PALLAS
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PCA Market Commentary

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Uncertainty and COVID-19

The stream of COVID-19 headlines continues with little end in sight. The ability of health officials and policy makers to model its spread and associated implications has been complicated by the similarities of symptoms of this virus against that of more common counterparts such as the flu. This ambiguity has amplified the noise within the capital markets and has further polarized investor views.

Within the hundreds of known coronaviruses, seven are known to cause human disease. Four of these are mild: 229E, OC43, NL63 and HKU1. Three of them have been more serious: severe acute respiratory syndrome (SARS, 2002-2004), Middle East Respiratory Syndrome (MERS, 2012-current), and COVID-19. What has been most alarming about COVID-19 has been the pace of spread. However, the depth of impact upon population health has been relatively muted in context of its peers.

Capital markets have faced some number of headwinds when reviewing headlines over the past several quarters. (Our January commentary covers a few of the highlights.) The reaction to those challenges have been mostly benign up until the proliferation of COVID-19 beyond Wuhan, China and ultimately beyond that country's borders. This latest headwind presents the most credible threat to global productivity thus far and has engendered a sharp reaction throughout asset classes and geographies.

The key difference between this headline versus others, is that the virus is indifferent to decisions surrounding trade disputes, taxation, political posturing, elections, fiscal and monetary policy. While these forces will, at the very least, influence economic growth, the impact from COVID-19 is very direct in terms of decreasing productivity and impacting global growth via supply chain disruptions. The unanswered question is how the initial impact might be felt, and how sustained consequences might resonate over the long term.

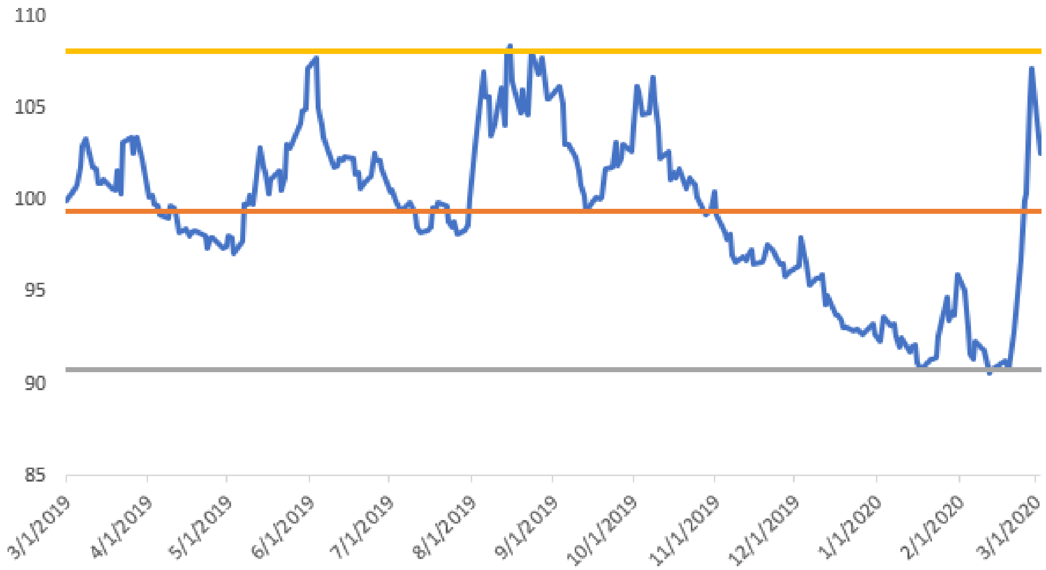
	Dates	Infections	Deaths	Mortality Rate
SARS	2002-2004	8,096	774	10%
MERS	2012-Current	2,519	866	34%
COVID-19	2019- Current	89,253	3,048	3%

Source: World Health Organization, National Institute of Health, Cato Institute, Pallas Capital Advisors

