PALLAS
CAPITAL ADVISORS

PCA Market Commentary

October 2019

Looking Past The Headlines

The S&P500 finished the third quarter of this year with slightly positive returns, +1.9%, which brought its year to date returns to 19%. The rise in both risk seeking and risk adverse assets demonstrates the uncertain view of the future held by investors. Without question, the geopolitical environment seems to hold sway in terms that we have not seen in many decades. The past quarter was punctuated by many important events:

In The Headlines:

Trade war and protectionism

Slowing in economic growth across the globe

Geopolitical instability

Yield curve inversion

Crude oil spike after Saudi oil production is attacked

Dollar strength creating strong headwinds for US trade

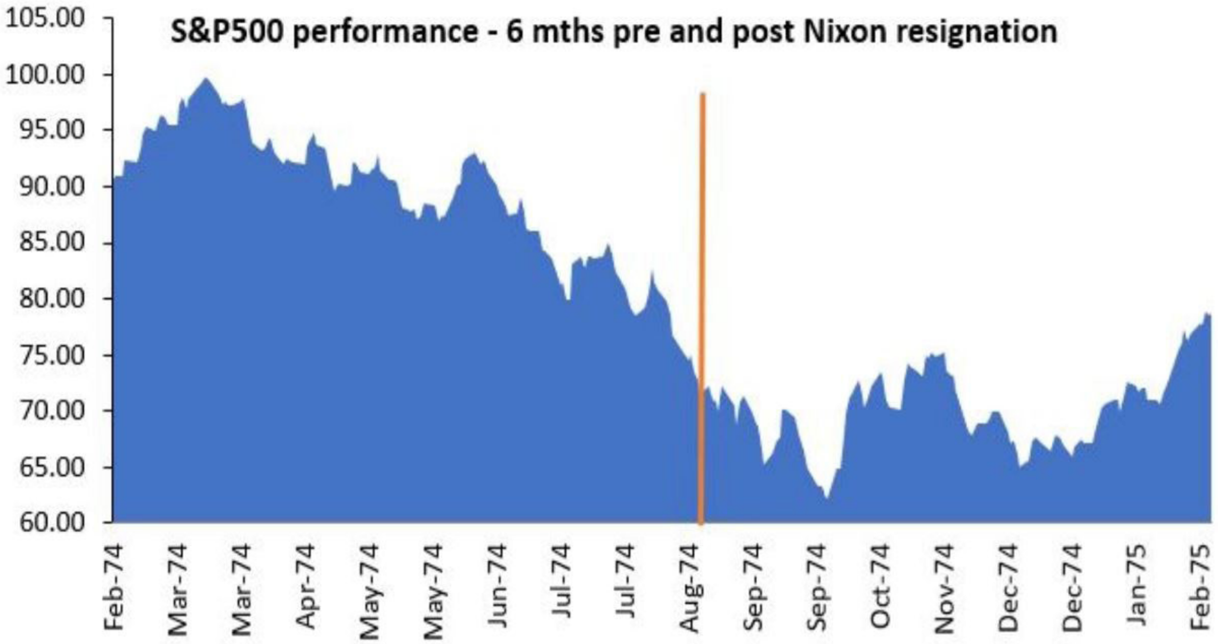
Repo rate spikes and variability

Impeachment momentum

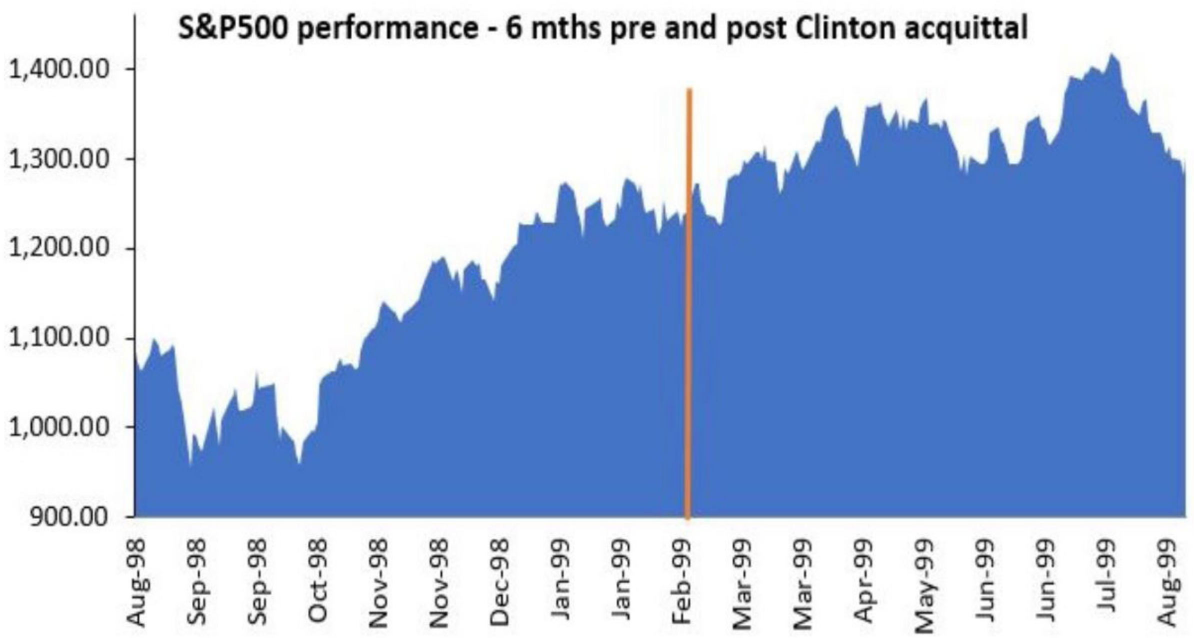
Intuitively, we understand that political instability is the antithesis of calm markets and uptrend's in asset performance. However, a closer examination of the two prior presidential impeachment (or near impeachment) scenarios, suggests that declining returns is not a foregone conclusion.

While negative markets overshadowed the Watergate controversy, positive performance was the trend surrounding the impeachment of Clinton. In both cases, the underlying economic fundamentals of the period outweighed the uncertainty of political turmoil.

In the prior six months to Nixon's resignation in August 9, 1974, the markets (proxied by the S&P500) declined -10.8%, and in the subsequent six months showed the markets continued the decline by -2.8%. This period was marked by economic contraction and failed stimulus policies by the President, Congress, and the Fed, which precipitated double digit inflation. Contrast this with the euphoric state of the economy during the Clinton impeachment, where the prior six months to the President's acquittal saw a market uptrend (proxied by the S&P500) of 13.5%, and a continued climb of 5.8% for the subsequent six months.

