PALLAS
CAPITAL ADVISORS

PCA Monthly Commentary

July 2020

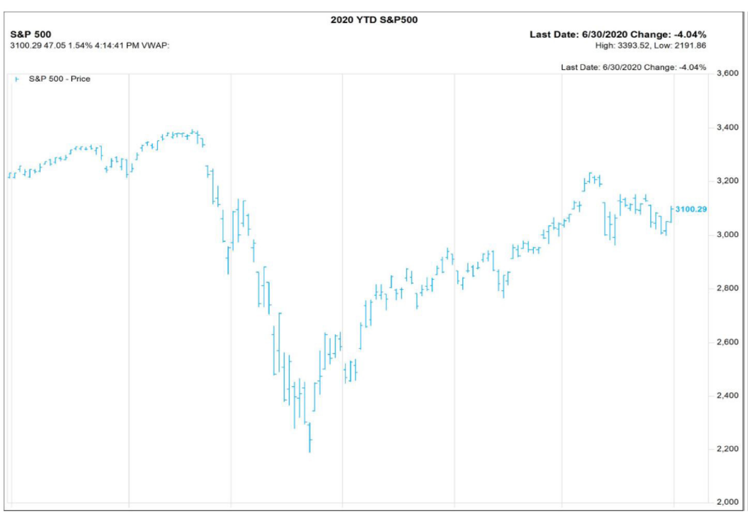
The Disconnect Between Wall Street and Main Street Widens

What We Are Seeing

Global equity markets have rallied in June with the S&P 500 +1.8%, NASDAQ +6.0%, EAFE +2.1% and Emerging Markets +6.0%. Fixed income performance was also in positive territory with the Bloomberg Barclays US Aggregate up 0.6% and Global High Yield up 2.2%. The positive returns in financial markets have been set against a backdrop of continued economic issues - persistent high unemployment, lowered GDP forecasts, and impaired economic activity resulting from government restrictions. The disconnect between Main Street and Wall Street will resolve itself by either the economy accelerating to meet the improved picture on Wall Street, or the equity markets being pulled lower towards the trend line of economic activity.

Equity Market Movements

Global equity markets continued to move higher in June, extending the rally from the trough in March 2020.



SOURCE: Pallas Capital Advisors, Factset

The general tone for June and this quarter was to focus on positive incremental change to important risk factors. Since March, the coronavirus medical situation improved with lower hospitalization usage and progress on treatments. The government responded with powerful fiscal and monetary programs. The US economy began the slow process to reopen.

While risk factors decreased in Q2, the composition of companies in the S&P also aided the recovery. The top five market capitalization stocks – Apple, Microsoft, Amazon, Alphabet, and Facebook – represent 22% of the index. All five are relative beneficiaries of a more technology driven, socially distanced workplace and personal life. As such, the markets can vary somewhat from the underlying economy when the composition of the index varies from the composition of the underlying economy.

While markets were up, the underlying earnings continued to be cut. Calendar year 2021 consensus earnings have been cut from 193 in February 2020 to 162 in June – a drop of 16%.

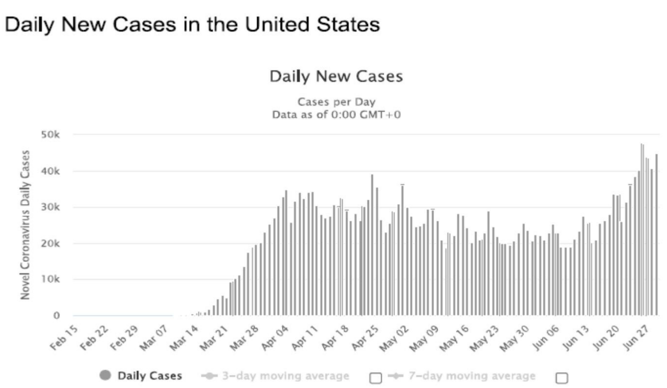
Date	EPS	Earnings Growth (%)	PE (x)
29 Jun '20	162.04	29.4	18.8
29 May '20	162.04	28.7	18.8
30 Apr '20	165.96	26.4	17.5
31 Mar '20	181.97	14.9	14.2
28 Feb '20	193.39	11.6	15.3
31 Jan '20	194.83	10.9	16.6
31 Dec '19	195.40	10.7	16.5

SOURCE: Pallas Capital Advisors, Factset

2021 earnings are also at risk as Q2 earnings season begins over the course of July. Many firms suspended guidance during the pandemic, and any updates will provide a window as to whether earnings need to be cut further. As a recent example, Nike reported numbers at the end of June and forward numbers were reduced an additional 12%. Finally, the rally in markets coupled with continued earnings cuts has expanded the 2021 P/E to 19x's from 16.5x's at the beginning of the year.

Coronavirus Tracking

Early June saw the number of new daily active coronavirus cases continue to fall. However, this metric inflected upwards at the end of the month driven by economies that had already re-opened – Florida, Texas, California, and Arizona to name a few.



SOURCE: Worldometer.com

The surge, shown above, is calling into question the pace of the economic recovery. Continued social distancing requirements will sustain the negative impact to travel, leisure, and restaurant industries as well as impact school opening in the fall.

What are potential silver linings to the increase in cases? Testing has increased by over 4x's since April, while reported cases have doubled. The percentage of positive tests is trending down. Many COVID cases were going undiagnosed early in the pandemic. With more widespread availability of testing, the US has a clearer picture of who is actually sick and subsequently treating those individuals.

The age groups testing positive are also skewing younger than during the early days of the pandemic. This is important as the hospitalization and incidence of death are materially lower in the younger population. While cases are trending up, the impact on human lives and the hospital system should be less severe with a younger patient set.

Scale of Economic Impact

The biggest question that Wall Street and the markets appear to have ignored during the rally is the sheer scale of the impact to the economy. Using the unemployment rate as a barometer, the US has not seen unemployment like this since the great depression.

SOURCE: fred.stlouisfed.org

Industries will be changed forever. Companies with poor balance sheets will not make it through the length of the downturn. Industries such as travel, retail, tv and film production, and fitness facilities all face material challenges over the coming quarters. The US is a consumer driven economy, and if the unemployment rate does not recover quickly, the earnings at most companies will have to be cut further. Even the large tech companies will not be immune, as their earnings are driven at the end of the day by consumer spending.

Another potential blow to the consumer includes stretched state budgets. States cannot print money like the Federal government. As they seek to balance their budgets, many jobs may be lost. Additionally, tax revenue is taking a hit due to lost local revenue. Tax increases may be another burden on consumers that is yet to come.

June was another positive month for financial markets despite the spike in coronavirus daily active cases. Since the beginning of the pandemic, stock market valuations have become more expensive as markets recovered while earnings were cut. The spike in coronavirus cases is a concern while hospitalization rates will need to be monitored as well as progress on treatments. US earnings season is about to begin, where companies will talk about the scale of the impact to their earnings bases. This disconnect between Main Street and Wall Street will resolve itself. Will the companies' results bolster the market's view that the recovery is underway? Or, will earnings guidance reflect the sheer scale of the negative impact to the economy from the coronavirus? A cautious approach seems warranted given the recovery in stocks, negative earnings trends, and the sheer amount of jobs losses in the consumer driven US economy.