The Impact of De-Risking

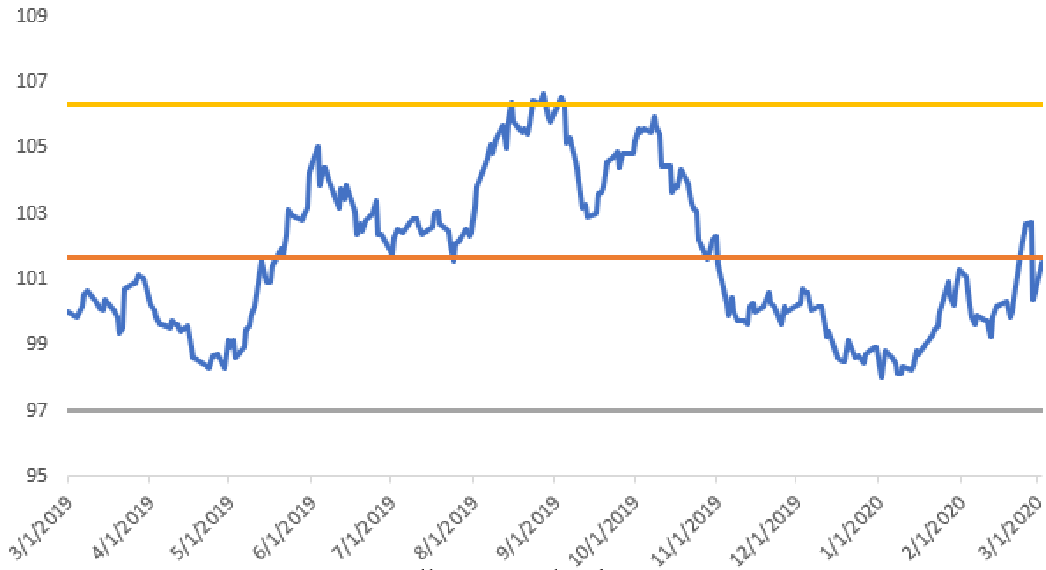
As our clients have heard within Pallas Capital's recent communication, our investment allocation targets began to shift several quarter's ago and was directed towards de-risking. This is not to say that we shifted to a dollar/treasury bias. Rather, we have tilted our strategies towards risk diversification within asset class, and across asset class. This mindset is asking in to questioning "how do the markets interact" rather than "which markets will win?" During periods of uncertainty and volatility, clarity on the former produces better outcomes than projections on the latter. To be fair, during calm periods punctuated with strong trends, projecting the winners helps investors move ahead in the performance race.

Risk aversion seen as an uptick in 7-10yr treasuries (IEF) vs SP500 (SPY)



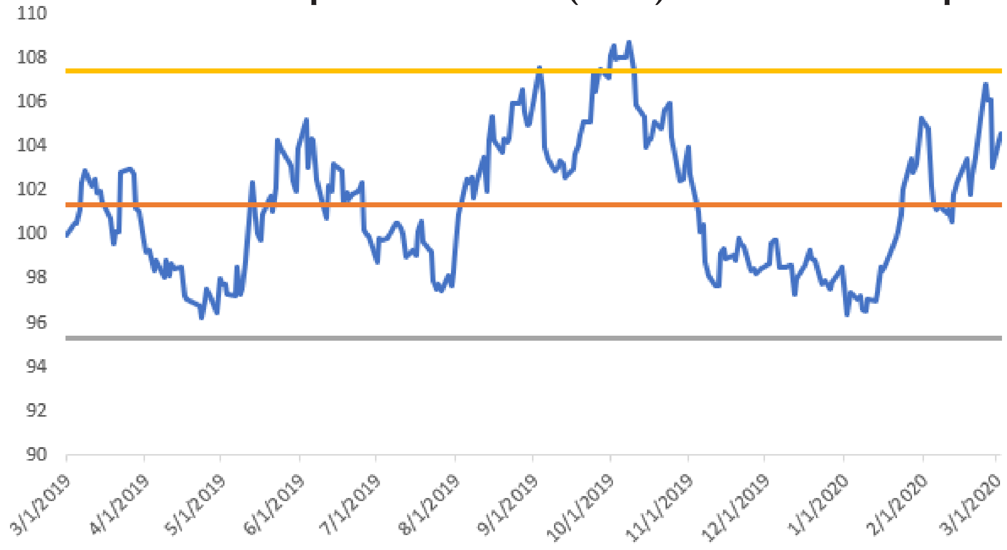
Source: Pallas Capital Advisors, Factset