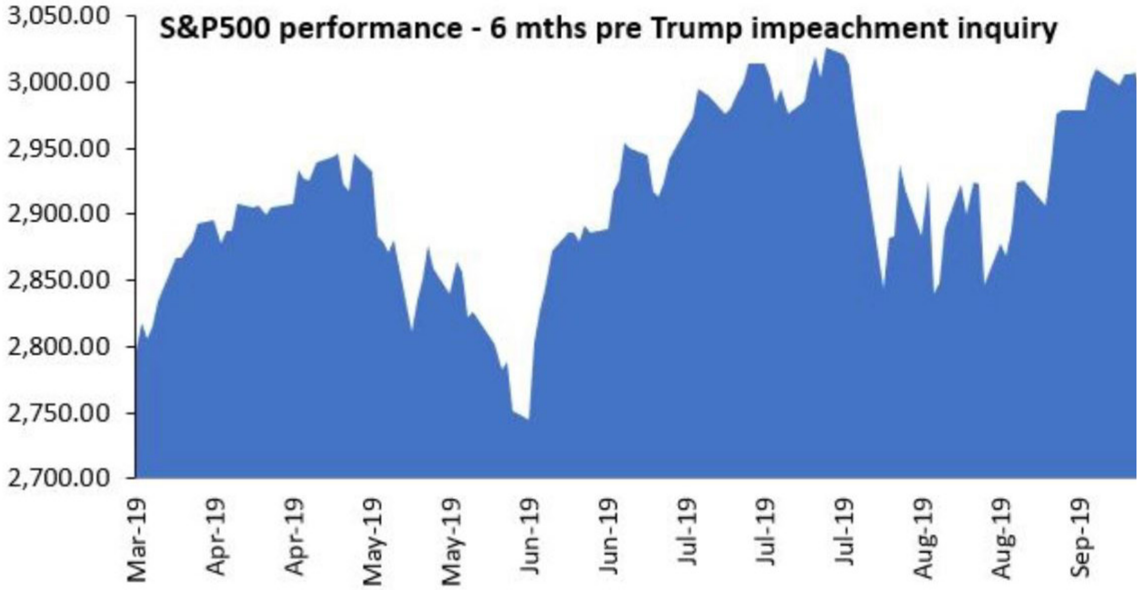


Source: Pallas Capital Advisors, Factset



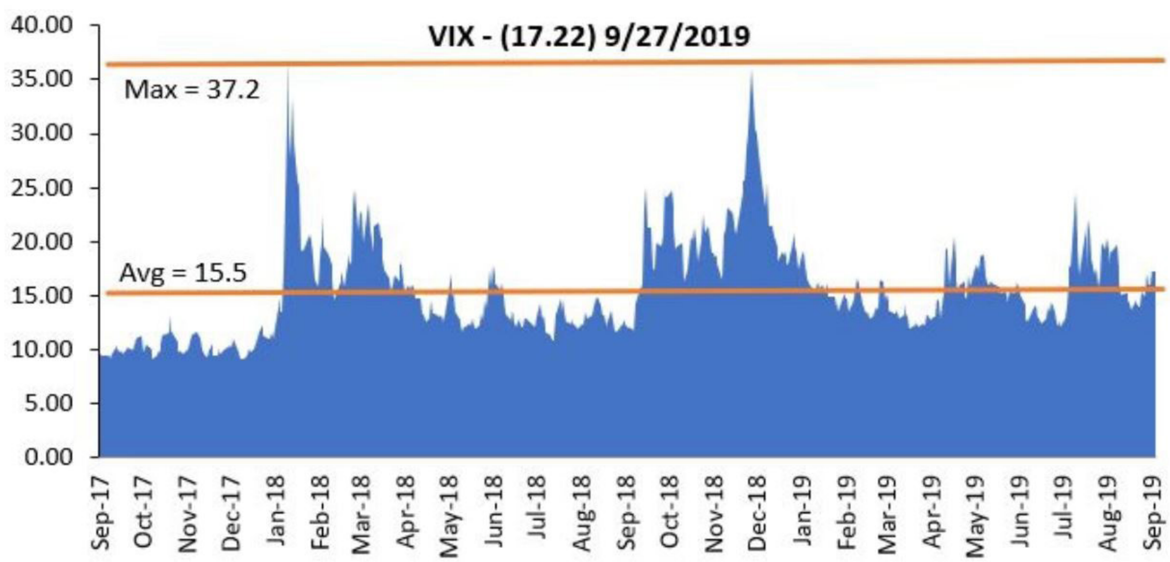
Source: Pallas Capital Advisors, Factset

Using this as context to analyze the impeachment inquiries resulting from the US President's conversations with his Ukrainian counterpart, we consider the performance of markets for the six months prior to September 24, when the House Speaker announced a formal investigation. In this period, the S&P500 index returned a positive 6.0%, but with some notable variation on both the upside and downside. This volatility is consistent with the shift from global growth to decline, where the slowdown pervades both industrial and consumer segments world-wide.

