REITs at this point in time. A soft-landing could mean the best possible outcome of positive absolute and relative returns for REITs. Rate cuts drive expectations of lower borrowing costs and discount rates which inordinately benefit capital intensive asset classes; meanwhile improving growth helps bolster the topline. Admittedly a recession may mean negative absolute returns for both broader equities and REITs. However, REITs have historically tended to be relatively defensive during such periods. Historical evidence suggests that REITs have delivered strong positive returns in the 12 months after real yields peaked.

Top 3 contributors

Relative performance versus the benchmark

Realty Income Corporation - An underweight to this net lease owner contributed positively. Earnings guidance came in below expectations as the company projected muted external growth activity in 2024 on transaction market uncertainty.

Marriott Vacations Worldwide Corporation - An overweight to this timeshare REIT contributed to performance. Fourth quarter earnings beat expectations, with no negative surprises, helping investors put faith back in the stock after a number of negative surprises in 2023.

Crown Castle Inc. - An underweight to this tower REIT contributed to our performance. News flow focused on the company's battle with founder/former CEO Ted Miller who is seeking his own slate of Board nominees (including himself) and earnings update. It was not stock moving, however. The other update was the upward move in real rates and likely higher for longer expectations on interest rates.

Top 3 detractors

Relative performance versus the benchmark

Ventas, Inc. - An overweight to this health care REIT detracted from performance. Earnings update disappointed with annual guidance (mainly FFO) falling short of expectations.

Simon Property Group, Inc. - An underweight to this mall/outlet stock detracted from our performance. Solid core trends and greater risk appetite on soft landing optimism contributed to performance. Investors also appeared to look past 2024 guidance that came in below expectations given the company's historical track record of conservatism.

Iron Mountain Incorporated - An underweight to this data storage and information management services REIT detracted from performance. The company put up better than expected quarterly earnings and issued upside 2024 earnings guidance.

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Risk considerations

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility. Real estate investment options are subject to risks associated with credit, liquidity, interest rate fluctuation, adverse general and local economic conditions, and decreases in real estate values and occupancy rates.

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