Risk aversion seen as an uptick in low volatility stocks (USMV) vs broad counterparts (SPY)



Source: Pallas Capital Advisors, Factset

Risk aversion seen as an uptick in utilities (XLU) vs broad counterparts (SPY)



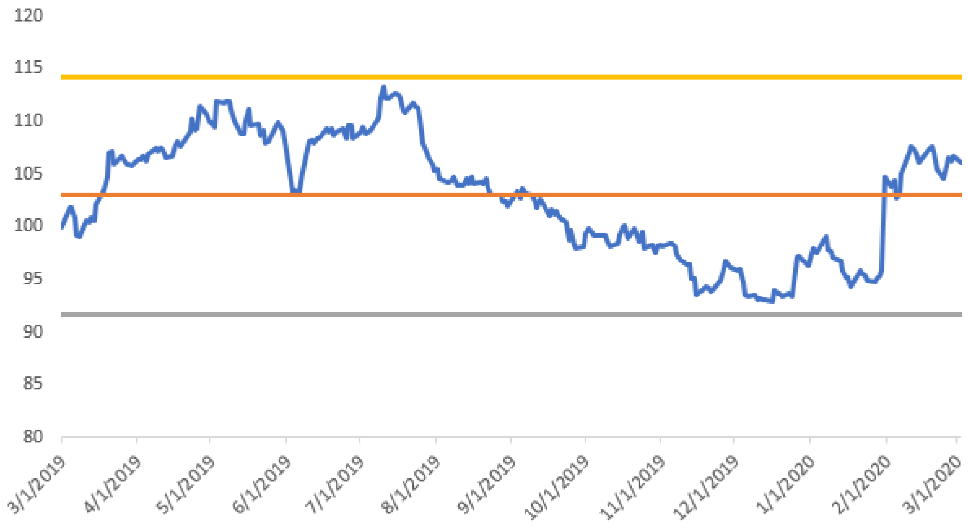
Source: Pallas Capital Advisors, Factset

Despite a sharp swing towards safety (and our strategies benefitting as a result), we believe that the current health threat remains controllable and is being actively moderated by global authorities. The knock-on effects of productivity declines, while very real, may not be as imminent or as likely as some headlines might suggest. The death rate within the infection's epicenter is 2.9% in comparison to the rest of China's death rate at 0.1%, which is a percentage that is closer in proportion to that suffered by Americans who have contracted the flu within the current season.