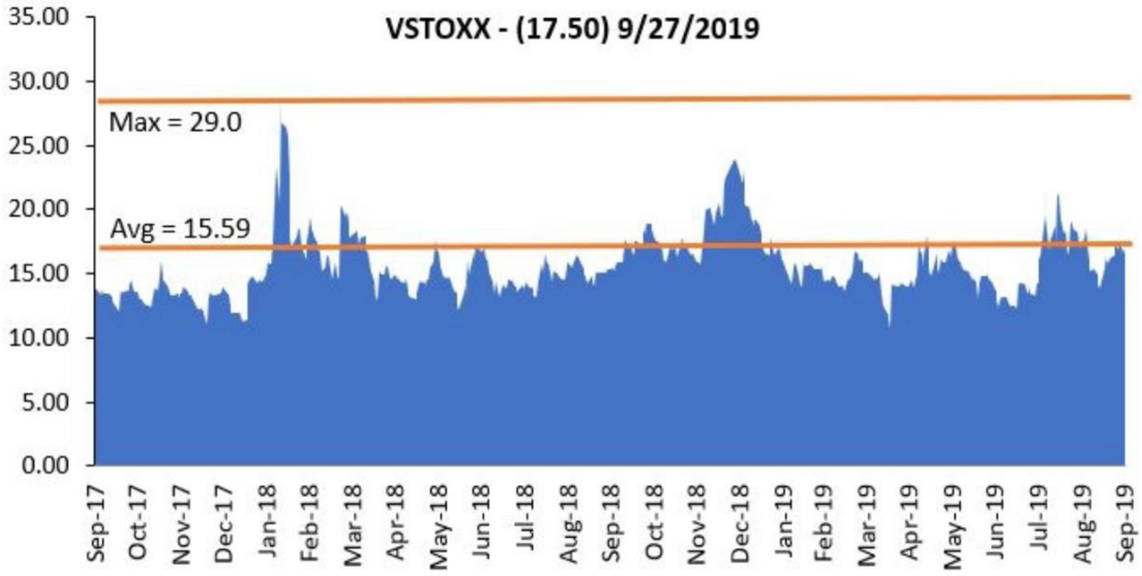


Source: Pallas Capital Advisors, Factset

To gauge investor sentiment, we take a closer look at various market risk indicators including VIX, global VIX proxy, and OAS metrics. Each of these signals are indicative of relative aversion to risk, aggregated from within the equity and bond markets. In the case of VIX and VSTOXX, we see risk expectations aggregated from the equity