Principal Asset Management℠

Principal Edge

2023 mid-year update

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The first half of 2023 brought with it the first high-profile casualties of the Federal Reserve's shift to aggressive interest rate increases. What is so striking about the failures of Silicon Valley, Signature, and First Republic banks is that they were driven by deposits, not credit, and it all happened in the blink of an eye. Despite these bank failures, the economy has remained resilient with the highly anticipated recession pushed out further into the future. The tension between economic growth, costs, and interest rates leaves us in somewhat uncharted territory, making this a particularly bewildering and exciting time for investors. It's bewildering because uncertainty makes predicting market movements in the short-term largely guesswork, and it's exciting because the resultant short-term dislocations can provide attractive investment opportunities for those with their dominant eye on the long-term.

One interesting aspect of the recent bank failures was how quickly investors and pundits were willing to paint all regional banks with the same brush. To us, the failures demonstrated the need for heightened vigilance and selectivity at the company level, not a wholesale rejection of an industry. Regional banks provide competitive accountability to large banks and are important providers of capital to small and medium-sized businesses. Many have expertise in niche or small markets, allowing them to build relationships with customers. While we acknowledge the potential for rising capital requirements and other regulatory headwinds to earnings, we also know there are regional banks that are already well-capitalized and are positioned to gain market share during these challenging times. We build our portfolios across sectors from the bottom up and believe we aren't doing our job if we can't identify any winners in a major sector of the economy.

The good news for bank investors is that a lot of bad news is already out and discounted in stock prices. But what about other industries? Rapidly rising interest rates don't just impact banks; they impact every company in every sector that uses leverage to manage their business. Commercial real estate is an obvious offshoot given the amount of leverage used and the challenges in sub-industries like office. But what about healthcare, consumer, or industrial companies that have depended on the ability to regularly refinance rising debt as they made acquisitions to drive growth? The point is that no industry is entirely immune from the impact of higher rates, and heightened vigilance is critical across the marketplace to select companies that can manage or even capitalize on headwinds and, more importantly, avoid those that can't.

So, the question becomes: With all these headwinds, why has the economy been so resilient when recession expectations remain on the horizon? Our conversations with management teams clearly indicate that economic activity has slowed, and inventory destocking is weighing on sales, but there are some silver linings as well. Supply chain issues are slowly improving, freight costs have declined, and many raw material prices have come down from lofty levels. For companies with differentiated products and services that have positioned their balance sheets conservatively, the environment is actually pretty good.

Even with softer demand, those that can take market share are well-positioned to grow profitably as the massive cost issues they've been facing abate. That brings us back to the tension between economic growth, costs, and interest rates. It provides both pitfalls and opportunities and is an exciting backdrop for long-term, fundamental investors.

We do not know what the second half of 2023 will bring, but we are confident in the businesses we own. We continue to rely on our sector-neutral approach and remain focused on investing in quality, cash flow generating dividend growers that we believe will be meaningfully larger over our long-term horizon. Our returns won't lead the way when the market is flying higher in a liquidity-driven risk-on environment, but our dedicated approach has historically led to upside participation and downside mitigation in a variety of market environments. While higher interest rates make the dividend yield less compelling in the short-term, interest alone can't compete with the powerful combination of compounding capital appreciation and dividend growth over longer time horizons.

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