The Search for Opportunities

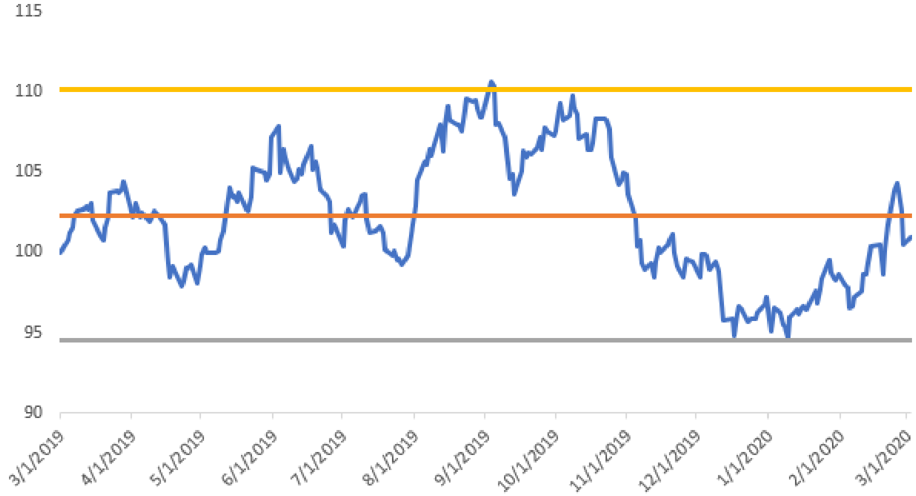
Even with prospects of continued market decline, pockets of opportunity do persist. When examining the performance of Chinese stocks, some technology companies have fared better, as investors started to price in the possibility of companies like Alibaba and Tencent benefitting through fewer supply chain disruptions. Folks appear to be gravitating towards delivery and e-commerce services such as Alibaba, as well as videogame and virtual chat providers such as Tencent. In both cases, these companies are reasonably positioned for an environment where a population is reticent to travel or may have been told via public mandate to keep movement to a minimum. Perhaps positive sentiment for these types of companies will translate outside of China.

AMZN parallels Alibaba - Price uptick and upwards earnings guidance



Source: Pallas Capital Advisors, Factset

Real estate uptick was also observed

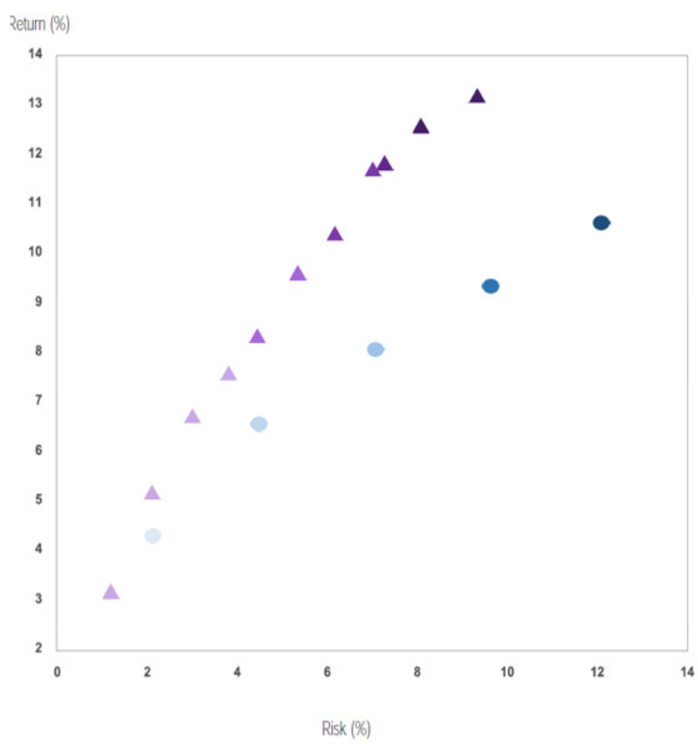


Source: Pallas Capital Advisors, Factset

Reacting to Gyrations

While recent headlines relating to COVID-19 have engendered a dramatic reaction within markets, we believe that it was merely the tipping point that provided investors the justification to de-risk (rebalance) and lock in the gains achieved over the past year. It is entirely possible that a recession might ensue (two successive quarters of GDP decline) from the spread of this virus. However, we don't believe that the trajectory of the global economy will be completely altered as a result. Regardless of the direction of shifting winds, our search for an appropriate tradeoff between downside protection and upside gains, means that we currently favor growth/value balance, higher quality, domestic assets, and low volatility.

Risk/reward Balance - Pallas (purple) versus more generic approaches (blue)



Source: Pallas Capital Advisors, Natixis

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