options markets within the US (VIX) and Eurozone (VSTOXX). Higher values suggest higher uncertainty and volatility in equity values. In both cases, options investors anticipate moderate, albeit climbing, risk levels during recent impeachment inquiries.

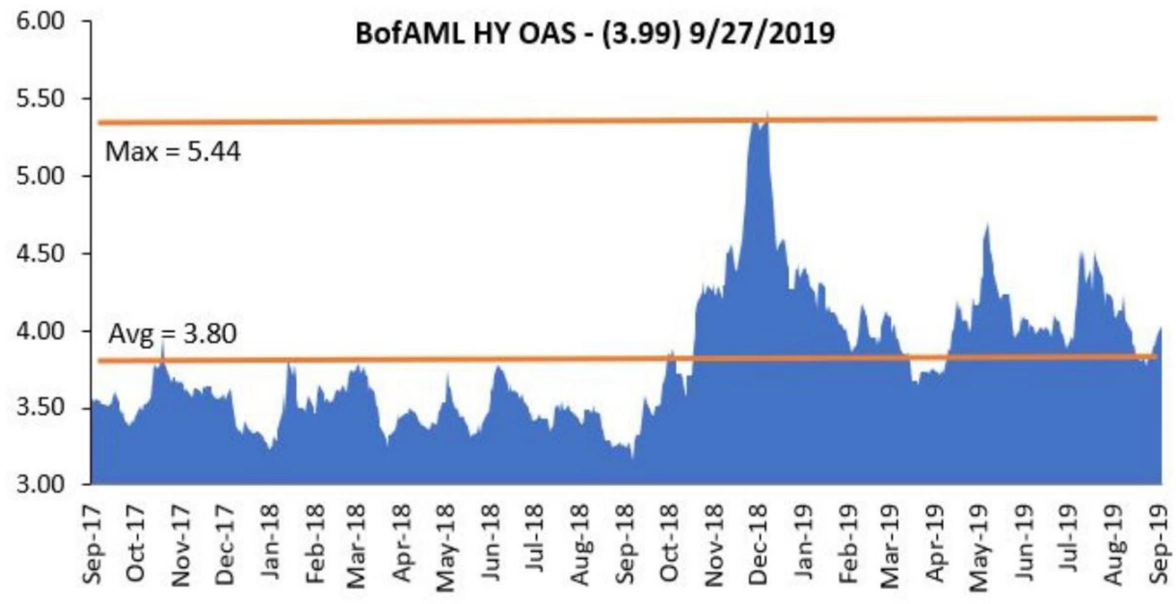


Source: Pallas Capital Advisors, Factset



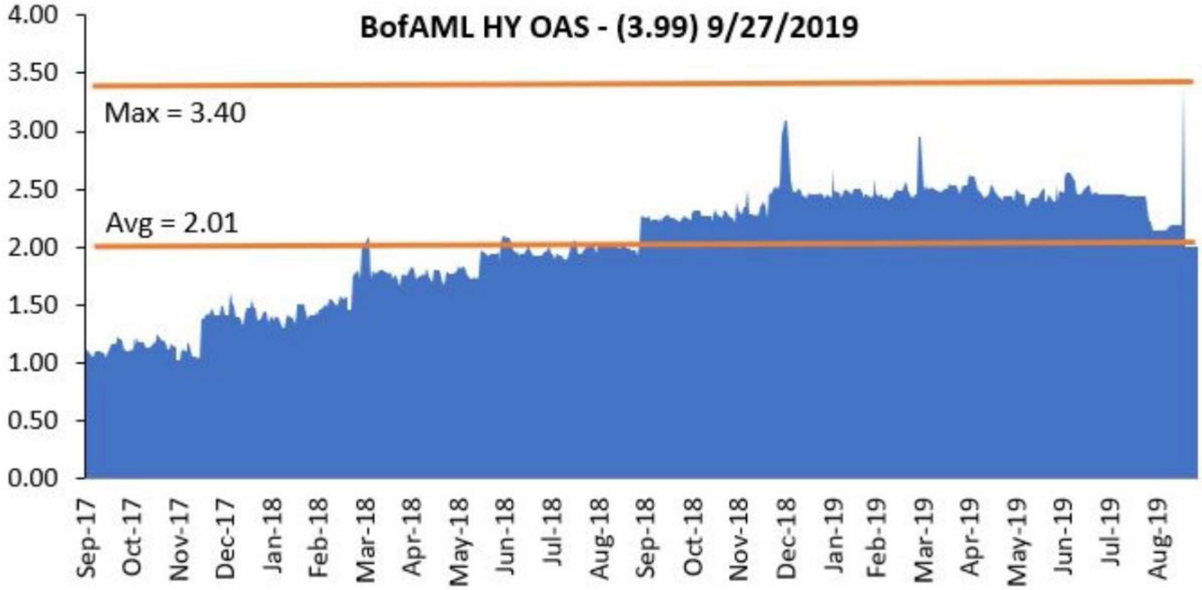
Source: Pallas Capital Advisors, Factset

Shifting into the bond markets, we examine the ICE BofAML High Yield Option Adjusted Spread index for a glimpse into the implied risk (and uncertainty) of the fixed income assets. This indicator measures the spread premium between a basket of high yield bonds against US treasuries. Higher spreads (such as seen in the 4th quarter of 2018) is a signal of elevated investor anxiety. As with the equity risk proxies that we just highlighted, the current level of OAS spread is near average, having subsided from higher levels earlier in the quarter, and trending well below that of December 2018.



Source: Pallas Capital Advisors, St. Louis Fed (FRED)

Finally, within our brief survey of some common market barometers, we examine the overnight lending rates being charged by the Federal Reserve banks to borrow from each other. While the underlying mechanism that drives these rates can be somewhat esoteric to anyone outside the Federal Reserve Board of Governors, what it indicates can be fairly interpretable – higher rates represent various parameters including Fed target rates, availability of financial liquidity, and general calm (or anxiety) of the creditors that underpin the financial markets.



Source: Pallas Capital Advisors, Factset

Within the last two years, we see that a dramatic spike occurred on September 17, where the overnight rate reached (briefly) as high as 10%. Even now, it's unclear why the spike had occurred, but we see that the rates settled into a normal pattern after the Fed implemented short term interventions designed to buffer and stabilize supply/demand dynamics within the banking system.

For now, repo rates have held steady at 2.0% since September 18, and importantly, in the days subsequent to the announced impeachment inquiries.

Looking Ahead

The breadth of risk factors that we currently read in the headlines is daunting. However, when taken as a whole, several baseline indicators of market health point towards relative stability for the time being. Most certainly, the politics of partisanship and impeachment inquiries are less destabilizing when the economy is underpinned by a robust banking system and market participants (both institutional and individual) that are keenly aware of the pain from one decade ago.

With normally functioning markets, albeit with a muddled picture of risk, and looming economic retrenchment, the best course is to balance the active exposure of portfolios to key drivers of performance. In context of the core-equity sleeve of a multi-asset portfolio, this implies building a foundation of holdings using companies with demonstrated quality, then culling those with the best balance between their relative-valuation and growth prospects.

The third quarter of 2019 has produced some significant day to day gyrations based upon headlines, where every tiny nuance has been parsed by investors. Because the wind continues to blow from all directions, we are best served by taking some solace in the current underpinnings of markets. The environment is far from dire, but we continue to be mindful of emerging structural shifts.

As of 8/31/2019	**Pallas Core Equity**	**S&P500**
High Yielding	25.89%	14.61%
Distressed	0.00%	0.38%
Hard Asset	8.31%	7.00%
Cyclical	35.13%	35.87%
Slow Growth	18.74%	13.90%
Classic Growth	5.93%	8.83%
Aggressive Growth	6.00%	15.07%
Speculative Growth	0.00%	1.35%
Price/Earnings	16.98	19.85
Price/Book	2.92	3.11
Price/Sales	1.71	2.16
Price/Cash-flow	8.91	13.10
Net Margin	16.58%	17.44%
ROE	73.03%	26.40%
ROA	8.64%	9.11%
Basic Materials	0.00%	2.37%
Consumer Cyclicals	8.95%	11.91%
Financial Services	15.21%	15.69%
Real Estate	0.00%	2.84%
Communication Svs	5.82%	3.75%
Energy	8.31%	4.42%
Industrials	12.10%	10.18%
Technology	20.95%	23.47%
Consumer Defensives	17.78%	8.10%
Healthcare	9.85%	13.80%
Utilities	1.03%	3.47%

Source: Pallas Capital Advisors, Morningstar